
Does Section 2703 Apply to the Valuation of Family Limited Partnerships?

Christopher P. Bray questions whether the application of Section 2703 prevents the use of valuation planning with FLPs.



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Since the enactment of Chapter 14,¹ which repealed Section 2036(c)² and added the special valuation rules in its place, practitioners and commentators have spent a great deal of time and energy trying to understand and navigate through these rules in the area of estate planning. Despite one of Chapter 14's intended designs—to prevent the use of certain valuation discounting techniques to substantially reduce a taxpayer's transfer tax liability pursuant to the results in *Estate of Harrison*³ and *Estate of Watts*⁴—many of these same practitioners and commentators have widely lauded the use of family limited partnerships (FLPs) in estate planning employing the same type of valuation discounts used in *Harrison* and *Watts*.

¹ Omnibus Budget Reconciliation Act of 1990, P.L. 101-508, 101st Cong., 2d Sess., § § 11601 and 11602.

² Unless otherwise provided, all statutory references are to the Internal Revenue Code of 1986, as amended (the "Code").

³ The Conference Committee Report on Chapter 14 specifically states that "These rules are intended to prevent results similar to that of *Estate of Harrison v. Commissioner*, 52 T.C.M. (CCH) 1306 (1987)." Conference Report on H.R. 5835, Omnibus Budget Reconciliation Act of 1990, P.L. 101-508, 101st Cong., 2d Sess., at 1137.

⁴ *Estate of Watts*, 87-2 USTC ¶ 13,726, 823 F.2d 483 (CA-11 1987).

The overwhelming amount of commentary on the use of FLPs in estate planning has focused on the impact of Section 2704, "Treatment of Certain Lapsing Rights and Restrictions," on the ability to obtain valuation discounts when limited partnership interests are transferred.⁵ The conclusion of most of this commentary has been that, with proper planning, valuation discounts applicable to FLPs are still obtainable even in consideration of Section 2704. Accordingly, taxpayers have forged ahead in their estate planning utilizing the attractive transfer tax valuation benefits of FLPs mindful of the application of Chapter 14, but confident that it wouldn't effect those benefits. Until recently, however, it seems that only the Service may have disagreed with that analysis. One notable commentator⁶ has suggested that Chapter 14 does prevent the use of valuation discounts in estate planning with FLPs; not because of the application of Section 2704, but because of the application of Section 2703, "Certain Rights and Restrictions Disregarded." It appears as though the Service has embraced this suggestion with vigor.

Like lemmings shuffling behind one another off of an arctic precipice, have taxpayers followed the advice of their advisors to use FLPs in their estate planning with confidence of their effectiveness in a Chapter 14 environment only to discover abruptly that they won't work? Why has so much of the planning with FLPs focused on Section 2704 rather than on any of the other provisions of Chapter 14? Specifically, does Section 2703 apply to the valuation of FLPs?

Section 2703

The general rule of Section 2703 is unassumingly brief. It states as follows:

(a) General Rule.—For purposes of this subtitle, 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.

Likewise, the exceptions to the general rule of Section 2703 are similarly brief and apparently straightforward. They are set forth as follows:

(b) Exceptions.—Subsection (a) shall not apply to any option, agreement, right or restriction which meets each of the following requirements:

(1) It 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 in money or money's worth.

(3) Its terms are comparable to similar arrangements entered into by persons in an arm's length transaction.

Significantly less has been said about Section 2703 than Section 2704. Of interest is that much of the written material on Section 2703 describes this provision as the "buy-sell agreement" section and with good reason.⁷ The Committee Reports for Chapter 14 discuss Section 2703 in the context of "Buy-sell agreements,"⁸ "Options and buy-sell agreements,"⁹ and "Buy-sell agreements and options."¹⁰ The Senate Committee Report summarizes congressional reasoning underlying Section 2703 as follows:

Options and buy-sell agreements—The committee believes that buy-sell agreements are

