# Estate & Succession Planning Corner

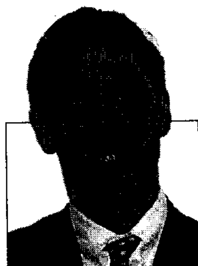
By Louis S. Harrison

## There is a Hol(e) Man in the Court's Reasoning

One of the more important appellate court valuation cases was handed down in late spring by the Eighth Circuit, *T.H. Holman*.[1] In this month's column, we analyze the reasoning and how it applies to the structuring of family limited partnerships.

The case focuses on three aspects of family partnership planning—the step-transaction, Code Sec. 2703 and application of the traditional willing buyer/willing seller test to valuation. Its holding is significant in all three areas.

The Holman partnership was funded with Dell stock and in certain regards, had a similar feel to *C.P. Schutt Est.*,[2] in which Exxon stock was contributed to the partnership, discounts in valuation for partnership interests were respected, and Code Sec. 2036 was held not to apply. In *Holman*, the goals of the partnership were to "preserve wealth within their family, and prevent their children from dissipating assets. At the same time, they sought to teach their children basic investing principles…." Limited partnership interests were transferred to trusts for the benefit of the children shortly after the partnership was created, and the value of these transfers was challenged by the IRS for gift tax purposes.



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## Step Transaction Section[3]

In the Tax Court opinion, Judge Halpern positioned his way into using the "interdependence test" to determine whether the step-transaction doctrine would apply to the limited partnership interests transferred within six days of partnership creation. Under this test, the question is whether each step

has independent significance. That is, did the creation of the partnership have significance different than the gifting?

Judge Halpern concluded it did, relying on three principles: First, when the partnership was established, the capital accounts were maintained and adjusted accordingly. Second, at the time of creation, the partnership interests were not gifted (meaning, the same day). Third, there was a period of time in which the partnership assets could have gone up or down in value prior to the transfer.[4]

The court's conclusion is that the gifting and partnership did not have interdependence because: "[W]e cannot say that the legal relations created by the partnership agreement would have been fruitless had petitioners not also made the 1999 gift."

The Tax Court thus held that the step-transaction doctrine was inapplicable. On appeal, the IRS did not challenge this "no step transaction" holding of the Tax Court.

> The *Holman* case, though depressing to the planner, needs to be understood for what it is and what it is not. It is not the death knell to partnership planning.

## Code Sec. 2703

In partnership planning in the modern age, meaning since 1990 and the introduction of chapter 14, discount planning has focused primarily on avoiding two sections of the Code, first Code Sec. 2704(b), and thereafter, Code Sec. 2036 (a). Once the *Kerr* case came out in 1999,[5] approving of the discount partnership if state law provides restrictions on redemption, the hurdle that was Code Sec. 2704 (b) was overcome. Thereafter, with the introduction of the *Strangi* case,[6] and its progeny, emphasis shifted to Code Sec. 2036(a) and how to avoid the negative impact of that section. Prior articles have focused on those progeny and the proper structuring of partnerships to avoid Code Sec. 2036(a).

Over the last 20 years, there have been attempts by the IRS to use Code Sec. 2703 as another impediment to achieving discounts in the family partnership setting. With the holding in the *Holman* case, that section got some bite. Emphasis though on "some bite," as the real meaning of the *Holman* case and its significance in this area needs to be carefully considered by practitioners and is discussed in the final section of this issue's column.

Code Sec. 2703 ignores restrictions in agreements for valuation purposes unless certain tests are met, including that the restriction be a "bona fide business arrangement." The *Holman* case tested whether a transfer restriction in a partnership involving readily marketable assets could be a bona fide business arrangement.

The Court concluded that the partnership at hand did not satisfy the test. Unlike the *Schutt* case, in which retention of Exxon stock was a purpose of the partnership, or a partnership that holds a single stock but with a plan of diversification, there was insufficient direction for investment purposes in this case. With "no stated intention to retain that stock or invest according to any particular strategy," the partnership was held to lack sufficient reason and was determined to have no business purpose. Accordingly, the transfer restrictions were ignored under Code Sec. 2703.

In considering the satisfaction of the bona fide test, the Court focused on the purposes of the partnership, versus the purposes of the restrictions. This looks to be in error and a misapplication of the Code Sec. 2703 exception. Had the Court focused on the transfer restrictions, the bona fide nature of these restrictions seems more easily satisfied. The dissent picked up on this distinction. It concluded that: "I would hold that the Holman **partnership agreement restrictions** are 'bona fide business arrangements' because they were not created for the primary purpose of avoiding taxes, and they served ... legitimate business purposes."

