



Estate of Smith, Jr., v. United States, No. 02-264 ERIE, July 22, 2005

The Facts: Mr. Smith (“Donor”) made gifts to his children of limited partner interests in the Smith Family Limited Partnership (the “Partnership”). After the gifts were made, Donor retained a 2% general partner equity interest (representing 2/3 of the general partner equity interests) and a 53.96% limited partner equity interest. The Partnership agreement contained a right of first refusal that allowed payment terms different than the offer. These terms indicated that the purchase price could be represented by non-negotiable promissory notes payable over a period of 15 years or less, in equal annual installments of principal and interest (with interest due at a rate equal to the applicable federal rate), initially due one year after the closing date. The issue at stake was whether a lack of discount for lack of marketability should be allowed.

The Arguments:

The IRS valuator ignored the restrictive provisions of the Agreement using the argument of Section 2703(a) which, in a nutshell, states that the fair market value of property is to be determined without regard to: (i) any option, agreement, or other right to acquire or use the property at a price less than its fair market value; or (ii) any restriction on the right to sell or use such property.

The taxpayer’s valuation expert countered that the Partnership agreement met the “safe harbor” provision in Section 2703(b). The Safe harbor provision indicates that 2703(a) shall not apply to an agreement that meets each of the following requirements:

1. It is a bona fide business arrangement.
2. It is not a device to transfer such property to members of the decedent’s family for less than full and adequate consideration.
3. Its terms are comparable to similar arrangements entered into by persons in an arms’ length transaction.

The sole issue before the Court at trial was the applicability of the right of first refusal restrictions to the valuation of the gifted interests.

The Findings:

The Court determined that before considering the “safe harbor” provisions of Section 2703(b), pre-section 2703 law pertaining to restrictive buy/sell agreements under Section 20.2031-2(h), Estate Tax regulations and Revenue Ruling 59-60 must be considered.

The Court referred to the Estate of Lauder (T.C. Memo 1992-736) for guidance on the pre-section 2703 issues. Such ruling stated that (1) the offering price must be fixed and determinable under the agreement; (2) the agreement must be binding on the parties both during life and after death; and (3) the restrictive agreement must have been entered into for a bona fide business reason and must not be a substitute for a testamentary disposition.

In reviewing whether the restrictive provisions were binding on the parties both during life and after death, the Court noted that the Partnership agreement gave the Donor the ability to unilaterally make all General Partner decisions (because he owned 2/3 of the general partner interests). Furthermore, because he owned more than 50% of the limited partner interests, he was also able to unilaterally give consent of the limited partners as defined by the Agreement (which stated that the partnership agreement could be altered with consent of or approval of limited partners owning at least 50% of the limited partner interests). From this analysis, the Court determined that the terms of the restrictive provision were not binding on the Donor during his lifetime. Accordingly, the Court, without ever considering the safe harbor provisions of Section 2703(b), determined that the restrictive provisions should be disregarded when determining fair market value for Federal gift tax purposes. Therefore, the discount for lack of marketability was disallowed.

Parting Thoughts:

An interesting case in which the “safe harbor” provisions were never tested. If the taxpayer had held less than 50% of the limited partner interests, would the Court have then considered 2703(b)? I guess we will never know.