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ACT NOW TO GET THE BEST VALUATION DISCOUNTS: HOW TO DO IT RIGHT

We want to alert you about a planning opportunity that may soon go away. Estate "freeze" techniques work best when three things are present: (1) lower asset values, (2) low interest rates, and (3) valuation discounts. We are hearing that valuation discounts may soon be severely limited. In addition, interest rates and asset values are also likely to rise. Therefore, time is of the essence.

The combination of depressed asset values, low interest rates, and the possibility of the elimination of discounts for interests in family entities have created a temporary planning opportunity for individuals to freeze the value of their estates and shift appreciation to future generations free of estate and gift tax. One method used to make such transfers is through gifts or sales of interests in family limited partnerships. Under current law, the limited partnership interest transferred may be valued taking into account discounts for lack of marketability and lack of control. However, there are concerns that Congress may enact legislation to eliminate these discounts and the IRS is reportedly set to issue regulations that would severely curtail their use. **Therefore, it is important that: (1) clients act NOW to take advantage of discounts before it's too late, and (2) transfers are structured properly in order to avoid attack by the IRS.**

While family limited partnerships can provide many wonderful benefits, it is important to remember that **forming, structuring, and operating a limited partnership involves many estate and gift tax, income tax, asset protection, and business succession issues which are unique from family to family.** In speaking about the practice of law, one estate planning attorney commented that what was once complex 10 years ago (family limited partnerships) has now become a commodity and clients can now get a form package at a Holiday Inn seminar. While many of our clients have been extremely successful in commodity businesses, we do not believe that the practice of law should be viewed as a commodity.

We are a specialty firm focusing our practice on the tax and estate planning needs of high net worth individuals and families. The lawyers in the firm have, through experience and training, developed expertise in the areas of tax and estate planning. Marvin Blum was recently named by *Worth* magazine to the **"Nation's Top 100 Attorneys"** list. Seven of the attorneys are also Certified Public Accountants, six are board certified by the Texas Board of Legal Specialization in estate planning and probate law, and two are board certified by the Texas Board of Legal Specialization in tax law. We work as a team to design a structure for clients to meet their needs and accomplish their goals while keeping abreast of the recent developments in this area.

Enclosed is a recent article by one of our attorneys, Dan McCarthy, that was published in the February 2009 issue of the *Texas Tax Lawyer*. We thought this article may be of interest to you. The article discusses recent decisions by the Tax Court addressing IRS arguments that discounts for lack of marketability and lack of control should not be allowed in valuing gifts of limited partnership interests shortly after the formation of partnerships. While the taxpayers prevailed on this argument, the decisions were dependent upon the facts in the case. **In particular, see the last two pages of the article for practical tips on how to structure a transaction and strengthen your case for discounts.**

Please let us know if we can assist you or your clients.

APPLICATION OF THE STEP TRANSACTION DOCTRINE TO TRANSFERS OF PARTNERSHIP INTERESTS

Daniel H. McCarthy[1]

Taxpayers utilize family limited partnerships as part of a wealth management strategy to provide a variety of tax and non-tax benefits including asset protection, consolidation of assets for investment management, retention of assets within a family, protection from spouses in event of divorce, avoiding out of state probate filings and inheritance tax liabilities, and providing management succession for family assets. As part of this wealth management strategy, senior generation family members will gift and/or sell limited partnership interests to children, grandchildren, or trusts for the benefit of junior generation family member's benefit.

