

Trusts & Estates

The Journal of Wealth Management for Estate-Planning Professionals—Since 1904

Committee Report: Estate Planning & Taxation

By William H. Frazier

The Pomeroy Bill Sledgehammer

Congress is considering a law that would kill the family limited partnership as an estate-planning strategy. But there are less draconian ways to eliminate perceived abuses

The valuation of fractional interests in family-owned businesses and investment entities faces possible extinction.

There are two possible executioners: Congress and the Treasury Department.

In the House of Representatives, the threat comes in the form of the Pomeroy bill. Introduced by Democratic Congressman Earl Pomeroy of North Dakota on Jan. 14, 2009, H.R. 111-436 seeks to eliminate the use of valuation discounts in valuing family limited partnerships (FLPs). The bill, formally known as “Certain Estate Tax Relief Act of 2009” also seeks to eliminate the use of minority interest discounts for family businesses.

The effect would be to end the use of the FLP as an estate-planning vehicle.

The Treasury is considering making similar changes through regulation that would have a similar result.

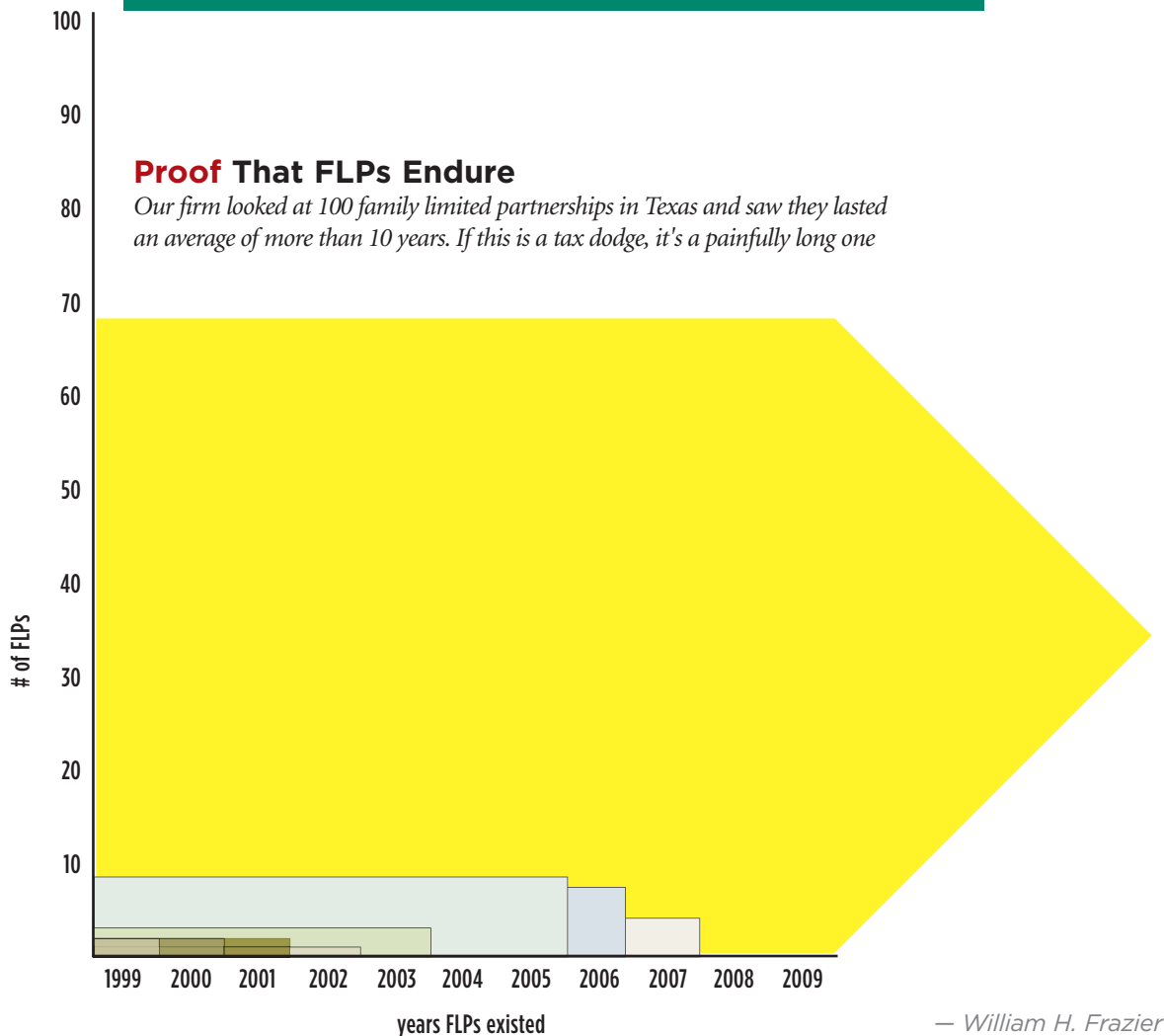
At its heart, the valuation provisions of the Pomeroy bill would reestablish family attribution. This doctrine has been largely discredited since a U.S. appeals court decision clearly denounced it back in 1981 in *Estate*

of Mary Frances Smith Bright v. United States.¹ Family attribution means that all fractional interests in family-controlled entities are deemed to be controlling interests. The Internal Revenue Service formally abandoned this notion in 1993 with Revenue Ruling 93-12. The Pomeroy bill seeks to do an end run around the judicial and regulatory prohibitions against family attribution.

