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FAMILY LIMITED PARTNERSHIPS: THE PARTS CAN BE WORTH LESS THAN THE WHOLE

Lappo v. Commissioner

Leslie Bounds

I. INTRODUCTION

"Family limited partnerships [hereinafter FLPs] are a commonly used vehicle through which wealth is transferred from one generation to the next."[1] In general, a FLP is a limited partnership where all of the partners are family members or family trusts.[2] The general partners have complete control over the management of the partnership and its assets. The limited partners are passive investors who have no say over the day-to-day management of the affairs of the partnership.[3] Typically, "[t]he donors (commonly the parents or grandparents) [retain] the general partnership interest . . . and over time, make gifts of limited partnership interests to the donees (commonly the children or grandchildren)."[4]

A significant tax benefit of a FLP is a potential valuation discount available for the gifts of limited partnership interests to the limited partners.[5] "When valuing FLP interests, courts consistently apply [ ] discounts for lack of control and lack of marketability."[6] "The availability of these discounts allows gifts of ownership interests to be made at values less than the proportionate share of the fair market value of the underlying assets."[7] Although similar, "[a] minority-interest discount recognizes the limited partner's lack of control within the partnership; [whereas] a lack-of-marketability discount recognizes the inability of a limited partner to transfer his interest in the partnership."[8]

The Internal Revenue Service [hereinafter IRS] has applied a number of different legal theories in challenging the use of FLPs to produce valuation discounts, although their arguments have generally been rejected by the courts.[9] One of the more litigious issues between the IRS and taxpayers is the quantification of lack of control and lack of marketability discounts as applied to partial ownership interests in FLPs.[10] This note will explore the development of the IRS's challenges to FLPs, analyze the Lappo Family

1. Leslie A. Droubay, Comment, *The Certainty of Death and Taxes for Family Limited Partnerships*, 7 J. SMALL & EMERGING BUS. L. 523, 524 (2003).
2. *Id.* at 525.
3. *Id.*
4. *Id.*
5. *Id.*
6. *Id.*
7. *Id.*
8. *Id.*
9. *Id.* at 526.
10. *Id.*

Limited Partnership, and compare its resulting litigation to two other recent tax court decisions concerning valuation of discounts.

II. FACTS

On October 20, 1995, Clarissa Lappo, the petitioner, and her daughter Clarajane formed the Lappo Family Limited Partnership.[11] On April 19, 1996, an initial capital contribution of marketable securities (principally municipal bonds) and certain parcels of Michigan real estate were conveyed to the partnership.[12] The initial partnerships interests were as follows:

Partner	General Interest	Limited Interest	Total
Clarissa	1.0	98.7	99.7
Clarajane	.2	.1	.3
Total	1.2	98.8	100.0[13]

Initial partnership interests were allocated based on the market value of the assets contributed to the partnership as of December 31, 1995.[14] The market value of the securities was $1,318,609 and the appraised value of the land was $1,860,000.[15]

On April 19, 1996, Clarissa transferred 69.4815368 percent of her limited partnership interest between Clarajane, as Trustee of the Lappo Generation Trust, and each of the four individual grandchildren.[16] On July 2, 1996, Clarissa gave her remaining limited partnership interest to Clarajane in her individual capacity.[17] Consequently, after these gifts, the partnership interests were as follows:

Partner	General Interest	Limited Interest	Total
Clarissa	1.0	-	1.0000000
Clarajane	.2	29.3184632	29.5184632
Lappo Generation Trust	-	66.8091700	66.8091700
1st grandchild	-	.6680917	.6680917
2nd grandchild	-	.6680917	.6680917
3rd grandchild	-	.6680917	.6680917
4th grandchild	-	.6680917	.6680917
Total	1.2	98.8000000	100.0000000[18]

11. Lappo v. Comm'r, 84 T.C.M. (RIA) P 2003-258, at 1431-32 (2003).
12. *Id.* at 1432.
13. *Id.*
14. *Id.*
15. *Id.*
16. *Id.*
17. *Id.*
18. *Id.*

As typical in many FLPs, the partnership agreement provided that all management authority resided in the general partners; the FLP terminated if there was no general partner; rules for withdrawing capital or taking distributions were spelled out; any withdrawal of capital would be paid in cash; any amounts contributed to, or accumulated in, the partnership were not entitled to interest; limited partnership interests could be assigned but the assignee would not receive any rights other than the right to distribution; assignees would not become a limited partner; the partnership had a right of first refusal if a limited partner wished to sell his or her interest; the partnership had the right to purchase limited partnership interests that were available due to death or a transfer by operation of law; and the partnership would terminate in 2045, unless a prior termination had already occurred.[19]

The petitioner filed a gift tax return in April 1997, valuing her April 1996 gifts of limited partnership interests at $1,040,000 and paid $153,000 in gift tax.[20] In February 1998, the petitioner amended her gift tax return to include the gift she made to her daughter in July 1996 valued at $423,871 with $177,265 in additional tax being remitted.[21]

The IRS issued a notice of deficiency in June 2001, stating the 1996 gifts should have been valued at $3,137,287, resulting in an additional tax bill of $998,508, less the $177,265 in tax that was paid on the July 1996 gift.[22]

III. BACKGROUND AND HISTORY OF THE LAW

A. *Family Limited Partnerships*

1. Development of Family Limited Partnerships

Family partnerships were a common vehicle first used for tax purposes principally to shift income from higher income tax bracket members to lower income tax bracket members.[23] In 1946, the Supreme Court refused to recognize family partnerships unless each partner provided original capital, vital services, substantially contributed to control and management of the partnership or all of the above.[24] This position disallowed the concept of partnership interests being created by gifts. The Supreme Court clarified this position three years later by reaffirming that a purported partner must contribute capital or services to the partnership, but held that the capital need not originate with the partner or the services be "vital."[25] However, the facts and circumstances must show that the parties "in good faith and acting with a

18. *Id.*
19. *Id.* at 1432-33.
20. *Id.* at 1433.
21. *Id.*
22. *Id.*
23. *See* Comm'r v. Tower, 327 U.S. 280 (1946).
24. *Id.* at 290.
25. Comm'r v. Culbertson, 337 U.S. 733, 744 (1949).

business purpose intended to join together in the present conduct of the enterprise."[26] The Court, in determining good faith, looked to the parties' agreement, conduct, statements, relationship, respective abilities and capital contributions, their actual control of partnership income, and testimony of disinterested persons.[27] Subsequently, Congress enacted § 191 and § 3797(a)(2) of the 1939 Code. These sections were carried forward into the 1954 and 1986 Codes as § 704(e).[28] Section 704(e) currently recognizes a partner for federal income tax purposes if he or she "owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not [the] interest was derived by purchase or gift from another person."[29] As a result, family partnership interests are often gifted from donors to donees.

