



Step or No Step—Holman Case

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## How Long Is Long Enough?

The step transaction doctrine is a court created doctrine that was designed to deal with transactions that attempt to accomplish a tax result through a series of steps what could not be accomplished if a more direct path were followed to get to the same end result, and for which the intermediate steps appear to serve no purpose except to obtain the favorable tax result that otherwise would not be available. When the doctrine is invoked, the series of steps is, for evaluation of the tax consequences, collapsed into a single transaction (thus, the “step transaction”), normally resulting in less favorable tax consequences to the taxpayer.

However, it's not always clear when a series of steps will or will not be given independent significance. That question is one that was dealt with in the case of *Holman v. Commissioner*, 130 TC No. 12. To the IRS, this case seemed to present the same series of steps the Tax Court had collapsed into a single

transaction in the *Senda* case, with the taxpayers simply inserting a short delay to attempt to avoid the *Senda* treatment. However, the Tax Court found that, in fact, this delay had a significant enough effect on the participants in the transaction to eliminate the ability to collapse this transaction under the step transaction doctrine.

Note that other issues were involved in this case that we won't deal with in this presentation—ones that didn't end up being decided in as favorable a manner for the taxpayer as did the step transaction issue.

## Indirect Gifts

Reg. §25.2511-1(a) recognizes that gifts can be either direct or indirect, and notes as follows:

(a) The gift tax applies to a transfer by way of gift whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible. For example, a taxable transfer may be effected by the creation of a trust, the forgiving of a debt, the assignment of a judgment, the assignment of the benefits of an insurance policy, or the transfer of cash, certificates of deposit, or Federal, State or municipal bonds. Statutory provisions which exempt bonds, notes, bills and certificates of indebtedness of the Federal Government or its agencies and the interest thereon from taxation are not applicable to the gift tax, since the gift tax is an excise tax on the transfer, and is not a tax on the subject of the gift.

An example of an indirect gift is found in Reg. §25.2511-1(h)(1):

(1) A transfer of property by a corporation to B is a gift to B from the stockholders of the corporation. If B himself is a stockholder, the transfer is a gift to him from the other stockholders but only to the extent it exceeds B's own interest in such amount as a shareholder. A transfer of property by B to a corporation generally represents gifts by B to the other individual shareholders of the corporation to the extent of their proportionate interests in the corporation. However, there may be an exception to this rule, such as a transfer made by an individual to a charitable, public, political or similar organization which may constitute a gift to the organization as a single entity, depending upon the facts and circumstances in the particular case.

It is not just a corporation that receives property that can create an indirect gift. A partnership would be treated similarly, as a transfer of property to the partnership is an indirect gift to the partners.

The Tax Court outlined the position it took in the *Shepherd* case in the case we're looking at today, noting:

In *Shepherd v. Commissioner*, 115 T.C. at 380-381, the taxpayer transferred real property and shares of stock to a newly formed family partnership in which he was a 50-percent owner and his two sons were each 25-percent owners. Rather than allocating contributions to the capital account of the contributing partner, the partnership agreement provided that any contributions would be allocated pro rata to the capital accounts of each partner according to ownership. *Id.* at 380. Because the contributions were reflected partially in the capital accounts of the noncontributing partners, the values of the noncontributing partners' interests were enhanced by the contributions of the taxpayer. Accordingly, we held that the transfers to the partnership were indirect gifts by the taxpayer to his sons of undivided 25-percent interests in the real property and shares of stock.

That said, a later gift of shares of the corporation won't generally be valued by reference to that original transfer—rather, at that point we'd value the corporate stock as corporate stock. That is important because a 10% interest in a corporation will not generally fetch a price between a willing buyer and willing seller that is 10% of the overall value of assets (both tangible and intangible) of the entity—the fact the assets are in a corporation with other owners imposes limitations on the buyer's ability to enjoy the use of those assets. Similarly, a limited partnership interest is similarly “discounted” due to those restrictions.

In family limited partnership transfer tax matters, the IRS has wanted to attempt to argue the indirect gift theory, taking advantage of a step transaction theory. In the *Senda* case the IRS was able to get the Tax Court to accept the view that a transaction where the assets were technically transferred to the partnership and then immediately the interests were gifted was, effectively, the same transaction as in *Shepherd* with the same tax result.

The Tax Court notes as well:

In *Senda v. Commissioner*, *supra*, the Commissioner contended that the taxpayers' transfers of shares of stock to two family limited partnerships, coupled with their transfers of limited partner interests to their children, were indirect gifts of the shares to those children. In both instances, the stock transfers and the transfers of the partnership interests occurred on the same day. We said that the taxpayers' transfers of shares were similar to the transfer of property in the *Shepherd* case: “In both cases, the value of the children's partnership interests was enhanced by their parents' contributions to the partnership.” We rejected the taxpayers' attempt to distinguish the *Shepherd* case on the ground that they first funded the partnership and then transferred the partnership interests to their children. We found: “At best, the transactions were integrated (as asserted by respondent) and,

in effect, simultaneous.” We held that the taxpayers’ transfers of the shares of stock to the two partnerships were indirect gifts of the shares to their children.

