An Examination of IRC Section 2703

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Internal Revenue Code Section 2703(a) provides guidance on how valuation analysts should consider provisions of shareholder agreements and other restrictive agreements when valuing certain ownership interests for gift or estate tax purposes. The Internal Revenue Service has used Section 2703 in its attack of taxpayer-submitted valuations of business interests. This discussion summarizes the components of Section 2703 and examines several judicial decisions where the Internal Revenue Service has used the Code Section to rebut the taxpayer's valuation of transferred ownership interests in the context of a family limited partnership.

Introduction

Internal Revenue Code Section 2703 addresses how a valuation analyst should treat certain transfer restrictions that are contained in buy-sell agreements, stock purchase agreements, and family limited partnership (FLP) agreements for transfer tax valuation purposes. The section was established to eliminate situations where a buy-sell agreement (or other agreement) was drafted to be extremely restrictive (intentional or otherwise)—thus warranting higher valuation discounts in the valuation of the entity's ownership interests—yet somehow be nonbinding or unenforceable.

This discussion defines Section 2703 (a) and (b), as codified under Chapter 14, summarizes the reasons and effects of the section, and concludes with a discussion of two valuation-related court cases—*Sidney E. Smith III v. United States* (2004) and *Holman v. Commissioner* (2010). The outcomes of these decisions were affected by the court's interpretation of Section 2703.

Internal Revenue Code Section 2703 Defined[1]

Section 2703 has two components—the General Rule, which is described in Section 2703(a), and Exceptions, which are described in Section 2703(b). The following paragraphs present the language contained in Section 2703:

Section 2703. Certain rights and restrictions disregarded

(a) General Rule—For purposes of this subtitle, the value of any property shall be determined without regard to—

> (1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right), or
>
> (2) any restriction on the right to sell or use such property.

(b) Exceptions—Subsection (a) shall not apply to any option, agreement, right or restriction which 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 in money or money's worth.
>
> (3) Its terms are comparable to similar arrangements entered into by persons in an arm's-length transaction.

Discussion of Section 2703

The Section 2703(a) General Rule is that, for estate, gift, and generation-skipping transfer taxes purposes, the value of any property is determined without regard to any right or restriction relating to the property that would result in the property being valued at less than its fair market value.

Taken by itself, it appears that the General Rule would render any buy-sell agreement or shareholders agreement moot from the standpoint of considering the agreement in the estimation of a lack of marketability discount. However, Section 2703(b) allows for certain exceptions to the provision contained in Section 2703(a).

There are exceptions to the rule that certain rights and restrictions are to be disregarded for valuation-related purposes. One exception is actually an enhancement of the case and regulatory law that existed before the enactment of Chapter 14.[2]

Another exception can be viewed as a liberalization of the case and regulatory law when applied to entities that are not controlled by a single family (2703(b)(2)).

Each of the Section 2703(b) three requirements must be independently satisfied for a right or restriction to meet the exception requirement. For example, showing that an option, agreement, right, or restriction is a bona fide business arrangement is not sufficient to satisfy the other two requirements.

In other words, establishing that the right or restriction is a bona fide business arrangement does not, in and of itself, also establish that the option, agreement, right, or restriction is not a device to transfer property for less than full and adequate consideration.

The requirement that each of the three Section 2703(b) tests be satisfied independently has been discussed in several court cases. For example, in *Estate of Lauder v. Commissioner* (1990), the Tax Court stated "the restrictive agreement must have been entered into for a bona fide business reason and must not be a substitute for testamentary disposition."

The Tax Court further concluded that a buy-sell agreement in a bona fide business arrangement does not eliminate the possibility that it was a testamentary "device."[3]

The Tax Court's analysis of the testamentary device test, as it related to a buy-sell agreement, is included in *Estate of Blount v. Commissioner*.[4] In its analysis, the Tax Court examined various factors of the subject buy-sell agreement as of the date of the agreement.

These factors included: (1) the reasonableness of the purchase price contained in the agreement, (2) the intent of the parties to the agreement, and (3) the facts leading to the conclusion that the agreement is a substitute for a testamentary device. Factors that the Tax Court reviewed in determining whether the buy-sell agreement was a testamentary substitute included the following:

1. the grantor's health at the time the agreement was executed
2. any significant changes in the business as of the date of the agreement was entered into
3. selective enforcement of the restrictive provisions of the agreement
4. the nature and extent of negotiations that occurred among the parties to the agreement

Invariably, many of the Section 2703 prior court cases came down to a challenge of Section 2703(b) as opposed to Section 2703(a). This is because the taxpayer is ultimately trying to prove that the options, agreement, rights, or restrictions that impact the subject property interest should be considered in the analysis under the exceptions, or "safe harbor" clause of Section 2703(b).

