

Knight v. Commissioner [I. R. C. §§2511,2512, and 2704]
(Tax Court found family limited partnerships valid, but reduced the discounts allowed to value the interests)

Facts. Taxpayers owned a family ranch and two homes in which their son and daughter lived without paying rent. Taxpayers formed a family limited partnership (FLP) and conveyed the ranch, the two homes, and other investment assets to it. The fair market value of the FLP assets on the date the assets were transferred was approximately \$2 million. **Taxpayers established trusts for the son and daughter and gave interests in the FLP to each trust.** Taxpayers filed federal gift transfer tax returns for the year of the transfers and reported a gift of 22.3% interest in the FLP to each child's trust.

The IRS audited the returns and determined a tax deficiency.

Issues

Issue 1. Whether the partnership was disregarded for federal gift tax purposes.

Issue 2. Whether the fair market value of taxpayers' gifts was the value of the assets in the partnership reduced by portfolio, minority interest, and lack of marketability discounts totaling 44%.

Issue 3. Whether the fair market value of each of taxpayers' gifts to each children's trust on December 28, 1994, was \$263,165 as taxpayers contend, \$450,086 as IRS contends, or some other amount.

Issue 4. Whether I.R.C. §2704(b) applied to the transfer.

Analysis. The IRS argued that the FLP should be disregarded and that the FMV of each of the gifts was \$450,000, or 22.3% of the FMV of the assets transferred to the FLP. The taxpayers argued that the FLP should be recognized, since it was recognized by the state of Texas, and that a 10% portfolio discount, a 10-percent minority-interest discount, and a 30% lack-of marketability discount should apply, for an aggregate discount of 44%, which would result in a gift value of \$263,000.

The court applied the willing-buyer, willing-seller test, refusing to disregard the FLP; the court concluded that a hypothetical buyer or seller wouldn't disregard it. The court refused to accept the taxpayers' aggressive 44% discount, rejecting the portfolio discount since the evidence was not convincing as to why the partnership's mix of assets would not be attractive to a buyer. The court found the support for the other two discounts unconvincing; however, the court concluded **that a 15% discount should apply because the investment policy of the FLP was consistent with that of a closed-end bond**

fund in that bond fund investors have little influence over investment strategies.

A dissenting opinion claimed that proper focus of the valuation should have been on the assets transferred by the donors.

Holding

Issue 1. The Tax Court held that **the partnership was not disregarded for federal gift tax purposes.**

Issue 2. The Tax Court held that **discounts totaling 15%, not 44%, applied.**

Issue 3. The Tax Court held **the fair market value of each of taxpayers' gifts to each children's trust on December 28, 1994 was \$394,515.**

Issue 4. The Tax Court held that **I.R.C. §2704(b) did not apply.**

[*Knight v. Commissioner*, 115 T.C. 506 (2000)]

Practitioner Note. In a similar case, *Estate of Strangi v. Commissioner*, 115 T.C. 478 (2000), the Tax Court held that (1) a family limited partnership (FLP) was valid under state law and was recognized for estate tax purposes; (2) I.R.C. §2703 didn't apply to the agreement (the FLP was not a restriction on the sale or use of property that should be disregarded); and (3) the transfer of assets to the partnership was not a gift; however, (4) the discount allowed to value the partnership interests was reduced from an overall discount of 31% to an overall discount of 19%.