Office of Chief Counsel
Internal Revenue Service

memorandum

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date: September 25, 2002

to: [redacted], Manager, Team [redacted] [redacted] SANW
IRS, 5835 Callaghan Rd., San Antonio, TX 78228

from: Area Counsel
(Natural Resources: Houston)

subject: **Partnership Interest Valuation** POSTF 140838-02 [redacted]

Legend

[redacted]	= [redacted]
[redacted]	= [redacted]
Son	= [redacted]
Daughter	= [redacted], [redacted] of [redacted] and [redacted]
Son's Trust	= [redacted]. Trust
Daughter's Trust	= [redacted] Trust
[redacted]	= [redacted], Inc.
[redacted]	= [redacted]
S1	= [redacted], Inc.
S2	= [redacted], Inc.
[redacted]	= [redacted], Ltd.
[redacted]	= [redacted], Inc.
Valuation Report	= [redacted], Ltd. Valuation as of [redacted]

Issue

Husband and wife [redacted] and [redacted] each received as community property [redacted]% of closely held corporation S1 and [redacted]% of closely held limited partnership [redacted]. Combined, their ownership interests represented controlling interests in both S1 and [redacted]. Under case law, each spouse's separate noncontrolling interest should be valued as a noncontrolling interest **only if** it loses its community property character. Should these interests be valued as separate, noncontrolling interests?

Brief answer: No. They should be valued as parts of the respective controlling interests.

Facts

These are the facts upon which this opinion is based. Please review them carefully. Any material variation in the facts may render this opinion invalid.

1. [redacted] and [redacted], husband and wife, are Texas residents. In [redacted], already married to [redacted], [redacted] purchased with community funds [redacted]% interest of [redacted], a Texas corporation, from his father-in-law.

2. On [redacted] [redacted] elected to change [redacted] into an S corporation. In [redacted] [redacted]'s name was changed to [redacted]. [redacted] was the sole shareholder of its total [redacted] shares of stock.

4. Before [redacted], [redacted] gave as gifts [redacted] shares of [redacted] stock to [redacted], and another [redacted] shares to [redacted].

5. On [redacted], [redacted] reincorporated under Delaware law. [redacted] issued [redacted] shares to [redacted], [redacted] shares to [redacted]'s Trust and [redacted] shares to [redacted]'s Trust. Total outstanding shares of [redacted] stock were [redacted].

6. Shortly thereafter, certificates of [redacted]'s [redacted] shares in [redacted] stock were cancelled, and [redacted] issued [redacted] shares of stock to [redacted] and [redacted] shares to [redacted]. Their representative alleged that this arrangement was more representative of the ownership under Texas community property laws.

7. On [redacted] [redacted] formed two wholly-owned subsidiaries: S1 and S2. The two subsidiaries elected to be treated as Qualifying Subchapter S Subsidiaries under section 1361(b)(3).

8. Immediately thereafter, S1 and S2 formed a limited partnership - [redacted]. S1 was the general partner, owning [redacted]% of [redacted]; and S2 the limited partner, owning [redacted]% of the [redacted].

9. On [redacted] [redacted] merged into [redacted], making [redacted] partner with S1 in [redacted]. Immediately thereafter, [redacted] was liquidated. Its assets, [redacted]% interest in S1 and [redacted]% in [redacted], were distributed to the shareholders.

10. The Service believes that this series of transactions were conducted to avoid state franchise tax and to enable the shareholders to draw cash from the controlled business.

11. The liquidation and distribution resulted in the following new ownership structures:

Ownership of [redacted]:

[redacted]: [redacted]%;
[redacted]: [redacted]%;
Son's Trust: [redacted]%;
Daughter's Trust: [redacted]%.

Ownership of limited partnership [redacted]:

S1: [redacted]%;
[redacted]: [redacted]%;
[redacted]: [redacted]%;
Son's Trust: [redacted]%;
Daughter's Trust: [redacted]%.

12. The liquidation was a taxable transaction under I.R.C. section 331 and the fair market value of the property received should be included in the shareholders' tax returns. To determine the fair market value of the assets received, [redacted] hired [redacted], a business valuation firm, to appraise the value of:

[redacted]% interest in S1
[redacted]% interest in [redacted].

