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Comment

Estate and Gift Tax Valuation: Discounts of Partnership Interests

I. INTRODUCTION

Until recently, the corporation has been the preferred entity used by estate specialists in the planning and management of ongoing business interests. It has had the advantages of familiarity and the assurances afforded it by a recognized body of legal authority. The corporate entity, especially the close corporate variety, has almost exclusively possessed an additional feature which warranted yielding the burdens of corporate formalities and the corporate feature of double taxation. Because of the nature of the close corporation, courts were willing to discount the determined value, in calculating fair market value for federal estate tax

2. Comment, supra note 1, at 56.
3. "Closely held corporations are those corporations the shares of which are owned by a relatively limited number of stockholders. Often the entire stock issue is held by one family. The result of this situation is that little, if any, trading in the shares takes place." Rev. Rul. 59-60, 1959-1 C.B. 237.
5. Profits of the corporate entity are subject to tax at the corporate level under I.R.C. § 11. If the profits are then distributed to the shareholders as dividends, they are taxed as income under I.R.C. § 61. See Eastwood, The Farm Corporation from an Income Tax Viewpoint: Friend or Foe?, 54 Neb. L. Rev. 443, 444-45 (1975). For a more complete discussion of the advantages of operation of a business entity in the corporate form, see id; Kelley, supra note 1.
6. See note 3 supra. See also § IV of text infra.
8. I.R.C. § 2031 requires that the amount of all real or personal property, tangible or intangible, valued as of the date of a decedent's death, be included in a
valuation purposes. Since the inception of the discounted valuation principle, the Internal Revenue Service (Service) has argued for lower discounts and higher valuations, but has never seriously contested the validity of the discount principle. It has become a recognized and accepted part of the valuation process for close corporation stock in the determination of estate tax gross estate valuation.

Despite the substantial valuation bonus, the discount principle inherent in close corporations has given the estates of affected stockholders, the corporation has been losing some of the glamour it held for estate planners. Estate planners are beginning to appreciate the flexibility of the partnership as an estate planning entity. Notwithstanding the partnership's tax complexity, its
decedent's gross estate. This includes the value of stock in a close corporation despite the difficulties attending the placement of a fair market value on close corporate stock.

9. See Estate of Irene de Guebriant, 14 T.C. 611, 619-20 (1950); Mathilde B. Hooper v. Commissioner, 41 B.T.A. 114, 129 (1949); Hanscom v. Commissioner, 24 B.T.A. 173, 175 (1930) (denying a discount from net asset value for lack of evidence but implicitly accepting the principle); Andrew B.C. Dohrmann v. Commissioner, 19 B.T.A. 507, 515-517 (1930). For a complete summary of the major discount cases, see Moroney, Most Courts Overvalue Closely Held Stock, 51 TAXES 144 (1973).

10. See generally Central Trust Co. v. United States, 305 F.2d 393 (Ct. Cl. 1962) (allowing a 12.17% discount where the issue was whether a straight discount or a weighted average discount method should be applied); Bader v. United States, 172 F. Supp. 833, 836 (S.D. Ill. 1959) (allowing a 10% discount for non-marketability where the issue was basically one of amount of discount); Englebrecht & Davison, A Statistical Look at Tax Court Compromise in Estate and Gift Tax Valuation of Closely Held Stock, 55 TAXES 395, 400 (1977) (asserting that the Tax Court is not concerned with the validity of the discount argument, but instead acts as an arbitrator between the taxpayer's and the Service's asserted amounts of discount).

11. See Rev. Rul. 59-60, 1959-1 C.B. 237, 238-42. This revenue ruling mentions a number of factors that would justify a discount, such as a non-controlling interest, a low dividend paying capacity of the entity, a poor financial condition in terms of the asset-liability ratio, and a loss of key management personnel.


15. "[T]he taxation of partners and partnerships is among the most difficult, complex and frustrating branches of the tax law." Zeitlin, Foreword in 1 W. McKee, W. Nelson & R. Whitmire, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS v. (1977) [hereinafter McKee].
popularity for estate planning purposes is growing. Prior to 1977, however, there was only remote hope for the practitioner who sought a valuation discount for a partnership interest for estate tax valuation purposes. The Service took the position in valuing partnership interests under section 2031 of the Internal Revenue Code (Code) that, for example, a seventy percent interest in a partnership at death was worth seventy percent of the value of the net assets of the partnership. This position, referred to as the "asset valuation rule," viewed the partnership as an aggregate of rights in the partnership property which were held individually by the partners, and not as an entity or as an interest in an ongoing business similar to a corporation. Clearly a discount for a minority interest or lack of marketability is inconsistent with this characterization of a partnership. The practitioner was faced with an economic dilemma: using the corporate entity with all its drawbacks and thereby retaining the advantage of the discount factor or opting for the partnership entity with its flexibility and thereby losing the substantial benefit of valuing the interest at a discount for estate tax purposes.

The judicial inroads into the asset valuation rule occurred in 1977, when two courts found the discount principle applicable to partnership interests. The holdings in Estate of Goldie Brown v. Commissioner and Estate of Bischoff v. Commissioner initiated the use of the discount principle in the estate tax valuation of part-


17. For a more complete discussion of the Service position in valuing partnership interests, see § II of text infra.

18. Subchapter K represents a blending of two views as to the nature of partnerships. The first view is that a partnership is simply an aggregation of individuals, each of whom should be treated as the owner of a direct undivided interest in partnership assets and operations. The second view is that a partnership is a separate entity, apart from the partners. Under this view, a partner has no direct interest in partnership assets or operations, only an interest in the partnership entity separate and apart from its assets and operations.

1 McKee, supra note 15, ¶ 1.02 [1]. Treatment of the partnership as an entity would be analogous to the Service's treatment of corporations. For a good discussion of the entity and aggregate confusion in the partnership tax area, see Fellows, Partnership Taxation: Confusion in Section 702(b), 32 Tex. L. Rev. 67 (1976).

