



Close Call: Taxpayer Appeals FMV Standard and Discounts in Valuing FLP Restrictions

The Holmans created a family limited partnership (FLP) to preserve their substantial holdings of Dell stock for their children—in particular, to protect against the claims of creditors (including divorcing spouses) and to encourage wealth management skills. To this end, the FLP precluded transfers to outside parties and gave the partnership the right to redeem any proposed sales.

In *Holman v. Commissioner*, 130 T.C. No. 12 (2008), the IRS argued—and the Tax Court found—that the transfer restrictions did not serve a bona fide business purpose under IRC Sec. 2703, but were merely a device for the parents to gift highly liquid Dell stock at reduced values. The Tax Court also adopted a 12.5% marketability discount, based on the IRS expert's review of restricted stock studies as well as the FLP buy-back provisions, which acted as a natural “cap” or limit to any potential discount. In *Holman v. Commissioner*, **2010 WL 1331270 (C. A. 8 2010)**, the taxpayers appealed both aspects of the decision.

Hypothetical buyers or Holman buyers? The taxpayers claimed the Tax Court's definition of “bona fide business arrangement” was too limited, effectively requiring the FLP to be an active, operating business. Instead, the taxpayers' specific intent, as provided in the partnership agreement, should control. The nature of the assets is irrelevant, they said; the FLP was “an enterprise with the business purpose of generating profits through long-term growth.” The taxpayers also argued that the Tax Court's construction of the buy-back provisions violated the fair market value (FMV) standard of the hypothetical buyer/seller by asking what the *particular* partners in this case would do if faced with a proposed assignment of FLP shares.

The U.S. Court of Appeals for the Eighth Circuit disagreed on both points. First, “context matters” when determining whether a restriction constitutes a bona fide business arrangement, the court held. The FLP was not a business, “active or otherwise.” Moreover, the underlying Dell stock was easily valued and highly liquid, and the taxpayers did not have any particular investment strategy or skill. By burdening an otherwise liquid asset, the FLP was as a “mere container” to further a tax avoidance scheme.

As to the marketability discounts, in this case a hypothetical buyer would know that the FLP permitted the partners to buy out an exiting partner at little or no economic risk, given the liquid nature of the assets. Under these facts, the question became what the partners would reasonably do when faced with a pending sale of FLP interests at a

steep discount relative to net asset value. “Simply put, the Tax Court did not ascribe personal non-economic strategies or motivations to hypothetical buyers,” the court ruled, in affirming the decision; “it merely held that, presented with the opportunity, rational actors would not leave money on the table.”

Note: A single judge on the panel dissented, finding the FLP restrictions served a legitimate business purpose and the court’s determination of marketability discount violated the fair market value standard.

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