Benefits of Lifetime Transfers of Partnership Interests

Lifetime gifts or sales of partnership interests can provide many benefits. One benefit is that any appreciation in the value of the partnership interest gifted or sold will escape estate taxation at the death of the senior generation family member. Another benefit is that lifetime gifts of partnership interests can provide a defense to even the most successful argument that the IRS has made with respect to denying discounts for valuation of partnership interests at death which is the application of Code Section 2036(a)(1). The cases in which the IRS has been successful in challenging discounts taken by taxpayers for lack of marketability and lack of control in valuing partnership interests for estate tax purposes generally involve an argument that the taxpayer retained the right to the income from the underlying property conveyed to the partnership, thus requiring that the assets contributed to the partnership be includable in the decedent's taxable estate rather than the partnership interests.[2]

The gift tax statutes do not contain a counterpart to Code Section 2036(a)(1) so a taxpayer can gift or sell all of his or her partnership interest during life and avoid the application of Code Section 2036(a)(1) if the taxpayer survives the gift by more than three years to avoid the potential application of Code Section 2035.

Integrated Plan

In two recent Tax Court cases[3] the IRS asserted that gifts of limited partnership interests to children followed closely after the formation of the partnership were part of an "integrated plan" to convey the underlying partnership assets to the taxpayer's children. While the Tax Court ruled favorably on behalf of the taxpayers in each case, the Tax Court stated that it may have reached a different result had the underlying assets of the partnerships consisted of less volatile assets as opposed to the marketable securities held by the subject partnerships. It is likely that the IRS will continue to assert this argument in challenging the discounts taken by taxpayers in conjunction with gifts or sales of partnership interests. Prior to analyzing these cases, it is helpful to review the prior case law.

Prior Case Law

Shepherd v. Commissioner

In *Shepherd*[4], the taxpayer owned timberland and stock in three closely-held banks which he planned to convey to a newly formed partnership. On August 1, 1991 Mr. Shepherd executed the Shepherd Family Partnership Agreement, forming an Alabama general partnership.[5] The partnership agreement indicated that he was to own a 50% partnership interest in exchange for a $10 capital contribution and that each of his sons was to own a 25% partnership interest in exchange for a $5 capital contribution.[6] Mr. Shepherd also executed deeds to convey the timberland to the partnership on August 1. On August 2, Mr. Shepherd's sons executed the partnership agreement. On September 9, Mr. Shepherd conveyed a portion of the stock in each of the three closely-held banks to the partnership.[7] Mr. Shepherd filed a gift tax return for 1991 reporting a gift of the timberland and the bank stock (rather than a gift of the partnership interests). The IRS audited the gift tax return and proposed a valuation adjustment to the gifts.[8]

One of the issues addressed by the Tax Court was whether Mr. Shepherd made gifts of partnership interests or gifts of an undivided interest in the timberland and bank stock. Mr. Shepherd argued the former and that such gifts should be valued with discounts for lack of control and lack of marketability. The IRS argued the latter and pointed to the fact that Mr. Shepherd's gift tax return was consistent with this position.[9]

In support of its position the IRS also argued that, under Alabama law, a partnership was not created until August 2 (the day on which the sons executed the partnership agreement). The IRS then concluded that since the deeds conveying the timberland to the partnership were executed on August 1, Mr. Shepherd gave a 25% interest in the timberland property to his sons either directly or indirectly.[10]

The Tax Court found that no direct gifts of timberland or bank stock were made to the sons since any ownership the sons might have possessed was acquired by virtue of their status as partners in the partnership.[11] In analyzing the issue of an indirect gift, the Tax Court cited Treas. Reg. § 25.2511-1(a) which provides that a transfer of property to a corporation by a shareholder generally represents a gift by the transferring shareholder to the other shareholders. The Tax Court analyzed prior case law interpreting this regulation and found that it applies to partnerships; however, the Tax Court also noted that partnerships differ from corporations in that partnerships maintain capital accounts and that a contributing partner's capital account is generally credited with the value of the property contributed. However, in this case the capital accounts of the sons were each credited with 25% of the value of the timberland property and bank stock. As a result, the Tax Court found that Mr. Shepherd made an indirect gift of the timberland and bank stock to his sons.[12]