19. This development should not be considered a "breakthrough" in the discounted valuation area, since in the Bischoff case, the Service actually conceded the validity of the discount, questioning only the amount of the discount. 69 T.C. 32, 49 (1977).

20. 46 T.C.M. (P-H) 377, 381, 381 n.3 (1977).

nership interests. Nevertheless, the practitioner who expected the floodgates to open with partnership discounts similar to the historically recognized close corporation discounts has to date been disappointed.\(^2\) Even in the wake of these decisions, the Service has clung tenaciously to the asset valuation rule.\(^3\)

This comment will analyze the Service's position on partnership estate tax valuation and will consider the nature and effect of judicial inroads into the asset valuation rule. The partnership model will be compared to the close corporation in order to determine whether, and when, the same discount factors applicable and accepted by the courts in the corporate cases logically can be applied to general and limited partnership interests.\(^4\) An argument will be developed to ease the "all or nothing" dilemma of choice estate planners face with respect to valuation discounts when they choose between the corporate and partnership entities. The choice of the form of the entity then can be based on other more relevant factors affecting the ongoing enterprise.

II. THE SERVICE POSITION ON PARTNERSHIP VALUATION

A. The Asset Valuation Rule

In order for the practitioner to fully understand the nature of the changes that the recent Tax Court cases\(^5\) have signaled, it is necessary to detail the past and present position of the Service in partnership valuation cases. The scope of this comment is limited to considerations relevant to estate and gift tax valuations, and although their respective considerations often overlap or are similar, there arise certain instances when the distinctive nature of the transaction may effect a different result.\(^6\) Where that is likely to occur, this comment will specifically delineate the distinction; otherwise, for all practical purposes, the estate and gift tax valuation concepts are similar.

\(^{22}\) This author found no decisions subsequent to the 1977 decisions permitting discounting in the partnership setting.  
\(^{24}\) The Uniform Partnership Act [hereinafter cited as UPA] has been adopted by Nebraska and is codified at NEB. REV. STAT. §§ 67-301 to -343 (Reissue 1976). The Uniform Limited Partnership Act (1916) [hereinafter cited as ULPA] has been adopted by Nebraska and is codified at NEB. REV. STAT. §§ 67-201 to -232 (Reissue 1976).  
\(^{25}\) See notes 19-22 & accompanying text supra.  
\(^{26}\) For instance, a special discount valuation may be allowed in a gifting situation in which the donor is a key man, or in which the nature of the business as an ongoing entity is adversely affected by the gift of the interest.
1. Estate Tax and the Asset Valuation Rule

The clearest example of the operation of the asset valuation rule may be found in Estate of Pitts v. Commissioner.\(^27\) In Pitts, the court was called upon to determine the value of a 32\(\frac{1}{2}\)\% interest in each of two construction partnerships.\(^28\) The court held that the value to be included in the estate was a 32\(\frac{1}{2}\)\% interest in the value of the inventory of machinery and equipment, plus a like proportion of other items on hand valued at fair market value.\(^29\) There was no discussion of the value of the partnership as an ongoing entity,\(^30\) and no consideration was given to any "bundle of rights" that a 32\(\frac{1}{2}\)\% interest in the partnership might possess.\(^31\)

The position of the Service, simply stated, is that the value of a decedent's partnership interest at the time of his death is "the fair market value of the net partnership assets at the time of his death . . . .\(^32\) The asset valuation rule has the advantages of simplicity

\(^{27}\) 19 B.T.A. 288 (1930).
\(^{28}\) Id. at 289.
\(^{29}\) Id. at 293. The fact that the interest in the partnerships held by the estate was sold shortly after the decedent's death provided a complete inventory of all of the specific partnership-owned assets. Id. at 290-91. There was no question that the inventory or the agreed upon price for the 32\(\frac{1}{2}\)\% interest was a fair assessment of the value at death of the interest. Id. at 290. For a definition of the term "gross estate," see I.R.C. § 2031.
\(^{30}\) It was clear in this case, where the surviving partner purchased the decedent's interest, that the business itself would continue to operate as it had before. Yet the taxpayer did not present any argument as to the value of the partnership as an entity, perhaps because the sale price had fixed the interest at a reasonably low price, even under the asset valuation method. See id. at 292-93.
\(^{31}\) In George Edward Quick Trust, 54 T.C. 1336 (1970), acq. aff'd per curiam, 444 F.2d 80 (8th Cir. 1971), the court, considering the valuation of a partnership entity for estate tax purposes, characterized the interest as a "bundle of rights" in the partnership. However, the rights considered were rights in individual items of partnership assets, not in the rights inherent in the partnership interest. 54 T.C. at 1345. The "bundle of rights" that are considered here in the partnership are analogous to the rights a shareholder has in a corporation.
\(^{32}\) Fiorito v. Commissioner, 33 T.C. 440, 447 (1959). See Estate of Cutbirth v. United States, 38 A.F.T.R.2d (P-H) ¶ 6271, 6274 (N.D. Tex. 1975); Estate of Arthur J. Brandt, 18 T.C.M. (P-H) 726, 729 (1949); Estate of Philip Sugarman v. Commissioner, 20 B.T.A. 960, 963-64 (1930); McColgan v. Commissioner, 10 B.T.A. 958, 960 (1928). See also Estate of Bischoff v. Commissioner, 69 T.C. 32 (1977) (the Service argued that since the partnerships were engaged in the real estate business and were holding real estate, the partnership interest should be valued at the respective fractional interest the partnership would bear to a fractional interest value in the real estate. Id. at 48-49. This argument is akin to the asset valuation rule, though not exactly the same.); Rev. Rul. 68-154, 1968-1 C.B. 395 (the Service ruled that partnership assets "form no part of the deceased partner's estate. However, at his death, the right to share in the net partnership assets passes to his estate. To measure that
and ease of administration, but it lacks integrity in cases in which a fair valuation of the interest transferred is sought. If the partnership terminates for both state law and tax purposes at the death of a partner, and the partnership agreement calls for a distribution of the assets in the same percentage as the ownership of partnership interests, then perhaps the asset valuation rule has some credibility.