⁵ See Brier and Darby, "The Impact of Code Sec. 2704 on Family Limited Partnerships," (parts 1 and 2), *Trusts & Estates*, Sept. 1995, at 79, *Trusts & Estates*, Oct. 1995 at 76; August, "Planning for Lapsing Rights and Restrictions—The Impact of Section 2704 on Valuation," 82 *J. Tax'n* 342 (1995); August, "Artificial Valuation of Closely Held Interests: Sec. 2704," 22 *Est. Plan.* 6 (1995); Fife and Hosta, "Minimizing Application of § 2704 in the Estate Tax Valuation of a General Partner's Family Limited Partnership Interests," *J. Est. Gifts and Tr.* (BNA), May-June 1995, at 127; Brier and Darby, "Family Limited Partnerships: Decanting Family Investment Assets Into New Bottles," 49 *Tax Lawyer* 12.7 (Fall, 1995); Weiner and Leipzig, "Family Limited Partner-

ships Can Leverage the Annual Exclusion and Unified Credit," 82 *J. Tax'n* 164 (1995); Mulligan & Braly, "Family Limited Partnerships Can Create Discounts," 21 *Est. Plan.* 195 (1994); Eastland, "Family Limited Partnerships: Transfer Tax Benefits," *Probate & Property*, July-Aug. 1993, at 59; Gibbs, "A Family Limited Partnership as the Centerpiece of an Estate Plan," (parts 1 and 2), *Trusts & Estates*, Sept. 1992, at 45, *Trusts & Estates*, Oct. 1992, at 52.

⁶ See Pennell, "Wealth Transfer Tax Valuation Issues," *J. Est. Gifts and Tr.* (BNA), Nov.-Dec. 1995, at 207.

⁷ See Acker, "Sections 2703 and 2704 of the Internal Revenue Code," *J. Est. Gifts and Tr.* (BNA), Nov.-Dec. 1994, at 187; Leimberg, Johnson, Doyle, and

Kurlowicz, "Sections 2701-2704: Good Motives But A Tough Law to Follow," *J. Est. Gifts and Tr.* (BNA), May-June 1991, at 83; Aucutt, "New Valuation Rules of Chapter 14," *J. Est. Gifts and Tr.* (BNA), Jan.-Feb. 1991, at 3.

⁸ 1990 Senate Report on Proposed Revision of Estate Freeze Rules, 136 Cong. Rec. S15683.

⁹ Id., at S15680 and S15681. Conference Report on H.R. 5835, the Omnibus Budget Reconciliation Act of 1990, 101st Cong., P.L. 101-508, 2d Sess., at 1131.

¹⁰ Conference Report on H.R. 5835, the Omnibus Budget Reconciliation Act of 1990, P.L. 101-508, 101st Cong., 2d Sess., at 1137.

common business planning arrangements and that buy-sell agreements generally are entered into for legitimate business reasons that are not related to transfer tax consequences. Buy-sell agreements are commonly used to control the transfer of ownership in a closely held business, to avoid expensive appraisals in determining purchase price, to prevent the transfer to an unrelated party, to provide a market for the equity interest, and to allow owners to plan for future liquidity needs in advance. However, the committee is aware of the potential of buy-sell agreements for distorting transfer tax value. Therefore, the committee establishes rules that attempt to distinguish between agreements designed to avoid estate taxes and those with legitimate business agreements. These rules generally disregard a buy-sell agreement that would not have been entered into by unrelated parties acting at arm's length.¹¹

Additionally, the Senate Committee report clarifies that "[the bill] adopts the reasoning of *Saint Louis County Bank*,"¹² an 8th Circuit case concerning the estate taxation of closely held stock valued under a buy-sell agreement.¹³

The Conference Committee Report summarizes congressional reasoning underlying Section 2703 in two paragraphs as follows:

Options and buy-sell agreements—Some courts have held that the price contained in a buy-sell agreement limits fair market value for estate tax purposes if the price is fixed or determinable, the estate is obligated to sell, the agreement contains restrictions on lifetime transfers, and there is a valid business purpose for the agreement.¹⁴

Buy-sell agreements and options—The conferees do not intend the provision governing buy-sell agreements to disregard such an agreement merely because its terms differ from those used by another similarly situated company. The conferees recognize that general business practice may recognize more than one valuation methodology, even within the same industry. In such situations, one of several

generally accepted methodologies may satisfy the standard contained in the conference agreement.¹⁵

Curiously, the expression "buy-sell agreement" did not carry over into the statute. Sections 2703(a)(1) and 2703(b) use the isolated term "agreement" without the "buy-sell" modifier. Treasury has published only a single substantive regulation on Section 2703.¹⁶ The regulation, like the statute it interprets, refers to the term "agreement" rather than "buy-sell agreement."