2. Valuation of the Partnership

Once the fact of a partnership is established, the fair market value of a partnership interest is determined. Fair market value is "the price at which the property would change hands between a willing buyer and a willing seller, when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, and both parties having reasonable knowledge of relevant facts."[30] "The standard is an objective test using hypothetical buyers and sellers;" it is not a personalized transaction between a particular buyer and seller.[31] Fair market value, being a question of fact, is dependant upon circumstances in each case.[32] "No formula can be devised [to be] applicable to the multitude of different valuation issues arising in estate and gift tax cases."[33]

3. Minority Discounts

A lack of control discount, or a minority interest discount, is appropriate when valuing an interest in an entity in which the holder of the interest has no right to decide timing of distributions, liquidation of the entity and other matters affecting the ownership interest.[34]

The IRS has changed its position on minority interest discounts over time. On January 26, 1993, the IRS issued Revenue Ruling 93-12 stating "a minority discount will not be disallowed solely because a transferred interest, when aggregated with other interests held by family members, would be a . . . controlling interest."[35] Prior to the issuance of Revenue Ruling 93-12, the

26. *Id.* at 744-45.
27. *Id.*
28. I.R.C. § 704 (2000).
29. I.R.C. § 704(e)(1) (2000).
30. Treas. Reg. §§ 20.2031-1(b) (as amended in 1965), 25.2512-1 (as amended in 1992).
31. LeFrak v. Comm'r, 64 T.C.M. (RIA) P 93,526, at 2810 (1993).
32. Rev. Rul. 59-60, 1959-1 C.B. 237.
33. *Id.*
34. *Id.*

IRS attempted to enforce Revenue Ruling 81-253. Revenue Ruling 81-253 held no minority shareholder discount is allowed with respect to transfers of shares of stock between family members if, based upon a composite of the family members' interests at the time of transfer, control of the corporation exists in the family unit.[36] In essence, the IRS attributed the control held by the family as a whole to each family member's partial interest. In spite of Revenue Ruling 81-253, key court cases upheld the application of minority interest discounts to family ownership interests.[37] As a result of these cases and the issuance of Revenue Ruling 93-12, Revenue Ruling 81-253 has been revoked.[38]

4. Marketability Discounts

A lack of marketability discount takes into account the difficulty in finding a willing buyer for an interest in a non-publicly traded entity rather than finding a willing buyer for an interest in a publicly traded entity.[39] Additional expenses may be incurred, such as legal, accounting, and syndication fees, in order to sell the interest. The price of publicly traded interests reflect a lack of control discount but not a lack of marketability discount as they are sold on a recognized exchange, and by definition they are marketable. In contrast, a closely held interest is subject to both minority and marketability discounts.

B. IRS Challenges to FLPs

The gift tax regime requires a two-part inquiry – a determination of the property transferred by gift and the valuation of the transferred property at the date of gift.[40]

1. Identifying the property transferred

The Internal Revenue Code imposes a tax on property transferred by gift.[41] The gift tax applies "whether the gift [is in trust or otherwise], . . . direct or indirect, and whether the property is real[,] personal, tangible or intangible . . . ."[42] Where property is transferred for less than an adequate and full consideration in money or money's worth, the excess of the value of the property transferred over the value of the consideration is a gift except to the

36. Rev. Rul. 81-253, 1981-2 C.B. 253..

37. Estate of Bright v. U.S., 658 F.2d 999 (5th Cir. 1981); Propstra v. U.S., 680 F.2d 1248 (9th Cir. 1982).

38. Rev. Rul. 93-12, 1993-1 C.B. 202; *see also* Estate of Andrews v. Comm'r, 79 T.C. 938 (1982); Estate of Lee v. Comm'r, 69 T.C. 860 (1978).

39. *Id.*

40. *See* I.R.C. §§ 2501, 2511(a), 2512 (2000); Treas. Reg. §§ 25.2511-1 (as amended in 1997), 25.2511-2 (as amended in 1999), 25.2512-8 (as amended in 1992).

41. I.R.C. § 2501 (2000).

42. I.R.C. § 2511(a) (2000).

extent the transfer is in the ordinary course of business, i.e., it is bona fide, at arm's length, and free from donative intent.[43] As a result, the transfer of assets to a partnership for less than adequate and full consideration constitutes an indirect gift from the transferor partner to the other partners.[44] In a FLP, the first inquiry becomes whether the property transferred by gift is an interest in a partnership or, in substance, a gift of an interest in the underlying assets owned by the entity.[45]

a. Economic Substance

For years, "courts have applied the economic substance doctrine, or a variant thereof, . . . to disregard . . . transactions and entities . . . devoid of economic substance" solely generated for tax benefits.[46] Legal documents do not control for tax purposes when objective economic realities are to the contrary.[47]

> The inquiry into whether [a] transaction [ ] ha[s] sufficient economic substance to be respected for tax purposes turns on both the 'objective economic substance of the transactions' [practical economic consequences, other than the creation of tax benefits] and the 'subjective business motivation' behind them [valid business purpose or profit motive] . . . . [T]hese distinct aspects of the economic sham inquiry do not constitute discrete prongs of a 'rigid two-step analysis,' but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes.[48]

A fundamental principle of taxation is that "even where the 'form of the taxpayer's activities indisputably satisfie[s] the literal requirements' of the [law], the courts must examine 'whether the substance of those transactions was consistent with their form,' . . . because a transaction that is 'devoid of economic substance . . . simply is not recognized for federal taxation purposes.'"[49]

The determination of economic substance is a question of fact which sometimes results in conflicting determinations based on similar facts. In

43. Treas. Reg. § 25.2512-8 (as amended in 1992).
44. Treas. Reg. § 25.2511-1(h)(1) (as amended in 1997).
45. F.S.A. 2001 43 004 (October. 26, 2001).
46. *Id.*
47. *Id.*
48. ACM P'ship v. Comm'r, 157 F.3d 231, 247 (3d Cir. 1998) (quoting Casebeer v. Comm'r, 909 F.2d 1360, 1363 (9th Cir. 1990)).
49. *ACM P'ship*, 157 F.3d at 246 (quoting Lerman v. Commissioner, 939 F.2d 44, 45 (3d Cir. 1991)).