However, in a number of situations, the partnership does not terminate for tax purposes and the partnership agreement is drafted so that the partnership may continue, with either the estate, an heir, or one of the original partners taking the deceased partner's place in the partnership. It is particularly in such cases that the Service's asset valuation rule does not present a fair legal

right or interest, upon which the [estate] tax is based, the value of the partnership assets are properly taken into consideration." *Id.* at 396).

33. Certain contingencies must exist before the death of a partner will cause termination under state law. If the partner who died was the sole general partner of a limited partnership, his death will dissolve the partnership. *Neb. Rev. Stat.* § 67-220 (Reissue 1976). In a general partnership, if it is not contrary to the partnership agreement, dissolution (as defined by *id.* § 67-329) will occur on the death of any partner. *Id.* § 67-331.

34. *I.R.C.* § 708(b) provides two situations in which a partnership will terminate for tax purposes: if

(A) no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership, or

(B) within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits,

the partnership shall be considered as terminated.

This does not generally mean that the partnership terminates on the death of a partner, because death does not satisfy either of the above requirements of termination. However, the death of a partner may indirectly trigger termination if, as a result of death, the partnership's business ceases and the partnership assets are distributed to the partners. 1 MCKEE, *supra* note 15, ¶ 12.04[1]. Also, a termination for tax purposes does not necessarily mean that the entity's business has ceased; the result of tax termination is basically that the partnership's books must be closed for that taxable year, and the consequent basis adjustments, elections and constructive distribution and retribution of assets to the continuing partnership will occur. *Id.* ¶ 12.05 [2].

35. A distribution agreement which provides for distribution of the assets in proportion to the partner's partnership interests generally is concerned with the partner's capital, not profit interest. 1 MCKEE, *supra* note 15, ¶ 3.02[5].

36. One problem with a discussion of the possible occurrences on the death of a partner lies with the inherent flexibility the law accords partnerships. The agreements, basically contracts between the partners, can be drafted to suit the specific needs of the partners. In recognizing that problem, the reader is advised to examine carefully any partnership agreement before attempting to analyze the effects of the death of a partner in any particular partnership. *See generally* Nash, *supra* note 14, ¶¶ 1000, 1003.
or economic assessment of valuation.\textsuperscript{37} Clearly, when the interest in the partnership business is transferred at death and the entity does not cease business operations and distribute the net assets, something more than the pro rata interest in those assets has been transferred. Among the non-asset rights and duties in the business that have been transferred under Nebraska law are: the ability and right of the partner to act as an agent for the partnership;\textsuperscript{38} the liability of the newly-admitted partner for all pre-existing debts of the partnership;\textsuperscript{39} the right to demand a full accounting of the partnership's business affairs;\textsuperscript{40} the duty to be bound by a partner's breach of trust;\textsuperscript{41} and any and all other specific rights and duties that the partnership agreement may specify. These rights and duties are in addition to the partner's rights in specific partnership property—rights which serve as the basis for the Service's asset valuation rule. A substantive argument may be that the Service's myopic view, in applying the asset valuation rule, of the rights a deceased partner possesses in his partnership interest at death does not comport with economic or legal reality. If the situation is such that the entire bundle of rights which comprises the partnership is transferred at death, the Service should, in accord with the realities of the disposition, view the partnership as an entity and not as an aggregate of undivided interests in partnership net assets.\textsuperscript{43} Viewed as an entity, the partnership could be treated, in cases where it is appropriate, similar to an interest in a close corporation.\textsuperscript{44} The Bischoff\textsuperscript{45} and Brown\textsuperscript{46} courts appear to have recognized the validity of this approach in the estate tax valuation setting.

\textsuperscript{37} See note \textsuperscript{31} & accompanying text supra.


\textsuperscript{39} Id. § 67-317.

\textsuperscript{40} Id. § 67-322.

\textsuperscript{41} Id. § 67-314.

\textsuperscript{42} Id. § 67-324.

\textsuperscript{43} One court appeared to specifically apply the undivided interest analogy for estate tax valuation in an estate that held a 25\% capital interest in a real estate partnership. McColgan v. Commissioner, 10 B.T.A. 958, 959 (1928). See also note 18 supra.

\textsuperscript{44} "Once the fact of a partnership is established, the value of a partnership interest is determined in much the same manner as the value of closely held stocks." Chalmers, Valuation of Assets, Tax Mgmt. (BNA) 132-2d, A-13 (1977).

\textsuperscript{45} "[A] minority interest in a limited partnership is sufficiently similar to a minority interest in a corporation . . . ." 69 T.C. 32, 49 (1977).

\textsuperscript{46} The court did not explicitly recognize the corporation analogy but did consider the features of a minority interest previously limited to the corporate area in estate tax valuation theory. 46 T.C.M. (P-H) 377, 380 (1977).
2. Gift Tax and the Asset Valuation Rule

The same argument which supports discounting the value of the partnership in certain situations also applies in the context of valuation for the gift tax. Depending upon the value of the agreement, and the consequences of the substitution of a new partner, a similar transfer of a bundle of rights in the partnership entity may occur, thus similarly diminishing the validity of the asset valuation rule. The gift of an interest in a partnership entity which continues its business operations presents a situation not unlike that previously described, where on the death of a partner, the entity does not dissolve.

While it is logically more consistent than the Service's asset valuation rule, the entity or bundle of rights theory described above has not gained great favor with the Service. But important judicial inroads have been made, signaling a reconsideration, if not yet a retreat, from the traditional Service position regarding valuation of partnership interests.

