Valuation Discounting Techniques: Terms Gone Awry

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Valuation Discounting Techniques: Terms Gone Awry

WENDY C. GERZOG*

A discussion of valuation for transfer tax purposes1 almost always begins with the estate tax regulation defining fair market value as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."2 Then, the scholar, litigant, or court describes equivalent values in money or money's worth. Most of the time, this definition has been a perfectly good one, but the definition as applied has gotten out of control.

Thus, just as a regulation creates a rule, it should also create exceptions to that rule when the terms of the definition are not used in their normal sense. Specifically, when the seller is defined as someone who is seeking the lowest price for her product, fair market value needs a different definition to deal with the distortion created from the misuse of that term. Otherwise, we are in the land of Orwellian anti-logic where $100,000 in cash becomes the equivalent of $60,000.

Regulations in the income tax loss context can serve as a model for exceptions to a general rule. There are two Regulations that deny losses for intentional destruction of property values.3 They can serve as models for Treasury to refine the fair market value definition to conform to a more realistic and public policy supported meaning of value when terms in the general definition are twisted, muddled, and misapplied.

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1Transfer taxes include gift, estate, and generation skipping transfer taxes. I.R.C. Chapters 11, 12, and 13.

2Reg. § 20.2031-1(b). See United States v. Cartwright, 411 U.S. 546, 551 (1973) ("The willing buyer-willing seller test of fair market value is nearly as old as the federal income, estate, and gifts taxes themselves, and is not challenged here."); Estate of Jelke v. Commissioner, 507 F.3d 1317, 1321 (11th Cir. 2007); Estate of True v. Commissioner, 390 F.3d 1210, 1217 (10th Cir. 2004); Smith ex rel. Estate of Smith v. United States, 391 F.3d 621, 627 (5th Cir. 2004); Eyler v. Commissioner, 88 F.3d 445, 451 (7th Cir. 1996); First Nat'l Bank v. United States, 763 F.2d 891, 893 (7th Cir. 1985).

3See Reg. § 1.165-3 (denial of loss for property acquired with the intention of demolition); Reg. § 1.165-7 (denial of casualty loss for willful or gross negligence in an automobile accident).
I. The Fair Market Value Definition

Courts have interpreted the hypothetical players in the fair market value definition Regulation to be reasonable individuals who are motivated by economic factors. That is, "[i]t is well-settled that the willing buyer-willing seller test is an objective one, requiring that potential transactions be analyzed from the viewpoint of a hypothetical seller whose only goal is to maximize his profit on the sale of his interest." Moreover, just as courts have held that they "may not permit the positing of transactions which are unlikely and plainly contrary to the economic interest of a hypothetical buyer," that reasoning should also be applied to hypothetical sellers who act contrary to their economic interests. Likewise, that hypothetical standard is defined as incorporating a real sale: "by its very definition, this contemplates the consummation of the purchase and sale of the property..." 

The fair market value standard incorporates a hypothetical seller and buyer primarily to promote certainty by applying objective criteria to determine valuation. Employing hypothetical actors is "supported by the theory that the estate tax is an excise tax on the transfer of property at death and accordingly that the valuation is to be made as of the moment of death..." While the hypothetical sale is frozen at the valuation date, courts have urged that "common sense" be applied to valuation. In *Estate of Curry v. United

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4 *Jelke*, 507 F.3d at 1321 n.11 (citing *Newhouse v. Commissioner*, 94 T.C. 193, 218 (1990)) ("The buyer and seller are hypothetical, not actual persons, and each is a rational economic actor; that is, each seeks to maximize his advantage in the context of the market that exists on the valuation date."); *Estate of Jameson v. Commissioner*, 267 F.3d 366, 370 (5th Cir. 2001); *Estate of Curry v. United States*, 706 F.2d 1424, 1428 (7th Cir. 1983); *Estate of Kahn v. Commissioner*, 125 T.C. 227, 231 (2005).

5 *Estate of Watts v. Commissioner*, 823 F.2d 483, 486 (11th Cir. 1987).

6 *Eisenberg v. Commissioner*, 155 F.3d 50, 57 (2d Cir. 1998); *see also Estate of Curry*, 706 F.2d at 1428–29.

7 *Estate of McClatchy v. Commissioner*, 147 F.3d 1089, 1094 (9th Cir. 1998) ("However, the 'willing buyer willing seller' method posits not only a hypothetical buyer, but also a hypothetical seller.").

8 *Dunn v. Commissioner*, 301 F.3d 339, 353 (5th Cir. 2002).

9 *Citizens Bank & Trust Co. v. Commissioner*, 839 F.2d 1249, 1252 (7th Cir. 1988); *Propstra v. United States*, 680 F.2d 1248, 1251, 1252 (9th Cir. 1982) ("Defining fair market value with reference to hypothetical willing-buyers and willing-sellers provides an objective standard by which to measure value. The use of an objective standard avoids the uncertainties that would otherwise be inherent if valuation methods attempted to account for the likelihood that estates, legatees, or heirs would sell their interests together with others who hold undivided interests in the property. Executors will not have to make delicate inquiries into the feelings, attitudes, and anticipated behavior of those holding undivided interests in the property in question. Without an explicit directive from Congress we cannot require executors to make such inquiries.") (citation omitted).

10 *Estate of Bright v. United States*, 658 F.2d 999, 1006 (5th Cir. 1981).

States, for example, the Seventh Circuit held that common sense together with the buyer's goal of maximizing her position are reasons that voting and non-voting stock in a closely held company should be aggregated for valuation purposes under the hypothetical fair market standard in the Regulations. Specifically, the Seventh Circuit in *Estate of Curry* refused to consider manipulations in valuation, such as "the hypothetical bifurcation of an otherwise integrated bundle of property for valuation purposes," that would distort and reduce the decedent's estate tax liability.

While a hypothetical buyer would take into consideration partnership form limitations created either by the partnership agreement or by local law, a hypothetical seller would not try to discount the value of her assets by transferring them to a limited partnership form to minimize the value of her property in preparation for a sale to that hypothetical buyer. That is, a seller, who by definition has a profit motive for her actions, would not create a family limited partnership (FLP) with cash, cash equivalents, marketable securities, or other liquid assets or some combination because to do so would be to reduce the value of her property to a great extent without any, or without any sufficient, economic reason.

One of the main principles of valuation is to value an asset at its "highest and best use" rather than at its actual use. Exceptions to this rule are few and specifically defined by statute. "The fair market value of property is a reflection..."
tion of the 'highest and best use' of the property on the date of valuation."16 That ultimate use is "a reasonable and probable use that supports the highest present value as defined as of the effective date of appraisal."17 In Thornton v. Commissioner, the Tax Court elaborated:

We agree with petitioners that in determining the value of property on a given date a potential highest and best use for the property can be considered even though the potential use is prohibited on the valuation date by some restriction in a deed, statute or zoning Regulation . . . . However, the projected highest and best use must have a strong possibility of achievement. In other words, it should not be remote, speculative or conjectural.18

Since the likelihood of immediate gift giving or dissolving the partnership after the decedent's death is great,19 valuing the underlying assets of an FLP inheriting family farms, might otherwise be forced to sell them to pay estate taxes calculated on 'highest and best use' values, which often exceed significantly the land's value for farming purposes. In the hope of avoiding such a result and helping to preserve family farms and other closely held businesses, Congress allows qualifying property to be returned for estate tax purposes at its actual (farm) use value rather than its fair market value based on its highest and best use. As permission to elect this so-called 'special use valuation' constitutes an act of grace or a special dispensation by Congress, the courts have strictly construed § 2032A and its requirements.

16McMurray v. Commissioner, 985 F.2d 36, 40 (1st Cir. 1993); Estate of Juden v. Commissioner, 865 F.2d 960, 963 (8th Cir. 1989).
1856 T.C.M. (CCH) 395, 1988 T.C.M. (RIA) § 88,479, aff'd in an unpublished opinion, 908 F.2d 977 (9th Cir. 1990) (citations omitted). The court proceeded to explain how it would value that interest: "We also agree that in such a case the proper approach is to value the property at its highest and best use even though its highest and best use is prohibited at the date of valuation by the applicable restriction then to proceed to reduce or discount such value by a reasonable estimate of the cost of removing the restriction and for the time needed to accomplish such removal." Id. at 41–42. Because the transferor voluntarily imposed restrictions of the FLP form, this article would deny a reduction in value to reflect the costs of liquidating the partnership.
19Often immediately after FLP formation, parents begin transferring FLP shares to their children as gifts at a discounted value. See, e.g., Martha Britton Eller, Which Estates Are Afflicted by the Estate Tax?: An Examination of the Filing Population for Year-of-Death 2001, 25 Stat. Income Bull. 185, 192 (Summer 2005), available at http://findarticles.com/p/articles/mi_m2893/is_1_25/ai_n15756730 ("In these family limited partnerships (FLP's), which may hold a variety of assets, including common stock, real estate, and cash or cash equivalents, parents typically retain only a small general partnership interest and slowly give limited partnership interests to their children through lifetime gifts—using the annual exclusion available under the Federal gift tax—or bequests. For the parent who is a general partner, the primary goal of this arrangement is to reduce the wealth that will eventually be included in his or her estate or the estate of any surviving spouse."); Angela Schneeman, The Law of Corporations and Other Business Organizations 80 (3d ed. 2002) ("Most often, the family limited partnership is established by individuals who are concerned about protecting their assets and transferring them to their children with the least amount of income and estate tax liability . . . . The parents then gift their children with interests in the limited partnership as limited partners."); Larry D. Hause, Is a Family Limited Partnership Right For You? (1996), http://www.fredlaw.com/articles/tax/
makes the most sense. Thus, just as a decedent cannot give her estate the special use valuation benefits of section 2032A,\textsuperscript{20} by converting real estate into farm land that does not satisfy the requirements of that section, a seller who creates an FLP should not be able to convert liquid assets into illiquid ones to reduce the value of his gifts or of his estate.

With respect to gift tax valuation, the Fifth Circuit in \textit{Citizens Bank & Trust Company v. Commissioner} hypothesized that a donor could legitimately reduce the value of his gift of artwork by painting a mustache on it.\textsuperscript{21} The court stated, as is currently the state of the law, that

\begin{quote}
the same result as in our Mona Lisa case would follow in a case where the owners placed restrictions on their stock by agreement and the restrictions took effect before a transfer that was subject to gift or estate tax. In both types of case the reduction in value would have occurred before the gift was made.\textsuperscript{22}
\end{quote}

The court minimized the abuse impact of such a contrivance by contending that that kind of estate planning would be costly and, hence, self-limiting.\textsuperscript{23}

\textsuperscript{20} See Brockman v. Commissioner, 903 F.2d 518, 519 (7th Cir. 1990) ("For the purpose of determining federal estate tax, Section 2032A of the Internal Revenue Code allows heirs to family farms to value the assets of the farm in their current use, rather than being required, like other heirs, to value it at their commercially most lucrative use.").