Estate of Murphy v. Commissioner, the court disallowed a minority discount for transfer tax purposes because the partnership transaction lacked substance and was devised solely to reduce transfer tax liability.[50] However, in *Estate of Strangi v. Commissioner*, a case with substantially similar facts, the same court considered another partnership to be validly formed when the proverbial "i's were dotted" and "t's were crossed."[51] A partnership, as a legal matter, must change the relationships between the decedent and his heirs and creditors.[52] "Regardless of subjective intentions, [a] partnership [must have] sufficient substance to be recognized for tax purposes."[53] Minimal formalities have been sufficient, as an example, in *Estate of Knight v. Commissioner* even though the partnership kept no records, prepared no annual reports, had no employees, and the partners and/or representatives never met and never discussed any business activity of the partnership, the court determined potential purchasers would not disregard the existence of a partnership.[54] The Tax Court seems willing to respect a business entity for estate and gift tax purposes when a hypothetical willing buyer would not disregard the entity.[55] In recent cases the court disregarded the IRS's argument that a partnership should be disregarded for federal tax purposes because it lacked economic substance and business purpose.[56]

b. Gift on Formation

Gift tax is "not imposed upon the receipt of [ ] property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the transfer, nor is it conditioned [on the] ability to identify the donee at the time of the transfer."[57] Rather, gift tax "is measured by the value of property passing from the donor, and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable."[58] It is an excise on the donor's act of transfer.[59]

"The 'gift on formation' . . . argument is based on the theory that the difference between the value of assets contributed to an entity . . . and the value of the interest in the entity received by the transferor constitutes a gift."[60] This argument focuses solely on the transferor's initial transfer of assets to the entity and the resulting consideration received by the transferor for those

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50. Estate of Murphy v. Comm'r, 59 T.C.M. (RIA) ¶ 90,472,2257 (1990).
51. Estate of Strangi v. Comm'r, 115 T.C. 478, 486 (2000) (*rev'd in part on other grounds* Estate of Strangi v. C.I.R., 293 F.3d 279 (5th Cir. 2002)).
52. *Id.*
53. *Id.* at 486-87.
54. Estate of Knight v. Comm'r, 115 T.C. 506, 511 (2000).
55. F.S.A. 2001 43 004.
56. Estate of Thompson v. Comm'r, 82 T.C.M. (RIA) P 2002-246, at 1521-22 (2002).
57. Treas. Reg. § 25.2511-2(a) (as amended in 1997).
58. *Id.*
59. *Id.*
60. F.S.A. 2001 43 004.

assets.[61] The argument assumes that the transaction is a bona fide sale and therefore requires a "determination of whether the consideration received by the transferor (the partnership interest or corporate stock) is 'full and adequate consideration in money or money's worth'" for the assets transferred.[62]

The IRS prevailed in its argument in *Shepherd v. Commissioner* where the donor contributed property to the partnership and half the value was immediately allocated to the capital accounts of the donor's children.[63] "[T]he court held that the donor [ ] made a gift of [fifty percent] of the contributed assets to [the] children, as opposed to gifts of partnership interests."[64] This result makes sense when the donor's capital contributions are immediately credited to other capital accounts.[65] In substance, it is similar to gifting the capital contributions to other partners who then contribute them to the partnership.[66] Had "the donor in *Shepherd v. Commissioner* . . . created a valid partnership, . . . taken a partnership interest corresponding to the contribution of assets and [then] gifted half of the interest to [the] children," he would have avoided the gift on formation trap.[67] In *Estate of Strangi v. Commissioner*, the court rejected a gift on formation argument where the partnership agreement credited only the donor's capital account upon receipt of the donor's assets followed by subsequent gifts of the donor's interests to the donees.[68] It appears that, "as long as certain formalities are followed, . . . the 'gift on formation' argument should not apply."[69]

c. Retention of Control

The IRS has successfully attacked the validity of FLPs where the transferor retains control of the property.[70] Formation of a FLP requires care in asset ownership and receipt of income. Ownership of the assets must be transferred to the FLP and income of the assets must be received by the FLP and deposited in FLP accounts. Otherwise, the IRS will take the position the decedent retained the benefit of the property requiring inclusion in the decedent's estate under IRC § 2036(a).[71] In *Estate of Schauerhamer v. Commissioner*, the Tax Court sustained an IRS attack that the assets in the FLP should be included in the decedent's estate where she received checks issued to the FLP and deposited them into her personal account.[72]

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61. *Id.*
62. *Id.*
63. RICHARD B. STEPHENS ET AL., FEDERAL ESTATE & GIFT TAXATION ¶ 10.02 [2][c][v] (8th ed. 2002) (citing Shepherd v. Comm'r, 115 T.C. 376 (2000), *aff'd* 283 F.3d 1258 (11th Cir. 2002)).
64. *Id.*
65. *Id.*
66. *Id.*
67. *Id.*
68. *Id.*
69. *Id.*
70. F.S.A. 2001 43 004.
71. I.R.C. § 2036(a) (2000).
72. Estate of Schauerhamer v. Comm'r, 71 T.C.M. (RIA) P 97, 242, at 1505-06 (1997).

A properly formed partnership consistently operated should prevail in a retained control challenge under IRC § 2036(a)(1), but may still be vulnerable to attack under IRC § 2036(a)(2). In general, this section operates to pull the property over which the decedent held the power to determine who, other than the decedent, will receive the income from the property into the decedent's gross estate.[73] The Tax Court defined parameters for the application of IRC § 2036(a)(2) in that there must be independent control of assets or constraint on the decision making process such as economic realities of a business purpose or a fiduciary duty to the other owners in order to withstand a challenge under IRC § 2036(a)(2).[74]

The *Estate of Strangi v. Commissioner* court held that the decedent's estate must include the value of his assets transferred by him during his lifetime to a FLP where he retained extensive control over key decisions affecting the distribution of money among partners.[75] An asset transferor who becomes sole general partner appears to be the most at risk to the retention of control argument and should consider multiple general partners or an independent third party.

2. The Value of Transferred Property

The value of any transferred property interest is determined by applying the appropriate valuation standard.[76] Fair market value is defined as "the price at which the 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."[77] "This objective test requires [that] property [ ] be valued from the viewpoint of a hypothetical buyer and seller, [with each seeking to maximize] profit from any transaction involving the property."[78]

In addition to the fair market valuation standard, special valuation rules contained in Chapter 14 of the Internal Revenue Code may apply to transactions involving FLPs.[79] Congress enacted Chapter 14 in 1990 to replace § 2036(c), which had been enacted in 1987 to prevent the use of estate valuation freezing techniques that were perceived to be abusive.[80] Under former § 2036(c), transferred property and interests in property were brought back into the transferor's estate if the transferor transferred a disproportionate share of the future appreciation to younger family members and retained rights to