III. JUDICIAL INROADS INTO THE SERVICE'S ASSET VALUATION RULE

A. Estate of Bischoff v. Commissioner

Lest any unwarranted enthusiasm be created, the following discussion should be preceded by a caveat. In both Bischoff and Brown there existed certain specific and distinctive features which may restrict application of the discount principle to limited partnership interests or to those partnership interests which have similar characteristics, as described below. In any case, the Service can be expected to challenge application of the discount con-

47. NEB. REV. STAT. § 67-327(1) (Reissue 1976) provides:
   (1). A conveyance by a partner of his interest in the partnership does not of itself dissolve the partnership nor, as against the other partners in the absence of agreement, entitle the assignee, during the continuance of the partnership, to interfere in the management or administration of the partnership business or affairs, or to require any information or account of partnership transactions, or to inspect the partnership books; but it merely entitles the assignee to receive, in accordance with his contract, the profits to which the assigning partner would otherwise be entitled.
   Clearly, the statute provides that the partners can agree among themselves to delineate the rights and duties of the incoming partner.


49. This comment deals exclusively with the valuation of partnership interests. Any concepts of completed gifts, or part-sale, part-gift with respect to estate or gift tax valuation are beyond the scope of this comment.

50. See notes 16, 19-21 & accompanying text supra.

cept when it is applied to partnership interests in any ways dissimilar to those described below.

*Estate of Bischoff v. Commissioner* involved the estate tax valuation of a number of partnership interests at the death of a husband and wife. The relevant partnership interests were Bruno and Bertha Bischoff's interests in B.B.W., a limited partnership real estate holding company. The limited partnership interests were owned by three families. Bruno held a ten percent interest in B.B.W. at death, while Bertha held a fifteen percent interest in B.B.W. at death. The holding company had underlying assets valued at $858,000 at the time of Bruno Bischoff's death.

Unfortunately, the court does not discuss the features of the partnership agreement of B.B.W. The only facts relevant to valuation presented are the nature and value of the underlying assets. Clearly, the asset valuation rule was to some extent applied in *Bischoff*. However, the taxpayer also argued that the Service's expert erred when he failed to apply a discount of the asset valuation to arrive at a proper valuation for estate tax purposes. The taxpayer sought a twenty-five percent discount because the dece-

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52. *Id.* at 34.
53. *Id.* at 38. The holding company owned property in New York City, along with other minor investments and assets. *Id.*
54. *Id.*
55. *Id.*
56. Considerable discussion as to the features of the other partnership interests being valued was included by the court, but since their value had been set by a valid buy-sell agreement, that is not relevant to the valuation of B.B.W. See *Id.* at 35-36. It is not clear from the court's discussion whether the B.B.W. partnership had the same restrictions on marketability as the other multi-family partnerships being valued. Among those restrictions were: (1) an absolute prohibition upon inter vivos transfers of partnership interests, (2) redemption of partnership interests only by the partnership, and (3) a provision for a mandatory buy-out of the partner's interest upon death at a price which represented the affected partner's capital account with adjustments reflecting partnership income and withdrawals. *Id.* at 36. For a comparison of how restrictions on transferability might affect a discounted valuation of close corporation stock, see § IV-C of text *infra.*
57. 69 T.C. at 38.
58. In many cases of discount application, a key question is "To what figure should the discount be applied?" Here, the underlying asset valuation appears to be the figure which is discounted. In the corporate setting, numerous other value theories are employed to arrive at a value of the business entity to which an appropriate discount can be applied. See generally *Jensen*, supra note 7; Martin & Sanford, *Applying Fair Market Value Appraisal Techniques to Closely Held Preferred Stock*, 56 Taxes 108 (1976) (a statistical analysis of stock yield); Comment, supra note 7, at 739-41. As indicated by *Bischoff*, any burial of the asset valuation rule would be premature.
59. 69 T.C. at 48.
dent's interest represented only a minority interest, while the Service argued that no discount should be applied because B.B.W. was "'similar to a real estate syndicate whose fractional interests are traded at investment value.'"61

In Bischoff, the decedent could not, unless the agreement provided otherwise, compel dissolution or liquidation. Moreover, he had no voice in management or control over investment policies or partnership distribution, and possessed only a limited right to require a return of his contribution. On the basis of the agreement, the court granted a fifteen percent minority interest discount factor in arriving at fair market value for estate tax purposes. The court did not further explain its holding, except to draw an analogy between this type of partnership interest and similar types of corporate interests:

> In view of the existence of such restrictions on a limited partnership interest, we conclude that a minority interest in a partnership is sufficiently similar to a minority interest in a corporation to require the application, in otherwise appropriate cases, of a minority discount factor in determining the fair market value of such an interest.64

The Bischoff court has impliedly given its permission to draw the analogy between close corporate interests, which have traditionally merited discounted valuation, and limited partnership interests if those interests possess similar characteristics. Before considering the implications of the close corporate analogy, one further exploration of the judicial inroads into the asset valuation rule is warranted.

