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FAMILY LIMITED PARTNERSHIPS: DISCOUNTS, OPTIONS, AND DISAPPEARING VALUE

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I. INTRODUCTION

Family partnerships have become increasingly popular as a means of avoiding estate and gift taxes. As other estate freezing techniques have been closed off by statutory anti-abuse rules, estate planners have increasingly resorted to partnerships as a vehicle for transferring assets within a family at deeply discounted values. Discounts ranging from one third to over one half of the value of the underlying assets are routinely claimed, and often allowed, based on lack of marketability and lack of control, even where these disabilities have no lasting or ascertainable economic effect. Nevertheless, the use of family partnerships to suppress value for transfer tax purposes rests on shaky conceptual premises that deserve closer scrutiny.¹

II. DISAPPEARING VALUE

Reduced to its essential components, the family partnership transaction operates as a sort of sleight-of-hand trick in two steps. In the first step, the transferor contributes assets to a partnership in exchange for a limited partnership interest. In the second step, the transferor transfers the partnership interest, during life or at death, to another family member. If the technique is successful, the initial exchange does not give rise to a taxable gift because no value is actually shifted at that time. In effect, the partnership interest is deemed to represent full consideration for the contributed assets. The shift in value occurs in the subsequent transfer, and at that time the amount included in the transferor's gift or estate tax base is equal to the fair market value of the transferred interest, reflecting a substantial discount from the value of the assets in the partnership's hands. The difference between the "inside" value of the contributed assets and the "outside" value of the partnership interest – the entity discount – escapes transfer tax altogether, even though the assets remain intact in partnership solution and available for tax-free distribution to the transferee upon liquidation.

The use of family partnerships can be illustrated by a simple example involving *A* and her two children *B* and *C*. *A* contributes investment assets

1. For a valuable recent discussion of family partnerships and transfer tax avoidance, see Laura E. Cunningham, Remember the Alamo: The IRS Needs Ammunition in Its Fight Against the FLP, 86 Tax Notes 1461 (Mar. 13, 2000), and sources cited therein. See also Leo L. Schmolka, FLPs and GRATs: What to Do?, 86 Tax Notes 1473 (Mar. 13, 2000); Brant J. Hellwig, Revisiting *Byrum*, 23 Va. Tax Rev. 275 (2003).

worth \$99 to a newly formed partnership in exchange for a 99% limited partnership interest; *X*, a corporation owned equally by *B* and *C*, contributes \$1 in exchange for a 1% general partnership interest. The partners' capital accounts are initially equal to the value of their respective contributions, and all items of income, gain, and loss are allocated in proportion to the partners' respective percentage interests. *A* files a gift tax return showing no taxable gifts. Subsequently, by gift or by will, *A* transfers her 99% limited partnership interest to *B* and *C*. This subsequent transfer is valued for gift or estate tax purposes at \$66, reflecting a one-third discount from liquidation value (i.e., the amount that *A* would be entitled to receive on a hypothetical liquidation of the partnership) due to lack of marketability and lack of control. Eventually, the partnership liquidates and distributes \$1 to *X* and \$49.50 of investment assets each to *B* and *C*. The net result, if *A*'s reporting of the transaction is accepted, is that *A* has transferred assets worth \$99 for a reported value of only \$66; the difference of \$33, representing a one-third valuation discount, simply disappears from the transfer tax base.

The above example raises two interrelated issues: whether *A* makes a gift upon formation of the partnership, and, if not, whether a one-third discount is allowable in valuing the transfer of the partnership interest in the subsequent transfer. On the first question, the courts appear to accept the notion that no gift occurs upon formation of a partnership as long as each partner's contribution is properly reflected in his or her capital account and does not enhance the value of any other partner's interest in the partnership.² These requirements are usually met without difficulty, even though the partnership interest that *A* receives is worth less than the assets she contributed. There is no immediate capital shift from *A* to another partner, nor is the value of any other partner's interest enhanced by *A*'s contribution. Instead, the formation of the partnership is treated as if it resulted in a loss or destruction of value, since the aggregate value of the partners' interests in the partnership is less than the total value of the contributed assets.

Nevertheless, the contributed assets remain intact in the hands of the partnership, which could sell the assets at any time and distribute the proceeds to the partners in liquidation. Arguably, since there is no actual loss or destruction of value, *A* should be treated as making a gift of the difference in value between the assets she contributed and the partnership interest she

2. See *Estate of Strangi v. Commissioner*, 115 T.C. 478, 489-90 (2000), *aff'd in part and rev'd in part on other grounds*, 293 F.3d 279 (5th Cir. 2002); *Estate of Jones v. Commissioner*, 116 T.C. 121, 127-28 (2001); see also *Church v. United States*, 2000-1 U.S. Tax Cas. (CCH) ¶ 60,369, 85 A.F.T.R. 2d (P-H) 2000-804 (W.D. Tex. 2000), *aff'd mem.*, 268 F.3d 1063 (5th Cir. 2001).

received in exchange.³ She has relinquished dominion and control of property in exchange for property of lesser value; for gift tax purposes, it does not matter that the transfer does not immediately enrich an ascertainable donee, nor that the transferred assets may eventually return to *A* or be included in her gross estate at death.⁴

There are two possible arguments that could be advanced against a completed gift on formation of the partnership, but neither of them ultimately offers *A* much comfort. First, *A* might argue that she retained sufficient control over the beneficial enjoyment of the contributed assets to prevent a completed transfer from taking place. This degree of retained control, however, would merely defer the taxable transfer until her retained control terminated during life or at death and would not result in any transfer tax reduction.⁵ Alternatively, *A* might argue that her partnership interest is equal in value to the contributed assets and thus represents full consideration received in exchange for the contributed assets. This argument, however, implies that *A*'s partnership interest would continue to be worth her proportionate share of the value of the partnership assets at the time of the subsequent transfer.⁶ In that case, the transaction would fail to achieve the intended result of making value disappear from *A*'s transfer tax base, and there would be no point in creating the family partnership.

By ignoring the difference in value between the contributed assets and the partnership interest received in exchange, the courts allow *A* to set the stage for substantial transfer tax avoidance. Having escaped gift tax liability on the initial exchange, *A* is free to claim a substantial valuation discount on a subsequent transfer of her partnership interest during life or at death. As long as the existence of the partnership is respected for gift and estate tax purposes, the difference between the inside value of the assets contributed by *A* and the

3. For an elaboration of this argument, see Schmolka, *supra* note 1, at 1487 (“The loss in value is not the subject of the transfer. The property contributed to the partnership is the *subject* of the transfer; the *extent* of the transfer is measured by the inadequacy of the consideration (the partnership interest) received in exchange.”).

4. The transaction is analogous to a transfer in trust. If the trust is irrevocable and the settlor relinquishes dominion and control while retaining a reversionary interest, there is clearly a taxable gift. See *Smith v. Shaughnessy*, 318 U.S. 176 (1943). The amount of gift tax payable on such a transfer should be allowed as a credit or offset against any subsequent estate tax liability. See IRC §§ 2001(b)(2), 2012.

5. See IRC § 2038 (estate tax); Reg. § 25.2511-2(f) (gift tax). Cf. *Estate of Strangi v. Commissioner*, 115 T.C. 478, 490 (relying in part on a finding that “we do not believe that decedent gave up control over the assets” to support conclusion that the formation of the partnership did not result in a taxable gift).