The reasons for this are fairly clear; if the subject property interest is to be valued without regard to the exceptions described in Section 2703(b), the taxpayer runs the risk of a revaluation of the property interest by the Service. And, this revaluation may ultimately result in a higher concluded value for the property interest and a higher level of transfer tax.

The Service's use of Section 2703 to challenge the valuation of property interests is not limited to cases where the subject property interest is subject to a buy-sell agreement.

The Service has expanded its use of Section 2703 to challenge the validity, for valuation-related purposes, of certain provisions of FLP agreements.

The following discussion summarizes two judicial decisions where the Service used Section 2703 to challenge the taxpayer's valuations of ownership interests in FLPs that were prepared for transfer tax purposes.

Sidney E. Smith III v. United States[5]

In the case of Sidney E. Smith III (and executors of the Estate of Sidney E. Smith Jr.), the U.S. District Court for the Western District of Pennsylvania disregarded transfer restrictions in the Smith FLP for gift tax valuation purposes.

Background

Sidney Smith and his children, Sidney and Jill, formed Smith FLP. Upon formation of the partnership, the partners collectively contributed to the FLP 100 percent of the common stock of an operating company. Smith was a 2 percent co-general partner and his son was a 1 percent co-general partner.

Upon formation, Smith owned a 95.15 percent limited partnership interest, his son owned a 0.90 percent limited partnership interest, and his daughter owned a 0.95 percent limited partnership interest.

Smith initially transferred a 6.865 percent limited partnership interest to each child. Later in the same year, he transferred an additional 13.37 percent limited partnership interest to each child. Smith filed a gift tax return valuing the transfers at $1,025,392 and paid a gift tax of $262,243.

The Service audited the gift tax return and increased the total value of the transfers to $1,828,598. This adjustment resulted in an assessment by the Service of $360,803.

Smith paid the additional gift tax, requested a refund, and after six months filed suit in Federal Claims Court under the provisions of Section 6532.[6]

Valuation-Related Issue

The Smith FLP partnership agreement contained provisions that restricted transfers of partnership interests. The agreement also granted the partnership a right of first refusal to acquire any partnership interests that were the subject of a prohibited transfer.

The right of first refusal limited the price that the partnership would be required to pay a partner for his limited partnership interest. In addition, it also permitted the price to be paid over 15 years with interest at the applicable federal rate. The right of first refusal was the contentious provision of the agreement.

The Service claimed that under Section 2703(a), the right represented an "option" and therefore should be disregarded for transfer-tax-related purposes. Conversely, the Smiths argued that the Smith FLP agreement satisfied the safe harbor requirements of 2703(b).

Conclusion

The District Court granted partial summary judgment in favor of the Service. The District Court found that Section 2703(a) did indeed apply to the restrictive provision contained in the Smith FLP agreement. Yet, the District Court also granted partial summary judgment in favor of the Smiths, finding that the restrictive provision satisfied the first safe harbor requirement set forth in Section 2703(b)(1).

However, as mentioned earlier, all three of the requirements described in Section 2703(b) need to be met for an exception under Section 2703(b) to be satisfied. Further, the District Court found issues of material fact existed as to whether the safe harbor requirements of Sections 2703(b)(2) and 2703(b)(3) were satisfied.

Because Smith owned approximately two-thirds of the general partnership interests and a majority of the limited partnership interests at all times before his death, he had the power to unilaterally amend the partnership agreement and remove the right of first refusal. As a result, the District Court held that the partnership agreement and the right of first refusal were not binding on Smith during his lifetime.

This "selective enforcement" issue fundamentally violated the concept of the testamentary device test and, therefore, violated Section 2703(b)(2). As a result, the partnership agreement was disregarded for purposes of estimating the value of the partnership interests for federal gift tax purposes.

Holman v. Commissioner[7]

Background

On November 3, 1999, Thomas H. Holman Jr. and Kim D.L. Holman formed an FLP. A trust for the benefit of the Holman children contributed 100 shares of Dell Corp. stock to the FLP. And, Mr. and Mrs. Holman collectively contributed 70,000 shares of Dell Corp. stock to the FLP.

The purpose of the partnership was four fold: (1) long-term growth, (2) asset preservation, (3) asset protection, and (4) funding for the children's education. Subsequent gifts of partnership interests were made by the parents to their children on November 8, 1999; January 4, 2000; and February 2, 2001.

Valuation-Related Issues

The Service levied three different attacks on the Holmans' (the "petitioners") valuation of the transferred partnership interests: (1) the gifts were actually indirect gifts of Dell stock rather than of partnership interests, (2) Section 2703 rendered the transfer restrictions contained in the partnership agreement invalid, and (3) the valuation discounts used by the taxpayers were excessive.