B. Estate of Goldie Brown v. Commissioner65

The partnership subject to valuation in Brown held as its sole assets several contiguous and noncontiguous parcels of undeveloped real estate near Scottsdale, Arizona. Some of the parcels had residential development possibilities but considerable expense and lead time would have been required before they could be made suitable for tract use. There, as in Bischoff, the court

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60. Id.
61. Id. at 49 (citation omitted).
62. Most of these rights were founded on New York State partnership law. Id.
63. Id. at 49-50. This court did what one commentator suggests the Tax Court has been doing for years in close corporate valuation discount cases: arbitrated between the taxpayer's and the Service's suggested discounts. Jensen, supra note 7, at 240.
64. 69 T.C. at 49.
66. Id.
67. Id. at 380. The court considered the terrain features, lack of water and separation of the parcels in valuing and allowing a 10% discount of the value of the land. Id. at 379, 380.
looked to the underlying value of the partnership assets in arriving at an estate tax valuation of the decedent's partnership interest.\textsuperscript{58}

Although the partnership in \textit{Brown} was general and not limited, at least in form, the nature of the relationship between the parties to the partnership agreement may be analyzed in such a way that in effect, the rights of the decedent partner at her death were so limited that the partnership resembled a limited, not a general, partnership. The court clearly considered this relationship in valuing the decedent's partnership interest.\textsuperscript{59} The other partner was not only a wealthy and influential businessman whose position placed a minority partner at a distinct disadvantage,\textsuperscript{60} he also was executor of the estate of the previous holder of Goldie Brown's one-quarter interest in the partnership and possessed the contractual power of management of the partnership—a power which was not to expire for a number of years.\textsuperscript{71} It is readily apparent that although the partnership was general on paper, Goldie Brown's interest was limited by virtue of the relationship between the partners in a manner not unlike a formal limited partnership similar to the interest discussed in \textit{Bischoff}.\textsuperscript{72} The court, rejecting the pure asset valuation rule, allowed a discount off the value of the real estate, as the decedent held only a minority interest in the partnership.

Both appraisers' reports agree that a discount of at least 10 percent on a one-quarter minority interest in the DC Ranch partnership should be made to account for the disadvantages of a minority status. . . . We see no reason to think that [the other partner], though amenable to partitioning, would not vigorously pursue his own interests to the fullest in any litigation to partition the property.\textsuperscript{73}

Under the pure asset valuation method,\textsuperscript{74} the rights in the partnership entity which a decedent did or did not possess at death would be largely irrelevant. But in \textit{Brown}, the court considered the legal status of a minority partner less desirable than that of a partner with a majority interest, warranting a discount of ten percent. The argument that when the courts value partnership interests, the entity and its concurrent bundle of rights should be considered in addition to the underlying value of the partnership

\textsuperscript{58} \textit{Id.} at 379. The asset valuation rule appears entrenched in the judicial formulation of partnership valuation theory for estate tax purposes.

\textsuperscript{59} The court's interpretation of this relationship is rather cryptic but it is nonetheless clear by inference that the court felt these to be important factors. \textit{See id.}

\textsuperscript{60} \textit{Id.} The other partner, Kemper Marley, was a man of apparently great wealth and influence in the Phoenix area.

\textsuperscript{71} \textit{Id.}

\textsuperscript{72} \textit{See} § III-A of text \textit{supra}.

\textsuperscript{73} 46 T.C.M. (P-H) at 381 n.3.

\textsuperscript{74} \textit{See} § II-A of text \textit{supra}. 
assets\textsuperscript{75} gained credence with the Brown decision. Brown and Bischoff\textsuperscript{76} provide a basis for drawing an analogy between the valuation of corporate interests and of partnership interests.

C. The Close Corporation Analogy

If certain partnership interests possessing features similar to those described in the cases discussed above should be valued in the same manner as interests in closely-held corporations, then logically, some of the discounted valuation concepts of the close corporation ought to apply to those partnership interests.\textsuperscript{77} Depending, of course, upon the nature of the rights as defined by local law and the partnership agreement, the same characteristics of minority interest,\textsuperscript{78} lack of marketability,\textsuperscript{79} restrictions on transferability\textsuperscript{80} and loss of key man\textsuperscript{81} discount factors which have a

\textsuperscript{75} Id.
\textsuperscript{76} 69 T.C. at 49.
\textsuperscript{77} See § IV of text infra.
\textsuperscript{78} A minority interest can be defined in terms of a less than 50\% interest, or an interest lacking sufficient control to force dissolution of the corporation. In Nebraska, a two-thirds vote is required for voluntary dissolution. Neb. Rev. Stat. § 21-2083(3). Also, it takes a two-thirds vote to amend the articles of incorporation. Id. § 21-2057(3). Most of the commentators view a minority interest sufficiently minor to permit discounting as one which lacks control of the business or management of the corporation. See Comment, supra note 7, at 733-34. But the courts appear reluctant to allow a discount for an interest which possesses in excess of 50\% voting control. Cf. Nesta Obermer v. United States, 238 F. Supp. 29, 36 (1964) (allowing a 33\frac{1}{3} \% discount from a 50\% interest in a close corporation where state law required a two-thirds vote to dissolve). See also Drybrough v. United States, 208 F. Supp. 279 (W.D. Ky. 1962) (defining minority interest as an interest which could not by itself force liquidation). For the purposes of this comment, a minority interest will be defined as one which, under the local law of the state, cannot control the organic management decisions, such as liquidation, dissolution or merger, and cannot force the majority interest to declare dividends.

\textsuperscript{79} Some courts confuse the discount concept of authority interest with that of lack of marketability. Estate of Gregg Maxcy v. Commissioner, 28 T.C.M. (CCH) 783 (1964) (allowing a 15\% discount for nonmarketability based on the undesirability of a minority interest); Worthen v. United States, 192 F. Supp. 727 (D. Mass. 1961) (allowing an 11\% discount for minority interest and lack of marketability, while not distinguishing the terms). Some commentators have likewise missed the distinction. See Moroney, supra note 8, at 144. It is easy to fail to make the distinction, because the concept of minority interest does affect marketability. But the marketability discount concerns itself exclusively with the lack of a ready buyer for the interest for whatever reasons, \textit{e.g.}, lack of a guaranteed return in the form of dividends, lack of ability to make management decisions in a corporation run by a single family, and lack of an ability to realize capital gain on the investment. See also Rev. Rul. 59-60, 1959-1 C.B. 237, 239. For a discussion of the special features that make close corporation stock less marketable, warranting a discount, see id. See also § IV-B of text infra.