6. See discussion *infra* Part IV (pursuing this argument further).

outside value of the partnership interest that she receives in return will disappear from her transfer tax base.⁷

The discounts for lack of control and lack of marketability reflect the notion that *A* would not be able to sell her partnership interest to a hypothetical arm's-length purchaser for a price approaching her proportionate share of the partnership's net asset value. This disparity of value prompts a question about the nature and purpose of the partnership: Why would an investor exchange assets worth \$99 for a limited partnership interest worth \$66, with no right to control the partnership and no right to compel a distribution of her share of partnership assets? The short answer is that no rational person dealing at arm's length would ever make such an investment. In fact, the notion of fair market value, premised on a voluntary arm's-length exchange, is profoundly unrealistic in this context. *A*'s partnership interest is specifically designed to be given away during life or at death, and it seems incongruous to postulate an arm's-length sale of such an interest.⁸ Nevertheless, the courts appear to have accepted the notion that a family partnership can generate substantial valuation discounts for gift and estate tax purposes even if it has no business purpose.

To obtain the largest available discount, however, a taxpayer must take care to ensure that the transaction is structured as a gift of a partnership interest rather than an indirect gift of the contributed assets. In the case of a disproportionate capital contribution to a corporation, the contributing shareholder is generally treated as making an indirect gift to the other shareholders "to the extent of their proportionate interests in the corporation."⁹ Courts have traditionally valued the gift simply by subtracting the donor's retained proportionate interest from the value of the contributed assets.¹⁰ In the

7. If *A* retains possession or enjoyment of the contributed property or a right to control beneficial enjoyment of the property for life, the existence of the partnership may in effect be disregarded for estate tax purposes under § 2036. See *infra* notes 79-80 and accompanying text.

8. See *Wallace v. United States*, 566 F. Supp. 904, 918-21 (D. Mass. 1981) (noting the difficulty of constructing terms of a hypothetical sale of "property interests that would never be fashioned for transfer in an arms-length transaction"). In some cases, a token 1% limited partnership interest is given to an unrelated party, often a charity, in order to create the appearance of an arm's-length transfer. The charity, however, does not retain the interest. Instead, the interest is likely to be redeemed by the partnership, possibly at a bargain price. See, e.g., *McCord v. Commissioner*, 120 T.C. 358 (2003).

9. Regs. § 25.2511-1(h)(1).

10. See *Kincaid v. United States*, 682 F.2d 1220 (5th Cir. 1982), involving a contribution of assets to a newly formed family corporation. The court characterized the gift as an enhancement of the value of the donees' stock, equal to the difference between the value of the contributed assets and the taxpayer's interest based on her proportionate stock ownership; the court did not consider or allow any valuation discounts. See *id.* at

case of a partnership, however, the capital account rules of section 704(b) require that the value of the contributed assets be credited to the contributing partner's capital account.¹¹ If the contribution results in the enhancement of another partner's capital account – in violation of the capital account rules – the contributing partner is likely to be treated as making an indirect gift of the contributed assets, generating a smaller discount than a gift of a partnership interest.¹²

To illustrate several alternative ways of valuing the contributing partner's gift, suppose *D* contributes land worth \$100 to a family partnership of which *D* is a 40% general partner and her two children are each 30% general partners. Instead of crediting the full value of the land to *D*'s capital account, *D* receives a capital account of \$40 and each of the children receives a capital account of \$30. The available discount is 15% for a gift of an undivided fractional interest in the land, or 30% for a gift of a partnership interest. Depending on how the transfer is characterized, *D*'s gift might be valued in any of five possible ways:¹³ (a) \$42, the sum of the discounted partnership interests received by the children;¹⁴ (b) \$51, the sum of the fractional interests in land received by the children;¹⁵ (c) \$60, the value of the land less *D*'s proportional retained interest (or the sum of the children's proportional interests in the land);¹⁶ (d) \$66, the value of the land less *D*'s discounted fractional interest in the land;¹⁷ or (e) \$72, the value of the land less *D*'s discounted partnership

1224, 1226. See also *Heringer v. Commissioner*, 235 F.2d 149 (9th Cir. 1956) (contribution of land to family corporation of which donors were 40% owners, treated as gift of 60% of value of contributed land).

11. See Regs. § 1.704-1(b)(2)(iv)(d)(1).

12. See *Shepherd v. Commissioner*, 115 T.C. 376 (2000), aff'd, 283 F.3d 1258 (11th Cir. 2002). In *Shepherd*, the Tax Court treated a contribution of land to a newly formed partnership as an indirect gift of undivided fractional interests in the land. The court allowed a combined 15% discount to reflect lack of operational control, risk of disagreement about disposition, and possibility of future partition. See 115 T.C. at 388-90, 400-02. This was less than half the 33.5% stipulated discount for lack of control and lack of marketability that would have applied to gifts of limited partnership interests.

13. The example in text is adapted from Richard Covey's hypothetical based on the *Shepherd* case. See *The Shepherd, Knight and Strangi Cases – Family Partnerships Survive IRS Attack But More to Come*, Practical Drafting 6295, 6297 (U.S. Trust Co., 2001).

14. $2 \times (\$30 \times (1 - 30\%))$. This is apparently the approach favored by Judge Foley. See *Shepherd*, 115 T.C. at 416-17 (Foley, J., dissenting); *Shepherd*, 283 F.3d at 1266-68 (Ryskamp, J., dissenting).

15. $2 \times (\$30 \times (1 - 15\%))$. This is the approach of the majority in both *Shepherd* decisions. See *Shepherd*, 115 T.C. at 400-02; *Shepherd*, 283 F.3d at 1260-64.

16. $\$100 \times (1 - 40\%)$. This is apparently the approach favored by Judge Ruwe. See *Shepherd*, 115 T.C. at 409-14 (Ruwe, J., concurring in part and dissenting in part).

17. $\$100 - (\$40 \times (1 - 15\%))$. This is a variant of the approach apparently favored by Judge Beghe. See *Shepherd*, 115 T.C. at 414-16 (Beghe, J., concurring in part and dissenting in part).

interest.¹⁸ Although the distinction may seem highly formalistic, an indirect gift of assets at the time of the contribution is apparently taxed more heavily than a gift of partnership interests following a contribution.

III. PARTNERSHIP DISCOUNTS AND OPTIONS

For the family partnership to produce the intended results, it is important that each partner's contributions be reflected in his or her capital account. Scrupulous maintenance of capital accounts is necessary to document the absence of a capital shift from one partner to another upon formation of the partnership for gift tax purposes. Capital accounts also establish a link between the individual partners and their respective shares of partnership assets for income tax purposes. Capital accounts reflect an aggregate view of the partners as owning shares of partnership assets, which underlies many of the income tax provisions of Subchapter K. In effect, capital accounts serve both to measure the value of the partnership assets to which a partner is entitled on liquidation and to preserve the partner's share of built-in gain or loss attributable to particular assets.

A partner may acquire a discounted partnership interest from an existing partner in a transfer (by gift or by sale) or from the partnership in exchange for a capital contribution. If the acquiring partner's interest is worth less than a ratable share of the partnership assets that he would receive in a hypothetical liquidation of the partnership, the issuance of the partnership interest gives rise to a capital shift from the existing partners to the acquiring partner. In turn, this capital shift may trigger a deemed gift of a fractional interest in a corresponding portion of the partnership assets. If the bargain issuance of a partnership interest would give rise to a deemed gift, a similar result may be appropriate in the case of a capital contribution followed by a transfer of a discounted partnership interest.