Given this background, we turn to the *Holman* facts.

## The Holman Partnership

Tom Holman was a Dell employee who ended up with a large block of Dell stock, which served as a pool of wealth that he wanted to transfer to his children. When Mr. Holman moved from Texas to Minnesota, he sought counsel from an estate planning attorney—not a bad idea, since the court notes that at the time Mr. and Mrs. Holman had no wills.

They began discussions with E. Joseph LaFave, a business and estate planning attorney about wealth management and estate planning. Over the next two years they continued these discussions, and the idea of family limited partnerships was discussed to accomplish the Holman's goals.

On November 2, 1999 the Holmans formed the Holman Limited Partnership, holding all interests either personally or via their trust. The partnership received 70,100 shares of Dell stock at this time.

On November 8, 1999 a gift was made of certain limited partnership units. On the Form 709 filed regarding these gifts, the value of the partnership units was computed and used as the gift value rather than the value of the underlying Dell stock on that day (remember, the partnership's only assets were shares of Dell stock).

## Really an Indirect Gift?

The question of whether this was an indirect gift of the Dell shares, or was rather a gift of the partnership units, which would impact whether the undiscounted value of the proportionate number of Dell shares would count as the gift, or whether the limited partnership interest (which would be subject to some discounts) would be the actual asset transferred.<sup>1</sup>

The IRS found that this transaction looked to it to be just another variant in line with *Shepherd* and *Senda*. Their argument was

The gift tax is imposed on the donor, and is based on the value of the transferred property on the date of the gift. \* \* \* Here, the property that passed from the donors is Dell stock, not the \* \* \* LP units. Therefore, Tom and Kim’s transfers

<sup>1</sup> The actual amount of discount allowed by the Tax Court would turn out to be less than the taxpayer asserted was proper, but had the Tax Court found this to be an indirect gift no discounts would have been appropriate.

of Dell stock, not the \* \* \* LP units, as of November 8, 1999, are taxed under the terms of § 2501(a)(1).

Alternatively, the formation, funding, and gifts of \* \* \* LP units dated as of November 8, 1999 are steps of an integrated donative transaction. Once the intermediate steps are collapsed, Tom and Kim's gifts are gifts of Dell stock in the form of \* \* \* LP units. \* \* \*

To the IRS, the six day period between the date the shares were transferred to the partnership and the date the gift was made indicates that, in reality, what was meant to be transferred were the Dell shares, and the partnership was, shall we say, so much window dressing.

As you might expect, the taxpayers had a different view of the situation. Their response was as follows:

First, no donative transfer occurred on formation of the Partnership because each partner contributed Dell stock to the Partnership, and each received interests in the Partnership precisely in proportion to the assets contributed by each. Further, because the Partnership was clearly and properly established under Minnesota law on November 3, 1999, Petitioners' gifts of Partnership interests on November 8, 1999, to the Trust and to the Minnesota UTMA Account cannot constitute indirect gifts of the Dell stock owned by the Partnership on that date.

To the taxpayers, the partnership was validly established and funded six days before the interests were gifted. The question before the Tax Court boiled down to whether or not it was proper to respect those steps as distinct transactions, or whether they should be collapsed into a single transaction of an indirect gift of the stock to the partners of the partnership.

The IRS argues that this case is essentially the same as the *Shepherd* and *Senda* cases. The IRS would argue that, like *Senda*, even though the partnership may have been technically formed and funded prior to the gift, in fact the entire transaction (funding, formation and gift) were all really one transaction where the parents took their undivided interest in Dell stock and transferred a portion of those shares to their children.

The Tax Court, however, did not agree. First, the Court rejected the IRS's first argument by noting that, clearly the funding and formation took place six days before any transfers. That was different from either the *Shepherd* fact pattern where the interests simply flowed to the donees, or the *Senda* case where it appears the same thing happened as in *Shepherd*, except that the taxpayer attempted to paper it over with a structured set of transactions that took place one right after the other on the same to arrive at the same result as *Shepherd*.

So now the court looked to whether it could use the step transaction doctrine to collapse these transactions, separated by six days, into one. The Tax Court notes that there are three alternative tests that may be invoked to justify the use of the step transaction doctrine to recast a transaction:

1. Binding commitment test (is there a requirement to follow with all transactions once the first one is entered into)
2. Interdependence test (“legal relations created by one transaction would have been fruitless without a completion of the series.
3. End result test

The Tax Court, after considering the IRS arguments, decided that the IRS was arguing for the interdependence test. The Court notes:

The nub of respondent’s argument is that petitioners’ formation and funding of the partnership should be treated as occurring simultaneously with their 1999 gift of LP units since the events were interdependent and the separation in time between the first two steps (formation and funding) and the third (the gift) served no purpose other than to avoid making an indirect gift under section 25.2511-1(h), Gift Tax Regs.

But the Tax Court noted that for later gifts the IRS had conceded that the transfer to the partnership had significance independent of the gift.