\textsuperscript{80} The restrictions on transferability discounts relate directly to the marketabil-
substantial basis in the corporate area, could logically be applied in the partnership valuation area.

The immediate hurdle to the acceptance of the corporate analogy and the specific discounts it allows in the partnership valuation area is the Service’s continued insistence on the use of the asset valuation rule. While the Service continues to argue for an aggregate or asset valuation approach in estate and gift tax valuation, the reality of the situation and the developing judicial acceptance of an entity approach appear to place the practitioner on semi-solid ground if he takes a discount from the net asset value of a partnership interest based upon one of the previously enumerated corporate discount factors. The following discussion will compare and analyze each of the four basic discount factors, examining their operation in the close corporate setting, and developing a theory for their application to the valuation of limited and general partnership interests. It will be suggested that the asset valuation rule has limited applicability in partnership valuation, and, accordingly, its use should be curtailed significantly in favor of an entity or bundle of rights approach similar to that presently applied by the Service to close corporate interests.

81. If a business is such that the loss of the managing executive would seriously depreciate earning power of the business, a key man discount may legitimately be applied upon the death or retirement of that individual. Maher, Application of Key Man Discounts in the Valuation of Closely-Held Businesses, 55 Taxes 377, 378-79 (1977). The application of this discount concept should be applied only in those cases where the success or failure of the business depends largely on the ability and guidance of a key man. See id.


83. The question of “discount from what?” is answered in Moroney, supra note 9, at 144-46.

84. The discount factors are minority interest, lack of marketability, restrictions on transferability and loss of key man. See notes 77-82 supra.
IV. DISCOUNT CHARACTERISTICS OF PARTNERSHIPS AND THE CLOSE CORPORATION ANALOGY

A. Minority Interest Discounts

1. Close Corporations

A close corporation has limited value unless there is inherent in that corporation some guarantee to the interest holder of an income return or of future capital gain that has a potential of being realized.\(^8\) Aside from the by-laws, the shareholders' rights under local law generally determine the nature of the rights the minority interest holder possesses.

a. Rights Under Local Law

A minority interest\(^8\) in a close corporation in Nebraska entails a right to compel the directors to act within the limits of fiduciary duty to any shareholder.\(^8\) Beyond that, a minority shareholder has little effective control over the dividend policy of the corporation\(^8\) or over dissolution or liquidation\(^9\) of the corporation. Thus, the rights that could make the minority interest valuable are beyond the minority shareholder's control, excluding the possibility of a minority interest alliance with other shareholders. A minority interest, while not worthless, is worth considerably less than its fair market value\(^9\) because a purchaser\(^9\) of the interest would not be willing to pay fair market value for an interest that conceivably would produce no income or capital gain. It should be clear that a

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85. See Comment, supra note 7, at 734.
86. For the purposes of this comment, a minority interest has been defined as one that cannot force dissolution. See note 78 supra. For a treatment of different concepts of minority interests, see Butala, Valuation of Closely Held Corporations, 7 U. MIAMI EST. PLAN. INST. ¶ 73.1400 (1973). Butala sets out four major types of control: (1) majority or greater than 50% control; (2) liquidating or dissolution control; (3) "effective" control—control sufficient because the other shareholders are numerous, scattered or passive in their attitudes; and (4) a balance of control—owning a block of stock which adverse factions seek to achieve their control. Id. ¶ 73.1406.
88. See id. § 21-2043.
89. See id. § 21-2083.
90. Just how much less is still the subject of considerable debate. At least one commentator has argued that for a minority interest, a 75 to 90% discount is not unreasonable. Moroney, supra note 9, at 156.
91. Herein lies the cause of the confusion between minority interest discounts and marketability discounts. The Service values interests under the willing buyer-willing seller concept. Treas. Reg. § 20.2031-1(b) (1958). For a full discussion of this problem, see § IV-B-1-a of text infra. See also Krahmer & Henderer, Valuation of Shares of Closely Held Corporations, TAX MNGMT. (BNA) 221, A-52 (1969).
minority interest in a partnership may possess these same disadvantages, thus warranting application of the discount factor to the minority interest in a partnership.

2. General Partnership Interests

Though Nebraska law places limitations on a minority interest in a general partnership, there are no provisions comparable to those pertaining to close corporations which limit a partner's right to income or dissolution.\textsuperscript{92} Nebraska law does provide that any difference among the partners as to ordinary matters of the partnership business can be decided by majority vote.\textsuperscript{93} Also, a single partner may cause the partnership to be dissolved,\textsuperscript{94} entitling him to his proportionate share in the partnership assets,\textsuperscript{95} absent a partnership agreement to the contrary. Furthermore, an individual general partner has an equal voice in the management of the partnership regardless of the percentage of the interest he possesses.\textsuperscript{96} Thus, under a purely legal analysis, it appears that the value of the minority interest rights in a corporation and a partnership are not sufficiently similar to merit similar discount treatment.

Partnership law, however, provides that since the value of a partnership agreement is inherently contractual, the partners may delimit and define their rights and duties as they so choose. An agreement which places limitations on minority rights to dissolve the partnership should be afforded the same respect as a similar corporate by-law.\textsuperscript{97} Since the application of a discount in this context depends largely upon the nature and effect of the partnership agreement, no generalizations should be made at this juncture. Suffice it to say that the closer the partnership agreement comes to limiting a partner's rights in a manner similar to the way local law limits a minority shareholder's rights, the more effective the argument for application of a discount becomes.