\textsuperscript{21} 839 F.2d 1249, 1254-55 (7th Cir. 1988) ("This is not to suggest that a donor can never gain a tax advantage from acts intended by him to depress the value of the gift. If you own the Mona Lisa and paint (indelibly) a mustache on it before giving the painting to your child, with the result that its value is greatly reduced, still your gift tax will be computed at the reduced value. Maybe that is how Whittemore is to be understood. Or maybe it simply was wrongly decided, not because the court should have tried to estimate the probability of the heirs' getting together and reassembling their father's control bloc but because the 600 shares should have been valued as if sold to a hypothetical buyer, who would pay a premium for control.").

\textsuperscript{22}Id. at 1255.

\textsuperscript{23}Id. ("This would make it a more costly method of reducing the market value of the stock when and if transferred than would be deferring the restriction until the stock was no longer theirs. Hence, as we noted earlier in a different context, it would be a self-limiting tactic; and hence it would have less appeal as a method of avoiding taxes.").
By contrast, of course, FLPs have proliferated and are extensively marketed\textsuperscript{24} because of the much greater estate tax savings such planning, only modestly expensive,\textsuperscript{25} achieves.\textsuperscript{26}

More importantly, however, a sane seller would not have intentionally placed a mustache on the Mona Lisa. So, ascribing volitional acts to the owner of a valuable painting that are contrary to common sense produces the kind of illogic and distortion that this article is trying to counter. Additionally, if you could remove that mustache to restore the painting to its unmarred value, you, as a seller, would do just that. Likewise, a rational seller, or his family, will ultimately liquidate the partnership to receive its assets at their highest and best value. The mustached Mona Lisa argument is specious and should be rejected as such.

Recently, the Tax Court in \textit{Estate of Lee v. Commissioner}\textsuperscript{27} refused to give effect to the provisions in decedent's will that defined his wife as a "surviving spouse" when she actually died 46 days before him, despite directions in his will that this definition be applied.\textsuperscript{28} The court stated: "[t]he ordinary meaning of the word 'survivor' is one who survives another; . . . the term 'surviving spouse' requires that a spouse actually survive his or her spouse; [that is], the later-dying spouse must actually outlive his or her spouse."\textsuperscript{29} Likewise, a

\textsuperscript{24}Ronald R. Cresswell, Patrick J. Pacheco, Sarah Patel Pacheco, & Marjorie J. Stephens, \textit{4 Tex. Prac. Guide Wills, Trusts and Est. Plan.} § 13:11 ("Although it appears that some planners believe that everyone needs an FLP (much in the same way these same planners believe everyone needs an ILIT), not all clients are suitable prospects for an FLP. For example, while substantial tax savings may in fact be available, the make-up or total value of the client's assets may make an FLP wholly unsuitable."); Eller, \textit{supra} note 19, at 192 ("Estates [also] reported almost $1.7 billion in family limited partnership interests."). In her article, Eller reports, "while family-owned businesses are frequently organized as limited partnerships, for several years now, wealth management and estate planning professionals have advocated use of the entities as tax shelters for family wealth." \textit{Id.

\textsuperscript{25}Cresswell, \textit{supra} note 24, at § 13:19 ("What is the smallest estate size necessary for a viable FLP? The opinion[s]of practitioners vary widely with many focusing solely on the potential tax savings versus the relatively de minimis cost of formation and operation in recommending FLP planning to relatively 'small' net worth clients. Unfortunately, this thinking ignores important aspects of the FLP decision such as . . . the costs of defending the FLP in the face of [Service] challenge, etc. For example, [Service] audit requests may be highly detailed and very expensive for the client, not to mention the cost of defending the FLP in Tax Court or Federal District Court? While there are [no] bright line tests, it appears that a client who is unable to contribute at least $3,000,000 to $5,000,000 to an FLP . . . [should not do] FLP planning.").

\textsuperscript{26}In re the Appeal of Anderson, No. 313978, 2006 WL 3485542, at *2 (Cal. St. Bd. Eq. Nov. 20, 2006) ("Here, it is appellants who chose the form of the transactions at issue in order to use the FLP's as estate planning vehicles. That form allowed them to take advantage of substantial estate and gift tax savings.").

\textsuperscript{27}No. 14511-06, 2007 WL 4463631 (T.C. Dec. 20, 2007).

\textsuperscript{28}Id. at *1, *4 ("While decedent may have intended that Ms. Lee, even though dead, be deemed to have survived him, the operation of a will or wills cannot alter the order of the actual deaths of decedent and Ms. Lee.").

\textsuperscript{29}Id. at *4.
"seller" is someone seeking the highest price for her product; she would inherently not intentionally destroy that value.

II. A Creature of the Regulations

The definition of fair market value appears in the estate tax Regulations under section 2031 and courts have been reluctant to stray from this venerable, and for the most part workable, definition of market value. Likewise, although legislation has been proposed to thwart valuation discounts, there has been little progress in this quarter. Congress has enacted very little legislation dealing with transfer taxes; its chief concern at this point appears to center around the exemption amount and rates.

The hypothetical standard definition of fair market value is a creature of the Regulations; however, for valuing different types of property, the regulations provide special rules. In *United States v. Cartwright*, the Supreme Court held that the valuation rules found in the Regulations were inadequate to deal with the valuation of mutual funds that "once issued are not subject to disposition

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30 The government has asserted a "substance over form" argument that has been consistently rejected in court. See, e.g., Estate of Thompson v. Commissioner, 84 T.C.M. (CCH) 374, 385, 2002 T.C.M. (RIA) ¶ 2002-246, at 1522, aff'd, 382 F.3d 367 (3d Cir. 2004) ("Respondent contends that the Thompson Partnership and the Turner Partnership should be disregarded for Federal tax purposes because they lack economic substance and business purpose...[but the court held that] the partnerships had sufficient substance to be recognized for Federal estate and gift tax purposes."); Knight v. Commissioner, 115 T.C. 506, 513-15 (2000); Estate of Strangi v. Commissioner, 115 T.C. 478, 485 (2000), aff'd on this issue, rev'd and remanded, 293 F.3d 279, 282 (5th Cir. 2002); Kerr v. Commissioner, 113 T.C. 449, 464-65 (1999).

31 See, e.g., Joint Comm. on Tax'n, Options to Improve Tax Compliance and Reform Tax Expenditures, JCS-02-05 at 2, 396-404 (2005) ("Valuation issues, whether in the context of charitable contributions, transfer taxes, or other situations presented by the tax law, are a common source of noncompliance. The report contains several proposals to resolve valuation controversies in a simpler and more administrable way."), available at www.house.gov/jct/pub05.html; Staff of the Joint Comm. on Tax'n, Description of Revenue Provisions Contained in the President's Fiscal Year 2000 Budget Proposal, JCS-1-99 at 291 (1999); Dep't of the Treasury, General Explanations of the Administration's Fiscal Year 2001 Revenue Proposals (2000) at 184-85; Omnibus Budget and Reconciliation Act, H. Rep. No. 100-391 (II) at 1043 (1987).


in a market of ‘willing buyers’ and ‘willing sellers.’”34 Because of the lack of potential buyers (as shares must be redeemed by the issuing company), the court held that mutual funds were most reasonably valued by their redemption price35 and not the price of the government’s Regulation,36 the price in the public offering market, or the “asked” price.37 Thus, the court held that the general valuation rule was inapplicable here. “Whatever the situations may be where it is realistic and appropriate . . . to use a standardized retail price to measure value for estate tax purposes, it is sufficient to note here that for the reasons given, the valuation of mutual fund shares does not present one of those situations.”38 Treasury revised its Regulations to conform to Cartwright,39 and it is time for Treasury to carve out another exception to its fair market value definition when its terms have lost their natural meaning.

Treasury could find assistance in the income tax Regulations that specifically deny deductions for losses where they stem from the taxpayer’s intentional destruction of value. Currently, there are two Regulations under section 165 that deny income tax property loss deductions for the taxpayer’s volitional acts that diminish her property’s value. First, there is a Regulation that denies a loss deduction for taxpayers who acquire real estate with the intent to demolish existing buildings40 and second, under the casualty loss Regulations, there is a prohibition against a deduction for the valuation loss in an automobile accident where the taxpayer or his agents were grossly negligent or intentionally created the casualty.41

34 411 U.S. 546, 559 (1973). According to the court, “[t]he result of this pricing system, it is apparent, is that the entire cost of selling fund shares is generally borne exclusively by the purchaser of new shares and not by the fund itself. In this respect the offering of mutual fund shares differs from, say, the offering of new shares by a closed-end investment company or an additional offering ‘at the market’ of shares of an exchange-listed security, where at least a portion of the selling cost is borne by the company selling the shares. Private trading in mutual fund shares is virtually nonexistent. Thus, at any given time, under the statutory scheme created by the Investment Company Act, shares of any open-end mutual fund with a sales load are being sold at two distinct prices. Initial purchases by the public are made from the fund, at the ‘asked’ price, which includes the load. But shareholders ‘sell’ their shares back to the fund at the statutorily defined redemption or bid price.” Id. at 548–49 (citations omitted).

35 Id. at 560 (“[T]he only practical means of disposing of mutual fund shares once acquired is redemption, and redemption cannot be deemed a sale of the sort described in the general rule (Reg. §20.2031-1(b)), since the party purchasing (the issuing company) is under an absolute obligation to redeem the shares when tendered, and the party selling has no practical alternative, if he wishes to liquidate his holdings, other than to offer them to the issuing company for redemption.”).

36 The court therefore affirmed the appellate court and invalidated Regulation § 20.2031-8(b) as an unreasonable regulation. Id. at 557.