[redacted] calculated the fair market value on the assumption that these interests were **noncontrolling**. "[T]he estimate of value derived using the Income Approach was based on the present value of cash flows available to a noncontrolling partner. The Market Approach used Price to NAV ratios of noncontrolling interests to estimate a value." Valuation Report at 25.[1] The Service questions the validity

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[1] A factual clarification: [redacted]) to us, you mentioned that "the appraisal reflects a [redacted]% discount for the lack of marketability of the noncontrolling partnership interest." We would like to clarify that, according to the Valuation Report, the [redacted]% discount for lack of marketability is ***not*** based on the so-called lack of control. Rather it is based on the lack of a public or secondary market. Valuation Report at 25. What [redacted] did to calculate the fair market value of the [redacted]% interest in [redacted] is this:

1. Using income approach on a **marketable**, but **noncontrolling** basis, it estimated the present value of [redacted] as $[redacted];

of the assumption that the interests were noncontrolling.

Analysis

I. Fair market value of the [redacted]% interest in S1.

[redacted] and [redacted], husband and wife, each owned [redacted]% of S1, a noncontrolling minority interest if viewed separately, while together they owned as community property [redacted]% of S1. A controlling interest is the ownership percentage which enables the holder to exercise control over important corporate acts. States vary in their requirements for establishment of corporate control. Under Texas law, unless otherwise provided in the articles of incorporation, a simple majority of voting shares can control a corporation. See Tex. Bus. Corp. Act Ann. art. 2.28 (West 1998). Thus [redacted] and [redacted] had a controlling interest. As a controlling interest in a closely held corporation is worth more than a non-controlling interest[2], or the fair market value of the former is higher than that of the latter, the sole issue in this case is

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2. Using market approach on a **marketable**, but **noncontrolling** basis, it estimated the present value of [redacted] as $[redacted];

3. It averaged the above two figures to arrive at an estimated value of [redacted] of [redacted] on a **marketable**, but **noncontrolling** basis;

4. Finally it applied a [redacted]% discount to arrive at $[redacted] to reflect lack or marketability. [redacted]% of this value is $[redacted]. See Valuation Report (for summary, see its Exhibits 2 through 4).

As the above shows, the estimated value before the [redacted]% discount **already incorporated** a noncontrolling factor. We do not know what noncontrolling discount [redacted] applied to arrive at the starting point. But it is on top of this already discounted (for lack of control) value that the [redacted]% discount for lack of marketability is applied.

[2]This proposition is generally accepted. It is also an assumption of [redacted]'s valuation. See Valuation Report at 24. In the interest of brevity, we shall not discuss or cite any authority on this proposition

whether, for income tax purposes, the [redacted]% interest each spouse received in [redacted] should be valued as a controlling interest or a noncontrolling interest. In other words, should it be valued separately as a minority interest or as one-half of a block of the entire controlling interest.

Our research in income tax law has not uncovered any right-on-point statutes or cases. However, we found much guidance from estate tax law for the present case.

Estate tax is imposed on the property transferred at death, see Estate of Bright, 658 F.2d 999 (5th Cir. 1981); United States v. Land, 303 F.2d 170 (5th Cir. 1962); while income tax is imposed on the net gain from property received. See I. R. C. §§ 1001(b) and (c); Treas. Reg. §§ 1.61-1(a), -6(a). This distinction, however, should not affect the valuation methods of the property involved. Thus, except for those unique to estates, valuation principles that apply for estate tax purposes should also apply for income tax purposes.

How should we value [redacted] and [redacted]'s interests in S1? To answer this question we must first determine whether [redacted] and [redacted] each received half of a controlling interest or separate noncontrolling interests. Federal courts determine the character of taxpayers' property interests by looking at state laws. See Aquilino v. United States, 363 U.S. 509, 515 (1960); Morgan v. Commissioner, 309 U.S. 78 (1940). Since [redacted] and [redacted] have been Texas residents, Texas law controls in determining the character of their interests in [redacted] and S1. Under Texas law, unless otherwise agreed by the spouses in writing, property acquired during marriage is community property. See Tex. Fam. Code Ann. § 3.002 (West 1998). Whether the title bears both spouses' names or just one spouse's name does not affect the community property character. See Wells v. Cockrum, 13 Tex. 127. While married to [redacted], [redacted] acquired [redacted], the predecessor of [redacted]. Therefore, under Texas law, even though it was under [redacted]'s name, the [redacted]% interest in [redacted] was community property, and [redacted] and [redacted] each had one half of equal, undivided interest in this [redacted]% ownership.[3]