Unfortunately, as of yet, there is no case law that has developed concerning Section 2703. There are, however, a number of letter rulings that have been issued by the Service since the enactment of Section 2703. Most of these rulings pertain to the subject of buy-sell agreements.¹⁷

The Argument for Application of Section 2703

Simply stated, this argument concludes that the partnership agreement itself should be disregarded when valuing the transfer of limited partnership interests in an FLP under the plain language of Section 2703(a)(2). The argument reasons that the partnership agreement creating the subject limited partnership interests is an "agreement" and Section 2703, by its plain language, applies to "any agreement."¹⁸ Accordingly, Section 2703(a)(2) operates to remove all restrictions, whether or not imposed by state law, inherent in the partnership agreement. For valuation purposes, therefore, the partnership agreement is invisible and the transfer of limited partnership interests is nothing more than a transfer of undivided interests in the underlying assets of the partnership. This result is unavoidable unless the tests for exception from this treatment under Section 2703(b) are met.

The main thrust of the argument is that Section 2703 should be broadly interpreted to include not only buy-sell agreements, but any agreement that has the effect of restricting the right to sell or use property, including a partnership agreement. If Congress had intended Section 2703 to apply nar-

¹¹ 1990 Senate Report on Proposed Revision of Estate Freeze Rules, 136 Cong. Rec. S15681.

¹² *Supra*, note 7.

¹³ *St. Louis County Bank v. U.S.*, 82-1 USTC ¶ 13,459, 674 F.2d 1207 (CA-8 1982).

¹⁴ Conference Report on H.R. 5835, the Omnibus Budget Reconciliation Act of 1990, P.L. 101-508, 101st Cong., 2d Sess., at 1131.

¹⁵ *Id.*, at 1137.

¹⁶ Reg. § 25.2703-1.

¹⁷ See CCH IRS LETTER RULINGS REPORT No. 1035, Jan. 2, 1997, LTR 9652010 (Sept. 26, 1996), CCH IRS LETTER RULINGS REPORT No. 1035, Jan. 2, 1997, LTR 9652009 (Sept. 9, 1996), CCH IRS LETTER RULINGS REPORT No. 1005, June 5, 1996, LTR 9622036 (March 4, 1996), CCH IRS LETTER RULINGS REPORT No. 1003, May 22, 1996, LTR 9620017 (Feb. 15, 1996), CCH IRS LETTER RULINGS REPORT No. 911, Aug. 17, 1994, LTR 9432017 (May 16, 1994), CCH IRS LETTER RULINGS RE-

PORT No. 851, June 23, 1993, LTR 9324018 (March 19, 1993), CCH IRS LETTER RULINGS REPORT No. 822, Dec. 3, 1992, LTR 9248026 (Sept. 1, 1992), CCH IRS LETTER RULINGS REPORT No. 800, July 1, 1992, LTR 9226051 (March 30, 1992), and CCH IRS LETTER RULINGS REPORT No. 763, Oct. 16, 1991, LTR 9141043 (July 16, 1991).

¹⁸ IRC Sec. 2703(a)(1).

rowly to buy-sell agreements it would have used the expression "buy-sell" in its construction of the statute, especially to modify the term "agreement" as it appears in Section 2703(a)(1). Subscribers to this view also point to the Senate Committee Report where, under the heading "Buy-sell agreements," the Committee elaborates that "the value of property for transfer tax purposes is determined without regard to . . . any restriction on the right to sell or use such property, unless the . . . restriction meets three requirements. These requirements apply to any restriction, however created. For example, they apply to restrictions *implicit in the capital structure of the partnership or contained in the partnership agreement* . . ."¹⁹

Those who would argue that Section 2703 should be broadly applied to include a partnership agreement in and of itself point to Example 1 of Reg. § 25.2703-1(d). There, T and T's child enter into a lease which is not comparable to leases for similar property made between unrelated parties. Under Section 2703, the example concludes that the lease is a restriction on the use of the property that is disregarded in valuing the property for federal transfer tax purposes. Just as a lease is both an agreement and a contract and all partnership agreements are contracts, Example 1, dealing with leases, must also apply to partnership agreements. Just as the entire lease is ignored in Example 1, an entire partnership agreement may be ignored under Section 2703 to value the underlying property.