A. Formation

The family partnership transaction assumes that the total outside value of the partners' partnership interests is less than the total inside value of the partnership's assets. If all of the partners' interests have the same proportionate discount and partnership items are shared ratably, it would be possible to equate the partners' initial capital accounts with aggregate outside value without distorting the partners' economic arrangement. Consider again the example in which *A* contributes investment assets worth \$99 to a newly formed partnership

18. $\$100 - (\$40 \times (1 - 30\%))$. This is apparently the approach favored by Judge Beghe. See *Shepherd*, 115 T.C. at 414-16 (Beghe, J., concurring in part and dissenting in part).

for a 99% limited partnership interest and *X*, a corporation owned equally by *B* and *C*, contributes \$1 in exchange for a 1% general partnership interest. If the value of each partner's capital contribution is understated by one third, the formation of the partnership should not give rise to a capital shift among the partners.¹⁹ Even though *A*'s capital account is initially credited with a contribution of \$66 (the discounted value of her partnership interest), *A* has a right to 99% of the "excess" inside value not yet reflected on the partnership's books. Thus, upon an eventual sale of the partnership's assets for their full fair market value, *A*'s initial capital account would be increased by \$33 to reflect her 99% share of the excess inside value attributable to her own contribution as well as the contributions of *B* and *C*, remedying the initial understatement.²⁰ If *A* subsequently transfers a portion of her partnership interest for its discounted value, however, *A* will relinquish her ability to recoup her full share of the excess inside value.

B. Transfer of Interest

If *A* transfers one half of her discounted partnership interest (worth \$33) to *D* as a gift, the capital account rules treat *D* as stepping into *A*'s shoes with respect to the transferred interest.²¹ Because a transfer of a partnership interest merely substitutes one partner for another partner, no revaluation of the partnership's assets or the partners' capital accounts is required or permitted.²² If capital accounts are initially stated at the undiscounted value of the partners' contributions, *D* would receive a capital account of \$49.50 (one half of *A*'s capital account of \$99). The offsetting reduction in *A*'s capital account (\$49.50) represents the outside value of the transferred interests (\$33) plus a corresponding share of excess inside value (\$16.50). Thus, *A* has permanently relinquished her claim on \$16.50 of inside value which has been shifted to *D*. Even though *D* is treated as acquiring a discounted partnership interest, the capital account rules continue to link the partners with particular partnership assets. Thus, the transferee is tagged with a proportionate share of any built-in gain (or loss) inherent in assets contributed by the transferor.²³

19. Such an understatement could arise, for example, as a result of a mistaken valuation of the underlying assets at the time of contribution. Cf. Regs. § 1.704-1(b)(2)(iv)(d)(1).

20. The capital shift from *A* to *B* and *C* would be \$.33 ($1\% \times \frac{1}{3} \times \99); there would, however, be an offsetting capital shift of \$.33 ($99\% \times \frac{1}{3} \times \1) from *B* and *C* to *A*.

21. See Regs. § 1.704-1(b)(2)(iv)(I) (transferor's capital account attributable to the transferred interest carries over to the transferee).

22. See Regs. § 1.704-1(b)(2)(iv)(f) (permitted revaluation events).

23. See Regs. §§ 1.704-3(a), 1.704-4(d)(2).

Assume instead that *D* (an unrelated party) purchases one half of *A*'s partnership interest for its discounted value of \$33 when *A*'s entire partnership interest has a basis of \$99 (the same as the basis and value of the assets contributed by *A*). For capital account purposes, *D* again takes over one half of *A*'s capital account (\$49.50), reflecting a shift of \$16.50 of excess inside value to *D*.²⁴ Upon the transfer of one half of her interest to *D*, *A* recognizes a tax loss of \$16.50 (\$49.50 allocable share of outside basis less \$33 amount realized).²⁵ *A*'s recognized loss does not reflect any shrinkage in the fair market value of the partnership's assets, since inside value has remained constant; instead, the recognized loss arises solely because *A* has relinquished her claim to the excess inside value shifted to *D*.²⁶

If a section 754 election is in effect, the basis adjustment rules of section 743 identify the transferee with an undiscounted share of partnership assets.²⁷ Even though the transaction involves a transfer of a partnership interest, the transferee is essentially treated as acquiring a proportionate share of the partnership's assets at a bargain price.²⁸ Because *D* would be treated as acquiring \$49.50 worth of partnership assets for a bargain price of \$33, *D* would be required to "write down" his share of inside basis in the partnership's assets to reflect the \$16.50 potential gain inherent in his partnership interest.²⁹

24. See Regs. § 1.704-1(b)(2)(iv)(l).

25. *A*'s basis must be allocated between the retained and transferred interests based on their respective fair market values; the seller's amount realized also includes her allocable share of liabilities attributable to the transferred interest. See IRC § 752(d).

26. If the partnership had any § 751 assets, the seller would recognize ordinary income (or loss) equal to her allocable share of the partnership's total income or loss on a hypothetical sale of its § 751 assets. See Regs. § 1.751-1(a)(2). The hypothetical sale approach under the § 751 regulations is based on the assumption that the transferee has a proportionate share of the inside value of the partnership's ordinary income assets.

27. Technically, the § 743 adjustment is personal to the transferee and does not affect the partnership's common basis in its assets. See Regs. § 1.743-1(j)(1); see also Regs. § 1.704-1(b)(2)(iv)(m)(2) (§ 743 adjustment not reflected in the transferee's capital account or on the partnership's books).

28. The § 743 adjustment is equal to the difference between the transferee's outside basis and the transferee's share of the common basis of partnership assets. See Regs. § 1.743-1(b). The transferee's share of the common basis of partnership assets (i.e., the transferee's share of previously taxed capital plus liabilities) is determined by reference to a "hypothetical transaction" in which the partnership sells all of its assets in a fully taxable transaction. See Regs. § 1.743-1(d)(1) and (2).

29. The § 743 adjustment is allocated between and among different classes of partnership assets (i.e., capital assets and ordinary assets) based on the amount of tax gain (or loss) that would be allocated to the transferee on a hypothetical sale of partnership assets for their fair market value. See Regs. § 1.755-1(a)(1) and (b); see also Regs. § 1.755-1(a)(2) (residual method of determining fair market value).

Thus, the basis adjustment rules create inside gain to match the transferee's outside gain in the case of a bargain purchase of a partnership interest.³⁰

No such basis adjustments occur if a partnership interest is acquired by gift because the donor's basis in the transferred interest carries over in the donee's hands.³¹ Thus, there is generally no disparity between the partnership's inside basis and the partners' aggregate outside basis to remedy.³² Any economic loss to the donor as a result of the capital shift is simply disregarded, an appropriate result because the "lost" value reappears in the donee's capital account. The carryover basis rule for gifts of partnership interests merely serves to mask the capital shift between *A* and *D*. By contrast, a sale of a discounted interest between unrelated parties results in an economic loss to the transferor and a matching potential economic gain to the transferee. Assuming a section 754 election is in effect, *D*'s potential gain inside the partnership is equal to *A*'s recognized loss on the transfer.