73. I.R.C. § 2036(a)(2) (2000).
74. F.S.A. 2000 49 003 (Dec. 8, 2000).
75. *Estate of Strangi*, 115 T.C. at 480.
76. F.S.A. 2001 43 004 (October 26, 2001).
77. Treas. Reg. §§ 20.2031-1 (as amended in 1965), 25.2512-1 (as amended in 1992).
78. F.S.A. 2001 43 004.
79. I.R.C. § 2701 (2000).
80. F.S.A. 2001 43 004.

income or management.[81] As interpreted by the IRS, it applied to many arrangements passing property and interests in property to younger family members and required complex calculations to determine the amount later included in the transferor's estate.[82] Adopting a different approach, Chapter 14 applies at the time of the initial transfer with resulting gifts upon a transfer of a retained interest or the death of the transferor.

a. The Effect of Restrictions on Transferred Property

The value of any property is determined for transfer tax purposes without regard to any right or restriction relating to the property.[83] Restrictions include "[a]ny option, agreement, or other right to acquire or use the property at a price less than the fair market value [of the property] (determined without regard to the option, agreement or right); or [a]ny restriction on the right to sell or use the property."[84] Such restrictions include restrictions on the owner's right to require the entity to buy the owner's interest at a reasonable price or on the right to transfer the owner's interest to third parties without unreasonable restrictions.[85] The IRS has attempted to expand the reach of § 2703 by arguing that the entity itself may be disregarded under § 2703 with the result that for transfer tax purposes a transfer of an interest in the entity is treated as a transfer of an interest in the underlying assets held by the entity.[86] Accordingly, the IRS will not allow a discount to a transfer of an interest in an entity holding marketable securities, and only allows a fractionalization discount, presumably less than a combined lack of control and lack of marketability discount, to a transfer of other kinds of investments including real estate.[87] This position disregards the fundamental precept of federal transfer taxation that state law determines the property rights includible in a decedent's estate.[88] The Tax Court specifically rejected this IRS position in *Estate of Strangi v. Commissioner*, finding that neither the statute nor the regulations support valuing the underlying assets of a partnership rather than the partnership interest held by the transferor or decedent.[89]

There are two exceptions to § 2703, one statutory and one regulatory. Under the regulatory exception, a right or restriction on the interest's value is not ignored when the family owns less than 50% of the value or voting rights

81. *Id.*

82. *Id.*

83. I.R.C. § 2703(a)(2) (2000).

84. Treas. Reg. § 25.2703-1(a)(2) (1992).

85. *Id.*

86. *See* Tech. Adv. Mem. 97 36 004 (June 6, 1997), 97 35 003 (May 8, 1997), 97 30 004 (April 3, 1997), 97 25 002 (Mar. 3, 1997), 97 23 009 (Feb. 24, 1997), 97 19 006 (Jan. 14, 1997).

87. F.S.A. 2001 43 004.

88. *See, e.g.*, Comm'r v. Bosch Estate, 387 U.S. 456 (1967); Aquilino v. United States, 363 U.S. 509 (1960); United States v. Bess, 357 U.S. 51 (1958); Morgan v. Comm'r, 309 U.S. 78 (1940).

89. Reed W. Easton, *Courts Affirm Family Limited Partnership Technique – Service Vows to Fight On*, 5 VALUATION STRATEGIES 10 (2002).

in the entity.[90] Under the statutory exception, a right or restriction that satisfies the three requirements of § 2703(a) will not be disregarded.[91] It appears that a restriction that is commercially reasonable will not be disregarded in valuing an interest in a family-controlled business.[92] However, the IRS has held that the series of transactions (the creation and funding of the partnership and the transfer of partnership interests) are in substance one integrated transaction subject to the partnership agreement resulting in a transfer of the underlying partnership assets and ignoring the partnership agreement.[93]

b. Restrictions on Liquidation

When valuing a transfer of interest in a controlled entity to a family member, restrictions on the ability to liquidate the entity are disregarded if they are more limiting than state partnership law.[94] Section 2704(b) attacks valuation discounts based on restrictions on the ability of an entity to liquidate.[95] This provision determines the value of an ownership interest in the entity by disregarding certain features which would otherwise be taken into account in determining fair market value.[96] Section 2704(b) applies only if there is a transfer of an interest in an entity to a member of the transferor's family and the transferor and members of his family control the entity immediately before the transfer.[97] In essence, "applicable restrictions" are disregarded under § 2704(b).[98] An applicable restriction is a restriction limiting the ability of an entity to liquidate.[99] In addition to being an applicable restriction, either (1) the restriction must lapse, in whole or in part, after the interest in the entity has been transferred or (2) the transferor or any member of his family, alone or collectively, must have the right to remove the restriction after the transfer.[100]

The IRS has lost § 2704(b) challenges in a number of cases. The court in *Kerr v. Commissioner* concluded that partnership agreements providing for dissolution on a specific date or by agreement of all the partners were no more restrictive than the state law.[101] *In Harper v. Commissioner*, the Tax Court held that the limitations on liquidation contained in a California partnership agreement are not applicable restrictions within the meaning of § 2704(b).[102] The Tax Court held, in a similar situation, that the provisions of a

90. Treas. Reg. § 25.2703-1(b)(3) (1992).
91. Treas. Reg. § 25.2703-1(b)(1) (1992).
92. Church v. United States, 85 A.F.T.R.2d (RIA) 2000-428 at 811 (W.D. Tex. 2000).
93. F.S.A. 2001 43 004.
94. Treas. Reg. § 25.2704-2(b) (1992).
95. I.R.C. § 2704(b) (2000).
96. F.S.A. 2001 43 004.
97. *Id.*
98. I.R.C. § 2704(b) (2000).
99. I.R.C. § 2704(b)(2)(B) (2000).
100. *Id.*
101. Kerr v. Comm'r, 113 T.C. 449, 472-74 (1999).
102. Estate of Harper v. Comm'r, 78 T.C.M. (RIA) P 2000-202, at 1145-46 (2000).

Texas partnership agreement relating to dissolution and lack of withdrawal rights were not applicable restrictions under § 2704(b).[103] In *Estate of Jones v. Commissioner*, the Tax Court held that provisions in two Texas partnership agreements addressing the right to liquidate the partnerships do not constitute applicable § 2704(b) restrictions and need not be disregarded when determining the value of the partnership interests that the decedent transferred by gift.[104]

c. Allowance of Lack of Control and Lack of Marketability Discounts

Quantification issues in valuation and discount cases permeate this area. "We approximate that 243 sections of the Code require fair market value estimates in order to assess tax liability, and that 15 million tax returns are filed each year on which taxpayers report an event involving a valuation-related issue."[105] Valuation is a highly sophisticated process. We cannot realistically expect that litigants will be able to, or will want to, settle, rather than litigate, their valuation controversies if the law relating to valuation is vague or unclear.

