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HEART OF AMERICA FELLOWS INSTITUTE
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AMERICAN COLLEGE OF TRUST & ESTATE COUNSEL

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I. WHAT IS "FAIR MARKET VALUE"?

For gift tax purposes, the "value" of property subject to a gift "is the price at which such 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." Reg §25.2512-1.

For estate tax purposes, the value of the decedent's gross estate is the total value of all interests described in Code §2033-2044. Reg §20.2031-1(a). Then, the value of every item of property includable in the decedent's gross estate under §2031-2044 is its "fair market value" at the time of the decedent's death. Fair market value is defined in the same manner as in Reg §25.2512-1. See Reg §20.2031-1(b).

The cases indicate that the definition of fair market value is identical for purposes of estate and gift taxes. See U.S. v. Campbell, 65AFTR 2d 90-1003 (1990); Peck v. Comr., (1985 CA9) 55 AFTR 2d 85-804; Drybrough (1966) 45 TC 424.

Who is a "willing buyer" or "willing seller"? Question whether a hypothetical "willing buyer" will be deemed to be a family member or not a family member of the donor or the decedent. For example, if there is a transfer restriction in an entity agreement stating that the equityholder may only transfer an interest in the entity to a family member, then a family member may be willing to pay a higher price as a willing buyer then a nonfamily member.

The willing buyer, willing seller test is an objective one and does not presume that a particular individual is the willing buyer. See Steinberg TC Memo 1983-354, affirmed Pulte Home Corp (1985) 56 AFTR 2d 85-5878. Kerr (1999) 113 TC 449 affirmed (2002, CA5) 89AFTR 2d 2002-2838 held that the gift tax value of an interest in two family limited partnerships was equal to the price that a hypothetical willing buyer would pay for the interest. The taxpayer had argued that the hypothetical willing buyer should be assumed to be an outsider who had approached the purchase of the interests with the understanding that he could only buy an assignee interest and there would be no guaranty of admission as a limited partner. However, the Tax Court rejected the taxpayers' "attempt to expand" the Regulations beyond their intended scope by using a provision to redefine the character of the property interests in question as assignee interests. Similarly, see Tanenblatt TC Memo 2013-263.

Difference In Qualification For Discounts Between Gifts And Estates. Example 1-1: Mom owns all 100 shares of stock in X corporation. X corporation has $100x in assets. Thus, the net asset value of one share of stock is $1x. Mom sells one share to child. Although the one share had a net asset value of $1x, it is possible that the fair market value of that share for gift tax purposes is less than $1 because of potential valuation discounts. On the other hand, if Mom dies owning all 100 shares, then there would be little or no valuation discount, because Mom owned all of the stock and thus had a right to liquidate the corporation. Before the enactment of §2703 in 1992, there were a number of cases involving buy-sell agreements that were intended to fix the price and terms that equity interests could be sold either through a crosspurchase arrangement between equitholders or through a redemption arrangement with the entity. In a family context, the often hidden agenda of the more wealthy senior family members was to use a buy-sell agreement to fix the price at which their equity interest would be sold, usually at death, at an unrealistically low price so as to transfer property to the natural objects of their bounty for less than full and adequate consideration. St. Louis County Bank V U.S. 674F.2d 1207 (8th Cir 1982) and Lauder v. Comr. T.C. Memo 1992 – 736.

II.
TYPES OF VALUATION DISCOUNTS IN FAMILY CONTROLLED ENTITIES.

Valuation discounts are based on factors which would tend to cause an otherwise willing buyer to become unwilling. The most common discounts are for lack of control and lack of marketability. A lack of control discount, sometimes referred to as a minority interest discount, applies when the interest being valued does not confer on the holder the right to exercise voting control over the decisions of the entity. The lack of marketability discount takes into account whether the interest may be permissibly transferred under the applicable agreements or organizational documents of the entity, and even if transferable, whether there is a ready market.

In some circumstances there may be a "key person discount" reflecting the fact that there is some person who is key to the value of the entity, and if that person for any reason ceases to be involved with the entity, then the value of the entity could decline.

III.
CHOICE OF ENTITY

A. PARTNERSHIP. Generally, not recommended. Under the Uniform Partnership Act as well as under the partnership laws of most states, a general partner's interest is usually fully transferable, and any restriction on the right to transfer would be a §2703 disregarded restriction. Further, general partners typically have the right to commit some act which would cause a liquidation of the partnership or a liquidation of the general partner's interest, thus giving the general partner a liquidation right, any restriction of which would be a §2704(b) applicable restriction.

B. LIMITED LIABILITY COMPANY (LLC). Taxed as a partnership under Subchapter K. May be preferable to a limited partnership since an LLC may be created with both voting units and nonvoting units. For example, an LLC may issue a few voting units and many nonvoting units. See Example 3-1 below. This is similar to the general partner – limited partner structure of a limited partnership, but without the complexity of having an entity serving as general partner and thus creating a two tier structure.

Example 3-1: Model Discount Family LLC. Mom and Dad contribute a family business and investment assets to newly created FLLC in exchange for four voting units and 9,996 nonvoting units, divided between them as follows:

MEMBER	VOTING UNITS	NONVOTING UNITS	TOTAL
Mom	2	4,998	5,000
Dad	2	4,998	5,000
Total	4	9,996	10,000

The voting units and nonvoting units have identical rights and obligations, except that the voting units have all voting rights and the nonvoting units have no voting rights. Mom and Dad create Daughter's Trust for their daughter and Son's Trust for their son. Mom and Dad then make a gift of cash to each of the Trusts. These Trusts are irrevocable and grantor to Mom and Dad for income tax purposes. Mom and Dad are Trustees of these Trusts, although certain Trustee's duties, such as making distribution decisions for reasons other than HEMS, are delegated to an Independent Trustee.

Dad then sells one voting unit to Daughter's Trust, and Mom sells one voting unit to Son's Trust for fair market value. Since each voting unit sold represents only a 0.01% interest in the net assets of the FLLC, the sales price would presumably be modest.

Following these sales, the ownership of the units would be as follows:

MEMBER	VOTING UNITS	NONVOTING UNITS	TOTAL

Mom	1	4,998	4,999
Dad	1	4,998	4,999
Daughter's Trust	1	0	1
Son's Trust	1	0	1
Total	4	9,996	10,000

Mom and Dad could then decide whether to make sales or gifts of nonvoting units to the Trusts, or do some combination of the two. If the FLLC Operating Agreement is properly drafted and if the necessary protocols are observed, then these sales/gifts should qualify for minority interest and marketability valuation discounts.

Assume that Dad dies with Mom surviving. Dad does not want to leave his one voting unit to Mom, since that would give Mom half of all outstanding voting units. The family could get greater minority interest and marketability discounts if Mom dies with 25% and not 50% of all voting units. Instead, Dad may leave his one remaining nonvoting unit to a Marital Trust for Mom and/or to a Bypass Trust, which would have Mom as the beneficiary. At Mom's death, any voting units owned by Mom's Marital Trust or by a Bypass Trust would not be aggregated for control purposes with the one voting unit owned by Mom. See Mellinger vs. Comr., 112 TC 26 (1999) and Nowell vs. Comr., TC Memo 1999-15. Again, if the Operating Agreement is properly drafted and all protocols are observed, then both the one voting unit and all nonvoting units owned in Dad's estate should qualify for a minority interest and marketability valuation discount.

At Mom's death, she would still own only one voting unit and a substantial number of nonvoting units. At Mom's death, because she would own only one voting unit out of four voting units, then her estate should qualify for a discount. Even if she is Trustee of a Marital Trust and/or a Bypass Trust and/or one or both of the Children's Trusts, the ownership of those voting units should not be aggregated with the voting units owned by her personally so as to prevent the minority interest discount.

C. LIMITED PARTNERSHIP. Most of the reported tax cases dealing with family entity valuation discounts have involved limited partnerships. The partnership tax regime under Subchapter K of the Code is straightforward. A disadvantage of limited partnerships is that there must be at least one general partner and one limited partner. Oftentimes, individual family members do not want to serve personally as general partner because a general partner has personal liability for partnership obligations, and because the death of a general partner may under state law create issues. The alternative is to form an entity to serve as general partner.

Creation of an entity to serve as general partner can create a two tier structure and another level of complexity.

D. S CORPORATION. Taxed under Subchapter S and not Subchapter K. S corporations are less flexible than LLCs and partnerships. For example, there are a number of requirements to qualify as an S corporation, and thus, there is always a risk of inadvertent termination. See Code §1361(b). Subchapter S does not permit an S corporation to step up the basis of its assets upon a transfer of S corporation stock, or upon the death of an S corporation shareholder, or upon a distribution such as §754, §734, and §743 do for partnerships and LLCs. In addition, distributions of appreciated property from an S corporation are taxable to the corporation and may be taxable to a shareholder if the value of the appreciated property exceeds the shareholder's outside basis in that shareholder's stock, whereas distributions to partners and LLC members are not taxable except to the extent that cash is distributed in excess of outside basis. S corporations do permit both voting and nonvoting stock. S corps are inferior to limited partnerships and LLCs as discount entities, but are used most often when the S corporation is already in existence and has been funded with family assets.

Example 3-2: A Discount Family S Corporation. This example would be similar to Example 3-1 for limited liability companies, described above. An S corporation may permissibly have separate classes of voting and nonvoting stock, so long as the only difference between them is voting rights. The Children's Trusts would be permissible shareholders, since they are grantor for income tax purposes. If they should cease to be grantor for any reason, then they would need to qualify as QSSTs or ESBTs. In the alternative, Mom and Dad could have created the Trusts as both grantor to themselves and to the beneficiaries. Then, if the Trusts cease to be grantor to Mom and Dad for any reason, then they would be grantor to the beneficiaries under §678.

