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Minority Discounts: the Alchemy in Estate and Gift Taxation

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# Minority Discounts: The Alchemy in Estate and Gift Taxation

JAMES R. REPETTI*

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. Introduction</td>
<td>416</td>
</tr>
<tr>
<td>II. An Overview of the Dichotomy Between Estate and Gift Taxation</td>
<td>419</td>
</tr>
<tr>
<td>III. Valuation</td>
<td>422</td>
</tr>
<tr>
<td>A. Closely Held Corporations</td>
<td>423</td>
</tr>
<tr>
<td>B. Real Estate</td>
<td>428</td>
</tr>
<tr>
<td>C. Partnership Interests</td>
<td>429</td>
</tr>
<tr>
<td>IV. Using Valuation Methods to Reduce Estate and Gift Taxes</td>
<td>431</td>
</tr>
<tr>
<td>V. The Legislative and Judicial Responses</td>
<td>434</td>
</tr>
<tr>
<td>A. Legislative Response</td>
<td>435</td>
</tr>
<tr>
<td>1. Legislation Addressing Transfers of Opportunity</td>
<td>435</td>
</tr>
<tr>
<td>2. Legislation Addressing Lapsing Restrictions and Voting Rights</td>
<td>438</td>
</tr>
<tr>
<td>B. The Judicial Response</td>
<td>441</td>
</tr>
<tr>
<td>1. Rejection of Family Attribution</td>
<td>441</td>
</tr>
<tr>
<td>2. Critique of the Judicial Response</td>
<td>444</td>
</tr>
<tr>
<td>a. The Willing Buyer-Willing Seller Standard</td>
<td>444</td>
</tr>
<tr>
<td>b. Boundless Subjective Inquiries</td>
<td>445</td>
</tr>
<tr>
<td>c. Congress and Not the Courts Should Adopt Family Attribution Rules</td>
<td>448</td>
</tr>
<tr>
<td>VI. Arguments Available to the Service to Capture Lost Value</td>
<td>450</td>
</tr>
<tr>
<td>A. Substance Over Form</td>
<td>450</td>
</tr>
<tr>
<td>1. Family Partnerships</td>
<td>452</td>
</tr>
<tr>
<td>B. Step Transaction Doctrine</td>
<td>458</td>
</tr>
<tr>
<td>C. Swing Vote</td>
<td>462</td>
</tr>
<tr>
<td>1. Game Theory</td>
<td>463</td>
</tr>
</tbody>
</table>

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I. INTRODUCTION

A pernicious force is stalking the American economic landscape. Individuals owning valuable properties have watched their value decrease by 30 to 40% with the stroke of a pen. This wholesale and wanton destruction of value has not created consternation, however. Indeed, it is often the result of careful planning for which the owners of the devalued property pay large fees to appraisers and lawyers. A common tool of estate planning involves the purposeful diminution in value of family property in order to reduce estate and gift taxes.

This Article considers a basic strategy that involves dividing up control of an asset such as a business or real estate. Division of control reduces the value of the assets because it impairs the ability of the donees to direct the use of the assets to more profitable pursuits. Because donees will incur transactional costs in negotiating among themselves before implementing any new activity with respect to the asset, this strategy frequently results in the reduction in the value of the transferred property by up to 40%.

This technique presents a major mystery. The maximum statutory tax rate applied to gifts or estates is 60%. Although a donor may save transfer taxes by reducing the value of the transferred property, the tax savings will not equal the donee's economic harm if the diminution in value is real. For example, a reduction by $100 in the value of real estate transferred upon the taxpayer's death will reduce estate

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1 IRC § 2001(c). Although § 2001(c)(1) refers to a maximum rate of 55%, § 2001(c)(2) increases the rate to 60% for amounts that exceed $10 million but are less than $21.04 million in order to phase out the benefits of the graduated tax rate and the unified credit.

2 Joseph M. Dodge, Redoing the Estate and Gift Taxes Along Easy-to-Value-Lines, 43 Tax L. Rev. 241, 254 n.54 (1988) [hereinafter Redoing] (“Of course, in many of these cases, the economic loss attributable to the creation of minority interests is probably illusory, or else the transaction would not have been undertaken in the first place.”)
tax by up to $60, but the legatee will receive property that is worth $100 less. In most situations, a rational taxpayer would not engage in such a transaction. Thus, it is unlikely that the taxpayer has destroyed value by $100. Instead, the high marginal tax rate on estates and gifts makes it economically feasible on an after-tax basis for a donor to destroy some value so long as the remaining residual value has been transformed into something that will escape taxation. The estate planning devices transform a portion of the value formerly associated with control into an option or opportunity for the donees to recreate the “value” attributable to control. So long as this option or opportunity escapes estate, gift and income taxation and has a value greater than any after-tax value in the asset that has been permanently destroyed, the donor and donee will benefit.

For example, consider a parent who transfers a family business to two children, giving each child an equal right to control the business. The sum of the values of the children’s interests in the business is less than the value that the business had when owned entirely by the parent. This reduction in value reflects the fact that neither child can implement her plans for the business unilaterally. Thus, if one child wishes to sell the business but the other does not, the former will not maximize profit from the sale because a third party buyer will have to negotiate control with the latter. If the value of the business is discounted by $100, the donor saves $60 in gift tax because the gift tax applies to the value of the property transferred to each donee. Note that if this diminution in value is irreparable, the children have lost $100. Suppose, however, that they can restore $100 of value by incurring $10 of transaction costs to negotiate an agreement to sell the business together to a third party. If they do so, they will enjoy a net increase of $90 in value, while the donor will save $60 in gift tax. So long as the children incur transaction costs of less than $60 to restore the $100 value, there will be a net benefit to the family.3

This phenomenon results from a fundamental discontinuity between the estate tax and the gift taxes.4 Although the gift tax is in-

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3 The analysis in the text assumes no taxable capital gain upon the children’s sale of the business. In fact, if the parent had a low tax basis in the business, the children would have taxable capital gain because they would receive the asset with a carryover basis under § 1015(a). If the children could have avoided the capital gains tax by receiving the asset at the parent’s death and obtaining a stepped-up basis under § 1014(a), the tax payable in the inter vivos gift context is an additional cost that should be factored into the analysis. Therefore, so long as the children can avoid incurring transaction costs and capital gains tax expenses of $60 in restoring the $100 value, there will be a net benefit to the family.

tended to serve as a backstop to prevent circumvention of the estate tax, the definition of the tax base for gift tax purposes differs significantly from the tax base for estate tax purposes. The gift tax base is the value of each gift measured using a purely hypothetical transferee and not considering the personal characteristics of the actual transferor or transferee. The estate tax base is the value of all property held by the decedent at the time of death regardless of whether the property will be divided among legatees, again using a hypothetical third party standard.

None of the five proposals offered by academics, policymakers and the House of Representatives to address this discontinuity has been adopted. One reason for the absence of legislative response may be an incomplete analysis of the concept of including the transfer of an opportunity in the gift tax base or, alternatively, of excluding a control premium in the estate tax base where none of the legatees receives control. There also may be a sentiment that the Service currently has sufficient tools to deal with egregious abuses of the discontinuity. Finally, there may be some concern about the constitutionality of subjecting the control premium to a gift tax if the control premium in fact is destroyed.

Section II briefly reviews the dichotomy between the estate and gift taxes. Section III explores how closely held corporations, real estate and partnerships have been valued. Section IV describes valuation methods currently used by taxpayers and the courts to create minority discounts. The analysis shows that the method currently used by the courts to value minority interests is biased in favor of low valuations. Section V analyzes legislative and judicial responses to these tax reduction strategies. In Section VI, I analyze tools available to the Service to try to capture some of the lost value. It shows that the notion

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6 See Treasury I, note 4, at 388.

7 See text accompanying notes 30-31.


of “swing vote” value that recently has been employed by the Service to add value to minority shares of stock is a game theory concept that actually may result in lower valuations, not higher valuations, when applied in the context of current regulations. The Article also shows that the substance-over-form and step transaction doctrines are only applicable in the most egregious situations and easily can be avoided with careful planning. Section VII analyzes whether the current discontinuity makes sense from the perspective of efficiency and equity. The Article concludes that it does not and that the opportunity to participate in control should be included in the gift tax, as well as estate tax, base when the transferor and family members control an asset or business both before and after the transfer. This approach is not without precedent. It is similar to the existing treatment of certain other transfers by chapter 14 in very narrow circumstances. In Section VIII, I determine that such an inclusion in the gift tax base would be constitutional regardless of whether the opportunity actually is transferred. Section IX is a brief conclusion.

II. AN OVERVIEW OF THE DICHTOMY BETWEEN ESTATE AND GIFT TAXATION

The estate tax is imposed on the value of the decedent’s gross estate10 less certain deductions.11 The gross estate includes, in general, property owned by the decedent at death as well as property over which she exercised substantial control.12 The estate tax, therefore, is assessed upon all interests that the decedent possessed at death regardless of whether these interests will be divided among heirs or legatees. An asset in which a decedent owns a controlling interest thus is valued for estate tax purposes with the control premium.

In contrast, the gift tax is imposed upon the value of the property transferred by the donor to each donee.13 This discontinuity allows a person owning a controlling interest in an asset to avoid paying a transfer tax on the control premium by making inter vivos gifts of the asset. For example, suppose a donor holding 60 shares of common stock in a closely held corporation that has 100 shares of issued and outstanding stock is able to sell all 60 shares to a third party for $1,000

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10 The gross estate is defined in §§ 2031-2046.
11 The deductions are described in §§ 2053-2056.
12 The property includable in a decedent's gross estate because she exercised significant control is described in §§ 2035-2039 and 2041. See generally 5 Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates and Gifts chs. 126, 128 (2d ed. 1993).
13 Rushton v. Commissioner, 498 F.2d 88, 92 (5th Cir. 1974); Whittemore v. Fitzpatrick, 127 F. Supp. 710, 713-14 (D. Conn. 1954); Phipps v. Commissioner, 43 B.T.A. 1010, 1022 (1941), aff'd, 127 F.2d 214 (10th Cir.), cert. denied, 317 U.S. 645 (1942); T.A.M. 9449001 (Mar. 11, 1994); see also Reg. § 25.2512-2(c) (discussing valuation of each gift).
per share. The donor probably would be able to sell one share of stock to a third party for a substantially lesser amount, say $700 per share,14 because the share of stock, by itself, would not provide control of the corporation.15 One method to reduce the gift tax is to divide the shares among several donees so that no donee would have control.16 The value of each gift would not reflect a control premium.17 Indeed, the donor need not give all her stock away during her lifetime. So long as she reduces her percentage ownership below 50%, she can reduce the value of stock for estate tax purposes that she retains as well as stock that she gives away. In the prior example, if she gave away 11 shares, she would reduce her ownership to 49%, eliminating a control premium for gift and estate tax purposes.18

Another method to reduce the value of gifts involves dividing up an asset but retaining control of the asset. This is accomplished by making gifts of interests in a partnership, into which valuable assets have been placed.19 For example, suppose that the donor owns valuable rental property. Rather than give individual interests in the real es-

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14 One study that analyzed publicly announced mergers and acquisitions for the period 1968 to 1987 found that purchasers of controlling interests paid, on average, a premium of approximately 37 to 38% over the market price in order to obtain a controlling interest. Robert P. Lyons & Michael J. Wilczynski, Discounting Intrinsic Value, 128 Tr. & Est. 22, 22-24 (1989). In other words, the study found that minority interests in corporations trade on public exchanges on average at a discount of approximately 27 to 28% of the intrinsic value of the corporation. Id. It is important to note, however, that because the study involved publicly announced acquisitions, the premium may result from the ineptitude of the incumbent management in those acquired companies, rather than representing a universal measure of value of control. For an interesting critique of control premiums, see Thomas D. Hall, Comment, Valuing Closely Held Stock: Control Premiums and Minority Discounts, 31 Emory L.J. 139 (1982); see also Lance S. Hall, Valuation of Fractional Interests: A Business Appraiser’s Perspective, 57 Appraisal J. 173 (1989), for a discussion of the importance of calculating the minority discount in light of the facts associated with the specific company. Not surprisingly, this latter article finds that the minority discount is larger for poorly managed companies than well managed companies. Id. at 176.

