Holman v. Commissioner US Court of Appeals for the Eighth Circuit No. 08-3774

By Chris D. Treharne, ASA, MCBA, BVAL
and John Walker
Gibraltar Business Appraisals, Inc.
1325 Dry Creek Drive, Suite 201
Longmont, CO 80503
303.532.2545

CITATION:
Thomas H. Holman, Jr.; Kim D.L. Holman, Donors, v. Commissioner
105 AFTR 2d ¶ 2010-721 (8th Cir. April 7, 2010)

OVERVIEW:
Both the Eighth Circuit Court of Appeals and Tax Court ruled adversely with respect to specific provisions of the taxpayers' partnership agreement. Nonetheless, both courts accepted discounted direct transfers of partnership interests (as opposed to indirect transfers of assets owned by the partnership) and significant discounts (lack of control and lack of marketability) for limited partnership interests in an undiversified partnership owning only one publicly traded stock.

The case is also notable for its vigorous dissent and the legal framework provided for future taxpayer challenges of § 2703 disputes.

The majority of judges in the Eighth Circuit upheld the Tax Court's determination that the Holman FLP's restrictions on transferability did not serve a "bona fide business arrangement" under I.R.C. § 2703(b)(1).

Unlike the Tax Court, the Eighth Circuit majority did not address the testamentary transfer rules of § 2703(b)(2) because the partnership agreement failed § 2703(b)(1).

For similar reasons, the Eighth Circuit majority did not consider the factors in § 2703(b)(3), i.e., whether the partnership agreement terms were "comparable to similar arrangements entered into by persons in an arms' length transaction."

Presumably, the preceding adverse rulings with respect to specific provisions of the partnership agreement did not invalidate the partnership agreement in whole because the Tax Court ultimately recognized the gifts were direct transfers of limited partnership interests rather than indirect transfers of publicly traded Dell stock, the sole asset of the FLP. While not explicit, however, the taxpayer-adverse § 2703 conclusions may have mitigated the court's choice of a marketability discount.

In its ruling, the Tax Court awarded total discounts (lack of control and lack of marketability) for the four separate gifts ranging from 16.6% to 25.0%.

THE FACTS:

Thomas H. Holman and Kim D.L. Holman's wealth accumulated in the form of Dell stock during Thomas' career with Dell. In Tax Court, Thomas testified that purposes for forming the FLP included transfer of wealth to their daughters, family wealth preservation, preventing the children from selling or otherwise dissipating the assets making up family wealth, and protecting family assets against future claims from creditors or a child's ex-spouse. In order to accomplish those goals, the family formed a family limited partnership.

The FLP had transfer restrictions that included forbidding limited partners from withdrawing from the partnership, denying partners the ability to encumber their interests, and providing rights of first refusal to the partnership and its partners upon the sale of partnership interests. Additionally, the partnership agreement allowed partners the ability to refuse an assignee admission as a substituted limited partner.

The Tax Court held that the partnership restrictions mentioned above did not serve "bona fide business purposes" and therefore the FLP did not serve a "bona fide business arrangement within the meaning of § 2703(b)(1)."

Additionally, the Tax Court determined the transfer restrictions were testamentary devices in that the FLP failed to satisfy the requirements of § 2703(b)(2).

DISCUSSION:

I.R.C. § 2703(b) is similar to IRC § 2036(a) in that they have "bona fide business" requirements and full and adequate consideration must be paid.

The Eighth Circuit majority determined the FLP failed to satisfy the "bona fide business arrangement" requirement of I.R.C. § 2703(b)(1) because "there was, and is, no 'business,' active or otherwise." In particular, the majority held that restrictions on partnerships holding "only an insignificant fraction of stock in a highly liquid and easily valued company with no stated intention to retain that stock or invest according to any particular strategy" served no bona fide business purpose.

The majority determined that *Estate of Amlie v. Commissioner*, 91 T.C.M (CCH) 1017 (2006), was inapplicable to the Holmans in that the security held by the Holmans' FLP did not require additional liquidity. In fact, the majority noted the Holmans were making the stock less liquid by placing it in the FLP.

The majority also relied on *Estate of Schutt v. Commissioner,* 89 T.C.M (CCH) 1353 (2005), which stated there was "no significant nontax purpose, however, where a family limited partnership is just a vehicle for changing the form of the investment in the assets, a mere asset container." The majority held that the FLP in the present case was a mere asset container. Additionally, the majority determined that "family membership, educational, and tax-reduction overshadow any claim of a business purpose for the restriction."

The Eighth Circuit also concurred with the Tax Court that the unanimous consent requirement for dissolution and the rights of first refusal set a cap on discounts for the FLP. In particular, the majority believed that economically rational insiders would step in to buy shares of an exiting partner if outsider buyers demanded too great a discount.

In dissenting from the majority, Judge Beam determined I.R.C. § 2703 contains no definition for the term "bona fide business arrangement" and that the Tax Court conceded in its decision in this case that the definition of the term was not self apparent. Accordingly, the dissent began by focusing on legislative intent in the creation of the law and found several congressional committees that support maintaining family control of assets is a legitimate business purpose.

Judge Beam further determined that "*same portion of legislative history* [emphasis in original] cited by the Tax Court in *Amlie*" recognizes preventing unauthorized transfers as a legitimate business purpose. The Judge wondered why, if active management was not required in *Amlie* but was cited by the Tax Court for the present case, would active management be required for the Holmans.

Further, the dissent indicated that protection of assets from creditors and from future ex-spouses, as well as the determination of who may permitted to become a partner, all served as legitimate nontax reasons for the restrictions. The Judge also wrote that the "underlying purposes of § 2703 are not served where, as here, the bona fide business arrangement test is applied in a manner that discourages family partnerships from creating restrictions principally to achieve non-tax, economic goals."

The dissent went on to state that § 2703(b)(2) is inapplicable because the section clearly states restrictions cannot be used to transfer assets for less than full and adequate consideration to family members of a decedent. As there was no decedent in the Holman case, the Judge determined § 2703(b)(2) was inapplicable.

Judge Beam agreed with the Tax Court that the transfer restrictions for the Holmans' FLP were comparable to those entered into by others in arms' length transactions. Accordingly, the comparable terms test of § 2703(b)(3) was satisfied.

Finally, the dissent disagreed with the majority in its application of willing buyer/willing seller test to determine a marketability discount. Judge Beam cited *Morrisey v. Commissioner*, 243 F.3d 1145, 1148 (9th Cir. 2001), which was supposed to prevent tailoring hypothetical scenarios in which the hypothetical willing buyer and willing seller are seen as the most likely to undertake the transaction. Specifically, the Judge indicated that the Tax Court's reasoning for capping discounts involved hypothetical buyers who already own FLP interests. This reasoning violates the hypothetical portion of the hypothetical willing buyer/willing seller test.

Because the FLP had no history of buying out exiting partners and no history of dissolution, the use of insiders in the hypothetical scenario for the Tax Court was inappropriate.

COMMENTS:

While a defeat for taxpayers, the Eighth Circuit's ruling in Holman is particularly notable for its vigorous and well-reasoned dissent. The majority decision paves the way for future IRS challenges to FLP gift valuations, while the dissent provides a legal framework to overcome the majority decision. As a result, the courts' opinions likely will be revisited in the business valuation and legal communities in the future.