Although the FLP continues to be a popular tax-planning vehicle, the IRS and the courts view many FLP's discounts with skepticism. When a taxpayer shows a FLP should be respected, interests in the FLP and not its underlying assets are valued for transfer tax purposes. The amount of any valuation discounts are "established through the testimony of a qualified expert."[106]

Three cases decided in the summer of 2003, *McCord v. Commissioner, Lappo v. Commissioner*, and *Peracchio v. Commissioner*, all involve FLPs holding multiple investments.[107] Initial attempts to disqualify the partnership form were abandoned or defeated resulting in valuation issues exclusively.[108] All three cases presented experts with impressive credentials on both sides, and the court rejected the experts' conclusions in these three cases and formed its own conclusions from empirical data.[109]

IV. INSTANT CASE

Lappo v. Commissioner provides a roadmap for valuation professionals to help in assembling evidence to determine the amount of valuation discounts.[110]

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103. Estate of Knight v. Comm'r, 115 T.C. 506, 519-20 (2000).
104. Estate of Jones v. Comm'r, 116 T.C. 121 (2001).
105. Estate of Auker v. Comm'r, 73 T.C.M. (RIA) P 98,185 at 1011 (1998).
106. F.S.A. 2000 49 003.
107. McCord v. Comm'r, 120 T.C. 358 (2003); *Lappo*, 84 T.C.M. (RIA) at 1429; Peracchio v. Comm'r, 84 T.C.M. (RIA) P 2003-280 at 1535 (2003).
108. *Id.*
109. *Id.*
110. *Lappo*, 84 T.C.M. (RIA) P 2003-258.

> In addition to the valuation issue, the notice of deficiency cited three other contentions: (1) lack of economic substance to the partnership's formation and operation; (2) the partnership interests should be valued without regard to any restriction on the right to use or sell the property within the meaning of § 2703(a)(2); and (3) a taxable gift was made upon formation of the partnership.[111]

However, these alternative contentions were subsequently withdrawn resulting in a pure valuation quantification case.[112]

The parties agreed on the method for determining fair market value of the partnership's assets (i.e., marketable securities and real estate) i.e., fair market value is the net asset value [hereinafter NAV] reduced by lack of control (minority interest) and marketability discounts.[113] The parties generally agreed on the NAV of the marketable securities and real estate,[114] although they disagreed on the minority interest and marketability discounts.[115] After the assessment of additional tax was made, the petitioner bore the burden of proof.[116]

A. Expert Opinions

The court evaluated the expert opinions in light of the evidence and accepted or rejected the expert testimony, in whole or in part, according to the courts' rationale.[117] "The persuasiveness of an expert's opinion depend[ed] largely upon the disclosed facts on which it [was] based."[118] Selective use of any part of an expert's opinion is within the discretion of the court.[119]

Petitioner's expert determined the components of the total discount to be: 7.5 % lack of control discount with respect to the marketable securities; 35% lack of control discount with respect to the real estate portion of petitioner's April 19, 1996 gifts; 30% percent lack of control discount with respect to the real estate portion of petitioner's July 2, 1996 gift; and a 35% marketability

111. *Id.* at 1433 n.2.

112. *Id.*

113. *Id.* at 1433.

114. *Id.*

115. *Id.* at 1433 n.3. "This agreed-upon value of the real estate is based on an appraisal report dated Jan. 24, 1996, and represents the market value of the leased fee estate as determined by an independent appraiser using a discounted cashflow analysis."

116. *Id.* at 1433.

117. *Id.* (citing Helvering v. Natl. Grocery Co., 304 U.S. 282, 295 (1938); *Shepherd*, 115 T.C. 376 (2000), *aff'd* 283 F.3d 1258 (11th Cir. 2002); Estate of Newhouse v. Comm'r, 94 T.C. 193, 217 (1990)).

118. *Lappo*, 84 T.C.M. (RIA) P 2003-258 at 1434 (quoting Estate of Davis v. Comm'r, 110 T.C. 530, 538 (1998)); *see* Tripp v. Comm'r, 337 F.2d 432, 434 (7th Cir. 1964), *aff'g* 22 T.C.M. (CCH) P 1225 (1963).

119. *Id.*

discount for each gift.[120] Therefore, a total discount of 50.4% applied at April 19, 1996 and 48.2% at July 2, 1996.[121]

Respondent's expert determined a lack of control discount of 8.5% and a marketability discount of 8.3%.[122] The expert's determinations resulted in a total discount of 16.1%.[123]

The court ultimately allowed an 8.5% discount for lack of control to apply to the marketable securities, a 19% discount for lack of control to apply to the real estate and a 24% discount for lack of marketability to apply to all

120. *Id.*

121.

	April 19, 1996			July 2, 1996		
	Percent of Net Asset Value	Minority Interest Discount Factor		Percent of Net Asset Value	Minority Interest Discount Factor	
Asset Class:						
Marketable Securities	0.41	0.075	0.03075	0.43	0.075	0.03225
Real Estate	0.59	0.35	0.20650	0.57	0.3	0.17100
Weighted Average Minority Interest Discount			0.23725			0.20325
Percent Total Value after Minority Interest Discount			0.76275			0.79675
Marketability Discount Factor			0.35000			0.35000
Marketability Discount			0.26696			0.27886
Percent Value after Minority Interest and Marketability Discount			0.49579			0.51789
Total Discount Percentage			0.50421			0.48211

122. *Id.* at 1435.

123.

	Percent of Net Asset Value	Minority Interest Discount Factor	
Asset Class:			
Marketable Securities	0.41	0.085	0.03485
Real Estate	0.59	0.085	0.05015
Weighted Average Minority Interest Discount			0.08500
Percent Total Value after Minority Interest Discount			0.91500
Marketability Discount Factor			0.08300
Marketability Discount			0.07595
Percent Value after Minority Interest and Marketability Discount			0.83906
Total Discount Percentage			0.16095

assets.[124] The court's overall discount was 35.4% as of both valuation dates.[125]

The experts' conclusions and the court's ultimate conclusion are summarized as follows:

		Lack of Control/Minority Interest			
		Real Estate	**Marketable Securities**	**Marketability**	**Overall**
Lappo	April, 1996	35%	7.5%	35%	50.4%
	July, 1996	30%	7.5%	35%	48.2%
IRS		8.5%	8.5%	8.3%	16.1%
Tax Court		19%	8.5%	24%	35.4%

B. Minority Interest Discount

In determining the fair market value of a minority interest in a closely held business entity, such as a family limited partnership, it may be appropriate to decrease NAV to reflect lack of control inherent in the interest.[126]

1. Marketable Securities

The parties agreed to use the IRS's slightly higher discount of 8.5%.[127] Petitioner's expert recommended a 7.5% minority interest discount while respondent's expert recommended an 8.5% minority interest discount.[128] As the parties agreed that the difference was not significant, the court's opinion does not state the methodologies used by the experts to determine these discounts.