15 See Ward v. Commissioner, 87 T.C. 78, 106 (1986) (“The minority discount is recognized because the holder of a minority interest lacks control over corporate policy, cannot direct the payment of dividends, and cannot compel a liquidation of corporate assets.”).


17 See, e.g., Clark v. United States, 75-1 USTC ¶ 13,076 (E.D.N.C. 1975); Whittemore, 127 F. Supp. 710; Estate of Piper v. Commissioner, 72 T.C. 1062 (1979); Estate of Lenheim v. Commissioner, 60 T.C.M. (CCH) 356 (1990); Estate of Heppenstall v. Commissioner, 8 T.C.M. (CCH) 136 (1949); see also Driver v. United States, 76-2 USTC ¶ 13,155, at 85,700 (W.D. Wis. 1976) (involving owner of 100% of stock who gave 84% to eight people; court applied neither minority discount nor control premium.)


tate to his children and, as a result, lose control of the real estate, the donor can form a limited partnership to hold the real estate and give limited partnership interests to his children. The donor, or frequently, the donor's wholly owned corporation is the general partner, enabling the donor to continue to control the real estate. Because the limited partners lack control, a minority discount is permitted in valuing the limited partnership interests. A cottage industry has sprung up using this strategy.

It may seem peculiar that such a simple strategy of making inter vivos gifts of minority interests effectively would circumvent the control premium that would be payable by an estate. One might wonder, for example, whether the fact that the donees are all in the same family or close friends means that the control premium has actually disappeared. As discussed below, the current definition of "value" for purposes of the gift tax precludes consideration of the relationship of the donees to one another and to the other owners.

The dichotomy between the estate and gift tax is not limited to minority discounts. The estate tax's focus on what the decedent owned at the time of death in contrast to what is actually transferred to specific legatees creates other anomalous tax results. For example, in *Ahmanson Foundation v. United States*, the decedent owned all the voting and nonvoting stock of a corporation. He bequeathed the vot-

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22 See Section III.

23 Other differences between the estate and gift taxes are discussed in the text accompanying notes 288-93.

24 674 F.2d 761 (9th Cir. 1981).
ing stock to his son and the nonvoting stock to a charity. The court held that the nonvoting shares had a higher value for purposes of calculating the gross estate than they did in calculating the charitable deduction. The court reasoned that, for purposes of the gross estate, the nonvoting shares would have to be valued together with the voting shares because the focus of the estate tax is on what the decedent owned at the time of death. This resulted in a higher valuation because the holder of both the voting and nonvoting shares could recapitalize the corporation and grant voting rights to the nonvoting shares, thereby increasing their value. In contrast, for purposes of calculating the charitable deduction, the court determined that the value of the nonvoting shares should be measured in isolation from the voting shares. This resulted in a smaller charitable deduction.

Similarly, the courts have concluded that the value of assets transferred to trusts as bequests or gifts must be determined without regard to the terms of the trusts. Thus, the fact that a trust may impose significant restrictions on the ability of the beneficiaries to exercise control of the corporation is irrelevant where the gift is complete upon the transfer of the stock to the trust.

III. Valuation

Because the estate and gift taxes are assessed on the “value” of property transferred, the definition of “value” has significant importance. Value is defined in the regulations as “fair market value,” that 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 to sell and both having reasonable knowledge of relevant facts.” The willing buyer and seller are not, however, the donor and donee, but rather are hypothetical people with no relationship to each other.

25 Id. at 772.
26 Id. at 769.
27 Id. In Estate of Curry v. United States, 706 F.2d 1424, 1434 (7th Cir. 1983), the Seventh Circuit, relying on Ahmanson Foundation, also determined that where the decedent held voting control of a corporation, his nonvoting stock should have the same value as his voting stock for estate tax purposes.
28 Ahmanson Foundation, 674 F.2d at 772; see also Estate of Chenoweth v. Commissioner, 88 T.C. 1577, 1589 (1987) (concluding that control premium would be appropriate for purposes of calculating marital deduction under § 2056 because decedent had bequeathed 51% of stock of corporation to his wife); cf. Ltr. Rul. 9403005 (Oct. 14, 1993) (ruling that where decedent transferred less than controlling block to spouse, minority discount must be applied for purposes of calculating marital deduction).
30 Reg. § 20.2031-1(b); see also Reg. § 25.2512-1.
Because the hypothetical buyer-seller standard for determining value is the primary reason that taxpayers can use inter vivos gifts to remove control premiums from the transfer tax base, the valuation process merits further study. The next three Sections examine the valuation of closely held companies, real estate and partnerships.

A. Closely Held Corporations

Determining the fair market value of stock in a closely held corporation is difficult. Where stock of a corporation is publicly traded, the mean between the highest and the lowest quoted selling price on the valuation date normally is used. The regulations direct, however, that the value of stock in a closely held corporation is to be determined based on “the company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors.” Other relevant factors include “the good will of the business; the economic outlook in the particular industry; the company's position in the industry and its management; the degree of control of the business represented by the block of stock to be valued; and the values of securities of corporations engaged in the same or similar lines of business which are listed on a stock exchange.”

The hypothetical willing buyer-willing seller standard is difficult to apply in the context of the closely held corporation because the use of these hypothetical people prevents consideration of the existing relationship between the donor and donee as well as among the donee and other stockholders. Relationships among stockholders of a closely held corporation normally constitute a significant component of value in such a corporation. Indeed, an authority on valuation lamented almost 60 years ago that “the willing-buyer, willing-seller incantation is a great bar to clear thinking in the law, and has no more place in legal opinions than it has in the literature of economic theory.” Another leading authority has commented that “in the case of closely held businesses, the Treasury will move heaven and earth to avoid using [the willing buyer-willing seller standard].”

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35 See text accompanying notes 49-62.
36 1 James C. Bonbright, The Valuation of Property 61 (1937).
In valuing stock in a closely held corporation, the courts generally engage in a multistep process. First, the value of the corporation as a whole is determined. If there is only one class of stock, the value of each share of stock is calculated by dividing the number of shares into that value. An appropriate discount to reflect lack of control and liquidity or an appropriate premium to reflect control then is applied to the block of stock subject to the transfer tax.

Despite the apparently formalistic simplicity of the analytical process, the lines separating the analytical steps are often blurred. As noted earlier, the regulations state that fair market value is calculated by considering the company's net worth, prospective earning power, dividend paying capacity and "other relevant factors." At the outset, application of each factor depends upon whether the court is valuing the corporation as a whole from the perspective of a controlling or minority shareholder. For example, dividend paying capacity would not be heavily weighted by a stockholder who did not control the corporation's board of directors, and who, therefore, could not insure that dividends would be paid. Similarly, the capitalization of earnings method requires an estimate of earnings and a determination of the appropriate discount rate. The earnings estimate may be based on changes in the conduct of a business that only a controlling stockholder could implement. The appropriate discount rate also depends on control, because control reduces risk and, therefore, the discount rate. Some courts have approached the problem by calculating value for the company as a whole assuming control and then applying a discount to calculate minority value. Other courts simply have valued the corporation as a whole assuming no control, and, therefore, have not discounted minority ownership further but have

24, 1992). Professor Kasner points out that, in urging Congress to adopt § 2701, Treasury abandoned the willing buyer-willing seller test. Id.


39 See text accompanying note 34.

40 See Fellows & Painter, note 4, at 910-12.

41 Id. at 912; see also Joseph D. Hartwig, Valuation Problems Before the Internal Revenue Service and the Tax Court, 13 Inst. on Fed. Tax’n 1143, 1150-51 (1955).

42 Fellows & Painter, note 4, at 912.

43 Id.

44 Id. at 913; see also Estate of Hall v. Commissioner, 34 T.C.M. (CCH) 648, 667 (1975).

added premiums to control stockholders.46 A few confused courts initially valued the corporation assuming control and then added a control premium to the controlling block,47 in effect, double counting for the premium. Other courts have allowed a discount for lack of control in valuing stock without first stating whether the value from which it subtracted the discount was the value assuming control.48

A discount for lack of control should be deducted only where the corporation was valued assuming control. If control is assumed, the court must carefully identify the attributes of control that provide value. This determination should be based upon the extent to which control can benefit the controlling stockholder.49

To understand the value of control, it is helpful to review briefly the basic principles of corporate governance. Stockholders of a corporation do not directly manage the affairs of a corporation; instead, they elect directors who are charged with the duty of managing the corporation’s affairs.50 Unless cumulative voting is permitted, the entire board of directors will be elected by the majority shareholder.51 Moreover, under most state statutes, the entire board, or any individual member of the board, may be removed by the majority stockholder.52 Thus, the majority stockholder controls the corporation by controlling the board.

The ability to control the board of directors offers a number of benefits to a majority stockholder. For example, he can cause the corporation to employ himself or family members.53 This power may be particularly valuable where the corporation is taxable under subchapter C because payment of dividends is not deductible, unlike the payment of reasonable compensation for services to the company.54 Moreover, this transfer of cash to family members is not subject to the

47 See Parker, 376 F.2d 402; Driver v. United States, 76-2 USTC ¶ 13,155 (W.D. Wis. 1976); see also Fellows & Painter, note 4, at 913-16.
50 Robert C. Clark, Corporate Law 94-95, 105 (1986).
51 Id. at 362.
52 See id. at 105.
54 IRC § 162(a)(1).
gift tax so long as the recipient is in fact performing services.\textsuperscript{55} In addition, control of the corporation provides a higher degree of job security for the controlling stockholder or family members than is normally available in the employment market.\textsuperscript{56}

Perhaps most importantly, corporate control reduces the intrinsic risk associated with an investment in the corporation. Financial economists frequently identify two sources of risk associated with a stock investment— intrinsic risk\textsuperscript{57} and systemic risk.\textsuperscript{58} Intrinsic risk is the risk associated with the particular company: generally the risk that it will be mismanaged or looted. Systemic risk is the risk associated with prevailing market conditions; in other words, the risk that demand for the stock will diminish because of adverse economic conditions. Normally, intrinsic risk is minimized by diversification;\textsuperscript{59} it also can be reduced by obtaining control. A controlling stockholder can select management that he believes is competent and honest.\textsuperscript{60} If they turn out not to be, he can remove them quickly and minimize the damage.