While all three attacks were considered in this case, points 1 and 3 are beyond the scope of this discussion. As a result, this discussion focuses solely on the Section 2703 issues pertaining to point 2.

More specifically, the Service's argument regarding Section 2703 was that the transfer restrictions contained in the partnership agreement should be disregarded. This is because the agreement failed both: (1) Section 2703(b)(1) (bona fide business arrangement requirement) and (2) Section 2703(b)

(2) (not a device to transfer property for less than full and adequate consideration requirement).

Conclusion

The Eighth Circuit affirmed the Tax Court findings that the transfer restrictions in the FLP agreement do not constitute a bona fide business arrangement within the meaning of Section 2703(b)(1). The Appeals Court acknowledged that the bona fide business arrangement requirement does not necessarily require an actively managed business, but, in the case of *Holman*, the fact that the partnership was essentially a holding entity for shares of Dell stock wasn't enough to warrant a consideration for 2703(b)(1).

With regard to this point, the Eighth Circuit stated:

> That is not to say we necessarily believe it will always be easy to apply 2703(b)(1) or that investment-related activities cannot satisfy the subsection (b)(1) test. When the restrictions at issue, however, apply to a partnership that holds only an insignificant fraction of stock in a highly liquid and easily valued company with no stated intention to retain that stock or invest according to any particular strategy, we do not view this determination as difficult.

Further, the Appeals Court gave insight into several factors that will not satisfy the bona fide business arrangement requirement for investment partnerships. These factors included: purposes of estate planning, tax reduction, wealth transference, protection against dissipation by the children, and education for the children.

Regarding Section 2703(b)(2), the Appeals Court examined whether the transfer restrictions within the partnership agreement constituted a device to transfer property to natural objects of the transferor's bounty for less than full consideration. In its conclusion, the Appeals Court did indeed deem the restrictions a "device." This is because they deprive the children of realizing the difference between the fair market value of the limited partnership units and the units' proportionate share of the partnership's undiscounted net asset value.

With regard to this point, the Eighth Circuit believed that Mr. Holman:

> . . . understood the redistributive nature of paragraph 9.3 [i.e., the partnership's purchase option] and his and Kim's authority as general partners to redistribute wealth from a child pursuing an impermissible transfer to his other children. We assume, and find, that he intended paragraph 9.3 to operate in that manner, and this intention leads us to conclude, and find, that paragraph 9.3 is a device to transfer LP units to the natural objects of petitioners' bounty for less than adequate consideration.

Summary and Conclusion

In the two judicial decisions examined above, the Service used Section 2703 in different ways to attack the taxpayer-submitted valuations of FLP ownership interests.

In the case of *Smith*, the issue of unilateral control did not satisfy the exception requirements of Section 2703(b)(2). In other words, Mr. Smith considered the restricted language within the partnership agreement at the time of the transfers, thereby using the agreement as a "device" to obtain a higher valuation discount. However, he also had the ability to amend the agreement's restrictive language at a later date.

In the case of *Holman*, the Appeals Court ruled that the partnership agreement did not meet the requirements of Sections 2703(b)(1). The Appeals Court also concluded that the partnership agreement failed the requirement of 2703(b)(3) in that it was a device to transfer partnership units to family members for less than adequate consideration.

While buy-sell agreements, shareholder agreements, and partnership agreements will continue to play an important role in closely held, family-controlled business planning, provisions of these agreements will continue to be the subject of the Service scrutiny. It is reasonable to expect that the Service will continue to use Section 2703 in its attack on business interest valuations where the analysis considers the valuation impact of certain options, rights, agreements, or restrictions.

<u>Notes</u>:

1. U.S. Code Title 26, Subtitle B, Chapter 14, Section 2703.
2. Section 2703(b)(1) is an enhancement of Treasury Regulations Section 20.2031-2(h) and Revenue Ruling 59-60, 1959-1 C.B. 237.
3. *Estate of Lauder v. Commissioner*, T.C. Memo. 1992-736.
4. *Estate of Blount v. Commissioner*, T.C. Memo 2004-116.
5. *Sidney E. Smith III v. United States*, No. 02-264 Erie, U.S. Dist. Ct. (W.D. Penn. July 22, 2004).
6. Section 6532 Periods of Limitations on Suits. Section 6532(a)(1) states "No suit for the recovery of any internal revenue tax, penalty, or other sum, shall be begun before the expiration of 6 months from the date of filing the claim. . . ."
7. *Holman v. Commissioner*, 105 AFTR 2d 2010-721 (8th Cir. April 7, 2010), *aff'g* 130 T.C. 170 (2008).

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