2. Real Estate

In determining the lack of control discount with respect to the real estate "both experts agree[d] that publicly traded real estate investment trusts

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124. *Id.* at 1438-40.

125.

Minority Interest Discount determined by Court	0.15000
Percent Total Value after Minority Interest Discount	0.85000
Marketability Discount Factor	0.24000
Marketability Discount	0.20400
Percent Value after Minority Interest and Marketability Discount	0.64600
Total Discount Percentage	0.35400

126. *Id.* at 1434.

127. *Id.*

128. *Id.*

(REIT's) provide[d] an appropriate starting point for determining the . . . discount with regard to the partnership's real estate holdings."[129] "They disagree[d], however, on which REIT's should be used for comparison and on the analysis of the REIT's data."[130]

The petitioner's expert considered over 400 publicly traded REIT's and real estate companies and selected seven.[131] Of these, three were REIT's and four were real estate companies.[132] The court rejected all four real estate companies as incomparable as they were separate tax-paying entities, unlike Lappo FLP, a conduit entity.[133] Furthermore, two were highly leveraged and the other two were financially troubled, whereas Lappo FLP was neither.[134] With regard to the taxpayer's expert, the court concluded, "We are not persuaded that [the expert's] guideline group is sufficiently large or made up of companies sufficiently comparable to the partnership."[135] "While we have utilized small samples in other valuation contexts, we have also recognized the basic premise that '[a]s similarity to the company to be valued decreases, the number of required comparables increases.'"[136]

The taxpayer's expert attempted to confirm his 35% and 30% discounts for lack of control by mentioning he had also examined fourteen publicly registered, non-publicly traded real estate limited partnerships and found an average discount from net asset value of 36%.[137] However, the court rejected this attempt because the details of the study were not submitted into evidence and real estate limited partnerships, as non-publicly traded entities, have very limited trading volume, with the result that their discounts incorporate not only lack of control, but also significant illiquidity.[138]

The taxpayer's expert did not explain how he derived NAV which is critical to computation of a price-to-NAV discount.[139] He also offered no explanation for upward adjustment of the companies' reported book values with a directly corresponding upward effect on his price-to-NAV discount computations.[140] He further failed to adequately explain the apparent volatility in his recommended price-to-NAV discounts over less than three months.[141] The court reasoned "that the volatility results from the small size of his sample and the inclusion of entities that are insufficiently comparable to the partner-

129. *Id.*
130. *Id.*
131. *Id.*
132. *Id.*
133. *Id.*
134. *Id.* at 1435 n.6.
135. *Id.* at 1435.
136. *Id.* (quoting *McCord*, 120 T.C. at 384 (quoting Estate of Heck v. Comm'r, 81 T.C.M. (RIA) P 2002-038, at 175 (2002))).
137. *Lappo*, 84 T.C.M. (RIA) P 2003-258 at 1436.
138. *Id.*
139. *Id.*
140. *Id.* at n. 9. (In determining a $25,928,000 NAV for Shopco as of July 2, 1996, taxpayer's expert started with a reported book value of $4,862,000 and adjusted it upward by $21,066,000).
141. *Id.*

ship."[142] The Court indicated that after excluding the four real estate companies found to be dissimilar to the partnership, the median price-to-NAV relationship for the remaining three REIT's is, as of April 19, 1996, a 5.3 % discount, and as of July 2, 1996, a .5 % premium which was generally in line with the price-to-NAV data indicated by the IRS expert's guideline group.[143] The taxpayer's expert did not explain "how he quantified each factor, how the factors were netted, or why [his] net effect [ ] result[s] in [ ] upward adjustment to the median guideline company discounts, rather than a downward adjustment . . . ."[144] "It seems most likely that [the taxpayer's expert's] upward adjustments are, to some extent, plug numbers used to justify his ultimate, very round minority interest discount figures of 35 percent and 30 percent for April 19, 1996, and July 2, 1996, respectively."[145]

After rejecting the limited data and poorly founded conclusions of the taxpayer's expert, the court turned to the analysis of the IRS's expert. The IRS expert started with sixty-two real estate companies followed by an investment research firm and eliminated ten that were not REIT's or were otherwise not comparable.[146] The remaining fifty-two REIT's traded at a 4.8% premium over the net asset value estimated by the investment firm.[147] The IRS's expert noted certain characteristics that made Lappo FLP less attractive than the REIT's and consequently looked to the fifteenth percentile of the data, which was a .8% discount as of March 25, 1996, and 1.48% premium as of June 25, 1996.[148] The court believed the size of his "sample was sufficiently large to make tolerable dissimilarities between the partnership and the REIT's in his guideline group."[149]

The taxpayer's expert criticized the use of an investment firm's REIT data, suggesting that the investment firm's method of estimating the net asset value of the REIT's was not comparable to the appraisal method used for Lappo FLP's real estate.[150] Although not identical the valuation method used by the investment firm "appears similar to that used to value the partnership's real estate."[151] "[E]ven if the valuation methods are not identical, insofar as each method is reliable and unbiased (and petitioner does not contend that either is not), each might be expected to produce reasonable valuations so as to provide a meaningful basis for comparing share prices to net asset values."[152]

142. *Id.*
143. *Id.* at 1436 n.11.
144. *Id.* at 1436.
145. *Id.*
146. *Id.*
147. *Id.* at 1436.
148. *Id.* at 1436-37.
149. *Id.* at 1435.
150. *Id.*
151. *Id.*
152. *Id.*

The IRS's expert claimed the REIT discount (or premium) reflected two components: a discount for lack of control and a premium for liquidity.[153] The premium is based on the fact that publicly traded stock is more marketable than directly owned real estate. The court accepted the methodology of the IRS's expert, if not his conclusions. In particular, the court stated, "[I]n quantifying that liquidity premium, however, we hesitate to rely on a single academic study – particularly one that [the IRS's expert] did not participate in preparing and could not elaborate upon first hand."[154] The court rejected the concept of breaking the restricted stock discounts into three parts and using only the illiquidity component and used the overall average of the study, as well as other restricted stock studies, to calculate an average liquidity premium of 17.6%.[155] Combining this with the .8% REIT discount as of April 1996 and rounding up, the court selected a 19% discount for lack of control as of both valuation dates.[156]

C. Marketability Discount

Because the liquidity premium and discount for lack of marketability are based on the same data, the court arrived at a similar figure for the discount for lack of marketability. First, the court rejected the data and conclusions of the taxpayer's expert.[157] Thirteen of the thirty-nine restricted stock transactions used by him were rejected because they involved technology companies, which are considered riskier and incomparable.[158] It was noted that they had the highest discounts.[159] The remaining twenty-six transactions had a median discount of 19.45%.[160]

The court favored the more extensive data of the IRS's expert – eighty-eight transactions. However, the court took the overall discount of 22.21% and averaged it with a study cited by the IRS's study to get a 21% benchmark discount for lack of marketability.[161] The Court noted that this figure was similar to the 19.45% discount derived from the data of the taxpayer's expert after removing the technology companies.[162] The court then added three percentage points to incorporate characteristics specific to the partnership, to determine a marketability discount of 24%.[163]

153. *Id.* at 1437.
154. *Id.*
155. *Id.* at 1437.
156. *Id.* at 1437-38.
157. *Id.* at 1438.
158. *Id.*
159. *Id.*
160. *Id.*
161. *Id.* at 1439.
162. *Id.*
163. *Id.* at 1439-40.