\textsuperscript{92} The general rule is that a partner must share equally in the profits and losses of a partnership. \textit{See Neb. Rev. Stat.} § 67-318(a) (Reissue 1976).
\textsuperscript{93} \textit{Id.} § 67-318(b).
\textsuperscript{94} \textit{Id.} § 67-331(1)(b).
\textsuperscript{95} \textit{See id.} §§ 67-338(1), 67-340(d).
\textsuperscript{96} UPA § 18(e) reads: "All partners have equal rights in the management and conduct of the partnership business."
\textsuperscript{97} \textit{See, Bischoff}, 69 T.C. 32; and \textit{Brown}, 46 T.C.M. (P-H) 46. Although both courts allowed discounts for partnership interests specifically because of their minority status, only the \textit{Brown} court considered the difficulties of dissolution. 46 T.C.M. (P-H) at 381 n.3. The \textit{Bischoff} court was dealing with a limited partnership. \textit{See} § IV-A-3 of text \textit{infra}. 

3. Limited Partnership Interests

The concept of a minority interest in a limited partnership is somewhat anomalous. A limited partner generally does not possess management powers in any case, so whether the interest is a minority interest appears to make little difference. A limited partner's interest in personal property which may be freely assigned basically entitles him to a return on his capital interest while protecting him from the general liability of the partnership entity. He has a right to his proportionate capital interest in the partnership net assets upon dissolution.

In Bischoff, the court allowed a minority interest discount specifically because of the limitations local law placed on the limited partner. The basis for this discounting appears solid, and Bischoff may be cited as compelling authority in the limited partnership minority interest valuation cases. Since Brown may also be analyzed as a limited partnership valuation case, it too may be cited as authority for the allowance of a discount for a minority interest in a limited partnership.

B. Lack of Marketability Discounts

1. Close Corporations

Much of the above discussion on rights under Nebraska law is also applicable to the close corporation. Where the local law or the entity agreement limits the interest holder's rights, there is a concurrent reflection on marketability. The practitioner should be aware of this overlap in characterization. But the marketability discount is distinct from the minority interest discount in that it deals primarily with the quality of the entity from an economic standpoint. Generally, the starting points in the application of a

100. Id. § 67-219 (1978 Cum. Supp.).
102. Id. § 67-223 (Reissue 1976).
103. In so doing, the court stated:

[U]nless provided otherwise in the partnership agreement or by reason of a court decree, a limited partner cannot compel dissolution and liquidation of a limited partnership. . . . A limited partner merely has the right to require a return of his contribution to the limited partnership. . . . Moreover, a limited partner generally has no voice in the management of the partnership and cannot control investment policies or partnership distribution.

69 T.C. at 49 (citations omitted).
104. See notes 85-97 & accompanying text supra.
105. See Moroney, Why 25% Discount for Nonmarketability in One Valuation, 100% in Another?, 55 Taxes 316, 318 (1977). Central Trust Co. v. United
Valuation Discounts are necessary due to marketability discount are Treasury Regulation § 20.2031-1(b) and Revenue Ruling 59-60.

a. The Hypothetical Sale: Section 20.2031-1(b) and Revenue Ruling 59-60

The Service has taken the view that fair market value is "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." The problem with this hypothetical sale method in the close corporation context is apparent. There generally is no ready market for interests, minority or otherwise, in close corporations. The Service recognized this problem when it issued Revenue Ruling 59-60. There, the Service adopted a distinct approach for dealing with valuation of closely held stock where no ready market existed. The following factors were to be considered in arriving at a determination of fair market value:

(a) The nature of the business and the history of the enterprise from its inception.
(b) The economic outlook in general and the condition and outlook of the specific industry in particular.
(c) The book value of the stock and the financial condition of the business.
(d) The earning capacity of the company.
(e) The dividend-paying capacity.
(f) Whether or not the enterprise has goodwill or other intangible value.
(g) Sales of the stock and the size of the block of stock to be valued.

These are factors which are to be considered when valuing the corporate entity. In this revenue ruling, the Service also accepted the concept of a discount for a lack of marketability. The lack of marketability may result from the negative impact any or all of the factors have on the economic condition of the business, including the additional handicaps that a minority interest would impose on the shareholder. If the courts begin to accept the entity or bundle of rights concept with respect to partnership valuation, as it ap-

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107. Some commentators have suggested that an actual sales analysis should be applied, and have compared the discounts for sales of "restricted letter stock" of public corporations with close corporate interests. Discounts as high as 70% have been suggested under this method. See Coolidge, Fixing Value of Minority Interest in a Business; Actual Sales Suggest Discount as High as 70%, 2 EST. PLAN. 138 (1975); Trout, Estimation of the Discount Associated With the Transfer of Restricted Securities, 55 TAXES 381 (1977).
109. Id. at 238-39.
pears they are, then these factors justifiably could be applied to the partnership interest to ascertain its marketability or lack thereof.

2. Partnership Interests and the Marketability Discount

In addition to a consideration of the factors cited above, a partnership may possess special features which limit its marketability. In the case in which the partner’s only interest in the partnership is his right to share in the profits and surplus of the partnership “as is the case where the partner is the assignee of the partnership interest,” and thus has no voice in the management of the business, there is an inherent limitation on the marketability of the interest. Few buyers would be willing to purchase an interest in an ongoing partnership if they knew that they might have no voice in management or control of the business.

Although a full discussion of the application of discount principles to “frozen” partnership interests is beyond the scope of this comment, a short discussion of the lack of marketability discount with respect to these interests is appropriate. A “frozen” partnership interest is one that will have a fixed liquidation value and maintain a preferred income distribution position. In many respects, it resembles the preferred stock in a corporate setting. The rationale behind freezing the interest is to prevent the further appreciation in value of that interest, thus in effect limiting valuation for estate tax purposes. The “frozen” partnership units may or may not carry the incidents of control and management of the partnership. The rights that might be attached to the frozen units will depend entirely upon the client’s needs and the partnership agreement. A discussion of potential discount features therefore necessarily requires a caveat: the partnership agreement should be the starting place in a consideration of features meriting a discount.

a. Lack of Marketability

It should be clear that a partnership interest which possesses a relatively low rate of return and no possibility of sharing in any future appreciation of the entity will have a minimal market at best. In the corporate area, a discount was allowed for corporate

110. See notes 54-66 & accompanying text supra.
113. Abbin, supra note 13, ¶ 1801.1.
114. Comment, supra note 1, at 62.
preferred stock with a yield below the market rate.\textsuperscript{115} Although there is no authority for this in the partnership area, if the features of the frozen units sufficiently resemble the preferred stock which was given a discount, there does not appear to be any justification for not according the partnership interest similar treatment.