Generally, rights and restrictions under buy-sell agreements, shareholders' agreements, redemption agreements, and so forth will not be deemed to create a second class of stock unless (i) the principle purpose of the agreement is to circumvent the one class of stock requirement and (ii) the purchase price of the stock subject to the agreement is significantly above or below the fair market value of the stock at the time the agreement is entered into. Thus, it would appear that if there is a shareholders' agreement that restricts the transfer of stock but does not fix a value for that stock to be purchased, then that would not create a second class of stock issue.

E. C CORPORATION. Generally, not recommended, seldom needed because of income tax at the corporate level, although the reduction in the C corporate tax rate to a flat 21% may incentivize some folks to use a C corporation in certain limited circumstances.

IV.
CIRCUMSTANCES THAT CAN DISQUALIFY A DISCOUNT ALTOGETHER.

Before we talk too much about maximizing discounts, we need to first make sure that the interests in our entity qualify for a discount. Since the late 1990's, the IRS has developed a series of arguments to not only minimize discounts but to avoid discounts altogether.

In the late 1990's, the Service issued seven TAMs in which the IRS asserted that the limited partnerships and the LLC in question should be disregarded altogether for estate and gift tax purposes based generally on a gift on formation theory. See TAMs 9842003, 9736004, 9735003, 9730004, 9725002, 9723009 and 9719006. Those TAMs were discredited by Church vs. U.S., 85 AFTR 2d 2000-742; (W.D.Tex.2000), affirmed 202 F.3d. 1290 (5th Cir. 2001); Strangi vs. Commissioner, 115 T.C. 478 (2000) affirmed in part and reversed in part Gulig vs. Comr., 293 F.3d 279 (5th Cir. 2002); and W.W. Jones II vs. Comr.

In Reichardt Estate vs. Comr., 114 T.C. 144(2000), the Government prevailed because the taxpayer did not observe the requisite formalities in the formation and operation of the entity.

There then ensued a long series of cases in which the Government relied on §2036(a)(1), usually arguing that the interests in the entity given, sold, or bequeathed should be included in the gross estate because of an implied agreement of retained enjoyment by the donor/seller/decedent. These cases are all fact intensive, and the taxpayer's success has generally been based on the bona fide sale for full consideration exception under §2036(a).

Most recently in Estate of Powell vs. Comr., 148 T.C. 18 (May 18, 2017), the Tax Court applied §2036(a)(2) to decedent's limited partnership interests. In Powell, the decedent had given her son a power of attorney pursuant to which the son contributed $10,000,000 of cash and marketable securities to an FLP in exchange for a 99% limited partner interest. The decedent's son and his brother contributed unsecured notes to the partnership in exchange for a 1% general partner interest. Immediately thereafter, the son holding the power of attorney transferred the 99% limited partner interest to a charitable lead annuity trust. The decedent died one week later. The fact pattern was obviously egregiously unfavorable to the taxpayer.

The Tax Court held that the $10,000,000 contributed to the FLP by the decedent through her attorney-in-fact son was includable in her estate under either §2036(a)(1) retained enjoyment of income or §2036(a)(2) retained "right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom".

The Tax Court takes this case an unnerving step beyond its decision in Strangi. In Strangi, the Tax Court discussed the Byrum case where the Supreme Court held that Mr. Byrum "did not have an unconstrained de facto power" to designate who was to enjoy the income from the trust property. The Tax Court held that in Strangi, "decedent's rights go beyond the management powers and influence at issue in Byrum…."

In Powell, however, the Court found that the decedent, who was only a limited partner, retained a §2036(a)(2) power to designate, which she held in conjunction with her sons who controlled the 1% general partner.

Perhaps the Court would have reached a different decision had the decedent been competent to make an independent decision to form and fund the FLP and to transfer the 99% limited partner interest. The fact that the son was wearing two hats, that of an attorney-in-fact on behalf of his limited partner mother and as controlling the general partner, was a bad fact.

This obviously makes it all the more important to create a bona fide sale for full consideration exception to §2036.

For a thorough discussion of these cases and the various theories and legal arguments in play, see Steve Akers' very thorough outline at www.bessemer.com/Advisor; John Porter's chart summarizing discounts that have been recognized in family limited partnership and LLC cases at www.bessemer.com/Advisor; and Louis Mezzullo BNA Tax Management Portfolios Family Limited Partnerships and Limited Liability Companies, BNA Portfolio 722-3rd and Transfers of Interests in Family Entities under Chapter 14: §2701, §2703 and §2704 BNA Portfolio 835-4th.

V.
CODE §2703 AND §2704(a) and (b) - HURDLES TO MAXIMIZING DISCOUNTS.

Even if the transfer of an interest (either during lifetime or at death) would otherwise qualify for a discount, overly restrictive provisions in the agreement might be ignored in determining the amount of the discount.

A. §2704(A) LAPSE OF A VOTING RIGHT OR LIQUIDATION RIGHT.

Code §2704(a) addresses the treatment of lapsed voting or liquidation rights.

Reg §25.2704-1(a) "Lapse treated as Transfer - (1) In General – The lapse of a…liquidation right in a corporation or a partnership is a transfer by the individual…holding the right ….this section applies only if the entity is controlled by the holder and members of the holder's family immediately before and after the lapse….if the lapse of…a liquidation right occurs during the holder's lifetime, the lapse is a transfer by gift. If the lapse occurs at the holder's death, the lapse is a transfer includable in the holder's gross estate.

Reg §25.2704-1(a)(2)(v): "A liquidation right means a right or ability to compel the entity to acquire all or a portion of the holder's equity interest in the entity including by

reason of aggregate voting power, whether or not an exercise would result in the complete liquidation of the entity."

<u>**Reg §25.2704-1(d):**</u> **"The amount of the transfer is the excess, if any, of…. The value of all interests in the entity owned immediately before the lapse (also apply to the ability of an equityholder in the entity to compel the entity to acquire the equityholder's interest in the entity?)"**

How can §2704(a) be avoided? Since most such lapses are man-made, then don't draft any entity documents/agreements which permit a lapse.

What about lapses that occur by statute? Reg §25.2704-1(a)(4) provides: **A voting right or a liquidation right may be conferred by and may lapse by reason of a State Law, the corporate charter or bylaws, an agreement, or other means.** Does this mean that if the lapse of a voting right or liquidation right occurs because of state law, which the taxpayer has no control over, and not under the man-made entity documents which the taxpayer may have control over, there is nevertheless a taxable transfer? For LLCs and corporations, there should be no applicable state statutes which create a situation where a §2704(a) lapse will occur. (Consider in our Example 1-1 when Mom sells one voting unit to Daughter's Trust for fair market value, this should not be a lapse since the voting rights associated with voting unit do not lapse. Contrast this to a transfer of one voting unit by Mom to Daughter's Trust with a provision in the operating agreement that provides that upon transfer the voting unit is converted to a nonvoting unit.) It is conceivable that a lapse of a voting right or liquidation right could occur in a limited partnership situation if state law provided that if a general partner transfers a general partner interest, the transferee becomes a limited partner. However, this would be a lapse created by state law.

The Regs at §25.2704-1(f) contain nine Example 9 appears to describe a lapse that occurs because of state law and not a man-made document.

If you look at Example 3-2 above, if Mom owns all 100 shares of X corporation and dies, she has a liquidation right. There will not be any valuation discount on Mom's death owning 100 shares. However, Mom can make a gift of 30 shares to Child 1 and 30 shares to Child 2 leaving Mom with 40 shares and no liquidation right. §2704(a) does not apply to those gifts because the voting rights with respect to the corporation are not restricted or eliminated by reason of the transfer. See Reg §25.2704-1(f) Example 4.

B. <u>§2704(B) APPLICABLE RESTRICTIONS</u>. For a further discussion of applicable restrictions and some suggested entity agreement language as to the right to withdraw and put rights, see VI.B below, as to the right to cause dissolution of the entity, see VI.C. below, and as to concentrated voting control, see VI.H. below.

Definition and Consequences of an Applicable Restriction. **Code §2704(b): "if (A) there is a transfer of an interest in a corporation or partnership to…a member of the transferor's family, and (B) the transferee and the members of the transferor's family hold…control of the entity… any applicable restriction shall be disregarded in determining**

the value of the transferred interest... the term applicable restriction means any restriction. …which effectively limits the ability of the corporation or partnership to liquidate….”

The Regs expand on the Code definition as follows: “**An applicable restriction is a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under state law generally applicable to the entity in the absence of the restriction….If an applicable restriction is disregarded under this section, the transferred interest is valued as if the restriction does not exist and as if the rights of the transferor are determined under the state law that would apply but for the restriction.” Reg §25.2704-2(b) and (c).**

Is it an applicable restriction if the entity agreement prohibits an equityholder from withdrawing from the entity? Note that the Regs expand on the Code definition of applicable restriction by providing that an applicable restriction is a limitation on the ability to liquidate the entity “(in whole or in part)”. Does “in whole or in part” expand the definition of applicable restriction to include not only a restriction on the ability to liquidate the entity but also on the ability of an equityholder in the entity to cause the entity to acquire all or a portion of the equityholder’s interest in the entity, tantamount to a put right? Note that under Reg §25.2704-1(a)(2)(v), dealing with lapses of liquidation rights, a liquidation right is defined as the right to compel the entity to acquire all or a portion of the equityholder’s interest in the entity. This is in effect a put right. However, the Regs at §25.2704-2 relating to applicable restrictions do not contain this language. If a §2704(b) applicable restriction was intended to apply to the right of an equityholder to compel the entity to acquire the equityholder’s interest in the entity, then why would §2704(b) and/or the Regs thereunder not expressly state this intention as §2704(a) does?

The IRS’ position is that an applicable restriction includes a restriction on the right of an equityholder to require the entity to liquidate the equityholder’s interest. See TAM 9735003. In that TAM, the IRS considered a partnership agreement which provided, “No limited partner shall have a right to withdraw voluntarily from the partnership….”. Under applicable Massachusetts state law, the default rule was that a limited partner may withdraw upon six months prior notice to the general partner. Then, without discussion, the TAM concludes that the prohibition on withdrawal in the partnership agreement is an applicable restriction.