If a partner purchases a partnership interest from another partner at a discount, presumably a similar discount should be allowed if a new partner contributes cash to the partnership for an equivalent interest. For example, assume that *A* recontributes the \$33 cash paid by *D* for one half of *A*'s limited partnership interest; in exchange for *A*'s contribution, the partners agree to treat *A* as acquiring an additional 33% limited partnership interest. Because *A* has contributed an amount equal to *D*'s purchase price for a similar interest, it might appear that *A* should also be entitled to a \$49.50 capital account. This result is not permitted, however, because the total inside value allocable to the combined limited partnership interests is only \$132 (*A*'s original contribution of \$99 worth of investment assets plus \$33 cash). A pro rata division of inside value among the limited partners based on their percentage interests would result in the following capital accounts: \$88 for *A* ($\frac{2}{3} \times \132) and \$44 for *D* ($\frac{1}{3} \times \132).³³ In effect, *A* would recapture a portion of the value shifted to *D*,

30. Any shortfall in the § 743 adjustment is allocated first to capital assets and then to ordinary income assets if the basis of capital assets is insufficient to absorb the required adjustments. See Regs. § 1.755-1(b)(2).

31. See IRC § 1015(a) (donee takes donor's basis in transferred property, subject to fair market value limit for loss purposes).

32. A discrepancy may arise, however, if the donor incurs a gift tax liability on a gift of a partnership interest with a value exceeding the donor's outside basis. See IRC § 1015(d) (basis adjustment for gift tax attributable to net appreciation in gift).

33. The result is the same if the general partner's \$1 contribution is taken into account. Following *A*'s additional \$33 contribution, the combined percentage interest of the limited partners, based on their capital contributions, is 99.25% ($\$132/\133), while the percentage interest of the general partner is 0.75% ($\$1/\133). A pro rata division of the total inside value of \$133 among all the partners yields the following capital accounts: \$88 for *A* ($\$133 \times (\frac{2}{3} \times 99.25\%)$), \$44 for *D* ($\$133 \times (\frac{1}{3} \times 99.25\%)$), and \$1 for *X* ($\$133 \times 0.75\%$).

reducing the total capital shift to *D* from \$16.50 to \$11 (\$44 capital account less \$33 purchase price).³⁴

Since such treatment would dilute *D*'s discount,³⁵ however, *D* may insist that his capital account should remain \$49.50 to reflect the agreed upon discount at the time of purchase. In this event, *A*'s remaining limited partnership interest would correspond to a capital account credit of \$82.50 (\$49.50 retained capital account increased by \$33 contribution).³⁶ Of course, it makes no economic sense for *A* to agree to a capital account credit of only \$33 in exchange for her contribution, in view of the one-third discount reflected in *D*'s purchase of one half of *A*'s former interest. More importantly, treating partners as acquiring interests at a discount may threaten to undermine the function of the elaborate capital account rules linking each partner's interest in the partnership with a share of partnership assets upon liquidation.³⁷ The threat to the integrity of the capital account rules is heightened to the extent that such discounts occur between related parties who lack adverse economic interests. The claimed discounts may be economically meaningless because no actual market exists for sales of comparable discounted interests and the shifted value merely reappears in a related party's capital account.

C. Purchase from Partnership

As exemplified by the family partnership transaction, the allowance of discounts in connection with gifts of partnership interests has become quite routine. Until recently, there was considerable uncertainty concerning the

34. The shortfall in inside value (\$16.50) is borne two thirds by *A* (\$11) and one third by *D* (\$5.50). See *infra* note 36.

35. *D*'s discount would be diluted from one third (\$16.50/\$49.50) to one fourth (\$11/\$44).

36. *A*'s capital account (\$82.50) represents the undiscounted value of *A*'s initial contribution (\$99) less the capital shifted to *D* (\$16.50). The partners' capital accounts are no longer proportionate to their percentage interests in the partnership, however, since the shortfall in inside value is borne entirely by *A*. If *D*'s capital account is \$49.50, the implied value of the total limited partnership interests is \$148.50 (\$49.50 × 3), producing a \$16.50 shortfall in inside value (\$148.50 less \$132).

37. See Mark P. Gergen, *The End of the Revolution in Partnership Tax?*, 56 SMU L. Rev. 343, 356 (2003) ("At best, the response to discounts and options will erode the system's conceptual elegance and require more complex rules. . . . The proliferation of ways or justifications for making payoffs from a partnership that differ from capital accounts makes it difficult to trust how partners value assets, which is the linchpin of the system of capital accounts analysis."); see also *id.* at 359 ("There also will be vexing technical issues in translating an interest in a partnership into an interest in assets."). Cf. Lawrence Lokken, *As the World of Partnership Taxation Turns*, 56 SMU L. Rev. 365, 373-376 (2003) (suggesting that the existing system is capable of handling this phenomenon).

capital account treatment of a bargain issuance of a partnership interest.³⁸ Nevertheless, a bargain issuance of a partnership interest may be structured in a manner that is economically equivalent to a transfer of a discounted interest. Recently issued proposed regulations provide guidance on how to account for a capital shift resulting from the exercise of a noncompensatory option to acquire a partnership interest.³⁹

Assume again that *A* contributes investment assets worth \$99 to a newly formed partnership for a 99% limited partnership interest and *X*, a corporation owned equally by *B* and *C*, contributes \$1 in exchange for a 1% general partnership interest. Subsequently, the partners agree to admit *D* as a 33% limited partner in exchange for a capital contribution of \$33, \$11 less than *D*'s one-third share (\$44) of the total partnership capital attributable to the combined limited partnership interests immediately after *D*'s admission (\$132). The partners agree to the discounted price based on the conclusion that a purchaser would demand a 25% discount for such a limited partnership interest. In connection with *D*'s admission, *A*'s capital account is reduced from \$99 to \$88 to reflect the \$11 capital shift to *D*. If the capital shift occurred upon formation of the partnership, *A* would apparently be treated as having transferred a fractional interest in the underlying assets to *D* as a gift.⁴⁰ Nevertheless, if *D* acquires the identical interest in partnership capital upon transfer of a discounted partnership interest, no gift is deemed to occur. Yet the two transactions are economically indistinguishable and both should be analyzed in terms of the underlying capital shift.

Under the proposed regulations, the exercise of an option to acquire a partnership interest is treated as a capital shift from the historic partners to the

38. See Notice 2000-29, 2000-1 C.B. 1241 (inviting public comments concerning the tax treatment of options to acquire a partnership interest and similar instruments). Upon exercise of an option to acquire a partnership interest, the § 721 regulations might be construed as requiring recognition of gain as a result of the capital shift from the historic partners to the option holder. See Regs. § 1.721-1(b)(1) (denying § 721 treatment to the extent that a partner gives up his right to be repaid all or a portion of his capital contribution in favor of another partner "as compensation for services (or in satisfaction of an obligation)"). In the case of noncompensatory options, commentators offered various rationales for nonrecognition treatment of both the historic partners and the option holder. See generally Simon Friedman, Partnership Securities, 1 Fla. Tax Rev. 521 (1993); Sherwin Kamin, Partnership Options—A Modified Aggregate Theory, 91 Tax Notes 975 (May 7, 2001); New York State Bar Ass'n Tax Section, Taxation of Partnership Options and Convertible Securities, 94 Tax Notes 1179 (Mar. 4, 2002) [hereinafter NYSBA Report].

39. The regulations do not address the treatment of options and similar instruments issued in connection with the performance of services. See REG-103580-02, Noncompensatory Partnership Options, 2003-9 I.R.B. 543, 543 [hereinafter Preamble].