The case was appealed to the 11th Circuit which affirmed the holdings of the Tax Court.[13] In dicta the court noted that if steps in the funding and gifting of the partnership interests had been properly ordered (if the value of the timberland and bank stock were first credited to Mr. Shepherd's capital account and Mr. Shepherd then made gifts of partnership interests), it would have been possible for Mr. Shepherd to take the discounts for lack of marketability and lack of control in valuing the gifts of the partnership interests.[14]

Jones v. Commissioner

The next case addressing the indirect gift argument was *Jones.*[15] Mr. Jones was a cattle rancher and had a desire to keep his ranches in his family after his death. Mr. Jones had one son and four daughters who each owned an interest in certain real property used for ranching which they inherited from an aunt. Mr. Jones and his son formed a Texas limited partnership on January 1, 1995. Mr. Jones contributed certain assets to the partnership in exchange for a 95.54% limited partnership interest and his son contributed certain assets in exchange for general and limited partnership interests collectively representing a 4.46% interest. The books of the partnership reflect the fact that each partner's capital account was credited with the value of the assets he contributed. Mr. Jones then made a gift to his son of an 83.08% limited partnership interest on the same day.[16]

Mr. Jones formed a second limited partnership with his four daughters on January I, 1995 whereby he contributed certain real estate to that partnership in exchange for an 82.18% limited partnership interest and his four daughters contributed property for general and limited partnership interests representing a 17.82% partnership interest. Mr. Jones made a gift of 16.92% limited partnership interests to his daughters on the same day.[17]

Mr. Jones filed a gift tax return reporting the gifts of the limited partnership interests which reflect discounts for lack of control and lack of marketability as determined by an appraiser.[18]

One of the arguments raised by the IRS was that Mr. Jones made a taxable gift upon the formation of the partnerships since he contributed property worth $17,615,857 to the partnerships and the limited partnerships he received in consideration were only worth $6,675,156 after taking into account discounts for lack of control and lack of marketability.[19] The court rejected the IRS's argument and distinguished its current holding from that in *Shepherd* on the basis that the property contributions made by Mr. Jones were all credited to his capital account unlike those by Mr. Shepherd. Accordingly, the court rejected the indirect gift argument.[20]

The difference in the results between *Shepherd* and *Jones* indicate the importance of adhering to proper formalities in documenting partnership transactions.

Senda v. Commissioner

In *Senda v. Commissioner,*[21] Mr. Senda, his wife, and Mr. Senda in his capacity as trustee of trusts for his three children, executed the Mark W. Senda Family Limited Partnership Agreement on April 1, 1998, and on June 3, 1998 the Secretary of State of Missouri issued a Certificate of Limited Partnership. No written trust agreements existed for the three trusts and the children reported their share of income or loss from the partnership on their individual returns. On December 28, 1998, Mr. and Mrs. Senda transferred 28,500 shares of MCI stock to the partnership and the children's trusts purportedly contributed accounts receivable to the partnership although no written documentation existed to support the validity of the accounts receivable. Mr. and Mrs. Senda sent a facsimile transmission to their accountant informing him of the capital contributions and requested advice on the percentage partnership interest to gift to the trusts. Mr. and Mrs. Senda together gifted a 29.99% limited partnership interest to each trust although the assignment memorializing the transfer was not executed until several years later.[22]

Mr. and Mrs. Senda decided to make additional gifts in 1999 and were advised to create a new limited partnership. A certificate of limited partnership was issued by the Secretary of State of Missouri on December 2, 1999. Trusts agreements for the children were executed by one of the trustees on December 4, 1999, but Mr. and Mrs. Senda did not execute the trust agreements until May 2000. On December 17, 1999, Mr. and Mrs. Senda and the trustee of the children's trusts executed the partnership agreement. On December 20, 1999, Mr. and Mrs. Senda contributed 18,477 shares of MCI stock to the new partnership and the children's trusts purportedly contributed accounts receivable, although no documentation existed to support the existence of the accounts receivable. On that same day, Mr. and Mrs. Senda made a gift of a 17.9% limited partnership interest to each child's trust, but the assignments memorializing the transfer were not made until several weeks later. On December 22, 1999, Mr. Senda sent a facsimile transmission to his accountant informing him of the capital contribution and asking advice as to how large a gift to make to his children's trusts to maximize the remaining lifetime gift tax exemption. On January 31, 2000, Mr. and Mrs. Senda made a gift of a 4.5% limited partnership interest to each child's trust.[23]