However, the case law does not support the IRS’ position. In Knight vs. Comr., 115 TC 506 (2000), the limited partnership agreement prohibited withdrawal by a limited partner. The IRS contended that this was an applicable restriction under Texas law. The Tax Court noted: “An ‘applicable restriction’ is a provision that limits the ability of the partnership or a corporation to liquidate….”. The Court noted that under Texas law, a limited partner may withdraw from a partnership without requiring the dissolution or liquidation of the partnership which gives a limited partner the right to withdraw upon six months notice. The Court held that no applicable restriction existed.

Shortly after the Knight decision, the Tax Court decided W.W. Jones II vs. Comr., 116 TC 121 (2001). In Jones, the partnership agreement prohibited a limited partner from withdrawing. The IRS again argued that this was an applicable restriction, since governing Texas law permitted a limited partner to withdraw on six months notice to the general partner.

The Tax Court in part held: "Respondent's reliance on [the Texas statute giving the limited partner a right to withdraw] is misplaced. [Texas law] governs the withdrawal of a limited partner from the partnership – not the liquidation of the partnership. In this regard, we conclude that [Texas law] is not a 'limitation on the ability to liquidate the entity' within the meaning of §25.2704-2(b), Gift Tax Regs." The Court also cited Harper vs. Comr., T.C. Memo 2000-202 and Kerr, 292 F3rd 490 (2002).

Therefore, since withdrawal doesn't trigger dissolution or liquidation, then prohibition of the withdrawal by a limited partner is not an applicable restriction. Although it is not entirely clear, it would seem that the position of the Tax Court is that if the withdrawal by a limited partner could cause a dissolution of the partnership, then restrictions on the right to withdraw that are more restrictive than state law would be applicable restrictions. In a state where the withdrawal by a limited partner does not trigger dissolution, then there is no applicable restriction.

However, consider the following example found at Reg §25.2704-2(d).

Example 5: D owns 60 percent of the preferred and 70 percent of the common stock in Corporation X. The remaining stock is owned by individuals unrelated to D. The preferred stock carries a put right that cannot be exercised until 1999. In 1995, D transfers the common stock to D's child in a transfer that is subject to §2701. The restriction on D's right to liquidate is an applicable restriction that is disregarded in determining the amount of the gift under §2701.

Example 5 seems to be wrong on two counts. First, it equates D's put right to a right to liquidate the corporation in whole or in part. Perhaps the fact that D owned 60% of the preferred stock would result in a partial liquidation of the corporation if she exercised her put right with respect to the preferred stock. We don't have those facts, but presumably Example 5 stands for the proposition that a §2704(b) liquidation right includes a put right.

Second, a restriction on D's ability to exercise the put right that is more restrictive than state law presumes that state law provides D with a put right in the first place. Otherwise, how could this restriction on D's put right be more restrictive than state law? Presumably, state law does not grant D a put right, so this restriction on the exercise of the put right cannot be more restrictive than state law.

Applicable Restrictions as to LLCs in Oklahoma. As for the right to cause dissolution, in Oklahoma under 18 OS §2037A.3, the unanimous vote of all members is required to dissolve the LLC unless the LLC operating agreement provides otherwise. Thus, in Oklahoma, a provision in the operating agreement requiring the unanimous vote of all members to dissolve would not be an applicable restriction.

As for the right to withdraw, under the prevailing case law discussed above, a restriction on the right of an equityholder to withdraw from the entity and exercise a put right back to the entity should not be an applicable restriction. The withdrawal by a member does not cause dissolution of the LLC. If the withdrawal of a member does not cause the dissolution of the LLC, then how can the restriction on a member's right to withdraw be an applicable restriction on the member's right to liquidate the entity (unless the right of a member to withdraw is defined to include the member's ability to liquidate the entity "in whole or in part")?

Applicable Restrictions As To Corporations in Oklahoma. As for the right to cause dissolution, in Oklahoma, under the General Corporation Act, the default rule is that dissolution must be approved by the board of directors and by a majority vote of the shareholders, or in the alternative, by the unanimous vote of the shareholders. See 18 OS §1096. Thus, it would not be an applicable restriction if the man-made corporate documents tracked the language of the statute.

As for the right to withdrawal, shareholders do not have a statutory right to voluntarily withdraw and compel the corporation to acquire their stock. Thus, in Oklahoma, a provision in the man-made documents prohibiting withdrawal by a shareholder or requiring unanimous consent of the shareholders for the withdrawal by a shareholder would not be an applicable restriction.

Applicable Restrictions As To Limited Partnerships in Oklahoma. As for the right to cause dissolution, the default rule for limited partnerships in Oklahoma is that dissolution must be approved by the general partner and by a majority vote of the limited partners. Thus, a requirement that all partners consent to dissolution would be an applicable restriction. However, it would not be an applicable restriction if the limited partnership agreement merely tracked the language of the statute.

As for the right to withdraw, the default rule in Oklahoma is that limited partners do not have a right to withdraw, but they do have the right to dissociate. Therefore, a prohibition in the partnership agreement against withdrawal by a limited partner would not be an applicable restriction.

Consider the situation where there is one general partner who also owns a majority of the limited partner interests. In that event, the general partner could withdraw as the general partner and then as the majority limited partner refuse to consent to the continuation of the partnership, although the withdrawal of the general partner caused the event of dissolution. Due to the complexity of state law regarding the consequences if a general partner withdraws or if some event of dissociation occurs with respect to the general partner. In the alternative, the better practice may be to have an entity rather than as an individual serve as general partner and that a general partner not own limited partner interests. This problem does not exist with LLCs.

C. §2703 DISREGARDED RESTRICTIONS ON FIXING A PRICE AND ON THE RIGHT TO SELL AN INTEREST IN AN ENTITY. For further discussion of certain rights and disregarded restrictions and suggested entity agreement language, see VI.A. below.

Code §2703(a): "the value of any property shall be determined without regard to…(1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right), or (2) any restriction on the right to sell or use such property."

Code §2703(b): "Subsection (a) shall not apply to any option, agreement, right, or restriction which meets each of the following requirements: (1) is a bona fide business arrangement. (2) It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration…(3) Its terms are comparable to similar arrangements entered into by persons in an arm's length transaction.

Note the distinction between §2704(b) applicable restrictions and §2703 disregarded restrictions. Under §2704(b), a restriction will be disregarded only if it is more restrictive than under applicable state law. On the other hand, §2703 would appear to disregard a restriction, even though the restriction is not more restrictive than under state law.

Is it possible that §2703 would operate to disregard a state statute which says that an interest is not transferable? For example, suppose state law provides that an interest in the entity is not transferable. The entity agreement also provides that the interest is not transferable. §2703 would appear to operate to disregard the provision in the entity agreement which says that the interest is not transferable. However, wouldn't state law still operate to provide that the interest is not transferable, so that the disregard of the provision in the entity agreement would be of no consequence? Reg §25.2703-1(a)(3) provides: **"A right or restriction may be contained in the partnership agreement, articles of incorporation, corporate bylaws, a shareholders' agreement, or any other agreement…." Thus, §2703 should not operate to disregard a state statute.**

1. Price-Fixing Provisions Are Not Useful. There have been numerous cases where parties have attempted to fix the value of an interest in an entity by establishing a fixed price or some methodology or other objective standard for setting the price at which an interest in the entity must be sold upon the occurrence of some event.

For example, Mom may enter into a buy-sell agreement with her two children which provides that upon the first of them to die, the entity will purchase the deceased person's interest at book value, which under the circumstances is clearly below market.

Case law prior to the enactment of §2703 generally provided that in order for these types of buy-sell agreements to be valid to fix value, the agreement must be binding on all parties to sell in the event of the death of a party, and the agreement must be a bona fide business arrangement and not a device to pass the interest to the children for less than full and adequate consideration. For example, see St. Louis County Bank vs. U.S. 674 F2d 1207 (8th Cir. 1982) and Lauder Estate vs. Comr., TC Memo 1992-736. In that regard, as far as fixing the price in buy-sell agreements, §2703 pretty much codified prior law.

It is submitted that trying to fix the value of an interest in an entity in a buy-sell agreement is a clumsy way to achieve a discount. Discounts can be better achieved by not trying to fix a price but instead by depressing value through enhancing discounts.

Since the enactment of §2703, the cases involving agreements apparently intended to set a below market price seem to generally concede that the agreement in question operates to set a below market price but the inquiry in the case is whether that agreement is within the §2703(b) statutory exceptions.

In Sidney E. Smith V. U.S. (2004 W.D.PA 2004) 94 AFTR 2d 2004-5283, 2004-2 USTC ¶60,488, the Court in what it called a case of first impression addressed a provision in a family limited partnership (FLP) agreement that limited the price and terms upon which the FLP would be required to pay a partner for the limited partner's partnership interest in the FLP if the FLP exercised its right of first refusal. The taxpayer argued that §2703(a) does not apply to a restrictive provision in the FLP agreement because §2703 pertains solely to buy-sell agreements and not too restrictive provisions in "entity-creating partnership agreements." The taxpayer argued that §2703 was enacted to challenge buy-sell agreements that create the right of a buyer to purchase an equity interest at a bargain price and not to partnerships validly created under state law. The Court rejected the taxpayer's argument and said that Reg §25.2703-1(a)(3) makes it clear that the restrictive provision in the FLP is the kind of restriction to which §2703(a) was intended to apply. Note that the summary judgment in Smith did not necessarily mean that the restrictions in the FLP agreement had to be disregarded in valuing the equity interest in the FLP. The Court recognized that there was a possibility that the provision could qualify for the "safe harbor" exception of §2703(b).

In Strangi TC Memo 2003-145, the Court said that the Government correctly argued that according to the plain language of the Code and Regs, §2703(a) was not aimed just at independent buy-sell agreements and could apply to restrictive provisions contained within the partnership agreements.