Consequently, Section 2703 applies to a partnership agreement in its entirety and operates to ignore "any restriction, however created"²⁰ including restrictions created by state law. Since leases, which are recognized under state law, are ignored under Section 2703 for purposes of valuing the subject property, then partnership agreements, including any state law default restrictions that accompany their creation, can also be disregarded.

Once Section 2703 has been found to apply to a partnership agreement, the only possibility of preventing it from being ignored in valuing the underlying property for purposes of estate, gift, and generation-skipping transfer taxation is if the partnership agreement meets the exceptions of Section 2703.²¹ Although proponents for the application of Section 2703 to FLPs may concede that the bona fide business arrangement²² and comparability²³

exceptions can often be satisfied in an FLP, they argue that the device²⁴ exception can almost never be satisfied. This is because, it is reasoned, the discounts that arise in the formation of FLPs and subsequent transfer of limited partnership interests to family members represent, by definition, "a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth."²⁵ In other words, if a the formation of an FLP will immediately result in a 35 percent and greater reduction in value of the fair market value of most of the interests in the FLP, no rational business person would engage in such a transaction unless it were a device to transfer the underlying property of the FLP to members of the transferor's family for less than full and adequate consideration.

The Argument Against Application of Section 2703

A partnership agreement, in its entirety, cannot be disregarded under Section 2703 for the simple reason that Section 2703 does not, and was never intended to, operate to erase an entire economic and legal entity, whether it be a partnership, a corporation or any other organized group or association. The suggestion that Section 2703 operates to completely disregard a valid partnership organized under state law ignores legislative intent in enacting Section 2703, ignores legislative intent in enacting Section 2704, inappropriately expands the scope of Treasury's guidance provided under Reg. § 25.2703-1, and misinterprets the clear language of Section 2703. So this argument goes.

The Congressional Record is straightforward and unambiguous concerning the intention underlying the enactment of Section 2703. As previously noted, all discussion concerning the intent of Section 2703 is recorded in legislative history under a heading that includes the description "buy-sell agreement."²⁶ The closest that any discussion in the legislative history of Section 2703 gets to an argument that the section should be applied to disregard a partnership for federal transfer tax purposes is the language in the Senate Committee Report, "These requirements apply to restrictions *implicit in the capital structure* of the partnership or *contained in a partnership agreement* . . ."²⁷ The

¹⁹ Supra, note 7 (emphasis added).

²⁰ Id.

²¹ IRC Sec. 2703(b).

²² IRC Sec. 2703(b)(1).

²³ IRC Sec. 2703(b)(3).

²⁴ IRC Sec. 2703(b)(2).

²⁵ Id.

²⁶ See supra, notes 7-9.

²⁷ Supra, note 7 (emphasis added).

language would need to be revised to read "These requirements apply to restrictions *such as a partnership or a partnership agreement*," in order to properly support a position that Congress intended the operation of Section 2703 to disregard partnerships, which would cause serious damage to the recorded legislative intent.

The Senate Committee Report highlights legislative intent with respect to the enactment of Section 2704 and the treatment of lapsing rights that "These rules are intended to overturn the result and reasoning of *Harrison v. Commissioner*."²⁸ The perceived abuse in *Harrison*²⁹ centered on the valuation of a decedent's limited partnership interest. The decedent's partnership interest was valued at a discount of approximately 50 percent of the interest's pro rata share of the partnership's net asset value. As the Senate Committee Report indicates, Congress was compelled to enact Section 2704 (specifically, Section 2704(a)) to combat the result in *Harrison*. If it was Congress's intention that Section 2703 would operate to ignore an entire partnership agreement there would be no need to waste additional effort to adopt Section 2704 as Section 2703 alone would defeat the *Harrison* result. Because it was not in any way Congress's intention that Section 2703 be applied to disregard partnerships or corporations in valuing property, Section 2704 had to be enacted to collapse *Harrison*.