## Willing Buyer/Willing Seller

The hypothetical willing buyer/willing seller test means that the liquidity discount associated with a limited partnership interest should focus on what a third party buyer, not another partner in the partnership, would pay for the interest. The Appellate Court disagreed, though it did so subtlely.

It agreed with the IRS's expert that the discount would be constrained, or cut back, by what "economically rational insiders" would pay for the stock. That is, if it were determined that non-partners would pay 60 percent of the liquidation value for the limited partnership interest, insiders would step in and pay

*Continued on page 62*



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instrument and the date of the alteration or modification is not taken into account to the extent that the decrease in fair market value is attributable to the deterioration in the financial condition of the obligor and not to a modification of the terms of the instrument. Under Proposed Reg. §1.1001-3(f)(7)(ii)(B), if there is a substitution of a new obligor or the addition or deletion of a co-obligor, Proposed Reg. §1.1001-3(f)(7)(ii)(A) does not apply.

The problem with the proposed regulations is the last few words in Proposed Reg. §1.1001-3(f)(7)(ii)(A): "and not to a modification of the terms of the instrument." How is this distinction going to be drawn? For example, assume that Acme Explosives LLC (of Road Runner fame) had a bust in its earnings, and as a result of its precarious and grossly overleveraged financial condition, its lender required a modification of the terms of its debt instrument. The lender agreed to extend the term of the debt for 10 years (clearly a significant modification under Reg. §1.1001-3(e)(2)), but it also decreased the interest rate from 12 percent per annum to eight percent per annum. If Acme has minimal capital, does the significant modification result in equity for tax purposes, even though the change in the terms of the instrument was a result of the decline in the issuer's financial condition? The Proposed Regulations would appear to say "yes it could" if there was a decline in the value of the debt instrument because its interest rate had decreased.

This problem is not limited to situations with changes to interest rates. There are numerous other transactions that regularly occur in debt workouts, including changes to the terms of a debt instrument as to the timing and amount of payments. For example, if a bank permitted a substantial deferral of interest payments, this could result in a significant loss of value for the holders of the debt instrument. If the value of the debt declined because of the changes to the instrument's terms, and not because of the decline in the issuer's value, then the last sentence in Proposed Reg. §1.1001-(3)(f)(7)(ii) could result in recharacterization of the debt instrument from debt into equity.

Moreover, if a lender is willing to modify a debt instrument of an over-leveraged issuer, the lender's sole motivation is often to have another co-obligor. Proposed Reg. §1.1001-3(f)(7) follows the approach in Reg. §1.1001-3(e)(5)(i) that any substitution of an obligor or the addition or deletion of a co-obligor results in a significant modification. Thus, the proposed regulations (and the existing regulations) potentially result in a significant modification solely because the lender sought additional collateral for its debt instrument.

Thus, it appears that the IRS has attempted to "fix" the glitch in Reg. §1.1001-3(e)(5)(i) under which a significant modification of a debt instrument could result in recharacterization of the instrument into equity. However, the proposed regulation does not clearly provide that if there is a significant modification of a debt instrument, the instrument is not re-tested to determine whether it is debt or equity. This approach is needed, but the proposed regulations follow the approach of the existing regulations by leaving open the possibility of debt/equity re-testing whenever a significant modification of a debt instrument occurs.

## ENDNOTES

1 Reg. §1.1001-3(b).

2 *Cottage Savings Ass'n*, SCt, 91-1 USTC ¶50,187, 499 US 554, 111 SCt 1503.

3 The recent clarification of the economic substance doctrine through the enactment of Code Sec. 7701(o) has drawn additional attention to *Cottage Savings*, because the transaction described therein was undertaken solely for tax purposes and had no perceived economic impact on the parties. It appears likely that the result in *Cottage Savings* was not altered because Code Sec. 7701(o) expressly provides that the economic substance doctrine is applied only to transactions for which it is "relevant," which are transactions that would have been subject to the doctrine prior to the enactment of Code Sec. 7701(o). Since the Supreme Court saw fit not to apply the economic substance doctrine to the *Cottage Savings* transaction in 1989, presumably the exact same transaction would not be subject to application of the economic substance doctrine after the enactment of Code Sec. 7701(o).

4 The regulations are further proof of the old adage "be careful what you ask for, because you just might get it."

5 Reg. §1.1001-3(c)(1)(i).

6 Reg. §1.1001-3(e)(1).

7 Reg. §1.1001-3(e)(2), (3) and (4).

8 TD 8675, September 24, 1996.

9 This would be a significant modification under Reg. §1.1001-3(e)(1) because the interest rate was reduced by more than 25 basis points.

## Estate & Succession

Continued from page 16

more, say 87.5 percent. And that, therefore, the discount could not exceed what the insiders would pay (the 87.5 percent). The flaw in this logic, emphasized by the strong dissent in the *Holman* case, is that insiders are not a hypothetical willing buyer. They are a strategic willing buyer.