2. What is a "Restriction on the Right to Sell Property? This language raises a number of questions. What if the universe of permissible buyers under the agreement is limited to a certain class of persons? What if the interest in an entity being sold to a buyer will automatically convert to a different kind of interest, such as from voting to nonvoting, or such as from general partner to limited partner? What if the property is subject to a right of first refusal? See the discussion at VI.A. below.

The better practice is to try to avoid §2703 altogether and not try to rely on the statutory exceptions. Except for rare cases such as Amlie Estate, T.C. Memo 2006-76, which had a unique fact situation, compliance with the statutory exceptions can be rigorous.

VI.
TYPICAL PROVISIONS IN FAMILY ENTITY AGREEMENTS THAT CAN CREATE AND/OR MAXIMIZE VALUATION DISCOUNTS.

Formation documents, partnership agreements for limited partnerships, operating agreements for LLCs, and shareholders' agreements and bylaws for corporations can include provisions which can increase valuation discounts. Here are some examples:

A. TRANSFER RESTRICTIONS. (Also see the discussion at Section V.C. above). Most entity man-made documents place some restrictions on the power of an equityholder to transfer an interest in the entity. It is believed that greater restrictions on the transferability of interests will result in commensurately greater marketability discounts, because such restrictions would tend to make a willing buyer offer to pay less for an interest that has restrictions on transferability. Restrictions on transferability would generally not be subject to §2704(a) lapse of liquidation or voting rights or §2704(b) applicable restrictions. However, they would certainly be subject to §2703.

1. Types of Transfer Restrictions. One common type of transfer restriction is to limit the persons or class of persons to whom transfers can be made. For example, perhaps transfers may only be made to certain family members. Or, transfers may only be made to existing equityholders. Or, transfers may not be made to persons in a competitive business. Or, for a professional entity, transfers may not be made to anyone who is not a licensed professional in the applicable profession.

Another common type of transfer restriction is to require that the transfer be subject to approval. For LLCs, approval might be required by a majority vote, or a supermajority vote, or unanimous vote of the members, or by the managers, or some combination thereof. With limited partnerships, approval might be required by a combination of the general partner and limited partners. For corporations, approval might be required by some combination of the board of directors and the shareholders.

2. Scope of §2703 Limited to Sales? Reg §25.2703-1(2)(ii) says that a §2703 restriction is: "any restriction on the right to sell or use the property." Why is the term "sell" used here? Why was the term, "transfer", not used here as it is in §2701, §2702, §2704(b), and in numerous other places in the Code relating to estate and gift tax, such as §2036, §2037, and §2038? Does the term "sell" mean a sale for full and adequate consideration? Literally, it does not include a gift and perhaps may not include a bargain sale at below fair market value. Could the entity agreement permit a sale, but then require that any sale at below fair market value or any gift must be approved by the entity and/or other equityholders?

3. §2703 as to LLCs in Oklahoma. In Oklahoma, under 18 OS §2033, unless otherwise provided in an operating agreement, an LLC membership interest is not transferable. However, "a member may assign the capital interest associated with a membership interest". This capital interest is sometimes referred to as an assignee interest. The assignee is entitled to share in profits, losses, and distributions but does not have any right to "participate in the management and affairs of the limited liability company or to exercise any rights or powers of a member." The statute at 18 OS §2035 provides that unless the operating agreement provides otherwise, the assignee may not become a member unless "the members representing a majority of the profits which are not the subject of the assignment consent in writing."

What is noteworthy under the Oklahoma statute is this: The statute does not state that a member may transfer a membership interest in which event the transferee will become the holder of a capital or assignee interest. The statute flatly says that unless the operating agreement provides otherwise, a member may only assign a capital interest and may not assign a membership interest. The difference may be critical in valuing the capital interest. See, D. Creating An Assignee Interest, below. Under the Oklahoma statute, unless otherwise provided in the operating agreement, the transferor cannot transfer the membership interest but can only transfer a capital interest, and thus that capital interest must be the interest that is subject to valuation.

Here is a provision for inclusion in the operating agreement:

(a) As provided for in 18 OS §2033, a member shall not have the right to transfer a membership interest. This language appears to be within §2703 and thus may be disregarded. However, §2703 should not operate to disregard state law, and 18 OS §2033 does prohibit the transfer of a membership interest.

If you believe that Reg §25.2703-1(2)(ii) applies literally to a sale and not a transfer other than a sale, then consider the following language:

(b) A member may sell a capital interest associated with the member's membership interest in the LLC for full and adequate consideration. However, a transfer of a capital interest for less than full and adequate consideration, including a gift, must be approved by a majority/supermajority/unanimous consent of the Members.

If §25.2703-1(2)(ii) is restricted to a sale by its literal terms and not to any other type of transfer, then this will work. If it is determined that the term "sell" in the Regs includes any type of transfer, then the second sentence of this provision will be disregarded. In that event, there is no real downside, since the member is still limited to transferring only a capital interest, and as provided for in suggested language below, the assignee will not become a member without unanimous approval of all other members.

What if the operating agreement is silent as to transferability? Then, the default rule is the Oklahoma statute at 18 OS §2033, which provides that the membership interest is not transferable, but a member may transfer the capital interest associated with that membership interest, and the assignee will have a capital interest or an assignee interest. Thus, the operating agreement may, but need not, provide for this rule, since it is the default rule by statute.

This highlights a distinction between §2704(b) applicable restrictions and §2703. §2704(b) permits a restriction on the right to liquidate that is more restrictive than under state law. §2703 prohibits any restriction on the right to sell property, even if that restriction is no more restrictive than under state law. Under Oklahoma law, the default rule is that a membership interest is not transferable. If we provide in the operating agreement that a membership interest is not transferable, then this rule may be disregarded under §2703, although it will be the default rule in Oklahoma. Thus, in Oklahoma we might provide something as follows:

(c) The right to transfer a membership interest in the LLC and the right to transfer a capital interest associated with a membership interest shall be governed by 18 OS §2033.

Thus, even if this provision is disregarded under §2703, the default rule in 18 OS §2033 would still apply to impose the restriction.

Also consider:

(d) If a member transfers a capital interest in the LLC as may be permitted herein, then the assignee shall only have those rights as the holder of a capital interest as set forth in 18 OS §2033.

Question whether the transfer of a membership interest that has voting rights to a transferee who under applicable law will be treated as owning a capital interest with no voting rights unless admitted to the LLC as a member would be a §2704(a) lapse of a voting right. See the discussion in V.A. above, where we observed that the lapse of a voting right under §2704(a) should only apply to lapses under man-made entity documents and not by statute. On the other hand, a transfer of a nonvoting interest in an LLC would avoid the issue altogether since the nonvoting interest has no voting right. Consider the following provision:

(e) Any permitted assignee of a capital interest associated with a membership interest may become a member but only with the unanimous approval of all other members. This requirement is more restrictive than 18 OS §2035, which only requires approval of members representing a majority of the profits. But, does that matter? Requiring unanimous approval to admit an assignee as a member should not be a disregarded §2703 restriction, since it is not a restriction on the right to sell the interest. This provision only affects the status of the assignee. None of the reported cases dealing with §2703 have given any indication that the Government is taking the position that requiring unanimous approval to admit an assignee as a member would be a §2703 restriction.

It is likely that a willing buyer would be less willing to buy an interest in the LLC if the buyer could only buy an assignee interest and could not be a full member without unanimous consent of all members. See D below.

Question whether the transfer of an LLC interest which results in the transferee merely being an assignee holding a capital interest with no voting rights is a §2704(a) lapse of a voting right. See the discussion at V.A. above.

<u>§2703 as to Limited Partnerships in Oklahoma</u>. Just as in the case of transfers of LLC interests, Oklahoma law provides in 54 OS §500-702A that unless the limited partnership agreement provides otherwise, a limited partner may transfer the limited partner's "transferable interest" in the limited partner interest thus, similar to the statute with LLCs, it appears that a limited partner in Oklahoma may not transfer a limited partner interest, but may transfer the "transferable interest", whatever that is, with respect to the limited partner interest. Any such transfer does not cause the partner's dissociation or a dissolution. However, the transferee has an assignee interest and is not entitled "to participate in the management or conduct of the limited partnership's activities, to require access to information concerning a limited partnerships transactions…, or to inspect or copy the required information or the limited partnership's other records." The assignee is only entitled to share in distributions and upon dissolution an account

of the limited partnership's transactions from the date of dissolution. Otherwise, the transferee will only have an assignee interest.

The Oklahoma Limited Partnership Act does not provide for how the holder of an assignee interest can become a limited partner. It is suggested that the limited partnership agreement should provide that an assignee can only become a limited partner with the unanimous consent of the general partner and all limited partners. This is similar to how an assignee of an LLC membership interest might become a full member as provided for above.

In drafting transferability provisions in the limited partnership agreement, one might include two parallel restrictions on transferability as set forth for LLCs in paragraph 3.(a) and (b) above. The first restriction would restrict any transfer other than a sale. This is based on the assumption that §2703(a) only permits a sale and does not permit a transfer for less than full and adequate consideration. It would read as follows:

A limited partner may sell the limited partner's transferable interest in the Partnership for full and adequate consideration, in which event the buyer will have the rights as an assignee only. However, a transfer of a limited partner's transferable interest for less than full and adequate consideration, including a gift, must be approved by the general partner and a majority/supermajority/unanimous consent of the limited partners.

Question whether the transfer of a limited partner interest which results in the transferee being merely an assignee with no voting rights is a §2704(a) lapse of a voting right. See the discussion at V.A above.

<u>§2703 As to Corporations in Oklahoma.</u> Consider the following:

A shareholder may sell stock in the corporation for full and adequate consideration. However, a transfer for less than full and adequate consideration, including a gift, must be approved by the board of directors and a majority/supermajority/unanimous consent of the shareholders. If it is determined that §2703 applies to any transfer, whether a sale or a transfer for less than full and adequate consideration, this restriction will be ignored. However, there is no other downside.