37 Id. at 551–52.

38 Id. at 553 n.8.

39 Reg. §§ 20.2031-8(b), 25.2512-6(b) (shares of open-end investment company).

40 Reg. § 1.165-3.

41 Reg. § 1.165-7.
A. Purchase with Intent to Demolish a Building

Where business or investment real property is purchased with the intention of destroying the buildings on the land, no deduction is allowed for the demolition and the entire basis must be allocated to the land.\(^\text{42}\) This Regulation applies regardless of whether that plan is "subsequently deferred or abandoned."\(^\text{43}\) However, a plan formed after purchase to demolish a building does not fall within the proscription of this regulation.\(^\text{44}\) While evidence of such an objective is determined under a facts and circumstances test,\(^\text{45}\) factors indicating intent include variable factors such as timing, cost, prohibitions, suitability, and lack of income.\(^\text{46}\) In *Wilson v. Commissioner*, the Tax Court applied common sense notions about behavior:

> It is hard to imagine why a prudent businessman would purchase the Rizzuto property to raise prunes in light of the decline in the prune market and the insect infestation problem that existed at that time. On the other hand, it is easily understandable why one would purchase the property for real estate investment purposes.\(^\text{47}\)

Then, the court proceeded to review all of the factors and arrived at the same conclusion to deny the taxpayer his loss deduction.\(^\text{48}\)

The cited regulation is the current version of an extremely old one, written in 1921,\(^\text{49}\) and reverberates with simplicity and common sense:

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\(^\text{42}\)Reg. § 1.165-3(a)(1). Basis is adjusted to reflect either the cost of demolition (upward) or the net proceeds from the demolition (downward). *Id.* Before demolition, if used for business or income production, some of the basis may be allocated to the building and appropriate depreciation allowed. Reg. § 1.165-3(a)(2)(i).

\(^\text{43}\)Reg. § 1.165-3(a)(1).

\(^\text{44}\)Reg. § 1.165-3(b)(1).

\(^\text{45}\)Reg. § 1.165-3(c)(1).

\(^\text{46}\)Reg. § 1.165-3(c)(2) ("An intention at the time of acquisition to demolish may be suggested by: (i) A short delay between the date of acquisition and the date of demolition; (ii) Evidence of prohibitive remodeling costs determined at the time of acquisition; (iii) Evidence of municipal regulations at the time of acquisition which would prohibit the continued use of the buildings for profit purposes; (iv) Unsuitability of the buildings for the taxpayer's trade or business; or (v) Inability at the time of acquisition to realize a reasonable income from the buildings.").

\(^\text{47}\)41 T.C.M. (CCH) 381, 389, 1980 T.C.M. (RIA) § 80,514, at 2196.

\(^\text{48}\)Wilson, 41 T.C.M. (CCH) at 390, 1980 T.C.M. (RIA) § 80,514, at 2197–98. ("Again, it is impossible to make a determination as to Rietz's intent at the time he acquired the Rizzuto property based solely on one or two facts. However, when all the facts are viewed together, we find that Rietz intended to remove the prune trees at the time the Rizzuto property was purchased.").

\(^\text{49}\)It was in effect in 1918. Meyer v. United States, 247 F. Supp. 939, 941 (D. Mass. 1965) ("The foregoing regulation is the lineal descendant of the following Treasury regulation, in effect in 1918 when it was known as Article 142 (see Treasury Regulations, 1919 edition, page 45.").
'Art. 142 Voluntary removal of buildings.— * * * ‘When a taxpayer buys real estate upon which is located a building which he proceeds to raze with a view to erecting thereon another building, it will be considered that the taxpayer has sustained no deductible loss by reason of the demolition of the old building, and no deductible expense on account of the cost of such removal, the value of the real estate, exclusive of old improvements, being presumably equal to the purchase price of the land and buildings plus the cost of removing the useless building.’

As the *Bender* court found, this Regulation, long in effect, has the presumption of correctness.

The reasoning underlying this Regulation is that “if the taxpayer buys the land intending to demolish the building, the building can have no value to him, and its demolition occasions no loss.” Likewise, as the Seventh Circuit in *Landerman v. Commissioner* explained, the fundamental theory behind the regulation is that “the taxpayer has incurred no actual uncompensated loss.” Analogously, where the taxpayer transfers assets to an FLP, it is her expectation and desire temporarily to discount the value of her assets. Moreover, it is not significant that the taxpayer’s intention to reduce the value of her estate may be a desired consequence that occurs many years after the formation of the FLP. With respect to the demolition Regulation, the demolition does not need to happen immediately after purchase and, indeed, the Regulation further provides that, if prior to demolition, the building is used for business or investment purposes, the taxpayer may take deductions pursuant to such interim use.

While the FLP functions as a partnership, and it may be treated as such for income tax purposes, when the transferor makes gifts or dies owning the partnership interests, since he intentionally created the FLP to lower the value of his assets, that diminution in value attributable to the assets being held in partnership form should be ignored.

Like the creator of an FLP who seeks to reduce his transfer taxes, the tax-

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50Bender *v.* United States, 383 F.2d 656, 661 (6th Cir. 1967) (citing Reg. 45, Art. 142 (1921)).

51Id. at 661 (“Both the length of time this general administrative interpretation has been in effect and the fact that in the intervening years Congress has not amended the Internal Revenue Code to alter this interpretation are due some weight.”); *Meyers*, 247 F. Supp. at 943 (“The regulations, being based upon a series of prior regulations now almost half a century old, have in effect been approved by the silence of Congress. Moreover, the overwhelming weight of judicial authority supports the proposition that where a taxpayer purchases property with the intention of demolishing either immediately or subsequently the buildings thereon, the cost basis of the property so purchased shall be allocated to the land only.”).

52Ivey *v.* Commissioner, 423 F.2d 862, 864 (2d Cir. 1970) (“The regulations promulgated under the 1939 Code, Treas. Reg. 118, § 39.23(e)-2 declared the policy that when ‘a taxpayer buys . . . a building, which he proceeds to raze with a view to erecting thereon another building, it will be considered that the taxpayer has sustained no deductible loss . . . the value of the real estate . . . being presumably equal to the purchase price of the land.’”).

53454 F.2d 338, 341 (7th Cir. 1971).

payer who destroys a building on his property is not irrational. In the latter circumstance, the taxpayer is willing to have an interim loss in value because she usually expects to replace the demolished building with a much more valuable holding. Sometimes, moreover, the land itself is more valuable without the particular building on it. That was the case in *Barry v. United States*.\(^55\)

The government's expert witness, Mr. Curry, testified that on the date of inheritance, as well as on the alternate valuation date, the highest and best use of the property was either as vacant land suitable for parking, or suitable and available for the construction of a new commercial building. He further testified and the trial judge accepted his opinion that the old building was a detriment to the overall value of the property. Contrary to the assertion of appellants, the other downtown real estate sales investigated and relied upon by the government expert as comparables, provided convincing support, not only for Mr. Curry's valuation of the property as a whole, but for his conclusion that the entire value of it lay in the land.\(^56\)

With the FLP, the underlying assets are the more valuable holdings and the reason for the temporary FLP form is the taxpayer's expectation of profit, at a cost to the federal fisc, through lower transfer taxes.

In *Levinson v. Commissioner*, the Tax Court rejected the taxpayer's arguments that the Regulation disallowing demolition losses "is meant to apply only in situations where the principal objective of a lease is to obtain the use of the land and the demolition occurs in order to accomplish that objective"\(^57\) and not "where the lease and the circumstances of its negotiation have only the use of the new building as their principal objective."\(^58\) The court underlined the distinction between the taxpayer's situation where, "by virtue of the lease, [he] acquired a valuable right and the demolition is an essential precondition to his realization of the economic benefits therefrom,"\(^59\) and one in which the taxpayer "first demolishes the old building, erects a new building on the same site, and then leases the new building."\(^60\) In the latter situation, the court explained, there was no causal connection between the demolition and the lease.\(^61\) Likewise, the intentional devaluation of assets occurring by the creation of an FLP and the transfer of liquid assets to that entity is "the demolition [that] is an essential precondition to his realization of the economic benefits therefrom."

\(^{55}\)501 F.2d 578 (6th Cir. 1974).

\(^{56}\)Id. at 583.

\(^{57}\)59 T.C. 676, 678 (1973).

\(^{58}\)Id. at 679.

\(^{59}\)Id. at 680.

\(^{60}\)Id.

\(^{61}\)The court described the distinction: "In the other [situation] such a direct causal relationship between the acquired right and the demolition is lacking, although admittedly every taxpayer who constructs a new building with the intention of leasing it necessarily recognizes that any existing building on the same site must be demolished before his objective can be
In *Wilson v. Commissioner*, the rule in the Regulation was extended from building demolition to the taxpayer's purchase of land with the intent to destroy the prune trees on it. Thus, the Regulation has not had a restricted application to buildings; there was the same intention to destroy property at the time of purchase that merited the disallowance of a loss deduction when that property was in fact razed. The facts indicated that the prune market was failing, the trees were infested with insects, and there was a new freeway-highway interchange that made the land itself attractive to an investor. The court cited a decision from the 1930s in which apple and pear trees were likewise removed as part of the taxpayer's intention at the time of his land purchase; in both cases, the taxpayer was denied a loss deduction on the rationale that there was no basis in the trees due to his intent to remove them. While typically basis would be allocated both to the land and to the trees, the taxpayer's intention at the time of purchase to ignore the trees by removing them after purchase provides an exception to the loss rules analogous to the creation of an FLP with the intention of devaluing the underlying assets for transfer tax valuation purposes.

Finally, there are some cases where the demolition loss provision applied where the taxpayer alternatively argued that he was entitled to a casualty loss. However, where the demolition Regulation applies, the taxpayer's basis is zero, effectively also denying him a casualty loss deduction that is limited by the value of the taxpayer's basis.

The Regulation redefines market value based on the purchaser's intention to devalue his property. Without knowing the purchaser's intention, there is no reason not to apportion the total cost objectively both to the land and to the building. Indeed, two purchasers with different objectives would have different tax consequences under that loss Regulation. The voluntary removal of a building that the purchaser of the property intended from the outset to

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62 *Id.*

63 *Id.*

64 *Id.*

65 *Id.*

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destroy does not result in a loss to him. Likewise, the voluntary devaluation caused by the owner of liquid assets by intentionally subjecting them to the restrictions of an FLP should not be a diminution recognized by the fair market value definition Regulations because, in that instance, he is not acting like a seller, who by nature is profit-seeking.

B. Automobile Damage Due to Taxpayer's Gross Negligence or Intentional Acts

Where a taxpayer acts willfully such that a probable consequence of his actions is damage or destruction of his automobile, he is not entitled to a casualty loss deduction for that loss in value. According to the Regulation, automobile damage “due to the willful act or willful negligence of the taxpayer or of one acting in his behalf” is not deductible.\(^6^6\) While the taxpayer may have legal “fault” or liability and may still qualify for a deduction, where she is liable for willful or gross negligence, she will be denied a casualty loss deduction.\(^6^7\)

This Regulation\(^6^8\) was promulgated in response to a very early case, Shearer v. Anderson, in which the plaintiff was denied a deduction with respect to the property damage due to a collision caused by icy road conditions during his chauffeur's larcenous use of his automobile.\(^6^9\) The court had to determine whether term “other casualty” as used in the statute covered damage from that accident. The court allowed the deduction because

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\text{whether the complaint be interpreted as charging the loss to be due proximately to the overturning caused by the faulty driving of the chauffeur over any icy road, or to subsequent freezing of the motor, in any event, it is alleged to be due to a casualty, analogous to a shipwreck, not caused by the willful act or neglect of the owner, or of one acting in his behalf.}\(^7^0\)
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\(^{6^6}\)Reg. § 1.165-7(a)(3) provides: “An automobile owned by the taxpayer, whether used for business purposes or maintained for recreation or pleasure, may be the subject of a casualty loss, including those losses specifically referred to in subparagraph (1) of this paragraph. In addition, a casualty loss occurs when an automobile owned by the taxpayer is damaged and when: (i) The damage results from the faulty driving of the taxpayer or other person operating the automobile but is not due to the willful act or willful negligence of the taxpayer or of one acting in his behalf or (ii) The damage results from the faulty driving of the operator of the vehicle with which the automobile collides.” (emphasis added).

