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Passive Asset Family Limited Partnership Discounts

Current Posture of the Chicago IRS Office

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Summary:

The Chicago office of the IRS Estate and Gift Tax Division is paying attention to the litigated cases, but, like most agencies with a limited budget, they prefer not to litigate valuation disputes. If there are no Section 2036 issues, a 25% discount on a passive asset family limited partnership (FLP) could escape audit.

Background:

The Chicago office looks at *McCord v. Commissioner*¹ as a starting point in the discount area although they do not necessarily like the methodology employed in that case. In *McCord*, the Court applied different discounts to each separate class of assets held within a partnership. For example, the Court applied a 10% minority interest discount to equities and bonds. Real estate partnership interests held by the partnership were discounted 23% while directly held real estate was valued at a 40% discount. Oil and gas interests held in the partnership yielded a 33% discount. Thus, the Court applied a different discount to each class of assets held within the partnership.

The IRS expert witness in the *McCord* case, Mukesh Bajaj, Ph.D., is the Chicago expert sometimes used for valuation disputes.

As the starting point in any valuation analysis, it is important to ensure that all partnership formalities have been complied with in terms of the structure, formation and operation. If not, then the transfer sections of the Code may be sought to be applied as the IRS will seek full inclusion of the transferred assets.

¹ 120 T.C. No. 13, 120 T.C. 358, 2003 WL 21089049 (2003)



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Marketability Discount:

The IRS expert's conclusion in *McCord* is that the lack of marketability discount should be only 7.4%. Accordingly, as to the marketability – not minority – discount, the Chicago position is to start with 7.4%. Again, this assumes there are no Section 2036 issues and there are only passive underlying partnership assets. So, for audits, their opening position may typically be near a 7% discount for marketability. Usually a taxpayer seeks a much more substantial marketability discount.

The negotiations ensue with various facts proffered, and the parties could end up at 20% for a marketability discount. A 20% marketability discount was also the result the court reached in *McCord*.

Minority Interest Discount:

In the IRS' view, the appropriate minority interest discount should be comparable to the discounts on closed end mutual funds, i.e. 6%. Accordingly, the IRS begins at a 6% minority interest discount as their negotiating position.

Typically, the IRS will jump up to 10% in negotiations (because it is reasonably close to 6%) for the minority interest discount.

So, if the taxpayer is content with a 20% discount for **marketability**, then the IRS may look to settle. A common settlement posture may be a 20% marketability discount, and a 10% minority interest discount.

Conclusion:

If the taxpayer is taking a 25% total discount, there may not be an audit at all. Importantly, this assumes there are no other issues out there: no deathbed transfer, sham arguments or Section 2036 issues. If the taxpayer is standing firm and the amount is between a 25% and 30% total discount, the IRS may determine to close the case, be it on the gift or estate tax side.

In some recent cases, the IRS agents are trying to stick to a 25% total discount and the taxpayer is trying to push for a 35% total discount. If counsel for the taxpayer pushes hard, they may be able to achieve a 30% total discount.

It is important to note that, primarily, IRS agents are instructed by the national office to look for 2036 issues so as to achieve full inclusion. As to the amount of the discount, the national office provides less direction. So, the Chicago office appears to be more on its own as to the level of discount.



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In summary: Low hanging fruit is what perks up the IRS. Their resources are limited and they must choose their battles. When a taxpayer tries to achieve a 40% discount, they can then expect substantial attention from the IRS. If all transfer tax issues appear in order, 25% discounts may squeak through without audit.