Nothing in the Oklahoma statutes restricts the transferability of shares of stock in a corporation. However, it would seem that the corporation organizational documents (articles, bylaws, shareholders' Agreement, etc.) could provide that, perhaps with some exceptions, any stock transferred to a transferee would become nonvoting. That would be a §2704(a) lapse, but so what. This would make a buyer less willing to buy stock but would not be a §2703 restriction on a shareholder's right to sell stock.

Consider the following restriction, which is not a restriction on the right to sell the stock:

The transferee of any stock in the Corporation shall have no voting rights with respect to the transferred stock nor shall the shareholder have any other rights as a

shareholder under the General Corporation Act without the consent of the Board of Directors and all the other shareholders.

B. <u>WITHDRAWAL RIGHTS AND PUT RIGHTS</u>**.** A willing buyer would certainly be more willing to acquire an interest in an entity if the buyer were able to voluntarily withdraw from the entity and compel the entity to pay fair value for that equityholder's interest. One must distinguish the right to withdraw verses a put right. The LLC and limited partnership statutes of many states give a member or a limited partner, as the case may be, a right to withdraw, in which event the member or limited partner will have only an assignee interest. However, states do not typically give a withdrawing member or a limited partner a put right, that is, the right to compel the LLC or limited partnership to pay fair value for the withdrawing equityholder's interest in the entity.

Withdrawal rights and put rights are not subject to §2704(a) or §2703. However, as discussed in Section V.B., above, apparently it is the IRS' position that a restriction on the power of an equityholder to withdraw from the entity is a §2703 applicable restriction. Reg §25.2704-2(d), Example 5 appears to take that position as well, but that may be inadvertent. However, the cases cited in Section V.B. clearly reject the IRS' position.

Reg §25.2704-2 provides that an "applicable restriction" will be disregarded in determining the value of an interest. An applicable restriction is a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under state law…in the absence of the restriction. As discussed above at V.B, so long as the withdrawal of an equityholder from the entity does not trigger dissolution of the entity under state law, then the restriction on the ability of an equityholder to withdraw should not be an applicable restriction, since it is not a restriction on the right to cause liquidation of the entity. If a restriction on the right to withdraw is not an applicable restriction under §2704(b), then the entity agreement can flatly prohibit withdrawal. If such a right to withdraw is covered by the applicable restriction rules, then resort would need to be made to applicable state law to determine what rights an equityholder has to withdraw. In states that do not permit withdrawal or that permit withdrawal with only unanimous approval, then this is not an issue, since the entity agreement can merely mirror state law.

<u>As For LLCs in Oklahoma.</u> In Oklahoma, under 18 OS §2036. A member has the power to withdraw as a member at any time, rightfully or wrongfully. "A withdrawal is wrongful if the operating agreement does not specifically grant to the member a right to withdraw….the wrongful withdrawal shall constitute a breach of the operating agreement and the limited liability company may recover from the withdrawing member damages….". However, if a member does withdraw, then under 18 OS §2036, unless the operating agreement provides otherwise, the withdrawing member shall be deemed to be "an assignee with right to the interest."

There are two options here. First, if you believe the IRS' position that restrictions on withdrawal are applicable restrictions on the right to liquidate the entity, then the operating agreement may merely track state law and provide that a member has the right to withdraw, in which event that member will have an assignee interest, all as provided under 18 OS §2036. On the other hand, if you believe the prevailing case law that prohibition on withdrawal is not a restriction on the right to liquidate the entity, then the operating agreement can flatly prohibit withdrawal, and if a member wrongfully withdraws, this will be a breach of the operating agreement.

Based on what we believe to be the better view, that is, a prohibition on the right to withdraw is not an applicable restriction on the right to liquidate an entity, then consider the following language for the operating agreement:

A member shall not have the right to withdraw as a member. Any purported attempt by a member to withdraw or resign from the member's managerial duties is a breach of this operating agreement, and the LLC may recover from the withdrawing member all damages permitted by 18 OS §2036 and any other damages permitted by law.

As To Limited Partnerships in Oklahoma. A limited partner does not have the right withdraw and receive the value of that limited partner's interest. 54 OS §500-601A states, if the partnership has notice of a limited partner's express will to withdraw, then the limited partner will become dissociated. A dissociated limited partner will then hold that person's interest in the limited partnership as a transferee and is not entitled to be paid fair value for that interest. Thus, contrary to the law in Oklahoma for LLCs under 18 OS §2036, the limited partnership agreement cannot provide that a dissociating limited partner will be in breach of the limited partnership agreement. On the other hand, it is submitted that the right of a limited partner to withdraw and become a dissociated limited partner is something that a limited partner would not necessarily want to do, and the right of a limited partner to become a dissociated limited partner would be of little value to a willing buyer of a limited partner interest.

Thus, the limited partnership agreement might merely track the language of the statute. Further, the limited partnership agreement could provide that a dissociated limited partner can only be reinstated as a limited partner with the consent of the general partner and all other limited partners. This should not be an applicable restriction since it is not a restriction on the right of the limited partner to liquidate the partnership.

Consider the following language in a limited partnership agreement:

If a limited partner gives 30 days notice to the general partner of the limited partner's will to withdraw, then the limited partner will become dissociated. A dissociated limited partner will only have those rights granted to a dissociated limited partner under 54 OS §500-601A. A dissociated limited partner may be reinstated as a limited partner only with the consent of the general partner and all other limited partners.

C. RIGHT TO CAUSE LIQUIDATION OF THE ENTITY. A willing buyer would be inclined to pay less for an interest in an entity if that buyer were unable to require dissolution of the entity. A restriction on the right to require dissolution of the entity is not subject to §2703 or

§2704(a), but is subject to §2704(b), which provides that any applicable restriction will be disregarded. An applicable restriction is a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the restrictions that would apply under state law. Question whether an applicable restriction applies not only to the ability to liquidate the entity or whether it also applies to any restriction on the ability of an equityholder to put his interest to the entity. See paragraph VI.B., above, regarding discussion of and suggested provisions for Withdrawal Rights and Put Rights. This paragraph VI.C., will address only rights of an equityholder to liquidate the entity.

Generally, an interest in an entity that allows a decedent who owns that interest to cause dissolution of the entity will not be subject to a significant discount. In determining whether the person has the right to require dissolution of the entity will be determined without regard to any applicable restriction, meaning any restriction on the person's ability to liquidate the entity that is more restrictive than state law.

As to LLCs in Oklahoma. In Oklahoma, the default rule for LLCs under 18 OS §2037A.3 is that the unanimous vote of all members is required to dissolve the LLC. So, in Oklahoma, if the operating agreement requires unanimous consent for dissolution, this would not be a §2704(b) applicable restriction. Thus, consider the following language for an Oklahoma LLC operating agreement:

Unless otherwise required by law, the LLC may not be dissolved without the unanimous vote of all members to dissolve.

In a state where dissolution of an LLC is permissible with a majority vote of the members, then a provision in the operating agreement requiring unanimous consent to dissolve would be an applicable restriction.

As To Limited Partnerships in Oklahoma. In Oklahoma, under 54 §500-801A, the default rule for dissolution requires the consent of all general partners and the consent of limited partners owning a majority of the rights to receive distributions as limited partners. Therefore, any restriction on dissolution more restrictive than this would be an applicable restriction under §2704(b) and would be disregarded.

In some states, removal of a general partner can trigger events leading to dissolution. In Oklahoma, however, there is no express right of the limited partners to remove the general partner. However, 54 §500-603A describes events which can cause the dissociation of a general partner. Generally, the statute requires that the general partner may be dissociated voluntarily, or for certain kind of cause, or under some triggering event. See 18 OS§500-603A. If a general partner is dissociated, then under 54 §500-801A, dissolution will occur (A) if the partnership has at least one remaining general partner, and a consent to dissolve the limited partnership is given within 90 days after dissociation by partners owning a majority of the rights to receive distributions or (B) if the partnership does not have a remaining general partner, the passage of 90 days after the dissociation unless limited partners owning a majority of the right to receive distribution consent to continue the partnership and admit at least one additional general partner. So, in Oklahoma, if a person serves as general partner or owns a majority of any entity that serves as general partner and if that person also owns a majority of the rights to receive distributions as limited partners, then that person could cause an event of dissociation to occur as general partner and then as limited partner refuse to consent to continuation of the partnership, in which event the partnership would be dissolved. Thus, in Oklahoma and in other states with the same statutory regime, a person should not be or control the general partner and also own a majority of the limited partner interest. Perhaps a general partner could be an entity, and the owners of the entity might own general partner interests separately. Another alternative might be to have two general partners in a situation where if one general partner withdraws or has an event of dissociation, the limited partnership will continue with the remaining general partner. However, if state law does not provide for continuation of the limited partnership if one general partner withdraws with another general partner remaining, then this could be an applicable restriction.

As To Corporations in Oklahoma. As to corporations, the default rule in Oklahoma is that dissolution must be approved by the board of directors and by a majority of the shareholders. See 18 OS §1096. Thus, a corporation requirement for dissolution may not be more restrictive than board and majority shareholder approval.

Perpetual Terms. In addition to restricting the right to dissolve, the man-made instruments of the entity should provide for the longest term permitted by law. In Oklahoma, as well as in many other states, a perpetual term is permitted for LLCs, limited partnerships, and corporations. For LLCs and partnerships, this would not be an applicable restriction, since it is not more restrictive than under state law. See Knight vs. Comr., 115 TC 506 (2000), and Kerr vs. Comr., 113 TC 449 (1999).

D. CREATING AN ASSIGNEE INTEREST.

We observed that the IRS' position is that a restriction on the ability of an equityholder to withdraw from the entity is subject to the applicable restriction rules, although case law says that the right to withdrawal from an entity is not an applicable restriction unless the withdraw would cause a dissolution of the entity.