In [redacted], [redacted] and [redacted] changed the manner in which they held their interests in [redacted]. Instead of [redacted] holding the [redacted] shares under his

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[3] Before [redacted] made the gifts of [redacted]% of [redacted] to Son and Daughter, he and [redacted] each had one half of undivided, equal interest in the [redacted]% ownership of [redacted].

name, [redacted] held [redacted] shares in his name and [redacted] held [redacted] shares in hers. This arrangement did not change the community property character of the shares. Under Texas law, community property can only be partitioned by written agreement between the spouses. See Tex. Const. Art. 15; Tex. Fam. Code Ann. § 4.104 (West 1998). Therefore, regardless of whose name they were under, unless partitioned by written agreement, the shares in [redacted] stock remained [redacted] and [redacted]'s community property, restricted, as well as protected, by the Texas community property law.

The [redacted]% interest in S1 was distributed [redacted]% each to [redacted] and [redacted] in proportion to their community property interests in [redacted]. Since the distribution was during their marriage in exchange for their community property--the [redacted] shares--it follows that [redacted] and [redacted]'s interests in S1 were community property.

When a property, a block of shares of stock for example, is held as community property, the community property law protects and mandates its integrity. Under Texas community property law, community property is subject to the joint management, control and disposition of both spouses. See Tex. Fam. Code Ann. § 3.102 (West1998). Neither spouse can dispose of his/her share of the community property without consent of the other.[4] See Dalton v. Don J. Jackson, Inc., 691 S.W.2d 765. Therefore the community property law protected each spouse's [redacted]% from becoming an alienated minority interest. On the other hand, the two spouses could agree to sell their entire interests as a controlling block for a better price.

The next and the most important question is how the distributed interests should be valued. Should we value the [redacted]% as an integral block and divide the value by two to arrive at the value of the [redacted]%, or should we merely value the [redacted]% as a noncontrolling minority interest?

In the landmark case Estate of Bright, Mr. and Mrs. Bright held 55% of several non-publicly traded corporations as community property

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[4] The only way for one spouse to dispose of part of the community property without consent of the other is to partition the community property by written agreement. However, once any part of the community property is partitioned, it becomes two ***separate*** properties. Thus the only way to escape the restrictions of community property law is to convert the property into separate property. In other words, as long as the property remains community property, the restrictions are always attached.

under Texas law. Upon Mrs. Bright's death, her share of this 55% (27.5%) passed to a trust for the benefit of her four children. Her husband, Mr. Bright, was the trustee. 658 F.2d 999 at 1000. The government maintained that the decedent's 27.5% was an undivided, one-half interest in the controlling block of 55% of the stock and should be valued as one half of a controlling block with a control premium. Id. at 1001. The court rejected the government's method and held that Mrs. Bright's 27.5% interest should be valued as a separate interest and a minority discount should be allowed. The court reasoned that Mrs. Bright's death dissolved the community, dividing it equally, leaving the estate with the equivalent of a 27.5% block of the stock, not half of the controlling block. Essentially, neither the estate nor Mr. Bright could now prevent each other from selling that party's 27.5%. Id.

It can be inferred from Estate of Bright that, if, because of the loss of its community property character, the controlling block is fragmented, then each fragment should be valued separately -- not as part of a controlling block.

The converse inference is that if the controlling block remains community property, though divided in form, then the value of each fragment should be valued as a part of the controlling block.

This converse inference is true only if the rule inferred from Estate of Bright can be further interpreted as: only when the fragmentation is attributed to the loss of community property character, can the fragment be valued separately. As previously discussed, when community property law compels the integrity of the controlling block, the only way to break the block is to break the community property (e.g. by partition, death of a spouse or divorce). Thus we conclude that the converse inference is true.

The fundamental difference between the present case and Estate of Bright is that in Estate of Bright, Mrs. Bright's death dissolved the community; while in the present case the community continued and was never disturbed. When [redacted] held the [redacted] shares of [redacted], the community had a [redacted]% controlling interest in the corporation. When in [redacted] the [redacted] shares were divided into [redacted] [redacted]-share blocks, the community still had a [redacted]% controlling interest.[5] Dividing the [redacted] shares into [redacted] [redacted]-share blocks did not change the community property nature of the shares. [redacted] and [redacted]'s interests in [redacted] was community property; their distributed interests in S1 upon

[5] As discussed previously, under Texas law, property acquired during marriage is community property.

liquidation of [redacted] were also community property. Thus the [redacted]% interest in S1 that each spouse received was community property.