40. See supra notes 9-12 and accompanying text.

option holder who acquires a bargain partnership interest.⁴¹ Typically, the option holder pays a premium for the option and is entitled to receive a partnership interest upon payment of the exercise price to the partnership. The option privilege has value because it represents the opportunity to benefit from any appreciation in the value of the property subject to the option, without risking any capital.⁴² Thus, the fair market value of an option includes not only any value inherent in the option at the time of grant (i.e., the difference between the current value of the property subject to the option and the exercise price) but also the value of the option privilege for the remaining period until exercise.⁴³

The option holder will normally exercise the option only if he would be entitled to receive an interest in partnership capital in excess of the amount of the option premium and exercise price. Upon exercise, the option holder is in the same position as a partner who acquires a bargain interest from the partnership which reflects market discount. In both situations, the acquiror obtains a partnership interest in exchange for a capital contribution that is less than a ratable share of the fair market value of partnership assets to which the contributor would be entitled upon an immediate liquidation of the partnership.⁴⁴ The market discount is analogous to the fair market value of the option, i.e., the difference between the option holder's capital account based on liquidation value and the exercise price (plus any option premium).

In the above example, the partnership could agree to issue *D* an immediately exercisable option to acquire a 33% limited partnership interest for an aggregate option price and exercise price of \$33. (For this purpose, ignore any additional option premium that *D* should be willing to pay for the privilege of deferring exercise.) Suppose *D* immediately exercises the option, entitling him to a capital account of \$44. If *D* is treated as acquiring an option to purchase a 33% partnership interest for which a market discount of 25% would be allowed, there is apparently no disguised gift to *D*. Under the proposed regulations, however, *D* is treated as receiving a capital shift of \$11 from the

41. The shift may consist of previously booked capital as well as a share of unrealized appreciation which has not yet been reflected on the partnership's books. Although the § 721 regulations refer to a partner's right to be repaid his "contribution," it is commonly understood that a partner's share of capital also includes his share of unrealized appreciation in partnership assets. See William S. McKee et al., *Federal Taxation of Partnerships and Partners* ¶ 5.02[1] at 5-5 (3d ed. 1997).

42. See Regs. § 1.83-7(b)(3).

43. See *id.*

44. If the exercise price of a noncompensatory option exceeds the capital account received on exercise, the proposed regulations warn that the transaction will be treated according to its "true nature." Prop. Regs. § 1.721-2(a). In this situation, the option holder would be paying more for the interest than its liquidation value, suggesting the possibility of a disguised transfer to the historic partners.

historic partners.⁴⁵ Although the proposed regulations provide that exercise of an option is treated as a nonrecognition event with respect to the option holder and the historic partners,⁴⁶ the resulting capital shift should arguably give rise to an indirect gift of a disproportionate share of partnership assets from the historic partners to *D*.⁴⁷

The exercise of an option entitles the option holder to acquire a partnership interest at a bargain price. Nevertheless, the proposed regulations look through the partnership and treat the option holder as acquiring a share of partnership assets based on the liquidation value of his capital account immediately after exercise. The partnership's assets are revalued immediately after exercise, and the option holder's capital account is initially credited with the amount of his contribution, i.e., the option premium and the exercise price.⁴⁸ Next, the option holder's capital account is credited with unrealized appreciation in the partnership's assets (not yet reflected in the partners' book capital accounts) to substitute for the built-in gain inherent in the option itself.⁴⁹ If the option holder is entitled to additional capital in excess of the built-in gain in the partnership's assets, capital is reallocated from the historic partners' capital accounts to the option holder's capital account.⁵⁰ In this situation, the

45. Since the fair market value of the contributed property was reflected in the partners' book capital accounts at the time of contribution, the \$11 capital shift consists entirely of previously booked capital; if the partnership's assets had appreciated after contribution, the capital shift would include a share of unrealized appreciation.

46. See Preamble, *supra* note 39, at 543-44. While concluding that § 721 applies to exercise of a noncompensatory option, the proposed regulations fail to state "the specific theory or principles" overriding the contrary implication in Regs. § 1.721-1(b). Elliott Manning, Proposed Non-Compensatory Partnership Options Regulations, 16 *J. Tax'n Fin. Institutions* 16, 22 (May/June 2003).

47. See Regs. § 1.704-1(b)(1)(iv) (warning that a capital shift may be treated as a disguised gift).

48. See Prop. Regs. § 1.704-1(b)(2)(iv)(s)(1). Under the conventional approach of the § 704(b) regulations, the partners' capital accounts would be booked up immediately before admission of a new partner. See Regs. §§ 1.704-1(b)(2)(iv)(f), 1.704-1(b)(5) exs. 14 and 18. A post-exercise bookup allows pre-exercise unrealized appreciation to be allocated on a priority basis to the option holder to the extent necessary to implement the parties' economic arrangement.

49. See Prop. Regs. § 1.704-1(b)(2)(iv)(s)(2). The built-in gain inherent in the option privilege cannot be allocated to the option holder directly under § 704(c) principles because the option privilege terminates upon exercise. See Preamble, *supra* note 39. Nonrecognition treatment on exercise merely results in deferral, since the option holder will eventually recognize built-in gain attributable to the underlying assets under § 704(c) principles.

50. See Prop. Regs. § 1.704-1(b)(2)(iv)(s)(3).

partnership is required to make corrective allocations to reflect the “capital account reallocation.”⁵¹

The required adjustments under the proposed regulations resemble section 743 basis adjustments in connection with a bargain purchase of a partnership interest. The common assumption underlying these different adjustments is that the bargain element inherent in the partnership interest can be translated into a bargain acquisition of partnership assets. From the historic partners’ perspective, it might seem unrealistic to distinguish between a shift to the option holder of pre-admission unrealized appreciation (to the extent not previously booked in the partners’ capital accounts) and a shift of previously booked capital. In economic terms, both types of shifts represent a loss of value to the historic partners.⁵² To the extent that the previously unbooked appreciation will eventually be taxed entirely to the option holder, however, the historic partners are not entitled to any tax loss to match their economic loss.⁵³ The proposed regulations reject the notion of taxing the historic partners on the unrealized appreciation transferred to the option holder as part of the bargain purchase.⁵⁴ As one commentator noted, treating the shift in unrealized appreciation as a taxable event would mean that the historic partners “would be taxed not on an accession to wealth, the value they received, but on a deaccession to wealth, value they had forever foregone.”⁵⁵

From the option holder’s perspective, receipt of a partnership interest upon exercise of the option is a tax-free event, based on section 721 and general open-transaction principles applicable to options.⁵⁶ In acquiring the option, the option holder has bargained for the right to acquire a capital account in excess

51. See Prop. Regs. § 1.704-1(b)(2)(iv)(s)(4). A corrective allocation is an allocation for tax purposes of gross income or other items that differs from the partnership’s allocation of the corresponding book items. See Prop. Regs. § 1.704-1(b)(4)(x). If the partnership has significant gross income, corrective allocations may trigger immediate income to the option holder, reducing the historic partners’ share of income and eliminating any deferral to the option holder.

52. Alternatively, the option holder could be viewed as having been entitled to a share of appreciation from the outset. See Gergen, *supra* note 37, at 357 n.49 (“In truth, the original partners give up and get nothing on exercise for the option holder always had a claim on asset appreciation.”).

53. Thus, corrective allocations are necessary only with respect to capital account reallocations which represent shifts in value that have already been taken into account for book purposes.

54. Although the regulations do not specifically state that the historic partners are entitled to nonrecognition treatment upon a capital shift, the examples confirm such treatment. See, e.g., Prop. Regs. § 1.704-1(b)(5) ex. 21.