The 1998, 1999, and 2000 gift tax returns filed by Mr. and Mrs. Senda reported the gifts of the limited partnership interests with valuation discounts for lack of control and lack of marketability.[24]

In challenging the value of the reported gifts, the IRS again asserted the indirect gift theory arguing that Mr. and Mrs. Senda actually made gifts of the MCI stock to their children and cited the holding in *Shepherd*. The IRS also argued that even if the contribution of the MCI stock to the partnership was actually credited to the capital accounts of Mr. and Mrs. Senda that such allocation was merely transitory and were all steps in an integrated transaction which attempted to transfer the stock to the children in partnership form. This argument was presumably made as a response to the language in the 11th Circuit's opinion in *Shepherd* which implied that if the capital accounts of Mr. Shepherd had been first credited with the capital contribution of the property, rather than 50% to Mr. Shepherd and 50% to his two sons, the result would have been different. Mr. and Mrs. Senda argued that the holding in *Jones* was applicable and that contributions to partnerships and gifts of partnership interests made on the same day should be respected as long as the capital accounts are properly credited.[25]

The Tax Court found in favor of the IRS stating that the facts were similar to *Shepherd*. The Tax Court stated that the taxpayers were unable to prove that the MCI stock was ever credited to their capital accounts which differentiated the case from *Jones*. The court also pointed to the fact that the Sendas did not maintain any books and records other than the brokerage statements and the tax returns. That Court concluded "[a]t best, the transactions were integrated (as asserted by respondent) and, in effect, simultaneous."[26]

It is interesting to note that the Tax Court's decision only covers the 1998 and 1999 gifts since the IRS conceded prior to trial that the Sendas made gifts of partnership interests on January 31, 2000 which was 42 days after the second partnership was funded.

On appeal, the 8th Circuit affirmed the ruling of the Tax Court that the formation and funding of the partnership was part of an integrated transaction. The 8th Circuit did state that even if the Sendas were able to demonstrate that the MCI stock was first credited to their capital accounts that "this formal extra step does not matter."[27] This language is at odds with the language contained in the 11th Circuit's opinion in *Shepherd* which implies that had Mr. Shepherd first contributed the land to the partnership, and then made gifts to his sons, the result would have been different.[28]

Recent Cases

Holman v. Commissioner

In *Holman*[29] the taxpayer was a former executive of Dell and had accumulated a substantial amount of Dell stock. Mr. Holman and his wife began to transfer Dell stock to their three children through uniform transfer to minors accounts (UTMA) which they established in 1996. In 1997 Mr. Holman and his wife relocated to Minnesota and sometime thereafter met with an estate planning attorney to discuss various estate planning matters. The Holmans recognized that they were wealthy and wanted to transfer their wealth to their children in a manner which would create responsibility in the children in managing the wealth. The attorney discussed the benefits of creating a family limited partnership and transferring interest to the children. The attorney discussed with the Holmans the transfer tax savings which would arise because of the discounts associated with lack of control and lack of marketability. Mr. Holman stated that he had four reasons for creating the partnership: (i) very long-term growth; (ii) asset preservation; (iii) asset protection; and (iv) education.[30]