\(^{6^7}\)Farber v. Commissioner, 57 T.C. 714, 718 (1972); White v. Commissioner, 48 T.C. 430 (1967) (deduction for diamond popping from the taxpayer's ring when she closed the car door on her hand was allowed as a casualty loss).

\(^{6^8}\)Reg. § 214, art. 141, 1928-VII-1 C.B. 85. This regulation, excluding the taxpayer's “willful act or negligence” was declared obsolete by Rev. Rul. 69-43, 1969-1 C.B. 310. However, “willful act or willful negligence” is used currently in Reg. §1.165-7(a)(3).

\(^{6^9}\)The court in Shearer was interpreting section 214a(6) of the Revenue Act of 1918, but that provision remains unchanged with respect to the use of the term “other casualty.” 6 F.2d 995 (2d Cir. 1927).

\(^{7^0}\)Id. at 996–97 (emphasis added). It also might be deductible as a theft loss.
Inherently, casualty losses must be unexpected; thus, the destruction of property by an arsonist or even an angry person who lawfully destroys an expensive lamp (or mars the recipient wall of his home) would not so qualify. That was the result in Blackman v. Commissioner where the taxpayer intentionally ignited his wife's clothes and, consequently, burned his house to the ground. According to the court, his gross negligence barred the deduction.

Admittedly, there is an element of public policy in expanding the Regulation to cover these facts: “[i]n addition, allowing the petitioner a deduction would severely and immediately frustrate the articulated public policy of Maryland against arson and burning.” One might likewise argue that there is a public policy argument against allowing a discount for the taxpayer’s transfer of liquid assets to an FLP because the taxpayer is intentionally devaluing her property for transfer tax purposes, distorting what she rightfully owes to the public.

Thus, courts have held that “[n]eedless to say, the taxpayer may not knowingly or willfully sit back and allow himself to be damaged in his property or willfully damage the property himself” and still qualify for a casualty loss deduction. That is, they have expanded on the duty of the taxpayer to prevent a casualty loss as a prerequisite for qualification for the deduction. While the Regulation concerns automobile damage as a casualty loss deduction, the courts have also looked at the taxpayer's actions in other types of casualties.

Its application has been consistently broadened so that wherever unexpected, accidental force is exerted on property and the taxpayer is powerless to prevent application of the force because of the suddenness thereof or some disability, the resulting direct or proximate damage causes a loss which is like or similar to losses arising from the causes specifically enumerated in section 165(c) (3).

For example, in Axelrod v. Commissioner, the taxpayer was denied a deduction for the sailboat that he raced because he had not proved that it was damaged by a casualty. He had failed to prove he “did not 'knowingly or willfully sit back and allow' his property to be damaged or through his persistent hard

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71 88 T.e. 677 (1987).
72 Id. at 682 (“In our judgment, the petitioner's conduct was grossly negligent, or worse. He admitted that he started the fire. He claims that he attempted to extinguish it by putting water on it. Yet, the firemen found clothing still on the stove, and there is no evidence to corroborate the petitioner's claim that he attempted to douse the flame. The fact is that the fire spread to the entire house, and we have only vague and not very persuasive evidence concerning the petitioner's attempt to extinguish the fire. Once a person starts a fire, he has an obligation to make extraordinary efforts to be sure that the fire is safely extinguished, and this petitioner has failed to demonstrate that he made such extraordinary efforts. The house fire was a foreseeable consequence of the setting of the clothes [on] fire, and a consequence made more likely if the petitioner failed to take adequate precautions to prevent it.

73 Id.
74 White v. Commissioner, 48 T.e. 430, 435 (1967).
75 Id. (emphasis added).
76 56 T.C. 248 (1972).
sailing and not turning in as did 38 other boats in fact 'willfully damage the property himself.'\textsuperscript{77}

With respect to casualty losses, a taxpayer may not deduct a compensated loss because to do so would be to give "an unwarranted tax benefit to taxpayers who sustain essentially ephemeral losses . . . The allowance of a loss under such circumstances would clearly provide a windfall to taxpayers who have not sustained an economic loss in any realistic sense."\textsuperscript{78} With respect to FLPs, the discounted value of a taxpayer's assets in limited partnership form should be an exception to the general fair market value definition because the only economic loss he has sustained is the one he has intentionally desired.

III. FLPs: Assets, Intent, and Business

Typically, the creator of an FLP has liquid assets that are converted to illiquid ones through the transfer of those assets to the limited partnership form, in which there are limitations on marketability. Moreover, gift-giving often includes the transfer of minority interests and, after inter vivos gifts, a decedent often holds a minority share in the FLP. Applying the figures from the estates of decedents who died in 2001, we can see that FLP assets consist primarily of stock (mostly publicly traded securities) and real property, as well as bonds, cash assets, and the like.\textsuperscript{79} The discounted value of using the partnership form varies, but ranges 30\% to 60\%.\textsuperscript{80}

Case law conforms to this description: an FLP is formed primarily with liquid assets and, by using the FLP form and by being assessed as a limited partnership interest, the assets become illiquid and devalued. In Estate of Korby v. Commissioner, the decedents transferred cash, stocks and bonds to their

\textsuperscript{77}Id. at 258. At the same time, if the taxpayer takes measures to prevent a casualty, those costs are not in themselves casualty losses for which she may take a deduction. Austin v. Commissioner, 74 T.C. 1334, 1338 (1980) (the removal of trees to prevent power line problems or house damage did not constitute a casualty loss). The court held they were analogous to other section 262 nondeductible personal and living expenses. Id.

\textsuperscript{78}Axelrod, 56 T.C. at 2590 (Fay, J., concurring).

\textsuperscript{79}Eller, supra note 19 at 192 ("By far, the two most prevalent FLP assets were stock and real estate. Total stock holdings, including closely held and common stock, or publicly traded stock, represented almost a third, 32.9\%, of all FLP assets, although publicly traded stock made up the largest share, 85.6\% ($468.5 million), of stock holdings. Total real estate represented 30.9\% of FLP assets and included personal residences, improved and unimproved real estate, real estate partnerships, and real estate mutual funds, such as real estate investment trusts (REIT's). Estates reported bonds as the third largest asset category in FLP's. Included in this category, which represented 10.9\% of all FLP holdings, are bonds of many types, including Federal savings and other Federal bonds, corporate, foreign, State, and local bonds, as well as bond funds. While 10.8\% of all FLP assets were either limited partnerships interests or FLP's with undeterminable content, the remaining 14.5\% of FLP assets were distributed across a handful of asset categories: cash assets, such as money market accounts and certificates of deposit; noncorporate business assets; mortgages and notes; other assets, including life insurance and retirement assets; and mixed mutual funds, which contain a variety of investment instruments.").

\textsuperscript{80}Id. at 197 ("According to [Service] estate and gift tax attorneys, who review and audit Federal estate tax returns, and various private-sector studies of valuation discounting, recent discounts of FLP interests fall between 30\% and 60\%.").
partnerships. In Estate of Rosen v. Commissioner, the decedent transferred cash and marketable securities to her FLP. In Estate of Harper v. Commissioner, the decedent transferred marketable securities and a note receivable; in Estate of Thompson v. Commissioner, the decedent did the same. In Kimbell v. United States, the principal assets transferred to FLP were liquid ones like cash, securities, and notes although, to a much smaller degree, they included oil and gas working and royalty interests. In Estate of Harrison v. Commissioner, FLP assets consisted "primarily of real estate, oil and gas interests, and marketable securities." In Church v. United States, the majority of assets contributed to the FLP were liquid ones: the date of death valuation of the underlying assets "was $1,467,748 . . . the value of the Ranch accounted for $380,038 [or 25.89%], and the value of the cash and securities contributed by Mrs. Church was $1,087,710 [or 74.11%]." In Estate of Hillgren v. Commissioner, the decedent transferred real estate; in Estate of Abraham v. Commissioner, the Korbys transferred to KPLP stocks valued at $1,330,442, state and municipal bonds valued at $449,378, and savings bonds valued at $71,043, for a total transfer of $1,850,863. In return, the Korbys obtained a 98% limited partnership interest from KPLP. In addition, the Korbys' living trust transferred to KPLP a savings account worth $37,841, to bring the full funding of KPLP to $1,888,704. In return, the living trust obtained a 2% general partnership interest from KPLP. On October 11, 1996, decedent's daughter, acting as attorney-in-fact for decedent and as co-trustee of the Lillie Investment Trust, caused $2,404,781 in cash and marketable securities to be transferred from the Lillie Investment Trust to the LRFLP as consideration for the Lillie Investment Trust's 99% limited partnership interest. Respondent claims these assets were valued at approximately $60 million on contribution and at decedent's death; petitioner claims they should be discounted because the decedent's liquidation rights disappeared at his death. Thus, the court adopted the petitioner's argument and valued the assets at a discounted $33 million.. 52 T.C.M. at 1308, 1987 T.e.M. (RIA), 87008,. at 41. Respondent claims these assets were valued at approximately $60 million on contribution and at decedent's death; petitioner claims they should be discounted because the decedent's liquidation rights disappeared at his death. Thus, the court adopted the petitioner's argument and valued the assets at a discounted $33 million.. 52 T.C.M. (CCH) at 1308, 1987 T.C.M. (RIA) ¶ 87,008, at 41. 87 T.C.M. (CCH) 1008, 1011, 2004 T.C.M. (RIA) ¶ 2004-046, at 316 ("The seven LKHP properties that were contributed to the partnership at its formation included the three Orange County properties and the University property that were already the subject of the BLA and that were used to fund the amended trust. In addition, the other three properties that were contributed were the Crescent Bay, Railroad, and Manzanita properties in California that also previously were used to fund the amended trust."). 408 F.3d 26 (1st Cir. 2005), aff'd 87 T.C.M (CCH) 975, 2004 T.C.M. (RIA) ¶ 2004-039.