While we have no doubt that petitioners’ purposes in forming the partnership included making gifts of LP units indirectly to the children, we cannot say that the legal relations created by the partnership agreement would have been fruitless had petitioners not also made the 1999 gift. Indeed, respondent does not ask that we consider either the 2000 gift (made approximately 2 months after formation of the partnership) or the 2001 gift (made approximately 15 months after formation of the partnership) to be indirect gifts of Dell shares. We must determine whether the fact that less than 1 week passed between petitioners’ formation and funding of the partnership and the 1999 gift requires a different result.

The Tax Court returned to the *Senda* case, as the IRS emphasized that the Eighth Circuit hadn't ever indicated that a single day was the link. But the Tax Court noted a basic inconsistency in the IRS's position.

Nevertheless, the Court of Appeals in *Senda* did not say that, under the step transaction doctrine, no indirect gift to a partner can occur unless, on the day property is transferred to the partnership, the partner is (or becomes) a member of the partnership. As respondent’s failure to argue indirect gifts on account of the 2000 and 2001 gifts suggests, however, the passage of time may be indicative

of a change in circumstances that gives independent significance to a partner's transfer of property to a partnership and the subsequent gift of an interest in that partnership to another.

So since the date was up in the air, the Tax Court looked the specifics of what happened during the six day period in this case. It noted that the price of the underlying Dell shares during the periods between the various gift dates as noted in the table below:

| Date                   | Percentage |
|------------------------|------------|
| 11/2/1999 to 11/8/1999 | -1.316     |
| 11/2/1999 to 1/4/2000  | +17.745    |
| 11/2/1999 to 2/2/2001  | -35.748    |

The Court noted that variation did create risk—and some risk (and actual movement) occurred during those six days.

The value of an LP unit, based on its proportional share of the average value of the Dell shares held by the partnership, fell or rose between the dates indicated by the percentage indicated. Respondent has proposed as a finding of fact, and we have found, that, at the time Tom decided to create the partnership, he had plans to make the 1999, 2000, and 2001 gifts. Petitioners bore the risk that the value of an LP unit could change between the time they formed and funded the partnership and the times they chose to transfer LP units to Janelle. Indeed, the absolute value of the rate of change in the value of an LP unit was greater from November 2 to November 8, 1999, than it was from November 2, 1999, to February 2, 2001. Moreover, the partnership held only shares of Dell stock on both November 8, 1999 (the date of the 1999 gift), and January 4, 2000 (the date of the 2000 gift), and the partnership agreement was not changed in the interim. Respondent apparently concedes that a 2-month separation is sufficient to give independent significance to the funding of the partnership and a subsequent gift of LP units. We assume that concession to be on account of respondent's recognition of the economic risk of a change in value of the partnership that petitioners bore by delaying the 2000 gift for 2 months. We draw no bright lines. Given, however, that petitioners bore a real economic risk of a change in value of the partnership for the 6 days that separated the transfer of Dell shares to the partnership's account and the date of the 1999 gift, we shall treat the 1999 gift the same way respondent concedes the 2000 and 2001 gifts are to be treated; i.e.,

we shall not disregard the passage of time and treat the formation and funding of the partnership and the subsequent gifts as occurring simultaneously under the step transaction doctrine.

It is important to note the caveat that the Tax Court did not draw any “bright lines” and the Court emphasized this point in a footnote at the end of the above passage. That note reads:

The real economic risk of a change in value arises from the nature of the Dell stock as a heavily traded, relatively volatile common stock. We might view the impact of a 6-day hiatus differently in the case of another type of investment; e.g., a preferred stock or a long-term Government bond.

Thus the Tax Court serves to emphasize a point sometimes lost on tax professionals who are too quick to seize on a case as “the rule” for an item—that the ruling involves the application of the law to a specific set of facts and if those facts are not the same (and they virtually never will be) we must consider what impact those differing facts may have on the conclusions under the law. In this case it seems safe to presume that the “might” above should be read as “would” for this purpose.

## Lessons Learned

In many ways, this case is the poster child for the difference that the specific facts involved can make to the court—and, I would note, not just on this issue but also the other matter involving §2703 that we didn't consider (and which the taxpayer did not fare as well on).

*Shepherd* gave us what would be an expected result—if you want to use the independent existence of the partnership to enable the use of discounts for a gift of partnership interests rather than the underlying assets, it's important to actually gift the interests rather than have those inherit their rights—that is, you don't worry about substance over form issues when you foul up the form. *Senda* is a cautionary tale about the need to recognize when you undertake a tax planning engagement that depends on distinct steps that attempting to minimize the “step to step” risk will often cause the step transaction to come crashing down on the transaction.

Similarly, in this case the fact that there was a true risk taken by the taxpayers by delaying the transfer was crucial to having the Tax Court accept the partnership's reality—and the Court made clear that they would “look through” the partnership to see if there truly was economic risk by looking at the composition of the underlying assets.

For those that like “bright line” tests, this opinion will be singularly unsatisfying—

but in this area of planning, we often find the only “bright lines” will be those that will, for certain, cause the plan to fail. We need to counsel clients who are gifting securities in a family limited partnership that the question of “how long” the partnership must be in existence for the transfer to be respected is not an item we can easily answer—but the longer it is in there, the better.