The partnership agreement was executed on November 2, 1999 by Mr. and Mrs. Holman as both general and limited partners, and Mr. Holman's mother, as trustee of a newly created trust for the Holman's children, and as custodian of the UTMA accounts. Each partner transferred a certain amount of Dell stock to the partnership in exchange for a proportionate interest in the partnership on November 2, 1999 as well. On November 3, 1999, a certificate of limited partnership was filed with the Minnesota Secretary of State.[31] On November 8, 1999, Mr. and Mrs. Holman made gifts of limited partnership interests to the newly created trust as well as to the UTMA account for their youngest child which represented approximately 70% of the limited partnership interests. The Holmans filed gift returns reporting the gifts with the value of the gifts determined by an independent appraiser who took a combined discount of 49.25% for lack of control and lack of marketability.[32]

Mr. and Mrs. Holman made subsequent gifts of limited partnership interests on January 4, 2000 and January 4, 2001. The limited partnership interests were appraised each year and the Holmans filed gift tax returns reporting the gifts and claimed discounts for lack of marketability and lack of control.[33] The IRS audited the gift tax returns for 1999, 2000 and 2001 and asserted two separate indirect gift arguments - (i) the capital contribution to the partnership was an indirect gift of Dell stock to the children's trusts and (ii) that the formation and funding of the partnership should be aggregated under the step transaction doctrine.[34]

The Tax Court addressed the first argument by reviewing Treas. Reg. §25.2511-1(h)(1) which provides that a shareholder who makes a capital contribution to a corporation for less than full and adequate consideration makes an indirect gift of such property to the other shareholders and its holdings in *Shepherd* and *Senda*. The court found that those cases were not applicable because in *Holman* the partnership was funded six days prior to the gifts of the limited partnership. This case can be distinguished from the facts in *Shepherd*, where the taxpayer made gifts of partnership interests prior to the funding of the partnership and the funding was then allocated in proportion to the gifted interest, and *Senda*, where the funding and gifting occurred on the same day.[35]

The Tax Court then addressed the step transaction argument and began its analysis by summarizing the doctrine and the three tests employed by courts: binding commitment, interdependence, and end result. The court assumed that the IRS was basing its argument under the interdependence test which applies when "the steps in a series of transactions are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series" and, thus, the question to address is whether "the individual steps had independent significance or whether they had significance only as part of a larger transaction."[36]

The court then analyzed whether the formation and funding of the partnership were interdependent events. The IRS asserted that the six day delay between funding and gifting was done by the taxpayer to avoid an indirect gift under Treas. Reg. §25.2511-1. While the court acknowledged that one of the purposes in funding the partnership was to make gifts to their children the court stated "we cannot say that the legal relations created by the partnership would have been fruitless had petitioners not also made the 1999 gift."[37]

The court pointed out that the IRS did not assert the same argument made with respect to the 2000 gift or the 2001 gift and

stated that "the passage of time may be indicative of a change in circumstances that gives independent significance." The court found that that because the Dell stock held by the partnership changed in value between the date of contribution to the partnership and the date of the gifts, the change in value provided independent significance. The court did state that it was not making a bright line test (i.e. that a six day period between funding and gifting is sufficient to avoid that step transaction doctrine and in a footnote indicated that if the underlying assets consisted of another less volatile asset such as a government bond or preferred stock that it might have reached another conclusion).[38]

Gross v. Commissioner

The opinion in *Gross*[39] was written by Judge Halpern, who wrote the opinion in *Holman,* and reaches the same conclusions as those in *Holman.* Bianca Gross formed a limited partnership by filing the Certificate of Limited Partnership with the New York Secretary of State on July 11, 1998. Ms. Gross made a capital contribution of $100 and each of her two daughters contributed $10. During the next several months Ms. Gross contributed approximately $2 million of marketable securities to the partnership and the funding was complete on December 4, 1998. On December 15, 1998, Ms. Gross and her daughters executed a partnership agreement and Ms. Gross made a gift to each daughter of a 22.5% limited partnership interest. Ms. Gross filed a gift tax return reporting the gifts and claimed a combined 35% discount for lack of control and lack of marketability. The IRS audited the gift tax return and issued a notice of deficiency denying the discounts claimed for lack of control and lack of marketability on the theory that Ms. Gross made an indirect gift of 22.5% of the underlying securities to each of her daughters.[40] As in *Holman,* the IRS asserted two separate theories of how Ms. Gross made an indirect gift. The first theory was based upon Treas. Reg. §25.2511-1 and the holding in *Shepherd.* The second theory was based upon the application of the step transaction doctrine.[41]