In addition, the Conference Committee Report indicates that Section 2704 (specifically, Section 2704(b)) was adopted so that "any restriction that effectively limits the ability of a corporation or partnership to liquidate is ignored in valuing a transfer among family members..."³⁰ Congress, however, was careful in crafting Section 2704 so that it would not "throw the baby out with the bath water" in ignoring entire entities validly created under state law. Consequently, legislative intent is clear that Section 2704 "does not apply to . . . a restriction *required under State or Federal law*."³¹ Adoption of a measure that could have the effect of completely ignoring an entity validly created under state law was not an activity Congress was ready or willing to undertake.

Treasury, as well as Congress, didn't believe that Section 2703 could operate to disregard a partnership or corporation when valuing property for

federal transfer tax purposes. This is evident in Reg. § 25.2703-1. This regulation clarifies that under Section 2703 "A right or restriction may be *contained in* a partnership agreement, (in) articles of incorporation, (in) corporate bylaws, (in) a shareholder's agreement, or (in) any other agreement."³² This language is notably different from, "A right or restriction *may be* a partnership agreement," which would be required if Treasury believed that this was the effect of Section 2703 and wanted to communicate that belief to taxpayers.

Although the regulation also includes an example of a lease that is disregarded in determining value for federal transfer tax purposes,³³ to imply that a partnership agreement could also be disregarded pursuant to this example would require quite a stretch of imagination. The lease, in the example, constitutes an offending restriction on the use of property (Blackacre) required to be valued for federal transfer tax purposes and is therefore ignored. Similarly, restrictions "may be contained in a partnership agreement"³⁴ that affect the use of property (a partnership interest) and such restrictions may be offensive under Section 2703 to the extent that they are more restrictive than otherwise required under state law.³⁵ An argument that this example permits a partnership agreement to be ignored to value the pro rata value of the underlying assets requires not only a restriction to be ignored, but the property itself (a partnership interest) to be ignored. In the example, only the lease is ignored, not Blackacre.

Also, if a partnership or corporation could be disregarded under Section 2703, why would Treasury bother to include paragraph (b)(5) in Reg. § 25.2703-1 which reads:

Multiple rights or restrictions. If property is subject to more than one right or restriction described in (Section 2703(a)(1) or (2)), the failure of a right or restriction to satisfy the requirements of (Section 2703(b)) does not cause any other right or restriction to fail to satisfy those requirements if the right or restriction otherwise meets those requirements. Whether separate provisions are separate rights or restrictions, or are integral parts of a single right or restriction, depends on all of the facts and circumstances.

²⁸ Supra, note 7.

²⁹ *Harrison v. Com.*, CCH Dec. 43,609(M), 52 TCM 1306 (1987).

³⁰ Supra, note 9, at 1138.

³¹ Id., (emphasis added).

³² Reg. § 25.2703-1(a)(3), (emphasis added).

³³ Reg. § 25.2703-(d) Ex. 1.

³⁴ Supra, note 31.

³⁵ IRC Sec. 2704(b).

Clearly, if a partnership or corporation can be disregarded under Section 2703 as a "restriction" in and of itself, there is no need to elaborate on the subject of multiple restrictions. Accordingly, paragraph (b)(5) exists for the very reason that a partnership or corporation cannot be disregarded under Section 2703. Only certain restrictions "contained in" a partnership agreement, articles of incorporation, or other agreement may be disregarded if they do not fall within the exceptions of Section 2703(b).

Finally, the suggestion that Section 2703 operates to ignore a partnership or corporation to value the transfer as a transfer of an undivided interest of underlying assets in the partnership or corporation misinterprets the clear language of the statute. Section 2703 is a valuation provision, affecting the valuation of property for federal transfer tax purposes as follows, "For purposes of this subtitle, the value of any *property* shall be determined without regard to..."³⁶ Section 2703 cannot operate to value undivided interests of underlying assets in a partnership or corporation because undivided interests of underlying assets are not transferred, only partnership interests and stock (items of personal property under state law) are transferred. Consequently, the fallacy that exists in the suggestion that Section 2703 can be applied to ignore the entire partnership or corporation lies in the definition of "property" subject to the restrictions.³⁷

The Device Exception

If during the course of estate planning with FLPs it is determined that Section 2703 can be applied to ignore an entire partnership or corporation when valuing transfers of partnership interests or stock, taxpayers can still rely on the exceptions to the application of Section 2703 to ensure that such a result will not occur.³⁸ If the partnership or corporation represents a bona fide business arrangement, is not a device to transfer property to members of the transferor's family for less than full and adequate consideration, and is comparable to similar arrangements entered into by persons in an arm's length transaction, then Section 2703 will not apply. The subjects of business purpose and comparability have been discussed at length in the written material concerning planning with FLPs.³⁹

Based on the conclusions of many commentators, the exceptions of Section 2703(b) related to these subjects would likely not pose any problems if applied in the context of Section 2703. The meaning and use of the term "device," however, is somewhat more enigmatic.