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in *Bigelow v. United States,* the decedents did likewise. In *Estate of Schutt v. Commissioner,* the FLP held Alabama timberlands, marketable securities, and cash. In *Estate of Erickson v. Commissioner,* the decedent contributed securities and real estate to her FLP. In *Estate of Strangi v. Commissioner,* the decedent transferred securities, real estate, an annuity, two life insurance policies, and $400,000 of limited partnership interests for a total partnership contribution of approximately $10 million. Finally, in *Estate of Stone v. Commissioner,* the FLPs consisted mostly of real property, closely held (the family apparel business) preferred stock, and other securities.

From case law, stated rationales for forming an FLP include gift giving, estate planning, income tax savings, protection of assets from creditors or in case of a divorce, increased investment management, and asset protection. An FLP achieves the first three objectives by intentionally undervaluing the transferor's property. The latter three reasons are often unsupported or belied by the facts. Yet, even where there is some basis for those purposes, those goals...
are insufficient to produce a counterweight for the discounts that ultimately are not profit-driven. A hypothetical seller whose goal is to maximize her profit would not create an FLP and transfer mostly liquid assets to that entity because the primary consequence of creating an FLP is to devalue liquid assets. In *Citizens Bank & Trust*, the Seventh Circuit stated that "restrictions imposed before transfer are taken into account, provided they are not motivated by a desire to avoid gift or estate tax." Since that principal intention is sometimes obfuscated by other purported purposes for the creation of an FLP, the focus needs to be on the creator's intention to devalue his liquid property, something a seller would not do and something Treasury should remedy in its definition of fair market value.

Occasionally, the FLPs state that they were formed to serve the creator's donative or estate planning intentions; additionally, the creator often makes gifts of FLP interests to her family after she has established her FLP. Facilitating the transferor's gift giving was named as a primary purpose of the FLPs in *Thompson*, *Estate of Strangi*, *Estate of Abraham*, and, after the formation of the FLP, the decedent in those cases indeed made family gifts in these and other cases. In *Kimbell*, one of the stated purposes was to "establish a

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96 839 F.2d at 1252 (emphasis added).
97 *Thompson v. Commissioner*, 382 F.3d 367, 369 (3d Cir. 2004) ("A financial advisor to decedent's family stated the primary advantages of the Fortress Plan included: '(1) lowering the taxable value of the estate, (2) maximizing the preservation of assets, (3) reducing income taxes by having the corporate general partner provide medical, retirement, and 'income splitting' benefits for family members, and (4) facilitating family and charitable giving.'").
98 *Estate of Strangi v. Commissioner*, 417 F.3d 468, 473 (5th Cir. 2005) (Like *Thompson*, *Estate of Strangi* also used the Fortress Plan. "The Fortress Plan was billed as a means of using limited partnerships as a tool for (1) asset preservation, (2) estate planning, (3) income tax planning, and (4) charitable giving. Fortress marketed the plan as a means of, among other things, 'lowering the taxable value of your estate' by means of 'well established court doctrines which recognize that the value of a limited partnership interest is worth less than the value of the assets owned by the limited partnership'").
99 *Estate of Abraham v. Commissioner*, 408 F.3d 26, 30 (1st Cir. 2005) ("The decree provided that annual gifts consisting of limited partnership interests in the three FLPs would be made 'in amounts not to exceed the then available annual gift tax exclusion for federal gift tax purposes' to the three children and their families.").
100 *Thompson*, 362 F.3d at 371–72 ("In 1993, the Turner and Thompson Partnerships made cash distributions of $40,000 each to decedent which he used to provide holiday gifts to family members. Again in 1995, the Thompson and Turner Partnerships made cash distributions to decedent of $45,500 and $45,220 respectively. During the same time period, decedent made gifts of interests in both partnerships to individual family members."); *Estate of Abraham*, 408 F.3d at 28 ("Between 1995, when the FLPs were set up, and 1997, when Mrs. Abraham died, she, through her guardian ad litem, transferred percentage interests of her share in the partnerships to her children and their families."); *Estate of Korby v. Commissioner*, 471 F.3d 848, 850 (8th Cir. 2006) (In the year after the FLP formation, "the Korbys gifted their 98% limited partnership interest in KPLP to four irrevocable trusts created for their sons, with each son's trust receiving a 24.5% KPLP limited partnership interest. The Korbys filed gift tax returns in 1995 claiming a discount of 43.61% on the book value of each gift because the limited partnership interests
method by which annual gifts can be made without fractionalizing Family Assets."\textsuperscript{101} The goals of reducing the decedent's estate and minimizing income taxes were stated purposes of all of the Fortress Plan FLPs;\textsuperscript{102} the FLP in \textit{Estate of Abraham} likewise was created to save estate taxes.\textsuperscript{103} It was also the factual purpose in \textit{Rosen}\textsuperscript{104} although the stated purpose was stock trading, financing, and "any other purpose allowed by applicable law."\textsuperscript{105} Similarly, in \textit{Erickson}, the decedent's daughters were clearly motivated to create the FLP for decedent for estate planning purposes.\textsuperscript{106} In \textit{Estate of Schutt}, the decedent made yearly family gifts of limited partnership interests in amounts qualifying for the

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were minority interests, their transfer was restricted, and they lacked management control. Thus, while each gift had a book value of $462,732.48, the gift tax returns reported each gift as being worth $260,935." \textit{Id.} Moreover, "[b]etween 1995 and 1998—the year both Korbys died—KPLP made several distributions to the living trust as general partner, as well as a limited number of distributions to the four sons' trusts as limited partners."; \textit{Estate of Bigelow v. Commissioner}, 503 F.3d 955, 961–62 (9th Cir. 2007) ("Bigelow reported that decedent had given limited partnership interests in Spindrift to her children and grandchildren valued at $61.85 per unit in 1994 and 1995, $67.79 per unit in 1996, and $61.90 per unit in 1997, applying a 31\% discount for lack of marketability.").
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\textsuperscript{101}Kimbell v. United States, 371 F.3d 257, 260 (5th Cir. 2004).
\textsuperscript{102}See supra notes 98–99.
\textsuperscript{103}\textit{Estate of Abraham}, 408 F.3d at 29 ("The decree provided for the placing of the three pieces of income-producing commercial real estate in FLPs and then apportioning out percentage interests in the FLPs to the children in order to reduce the Estate's tax liability upon Mrs. Abraham's death.").
\textsuperscript{104}\textit{Estate of Rosen v. Commissioner}, 91 T.C.M. (CCH) 1220, 1223, 2006 T.C.M. (RIA) \textsection 2006-115, at 846 ("In 1994, decedent's son-in-law attended a seminar on family limited partnerships and concluded from this seminar that decedent's assets should be transferred to a family limited partnership in order to reduce the value of her estate for Federal estate tax purposes . . . . Feldman [an estate planning attorney] informed decedent's son-in-law (and later decedent's daughter) that simply changing the form in which decedent's assets were held from a trust to a limited partnership would generate significant tax savings. Feldman believed that such tax savings were a major and significant reason to form a limited partnership into which decedent's assets would be transferred.").
\textsuperscript{105}\textit{Estate of Rosen}, 91 T.C.M. (CCH) at 1224, 2006 T.C.M. (RIA) \textsection 2007-107, at 847.
\textsuperscript{106}\textit{Erickson v. Commissioner}, 93 T.C.M. (CCH) 1175, 1177, 2007 T.C.M. (RIA) \textsection 2007-107 at 758–59 ("Sigrid admitted that she did not understand the particulars of the transaction. She was aware, however, that a family limited partnership would have estate tax advantages due to valuation discounts that apply to the partnership interests . . . . The credit trust did not contribute any of the $1 million in marketable securities it owned to the Partnership. Both Karen and Sigrid were aware that there were no estate tax concerns regarding the assets in the credit trust unlike the estate tax concerns they had regarding Mrs. Erickson's personal assets. Instead, Karen and Sigrid would receive the credit trust assets free of estate tax after Mrs. Erickson's death. They thus opted to leave the credit trust securities outside the Partnership.").
annual exclusion for gift tax purposes.\textsuperscript{107}

Often FLPs are created near the end of an individual's life or at a time of illness or incapacity or both, implicitly suggesting an estate planning motive. "Estates of decedents 90 and older reported the largest average FLP holdings, about $1.4 million per estate . . . ."\textsuperscript{108} In \textit{Estate of Abraham}, the decedent's FLP was created when she had Alzheimer's disease.\textsuperscript{109} Likewise, in \textit{Erickson}, the decedent was 88 years old and had Alzheimer's.\textsuperscript{110} In \textit{Korby}, Mrs. Korby was similarly afflicted\textsuperscript{111} and Mr. Korby was 79 years old with heart problems.\textsuperscript{112} In \textit{Rosen}, the "decedent was 88 years old and in failing health."\textsuperscript{113} In \textit{Harrison}, the decedent's sons, under his powers of attorney, created an FLP about 6 months before decedent's death when his health was precarious.\textsuperscript{114} In \textit{Bigelow}, the decedent was in her mid-80s, had suffered a debilitating stroke, and had moved to an assisted living accommodation when the FLP agreement was executed.\textsuperscript{115} In \textit{Harper}, the decedent was 85\textsuperscript{116} and had cancer.\textsuperscript{117} In \textit{Hillgren}, when the FLP was formed, the decedent had been diagnosed with mental

\textsuperscript{107}Estate of Schutt v. Commissioner, 89 T.C.M. (CCH) 1353, 1356, 2005 T.C.M. (RIA) \$ 2005-126, at 1007 (This fact undermines the Tax Court's finding that the decedent's refusal to make certain gifts of FLP interests in one year to certain family members was an indication of a non-tax motive (emphasis added)); \textit{Estate of Schutt}, 89 T.C.M. (CCH) 1353, 1365, 2005 T.C.M. (RIA) \$ 2005-126, at 1007 ("In 1994, decedent declined to make annual exclusion gifts of limited partnership interests in the Schutt Family Limited Partnership to his daughter Sarah S. Harrison and her children.").

\textsuperscript{108}Eller, supra note 19, at 197 ("Estates of decedents 90 and older reported the largest average FLP holdings, about $1.4 million per estate, while estates of decedents under 50 reported the smallest average FLP holdings, $630,700 per estate. These youngest decedents were still accumulating wealth at the time of their deaths and certainly had not begun to consider asset divestiture plans, such as the formation of FLP's and the 'gifting' of FLP interests.").

\textsuperscript{109}\textit{Abraham v. Commissioner}, 408 F.3d 26, 29 (1st Cir. 2005).