The Tax Court first addressed the issue of when the partnership was formed. The IRS argued that the filing of a Certificate of Limited Partnership requires that the parties execute an agreement of limited partnership prior to the filing. The IRS further argued that since the parties executed the partnership agreement on December 15, 1998 that the partnership was not in existence prior to the signing date. The Tax Court disagreed with the IRS and found that a partnership was created on July 15, 1998, at which time the parties "agreed to the essential terms of their partnership arrangement". The Tax Court stated that even if all of the necessary formalities to form a limited partnership did not occur on that date, the parties still formed a general partnership on that date.[42]

The Tax Court reviewed its prior holdings in *Jones* and *Shepherd* in light of the fact of its determination that the partnership was formed on July 15, 1998 and found that the facts in *Gross* were analogous to those in *Jones* and dissimilar to those in *Shepherd.* As in *Jones,* the taxpayer contributed property to a partnership and the taxpayer's capital account was credited with the value of the property contributed. After the contributions were recorded on the books of the partnership, the taxpayer made gifts of partnership interests.[43]

In addressing the step transaction argument, the Tax Court cited its ruling in *Holman* and held that because (i) the partnership at issue held mostly marketable securities and (ii) 11 days elapsed between the funding of the partnership and the gifts, the step transaction doctrine was not applicable. As in *Holman,* the court included a footnote which stated that its conclusions may have differed if the partnership held less volatile assets.[44]

Analysis of Holman and Gross

Both *Holman* and *Gross* implied that if the underlying partnership assets had been less volatile that the Tax Court would have been more receptive to applying the step transaction doctrine in those cases. The volatility of the underlying assets between the date of funding the partnership and the date of the gift as a rationale for granting independent significance to the formation of the partnership as an independent step seems dubious. If, instead of Dell stock, the Holmans owned commercial real estate and contributed it to the partnership and made the same gifts of partnership interests, the Tax Court implied that it might be willing to use the step transaction doctrine to ignore the formation of the partnership as a separate step because, presumably, the commercial real estate would not have the same fluctuation in value as the Dell stock from the date of funding to the date of the gift.

The focus should be on whether the partnership would have been formed absent the transfer tax savings from the valuation discounts since the partnership interests were gifted and not the underlying assets. In *Holman,* the Tax Court acknowledged that the taxpayer had four objectives in forming the partnership: i) very long-term growth; (ii) asset preservation; (iii) asset protection; and (iv) education.[45] The Tax Court did not discuss whether any of these objectives could serve as a sufficient basis for ascribing independent significance to the formation of the partnership.

As the Tax Court discussed in *Holman,* courts have employed judicial doctrines to invalidate transactions designed to minimize or avoid estate and gift taxes.[46] The *Heyen*[47] case illustrates the application of a judicial doctrine in a gift tax case. In *Heyen,* the taxpayer made gifts of stock in a family business to various donees who, shortly after receiving the gifts of stock, make further transfers of the stock to the taxpayer's family members. The taxpayer claimed that the gifts of stock to the third party donees qualified for the annual gift tax exclusion under Code Section 2503. The court applied the substance over form doctrine to treat the taxpayer as making gifts directly to her family members.[48]

In that case the step of transferring the stock to the third party donees was disregarded because the subsequent actions of the donees indicated an intent that they not actually enjoy the benefits of the ownership of the stock. If in *Holman* or *Gross,* the partnership were dissolved soon after the gifts of the partnership interests were made so that a portion of the underlying assets were then distributed to the children or their trusts, it would be understandable if the court were to disregard the contribution of the assets to the partnership as transaction lacking independent significance. However, the Tax Court's focus on the change in value of the underlying assets rather than the partnership itself seems misplaced. The fact is that in both *Holman* and *Gross* the taxpayer gifted partnership interests which is a very different asset than the gift of the underlying marketable securities.