Before the enactment of Section 2703, the "device" test of Section 2703(b)(2) and business arrangement test of Section 2703(b)(1) were treated as a single test under Reg. § 20.2031-2(h) which provided that valuation restrictions in buy-sell agreements could be disregarded unless they represented "a bona fide business arrangement and not a device to pass the decedent's shares to the natural objects of his bounty for less than adequate and full consideration in money or money's worth." A number of courts held that maintenance of family control and ownership were a business purpose that precluded the possibility that a buy-sell agreement could serve as a device.⁴⁰ The Eighth Circuit Court of Appeals, however, in *St. Louis County Bank v. U.S.*⁴¹ held that business purpose and device should be considered independently. Congress agreed with the analysis of Eighth Circuit and codified it in Section 2703. The Senate Committee Report reveals legislative intent as follows:

(The requirements of Section 2703(b)(1) and (2)) are similar to those contained in the present Treasury Regulations, except that the bill clarifies that the business arrangement and device requirements are independent tests. The mere showing that the agreement is a bona fide business arrangement would not give the agreement estate tax effect if other facts indicate that the agreement is a device to transfer property to members of the decedent's family for less than full and adequate consideration. In making this clarification, it adopts the reasoning of *Saint Louis County Bank* and rejects the suggestion of other cases that the maintenance of family control standing alone assures the absence of a device to transfer wealth.⁴²

In *St. Louis County Bank*, the decedent's estate valued at zero common stock of a rental real estate investment company that was formerly an operating company pursuant to a buy-sell agreement. The buy-sell agreement valued the stock based on a multiple of earnings created while the company was an operating company. The earnings approach was an appropriate valuation approach

³⁶ IRC Sec. 2703(a), (emphasis added).

³⁷ See Kasner, "Family Partnerships: Focus Shifts to Section 2703," 68 *Tax Notes* 610-11 (July 31, 1995).

³⁸ IRC Sec. 2703(b).

³⁹ See *supra*, note 4.

⁴⁰ See, e.g., *Estate of Bishoff v. Com.*, CCH Dec. 34,702, 69 TC 32 (1977).

⁴¹ *St. Louis County Bank v. U.S.*, *supra*, note 13.

⁴² *Supra*, note 7.

while the company was an operating company, but as a rental real estate investment company, the earnings approach yielded a deceptive value since the company generated rental losses. Although the court conceded that "the agreement had a bona fide business purpose—the maintenance of family control" the court could not conclude "that the existence of a valid business purpose necessarily excluded the possibility that the agreement was a tax-avoidance testamentary device."⁴³ Such a conclusion would have resulted in the egregious inclusion of investment company stock (valued at zero) that would have had substantial value if valued pursuant to a more appropriate asset based approach.

Other than *St. Louis County Bank*, there is sparse judicial precedent concerning the circumstances surrounding the existence of a device. Although typical estate planning with FLPs involves the transfer of partnership interests possessing a fair market value sometimes significantly less than pro rata value of the partnership's underlying assets, it rarely, if ever, resembles the extreme valuation abuse addressed in *St. Louis County Bank*. It is important to note that in applying the device test under Section 2703(b)(2), Congress was clear that "it adopts the reasoning of *Saint Louis County Bank*." The reasoning of *St. Louis County Bank* includes a crucial statement as follows:

The fact of a valid business purpose could, in some circumstances, completely negate the alleged existence of a tax-avoidance testamentary device as a matter of law, but those circumstances are not necessarily presented here.

Therefore, although Section 2703 does distinguish business purpose and device as separate and independent tests, the existence and degree of business purpose will have a material impact on the determination as to whether or not a device exists.