\textsuperscript{10}\textit{Erickson}, 93 T.C.M. (CCH) 1175, 1177, 2007 T.C.M. (RIA) \$ 2007-107, at 758 ("Mrs. Erickson's doctor confirmed a diagnosis of Alzheimer's disease on March 5, 1999, when Mrs. Erickson was 86 years old. Mrs. Erickson's Alzheimer's disease continued to progress. By May 2000, Mrs. Erickson no longer drove or cooked."). The FLP agreement was signed in 2001. \textit{Id}.

\textsuperscript{111}\textit{Korby v. Commissioner}, 471 F.3d 848, 850 n.2 (8th Cir. 2006) ("Edna Korby began living in a nursing home in Pelican Lake, Minnesota, in February 1993 when she was diagnosed with severe Alzheimer's dementia. She lived there until she died on July 3, 1998.").

\textsuperscript{112}\textit{Korby}, 89 T.C.M. (CCH) 1142, 2005 T.C.M. (RIA) \$ 2005-102.


\textsuperscript{114}Estate of Harrison v. Commissioner, 52 T.C.M. (CCH) 1306, 1307, T.C.M. (P-H) \$ 87,008, at 41 (1987).

\textsuperscript{115}Bigelow v. United States, 503 F.3d 955, 958-59 (9th Cir. 2007).


\textsuperscript{117}\textit{Harper}, 83 T.C.M. (CCH) 1641, 1641, 2002 T.C.M. (RIA) \$ 2002-121, at 708 ("Decedent was diagnosed with prostate cancer in 1983 and with cancer of the rectum in 1989.").
illness and had tried to commit suicide. In Thompson, the decedent was 93 when the FLP was formed. In Kimbell, the decedent was 96 when, two months before her death, she created her FLP with a term of forty years. In Strangi, “[a]s foiling health began to telegraph that the inevitable would occur, Albert Strangi transferred approximately ten million dollars worth of personal assets into a family limited partnership.” Finally, in Church, two days before she died, the decedent created an FLP.

In Harper, the primary purpose of forming the FLP, as stated in the agreement, was investment management although according to the estate, the FLP was mainly organized for “the business purpose of protecting from Lynn’s creditors the assets that Lynn would receive or inherit from decedent.” While it was true that decedent’s daughter Lynn had creditors in connection with litigation over her condominium, decedent was 85 with metastatic cancers and hospitalized at the time he transferred 60% of his FLP to his two children and funded his FLP with trust assets. The court emphasized the testamentary nature of the transactions and the decedent’s desire to use the partnership for estate planning purposes. Underlining those intentions, the court concluded that the decedent “wanted to protect what Lynn would receive from him, not what she currently possessed.” In Hillgren, the principal stated purpose was asset protection although the management of the assets remained

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118Hillgren v. Commissioner, 87 T.C.M. (CCH) 1008, 1009, 2004 T.C.M. (RIA) ¶ 2004-046, at 313. Within a year, the decedent had a second, this time successful, suicide attempt. Id.


120Estate of Kimbell v. United States, 244 F. Supp. 2d 700, 701–02 (N.D. Tex. 2003), vacated and remanded by 371 F.3d 257 (5th Cir. 2004) (“The Partnership is for a term of 40 years (i.e., until Decedent would have been 136 years old.”).

121Strangi v. Commissioner, 417 F.3d 468, 472 (5th Cir. 2005) (emphasis added).


124Harper, 83 T.C.M. (CCH) at 1646, 2002 T.C.M. (RIA) ¶ 2002-121, at 714 (emphasis added).


127Harper, 83 T.C.M. (CCH) at 1650–52, 2002 T.C.M. (RIA) ¶ 2002-121, at 719–21 (“While we acknowledge that HFLP did come into existence prior to decedent’s death and that some change ensued in the formal relationship of those involved to the assets, we are satisfied that any practical effect during decedent’s life was minimal. Rather, the partnership served primarily as an alternate vehicle through which decedent would provide for his children at his death . . . . Hence, not only the objective evidence concerning HFLP’s history but also the subjective motivation underlying the entity’s creation support an inference that the arrangement was primarily testamentary in nature . . . . The fact that the contributed property constituted the majority of decedent’s assets, including nearly all of his investments, is also not at odds with what one would expect to be the prime concern of an estate plan. We additionally take note of decedent’s advanced age, serious health conditions, and experience as an attorney.”).

the same and decedent and Hillgren conducted partnership business without even revealing the FLP's existence. Likewise, in Estate of Rosen, Strangi, and Estate of Bigelow, there was little change in the relationship between each decedent and his or her assets. Additionally, in Bigelow, while the stated purpose of the FLP was to own and operate residential real estate, decedent's only residence, not only did nobody respect the entity's formalities, but also the only actual purpose for the transfer was to reduce the value of decedent's gifts, which the children, under a power of attorney, made to themselves on decedent's behalf.

In Kimbell, protection from potential creditors of their oil and gas interests or property division in the instance of a divorce, and asset

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129 Hillgren v. Commissioner, 87 T.C.M. (CCH) 1008, 1013, 2004 T.C.M. (RIA) § 2004-046, at 319-20 ("In response to questions that were posed by Goldenberg regarding LKHP, Hillgren explained the purpose of forming the partnership as 'Lea suffered from depression. She did not have a husband. She was dating a young guy. He was worried about his motives and she was worried too. The Partnership served as an asset protection.' Hillgren gave the same answer in response to questions as to why they formed the partnership when Hillgren was already managing decedent's properties under the BLA. Hillgren also stated that his rights under the BLA were senior to the partnership agreement and that he gave his consent for the transfer of the properties to LKHP.").

130 Hillgren, 87 T.C.M. (CCH) at 1012, 2004 T.C.M. (RIA) § 2004-046, at 317 ("The partnership was designed generally to be invisible to the public and to persons with whom decedent and Hillgren did business.").

131 Estate of Rosen v. Commissioner, 91 T.C.M. (CCH) 1220, 1225, 2006 T.C.M. (RIA) § 2006-115, at 848 ("After the transfer, there was no material change in the manner in which the transferred assets were managed."); Strangi v. Commissioner, 417 F.3d 468, 481-82 (5th Cir. 1005) ("In short, although Strangi may have transferred a substantial percentage of assets that might have been actively managed under SFLP, the Tax Court concluded, based on substantial evidence, that no such management ever took place. From this, the Tax Court fairly inferred that active management was objectively unlikely as of the date of SFLP's creation. As such, we cannot say that the Tax Court clearly erred in rejecting the Estate's 'active management' rationale." (emphasis in original text)); Estate of Bigelow v. Commissioner, 503 F.3d 955, 972 (9th Cir. 2007) ("[T]he Padaro Lane property was Spindrift's sole asset, required no active management, and was the partnership's only business.").

132 Estate of Bigelow, 504 F.3d at 961-62 ("Bigelow reported that decedent had given limited partnership interests in Spindrift to her children and grandchildren valued at $61.85 per unit in 1994 and 1995, $67.79 per unit in 1996, and $61.90 per unit in 1997, applying a 31% discount for lack of marketability."). In addition, the estate argued that her FLP "enhanced the ease of gifting interests to decedent's children and grandchildren." to which the court explained, "[F]irst, gift giving is considered a testamentary purpose and cannot be justified as a legitimate, non-tax business justification." Id. at 972.

133 Kimbell v. United States, 371 F.3d 257, 268 ("Specifically, a living trust did not provide legal protection from creditors as a limited partnership would. That protection was viewed as essential by Mr. Elyea and Mrs. Kimbell because she was investing as a working interest owner in oil and gas properties and could be personally liable for any environmental issues that arose in the operation of those properties. Mr. Elyea also stated that Mrs. Kimbell wanted the oil and gas operations to continue beyond her lifetime and they felt that by putting the assets in a limited partnership, they could keep the pool of capital together in one entity that would be enhanced over time").
management were the stated and, according to the circuit court, the documented rationales for the FLP. Yet, decedent was 96 years old, the assets transferred to his FLP were mainly liquid ones, and management remained essentially the same. In Stone, the Tax Court found that the decedents' prime motivations for the FLP's formation were their "investment and business [management] concerns" and their desire "to resolve the children's concerns [and disputes] regarding Mr. Stone's and Ms. Stone's assets." However, the children mainly argued over their inheritance of assets from their parents, again indicating decedent's testamentary intent. Likewise, in Estate of Abraham, one reason to create the decedent's FLP was to end litigation among the decedent's children, but the resolution consisted of court sanctioned gift-giving and estate planning.

134 Id. ("Mrs. Kimbell wanted to keep the asset in an entity that would preserve the property as separate property of her descendants. The family had faced that issue during the divorce of one of Mrs. Kimbell's grandsons.").

135 Id. ("Keeping the assets in one pool, under one management would reduce administrative costs by keeping all accounting functions together. The partnership would also avoid costs of recording transfers of oil and gas properties as the property was passed from generation to generation. . . . The partnership also served the purpose of setting up the management of the assets if something should happen to her son, which was a concern as he had experienced some heart problems and had undergone a serious surgery.").

136 Id. at 260. Other stated purposes in Kimbell were to: "facilitate the administration and reduce the cost associated with the disability or probate of the estate of Family members; promote the Family's knowledge of and communication about Family Assets; provide resolution of any disputes which may arise among the Family in order to preserve Family harmony and avoid the expense and problems of litigation; and consolidate fractional interests in Family Assets." Id.

137 Stone v. Commissioner, 86 T.C.M. (CCH) 551, 553, 2003 T.C.M. (RIA) § 2003-309, at 1737, n.74 ("At least as early as the last six months of 1995, Mr. Stone and Ms. Stone were in control of their respective assets. However, they no longer were interested or actively involved in managing those assets and wanted their children to become actively involved in the management of those assets.").

138 Stone, 86 T.C.M. (CCH) at 557, 2003 T.C.M. (RIA) § 2003-309, at 1744 ("Another very important reason why the Stone family desired to explore the use of family limited partnerships was to settle and bring an end to the litigation among the children. Finally, the Stone family also wanted to explore the use of family limited partnerships as a way to help avoid disputes among the children regarding the ultimate division of their parents' respective assets after their parents died, although that was not the primary reason for the Stone family's interest in exploring the use of such types of partnerships.").

139 Stone, 86 T.C.M. (CCH) at 557, 2003 T.C.M. (RIA) § 2003-309, at 1743 ("The primary reason why the Stone family became very interested in exploring the use of family limited partnerships was to resolve the children's concerns regarding Mr. Stone's and Ms. Stone's assets.").

140 Of course, a sure-fire way to find solidarity among squabbling relatives is to show them that they will all fare better at their parents' deaths and at the government's expense.

