Volume 3-20 / 2001
(Corrected)

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Tax Valuation E-Flash

FSA 200143004 (July 5, 2001)

The IRS has issued a Field Service Advice in which it concluded that a closely held S corporation, formed to reduce transfer taxes, should be disregarded for gift tax purposes because it lacked economic substance.

In this FSA, the mother formed a corporation and transferred municipal bonds and Treasury notes to it in exchange for all of its common stock. Over a period of several years, she transferred shares to family members. All transfers were made under the annual gift tax exclusion, relying on minority and lack of marketability discounts to remain under the exclusion limit.

The IRS noted that the estate or gift tax issue required a two-part analysis, first identifying the property transferred and then determining the value of the property.

Property Identification

1. Economic Substance

The first issue in identifying the property transferred was to determine if the corporation (FC) should be disregarded because it lacked economic substance. The FSA analyzed the recent Strangi (Estate of Strangi v. Commissioner, 115 T.C. 478) and Knight (Knight v. Commissioner, 115 T.C. 506) decisions. The IRS said, "The facts indicate that FC has conducted no activity

It would appear, therefore, that the alleged nontax motive for placing Donor's assets in FC, 'centralization of management of assets,' is not supported and no active management has been undertaken by FC.

beyond the filing of S corporation income tax returns and issuing Schedules K-1 detailing the allocation and distribution of income to shareholders. A document executed after the fact … indicates that shareholders' meetings were held in prior years. Further the corporation conducts no business of any sort, pays no salaries to its officers, and has no other employees. It would appear, therefore, that the alleged nontax motive for placing Donor's assets in FC, 'centralization of management of assets,' is not supported and no active management has been undertaken by FC."

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2. Gift on Formation

The second issue was whether the donor had made a gift on formation of FC. The FSA recommended against asserting this issue in this instance.

3. Indirect Gifts

For the first gifts after corporation formation (referred to as Date 2, with Date 1 being the corporate formation date), the FSA concluded that these were indirect gifts of the assets recently transferred into FC. Subsequent gifts were not considered to be indirect gifts, with the IRS saying, "With respect to the gifts to Donor's children, grandchildren, and great-grandchildren on Dates 3, 4, and 6, it could be argued that these transfers merely are part of Donor's overall testamentary, estate-tax reduction plan and as such similarly are indirect gifts in the amount of the enhancement in value of each shareholders' interest in the corporation (i.e., that proportionate share of the value of the underlying assets). This argument is difficult to make persuasively, however, where a corporation has been in existence for many years and where the parties have respected the corporate form throughout that time."

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Value of the Property Transferred

4. Ignoring Corporate Structure Under §2703(a)(2)

The IRS concluded that as long as there is a lack of economic substance, the §2703(b) safe harbor is not met and no discounts to the prorata share of underlying assets should be allowed.

5. Ignoring Restrictions in FC Documents Under §2703(a)(2)

The IRS did not reach a final conclusion on this issue other than to suggest further analysis relative to applicable state law, which might necessitate a §2703 appraisal.

6. Ignoring Liquidation Restrictions Under §2704(B)

Subject to further analysis, the IRS determined that this provision did not apply.

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- Intellectual Property (Patents, Trade Names, Software Copyrights, and Trade Secrets)

7. Discounts for Lack of Control and Marketability

The FSA noted, "Establishing the proper discount will require the Service to acquire an expert appraisal." The FSA also listed some of the considerations to be presented to the IRS appraiser. The first consideration was that a family corporation is analogous to a trust, "because in some cases the primary purpose of both is to hold assets for protection and investment for ultimate distribution to the beneficiaries/entity interest holders… In such a case, a reduction in the discount for minority interest or lack of control may be indicated."

The second consideration was that family partnerships and family corporations holding readily marketable assets are most closely comparable to publicly traded closed-end mutual funds. The FSA said, "Closed-end mutual funds generally trade at a discount from net asset value of 4 - 12 percent, a discount which is deemed sufficient by the public markets to reflect the disadvantages of a minority interest. Interests in family partnerships and family corporations usually are not readily marketable, as is the case with mutual funds. Thus, it may be necessary to concede a discount for lack of marketability, based on the facts and opinion of a qualified expert."

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The third consideration was the use of publicly traded partnerships as comparables. The FSA says the appropriate willing buyer/seller price comparison would be the price charged by the promoter when the partnership shares were originally sold to the public rather than the discounted price for a later sale in the secondary market. The IRS said, "Arguably, the family member receiving interests in a newly formed family limited partnership is in no different position from that of an investor purchasing publicly traded units in the initial public offering."

The fourth and final considerations were referred to as "Elements of Value." The first element of value asserted that, "Business purpose factors should enhance the value of the partnership interests, thereby offsetting some of the discounts claimed. Restrictions on the other partners' ability to withdraw from the partnership or transfer their interests arguably enhance the value

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of the subject partnership interest. These restrictions ensure that the underlying partnership assets will remain intact, and that the partnership will have a long and stable existence."

The second element of value considered the application of the willing buyer/willing seller test. The IRS said the willing seller would not sell his or her interest at a substantially discounted value, citing Mandelbaum (Estate of Mandelbaum v. Commissioner, T.C. Memo 1995-255). The IRS concluded, "The courts, therefore, have often agreed that an individual who just transferred liquid assets of significant value to a family partnership or corporation and is under no compulsion to sell that new interest would not agree to sell that interest at a price significantly less than the value of the assets he transferred to the partnership."

Editor's Notes:
This is a corrected E-Flash. After we published the orignal E-Flash, there was a correction issued to the FSA.

We are unable to provide a full-text version of this Field Service Advice.

Field Service Advice memos are advice from attorneys in the IRS National Office. FSAs are intended to provide nonbinding advice, guidance, and analysis to field personnel to help them develop an issue or determine litigation hazards for both substantive and procedural issues. FSAs are similar to technical advice memorandums, except that the taxpayer is not involved in the process.

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