It should be noted, however, that the features of priority in income and capital distributions that may be part of the frozen units\textsuperscript{116} would enhance their marketability. Perhaps one method to lessen the likelihood of creating a bonus instead of a discount feature would be to limit the income payments guarantee to the extent available from current income. The condition of the business would become of more importance in the valuation of these frozen units—which is the basic approach of Revenue Ruling 59-60.\textsuperscript{117}

The area of frozen partnerships is still developing and the practitioner should be aware of the possible pitfalls awaiting.\textsuperscript{118} But if the freezing of asset valuation is sought, coupled with the possibility of a discount for lack of marketability, the potential estate tax savings under this structure are substantial and may well be worth the risk.

Aside from the frozen partnership area, the Service may be expected to continue to assert that a partner gets the proportionate share of the underlying net assets and that the marketability factors should not be applied.\textsuperscript{119} The same reasoning applicable to close corporate interests and the marketability discount should be applied to general and limited partnership interests which possess similar characteristics of non-marketability. The Bischoff court has impliedly accepted that proposition,\textsuperscript{120} and the economic justification for adopting the entity approach is compelling.\textsuperscript{121}

\begin{itemize}
\item \textsuperscript{115} See Rev. Rul. 74-269, 1974-1 C.B. 87.
\item \textsuperscript{116} Abbin, \textit{supra} note 13, § 1802.1.
\item \textsuperscript{117} See § IV-B-1-a of text \textit{supra}. The planner must, however, be aware that the formula should not be structured so as to disqualify the payment from constituting a deductible guaranteed payment. I.R.C. § 707(c).
\item \textsuperscript{118} Some Service examiners have indicated that the "frozen partnership" vehicle will not be recognized for what it is, and will bring about automatic audit and challenge by the Service. Interview with Mike Eutelson, IRS Estate Tax Examiner, Omaha, Nebraska (Nov. 28, 1979).
\item \textsuperscript{120} 69 T.C. at 49-50.
\item \textsuperscript{121} "The entity approach . . . predominates in the treatment of transfers of partnership interests as transfers of interests in a separate entity rather than in the assets of the partnership." 1 McKee, \textit{supra} note 15, § 1.02[2]. See I.R.C. §§ 741, 742, 743(a). There appears to be no compelling reason to treat transfers at death or by gift any different for valuation purposes than the entity approach adopted by the Code in these instances.
\end{itemize}
C. Restrictions on Transferability

A discourse on the types of value-limiting devices available to the owners of corporate and partnership interests is beyond the scope of this comment. Rights of first refusal and valid buy-sell agreements may be employed in either a corporate or a partnership valuation case to set that valuation for estate or gift tax purposes. Consequently, once the valuation is set by either type of value-limiting device, the discounts for restrictions on transferability are not applicable.

Nevertheless, valid restrictions on transferability of a partnership or corporate interest may have an effect on the marketability of that interest. If a prospective seller must wait until his offer has first been refused by those persons to whom he is required to offer the interest, there is justification for allowing a discount to reflect a possible deterioration in the market value of those assets during the specified non-sale period. There appears to be substantial authority for allowing a discounted valuation of a partnership interest when first refusal rights or a valid buy-sell agreement exists sufficient to depress the marketability of the interest.

D. Loss of Key Man Discounts

The nature of a close corporation or a partnership is generally such that the death or retirement of key management personnel may substantially affect the success of the business. The Service has explicitly recognized this possibility. In the case of partnerships, there is as much justification for the allowance of a

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124. See Stechel, supra note 122, at 365.


126. See Maher, supra note 81, at 377.

127. The loss of the manager of a so-called one-man business may have a depressing effect upon the value of the stock of such business, particularly if there is a lack of trained personnel capable of succeeding to the management of the enterprise. In valuing the stock of this type of business the effect of the loss of the manager on the future expectancy of the business, and the absence of management-succes-
discount when key management personnel leave the business as in the corporate setting. The partnership entity is no less affected by reason of the availability of other partners in management capacities, if the loss of the key man truly represents a potential loss of future earnings, goodwill or creditworthiness of the entity.¹²⁸

In the limited partnership entity, the loss of the general partner may have substantial adverse effects, especially if the success of the partnership depended on the management skills and guidance of that general partner. It is not clear, however, whether the courts will allow substantial discounts in this type of case. The Service is likely to assert that the asset valuation rule and local law combine to limit the valuation of the interest to the partner's proportionate share of net assets.¹²⁹ This author knows of no reported case which explicitly grants a discount in the type of case mentioned above.

The application of corporate discount principles to the partnership entity is breaking new ground. While the arguments may appear economically and legally sound, the practitioner cannot, at this juncture, rely on the wisdom of the courts to grant the beneficial discounts sought. Careful drafting of partnership agreements may help provide a sound factual basis for some of the discounts.

VI. CONCLUSION

From an economic and realistic viewpoint, the Service is on loose and shifting sands if it continues to insist on the application of the asset valuation rule as the sole method in valuing partnership entities for estate and gift tax purposes. A much sounder approach would be to draw from the corporate area and use the long-recognized valuation concepts in arriving at the value of the partnership entity. Once this step toward the "bundle of rights" approach is taken, those discount concepts should naturally be applied where the situation so allows. Until that occurs, the practitioner will have to rely on the corporate analogy and the sparse judicial precedents when arguing the case for valuation discounts of partnership interests.

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