Planning and Defending Gifts or Sales of Partnership Interests

1. Ensure Proper Documentation and Order of Events. In order to avoid the indirect gift argument which proved successful

in *Shepherd and Senda*, it is important that all steps necessary to form, fund, and transfer the partnership interests are completed in the proper order. Such steps should include the following:

a. Identify the initial partners;
b. Determine the capital contribution of each initial partner;
c. Validly form the partnership for state law purposes;
d. Prepare necessary conveyance documents to document the contribution of assets to the partnership;
e. Establish appropriate capital accounts for each initial partner;
f. Prepare assignments of partnership interests;
g. Adjust the partnership books to reflect the assignment of partnership interests;
h. Report the gifts of partnership interests on a Form 709 (Gift Tax Return); and
i. Ensure that the Form 1065 (Partnership Tax Return) reflects the transferees as owning the transferred interests.

2. Future Capital Contributions. While *Shepherd, Jones, Senda, Holman,* and *Gross* all addressed the issue of indirect gifts upon the formation of a partnership, the issue can arise in the event of subsequent capital contributions under the indirect gift through a capital contribution theory described in Treas. Reg. § 25.2511-1. While this regulation addressed capital contributions to corporations and the Tax Court in *Jones* acknowledged that contributions to partnerships are different than contributions to corporations because partnerships have capital accounts[49], it is important that taxpayers appropriately document additional capital contributions. Failure to adjust partnership ownership percentages after a large capital contribution could result in a deemed gift of a partnership profits interest to the other partners. The steps necessary will likely be as follows:

a. Review the partnership agreement to determine the procedure for approving additional capital contributions and prepare any required documentation;
b. Prepare necessary conveyance documents to document the contribution of the additional assets to the partnership;
c. Comply with the terms of the partnership agreement regarding the adjustment of capital accounts and ownership percentages for the additional capital contribution;
d. Credit the capital account of the contributing partner; and
e. Ensure that the Form 1065 (Partnership Tax Return) reflects the updated ownership percentages and adjustment to capital account of the contributing partner.

3. Time Between Formation and Transfer of Interests. The steps outlined in 1 and 2 above address the proper ordering and documentation of a partnership interest transfers. It is also advisable to wait some period of time between funding and gifting the partnership interests. If the Tax Court were to decide *Jones* again under the rationale employed in *Holman* and *Gross*, it appears that the step transaction might disregard the formation of the partnership. For taxpayers forming partnerships with marketable securities or other volatile assets, *Holman* seems to suggest that a six day period between funding and transfer of interests is sufficient, although the Tax Court did state that it was not creating a bright line test.[50]

For taxpayers with less volatile assets such as real estate or mineral interests, this question is more difficult to answer. In *Senda*, the IRS conceded prior to trial that the step transaction doctrine did not apply to a gift of partnership interests 42 days after the funding of the partnership. Similarly, in *Holman* 63 days elapsed between the funding of the partnership and gifts made in 2000 to which the IRS did not argue that the step transaction applied. For situations involving less volatile assets, the IRS may argue that the step transaction covers a longer time period between funding and transfer for less volatile assets based upon the language in *Holman* and *Gross* so these 42 and 63 day periods may not be viewed as safe harbor time periods. Certainly if a taxpayer can demonstrate a change in value of underlying assets between date of funding and the date of a proposed gift of partnership interests, the taxpayer would have more comfort in using a shorter time period.