55. Simon Friedman, *A Better Tax Treatment of Compensatory Options*, 90 Tax Notes 1107, 1107 (Feb. 19, 2001).

56. See Preamble, *supra* note 39, at 544. See also Rev. Rul. 78-182, 1978-1 C.B. 265 (from the option holder’s perspective, purchase of an option is merely an investment in the option).

of the amount of his contributions. Thus, the option holder has simply made a bargain purchase of a partnership interest or, equivalently, a share of partnership assets. Generally, an option to acquire a partnership interest is likely to be “out of the money” at the time of grant, since the holder is speculating on future appreciation in the property subject to the option. By contrast, a hypothetical option to acquire a discounted partnership interest, as in the above example, is likely to be “in the money” at the time of grant if the property subject to the option is viewed as a share of the underlying partnership assets. From this perspective, the option privilege represents the ability of the option holder to unlock excess inside value upon a sale of the partnership’s assets or a liquidation of the partnership.⁵⁷ Although the economic value of such an option may be difficult to measure, it is clearly greater than zero. Nor is there any reason to believe that the value of the option is accurately reflected in the discounted value assigned to the minority partnership interest when the shifted value merely reappears in a related transferee’s capital account.

The proposed regulations suggest the alternative possibility of measuring the value of the option privilege based on a liquidation approach. For example, the proposed regulations require the pre-exercise “fair market value” of an option to be determined in connection with a revaluation of partnership assets upon admission of a new partner.⁵⁸ If the revaluation failed to take the fair market value of the option into account, the historic partners’ capital accounts would generally be overstated because the option holder may ultimately be entitled to a portion of the partnership’s assets. In this situation, the fair market value of an option is deemed to be equal to the value of the assets to which the option holder would be entitled on exercise of the option followed by an immediate liquidation of the partnership, less the exercise price.⁵⁹ By identifying the fair market value of the option with the share of underlying partnership assets to which the option holder would be entitled, the proposed regulations apparently assume away the problem of a discount for a minority interest.⁶⁰ Of course, such a liquidation approach is arguably

57. See Lokken, *supra* note 37, at 375 (alternative view that “all partnership interests are minority interests, none is more valuable than any other and the excess of inside value over outside value does not truly exist for any partner until it is unlocked by sale of the [partnership’s assets] and distribution of the proceeds to the partners”).

58. See Prop. Regs. § 1.704-1(b)(2)(iv)(h)(2).

59. Although the proposed regulations do not specifically prescribe the method of determining an option’s fair market value, the examples consistently adopt a liquidation approach. See, e.g., Prop. Regs. § 1.704-1(b)(5) ex. 22.

60. See Paul Carman & Sheldon I. Banoff, Proposed Regulations on Noncompensatory Partnership Options: No Gain, Some Pain, 98 J. Tax’n 197, 221-22 (Apr. 2003) (noting problems that arise if discounts are taken into account in determining the actual fair market value of an option).

unrealistic if the option is viewed as entitling the option holder only to a discounted partnership interest, not a proportionate share of partnership assets.⁶¹

In other situations involving transfers of hard-to-value interests, however, the Service has also used a liquidation approach to measure the fair market value of the transferred interest. For example, the Service has ruled that the taxable value of a partnership interest received in exchange for services should be determined based on the liquidation value of the interest.⁶² In effect, the liquidation approach disregards certain factors (e.g., rights to manage the partnership and restrictions on transferability) that theoretically should be taken into account in valuing such an interest.⁶³ One advantage of the liquidation approach is its relative ease of administration, since it requires valuing only the partnership's underlying assets.⁶⁴ Thus, application of Subchapter K rules in other areas may furnish indirect support for a liquidation approach in determining the amount of a capital shift for gift and estate tax purposes.

IV. PRESERVING VALUE

To the extent that the problem of disappearing value flows from inconsistent valuation assumptions in the separate steps of the transaction, it may be appropriate to impose a consistent framework for valuing the partnership interest in both steps. A consistent valuation rule could be formulated in any of several ways. One approach, based on the capital account rules of Subchapter K, would deem the transferor's partnership interest to have a value equal to the assets that would be distributed to the transferor in a hypothetical liquidation of the partnership. Under this capital account approach, there would still be no taxable gift in the initial exchange because the transferor would receive a partnership interest equal to the value of the contributed assets (as reflected in his or her capital account, assuming compliance with the capital account rules of section 704(b)). In the subsequent transfer the partnership interest would again be valued as a proportionate share of the inside value of the partnership assets. As a result, no entity discount would be allowed in the

61. Because the liquidation approach requires that a portion of the partnership's assets be effectively "set aside" for anticipated future allocation to the option holder, the references to the fair market value of an option may not be intended literally.

62. See Rev. Proc. 93-27, 1993-2 C.B. 343; see also Rev. Proc. 2001-43, 2001-2 C.B. 191.

63. See NYSBA Report, *supra* note 38, at 1201-02 (noting that the liquidation approach would create a disparity between the treatment of corporate stock options under § 83 and compensatory partnership options under Subchapter K, but recommending such an approach to achieve "internal consistency within subchapter K").

64. See *id.* at 1202 (liquidation approach "does not require analyzing myriad other factors (many of which are quite subjective) relevant to determining the true fair market value of a partnership interest").

subsequent transfer, and the transferor would make a taxable gift of the full amount that he or she would be entitled to receive in a hypothetical liquidation.

The capital account approach would undoubtedly prove controversial. In 1995 the Treasury Department attempted to extend the anti-abuse rules of Subchapter K to curb transfer tax avoidance techniques.⁶⁵ Although the rules could be interpreted narrowly to disallow entity discounts only for family partnerships involving non-business, non-income-producing assets (e.g., a vacation home),⁶⁶ the rules were promulgated without the usual opportunity for public comment and were hastily withdrawn following an outcry from members of the tax and estate planning bars.⁶⁷ By limiting the scope of the anti-abuse rules to income tax avoidance and failing to address valuation discounts in the transfer tax context, the Treasury Department has created a vacuum of guidance which has in turn encouraged the development and marketing of aggressive techniques involving family partnerships.⁶⁸

The proliferation of entity discounts also prompted the Clinton administration to propose curbing valuation discounts by requiring that interests in certain entities be valued based on a proportional share of the net value of the entity's non-business assets.⁶⁹ This proposal reflected the notion that it is appropriate to allow entity discounts based on the traditional fair market value standard in a bona fide business setting but that a stricter standard is needed in a non-business setting.⁷⁰ Similarly, the present discussion focuses primarily on

65. See T.D. 8588, 60 Fed. Reg. 23, 29 (Jan. 3, 1995), promulgating Regs. § 1.701-2(d) exs. 5 and 6.

66. The anti-abuse rules originally included an example involving a vacation home held in a family partnership. In that example, the partnership lacked any substantial business purpose. Because the subsequent transfer of discounted partnership interests would produce a substantial reduction in aggregate federal tax liability, the Service asserted the right to recast the transaction in a manner consistent with the intent of Subchapter K. See *id.* ex. 6. In contrast, another example involving actively-managed, income-producing property passed muster under the anti-abuse rules. See *id.* ex. 5. In a subsequent revision of the anti-abuse rules, however, both examples were deleted. See *infra* note 67 and accompanying text.

67. See T.D. 8592, 60 Fed. Reg. 18741 (Apr. 13, 1995) (revised final regulations, omitting exs. 5 and 6).

68. For example, the family partnership documents in *Strangi* were based on forms provided by the Fortress Financial Group, Inc., which “trains and educates professionals on the use of family limited partnerships” as a tax and estate planning tool. See *Estate of Strangi v. Commissioner*, 115 T.C. 478, 480, *aff’d in part and rev’d in part on other grounds*, 293 F.3d 279 (5th Cir. 2002).