Thus, a stockholder who owns a majority of stock normally will control the board of directors and, therefore, normally will control selection of management, dividend policy and his own employment. This control decreases the risks associated with incompetent or dishonest management, the stockholder’s employment security and the timing of cash distributions. Additional benefits of control, however, become available only as the percentage of stock ownership increases.\textsuperscript{61} For example, many state statutes require a two-thirds vote of shareholders to liquidate a corporation, sell substantially all the corporation’s assets, merge the corporation or amend the certificate of incorpora-

\textsuperscript{55} It is important to insure that the amount of compensation is reasonably related to the services performed. If not, the compensation is treated as a taxable distribution to the controlling stockholder followed by a gift to the purported service performer. See, e.g., Johnson v. Commissioner, 74 T.C. 1316, 1323 (1980); Epstein v. Commissioner, 53 T.C. 459, 474-75 (1969) (taxing as a distribution to controlling stockholder a corporate transfer for insufficient consideration in trust to member of stockholder’s family).


\textsuperscript{57} See, e.g., Richard A. Brealey & Stewart C. Myers, Principles of Corporate Finance 137 (1991). Intrinsic risk also is referred to as unique, unsystematic, residual, specific or diversifiable risk. Id. at 137 n.13.

\textsuperscript{58} Systematic risk also is referred to as market risk or undiversifiable risk. Id. at 137 n.14.

\textsuperscript{59} Id. at 136-38.

\textsuperscript{60} See William D. Andrews, The Stockholder’s Right to Equal Opportunity in the Sale of Shares, 78 Harv. L. Rev. 505, 526 (1965); Fellows & Painter, note 4, at 905.

\textsuperscript{61} See Shannon P. Pratt, Robert F. Reilly & Robert P. Schweihs, Valuing Small Business and Professional Practices 31 (2d ed. 1993) (stating that “the degree of control or lack of it may fall anywhere across a broad spectrum, depending on the percentage ownership, the distribution of other ownership interests, and state laws governing rights of various percentage ownership interests in circumstances pertinent to the valuation situation at hand”).
The ability to compel liquidation of a corporation or sale of its assets may be valuable if the value of the corporation's assets exceeds the value of its ongoing business. Similarly, the ability to compel or amend a corporation's certificate of incorporation may be valuable if the stockholder wishes to expand the rights or economic benefits of a class of stock.

Because benefits vary with degrees of ownership, it is important that a court identify the degree of control that it assumes in calculating the value of the corporation. Some courts have engaged in such a thoughtful analysis. For example, in *Estate of Gray v. Commissioner*, the Tax Court determined that a purchaser of 50.487% of the voting stock of a corporation that owned a television station, newspaper and real estate would pay the sum of the liquidation values of the constituent businesses reduced by a discount of approximately 5.5%. The court applied the discount to reflect the "substantial size of the minority interest and the potential for dissension and legal complications in the event of a liquidation." In *Estate of Yeager v. Commissioner*, the Tax Court determined that the best way to value the decedent's 50.25% stock interest in a real estate holding company was to value the real estate. The court then applied a discount to the sum of the values of the various parcels of real estate to reflect the fact that the decedent did not hold sufficient voting power to liquidate the corporation without the support of other stockholders.

Similarly, when estimating the appropriate amount of discount for a minority interest, it is important to establish specifically what aspects of control that contribute to value are not available to the minority block. For example, if the valuation of the entire company included only the rights to control dividends, employment and management, the court should allow a discount in valuing a minority block to reflect only the fact that the minority stockholder does not have those powers. The discount should not reflect the inability to control liquidation, sale of assets or recapitalization since those factors were not included in calculating the value of the company as a whole.

It is important to note that attempts to value lack of control are complicated further by a trend in many state courts to impose fiduciary...
ary duties on stockholders in closely held corporations. Imposition of such duties should slightly reduce the minority discount otherwise allowable. In Massachusetts, for example, shareholders owe a duty of utmost good faith and loyalty to one another. This duty, however, as interpreted by the Massachusetts courts, requires merely the existence of a bona fide business purpose for taking an action that is harmful to another stockholder. For example, there must be a business purpose for terminating the employment of a minority stockholder. Thus, the court’s imposition of such duties does not reduce the risk associated with minority ownership to the level that would exist if the stockholder controlled the corporation. Moreover, the cost of litigating an allegedly wrongful act itself would support a minority discount.

B. Real Estate

The willing buyer-willing seller standard also applies to the valuation of real estate. Using this standard, the courts frequently permit “minority” discounts for undivided interests in real estate. The term minority discount in the context of undivided interests in real estate, however, is a misnomer; an undivided fractional interest in land merely gives the possessor the right to the use and enjoyment of the

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69 See generally Estate of Luton v. Commissioner, 68 T.C.M. (CCH) 1044 (1994) (holding that safeguards provided by California statutes to stockholders would reduce size of minority discount); Murdock, note 68, at 472-73, 481-88 (arguing that fiduciary duties should reduce size of minority discounts in corporate appraisal rights proceedings).


71 E.g., Zimmerman v. Bogoff, 324 N.E.2d 849, 853 (Mass. 1978); Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657, 663-64 (Mass. 1976). If a bona fide purpose exists, the plaintiff must show that a less harmful method for achieving the purpose existed in order to recover damages. Id.

72 Wilkes, 353 N.E.2d at 663-64.


74 Bittker & Lokken, note 12, at 135-41 to 135-42.
land in a manner that does not conflict with the other owners.75 Even where an individual owns a 90% undivided interest in real estate, the value of the interest would not equal 90% of the value of the entire parcel because the 90% owner would have to obtain a partition of the property in order to obtain the right to exclusive possession of 90% of the property. Thus, a purchaser would deduct the costs and uncertainties of obtaining a partition in determining the value of the 90% individual interest.76 For example, in *Estate of Pillsbury v. Commissioner*77 the Tax Court allowed a 15% discount for a 77% undivided interest in real estate to reflect the illiquidity of the interest and the fact that the owner of the interest would have to share control of the parcel with the other joint owners. Because the owner of an undivided interest in real estate has a right to partition and to gain total control of a portion of the real estate, the discounts tend to be lower than for minority blocks of stock,78 usually only about 10 to 20% below a pro rata portion of the value of the total parcel.79 In contrast, minority discounts for closely held corporations usually average 20 to 30%.80

### C. Partnership Interests

The method used to value closely held corporations also is used to value partnership interests.81 Consequently, the courts have allowed

75 Anna C. Fowler, *Valuation of Undivided Interests in Realty: When Do the Parts Sum to Less Than the Whole?*, 13 J. Real Est. Tax’n 123, 125 (1986).
76 Id. For an excellent discussion of the valuation of other types of interests in real estate, specifically remainder interests and conservation easements, see Kingsbury Browne, Jr. & Walter G. Van Dorn, *Charitable Gifts of Partial Interests in Real Property for Conservation Purposes*, 29 Tax Law. 69, 86-93 (1975).
77 64 T.C.M. (CCH) 284 (1992).
78 Pratt et al., note 61, at 533.
79 See note 73; see also Bruce W. Bringardner, *Discounting the Value of Undivided Interests in Realty*, 72 J. Tax’n 12, 15 (1990) (listing selected cases and discounts).
80 Most cases do not separately state the discount for a minority interest in a closely held corporation, but instead combine it with a discount for lack of marketability. Recent cases that have separately stated the minority discount for closely held corporations, however, show that the minority discount ranges from 20 to 30%. See, e.g., Northern Trust Co. v. Commissioner, 87 T.C. 349, 385 (1986) (25% discount); Estate of Frank v. Commissioner, 69 T.C.M. (CCH) 2255, 2263 (1995) (20% discount); Estate of Luton, 68 T.C.M. (CCH) 1045, 1050-55 (1994) (20% discount); Estate of Ford v. Commissioner, 66 T.C.M. (CCH) 1507, 1518 (1993), aff’d, 53 F.3d 924 (8th Cir. 1995) (20% discount); Estate of Lenheim v. Commissioner, 60 T.C.M. (CCH) 356, 371 (1990) (30% discount); Carr v. Commissioner, 49 T.C.M. (CCH) 507, 514 (1985) (25% discount).
81 Rev. Rul. 68-609, 1968-2 C.B. 327 (stating that partnership interests should be valued using criteria for valuing stock of closely held corporations set forth in Rev. Rul. 54-60, 1959-1 C.B. 237); see also Reg. § 20.2031-3 (stating that for estate tax purposes, partnership interests are to be valued under similar criteria as corporate stock, to the extent applicable).
minority discounts for interests as limited partners and general partners. The courts, however, do not appear to have been as conscientious in distinguishing subtle aspects of control that partners exert over partnership affairs as some courts have been in the corporate context. In Knott v. Commissioner, for example the Tax Court applied the same minority discount for both limited partner and general partner interests. The court noted that the donor still possessed a controlling interest as a general partner and, therefore, minority discounts were appropriate for both the transferred limited and general partnership interests. The court failed to explore, however, whether the partnership interests should be entitled to identical discounts.

Usually, there are significant differences between the rights and obligations of a minority interest held as a general partner and one held as a limited partner that would justify different minority discounts. The general partner's liability for the obligations of the partnership may justify a larger discount, while the broader rights of the general partner may support a smaller minority discount. The general partner in a limited partnership also generally can participate much more extensively in management than limited partners can. Moreover, a general partner normally has the right to withdraw at any time and receive the value of her partnership interest, less any damages if her withdrawal was in breach of the partnership agreement. In contrast, a limited partner may withdraw and receive the fair value of the interest only if the partnership agreement permits withdrawal. If the partnership agreement is silent about the rights of limited partners to withdraw and does not designate a definite time for dissolving and winding up the partnership, a limited partner may withdraw only upon six months' notice to each general partner.

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84 Id. at 432.
86 See id. §§ 302, 303, 403(a).
87 Id. §§ 602, 604.
88 Id. §§ 603, 604.
89 Id.
Partners also owe fiduciary duties to one another comparable to the fiduciary duties owed by shareholders in closely held companies. The effect of such fiduciary duties should be a slight reduction in the minority discount otherwise allowable, but the courts have not considered this explicitly.

IV. USING VALUATION METHODS TO REDUCE ESTATE AND GIFT TAXES

Because the focus of the gift tax regulations is on the value of a specific asset transferred to a specific donee, whereas the focus of the estate tax regulations is on the value of all property in the estate regardless of the recipient, significant planning opportunities exist.

For example, assume A owns 100% of the stock of a company, and the value of that interest is $1 million. This valuation includes the control premium. A has three children to whom she wishes to leave the corporation. If A dies owning 100% of the stock, the entire $1 million is includable in her estate, even though she bequeaths one-third of the stock to each of her children. Given this prospect, A decides to make inter vivos transfers of the stock to her three children. If A is married, she and her husband can give stock valued at $60,000 to her children without incurring a gift tax.