141 See Estate of Abraham v. Commissioner, 408 F.3d 26, 29 (1st Cir. 2005) ("Litigation and discord among the children, mainly between Richard and the two sisters, continued. The feud was apparently over what amount was needed for Mrs. Abraham's protection. The litigation was also draining Mrs. Abraham's assets.").

142 Estate of Abraham v. Commissioner, 87 T.C.M. (CCH) 975, 976, 2004 T.C.M. (RIA) § 2004-039, at 264 ("The reason for the gifting powers was, inter alia, that decedent's estate is likely to be subject at her death to * * * taxes at the highest marginal tax rates then in Tax Lawyer, Vol. 61, No. 3
In *Church*, the stated purpose of the limited partnership was “to consolidate their undivided interests in a family ranch . . . for centralized management . . . and preserve the Ranch as an on-going enterprise for future generations” as well as to protect her “assets from judgment creditors in the event of a catastrophic tort claim against her.” Yet, the ranch was a relatively minor asset of the partnership in contrast to the overwhelming liquid assets in the FLP, decedent died two days after her FLP was created, there was no evidence of any history of tort claims, and it was clear that decedent’s family was concerned about estate planning. Finally, in *Estate of Korby*, the estate contended that the FLPs were created for creditor protection for their business and in the event of a divorce, but the court held that the estate had not proved its claim and had made the transfer for estate planning purposes.

Besides adherence to the formalities of an FLP, how much business must be conducted by the FLP? A review of case law under section 2036 shows that very little, if any, business must be conducted by the FLP to qualify under...
the bona fide sales exception of that statute. In *Estate of Harrison*,¹⁴⁹ the court continually emphasized weaknesses in the government’s case.¹⁵⁰ The *Estate of Bongard v. Commissioner* court commented that in *Estate of Harrison*, “[s]ome of the assets the decedent contributed included oil and gas assets, which required active management”¹⁵¹ and emphasized the family’s successfully operated family business, but the extent of the FLP’s active business activities was not explained by the court; indeed, the court’s business requirement had a very low threshold.¹⁵² In *Church*, the decedent’s children managed the land, which was leased for grazing and hunting as well as for oil and gas interests. The court held that the “character” of the majority of ownership interests “changed dramatically” after the FLP formation.¹⁵³ The liquid assets that


¹⁵⁰ *Estate of Harrison*, 52 T.C.M. (CCH) at 1309, 1987 T.C.M. (P-H) ¶ 87,008 ("With respect to business purpose, petitioner presented convincing proof that the partnership was created as a means of providing necessary and proper management of decedent’s properties and that the partnership was advantageous to and in the best interests of decedent. Respondent presented no proof to rebut petitioner’s showing.”) (emphasis added). Further, the court refused to find that the FLP was created for testamentary purposes because (1) all of the partners’ liquidation rights were restricted; (2) decedent was adequately compensated for the transfer of his assets to the partnership; and (3) “there is no proof in the record that the partnership was created other than for business purposes.” *Id.* (emphasis added).


¹⁵² *Estate of Harrison v. Commissioner*, 52 T.C.M. (CCH) 1306, 1309, T.C.M. (P-H) ¶ 87,008, at 42-3 (1987). ([The FLP] agreement will be ignored only if there is no business purpose for the creation of the partnership or if the agreement is merely a substitute for testamentary disposition. With respect to business purpose, petitioner presented convincing proof that the partnership was created as a means of providing necessary and proper management of decedent’s properties and that the partnership was advantageous to and in the best interests of decedent. Respondent presented no proof to rebut petitioner’s showing.”) (emphasis added) (citations omitted).

¹⁵³ *Church v. United States*, 2000-1 U.S.T.C. ¶ 60,369, 84,779, 85 A.F.T.R.2d 804, 807 (W.D. Tex. 2000). (“The Government contends that while the formation of the Partnership took the form of a bona fide business transaction, the transaction had no substance and was entered into for no purpose other than to reduce the taxation of Mrs. Church’s estate. I do not find this to be the case. The character of the interests owning a majority of the Ranch changed dramatically as a result of the Partnership. Prior to its formation, Plaintiffs and their descendants would have owned undivided interests in the Ranch, with each interest carrying the right
comprised the vast majority of assets transferred to the FLP were explained, satisfactorily to the court, as necessary to restore lost income from an expired grazing lease.\textsuperscript{154} But, the taxpayer created the FLP only two days before her death and although the court held that her death from cardiopulmonary collapse was unanticipated, she had been suffering from breast cancer.\textsuperscript{155} According to the Tax Court in \textit{Estate of Stone}, all of the five FLPs functioned “as joint enterprises for profit” in which the children provided active management, but most of the family squabbling was over the children’s expected inheritance of their parents’ assets.\textsuperscript{156} Moreover, in \textit{Estate of Schutt}, besides gifts and other estate planning, the Tax Court found as a sufficient non-tax motive that the decedent wanted to ensure that certain stock would be held and not sold.\textsuperscript{157} However, although that may be a non-tax motive, it is not evidence of any business or even any profit-seeking motive that is integral to being a seller.

Finally, in \textit{Kimbell}, the FLP’s oil and gas interests constituted a mere 11\% of its assets.\textsuperscript{158} “At formation, $438,000 of approximately $2.5 million in assets were oil and gas properties.”\textsuperscript{159} On the other hand, in \textit{Kimbell}, the vast

\textsuperscript{154}Church, 2000-1 U.S.T.C. § 60,369, at 84,777, 85 A.F.T.R.2d at 806 (W.D. Tex. 2000) (“The Partnership was also formed with an eye towards the possibility of actively engaging in raising cattle. The Ranch was in the midst of a prolonged and continuing drought. The grazing lease expired in 1994, and there was a question whether it would be renewed. The Partnership was prepared, if necessary, to replace this lost income through active operations. Working capital over and above income from the Ranch would have been necessary to engage in this activity” (citations omitted)).

\textsuperscript{155}Her breast cancer was in remission for the six months prior to her death and while the court held that she was not making a testamentary transfer, her medical history might have suggested otherwise. \textit{Id.}


\textsuperscript{157}Estate of Schutt v. Commissioner, 89 T.C.M. (CCH) 1353, 1357, 2005 T.C.M. (RIA) § 2005-126 at 989 (“Among the considerations providing an impetus for this potential restructuring of decedent’s assets, Mr. Sweeney and/or Mr. Dinneen recall discussing: (1) Decedent’s concerns regarding sales by family members of core stockholdings and his desire to extend and perpetuate his buy and hold investment philosophy over family assets; (2) the need to develop another vehicle through which decedent could continue to make annual exclusion gifts due to exhaustion of available units in the family limited partnership for this purpose; and (3) the possibility of valuation discounts.”).

\textsuperscript{158}Kimbell v. United States, 371 F.3d 257, 259 (5th Cir. 2001) (“At inception, approximately 15\% of the assets of the Partnership were oil and gas working (11\%) and royalty (4\%) interests.”); Estate of Bongard v. Commissioner, 124 T.C. 95, 119 (2005) (The oil and gas properties in \textit{Kimbell} related to a business created by Mr. Kimbell, decedent’s late husband, in the 1920’s.).

\textsuperscript{159}\textit{Kimbell}, 371 F.3d at 267 (Most (71\%) of the oil and gas interests were “working interests” as opposed to passive royalty interests.).
majority of interests were liquid: cash, notes, and securities and her son had performed the same management expertise for the trust assets before their transfer to her FLP.\textsuperscript{160} Certainly, little change in management pre- and post-transfer of assets to an FLP undermines any real expectation of a huge growth potential to recoup the large devaluation due to the change to a limited partnership form. The circuit court in \textit{Kimbell} considered the other assets necessary for maintaining the oil and gas business.\textsuperscript{161} Yet, if indeed the relatively small business activity required so much liquid assets, one must still question the profit intention of devaluing such a large percentage of liquid assets and of retaining the same management personnel with the same duties. With so much marketable securities, notes, and cash and so little business, with FLP discounts in \textit{Kimbell} amounting to roughly 50\%,\textsuperscript{162} how can the post-transfer values increase beyond the discounted value caused by the illiquid FLP form? Inevitably, one must wonder whether any seller (without depletion motives)\textsuperscript{163} would create an FLP primarily with liquid assets and question the policy reason for allowing such a large tax benefit for intentionally devaluing property. How can $2.5 million that is devalued to $1.25 million be doubled by other FLP considerations so that the decedent's estate is not depleted?

Beginning with definitions from the gift tax Regulations, a transfer for adequate and full consideration in money or money's worth is defined as including a "transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent)."	extsuperscript{164} Therefore, that definition includes the requirement that there be

\textsuperscript{160}\textit{Id.} at 268.

\textsuperscript{161}\textit{Id.} at 259, 267 ("Nonoperating working interest owners are called upon to pay their share of operating expenses and to make elections whether to participate in drilling operations or various phases thereof."). In \textit{Kimbell}, the Fifth Circuit concludes:

The business decision to exchange cash or other assets for a transfer-restricted, non-managerial interest in a limited partnership involves financial considerations other than the purchaser's ability to turn right around and sell the newly acquired limited partnership interest for 100 cents on the dollar. Investors who acquire such interests do so with the expectation of realizing benefits such as management expertise, security and preservation of assets, capital appreciation and avoidance of personal liability. Thus there is nothing inconsistent in acknowledging, on the one hand, that the investor's dollars have acquired a limited partnership interest at arm's length for adequate and full consideration and, on the other hand, that the asset thus acquired has a present fair market value, i.e., immediate sale potential, of substantially less than the dollars just paid a classic informed trade-off.

\textit{Id.} at 266.

\textsuperscript{162}\textit{Id.} at 265 ("[T]he value of Mrs. Kimbell's interest in the Partnership is worth only 50% of the assets she transferred (as discounted for lack of control and marketability)").

\textsuperscript{163}\textit{Kimbell} v. United States, 371 F.3d 257, 265 (5th Cir. 2004). As the \textit{Kimbell} court also stated, "[I]n order for the sale to be for adequate and full consideration, the exchange of assets for partnership interests must be roughly equivalent so the transfer does not deplete the estate." \textit{Id.}

\textsuperscript{164}\textit{Reg. \S\ 25.2512-8.}

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a functioning business (hence, "in the ordinary course of business") and that the transfer be "bona fide, at arm's length," and lack any gift-giving motive. The transfer of assets to an FLP for gift or estate purposes is not likely to satisfy that last criterion since such transfers are precisely made with a donative purpose. 165 What does "in the ordinary course of a business" mean? The Regulations should require that the primary intention of creating an FLP and transferring the decedent's assets to the FLP is consistent with a profit-motive. If the FLP funds are used to pay the transferor's personal and living expenses, the transferor's intent clearly lacks a profit-motive. If the transferred assets consist primarily of a combination of cash, cash equivalents, or marketable securities, the transferor's intent should be presumed to be lacking a profit-motive to FLP formation. Business or investment profit-motive does not include gift giving, bequests, or estate planning. Rather, intentions of gift-giving and estate valuation reduction in creating an FLP indicate an intention to devalue the transferor's assets. Protection from creditors as a purpose not only requires a history of litigation or other substantiated need for such protection but also needs to exist within the context of a profit making activity and not to protect personal or family assets when the FLP assets are devalued by discounts. Solidification of management as a motive requires significant post-FLP formation changes in investment to show how the business intended to recover the devaluation of FLP assets.