69. See Staff of the Joint Comm. on Tax’n, Description of Revenue Provisions Contained in the President’s Fiscal Year 2000 Budget Proposal 291 (JCS 1-99, Feb. 22, 1999).

70. See Cunningham, *supra* note 1, at 1469 (noting the definitional problem of carving out an exception for family partnerships engaged in an “active business”).

family partnerships that have no substantial business purpose.⁷¹ Family partnerships offer special opportunities for transfer tax avoidance because they can ordinarily be formed and liquidated without any toll charge in the form of an income tax on contributions or distributions of appreciated assets.⁷² Moreover, the capital account analysis pursued here is particularly well suited to deal with family partnerships. To the extent this analysis helps to resolve the problem of disappearing value in the core case of family partnerships, it may serve as a starting point to address related but distinct problems involving other forms of ownership such as closely held corporations,⁷³ joint tenancies,⁷⁴ and trusts.⁷⁵

71. The existence of a substantial business purpose may present a factual controversy. See, e.g., *Estate of Strangi*, 115 T.C. at 484-87 (expressing skepticism concerning purported business purpose but nevertheless concluding that “the partnership had sufficient substance to be recognized for tax purposes”). Similar questions arise in determining whether an arrangement falls within the statutory safe harbor for a “bona fide business arrangement” under § 2703. See IRC § 2703(b).

72. See IRC §§ 721, 731. Careful planning may be necessary, however, to avoid recognizing gain on certain contributions or distributions of appreciated assets. See IRC §§ 704(c)(1)(B) (distribution of contributed built-in gain property within seven years), 721(b) (contribution to investment partnership), 731(c) (distribution of marketable securities), 737 (distribution to contributing partner within seven years). See Thomas I. Hausman, *Mixing Bowls and Marketable Securities in a Family Limited Partnership*, 101 Tax Notes 373 (Oct. 20, 2003); Mark P. Gergen, *Potential Tax Traps in Liquidating a Family Limited Partnership*, 101 Tax Notes 1431 (Dec. 22, 2003).

73. Distributions of appreciated assets from a partnership ordinarily do not constitute a taxable event. See *supra* note 72 and accompanying text. In contrast, distributions of appreciated assets from a corporation give rise to an income tax at the entity level. See IRC §§ 311(b) and 336(a). In some cases, a built-in capital gain tax liability may give rise to a discount in valuing a transfer of shares. See *Estate of Eisenberg v. Commissioner*, 155 F.3d 50 (2d Cir. 1998); *Estate of Dunn v. Commissioner*, 301 F.3d 339 (5th Cir. 2002). Individual shareholders may also face a substantial toll charge as a result of a corporate distribution, notwithstanding the current preferred rates for qualifying dividends. See IRC § 1(h)(11)(A).

74. As a practical matter, joint ownership is less attractive than a family partnership for two reasons. First, the creation of a joint tenancy often results in either a gift tax (if one party furnishes all of the consideration) or an income tax (if there is an exchange of interests in appreciated assets). Second, a joint tenancy with fragmented ownership and control may lead to difficulties in reaching decisions concerning management or liquidation of the underlying property. The “fractional interest” discount allowed in valuing a transfer of an undivided joint ownership interest is typically smaller than the entity discount allowed for a limited partnership interest in a family partnership. See *supra* note 12 and accompanying text. Indeed, the Tax Court has denied any fractional interest discount in valuing a joint tenancy interest in real property for estate tax purposes under IRC § 2040(a). See *Estate of Young v. Commissioner*, 110 T.C. 297 (1998).

75. From a functional perspective, perhaps the closest analog to a family partnership is an express private trust. Denying an entity discount in valuing partnership interests would be fully consistent with the actuarial valuation methods traditionally employed in valuing trust interests. See IRC § 7520.

If the capital account approach is rejected, an obvious alternative would be to require consistent valuation of the partnership interest reflecting the discount claimed by the taxpayer. This entity discount approach would result in a taxable gift at the formation of the partnership, to the extent that the value of the assets contributed to the partnership exceeds the discounted value of the partnership interest received in exchange.⁷⁶ It should not matter that the excess inside value is now locked in the transferor's capital account, since the transferor has deliberately taken advantage of the partnership form to claim an entity discount.⁷⁷ The main difference between the two approaches is one of timing: under the entity discount approach a taxable gift occurs at the formation of the partnership, while under the capital account approach the taxable event is deferred until the transferor disposes of the partnership interest during life or at death.⁷⁸ Under either approach, however, the transferor's proportional share of the inside value of the partnership assets would be included in his or her transfer tax base.

A somewhat different approach to the problem of disappearing value is found in section 2036, which requires that property transferred during life be drawn back into the gross estate at death if the decedent retained possession or enjoyment of the property or a right to control beneficial enjoyment of the property for life.⁷⁹ Section 2036 has recently been invoked to reach assets held in a family partnership where the decedent retained substantially unimpeded access to the partnership assets until death.⁸⁰ The effect of section 2036, where

76. See *supra* note 3 and accompanying text.

77. See Schmolka, *supra* note 1, at 1486 ("it makes no difference where the [excess inside value] goes, or, indeed, whether it goes anywhere"). With this analysis, compare the analysis in *Estate of Bosca v. Commissioner*, 76 T.C. Memo (CCH) 62, T.C. Memo (RIA) 98,251 (1998), holding that a 50% shareholder who exchanged voting shares for nonvoting shares in a corporate recapitalization made separate gifts to the other two 25% shareholders equal to the value of the relinquished voting rights in two 25% blocks of stock.

78. If the value of the partnership assets is expected to appreciate substantially, a rational taxpayer might prefer to incur a gift tax immediately on formation of the partnership, in order to avoid incurring a later tax at a higher marginal rate. Experience suggests, however, that taxpayers often prefer to defer paying transfer tax even if this results in a higher overall tax burden.

79. See IRC § 2036(a)(1) (retained "possession or enjoyment of, or the right to the income from, the property"), (a)(2) (retained right "to designate the persons who shall possess or enjoy the property or the income therefrom"). Under § 2036(b), retention of the right to vote shares of stock in a controlled corporation is treated as retention of the enjoyment of transferred property for purposes of § 2036(a)(1). By its terms, however, § 2036(b) applies only to stock in a controlled corporation, not to interests in a family partnership. See IRC § 2036(b).

80. See *Estate of Schauerhamer v. Commissioner*, 73 T.C. Memo (CCH) 2855, T.C. Memo (RIA) 97,242 (1997); *Estate of Reichardt v. Commissioner*, 114 T.C. 144 (2000); *Estate of Harper v. Commissioner*, 83 T.C. Memo (CCH) 1641, T.C. Memo (RIA) 2002-121 (2002); *Estate of Thompson v. Commissioner*, 84 T.C. Memo (CCH)

it applies, is to disregard the existence of the partnership and to negate any entity discount previously allowed with respect to a lifetime gift of the partnership assets. In this sense, section 2036 may be viewed as an antidote to the lenient gift tax treatment of family partnerships. The reach of section 2036, however, is limited. If the transferor is careful to observe the formalities of partnership formation and operation during life, and is willing to relinquish management and control to other family members, the family partnership remains viable as a technique for making value disappear for gift and estate tax purposes.⁸¹ This is so even if after the transferor's death the other partners promptly liquidate the partnership in order to unlock the undiscounted value of the partnership assets.

