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Thomas H. Holman, Jr. and Kim D.L. Holman, Petitioners vs. Commissioner of Internal Revenue, Respondent T.C. Memo 130-12, May 27, 2008

The Facts:

Mr. and Mrs. Holman are the parents of four children. Mr. Holman was employed by Dell and had acquired a large block of Dell stock which the couple wanted to preserve for their daughters sake. On November 3, 1999, Mr. and Mrs. Thomas Holman formed the Holman Family Limited Partnership (the "Partnership"). The purpose of the Partnership was to accomplish four goals: (1) long-term growth, (2) asset preservation, (3) asset protection, and (4) education. The Partnership was initially funded with 100 shares of Dell Corp. stock owned by a trust established for the children and 70,000 shares of Dell Corp. stock contributed jointly by Mr. and Mrs. Holman. Gifts of limited partnership interests were made to each child five days after the Partnership's formation on November 8, 1999, and again on January 4, 2000 and February 2, 2001. By 2001, due to additional transfers of Dell Corp. stock, the Partnership owned 111,100 shares of Dell stock.

The Partnership Agreement included standard prohibitions against transfer typically seen in family limited partnerships. However, the Partnership Agreement included a buy-out clause for any prohibited transfer that allowed the Partnership to repurchase the transferred shares at "its fair market value based upon the assignee's right to share in distributions from the Partnership as determined by an appraisal performed by an independent appraiser." In addition, the Partnership had the option to pay that price at "ten percent of the purchase price at closing and pay the balance of the purchase price in five equal annual installments together with interest at the Applicable Federal Rate."

The Holman's filed IRS Form 709 Gift Tax Returns and claimed a total combined discount (for both lack of marketability and minority interest) that varied from 41.5% to 45.6% over the years of gifting.

The Arguments:

The IRS made four separate arguments against the Holman's and contested the valuation discounts. The IRS' arguments were (1) the gift of FLP interests was actually an indirect gift of Dell stock to their daughters, (2) Section 2703 rendered the Partnership's transfer restrictions invalid, (3) the Partnership was not a valid operating business, and (4) the valuation discounts taken were excessive.

The Findings:

First, the Court determined that there was no indirect gift. The Partnership was formed and five days passed prior to the initial gifting of FLP units providing time for "real economic risk of a change in the value." The Court stated "We shall not disregard the passage of time and treat the formation and funding of the Partnership and the subsequent gifts as occurring simultaneously under the step transaction doctrine."

In regards to the second and third arguments, the Court ruled that Partnership transfer restrictions were not to be considered for valuation purposes because, in regard to Sec. 2703(a) restrictions, the Court concluded, "we find the restrictions do not constitute a bona fide business arrangement within the meaning of Section 2703(b)(1)." Furthermore, the transfer restrictions were determined by the Court to be "a device to transfer LP units to the natural objects of petitioners' bounty for less than adequate consideration."

Lastly, regarding excessive valuation discounts, Mr. Holman's expert argued for minority interest discounts that varied from 10.0% to 16.3% over the course of the gifting while the IRS expert's minority interest discounts ranged from 5.0% to 13.4% over the course of the gifting (with most years being relatively close). However, the area of major disagreement was that the IRS expert recommended reducing the taxpayers claimed 35% marketability discount to 12.5% based on a convoluted analysis of restricted stock studies. Both experts arguments were considered, however, the Court chose to disregard Mr. Holman's expert due to lack of supportability of his arguments and agreed with the IRS expert's determinations due to his "more thoughtful" approach.

Parting Thoughts:

I totally disagreed with the Court's determination and reliance on the IRS's expert for the lack of marketability discount. This is a case where the poor outcome in terms of a lack of marketability discount for the taxpayer resulted simply because the IRS's expert did a better job of "selling" his valuation conclusions (even though his support for his conclusions was convoluted and unreasonable).