The seeds of the Pomeroy legislation are found in the Jan. 27, 2005, report of the Joint Committee on Taxation (JCT): “Under present law, valuation discounts can significantly reduce the estate and gift tax values of transferred property. Minority and marketability discounts in particular often create substantial reductions in value. In some cases these reductions in value for estate and gift tax purposes do not accurately reflect value. For example, a taxpayer may make gifts to a child of minority interests in property and claim lack-of-control discounts under the gift tax even though the taxpayer or the taxpayer’s child controls the property being transferred. A taxpayer also may contribute marketable property such as publicly-traded stock to a partnership (such as a family limited partnership) or other entity that he or she controls and, when interests in that entity are transferred through the estate, claim marketability discounts even though the heirs may be able to liquidate the entity and recover the full value by



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accessing the underlying assets directly.”²

By adopting this philosophy, proponents of the Pomeroy bill ignore the requirements of federal tax regulations that fair market value (FMV) be determined on the basis of a hypothetical buyer and seller. This is a fundamental part of the meaning of FMV and an issue with an extensive judicial and regulatory history.

The JCT is echoing the IRS’ complaints that FLP valuation discounts are determined on a hypothetical willing buyer-willing seller concept but, in reality, taxpayers abuse the construct, making the FLP nothing more than a device to escape estate taxes.

Without question, such abuses exist. But I’m convinced they happen most often in smaller transactions when taxpayers aren’t represented by truly qualified professionals. After all, a qualified appraiser³ would violate generally accepted appraisal guidelines (and risk incurring penalties and losing reputation) if he were to determine a significant valuation discount for an FLP that he knew was soon to be liquidated.

There are less draconian ways to solve the problem of potential abuses than the Pomeroy bill sledgehammer. Not only do the bill’s valuation discount provisions do far more harm than good, but also the tax dollars it seeks to recover for the Treasury are now illusory.

In 2004, because of substantial noncompliance of tax obligations by taxpayers, the U.S. Treasury announced a perceived “tax gap” of underreported revenues leading to a \$400 billion “shortfall” in collected revenues. The JCT, in its report, “Options To Improve Tax Compliance And Reform Tax Expenditures,” claimed that the elimination of valuation discounts for transactions involving family-controlled entities would raise \$500 million to \$600 million a year in additional estate taxes in 2011 and beyond. This estimate was based on the Congressional Budget Office’s 2004 baseline projections for 2005 to 2014. The projections related to estate and gift taxes assumed that the tax laws existing in 2004 would remain operative. Although understandable at the time, we now know that assumption is wrong.

Obviously, the JCT's projections are no longer valid.

We also know that the federal estate and gift tax laws will change. The Pomeroy bill itself seeks to increase the lifetime exemption amount to \$3.5 million per person. This equates to \$7 million for a married couple—\$5 million higher than was available when the JCT revenue analysis was made.

The practical effect of not valuing intra-family transfers by the FMV standard is that it will cause taxpayers to avoid making gifts. Money that's not gifted will stay in estates but with an exemption of \$7 million, much of this money will escape taxation. In other words, the tax-raising goal of the bill will be thwarted by its exemption provisions.

Interestingly, the Pomeroy bill does not really seek to ensure that FLPs are properly valued—only that more taxes are raised, fairly or not. If the aim of the bill was to fix valuation inequity in FLPs, the rules would apply broadly, not selectively to tax transactions involving FLPs.

For example, if Pomeroy were to be enacted, FLP interests gifted to a charity would be valued at FMV. Here, the transferred interest is valued in the hands of the donee, which is consistent with current Treasury rules (for example, Rev. Ruling 93-12) and a myriad of Tax Court cases. Under the proposed law or regulations, the focal point of the gift is the donor. The inconsistency here is obvious.

This inconsistency would create a conundrum with respect to sale transactions among family members. If one followed the intent of the bill's language, the partnership interest would have to be sold at more than FMV. If this is so, the sale could not be considered an "arm's length" transaction as required under Internal Revenue Code Section 2512.

An Alternative

Here's my suggested solution to the perceived problem of taxpayers abusing the FLP discount:

First, require that all tax-related valuations be done by qualified appraisers preparing a qualified appraisal.⁴ This will go a long way towards eliminating inexpertly done appraisals or outright cheating.

Next, in order to validate that an FLP is indeed a long-term investment vehicle designed to promote capital appreciation, professional asset management and intergenerational family wealth retention, we recommend that a valuation assurance clause be added to the partnership agreement.⁵ The clause will ensure that, if the FLP is liquidated before the 10th year of the date of a gift transfer, the transferee limited partners will not receive their full pro-rata share of the partnership's net asset value. During the 10-year period, any amount distributed in liquidation that exceeds the discounted value received at transfer would be subject to a tax surcharge unless donated to a qualifying charity.