In valuing the gifted stock, a lack of control discount would apply. Thus, although $60,000 of the $1 million value of the corporation would represent only 6% of the stock of the corporation, A, in fact, could give a higher percentage of the company to her children because of the minority discount. For example, if an appropriate minority discount was 40%, A could give 10% of her stock per year to her children without incurring any gift tax. This would enable her to eliminate her control of the corporation in five years.

Suppose, however, that A decided to give all her stock to her three children in one year, each child receiving one-third of the stock of the company. What valuation should be used to determine the amount of the gift tax? Because a controlling block of the stock is given in the

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91 See text accompanying notes 68-72.
92 See, e.g., Estate of Curry v. United States, 705 F.2d 1424, 1426-30 (7th Cir. 1983); Estate of Feldmar v. Commissioner, 56 T.C.M. (CCH) 118, 130 (1988).
93 Section 2503(b) allows each donor a $10,000 annual exclusion for gifts to each donee. Section 2513(a) allows spouses to elect to treat gifts made by one spouse as made one-half by each spouse. Gifts by A and her spouse in excess of $20,000 to each donee also may not be taxable because the unified credit, IRC § 2010(a), allows a donor to make an additional $600,000 of gifts during the donor's lifetime on a tax-free basis. See text accompanying notes 288-90 for a discussion of how a donor may use the unified credit advantageously.
same year, it could be argued that the stock should be valued with the control premium.94 The statutory language of § 2501, which imposes a gift tax on the transfer of property during a calendar year and does not specifically refer to valuation based on the identity of the donees, supports this view.95 Because the estate tax would value the control block with a premium and because a primary purpose of the gift tax is to prevent the circumvention of the estate tax,96 the same principles should apply. Section § 25.2512-2(e) of the regulations, which states that the gifted stock is to be valued "with reference to each separate gift," makes that argument difficult, however. The courts have applied this regulation to require that each gift be valued in isolation from other contemporaneous gifts to other donees.97

Suppose alternatively, that A decided to give all the shares over a period of years to one child. For example, she gives 10% of her stock to one child each year for 10 years. Assuming the step transaction doctrine did not apply, how should the annual gifts be valued?98

One approach would be to apply the minority discount to each gift of stock every year. A second approach would be to apply a minority discount to the gifts in the first five years and then control premiums to the gifts in the subsequent five years. The focus of § 25.2512-(e) of

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94 David E. Watts, The Fair Market Value of Actively Traded Securities, 30 Tax Law. 51, 71 (1976); see Michael H. Simpson, Note, Federal Gift Tax Regulation 25.2512-2(e)—The Use of the Blockage Principle, 1974 Wisc. L. Rev. 612, 619-22 (arguing that although the statutory scheme may be interpreted as requiring the value of each gift to be determined, it does not require value to be determined in isolation from all other gifts).

95 Watts, note 94, at 71.

96 See note 5.

97 Rushton v. Commissioner, 498 F.2d 88, 90 (5th Cir. 1974); Whittemore v. Fitzpatrick, 127 F. Supp. 710, 720 (D. Conn. 1954); Estate of Heppenstall v. Commissioner, 8 T.C.M. (CCH) 136, 143 (1949); cf. Lawrence C. Phipps, 43 B.T.A. 1010, 1014 (1940) (refusing to aggregate gifts of stock made to different donees for purposes of applying blockage discount), aff'd, 127 F.2d 214, 217 (10th Cir. 1942), cert. denied, 317 U.S. 645 (1944). The Service took the same view in a recent technical advice memorandum in which it determined that contemporaneous gifts by a donor of all the stock of a company to 11 donees should be valued in isolation and would be eligible for minority discounts. T.A.M. 9449001 (Mar. 11, 1994).

98 The courts have not considered this issue in the context of the gift tax. At first glance, it may appear that Brown v. Commissioner, 25 T.C.M. (CCH) 498 (1966), is relevant. In that case, the taxpayer transferred in 1961 stock in a closely held business to her son that was sufficient to give the son majority ownership. She valued the shares at $2,500 per share, the same valuation that had been used for estate tax purposes of the majority interest held by her husband at his death in 1955. The Tax Court rejected the Service's argument for a higher valuation. Although the $2,500 per share valuation used by the taxpayer and accepted by the court was the same $2,500 per share value used to value the controlling block at death, the court did not seem to be applying a control premium to the shares that the taxpayer gave to her son. The court stated, "The 42 shares involved herein did not represent a controlling interest in the Company." Id. at 500. Thus, it appears to have been merely coincidental that the shares had the same value as the controlling block valued six years earlier.
the regulations suggests that the first approach is the correct one. The statement that value is determined “with reference to each separate gift” suggests that the inquiry is what a willing buyer would pay for the specific block of stock given in a particular year. Because only 10% is given each year, a minority discount should apply. This approach also is consistent with the willing buyer-willing seller standard, which suggests that the subjective value of the gift to the donee is irrelevant. Indeed, in the context of the estate tax, the Service, relying upon the willing buyer-willing seller standard, recently ruled that the value of a decedent’s 48.59% block of the stock of a corporation bequeathed to his son, who already owned 51.41% of the stock, should be determined without regard to the son’s ownership, and, therefore, that a minority discount was appropriate.99 Moreover, the Tax Court, relying upon the willing buyer-willing seller standard, also has allowed minority discounts in calculating the estate tax for stock passing at death to family members who already owned significant amounts of stock.100

It is interesting to note that in the context of the income tax where the regulations do not explicitly contain the willing buyer-willing seller standard for defining fair market value, the courts have refused to permit minority discounts if the taxpayer receiving shares that represented a minority interest already owned a majority interest.101 Although this line of cases might be viewed as supporting the argument that the identity of the donee should be considered in valuing the gift, analogy to income tax cases is inappropriate. The income tax, in general, seeks to impose an income tax on a taxpayer’s accession to wealth.102 Consequently, it is appropriate to consider the identity and characteristics of the recipient in measuring the recipient’s accession to wealth. The gift tax, however, focuses on what is transferred by the donor to the donee. Moreover, even in the income tax area, courts seem reluctant to engage in a subjective inquiry of the actual value to

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100 See, e.g., Estate of Lee v. Commissioner, 69 T.C. 860 (1978), (applying minority discount where decedent held 40% undivided interest in closely held corporate stock that passed to his spouse who already owned 40%); see also Estate of Zaiger v. Commissioner, 64 T.C. 927 (1975).
101 In Andrews v. Commissioner, 35 T.C.M. (CCH) 459 (1976), the taxpayer exchanged 30% of the stock in one corporation for 30% of the stock in a corporation in which he already had a 70% interest. In determining that a discount for lack of marketability should be allowed in setting the fair market value, the court commented approvingly on the taxpayer’s failure to seek a minority discount. The court stated, “We understand why no discount for a minority interest was taken (as the stock was being transferred to the majority shareholder) . . .” Id. at 463. See also Turner v. Commissioner, 23 T.C.M. (CCH) 952 (1964), aff’d, 343 F.2d 150 (4th Cir. 1965) (rejecting minority discount for taxpayer who already controlled corporation, and who received, as taxable compensation, additional shares of stock in corporation, noting that block was worth more, not less, to him).
the recipient. Instead, the courts usually employ an objective measure for determining the fair market value of the property by using the familiar willing buyer-willing seller, or similar standard. The income tax cases that measure the subjective value of an asset to the recipient appear to be confined to narrow contexts.

V. THE LEGISLATIVE AND JUDICIAL RESPONSES

These tax reduction strategies are based upon an important factual assumption—that when control is eliminated, value is destroyed. Yet, it does not make economic sense to destroy value. Despite this contradiction, taxpayers have successfully argued that value does in fact disappear. The taxpayer in Estate of Harrison v. Commissioner gal­lantly explained to the court in its brief:

Value does appear and disappear frequently in ordinary transactions. If that is not apparent, only some thought is needed to make it so. Suppose A, B, and C contribute $100 each to form a corporation, each receiving one share. With only one share, none of them alone can force a liquidation so as to get his $100 back. Under the willing buyer-seller test, what is the value of A’s share? The value has decreased from the $100 contributed to something much smaller, perhaps $45, that reflects the loss of a right to liquidate. Where did the lost $55 go? It did not go to B or C, for each of them has suffered the same $55 loss. Such a loss may continue indefinitely as the corporation does business. We can see that readily by noting that the stocks of hundred of corporations sell on exchanges at substantially below liquidation values.

The brief’s example appears persuasive because it focuses on the value of the stock to a hypothetical third party. Each shareholder, however, presumably would state that his stock has a value of $100 to her. Otherwise, they never would have invested $100.


104 The narrow contexts include the Andrews and Turner cases discussed in note 101, and situations involving the taxpayer’s receipt of a contest prize. See McCoy v. Commissioner, 38 T.C. 841 (1962); Turner v. Commissioner, 13 T.C.M. (CCH) 462 (1954). But see Wade v. Commissioner, 55 T.C.M. 413 (1988) (using costs of prize to determine income to recipients).


What are the sources of this value? If, A, B or C intends to be involved in the day-to-day activities of the corporation, one source of value is an intimate knowledge of the corporation's activities. This knowledge reduces the intrinsic risk associated with the corporation. Moreover, their day-to-day contact gives them influence over the conduct of the corporation's affairs that further enhances the value of the investment. In addition, the mix of personalities and skills of the shareholders may create a synergy that will prove profitable. Stated another way, while a third party might pay only $45 for A's one share of stock, a third party might very well pay $100 to step into A's shoes and acquire all of A's interest and relations in the corporation as well as A's one share of stock.

The difficulty is that the transfer taxes apply only to the value of what could be transferred to a hypothetical third party. A may not be able to transfer his synergistic working relationship with the other shareholders or his ability to participate in the corporation's activities to any hypothetical third party. A, however, could transfer these attributes to someone he knows well and that anticipates will work well with the other owners. If the transferee has a close family relationship or friendship with B and C, the transferee may be able to step into A's shoes and exert influence over the conduct of corporate affairs. Thus, it is very likely where cordial relationships exist among the transferee and B and C that A could transfer some of the value inherent in his relationship with B and C.

The challenge is whether the relationship of stockholders or partners should be considered for estate and gift tax purposes. As discussed below, the legislative response has been ambivalent, while the judicial response has been negative.