The "Unpublished" TAM

On March 11, 1997, just prior to the publication of this article, a technical advice memorandum was published by a tax reporting service that acquired the TAM through unofficial channels prior to TAM's official release by the IRS.⁴⁴ The

publication of this TAM represents the first publicly available indication that the Service intends to use Section 2703 to ignore the existence of partnerships in order to value their underlying assets.

The facts of the TAM involved the formation of a limited partnership with the contribution of \$2,259,144 of marketable securities and real estate by a terminally ill mother⁴⁵ in exchange for a 98 percent limited partnership interest and a contribution of \$33,049 in cash by each of her two children in exchange for one percent general partnership interests. Two days later, the mother died and her estate took the position that the limited partnership interests were subject to a 48 percent discount from underlying value of the assets in the partnership formerly owned by the decedent. Clearly, as most practitioners would agree, the TAM represents a scenario of "bad facts" for the taxpayer.

Not surprisingly, the Service concluded that the partnership should be ignored in valuing the assets of the decedent for estate tax purposes. The Service's primary argument was that the formation of the partnership and transfer of the partnership interests should be treated as a single testamentary transaction based on the application of *Estate of Murphy v. Commissioner*⁴⁶ where a decedent, 18 days prior to her death, transferred a less than 2 percent interest of a closely held corporation to her children to leave the estate in a position to claim a minority interest discount on the 49.65 percent interest of the corporation remaining in the estate. The Tax Court disallowed the discount finding that the facts indicated that the transfer was consummated for the sole purpose of avoiding federal estate tax.

More importantly, the Service's alternative argument hinged on its understanding of the application of Section 2703 to limited partnerships. Using all of the aforementioned arguments for the application of Section 2703 (with the exception of the Example 1 lease argument of Reg. § 25.2703-1(d)) the Service reasoned that the partnership represented a restriction on the right to use property and, pursuant to Section 2703, the value of the partnership's underlying assets should be determined without regard "to any restriction on the right to sell or use such property." Further, the

⁴³ Supra, note 40.

⁴⁴ "Family Partnership Should Be Ignored For Estate Tax Valuation, Unpublished TAM Says," 47 *Tax Notes Today* 16 (March 11, 1997).

⁴⁵ The contributions were actually made by a revocable trust established by the mother and includible in her estate under Section 2038 and a marital trust established by her predeceased husband's will

and includible in her estate under Section 2041.

⁴⁶ *Estate of Murphy v. Com.*, CCH Dec. 46,846(M), 60 TCM 645 (1990).

Service reasoned that the partnership transaction did not fit within any of the exceptions to Section 2703 because it was not a bona fide business arrangement and the transaction was a device to transfer property to the decedent's family for less than full and adequate consideration.

Clearly, the transaction profiled in the TAM is at risk solely under the authority of *Murphy*. Additionally, the Service points to another troubling fact for the taxpayer in the TAM that "it is inconceivable that the decedent . . . would transfer all her liquid assets to a partnership, in exchange for a limited interest that terminated her control over the assets and their income stream . . ." Why the major contributor would not have acquired an interest as a general partner is a good question. Accordingly, there is a strong argument that Section 2704(a) might also operate to reverse the effect of any claimed discount. That argument, however, is not made.

In terms of a fact pattern surrounding a transaction to attack, it doesn't get much better for the government than the facts of this TAM. It is interesting to note that the argument for the application of Section 2703 represents the Service's alternative, rather than its primary, argument to attack the transaction. It may be that the Service isn't very convinced that Section 2703 really operates to

ignore partnerships. It also may be that reliance on such a tenuous argument may be too risky when used to attack a transaction that should otherwise be "easy" to collapse considering the facts and circumstances.

Conclusion

The recent release of the "unpublished" TAM confirms that the Service is looking to Section 2703 to put an end to estate planning using FLPs. Whether or not the Service is successful in using Section 2703 to ignore partnerships or corporations to value assets within these entities remains to be seen. Therefore, practitioners who are advising clients on planning with FLPs should not only understand the effect of the issues presented by Section 2704 on their planning, but they should also understand the effect of the issues presented by Section 2703. Although it may be clear to many practitioners that Section 2703 has no application to planning with FLPs, it is of critical importance that practitioners keep in mind that, at this point, the government believes otherwise. As a result, practitioners should have a thorough understanding of the arguments under Section 2703 that they may one day be faced with if they are advising clients to plan with FLPs.