Two questions: First, a member/limited partner transfers a membership interest/limited partner interest during lifetime or at death and the transferee does not become a member/limited partner but only holds the rights of an assignee, for estate tax/gift tax purposes, should the interest be valued as a membership interest/limited partner interest? Or, should the interest be valued as an assignee interest associated with the membership/limited partner interest?

Second, will the membership/limited partner interest be more valuable than the assignee interest?

1. How are assignee interests created?

In Oklahoma, as for LLCs, 18 OS §2033 provides that a membership interest is not transferrable, although a member may assign the capital interest associated with the membership interest. This applies to both lifetime and testamentary transfers. It is noteworthy that the statute does not provide that a member may transfer a membership interest and the assignee of that interest becomes an assignee. Instead, the statute says that the member may only transfer a capital interest. Thus, it should be a capital interest that is subject to valuation.

If a member of an LLC in Oklahoma withdraws under 18 OS §2036, the withdrawing member shall be deemed to be an assignee or the holder of a capital interest.

For limited partnerships in Oklahoma, 54 OS §500-702A provides that "the only interest of a partner which is transferable is the partner's transferable interest", and the transferee has only an assignee interest. This would apply to both lifetime and testamentary transfers.

In Oklahoma, a limited partner may withdraw in which event the limited partner will become dissociated and will have an assignee interest.

2. <u>What do the cases say about valuation of an assignee interest?</u>

In <u>Tanenblatt vs. Comr.,</u> TC Memo 2013-263 (2013), the decedent had transferred an interest in an LLC to a revocable trust and then died. Her interest was owned by her trust at the time of her death. The estate argued that her interest should be valued as an assignee interest rather than as a full membership interest in the LLC. The LLC operating agreement provided that transfers to members of the decedent's family would be transfers of membership interests entitling the transferee to become a member in the LLC. However, transfers to nonfamily members would only be transfers of assignee interests, and the transferee could only become a member with the unanimous approval of all of the members.

The taxpayer subsequently sought a new appraisal which modified the prior appraisal by valuing the interest in the decedent's trust as an assignee interest. The Tax Court said: "…petitioner contends that, in applying the willing buyer-willing seller standard, the hypothetical willing buyer must be assumed to be a nonfamily member, who would, in effect, be purchasing an assignee's interest since he could not become a member of the LLC without the unanimous approval of all membership interests." In its opinion, the Tax Court conceded that "a member's interest is more valuable than an equivalent percentage interest of an assignee, because the member's interest can participate in management and control of the LLC." The Tax Court then held that the interest held by the decedent's trust was a member's interest and not an assignee interest. But then, the Court said, "In applying the willing buyer-willing seller standard to determine the value of the subject interests, it would be appropriate to take into consideration the limitations in the operating agreement on the rights of a nonfamily member transferee to participate in control of management of the LLC and limitations on the transferee's right otherwise to be treated as a member." The Tax Court then goes on to concede that a hypothetical willing buyer would take into account the restrictions that would be imposed on the willing buyer if the interest were an assignee interest. Thus, it would appear that the Tax Court believed that the evidence supported a discount because the transferee would only be an assignee, but nevertheless did not admit that the interest subject to valuation was an assignee interest.

Question whether the Tax Court would have reached a different decision if transfers to family members would have been treated in the same manner as transfers to nonfamily members, conveying only an assignee interest.

In Streightoff vs. Comr., TC Memo 2018-178, during the decedent's lifetime, he transferred an FLP interest to his revocable trust. The FLP agreement provided that any assignee of an LP interest would only have an assignee's interest and would not be treated as a substituted limited partner without approval by the general partner and 75% (in one of the partnerships) and 100% (in the other partnership) approval by the limited partners. Decedent's estate valued the trust's FLP interest as an assignee interest for valuation discount purposes. The Tax Court held that the interest transferred and subject to valuation was a partnership interest and not an assignee interest. In so holding, however, the Tax Court pointed out some problems with the taxpayer's case. First, the applicable assignment recited that the decedent transferred her partnership interest with "all the rights and appurtenances thereto" and that the trust would be entitled to all rights associated with the ownership of the decedent's limited partner interest, not those of an assignee. Also, the decedent's daughter and executor and trustee of the trust executed the assignment as manager of the general partner and gave consent to its terms. Thus, the general partner tacitly approved the transfer conveying a membership interest, and the trust, owning 88.9% of the limited partnership interest, approved the transfer. Therefore, the facts indicate that there was implied approval for the trust to become a member, and that is what the Tax Court held. Curiously, the Court then later said that in Kerr, cited above, the Tax Court held that the only real difference between the rights of a limited partner and those of an assignee was the right to vote on partnership matters, and that was not significant. Then the Court said: "…we conclude similarly that whether the revocable trust held voting rights associated with the limited partnership interest would have been of no practical significance." This is contrary to what the Tax Court said in Tanenblatt, discussed above.

In W.W. Jones II vs. Comr., 116 T.C. 121 (2001), the decedent during his lifetime formed a family limited partnership and gave limited partner interests to his children. The partnership agreement provided that a person may only be admitted as a limited partner with the consent of all general partners. Similar to the facts in Streightoff, the Court said that the facts indicated that all of the family members intended for the transfers to include limited partner interests and there was implied consent for the children to become limited partners. In fact, the assignment was entitled "Gift Assignment of Limited Partnership Interests"**.** The Court distinguished the Estate of Nowell vs. Comr., T.C. Memo 1999-15.

In Nowell, the partnership agreement specified that an assignee would not become a limited partner unless the general partners consented to the assignee's admission as a limited partner. The Court there decided that the interests transferred should be valued for estate tax purposes as assignee interests, because the beneficiaries, the estate, and the decedent in the Nowell case never treated the transferred interests as limited partnership interests. An assignee, unlike a limited partner, has no right to any information or accounting of the affairs of the partnership, to inspect books and records, to vote, or to hold the general partner accountable for breach of a fiduciary duty. In Nowell, the Court said it must determine "precisely what property is transferred." It determined that under the Arizona Limited Partnership Act, "An assignment entitles the assignee to receive…only the distribution to which the assignor would be entitled….A partner in an Arizona limited partnership cannot….confer to an assignee the rights to exercise the powers of a partner, unless it is otherwise provided in the partnership agreement." Thus, the Court held that the property passing at the decedent's death should be valued as an assignee interest and not a limited partner interest.

3. <u>So, assuming that an assignee interest could be valued lower than a membership interest in an LLC or a partnership interest in a limited partnership, how would we draft the operating agreement or partnership agreement to maximize the discount?</u>

<u>As to LLCs in Oklahoma.</u> 18 OS §2033 is favorable in this regard since it provides that a membership interest is not transferable, but a member may assign the capital interest associated with the membership interest. Therefore, this would seem to foreclose any argument by the Government that an assignment by a member could be an assignment of a membership interest and not an assignee interest. In fact, if a member of an LLC purported to transfer that member's membership interest in the LLC, that transfer might be null and void when authorized by the operating agreement.

Consider the following language for an inter vivos assignment of a membership interest in Oklahoma:

Mom hereby assigns all of her capital interest associated with her membership interest in the LLC to Daughter.

Or, consider the following language for a testamentary transfer:

Dad hereby leaves a capital interest associated with all of his membership interest in the LLC to Son.

<u>As For Limited Partnerships in Oklahoma.</u> Oklahoma law also seems favorable for limited partnership interests. 54 OS §500-702A says: "The only interest of a partner which is transferable is the partner's transferable interest." Then, §500-702A says that the transfer of a partner's transferable interest does not entitle the transferee to participate in management, to information, to inspect books and records, or any other rights of a limited partner except the right to receive distributions, etc.

Thus, consider the following language for an inter vivos assignment of a limited partnership interest in Oklahoma:

Mom hereby assigns her transferable interest in her limited partner interest in the Partnership to Daughter. For these purposes, a transferable interest has the meaning set forth in 54 OS §500-701A and 702A.

A testamentary transfer might look like this:

Dad hereby leaves the transferable interest associated with his limited partner interest in the Partnership to Son. The term transferable interest shall have the meaning as set forth in 54 OS §500-701A and 702A.

E. DISTRIBUTION PROVISIONS. Appraisers valuing interests in an entity often examine (i) how is a distribution authorized and approved?; (ii) for what purposes are distributions permitted?; and (iii) what has been the distribution history of the entity in the past? Also, does the agreement permit tax distributions in the case of pass-through entities? To maximize discounts, consider drafting an agreement that does not encourage significant current distributions, that does not authorize tax distributions, and that requires supermajority approval for distributions. The requirement of a supermajority or unanimous approval for a distribution would not be subject to §2704(a) or (b) or §2703.

Consider the following provision: **The intent of the Company is to use Company income and resources for investment and growth. Therefore, for the foreseeable future, distributions to equityholders will be discouraged and will only be permitted if approved by a unanimous vote of the equitholders.**

F. MANDATORY CAPITAL CALLS. A willing buyer may not be so willing to purchase an interest in an entity which could subject that buyer to mandatory capital calls. The authority to make capital calls might reside with one or more equityholders who do not have a significant ownership interest in the entity and thus would not be seriously affected by the capital calls. For example, a 1% general partner or the holders of voting interests representing 1% equity in the entity might have the authority to make capital calls. Also, capital calls might be made to one class of equityholders and not to another class of equityholders.

Consider a provision in the entity agreement which provides that a person who does not fulfill a mandatory capital call will be expelled.

G. BUY AND HOLD STRATEGY OR IN THE ALTERNATIVE BLIND POOL STRATEGY. Any willing buyer who is looking for an exit strategy would not be inclined to buy an interest in an entity that expressly states that it is going to continue to hold its existing assets and/or business for the long term. Likewise, a willing buyer may not be inclined to buy an interest in an entity where the entity agreement permits the entity to change its business at any time.