In theory the "back-end" approach of section 2036 could be expanded to address family partnerships more comprehensively.⁸² A more flexible "front-end" approach, however, would focus on gift tax valuation and would assign a tentative value of zero to a partnership interest received in exchange for a contribution to a family limited partnership. This approach, which draws on the present law treatment of hard-to-value partial interest transfers and resembles the zero-value rule of section 2701, has the advantage of fitting in rather easily with traditional gift tax principles.⁸³ Under the proposed approach, a contributing partner would be free to overcome the zero-value rule by showing that his or her partnership interest had a positive fair market value. To provide maximum flexibility, the partner could even be allowed to elect a special value for the partnership interest anywhere in the range from zero to the value of the contributed assets. Any difference between the value of the contributed assets and the special value of the retained partnership interest would be treated as a transfer for gift tax purposes. Moreover, the partner would be required to report any subsequent transfer of the retained partnership interest, during life or at

374, T.C. Memo (RIA) 2002-246 (2002); *Estate of Strangi v. Commissioner*, 85 T.C. Memo (CCH) 1331, T.C. Memo (RIA) 2003-145 (2003). For critical commentary on the *Strangi* decision, see Mitchell M. Gans & Jonathan G. Blattmachr, *Strangi: A Critical Analysis and Planning Suggestions*, 100 Tax Notes 1153 (Sept. 1, 2003); Louis A. Mezzullo, *Is Strangi a Strange Result or a Blueprint for Future IRS Successes Against FLPs?*, 99 J. Tax'n 45 (July 2003).

81. See, e.g., *Estate of Stone v. Commissioner*, 86 T.C. Memo (CCH) 551, T.C. Memo (RIA) 2003-309 (2003).

82. Under former § 2036(c), enacted in 1987 and amended in 1988, if a person held a substantial interest in an enterprise and transferred property having a disproportionately large share of the potential appreciation in the interest while retaining an interest in the income of, or rights in, the enterprise, the transferred property would be drawn back into the gross estate under § 2036(a)(1). This provision drew fierce criticism from the tax bar and organized interest groups, and was eventually repealed in 1990 concurrently with the enactment of §§ 2701 through 2704.

83. See *Robinette v. Helvering*, 318 U.S. 184 (1943); Regs. § 25.2511-1(e). Cf. IRC § 2701(a)(3)(A) (zero-value rule).

death, using a consistent valuation assumption.⁸⁴ The valuation adjustment in the subsequent transfer would ensure that any portion of the value of the contributed assets that escaped gift tax in the initial transfer would ultimately be included in the partner's gift or estate tax base, and would also avoid double taxation of any portion previously included at the time of the initial transfer, by analogy to principles of existing law.⁸⁵

To illustrate the proposed front-end approach, assume that Parent contributes \$99 to a newly formed partnership in exchange for a 99% limited partnership interest; Child contributes \$1 in exchange for a 1% general partnership interest. Parent would be treated as making a gift of \$99 unless she either proved that her limited partnership interest had a positive fair market value or elected to assign a special value (between zero and \$99) to her interest. If the zero-value rule applied, Parent would be treated as making a gift of \$99, but on a subsequent transfer her interest would be deemed to be worthless, consistent with the valuation assumption in the initial transfer. Alternatively, if Parent claimed a one-third discount (for lack of control and marketability) and established a fair market value of \$66, on a subsequent transfer the value of her interest would be deemed to be equal to two-thirds of its liquidation value (i.e., the value of the partnership assets that would be distributed to her in a hypothetical liquidation of her interest). If she elected a special value of \$99, there would be no gift upon formation of the partnership, and on a subsequent transfer the full liquidation value of her interest would be subject to gift or estate tax.

V. CONCLUSION

The basic family partnership transaction involves nothing more complicated than a parent's initial contribution of assets in exchange for a partnership interest, followed by a subsequent transfer of the partnership interest to a child. Under existing law, the transaction can be structured to avoid any taxable gift on the formation of the partnership and to generate substantial valuation discounts on the subsequent transfer of the partnership interest. As a result, the difference between the inside value of the contributed assets and the outside value of the partnership interest escapes gift and estate tax in the parent's hands, even though the assets remain intact and available for distribution to the child upon liquidation of the partnership.

84. The concept of an election to claim or forego favorable tax treatment in an initial transfer coupled with consistent treatment in a subsequent transfer has counterparts in existing law. Cf. IRC § 2701(c)(3)(C) (election into or out of special valuation rules), 2701(e)(6) (valuation adjustment on subsequent transfer). Cf. also IRC §§ 2044, 2056(b)(7), 2519, 2523(f), relating to qualified terminable interest property.

85. Cf. Rev. Rul. 84-25, 1984-1 C.B. 191.

There is nothing inherently abusive in allowing valuation discounts for lack of marketability and lack of control in connection with the subsequent transfer of the partnership interest. Instead, the problem of disappearing value reflects a discrepancy between the tax treatment of the initial exchange and the subsequent transfer. The courts hold that no taxable gift occurs on formation of the partnership, if capital accounts are properly maintained and no capital is shifted from one partner to another. Although the capital account rules developed in the income tax context do not necessarily control the valuation of partnership interests for transfer tax purposes, they help to expose the problem of disappearing value. In effect, the courts treat the formation of the partnership as an ordinary business transaction in which each partner is deemed to receive adequate and full consideration for his or her contribution.⁸⁶ Typically, however, the formation of a family partnership is not an ordinary business transaction but rather an initial step in a donative transfer between related parties. When a parent contributes assets to the partnership in exchange for a partnership interest of lesser value, the difference in value is not destroyed but merely suspended in partnership solution. So far, the courts have failed to provide a coherent explanation for exempting the unequal exchange from the reach of the gift tax.

One possible reason for treating the parent leniently is that it is not clear at the time of the initial exchange that the assets contributed by the parent will actually emerge intact in the child's hands. It is possible, though unlikely, that a disagreement may erupt within the family or that the parent may sell his or her partnership interest to an unrelated party for its fair market value. But this sort of uncertainty about future events does not generally prevent an unequal exchange occurring outside the ordinary course of business from being treated as a taxable gift. Another possible concern is that a child who ultimately expects to benefit from a gift of the parent's partnership interest, should not incur a gift tax on his or her contribution to the partnership. The simplest way to avoid this problem is to allow the child to elect to ignore the entity discount upon formation of the partnership while requiring that the child abide by a consistent valuation assumption on any subsequent transfer of his or her partnership interest. Under the flexible front-end approach described above, each partner would be free to elect the most convenient and advantageous assumption for valuing his or her partnership interest upon formation of the family partnership, but would be required to apply a consistent assumption in a subsequent transfer. Each partner could make the election independently of the others, but the end result would be to capture the value that disappears from

86. Under the gift tax regulations, 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)" is exempt from gift tax because such a transfer is "considered as made for an adequate and full consideration in money or money's worth." Regs. § 25.2512-8.

the transfer tax base under existing law as a result of inconsistent valuation assumptions.

**** ADDENDUM ****

Note to Readers: Following the completion of this article in the spring of 2004, the federal appellate courts issued decisions in *Kimbell v. United States*, 371 F.3d 257 (5th Cir. 2004), and *Turner v. Commissioner*, 382 F.3d 367 (3d Cir. 2004). Although these two decisions clearly represent contrasting approaches to the estate tax treatment of family limited partnerships under section 2036(a), they do not significantly affect the analysis or the conclusions set forth in the article.