V. ANALYSIS

In 2003, three cases were decided involving FLPs holding multiple investments.[164] Although this note considers the *Lappo v. Commissioner* case, minimal comparison should be made to the other two cases. After initial skirmishes, attempts to disqualify the partnership form were abandoned or defeated resulting in pure valuation considerations.

A. Expert Opinions

Impressive expert opinions were presented by both sides in all three cases. In all three cases, the court rejected the expert's conclusions from their empirical studies but used the data for its conclusions.[165] Courts consistently criticize experts from both sides yet engage in their own detailed analysis using the expert's data apparently in recognition of the fact that valuation is not an exact science. "A sound valuation [is] based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance."[166]

B. Lack of Control

1. Marketable Securities

The opinion in *Lappo v. Commissioner* did not state the methodology used by the experts to determine marketable securities discounts, but they presumably used closed-end mutual funds which are a common comparative data source in discounts for lack of control for marketable securities. In *McCord v. Commissioner* and *Peracchio v. Commissioner*, the experts utilized closed-end mutual funds but the main dispute was the selection of closed-end funds to include in the discount calculation.[167] The courts were not satisfied with the experts conclusions and adopted compromise figures. As the *Lappo v. Commissioner* expert and IRS expert did not substantially disagree, the court agreed with the slightly higher IRS discount.[168] It should be noted that all three cases used a variation of the respective parties' expert opinions.

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164. Ted Israel, *A Trio of FLP Valuation Cases: What Can Be Learned from* McCord, Lappo, *and* Peracchio?, 7 VALUATION STRATEGIES 12 (2004).

165. *Id.* at 14.

166. Rev. Rul. 59-60, 1959-1 C.B. 237.

167. Israel, *supra* note 164, at 15, 17.

168. *Lappo,* 84 T.C.M. (RIA) P 2003-258 at 1439.

2. Real Estate

In determining the lack of control discount with respect to the real estate both experts agreed that publicly traded real estate investment trusts (REIT's) provided an appropriate starting point.[169] In a traditional analysis, REIT's are publicly traded shares and represent a marketable minority interest.[170] The difference between a controlling interest and a marketable minority interest is a lack of control discount. A second discount, lack of marketability discount, reduces a marketable minority interest to a non-marketable minority interest. Admittedly, the traditional discount for lack of control also reflects some differences in marketability.[171] Nevertheless, it brings the value down to a level at which we can apply the traditional discount for lack of marketability, which measures the difference between a publicly traded and non-publicly traded stock.

The taxpayer expert in *Lappo v. Commissioner* based his analysis on comparable publicly traded real estate companies and the IRS expert favored REIT's.[172] The taxpayer's expert identified seven companies and included three when deriving his range of discounts and the court did not consider his choices comparable or his sample large enough.[173] The IRS's expert included fifty-two REIT's in his analysis.[174] The IRS expert's data yielded a median price-to-NAV premium of 4.8%.[175] To be conservative, the expert looked below the median to the fifteenth percentile.[176] This lowered the valuation starting point to a .8% discount in March, 1996 and a 1.48% premium in June, 1996.[177] However, this expert believed the difference between price and NAV has two components: one positive (a liquidity premium) and one negative (a minority discount).[178] "The liquidity premium exists because the REIT allows the investor to own an illiquid asset (real estate) in a liquid form."[179] On the basis of the Bajaj study, the expert used a liquidity premium of 7.5%.[180] To arrive at the appropriate minority discount, this expert added the liquidity premium to the .8% discount and 1.48% premium.[181] This resulted in minority discounts of 8.3% and 6%.[182] The expert then compared these results to his own study.[183] His study suggested that minority interests

169. *Id.* at 1434.
170. James R. Hitchner & Gary Roland, *Marketability and Control Govern Value of Family Businesses*, 52 TAXATION FOR ACCOUNTANTS 24, 25, January (1994).
171. *Id.*
172. *Lappo*, 84 T.C.M. (RIA) P 2003-258 at 1434-35.
173. *Id.*
174. *Id.* at 1435.
175. *Id.* at 1436.
176. *Id.* at 1437.
177. *Id.*
178. Israel, *supra* note 164, at 14.
179. *Id.* at 15.
180. *Lappo*, 84 T.C.M. (RIA) P 2003-258 at 1437.
181. *Id.*
182. *Id.*
183. *Id.*

in holding companies trade at a discount of 8.5% relative to controlling interests.[184] Therefore, he chose to use this more comparable discount.

The court did not agree with the liquidity premium espoused by the IRS's expert.[185] Instead, the court used an average of three studies presented by the IRS expert.[186] Employing the same formula used by the expert, the court converted the average 15% liquidity discount to a 17.6% liquidity premium.[187] The court then added the premium to the price-to-NAV discount and premium resulting in minority interest discounts of 18.4% and 16.12%.[188] The court then rounded the discounts to arrive at a minority interest discount of 19% for the FLP's real estate interests.[189]

The minority discount analysis applied in *Lappo v. Commissioner* is remarkably similar to the *McCord v. Commissioner* discount analysis.[190] The taxpayer's expert used seven REIT's compared to five in *McCord v. Commissioner*.[191] The IRS expert in *Lappo v. Commissioner* relied on the analysis provided by the IRS expert in *McCord v. Commissioner*.[192] Once again, the court rejected the liquidity adjustment and computed its own.[193]

The best measurement of a lack of control discount as it relates to real estate was determined to be REIT's.[194] The fact that both experts agreed there should be a discount for lack of control, but the vast majority of the REIT's traded at premiums to their supposed net asset values, suggests strongly that the REIT's are in some way not comparable to *Lappo v. Commissioner*.[195] The IRS's expert in *McCord v. Commissioner* selected a percentile for the REIT data that produced essentially a zero discount, although in that case the percentile was the twenty-fifth.[196]