A. Legislative Response

1. Legislation Addressing Transfers of Opportunities

Congress has addressed the taxability of transferred opportunities on a rather haphazard basis. On the one hand, Congress has refused through legislation to eliminate minority discounts for the transfer of assets even though the circumstances of the transfer indicated that the owners would work together and, therefore, that control value had not been destroyed. For example, in November, 1984, Treasury proposed as follows:

107 See Pratt et al., note 61, at 56.
The value for transfer tax purposes of a fractional interest in any asset owned, in whole or in part, by a donor or decedent would be a pro rata share of the fair market value of that portion of the asset owned by the donor or decedent. Prior gifts of fractional interests in the asset, as well as any fractional interests in the asset held by the transferor's spouse, would be attributed to the donor or decedent for purposes of determining the value of the fractional interest transferred.\textsuperscript{108}

The reason for the proposal was a concern that minority discounts reduced the value of property within the transfer tax base in a manner "inconsistent with economic reality."\textsuperscript{109} The President's tax reform proposal to Congress in May, 1985, however, did not include this proposal.\textsuperscript{110}

Similarly, in 1987, the House Budget Committee proposed language stating that the value of stock is "deemed to be equal to its pro rata share of all the stock of the same class in such corporation, unless a different value is established by clear and convincing evidence."\textsuperscript{111} The committee report explained:

In determining whether a different value can be established under the clear and convincing evidence standard, all stock held, directly or indirectly, by an individual or by members of such individual's family is treated as held by one person. Thus, a minority discount will not be appropriate for transfers between family members unless all the stock held by that person or the person's family would qualify for the discount.\textsuperscript{112}

The House proposal, however, was not included in the Senate bill or the conference report.\textsuperscript{113}

On the other hand, Congress has adopted rules to prevent shareholders or partners from transferring the opportunity to participate in future appreciation of corporations or partnerships in transactions commonly referred to as "estate freezes." In the typical estate freeze, an older generation transfers ownership rights to a younger generation that are likely to appreciate in value while retaining interests that

\textsuperscript{108} Treasury I, note 4, at 387.
\textsuperscript{109} Id. at 386-87.
\textsuperscript{110} See the President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity (1985).
\textsuperscript{112} Id.
are unlikely to appreciate. Because the value of the retained interest is not likely to appreciate, the older generation has "frozen" the value of property that will be includable in its estate. Any future appreciation in the transferred interest will escape taxation.

For example, in a classic estate freeze, an older generation transfers common stock to the younger generation and retains preferred stock with a fixed dividend right. Even if the company becomes more profitable, the preferred stock will not appreciate because of its fixed dividend right. The future appreciation in common stock will not be subject to the estate or gift tax.

Congress first sought to address this problem in 1987 by adopting § 2036(c). Because § 2036(c) was deemed too vague, Congress repealed it in 1990 and replaced it with § 2701. In general, § 2701 deals with abuses in calculating the value of the transferred interests, the common stock in the above example. It assumes that the value of the common stock equals the value of all stock interests, common and preferred, minus the value of the preferred stock. The preferred stock generally is treated as having a zero value if the corporation is a "controlled entity" unless the preferred stock has a cumulative right to receive dividends. A "controlled entity" is defined as a corporation or partnership in which at least 50% of the total voting power or fair market value of the equity interests are owned immediately before the transfer "by the transferor, applicable family members, and any lineal descendants of the parents of the transferor or the transferor's spouse.”

Note that § 2701 assumes that, where the transferees have voting control and are family members, they will maximize the transferred value. The requirement that dividends be cumulative in the context of a family-controlled entity, in effect, creates an irrebuttable presumption that the family members will work together to increase the value

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115 5 Bittker & Lokken, note 12, at 136-2, 136-3.
116 Id.
117 For various critiques of § 2036(c), see, e.g., Karen C. Burke, Valuation Freezes After the 1988 Act: The Impact of Section 2036(c) on Closely Held Businesses, 31 Wm. & Mary L. Rev. 67 (1989); Joseph M. Dodge, Rethinking Section 2036(c), 49 Tax Notes 199 (Oct. 8, 1990) [hereinafter Rethinking]; Eastland, Legacy, note 9.
119 Id. § 11602(a), 104 Stat. at 1388-498.
121 Reg. § 25.2701-2(a), -2(b)(6), -2(c)(4).
122 Reg. § 25.2701-2(b)(5).
of the transferred interest after the taxable transfer by causing the company not to pay dividends. Congress apparently has not been willing to assume, however, that family members will work together with respect to other management matters. Section 2701 does not affect the availability of minority discounts. The regulations under § 2701 continue to allow a minority discount in calculating the value of the transferred interests that would have been allowed prior to the adoption of § 2701.123

2. Legislation Addressing Lapsing Restrictions and Voting Rights

Estate planners also have used the concept of disappearing value by employing formal legal rights that lapse upon the death of the holder. Frequently, a taxpayer would hold stock in a family owned corporation or an interest in a family owned partnership that would include the right to liquidate. If the corporation or partnership had valuable assets, that right may cause the stock or partnership interest to be more valuable than it would have been without a liquidation right. In order to minimize the value of the partnership interest or stock in the taxpayer’s estate, the liquidation right would lapse upon the taxpayer’s death.

The lapse of the liquidation right could result in a substantial diminution in the value of assets held by the estate and, therefore, a significant decrease in estate tax. Note, however, that the lapse would have no adverse economic impact on the legatees or other family members because the family’s control of the partnership or corporation would allow the family to liquidate the business at will. For example, in Estate of Harrison v. Commissioner,124 the taxpayer and the Service stipulated that a limited partnership interest in a partnership that held valuable real estate, oil and gas interests and marketable securities would have a value of more than $59 million if accompanied by a liquidation right but only $33 million without a liquidation right.125 The court held that because the taxpayer’s liquidation right lapsed upon death, the limited partnership interest should be valued at the lower amount even though the taxpayer’s family continued to control the partnership.126

123 Reg. § 25.2701-3(b)(4); see T.D. 8395, 1992-1 C.B. 316, 318 (stating that § 2701 does not “affect minority discounts otherwise available under law in effect before” enactment of § 2701).


125 Id. at 1308.

126 The court rejected the Service’s argument that the lapse of the liquidation right had transferred “something of value” to the taxpayer’s two sons who were the only other partners because the Service had stipulated the value of the son’s partnership interests had remained the same after the lapse. Id. at 1309; see also Estate of Watts v. Commissioner,
The legislative response to *Estate of Harrison* was § 2704(a), adopted as part of a major revision of the estate and gift taxes in 1990. Section 2704(a) provides that, in certain situations, the lapse of a voting or liquidation right with respect to an interest in an entity is a transfer for estate and gift tax purposes. The amount of the transfer is the reduction in value attributable to the lapse.

Section 2704(a) applies where the holder of the lapsed voting or liquidation right and the holder's family control the entity immediately before and after the lapse. The holder and holder's family must be able to liquidate an interest that the holder held and could have liquidated prior to the lapse. In determining whether the interest could be liquidated after the lapse, restrictions on liquidation that may be removed by the holder or holder's family are disregarded. In effect, § 2704 assumes that there has been no diminution in value when a liquidation right lapses, because the family, viewed as a whole, still has the power to liquidate the entity.

The amount of the transfer for estate or gift tax purposes is the difference between the value of all interests in the entity held by the taxpayer before the lapse and the value of such interests after the lapse.
lapse.\textsuperscript{133} Section 2704 does not identify the transferee, however. Thus, it is possible that the deemed transfer will not qualify for a marital deduction,\textsuperscript{134} charitable deduction\textsuperscript{135} or annual gift exclusion of $10,000\textsuperscript{136} even where the identity of the transferee is obvious because, for example, there is only one other partner.\textsuperscript{137}

Section 2704(a) also applies to a lapse of any "voting right." Voting right is defined as "a right to vote with respect to any matter of the entity,"\textsuperscript{138} for example, the right of a general partner to participate in partnership management.\textsuperscript{139} The holder of a lapsed voting right in a family controlled entity is treated as having made a taxable transfer.\textsuperscript{140} Again, the value of the transfer is the difference between the value of all interests in the entity held by the taxpayer before the lapse and the value of such interests after the lapse.\textsuperscript{141} Where the lapse of voting rights results in the holder losing control of the entity, the amount transferred should include the value of the control premium.\textsuperscript{142}

One remarkable aspect of § 2704(a) is that it, in effect, creates an irrebuttable presumption that family members will cooperate. It assumes that the transferor's voting or liquidation right has not disappeared but rather has been transferred to family members. Thus, in the narrow context of voting and liquidation rights, Congress has done what it refused to do in the broader context of minority discounts for assets held by family members.\textsuperscript{143} Indeed, Congress was very careful to point out that it did not intend to change the treatment of minority discounts or other discounts under present law.\textsuperscript{144}

The failure of Congress to extend the presumption in §§ 2701 and 2704 that family members will cooperate to achieve minority discounts may be based on two assumptions. First, it may reflect a belief that the Service has adequate tools to deal with abusive applications of minority discounts in the courts. Second, it may reflect a judgment

\begin{footnotes}
\textsuperscript{133} Reg. § 25.2704-1(d).
\textsuperscript{134} IRC §§ 2050, 2523.
\textsuperscript{135} IRC § 2522.
\textsuperscript{136} IRC § 2503(b).
\textsuperscript{137} See Dees, Monster, note 9, at 906.
\textsuperscript{138} Reg. § 25.2704-1(a)(2)(iv).
\textsuperscript{139} Id.
\textsuperscript{140} IRC § 2704(a).
\textsuperscript{141} IRC § 2704(a)(2); Reg. § 25.2704-1(d).
\textsuperscript{142} Harrison, Implications, note 120, at 914.
\textsuperscript{143} In § 2704(b), Congress similarly has assumed that family members would cooperate to remove certain restrictions on liquidating family controlled entities. See Dees, Monster, note 9, and Harrison, Implications, note 120, for discussions of § 2704(b) and some problems that arise from the interaction of § 2704(b) with RULPA.
\end{footnotes}
that minority discounts reflect sound tax policy. As discussed below, neither assumption is valid.145

B. The Judicial Response

1. Rejection of Family Attribution

The courts have not been responsive to attempts by the Service to address abusive applications of minority discounts. Until recently, the Service took the position, set forth in Revenue Ruling 81-253,146 that control discounts should not be allowed where a majority stockholder made lifetime gifts of stock to family members. The Service reasoned that had the majority stockholder died holding a majority interest, the stock in her or his estate would have been valued without a minority discount.147 Because the purpose of the gift tax is to prevent the avoidance of estate taxes through lifetime gifts,148 the Service argued that lifetime gifts of stock by a majority stockholder similarly should not benefit from a minority discount. The Service also reasoned that when a controlling block of stock is owned by members of a family, “there is a unity of ownership and interest, and the shares owned by family members should be valued as part of that controlling interest.”149 Recognizing that a unity of interest would not exist where family discord existed, the Service also stated that “where there is evidence of family discord or other factors indicating that the family would not act as a unit in controlling the corporation, a minority discount may be allowed.”150

The Service defended its position in Revenue Ruling 81-253 by relying upon four earlier cases that arguably had rejected a minority discount where a majority stockholder had made lifetime gifts to family members. Two of the cases,151 however, involved application of the

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145 See Sections VI and VII.
147 G.C.M. 38,520, note 146, at 18.
148 See note 5.
150 Id.
151 In the first step transaction case, Blanchard v. United States, 291 F. Supp. 348 (S.D. Iowa 1968), the taxpayer transferred to trusts for the benefit of her grandchildren an amount of stock sufficient to reduce her percentage of stock ownership in a closely held corporation to 50%. The taxpayer valued her gifts of stock at $315 per share, arguing that the gifts were entitled to a minority discount. Three weeks after the transfer, an unrelated third party purchased a majority interest in the corporation for $707.45 per share from the donee and taxpayer. The third party subsequently purchased additional shares at $315 per share. The court rejected the taxpayer's valuation of $315 per share for stock she had given to the donee because it found that at the time of the gifts, the taxpayer and donee...
step transaction doctrine. A very strained interpretation of the third case suggests that the court of appeals implicitly rejected a minority discount for stock in a holding company transferred by the taxpayer to family members. In the fourth case, the court of appeals obliquely condemned the concept of minority discounts but appeared to accept a valuation based on a minority interest although the transferor's family controlled all the stock.