Evidence

One of the central complaints of the IRS is that FLPs are a mechanism that merely recycles dollars of a family from one generation to the next. According to the IRS, FLPs are structured such that founders, typically a married couple, create and fund FLPs as close to death as possible. Gifts and/or sales to the next generation are then made at greatly discounted values. As soon as the last founding spouse dies and any IRS audit is closed, the partnership is liquidated. Thus, assets are transferred out of one generation at discounted values and distributed to the next at undiscounted values.

An important valuation issue here is the holding period of the limited partner transferee. An overlooked issue in the debate over FLPs is the holding period limited partners face after receiving gifts of limited partnership interests. The impression the IRS-JCT viewpoint creates is that this holding period is short. But such is not the case.

My firm, Howard, Frazier, Barker Elliott, Inc. (HFBE), conducted a study of 100 FLPs formed prior to 1999.⁶ These were all partnerships for which the firm had performed valuation assignments for gift or estate tax purposes. The study was not designed to adhere to any rigorous statistical criteria or hypothesis testing; but neither was it

an exercise in data-mining.⁷ As a matter of convenience, we selected only Texas partnerships, because part of our analysis involved checking the status of such partnerships with the Texas Secretary of State's office.⁸

Of the 100 partnerships examined 68, or, 68 percent, still exist. The average age of these partnerships is 12 years. Of the 32 partnerships that have been terminated, the average age from filing to cancellation was eight years.

The total assets in the 100 partnerships were about \$1.5 billion. The asset composition of the partnerships was 56 percent marketable equities, 11 percent private equity, 10 percent municipal bonds, 12 percent real estate and 4 percent cash. The remaining 7 percent was evenly divided amongst a number of smaller asset classes.

The average size of each FLP, then, was about \$15 million. The average number of years in existence for the 100 partnerships was more than 10. And in the case of 68 percent of partnerships, the average age is lengthening.

Thirty-five out of the 100 valuations were for estate tax purposes. Of these 35 estate tax assignments, 17 partnerships did terminate. Of the cancelled partnerships originally valued for estate tax purposes, on average, seven years elapsed between the date of death and the cancellation of the partnership. Further, only four partnerships out of the 17 cancelled in less than 5 years from the date of death.

Even if one accepts the "wink wink" assumption of parental control over the partnership advocated by the JCT and IRS, if the average time the recipient of a gift must wait before receiving his share of the partnership assets is at least 10 years, how can this interest possibly be valued as the equivalent of its pro-rata share of the partnership's net asset value?

If the limited partner transferee were to attest on a federal loan application or personal financial statement submitted to a bank in support of a loan, that the value of his ownership interest in the partnership was equal to the partnership's pro-rata net asset value, he might be committing a federal offense. Even

if the lender took no action against the borrower here, they are likely to place little, if any, collateral value on the interest.

Just the Facts

The HFBE study provides strong evidence that FLPs do, indeed, exist for a long period. It also shows that the IRS suggestion that a transferee's interest is the equivalent of a bank account is not supported by the facts. The legislative or regulatory suspension of the notion of FMV for transfers of interests in these entities under the guise of helping to close the tax gap is misguided and unfair. **TE**

Endnotes

1. *Estate of Mary Frances Smith Bright v. United States* 658 F.2d 999 (1981).
2. *Options to Improve Tax Compliance and Reform Tax Expenditures*, prepared by the staff of the Joint Committee on Taxation, JCS-02-05 (Jan. 27, 2005) p. 399.
3. As that term is defined under the proposed final regulations governing "Substantiation and Reporting Requirements for Cash and Noncash Charitable Contribution Deductions" (REG-140029-07).
4. *Ibid.*
5. William Frazier, "Valuation Assurance Clauses," *Trusts & Estates*, December 2007, at p. 42.
6. Special thanks are owed to Dorie Liucci, vice president, administration, in the Houston office of Howard Frazier Barker Elliott, Inc. who created, directed and compiled the study.
7. Our files are archived alphabetically in directories of different vintages. To select samples purely on a chronological basis would have been too time consuming given our purpose. Thus, the files were pulled randomly. The only test was that the partnership be a Texas partnership and that it was formed before 1999. No partnerships which met these tests were later excluded from the study. We have been performing Family Limited Partnership valuation assignments since 1992. The anecdotal evidence suggests the volume of such work has increased in each year.
8. The Texas Secretary of State website for this purpose is: https://direct.sos.state.tx.us/corp_inquiry/corp_inquiry-find.asp?Norder_item_type_id=10. The Texas Secretary of State website lists the definitions of its terms as:
Cancelled—an inactive status applicable to limited partnerships. This status indicates that a Texas or foreign limited partnership has filed a cancellation or has failed to file its periodic report after notice of forfeiture of its rights to do business in Texas.
In Existence—an active status indicating that the entity has not dissolved, forfeited its formation document, withdrawn, terminated, merged, converted or otherwise terminated its existence.