4. Demonstrate Independent Significance of the Creation of the Partnership. For taxpayers with completed transactions or for future transactions in which it may not be possible to structure a longer time period between the funding and transfer, it may still be possible to argue that the step transaction should not apply by focusing on the formation of the partnership as an independent action. Taxpayers should be able to demonstrate the benefit provided by the formation of the partnership. For example, if the purpose was to consolidate assets for more efficient management, the taxpayer should show how costs saving were achieved or how the aggregation of assets enabled the partnership to meet a minimum investment requirement of a money manager. Taxpayers should also ensure that the partnership is operated in compliance with the terms of the partnership agreement and that adequate books and records are kept which would indicate an intent to form and operate a valid partnership rather than to simply take advantage of discounts for transfer tax purposes.

Conclusion

The decisions of the Tax Court in *Holman* and *Gross* indicate a willingness of the Tax Court to apply the step transaction doctrine to the formation and subsequent transfer of partnership interests. Taxpayers should proceed cautiously when executing wealth planning strategies with partnership interests.

ENDNOTES

1 Daniel H. McCarthy dmccarthy@theblumfirm.com.
2 *See Estate of Reichardt v. Commissioner,* 114 T.C. 144 (2000); *Estate of Hillgren v. Commissioner,* T.C. Memo 2004-46; *Estate of Abraham v. Commissioner,* T.C. Memo 2004-39, *aff'd,* 408 F3d 206 (1st Cir. 2005); *Strangi v. Commissioner,* 417 F3d 468 (5th Cir. 2005), *aff'd,* T.C. Memo 2003-145, on remand from 293 F.3d 279 (2002), *aff'd in part, and reversing and remanding in part* 115 TC 478 (2000).
3 *Holman v. Commissioner,* 130 T.C. No. 12 (2008); *Gross v. Commissioner,* T.C. Memo 2008-221.
4 *Shepherd v. Commissioner,* 115 T.C. 376 (2000), *aff'd,* 283 F.3d 1258 (11th Cir. 2002).
5 *Id.* at 379.
6 *Id.* at 380.
7 *Id.* at 381.
8 *Id.* at 382.
9 *Id.* at 383-4.
10 *Id.* at 384.

11 *Id.* at 387.
12 *Id.* at 388-9.
13 *Shepherd v. Commissioner,* 89 AFTR 2d 2002-1251, *aff'd, 115* TC 376 (2000).
14 *Id.* at 1253.
15 *Estate of Jones v. Commissioner,* 116 T.C. 121 (2001).
16 *Id.* at 122-3.
17 *Id.* at 124.
18 *Id.* at 126.
19 Id. at 127.
20 *Id.*
21 T.C. Memo 2004-160, aff'd.
22 *Id.* at 952.
23 *Id.* at 953.
24 *Id.*
25 *Id.*
26 *Id.* at 956.
27 *Senda v. Commissioner,* 97 AFTR 2d 2006-419 at 422.
28 *Shepherd vs. Commissioner,* 89 AFTR 2d 2002-1251 at 1253.
29 *Holman v. Commissioner.*
30 *Id.* at 102-103.
31 *Id.* at 104.
32 *Id.* at 106-7.
33 *Id.* at 108-9.
34 Id. at 110-11.
35 Id. at 111-12.
36 Id. at 113.
37 *Id.*
38 *Id.* at 114.
39 *Gross v. Commissioner,* T.C. Memo 2008-221.
40 *Id.* at 1164.
41 Id. at 1169.
42 *Id.* at 1168.
43 *Id.* at 1170.
44 *Id.*
45 Holman at 103.
46 *Id.* at 113; *See* Harrison and Held, *Sham Transaction Doctrine,* Trusts and Estates (February 2003).
47 *Heyen v. US,* 68 AFTR 2d 91-6044.
48 *Id.* at 6047.
49 Shepherd at 389.
50 *Holman* at 144, footnote 7; *See also* Gross at 1170.