In contrast to the questionable authority supporting family attribution, the weight of authority prior to the issuance of Revenue Ruling 81-253 suggested that a minority discount should apply to the family.

152 Taxpayers also have applied the step transaction doctrine to their advantage. For example, in Ivey v. Commissioner, 46 T.C.M. (CCH) 172 (1983), the taxpayers successfully argued that their charitable gifts of separate contiguous tracts of land should be valued as though there had been a combined gift of one large tract, thereby enabling a larger charitable deduction.

153 Richardson v. Commissioner, 2 T.C.M. (CCH) 1039 (1943), aff'd, 151 F.2d 102 (2d Cir. 1945). The holding company's assets consisted primarily of marketable securities. The lower court determined that the only practical way to value the transferred stock was to consider the value of the marketable securities and rejected the application of a minority discount. On appeal, the Second Circuit affirmed the lower court's valuation on the ground that the lower court's use of the term "fair market value" sufficiently attested to the use of a proper standard. 151 F.2d 102, 105 (2d Cir. 1945), cert. denied, 326 U.S. 796 (1946). Thus, while the lower court had rejected a minority discount, the court of appeals never squarely addressed the issue.

154 Hamm v. Commissioner, 325 F.2d 934 (8th Cir. 1963), aff'd 20 T.C.M. (CCH) 1814 (1961), cert. denied, 377 U.S. 993 (1964). The taxpayer, who owned 263 shares of stock of a closely held corporation, transferred the stock to his children in trusts. All the other stock of the company was held by the taxpayer's sisters and their children and by the taxpayer's son. The taxpayer treated the stock as having a value of $100 per share. The Service asserted that the stock had a fair market value of $8,506 per share. In upholding the Service's valuation, the Tax Court did not appear to consider a minority discount, although it is not clear whether the court's valuation was premised on ownership of all the common stock of the company or upon minority ownership. On appeal, the taxpayer challenged the Tax Court's decision, arguing that a minority discount should be allowed. In a rather strained interpretation, the Eighth Circuit concluded that because the Tax Court had repeatedly referred to the value of the 263 1/3 shares transferred by gift, it had not based its valuation on ownership of all the stock of the company but rather on only 263 1/3 shares. Condemning the concept of minority discount with faint praise, the court then stated:

If, in view of the over-all complete ownership of the common by . . . [taxpayer's] family, this minority interest point has any real validity, the foregoing [references to 263 1/3 shares] convincingly demonstrates that the minority interest aspect was considered by the court and that its determination was made as to that specific interest.

Id. at 941.
Most of the earlier cases, however, failed to explain specifically why minority interests in family corporations should qualify for minority discounts. In *Estate of Bright v. United States*, a case decided just prior to the issuance of Revenue Ruling 81-253, the court provided a rationale. The court stated that established case law requires rejection of the family attribution argument, because it is "logically inconsistent with the willing buyer-seller rule." The court reasoned that under this rule, the identity of the decedent is irrelevant and, therefore, there can be no attribution to the decedent's relatives. The court also said that it was rejecting family attribution because it is "important policy that the law should be stable and predictable."

Similarly, after the issuance of Revenue Ruling 81-253, the Tax Court continued to reject the Service's argument for application of the family attribution rule, noting that, because Congress has explicitly required it in other areas, the doctrine should not be judicially grafted into a new area. Indeed, in a subsequent case, the court awarded litigation costs to the taxpayer on the grounds that the Service's litigating posture in seeking to deny a minority discount for a family business was unreasonable. The courts also rejected family attribution in cases involving real estate.

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156 658 F.2d 999 (5th Cir. 1981). The decedent and her husband owned as community property 55% of the common stock of several corporations and unrelated individuals owned the other 45%. In valuing the 27.5% block of stock that was included in the decedent's estate, the Service argued that a minority discount should not be allowed because prior to death, the decedent and her husband had held their stock as a controlling block and that, after her death, her husband held the block as trustee of a testamentary trust for their children. In effect, the Service sought to attribute the husband's stock to the decedent in order to apply a control premium in valuing the decedent's stock.

157 Id. at 1002.

158 Id. at 1005-06.

159 Id. at 1006.

160 See, e.g., *Estate of Andrews v. Commissioner*, 79 T.C. 938 (1982) (permitting minority discounts where decedent held 20% of stock in four companies and other 80% of the stock was held by decedent's brothers and sisters); *Ward v. Commissioner*, 87 T.C. 78, 103 (1986).


163 In *LeFrak v. Commissioner*, 66 T.C.M. (CCH) 1297 (1993), the court rejected the Service's argument that a minority discount should not be allowed for fractional interests in real estate, stating:

  The mere fact that all persons with ownership interests in the buildings are family members should not preclude allowance of a minority discount because the possibility of internecine bickering and dissension can never be excluded.
This string of defeats finally caused the Service to change its litigating posture and revoke Revenue Ruling 81-253, stating “[A] minority discount will not be disallowed solely because a transferred interest, when aggregated with interests held by family members, would be a part of a controlling interest.”

2. Critique of the Judicial Response

In summary, the courts have rejected family attribution for four reasons: (1) prior precedents should not be readily overturned; (2) the willing buyer-willing seller standard does not permit consideration of the characteristics of the actual transferee; (3) a subjective inquiry of the behavior of heirs and legatees would be boundless and (4) Congress, not the courts, should create a family attribution rule.

With respect to the first rationale, while courts generally respect precedent, they will reject stare decisis if it is incorrect. Thus, the validity of the courts' analysis rests upon the correctness of the latter three rationales. The following analysis shows that only the rationale relating to the willing buyer-willing seller standard is correct, but that the approach of the courts creates a bias in favor of low valuations of minority interests in family-controlled corporations and partnerships.

a. The Willing Buyer-Willing Seller Standard

As stated earlier, both the estate tax and the gift tax are imposed on the fair market value of the transferred property. The regulations define fair market value as "the price at which the property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." Both the Service and the courts have determined that this standard requires that such actors be hypothetical people rather than the actual transferor and transferee. The courts have reasoned that the estate and gift taxes are excise taxes on the transfer of property and that the property should be valued as it is...
transferred rather than in the hands of the transferor or transferee.\textsuperscript{168} Thus, the characteristics of the transferor or transferee are irrelevant.

The Service appears to have contemplated this approach from a very early date. An almost identical willing buyer-willing seller standard first appeared in the gift tax regulations in 1924\textsuperscript{169} and in the estate tax regulations in 1925.\textsuperscript{170} The early tax regulations also made it clear that the identity of the legatee has no impact on the calculation of the estate tax. The 1919 version of the estate tax regulation stated: "[T]he relationship of the beneficiary to the decedent has no bearing upon the question of liability or the extent thereof."\textsuperscript{171}

The notion that the identity of the transferee is irrelevant is somewhat circuitous in application. In defining fair market value, the regulations refer to the willing buyer and seller "having reasonable knowledge of relevant facts." A willing buyer certainly would seek to ascertain the market for resale and would discover that the property may have more value to certain purchasers. Thus, for example, while the willing buyer-willing seller test would prohibit the court from valuing a gift or bequest based on the subjective value assigned by the transferee to the property, a willing buyer would consider such subjective value in weighing the amount she would pay for the property since she, in turn, could sell it to the transferee for whom it has more value.\textsuperscript{172} The courts, however, have not addressed this circularity, and by ignoring it, are calculating not fair market value, but a somewhat lower value.

b. \textit{Boundless Subjective Inquiries}

The reluctance of the courts to consider the relationship of the transferee to other owners or stockholders because it would force the courts to engage in "boundless subjective inquiries" is ironic. The entire valuation process is a boundless subjective inquiry: To value an asset the court has to make guesses or assumptions about the future. These inquiries require speculation about the composition of management, the nature of the company's future products and general economic conditions.\textsuperscript{173}

\textsuperscript{168} See id.; see also Edwards v. Slocum, 264 U.S. 61, 62 (1924).
\textsuperscript{171} Reg. 37, Art. 1, T.D. 2910, 21 Treas. Dec. Int. Rev. 753 (1919). This statement appears to have been included to make clear that the new estate tax was not an inheritance tax like that which had existed from 1898 through 1902. See generally Randolph E. Paul, Federal Estate and Gift Taxation § 1.02 (1942).
\textsuperscript{172} 5 Bittker & Lokken, note 12, at 135-11.
Moreover, the courts already make such inquiries in another area of the estate tax. Prior to 1990, courts examined the relationship of decedent stockholders to the other stockholders to determine whether agreements among the decedent, the other stockholders and the corporation to purchase the decedent's stock at a fixed price should be considered in valuing the decedent's stock.\footnote{In Commissioner v. Beusel, 100 F.2d 639 (3d Cir. 1938), the court held that a buy-sell agreement affected the value of decedent's stock because it determined that decedent was not on friendly terms with his son and had agreed to the terms only after "protracted contentions and negotiations." Id. at 640.} The estate tax regulations prior to 1990 stated that the buy-sell agreement should be disregarded if it represented "a device to pass the decedent's shares to the natural objects of his bounty for less than adequate and full consideration in money or money's worth."\footnote{Reg. § 20.2031-2(h) (1976); see Rev. Rul. 59-60, 1959-1 C.B. 237, modified by Rev. Rul. 65-193, 1965-2 C.B. 370 (interpreting regulation to require inquiry into whether there is bona fide business arrangement).} Although legislation enacted in 1990 has made it much more difficult for decedents to use buy-sell agreements to establish value,\footnote{IRC § 2703(b) (as enacted by the Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11602, 104 Stat. 1388-498).} more recent regulations still require the court to determine whether the buy-sell agreement is "a device to transfer the property to the natural objects of the transferor's bounty for less than full and adequate consideration in money or money's worth."\footnote{Reg. § 25.2703-1(b)(1)(ii).} Thus, it appears that courts already are required to delve into interpersonal relationships as part of the federal transfer tax scheme.

In valuing property for estate and gift tax purposes, the courts have exhibited an uneven willingness to raise the boundless inquiry objection. The courts have adopted three distinct approaches. First, although the courts have not been willing to consider the relationship of a transferee to other owners who are members of the same family, the courts have considered the familial relationship of the other owners to one another in order to predict whether they will work together. For example, in \textit{Estate of Winkler v. Commissioner},\footnote{57 T.C.M. (CCH) 373 (1989).} the Tax Court observed that a willing buyer would consider the configuration of stock ownership between two different families in valuing a decedent's 10% block of stock. The 10% block would have additional value, the court stated, because it, in effect, would represent the tie-breaking vote if disputes arose between the two families. In assuming that the members of each family would work together to vote the shares as a family block, the court was not dissuaded by the inquiry that an analysis of this assumption would require. Similarly,
v. Commissioner, the Tax Court, in rejecting the Service’s argument that, because there was no majority partner, a minority discount should not be allowed, stated, “[W]e believe that a hypothetical buyer would realize that the other partners were all related and thus, in effect, a majority interest.” Again, the court did not raise the boundless inquiry objection.