The IRS's experts in *McCord v. Commissioner* and *Lappo v. Commissioner* attempt to isolate the pure discount for lack of control and bring the controlling interest value down to the theoretical level of a minority interest that is exactly as marketable as the underlying assets themselves.[197] In both *McCord v. Commissioner* and *Lappo v. Commissioner*, the IRS's expert started with a traditional discount for lack of control essentially equal to zero, then adjusted for the liquidity premium – based on the 7.2% discount for illiquidity – to

184. *Id.*
185. *Id.*
186. *Id.*
187. *Id.*
188. *Id.*
189. *Id.*
190. Israel, *supra* note 164, at 16.
191. *Id.*
192. *Id.* at 17.
193. *Id.*
194. *Id.*
195. *Id.*
196. *Id.* at 15.
197. *Id.* at 16-17.

reach a discount roughly equal to 7.2% (8.34% in *McCord v. Commissioner* and 8.5% in *Lappo v. Commissioner*).[198] Subsequently the IRS's expert takes an illiquidity discount that is also roughly equal to 7.2% (7.0% in *McCord v. Commissioner* and 8.3% in *Lappo v. Commissioner*), so the total discount is roughly equal to two times the illiquidity discount.[199] The experts' efforts to obtain a pure discount for lack of control were merely an exercise. The court disregarded this futile exercise in both *Lappo v. Commissioner* and *McCord v. Commissioner*.

In the three opinions, marketability is not defined by liquidity alone. As in *McCord v. Commissioner* and *Lappo v. Commissioner*, the parties in *Peracchio v. Commissioner* "agreed that NAV less minority and marketability discounts was the proper approach to value the partnership."[200] The courts also agreed that the best measurement of lack of control discount relating to real estate is REIT. The discount from NAV observed in publicly traded REIT's is composed of both a liquidity premium and a minority discount.[201] The liquidity premium must be isolated and removed in order to derive the minority discount properly.

The experts' conclusions and the court's ultimate conclusion are summarized as follows:

	IRS Expert	Taxpayer's Expert	Court
McCord	8.34%	22%	15%
Lappo	8.5%	30-35%	19%
Peracchio	4.4%	5-7.7%	6%

C. Marketability

> The experts agreed that empirical studies of marketability discounts fall into two categories: IPO studies and restricted stock studies. The IPO studies compare the price of shares before and after an initial public offering. The difference or discount is attributed to the pre-IPO shares' lack of marketability. The restricted stock studies compare transaction prices of restricted shares in public companies with their unrestricted counterparts. [T]he difference or discount is attributed to the restricted shares' lack of marketability.[202]

198. *Id.* at 15-16.
199. *Id.* at 15, 17.
200. *Id.* at 17.
201. *Id.* at 47.
202. *Id.* at 15.

The court in *McCord v. Commissioner* listened to both experts and then related the FLP characteristics to the middle group of the IRS expert's study.[203] The taxpayer expert in *McCord v. Commissioner* relied primarily on the restricted stock studies in arriving at a 35% marketability discount.[204] The court found flaws in the expert's testimony. It felt that he failed to adequately relate the partnership's key operating elements to those studies. Consequently, the court gave little weight to his restricted stock analysis. The IRS expert in *McCord v. Commissioner* hypothesized that discounts observed in restricted stock studies are attributable in part to factors other than impaired marketability resulting in only a 7% discount.[205] The court was impressed with his analysis, however it pointed out that he had isolated the liquidity portion of the discount, and the court was unable to accept that liquidity alone equated to marketability. Therefore, the court, not persuaded by the evidence, used the discount applicable to the average, 20.36%.[206]

The court in *Lappo v. Commissioner* followed the rationale of *McCord v. Commissioner*. The taxpayer expert determined his marketability discount based on restricted stock studies.[207] "The court did not agree with his selected guideline group and gave his testimony little weight."[208] The IRS expert used the *McCord v. Commissioner* analysis. Therefore,

> The court cited *McCord v. Commissioner* in justifying its rejection of 7.2% as the appropriate starting point for determining the partnership's marketability discount. The court once again examined the data in the cited studies, which indicated an average discount of 21%. Based on its assessment of characteristics specific to the partnership, the court adjusted the discount upward to 24%."[209]

In *Peracchio* "[t]here was not much offered by either side in support of their opinions regarding marketability discounts."[210] *Peracchio*'s experts were seeking a 35% discount and contended that precedent provided a benchmark discount in the range of 35% - 45%.[211] "The court disagreed."[212] *Peracchio*'s "experts also made reference to restricted stock studies and the

203. *McCord*, 120 T.C. at 395.
204. *Id.* at 388.
205. *Id.* at 393.
206. *Id.* at 395.
207. Israel, *supra* note 164, at 17.
208. *Id.*
209. *Id.*
210. *Id.* at 47.
211. *Id.*
212. *Id.*

range of discounts implied therein, but without relating them in any way to the [FLP]."[213] The IRS's "report stated that the discount should be in the range of 5% - 25%, but it did not offer any real quantitative support for the 15% he claimed."[214] The court split the difference.

Overall, the court looks first at the data used by both experts and favors the more extensive data. Then the court considers the arguments made by both experts and deviates from the averages of the studies only where the argument was well reasoned and supported by the data. The experts' conclusions and the court's ultimate conclusion are summarized as follows:

	IRS Expert	Taxpayer's Expert	Court
McCord	7%	35%	20%
Lappo	8.3%	35%	24%
Peracchio	15%	35-45%	25%

VI. CONCLUSION

In many ways, the IRS and the courts are accountable for the proliferation of FLPs as an estate planning tool. While the judges are not experts in valuation, they must balance the IRS's tendency to present high valuations with the taxpayer's tendency to present lower valuations. "The court's practice of 'splitting the difference' has no conceptual, theoretical or intellectually convincing basis and tends to be grounded, quite simply, in expediency."[215] The lessons to be learned from this are that courts favor: comparable detailed data; sound empirical data to justify deviations from the norm; and significant data to justify conclusions.

When an interest in property is transformed into an interest in an entity, the relevant consideration for transfer tax valuation purposes becomes the interest in the entity subject to the restrictions imposed in the agreement itself as well as those imposed by state law. Therefore, that interest must be discounted. The courts have thus made possible the principle that the sum of the parts can be worth less than the whole, the concept at the heart of the FLP.

213. *Id.*
214. *Id.*
215. Stephen J. Leacock, *The Anatomy of Valuing Stock in Closely Held Corporations: Pursuing Phantom of Objectivity into the New Millennium*, 2001 COLUM. BUS. L. REV. 161, 168 (2001).