H. ASSET PROTECTION FEATURES. An entity agreement might provide that if a member has a judgment creditor or similar creditor, then distributions to that member might be suspended and the voting rights of the member might be suspended. These are asset protection features to protect the member and also protect the other members in the entity from having a creditor involved in their business. This might also be considered as a negative feature to a willing buyer.

I. <u>CONCENTRATED VOTING CONTROL</u>. A willing buyer may also be put off if important decisions for the entity may only be made by equityholders with a small equity interest. For example, a willing buyer may be less willing to acquire an interest in an entity where the 1% general partner, in the case of a limited partnership, or the holder of 1% of the voting stock or units, in the case of a corporation or LLC, could make all major decisions with the buyer having little or no voting interest. If any such voting control provisions affect the ability of the equityholders to dissolve the entity or their interest in the entity or would restrict transferability, then those issues would need to be addressed under §2704(b) and §2703.

J. <u>FIXING A PRICE EVENTS UPON THE OCCURRENCE OF CERTAIN EVENTS</u>. The agreement may contain certain call events which will allow the entity to redeem an equityholder's interest upon the occurrence of certain events. Those events might include (i) ceasing to be an employee of the entity; (ii) competing or engaging in conduct that is in conflict of interest with or competitive with the entity; (iii) death or disability; (iv) retirement; (v) a change of control; and so on. The exercise of a call event by the entity should be discretionary, making it a one way street. The call event should not also be a put event in favor of the equityholder. The agreement should set forth the procedures for how a call event is exercised and closed. The agreement may try to fix a redemption price for the called interest. That would usually be based on some sort of formula. Consideration should be given to §2703 and the history of case law existing prior to §2703. A better result might merely be that the entity will obtain an appraisal of the redeemed interest, and that appraisal would of course take into account valuation discounts. Then, the purchase price might be paid over some period of time with an AFR note. A willing buyer might be inclined to pay less for an interest if that interest can be called away at a price favorable to the entity. The buyer may raise enforceability issues as to such provisions, but they should not be subject to §2703 or §2704(d).

K. <u>AMENDMENTS TO THE ENTITY AGREEMENT.</u> Consider a provision in the entity agreement which requires unanimous consent for any amendment to lower the required vote for any provision in the Agreement that requires unanimous consent, such as:

> **Any provision of this agreement which requires unanimous approval of the members may only be amended with unanimous approval of the members.**

VII.
CREATING, SAVING, AND/OR MAXIMIZING DISCOUNTS OUTSIDE OF THE ENTITY AGREEMENT.

Up to now, this outline has focused on man-made provisions in formation documents and entity agreements that will create or maximize valuation discounts. However, situations may be created other than where discounts might be created outside of formation documents and entity agreements if under the appropriate circumstances.

A. MULTIPLE DISCOUNTS WITH TIERED ENTITIES. Example: Mom owns 20% of Real Estate LLC. The other 80% of membership interests in Real Estate LLC are owned by unrelated parties. Mom and the family read up on all of the ACTEC literature on FLLC discounts. Mom transfers her 20% interest in Real Estate LLC to Family LLC. Mom then gifts or sells minority interests in Family LLC to the children. In valuing the Family LLC interests being gifted/sold, will there be two discounts? Presumably, in valuing a minority interest in Family LLC, one must first value the assets owned by Family LLC. Since one of the assets owned by Family LLC is a minority interest in Real Estate LLC, then there should be a discount at the Real Estate LLC level and then another discount at the Family LLC level.

B. WHEN MOM/DAD DON'T WANT TO GIVE UP CONTROL DURING LIFETIME. Problem: Business LLC has outstanding 10 voting units and 9900 nonvoting units. Mom owns all 10 voting units all 9900 nonvoting units. Mom is advised that if she retains ownership of the 10 voting units until her death, then neither the 10 voting units nor the 990 nonvoting units owned by her at the time of her passing will qualify for a discount.

> Solution: Mom forms Management Trust and seeds it with some capital. Management Trust is irrevocable. The beneficiaries are the kids. The purpose of the Management Trust is to provide for succession and continuation of management of the LLC. The Management Trust Trustees are folks whom Mom trusts and has confidence in, but they are all unrelated to her within the meaning of §672(c). Mom retains the right to remove and replace any Trustee, but any Trustee appointed by her must also be independent from and unrelated to her. See Reg §20.2036-1(b)(3). Mom then sells her 10 voting units to the Management Trust for full and adequate consideration. The voting units represent only 0.01% of all units in the LLC. Mom would need to be very careful about retaining any rights or power, either express or implied, to direct or control the Management Trust. When Mom dies, her estate would only own the nonvoting units.
>
> Alternative Solution: Okay, Mom cannot bring herself to sell the 10 voting units to the Management Trust during her lifetime as described in the solution above. So, she creates the Management Trust and decides to leave the 10 voting units to the Management Trust at her death. Dad is still living. So, here are her options:

Option 1: Leave the 10 voting units and 9900 nonvoting units to Dad. Problem: Now Dad is in control and will not get a discount unless he disposes of the 10 voting units during his lifetime. Not sure whether the circumstances will permit this to occur nor is there any assurance that Dad will be in a state of mind to sell or give away the10 voting units.

Option 2: Leave 10 voting units to Dad and 9900 nonvoting units to the children (or to trusts for the children, etc.). This is good in that Dad will only have 10 voting units and no nonvoting units in his estate. However, will Mom have enough applicable exclusion amount ("AEA") to leave this much value to the children? And, does Dad need to have the income from the 9900 nonvoting units for the remainder of his lifetime?

Option 3: Mom leaves 9900 nonvoting units to Dad and 10 voting units to an irrevocable bypass trust for dad. Good news in that when Dad passes, his estate should qualify for a valuation discount on the 9900 nonvoting units, and the 10 voting units won't be included in his estate and thus won't count in determining whether he is in control. Bad news is that the marital deduction for the 9900 nonvoting units being left to Dad will be discounted, while the aggregate value of the 10 voting units and 9900 nonvoting units in Mom's estate will not be discounted. This will create an unforeseen estate tax.

For example, suppose that Family LLC has a net asset value of $10,000x so that each of the 10,000 units has a net asset value of $1x. When Mom dies, she owns 10 voting units and 9,990 nonvoting units, so, since she is in control, her gross estate attributable to the Family LLC units will probably be $10,000x. However, the 9,990x nonvoting units going to Dad will be discounted in computing fair market value. If there is, for example, a 33 1/3% valuation discount, then the 9,990 nonvoting units going to Dad with a $9,990x net asset value will have an estate tax value of $6,660x. This means that Mom's marital deduction for the nonvoting units going to Dad will only be $6,660x. Thus, the difference between the voting and nonvoting units in Mom's gross estate having a fair market value of $10,000x will exceed the 6,660x fair market value of units going to Dad, creating a $3.330x increase in Mom's taxable estate if her estate is in an estate taxable mode. See Ahmanson vs. U.S. 674 F2d 761 (9th Cir. 1981).

Option 4: (Not the best in the world but the only one available): Mom leaves the 10 voting units to a QTIP Trust for Dad with Trustees other than Dad. The Trustees are not directed by the QTIP Trust to sell the 10 voting units to the Management Trust, but the Trust does not prohibit a sale if the Trustees believe it is appropriate. It should be appropriate, since selling the 10 voting units to the Management Trust will remove them from Dad's gross estate. Following Mom's death, the Trustees of Dad's QTIP Trust will sell the 10 voting units to the Management Trust for fair market value. Dad will then own 990 nonvoting units and no voting units, so he will not be in control.

Note: The IRS may well attack this situation under §2036(a)(2) using the same rationale as in Powell.

C. DISCOUNTING OF NOTE RECEIVED FROM SALE TO GRANTOR TRUST. Example: Dad sells LP units in Family LP having a net asset value of $1,500 to a newly created irrevocable IDGT, which is grantor for income tax purposes to Dad, in exchange for its fair market value of $1,000x, comprised of $100x cash and a $900x note. Thus, there was a 33.333% discount on the LP units from their $1,500x net asset value to their $1,000x fair market value. Dad now holds the $900x IDGT note. Dad then dies, and the IDGT note is included in his gross estate. Dad's estate obtains an appraisal that determines that the fair market value of the note is $810x, a 10% discount from its $900x face amount. Thus, Dad achieved a 33.333% discount on the sale of the units and then got a 10% discount on the value of the note in his estate. So the amount removed from his gross estate was the $500x discount on the sale and the $90x discount on the note equal $590, which is an aggregate discount of 39.33% from the $1,500x net asset value of the interest sold.

The appraisal of the note will take into account a number of factors, the most important of which are the interest rate, collateral (if any), and term. In this Example, the interest rate was the AFR. The term was 9 years, which is the maximum term for a mid-term AFR. Dad was careful to make sure that the 9 year term of the note did not exceed his life expectancy, or this might be considered a private annuity. The note was unsecured, although there might have been a negative pledge, where the IDGT did not provide collateral but agreed not to pledge the purchased assets to another lender. See Reg. §20.2031-4.

D. APPRAISALS.

Appraisers are generally trained in how businesses and investments operate in certain specific industries and in different economic conditions. They rely on statistical studies and other economic data. However, they are generally not lawyers and are not trained to read and understand legal documents, especially family entity agreements which can be quite complex, nor are they trained to interpret tax laws.

Therefore, consider having the attorney who drafted the family entity agreement provide the appraiser with a written explanation of certain provisions of the family entity agreement which might not be readily understood or which might be misunderstood by the appraiser. Any such written explanation would specifically mention those provisions of the family entity agreement that might create or maximize valuation discounts, such as those listed in Section VI above. For example, if the family entity agreement refers to an "assignee interest", then the appraiser might not understand what that term means.

Further, since appraisers are typically not lawyers, especially tax lawyers, they may not know or understand how the family entity agreement will be impacted by various tax laws. For example, what is an "applicable restriction", and does the family entity agreement contain any applicable restrictions? Likewise, are there any provisions in the family entity agreement which should be disregarded under §2703?