Second, where there is no familial relationship among the other owners and no history of how the other owners have behaved in similar events, the courts generally have refused to forecast how the other owners will relate to one another. Thus, for example, some courts have refused to speculate whether stockholders or partners intended to liquidate the business. Similarly, in Estate of Salsbury v. Commissioner, the Tax Court refused to consider whether a majority stockholder could form a coalition with some minority stockholders in order to obtain approval of a recapitalization that would advantage the majority stockholder. The decedent owned 51.8% of the voting power in the form of preferred stock with a 6% dividend preference. The court refused to include in the control premium the amount that the owner could obtain if he were able to negotiate a coalition with other stockholders that would provide the requisite two-thirds vote needed to recapitalize the corporation by amending the certificate of incorporation to increase the amount of dividends he was entitled to receive. The court rejected this argument because “to partially base the value of decedent’s shares on the possibility that the hypothetical purchaser could obtain an uncertain

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180 Id. at 1134.
181 The Service also has examined the ability of a minority stockholder to form coalitions with other stockholders in the context of determining whether redemptions are essentially equivalent to dividends under § 302(b)(1). In Revenue Ruling 85-106, 1985-2 C.B. 116, the Service ruled that a redemption should be taxable as a dividend in part because the redemption did not affect the ability of the stockholder to participate with two other stockholders in a coalition that would wield control. See Bloch v. United States, 261 F. Supp. 579, 611-12 (S.D. Tex. 1966), aff’d per curiam, 386 F.2d 839 (5th Cir. 1967) (making similar determinations); Johnson Trust v. Commissioner, 71 T.C. 941, 947 (1979); see generally Bernard Wolfman, Federal Income Taxation of Corporate Enterprise 214 (3d ed. 1990), for an insightful discussion of the role of potential coalition formation in the § 302(b)(1) dividend equivalency test.
183 Estate of Watts v. United States, 823 F.2d 483, 486 (11th Cir. 1987) (ruling that lower court should not have considered intent of other partners with respect to liquidation of partnership). But see Knott v. Commissioner, 55 T.C.M. (CCH) 424 (1988) (refusing to use liquidation value to value partnership interests where there was no evidence that partners intended to liquidate partnership).
184 34 T.C.M. (CCH) 1441 (1975).
185 Id. at 1452.
186 Id. at 1452.
participation in earnings would be to engage in mere speculation and conjecture.\textsuperscript{187}

Third, where there is a history of regular purchases of stock by shareholders unrelated to one another, the courts have exhibited a willingness to analyze this pattern of prior behavior as a means of predicting future conduct. For example, in \textit{Luce v. United States},\textsuperscript{188} the Claims Court disallowed a minority and lack of marketability discount on the grounds that there was a ready market for the stock among the family members and employees who were already shareholders. The court determined that a market existed because of prior purchases by the existing stockholders.\textsuperscript{189} In effect, the court assumed that the pattern of past behavior was strongly predictive of future behavior and, therefore, allowed it to forecast behavior without getting into predictions about intent.\textsuperscript{190}

The court's comfort with the use of the past to predict the future in this narrow circumstance suggests a simple limited solution to the "boundless inquiry" problem in the broader contexts of owners exercising control together. In order to determine whether a transferee and other owners are likely to work together, the courts can restrict their examination to the past relationships of the transferee and owners.

c. \textit{Congress and Not the Courts Should Adopt Family Attribution Rules}

The final rationale that the courts have used to permit minority discounts in the context of family corporations is that Congress, not the courts, should impose a family attribution rule. If the court's examination of the relationship of owners constituted a family attribution rule, it undoubtedly would be true that the courts would be acting outside the scope of their authority. The courts generally have refused to expand the scope of attribution rules beyond that specifically

\textsuperscript{187} Id. The court also quoted the Supreme Court's admonition in \textit{Olson v. United States}:

\begin{quote}
Elements affecting value that depend upon events or combinations of occurrences which, while within the realm of possibility, are not fairly shown to be reasonably probable should be excluded from consideration for that would be to allow mere speculation and conjecture to become a guide for the ascertainment of value—a thing to be condemned in business transactions as well as in a judicial ascertainment of truth.
\end{quote}

\textit{207 U.S. 246, 257} (1934).

\textsuperscript{188} \textit{84-1 USTC} \textsuperscript{13,549} (Ct. Cl. 1984); see also \textit{Estate of Neff v. Commissioner}, 57 \textit{T.C.M. (CCH)} \textit{669} (1989) (permitting only 10% discount for lack of marketability because company had over period of years been willing to repurchase stock.)

\textsuperscript{189} \textit{Luce}, \textit{84-1 USTC} at 84,391-92.

\textsuperscript{190} See id. at 84,392.
stated in the statute. 191 Family attribution rules that create an irrebuttable presumption of singularity of purpose among family members 192 or that treat family members as a unit 193 are exceptions to the Code's general rule treating individuals as separate taxable units. Such significant variations should be addressed from the broad perspective of the legislature rather than the narrow perspective of a court, which generally is limited to considering the facts before it. 194

A judicial determination that the courts should examine the relationships of the transferees and other owners would not create an irrebuttable presumption, but rather would merely allow the courts to determine whether control will be exercised by the group. As discussed earlier, 195 the courts have been willing to examine the past actions of stockholders and partners to determine whether a ready market for stock or partnership interests exists. Moreover, the courts are required to consider the prior relationship and actions of stockholders in order to determine whether restrictions on the resale of stock or partnership interests to third parties should affect the valuation of the stock or partnership interests. 196 In order to avoid a

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192 Courts have considered whether family attribution rules are always irrebuttable where family hostility exists in the context of §§ 267 and 318. The Tax Court has ruled that the family attribution rules of § 267 cannot be rebutted by showing hostility among family members. Miller v. Commissioner, 75 T.C. 182, 190 (1980). Similarly, the Fifth Circuit, the Tax Court in recent decisions and the Service have concluded that the § 318 attribution rules may not be rebutted by a showing of hostility. Metzger Trust v. Commissioner, 693 F.2d 459 (5th Cir. 1982), cert. denied, 463 U.S. 1207 (1983); Cerone v. Commissioner, 87 T.C. 1 (1986) (finding that attribution rules of § 318 were irrebuttable and rejecting earlier Tax Court decision that had suggested otherwise); Rev. Rul. 80-26, 1980-1 C.B. 66. But see Haft Trust v. Commissioner, 510 F.2d 43 (1st Cir. 1975) (concluding that § 318 attribution rules could be rebutted for purposes of § 302(b)(1) dividend equivalence test).

193 See, e.g., IRC § 1(g) (taxing unearned income of children under age 14 at their parent's top marginal rate), § 151(d)(2) (preventing both parent and child from claiming dependency exemption), § 1(a) (generally permitting special tax rates for married individuals who file joint return). For a review and critique of various attribution rules, see Coven, note 191; Thomas J. Reilly, An Approach to the Simplification and Standardization of the Concepts “The Family,” “Related Parties,” “Control,” and “Attribution of Ownership,” 15 Tax L. Rev. 253 (1960); Fred M. Ringel, Stanley S. Surrey & William C. Warren, Attribution of Stock Ownership in the Internal Revenue Code, 72 Harv. L. Rev. 209 (1958).

194 See Coven, note 191, at 640 (critiquing judicially created attribution rules). For an interesting argument that Congress should not adopt a broad irrebuttable presumption of family attribution in the estate and gift tax for purposes of combining ownership, see Moncrief, note 53, at 795.

195 See text accompanying notes 188-90.

196 See text accompanying notes 175-77.
boundless inquiry, the courts could confine their examination to the prior relationship of the owners in establishing a basis for predicting future behavior.

VI. Arguments Available to the Service to Capture Lost Value

The Service has employed three other approaches that may accomplish roughly the same objective of trying to capture the transferred opportunity to participate in control. These approaches apply the substance-over-form or step transaction doctrine to combine a series of gifts and bequests that have the long-term effect of transferring control. The Service also has attempted to capture additional value by measuring the “swing vote” attribute of transferred stock. It is likely, however, that these approaches have only limited application and are not very effective in capturing all the value transferred to family members because they easily can be avoided with careful planning.

A. Substance Over Form

One method to capture the control premium where a series of gifts of minority interests is made to a single donee is to apply the substance-over-form doctrine. Disregarding an initial transfer permits a subsequent transfer to be treated as conveying control. For example, in Estate of Murphy v. Commissioner,197 the taxpayer, who suffered from lung cancer, transferred 0.88% of the outstanding stock of a closely held corporation 18 days before her death to her two children, reducing her stock ownership to 49.65%. The taxpayer made the gifts after repeated written suggestions by her accountant that she would save significant amounts of estate tax if she held less than 50% of the company. At her death, she bequeathed the remaining 49.65% to her two children.198

The Tax Court denied a minority discount for the bequest because, in substance, the gifts never occurred. The court noted that, after making the gifts, the taxpayer continued to control the corporation and to serve as chairman. Finding that the sole purpose of the gift was to obtain a minority discount, the court concluded that transfers effected solely to reduce transfer tax, which have no impact on the transferor’s beneficial interest, will be disregarded.199

197 60 T.C.M. (CCH) 645 (1990).
198 Id. at 647-48.
199 Id. at 659.
Murphy should be contrasted with Estate of Lenheim v. Commissioner,200 in which the decedent gave minority interests in the family corporation to his sons three months before his death. The gifts reduced the decedent’s interest in the corporation from 58% to 20.8%. At death, the decedent bequeathed the remaining stock to his sons. The Service did not challenge the appropriateness of a minority discount. Factors that account for this failure may include the taxpayer’s retirement from the business three years prior to his death, the management of the business by his sons since that time, and the significant reduction of the taxpayer’s percentage of stock ownership. These facts indicate that the gifts were not motivated solely by tax avoidance but rather were intended to insure the transfer of ownership of the family business to those who already controlled it.

The paucity of cases applying the substance-over-form doctrine suggests that it is of limited usefulness to the Service in dealing with the transfer of an opportunity to participate in control. The paper trail in Estate of Murphy of the accountant’s repeated suggestions to reduce the taxpayer’s ownership in the company below 50% in order to reduce the estate tax, the gift of an extremely small percentage of stock, which suggested that the taxpayer was only transferring enough stock to break control, and the retention of her executive positions, made it easy for the court to conclude that, in substance, no transfer had occurred. Indeed, the court stated that the taxpayer’s retention of control after the gift may have caused § 2036(a)(1) to apply. Section 2036(a)(1) includes transferred property in an estate to the extent the decedent has retained the actual possession or enjoyment of the transferred property. The retention of the right to vote “directly or indirectly” shares of stock of a controlled corporation is retention of the enjoyment of transferred property.201 The court, however, declined to apply § 2036(a)(1) because the Service failed to raise the issue.202 A well-advised taxpayer could easily avoid the substance-over-form argument by insuring the existence of circumstances that indicate that a transfer of control in fact had occurred. For example, after the transfer the donees could call a new board of directors meeting. If they want the donor to continue as chairman of the board, they should vote to do so and set forth their reasons. At the directors’ meeting, they also can discuss their future plans for the business and direct the officers to implement those plans.