The Tax Court's current requirement of a non-tax motive is inadequate. 166 Its Bongard test requires "the existence of a legitimate and significant nontax reason for creating the family limited partnership, and [that] the transferors received partnership interests proportionate to the value of the property transferred." 167 In Estate of Bongard, the court described factors that indicated the

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165 Reg. § 25.2512-8. The regulation also states that "[a] consideration not reducible to a value in money or money's worth, as love and affection, promise of marriage, etc., is to be wholly disregarded, and the entire value of the property transferred constitutes the amount of the gift." Id. As most gifts and bequests are made because of the transferor's "love and affection," these are clearly not business reasons for the FLP creation. Id.

166 See generally Wendy C. Gerzog, Bongard's Nontax Motive Test: Not Open and Schutt, 107 Tax Notes 1711 (2005). The Bongard test is used to determine whether or not the "bona fide sale for adequate and full consideration" exception under section 2036 applies. With respect to the decedent's FLP in Bongard, the court held there was only a testamentary, and no nontax, motive for its formation. Estate of Bongard v. Commissioner, 124 T.C. 95, 125-26 (2005) ("At trial, Mr. Fullmer testified that BFLP was established to provide another layer of credit protection for decedent. Additionally, the estate asserts that BFLP facilitated decedent's and Cynthia Bongard's postmarital agreement. Messrs. Bernards and Fullmer both also testified that BFLP was established, in part, to make gifts. On December 10, 1997, decedent made a gift of a 7.72% ownership interest in BFLP to Cynthia Bongard. This gift was the sole transfer of a BFLP partnership interest by decedent during his life. BFLP also never diversified its assets during decedent's life, never had an investment plan, and never functioned as a business enterprise or otherwise engaged in any meaningful economic activity.").

167 Estate of Bongard, 124 T.C. at 118.
lack of a nontax purpose: (1) the taxpayer stands on both sides of the transaction; (2) the taxpayer needs partnership distributions for his maintenance and support; (3) the partners commingle partnership assets with their own; and (4) the taxpayer does not transfer the property to the FLP.\textsuperscript{168}

The non-tax motive test does not require a profit-making intent and its threshold is too low to identify the transferor with a hypothetical seller in the general fair market value definition sense. Indeed, the insufficiency of that test is readily apparent in the flawed \textit{Estate of Schutt} decision, and even more marked in the recent \textit{Mirowski} decision.\textsuperscript{169} In \textit{Estate of Schutt}, the Tax Court found that the FLPs were established in order to create an entity to buy and hold DuPont and Exxon stock, consistent with the decedent's investment philosophy and that the FLPs were intended to provide centralized management and prevent unwise sales of the decedent's family's stock holdings.\textsuperscript{170} Discussing the non-tax motive factors the court listed the following facts: There was an actual transfer of the property to the FLPs, there was no commingling of assets, the decedent had retained sufficient assets for his support and the maintenance of his lifestyle, and the decedent was not on both sides of the transaction. The \textit{Estate of Schutt} court explained that there was sufficient evidence of "give-and-take" and that the trust's representatives were very involved in the process. "Such a scenario bears the earmarks of considered negotiations, not blind accommodation."\textsuperscript{171} In \textit{Mirowski}, decedent controlled the formation and terms of the family LLC and the LLC paid her gift and estate tax liabilities. The only nontax motive in that case was decedent's goal of family cohesiveness, a purpose common to all FLPs and family LLCs. How are these findings indicative of a profit-motive sufficient to find equivalence in value between the transferred assets and their discounted value in FLP form?

IV. A Working Prototype

The proposed Regulation should resemble the demolition loss and automobile casualty loss Regulations. The following is a working prototype of a new Regulation (section 20.2031-1(c)) to be added as urged in this article:

\$ 20.2031-1(c) Definitions in general. (1) The terms "buyer" and "seller" are to be used in their normal, customary sense. A buyer is one who is seeking to pay the lowest price for property and a seller is one who is seeking to sell property at its highest price.

\textsuperscript{168}Id. at 118-19.

\textsuperscript{169}\textit{Estate of Murowski v. Commissioner}, T.C. Memo 2008-74; see Wendy C. Gerzog, "Tax Court FLP Confusion: Mirowski," 120 Tax Notes 263 (Jul. 21, 2008).

\textsuperscript{170}According to the Tax Court, the FLPs in fact served those aims and both the documentary and testimonial evidence evinced the decedent's concern over investment control. \textit{Estate of Schutt v. Commissioner}, 89 T.C.M. 1353, 1367, 2005 T.C.M. (RIA) § 2005-126, at 1010.

\textsuperscript{171}\textit{Estate of Schutt}, 89 T.C.M. at 1367, 2005 T.C.M. (RIA) § 2005-126, at 1011.
(2) Except as provided in subparagraph (3) of this paragraph, when a transferor has intentionally devalued his property, he is not entitled to have the definition of fair market value in §20.2031-1(b) applied for valuation purposes on the devalued asset. Rather, valuation under that section must be determined without regard to the volitional acts of valuation depression. This rule does not apply to the transferor's acts of negligence or gross negligence.

(3) If the transferor is engaged in a trade or business, subparagraph (2) shall not be applied to property used in that trade or business. If devaluation occurs when trade or business property is transferred, that transfer must be "bona fide, at arm's length," and lack "any donative intent."

(4) Evidence of intention.

(i) An intention to devalue property is presumed to occur when the transferor converts liquid assets to illiquid ones.

(ii) An intention to devalue property as well as donative intent may be suggested by: Gift-giving subsequent to the transfer; or the decedent's ill health or old age at or near the time of the act of devaluation.

(5) The application of this paragraph may be illustrated by the following examples:

**Example (1).** A creates an FLP, which does not function as a business, and transfers cash, certificates of deposit, and marketable securities to it. A is presumed to have the intention of devaluing his assets by converting liquid assets into illiquid ones. When he later transfers his partnership interest to his children, valuation under section 20.2031-1(b) must be determined without regard to the volitional acts of valuation depression. Thus, A must value his cash, certificates of deposit, or marketable securities without regard to his act of devaluation. Thus, his partnership interest must be valued by the fair market value of the assets he transferred to the FLP without regard to discounts attaching to the limited partnership form.

**Example (2).** B transfers marketable securities and oil interests to her FLP. The working oil interests represent 11% of the assets in the FLP. With respect to the marketable securities, B is presumed to have the intention of devaluing her assets by converting liquid assets into illiquid ones and must value the marketable securities without the discounts attaching to the limited partnership form. Because the working oil interests represent assets used in a trade or business, they can be valued under the general fair market value definition of section 20.2031-1(b) as long as transfers are "bona fide, at arm's length," and lack "any donative intent." If subsequent to the establishment of the FLP, B makes gifts of FLP interests to her children, or is 85 years old at the time of those transfers to the FLP, that fact may indicate that B intended to devalue his assets or may establish donative intent. In either event, that would require the oil interests to be valued at their underlying value.
V. Conclusion

Fair market value is defined in the section 2031 Regulations. That definition of fair market value relies on for its validity the normal definitions of its significant terms: a "seller" is someone who is seeking the highest price for her product and a "buyer" is someone who wants to obtain the lowest price for his purchase. It is only that tension that creates the realistic, and fair, market value of that asset. Indeed, without that conflict, the definition is comprised of hollow words.

In the context of family limited partnerships, terms have been misused. By utilizing the limited partnership shell, liquid assets become illiquid in order to discount those assets and to pay less transfer tax.

Because limited partnership interests have little, if any, influence on the activity of a partnership, the valuation of these interests may be significantly reduced by valuation discounts, such as discounts for lack of control or lack of marketability. Use of substantial discounts allows estates to minimize both the value of the reported limited partnership interest and the reported Federal estate or gift tax liability.172

Moreover, if a seller wanted to maximize her selling price, she would liquidate the partnership and sell its assets at their full fair market values.173 Any transfer of her partnership interest from that standpoint should reflect the value of the FLPs assets.174 If the current Regulation inadequately produces that result, the Regulation needs to be modified so that all of an estate's assets are accurately valued. A significant amount of revenue is at stake.175

The estate tax fair market value definition Regulation should be amended to account for situations where its assumptions do not apply and, therefore, results in a distortion of value. Currently, there are two income tax loss Regu-

172Eller, supra note 19, at 196.
173Estate of Strangi v. Commissioner, 115 T.C. 478, 495 (2000) (Parr, J., dissenting) ("If a hypothetical third party had offered to purchase the assets held by the partnership for the full fair market value of those assets, there is little doubt that decedent could have had the assets distributed to himself to complete the sale.").
174See id. at 491 (majority op.) ("Approximately 75% of the partnership's value consisted of cash and securities. It is unlikely and plainly contrary to the interests of a hypothetical seller to sell these interests separately and without regard to the liquidity of the underlying assets. SFLP was not a risky business or one in which the continuing value of the assets depended on continuing operations.").
175In 2001, although relatively few estate tax returns included limited partnerships, they represent over a billion dollars in revenue. Eller, supra note 19 at 192 ("For decedents who died in 2001, only a small fraction, 1.7%, of estates included interests in family limited partnerships, whether operating family businesses or mere estate-planning devices. These 1,880 estates reported almost $1.7 billion in family limited partnership interests"). With discounts averaging around 30% to 60%, that is a large revenue loss for what generally amounts to a slight of hand. See id. at 197.
lations that deal with the intentional destruction of property and they provide instruction for the drafting of an exception to the fair market definition in section 20.2031-1(b). The proposed Regulation should provide that where, prior to the valuation date, a transferor (donor or decedent) willfully acts to diminish the value of his property, the property’s value must be determined without reference to those actions. Further, where a donor/decedent creates an entity such as a family limited partnership and transfers liquid assets such as cash, cash equivalents, or marketable securities, she will be presumed to be acting willfully primarily to reduce the value of her estate. Unless she can prove that those assets were ordinary and necessary for the operation of her business, their value as part of an entity interest will be ignored and they must be valued in their pre-diminished, liquid form.