E. VACATION HOMES AND FAMILY PERSONAL USE ASSETS. High net worth families often have vacation homes and/or retreats at the lake, in the mountains, on the beach, and/or in the desert. Are these personal use assets that should be kept out of the discount entity?

It is submitted that such a second residence could be suitably owned by a discount entity if the business purpose of the home is to provide a common place, separate and apart from the residences of family members, to conduct family business; to educate and discuss with family members family business and investment goals, strategies, and results of prior performance; to do so in a confidential setting and without interruption. There should be minutes or memos documenting meetings and the various decisions and conversations occurring at or resulting from those meetings. There should be bylaws or rules of protocol as to how and when family members may use the residence and rules limiting what guests can be invited**.**

As an alternative to putting the home in the family discount entity, consider creating a separate LLC for the home. That LLC might also own all of the personal assets associated with the home, such as furniture, sport vehicles, etc. It is suggested that it is good to own the home in an entity so that after Mom and Dad are no longer around, the children will own the vacation home in an entity in which there can be rules of governance for the home.

F. SELECTING WHICH CLASSES OF ASSETS SHOULD BE CONTRIBUTED TO THE ENTITY. The IRS in its Appeals Settlement Guidelines Family Limited Partnerships and Family Limited Liability Corporations, issued October 18, 2006, still advocates a policy of assigning different valuation discounts to different asset classes owned within the entity. Even taxpayers' appraisals sometimes follow that approach. For example, the asset class of marketable securities would be assigned a lesser discount then the asset class of commercial real estate. We question whether this is logical. In every case, the subject of valuation is the interest in the entity. If an asset owned by the entity is not marketable, then that would be taken into account when determining the value of the entity but should not be taken into account when determining the marketability of an interest in the entity. When we questioned an IRS appellate officer on this issue his reply was: "But $1 of cash is worth more than $1 of real estate." Really?

VIII.
DISCOUNT VS. NO DISCOUNT: DO THE MATH

A corresponding disadvantage to the advantage of an estate tax valuation discount can be an increased capital gains tax if the interest included in the gross estate is subsequently sold. The relative advantage of paying less estate tax versus potentially paying more capital gains tax requires careful analysis and depends upon a number of variables. Let's start with the following simple example:

Example 8-1. Mom owns an interest in FLLC that has a net asset value ("NAV") of $100 but has a fair market value ("FMV") for estate tax purposes of $70, a 30% valuation discount. When Mom dies, the family anticipates that her interest will be liquidated and sold at its $100 NAV. The tax basis of the interest during Mom's lifetime is irrelevant, since it will be adjusted to FMV at Mom's death regardless of its tax basis during her lifetime. What are the tax consequences if the family takes a valuation discount at Mom's death or, alternatively, if the family decides not to take a valuation discount? Assume that Mom's estate is in a 30% combined federal and estate capital gains tax bracket.

With Discount:

Interest NAV	$100	
less 30% discount	(30)	
FMV	70	
Times estate tax rate	x 40%	
Estate Tax		$ 28
Sell interest	$100	
Less adjusted basis(1)	(70)	
Gain	30	
Capital gains tax rate	x 30%	
Capital gains tax		$ 9
Total tax		$37

(1) The value of the interest was reported on the estate tax return at $70. Therefore, this is its adjusted tax basis. See §1014(a).

Had the estate taken a 40% valuation discount, there would be $24 of estate tax and $12 of capital gains tax for a total tax of $36. If the estate had taken a 20% valuation discount, there would have been an estate tax of $32 and a capital gains tax of $6, for a total combined tax of $38.

Without Discount:

Interest NAV/FMV	$100	
Estate tax rate	x 40%	
Estate tax		$40
Sell interest	$100	
Less adjusted basis	(100)	

Gain	-0-
Total tax	$40

The decision about whether it is more advantageous to achieve estate tax savings through valuation discounts or the possible cost of incurring more capital gains taxes might be influenced by some of the following factors:

- What is the likelihood that the interest will be sold following Mom's death? If it will not be sold or if it may not be sold for some extended period of time, there is a time value of money by taking a discount and paying less estate tax up front.

- Will a §754 election be made to step up the basis of Mom's estate's share of the FLLC assets under §743? If a §754 election is not made then Mom's estate's share of the gain on the sale of an FLLC asset could be much higher. Typically, this is only a timing difference, since Mom's estate's share of the gain would increase its outside basis in its FLLC interest, it can nevertheless create problems.

- What capital gains tax bracket will the seller of the interest be in? Will the 3.8% net investment income tax apply?

- If there is potential §751 income in the entity (if it is a partnership or LLC), then if a valuation discount is taken, some of the gain incurred upon a later sale may be ordinary income. For example, suppose the assets that are subject to substantial depreciation recapture, or recapture of intangible drilling and development costs, or they are unrealized receivables or inventory? If Mom's estate took a 30% discount on its FLLC interest, then 30% of the subsequent sales price (assuming the sales price is estate tax value) will be gain, and much of that gain could be taxed as ordinary income. In Example 8-1, if all of the gain is taxed as ordinary income, and if the estate is in a combined 37% federal and 5% state income tax bracket such as in Oklahoma, then there would be a tax of 42% on the gain. In that event, the total tax would be greater if a discount were taken rather than not taken.

- There is also the complexity of structuring the transaction to create or maximize a discount.

IX. ESTATE AND GIFT TAX CONUNDRUM

Here is an estate and gift tax conundrum:

Dad owns a majority of XCorp, a corporation whose stock is publicly traded. Dad has previously created a Trust for his children which has assets. The Trust is grantor to Dad for income tax purposes and also owns some XCorp stock. Dad creates Family LLC and contributes shares of XCorp stock to Family LLC in exchange for 99 Family LLC nonvoting units and 1 voting unit. Then, later on, Dad sells 10 nonvoting units to the Trust. Each nonvoting unit has a \$1.00x net asset value. But, the parties obtain an appraisal stating that each nonvoting unit has a fair market value of \$.70x, which is a 30% discount from its \$1.00x net asset value. Then, as consideration, the Trust issues its note to Dad in the principle amount of \$7x, which is the fair market value of the 10 nonvoting units the Trust purchased from Dad.

After year one, the Trust borrows money from the Bank to pay the first year's interest on the note to Dad. After year two, the Trust needs to again pay interest to Dad but does not want to borrow any more money from the Bank. The Trust could attempt to pay Dad the interest in kind with nonvoting units. However, the Trust realizes that if it uses nonvoting units to pay Dad, the nonvoting units must be valued at a discount. In other words, if Dad sold the nonvoting units to the Trust at a discount from NAV, then if the trust pays interest on the note in kind with the nonvoting units, then those nonvoting units should be discounted as well.

So, instead, Family LLC agrees to redeem 1 nonvoting unit from the Trust. The redemption will be in kind with shares of XCorp stock. Thus, Family LLC will distribute shares of XCorp stock to the Trust in exchange for 1 nonvoting unit held by the Trust. (This distribution will be nontaxable, even though the XCorp stock will be treated like cash under Code §731(c) and even if the value of the XCorp stock exceeds the Trust's adjusted tax basis in the nonvoting unit, since the Trust is grantor to Dad for income tax purposes.) The Trust will then pay the interest to Dad in kind using XCorp stock.

Assume the trading price of the XCorp stock has not changed since it was contributed to the Family LLC by Dad, so each nonvoting unit still has a net asset value of \$1x and a fair market value of \$.7x. What is the appropriate redemption price that Family LLC should pay to the Trust to redeem 1 nonvoting unit? Is it the \$1x net asset value of the nonvoting unit? Or, the \$.7x fair market value of the nonvoting unit? The issue is this: Dad sold nonvoting units having a net asset value of \$1x each for a sales price of \$.7x each. If the Trust can now receive XCorp shares having a value of \$1x in redemption of a nonvoting unit for which it paid \$.7x then the Trust has made \$.3x on its ownership of the 1 nonvoting unit without the XCorp stock increasing in price. Thus, would the IRS argue that the redemption by the Family LLC of the 1 unit should be at the same \$.7x discounted price which the Trust paid to Dad for the 1 nonvoting unit?

If so, then there is another problem for the IRS. If Family LLC must pay a discounted price for the nonvoting unit redeemed from the Trust, then if Dad has any nonvoting units redeemed, shouldn't the same discounted price be paid to Dad? If so, then here is the problem. If the unit to be redeemed from the Trust and Dad must be redeemed at the discounted value, this means that Dad can contribute to Family LLC XCorp stock having a net asset value of \$1x to Family LLC in exchange for a unit having a net asset value of \$1x, and then the Family LLC can redeem that unit from Dad by paying him the discounted \$.7x redemption price.

Unless the IRS can collapse these transactions as being interrelated, the IRS is in a conundrum.

In Church, 85 AFTR 2d 2000-804., the decedent transferred assets to an FLP and received back an LP interest. Subsequently, Mrs. Church died and her LP interest was undivided in her taxable estate. The Government argued a taxable gift on formation and lost on that issue. In addition, the Government argued that the difference in value between the partnership interest which Mrs. Church received on formation and the value of the assignee interest transferred upon her death is the appropriate measure of the consideration she received by her contribution of her assets to the FLP. The Tax Court said: "Implicit in the Government's argument is the notion that since the value of the Partnership interest was less than the assets she contributed, someone must have received a gratuitous transfer of the difference. This was not the case, and never should be in the formation of a business entity in which each investor's interest is proportional to the capital contributed." The fact that Mrs. Church's LP interest included in her estate was valued at a discount from the value of the assets she contributed to the FLP in exchange of the LP interest was appropriate. Therefore, in our conundrum example above, shouldn't it be appropriate that distributions in redemption of Dad's units should be under the same net asset value methodology as his contribution of assets to the LLC?