The undisturbed, continuous community property feature of the shares in the present case, the very crux that distinguishes it from Estate of Bright, compels the conclusion that the [redacted]% interest must be valued as half of a controlling block. Thus, the assumption that the [redacted]% interest is noncontrolling should be rejected.

Alternative arguments:
[redacted] had the stock divided into [redacted] [redacted]% blocks to register each block separately under [redacted] and [redacted]'s names. Under Texas community property law, this transaction does not change the couple's ownership interest in the stock. In Estate of Murphy, Mrs. Murphy owned 51.41% of a closely held corporation. Shortly before her death, at the advice of her tax adviser, Mrs. Murphy gifted 0.88% of the corporation each to her two children. Evidence showed that Mrs. Murphy made the gifts solely to reduce her interest to 49.65% to enjoy a noncontrolling valuation discount upon her death. She exercised control of the corporation all the time, even after she made the gifts. Upon Mrs. Murphy's death, her estate discounted her interest in the corporation based on her reduced noncontrolling interest. The Court disallowed the noncontrolling discount, holding that when tax avoidance was the motive for making the gifts and the decedent never actually lost control, the noncontolling discount benefit should not be given to her estate. See Estate of Murphy, T.C. Memo. 1990-472.

In the present case, dividing the stock into [redacted] [redacted]% blocks had no economic substance. The only possible benefit, hence the only possible motive, was to discount the interests as noncontrolling upon [redacted]'s liquidation. [redacted] always exercised control of S1 and [redacted] through his control of [redacted], even after the stock was divided. Therefore, the division should be disregarded for lack of economic substance under Gregory v. Helvering, 293 U.S. 465 (1935). Thus the noncontrolling discount should not be allowed.

II. Fair market value of the [redacted]% interest in [redacted].
Under Texas law, the major difference between a general partner and a limited partner is that the limited partner does not participate in the management of the partnership. But the general partner cannot make important decisions without consent of the limited partners. See Vernon's Ann.Civ.St. Art. 6132a-3.02 & -4.03 (West Supp. 2002); see also Vernon's Ann.Civ.St. Art. 6132b-4.01 (West Supp. 2002). Therefore if a party controls the general partner of a limited partnership and owns the majority interest as a limited

partner of the same partnership, this party controls the limited partnership. As discussed in I, [redacted] and [redacted] had control of S1, the general partner of [redacted]. For the same reasoning as in I, after each was distributed [redacted]% of [redacted], [redacted] and [redacted] owned as community property [redacted]% of [redacted] as limited partners[6]. Therefore they controlled [redacted], and the [redacted]% interest in [redacted] should be valued as half of a controlling block.

Conclusion and Advice

I. The Discount for Lack of Control.

The Valuation Report did not specify the extent to which the author applied the discount for lack of control in calculating the fair market value of S1 and [redacted]. Please seek an in-house economist or engineer to quantify the discount and calculate the correct fair market values of S1 and [redacted].

II. The [redacted]% Discount for Lack of Marketability

It is settled law that a discount for lack of marketability is allowed when valuing closely held businesses. See Citizens Bank & Trust Co. v. CIR; 839 F.2d 1249, 1250 (7th Cir. 1988)[7]. However, to what extent the value of a closely held business should be discounted depends on many factual, economic factors. In the present case, [redacted] applied a [redacted]% discount for the lack of marketability on top of the value that had already been discounted for lack of control.

We noticed that on the [redacted] balance sheet of [redacted], the majority assets were liquid assets and the liabilities were negligibly small. Thus we question the reasonableness of the percentage [redacted] applied for lack of marketability. Again we

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[6] Whether [redacted] and [redacted] automatically became limited partners or just had the limited partnership interest depends on the partnership agreement, as well as relevant state laws. But this issue will not affect the outcome of this analysis and thus we shall not pursue it.

[7] The court recognized that stock in a closely held corporation is not as marketable as that of a publicly traded one and thus is worth less. We believe this is also true for a closely held limited partnership.

recommend that you seek an in-house economist to assist you on this issue.

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