More interesting and defensible would have been had the Court focused on the "willing seller" side of the equation. Perhaps a willing seller would not agree to a substantial discount knowing that there would be many buyers out there that could be both "hypothetical" buyers and "strategic" buyers at the same time.



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## Takeaways

The *Holman* case, though depressing to the planner, needs to be understood for what it is and what it is not. It is not the death knell to partnership planning. It is yet one more constraint that needs to be considered in partnership planning.

First, application of Code Sec. 2703 means that only certain restrictions are ignored for estate and gift tax valuation purposes, not all restrictions. In this context, restrictions on transferability are ignored, if the *Holman* "bona fide" test is not satisfied regarding business purpose. But query whether Code Sec. 2704(b) would apply in any event as to that specific restriction. An increased discount associated with transfer restrictions is but a pimple on the overall discount acne. After *Holman*, this one pimple may have been popped in certain cases.

Partnership discounts are more based on State law, and the inability of a partner to redeem its interest prior to the termination of the partnership. This inability leads to an interest that receives cash flow only if the general partner determines to distribute cash flow. And with that kind of interest, and the partnership not being publicly traded, there are not many buyers out there who would buy it from the holder of the interest. With few buyers, there is a reduction in value based on illiquidity discounts with not having a market to sell the interest. There is still an illiquidity discount even after *Holman*.

Second, *Holman* is an Eighth Circuit case; other circuits can still take the approach that Code Sec. 2703 does not apply (to negate restrictions). Practitioners should argue that the *Holman* case in incorrectly decided in those other circuits.

Third, the business purpose test to avoid Code Sec. 2036(a) is more easily satisfied than the business purpose test to avoid Code Sec. 2703 as enunciated by the *Holman* court. Therefore, practitioners should continue to enunciate business purposes even if those reasons may be insufficient to avoid Code Sec. 2703.

Fourth, the *Holman* court does give the practitioner room to develop and argue for business reasons (ponder whether the *Schutt* reasoning—holding a single concentration—would have been sufficient) that may be sufficient to constitute "bona fide business arrangements" and, therefore, qualify for this part of the exception to the application of Code Sec. 2703.

Fifth, the reduced level of discount that was allowed by the Tax Court, and affirmed by the Appellate Court, is still subject to argument in each and every case. Despite applying Code Sec. 2703 and using a bizarre application of the willing buyer/willing seller test, the Court still allowed a specific marketability discount of 12.5 percent. The practitioner should continue to develop strong arguments as to why a willing buyer/willing seller would reduce the value of an illiquid asset (such as a limited partnership interest) by greater than 30 percent.

Sixth, the avoidance of the step-transaction doctrine by putting time between the creation of the partnership and the transfer of limited partnership interests is still an important tool, and still valid law.

From a macro perspective, *Holman* is a speed bump on the partnership discount highway. A practitioner should slow down, go slowly over the Code Sec. 2703 bump, and then continue on the way to discount land. More troubling than the *Holman* case will be anti-discounting legislation that we may see by year-end. Stay tuned. Same bat channel, same bat time.

### Endnotes

1 *T.H. Holman*, CA-8, 2010-1 USTC ¶60,592.
2 *C.P. Schutt Est.*, 89 TCM 1353, Dec. 56,042(M), TC Memo. 2005-126.
3 Discussed in the prior column, Louis S. Harrison and John Janiga, Estate & Succession Planning Corner, *Say It Ain't So, Joe: Should the Step Transaction Doctrine Ever Apply in the Partnership Arena?* Linton, Adams *and* Gross, J. Passthrough Entities, Nov.–Dec. 2009, at 11.
4 "[P]assage of time may be indicative of a change in circumstances that gives independent significance to a partner's transfer of property to a partnership and the subsequent gift of an interest in that partnership to another."
5 *B.P. Kerr*, Dec. 53,667, 113 TC 449 (1999).
6 *A. Strangi Est.*, 85 TCM 1331, Dec. 55,160(M), TC Memo. 2003-145.

## Ethics and Tax

Continued from page 18

### Endnotes

1 The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the authors only, and does not necessarily represent the views or professional advice of KPMG LLP.
2 In general, Form 872 is used for an extension with a fixed period of time, and Form 872-A is used for an extension with an indefinite time.
3 The new language in Form 872 provides, "Without otherwise limiting the applicability of this agreement, this agreement also extends the period of limitations for assessing any tax (including additions to tax and interest) attributable to any partnership items (see section 6231(a)(3)), affected items (see section 6231(a)(5), computational adjustments (see section 6231(a)(6)), and partnership items converted to nonpartnership items (see section 6231(b)). This agreement extends the period for filing a petition for adjustment