201 IRC § 2036(b)(1).
202 Estate of Murphy, 60 T.C.M. (CCH) at 665.
1. **Family Partnerships**

Application of the substance-over-form doctrine to family limited partnerships merits special consideration. A donor may use a limited partnership to increase the size of a minority discount. For example, if a donor transfers an undivided interest in rental real estate, the courts normally permit only a 10 to 20% discount to reflect the estimated cost the donee would incur in obtaining a partition since an undivided interest in real estate gives the owner the right to the use and enjoyment of real estate.\(^\text{203}\) If, however, the real estate is contributed to a limited partnership, the gift of the limited partnership interest should qualify for a larger discount because the limited partner’s rights in the real estate are more circumscribed. A limited partner probably has no right to the use and enjoyment of the land unless the partnership agreement so provides.\(^\text{204}\) Moreover, a limited partner normally is restricted from participating in the management of the real estate and also normally is not able to withdraw from the partnership and receive the value of his interest.\(^\text{205}\)

The Service could use either of two arguments to challenge the use of a limited partnership. First, the Service could argue that the transfer of real estate to the partnership prior to the gift of the partnership interest served no business purpose. Second, the Service could argue that the partnership should be ignored because it is not a partnership for federal tax purposes.

The courts ignore an entity’s existence when it was not formed for a business purpose and has no business activity.\(^\text{206}\) Similarly, courts ignore the existence of an entity by treating it as a conduit even if it has a business purpose or activity, if the entity’s role in a particular transaction serves no business purpose other than tax avoidance.\(^\text{207}\) Because the courts frequently have held that limiting liability is a valid business purpose, placing rental real estate into a limited partnership prior to giving the interest to a donee in order to shield the donee from tort or environmental liabilities should constitute a valid business purpose.\(^\text{208}\) Similarly, placing securities in a limited partnership...
prior to making gifts in order to create a portfolio large enough to retain a sophisticated investment advisor and to reduce brokerage commissions should constitute a valid business purpose.

Assuming that a valid business purpose exists for using a limited partnership, the courts nevertheless may refuse to respect the partnership for federal tax purposes if it engages in no profit seeking activity. Section 7701(a)(2) defines a partnership for purposes of the income, estate and gift taxes as an entity “through or by means of which any business, financial operation, or venture is carried on . . . .” For example, if a partnership merely holds a personal residence or vacation property that is used only by family members who are partners, the courts may disregard the partnership. A failure to rent it or to plan to sell it for gain probably would not satisfy the definitional requirement that it carry on “a business, financial operation, or venture.”

The extent to which the partnership must engage in profit seeking activity to meet this requirement is not clear, however. Occasionally renting property in between periods that it is occupied by partners and hoping that the property will be sold for a gain in the future clearly does not qualify as a “business.” Because “financial operation” and “venture” are not defined in the Code or regulations, uncertainty exists as to whether occasionally renting the property and holding it for appreciation qualifies as a financial operation or venture. The regulations implicitly suggest that a partnership investing in securities is a financial operation. Analogizing a personal residence partnership that only occasionally rents the property and holds it for appreciation to a securities partnership may be inappropriate because there is no

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209 The Service adopted this position in § 1.701-2(d) (Ex. 6) of the regulations but subsequently revoked the example in Announcement 95-8, 1995-7 I.R.B. 56 (Feb. 13).

210 See Form Builders, Inc. v. Commissioner, 58 T.C.M. (CCH) 1415 (1990) (ignoring partnership for income tax purposes where there was no sharing of profits); Reg. § 1.761-1(a) (merely sharing expenses does not create partnership for federal income tax purposes); see also Bruce N. Lemons & Richard D. Blau, Significant Issues May Remain for S Corporation Partners Despite IRS’s Newest Ruling, 81 J. Tax’n 132, 134 (1994) (arguing that partnership will not exist for income tax purposes when there is no joint profit motive).

211 Commissioner v. Groetzinger, 480 U.S. 23, 35 (1987) (stating that to be engaged in a trade or business taxpayer must be involved in activity with continuity and regularity and primary purpose for activity must be for income or profit); see Michael B. Lang, When a House Is Not Entirely a Home: Deductions Under Internal Revenue Code § 280A for Home Offices, Vacation Homes, Etc., 1981 Utah L. Rev. 275, 276 n.95 (annotating cases that address whether vacation home was used in trade or business).

212 See Reg. § 1.761-2(a)(2) (allowing the participants in the “joint purchase, retention, sale, or exchange of investment property” to elect not to be taxable as a partnership); Reg. § 1.701-2(d) (Ex. 9) (partnership formed to engage in securities investments is bona fide).
personal use in the latter whereas personal use would predominate in the former. It is more plausible that a personal residence partnership might qualify as a "venture" since there has been an undertaking with a partial view to eventual profit, but the lack of authority is troublesome due to the personal use of the partnership.

In the event that a court determines that the limited partnership does not satisfy the requirement of carrying on a business, financial operation or venture, it could characterize the "partnership" as merely an agreement restricting the limited partner's right to use or sell the underlying property. The agreement probably would be disregarded under § 2703(a) because it would not represent a "bona fide business arrangement" within the meaning of § 2703(b)(1). A determination that no partnership existed because the partnership's predominant motive was a personal use of the real estate, in most circumstances, would preclude a determination that the "agreement was a bona fide business arrangement" since the property itself was pri-

213 See IRC § 165(c)(2); Reg. § 1.165-9(a) (denying loss deduction for real estate used as personal residence).

214 Although the courts frequently define the term "joint venture" for purposes of determining whether the joint venture is taxable as a partnership, they do not define the term "venture." See, e.g., Sierra Club, Inc. v. Commissioner, 103 T.C. 307, 322-23 (1994); Torres v. Commissioner, 88 T.C. 702, 736 (1987). Instead, they simply recite that the term "partnership" includes a "joint venture . . . through or by means of which any business, financial operation, or venture is carried on." IRC § 761(a).

215 It is also possible that the court would recharacterize the "partnership" as a trust for federal tax purposes. There are several conflicting considerations. Section 301.7701-4(a) of the regulations defines a trust as "an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts." While the "partnership" clearly would be holding the personal residence to protect it or conserve it, it is not clear that such activity would be under the "rules applied in chancery or probate court" since for state law purposes, the partnership would be governed by the applicable partnership statute. Moreover, there is also some authority that if a "trust" instrument confers the authority to conduct a business, the entity will not qualify as a trust for tax purposes even if no business activity occurs. Helvering v. Coleman-Gilbert Assoc., 296 U.S. 369, 374 (1935); see A.J. Alex Gelinas, Mineral Royalty Trust Transactions: The Use of the Grantor Trust to Avoid Corporate Income Tax, 37 Tax Law. 225, 231 (1982). On the other hand, there is some authority that a trust may exist where a responsible person has broad discretionary powers of administration with respect to property and is required to conserve that property. See, e.g., Rev. Rul. 69-300, 1969-1 C.B. 167; Rev. Rul. 61-102, 1961-1 C.B. 245; William J. Falk, Taxation of Non-Electing Settlement Funds Poses Many Questions, 74 J. Tax'n 106 (1991). The extent to which the general partner possesses these powers will depend upon the scope of authority conferred by the partnership agreement. If a court determined that the "partnership" was a trust, the transfer of the limited partnership interest could be subject to the special valuation rules of § 2702. Moreover, courts disallow minority discounts for gifts of property in trust. See text accompanying note 29.

216 See IRC § 2703(a), (b)(1); Reg. § 25.2703-1(b) (explaining exceptions).
marily held for nonbusiness reasons. This means that gifts of the limited partnership interests could be valued as mere cotenancies.

If a court determines that the limited partnership does satisfy the requirement of carrying on a “business, financial operation or venture,” § 2703 still may permit the Service to disregard portions of the partnership agreement. For example, the Service may apply § 2703 to challenge the validity of a buy-back provision in the agreement. Where, however, the limited partnership’s existence is respected, § 2703 normally does not permit the Service to disregard the restriction on a limited partner’s right to use, manage or sell the partnership’s assets. Sections 2703(b)(1) and (3) require such restrictions to represent bona fide business arrangements comparable to similar transactions entered into by unrelated persons dealing at arm’s length. Restrictions on the limited partner’s right to use, manage or sell the partnership’s assets serve a valid business purpose because they minimize interference with the business use of the property. Moreover, such limitations are probably present in every limited partnership organized under RULPA unless the partnership agreement provides otherwise. Consequently, it would be difficult for the Service to argue that such restrictions do not satisfy the provisions of § 2703(b)(1) and (3).

In addition, it is also unlikely that the limited partnership’s restrictions on the use or sale of partnership assets would constitute a “device” to transfer property “for less than full and adequate consideration” within the meaning of § 2703(b)(2) so long as the restrictions are not broader than necessary to achieve their business objectives. Determining whether partnership restrictions on the limited partner’s use, sale or management of partnership property constituted a device within the meaning of § 2703(b)(2) is somewhat difficult in the context of inter vivos gifts of limited partnership interests because the legislative history indicates that Congress focused on testamentary devices to deflate the value of bequests artificially. The Senate report states that the device standard adopts the reasoning of St. Louis County Bank v. United States that the “mere showing” that the agreement is a bona fide business arrangement would not give the agreement estate tax effect if other facts indicate that the agreement is a device. The court held that although a stock purchase

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217 IRC § 2703(b)(2); Reg. § 25.2703-1(b)(1)(ii).
218 See Reg. § 25.2703-1(a)(3) (stating that right or restriction subject to § 2703 may be contained in partnership agreement).
220 674 F.2d 1207 (8th Cir. 1982).
agreement had been adopted for valid business purposes—the main-
tenance of family control—it nevertheless could be disregarded in val-
uing the stock for the estate tax where the facts suggested that the
agreement was also a testamentary device to minimize estate taxes.222
The facts indicating a testamentary device to minimize the estate tax
were the poor health of the decedent at the time the agreement was
executed, the inadequacy of the consideration provided for in the
agreement and the failure to enforce the agreement at the decedent's
death.223

This legislative history suggests that in applying the device standard
to inter vivos gifts, the analysis should be whether the restrictions
were intended to deflate the value of the gifts artificially for purposes
of the gift tax. In the context of restrictions on the limited partner's
use, sale or management of partnership property, this analysis should
ascertain whether the restrictions are narrowly drafted to accomplish
the desired business objective and are enforced. Where the restric-
tions are broader than necessary to accomplish the business objective
for imposing such restrictions on limited partners (for example, to
minimize interference with the business use of the property) or they
are not enforced, they likely will constitute a device to minimize the
gift tax. Similarly, where the donor is in poor health at the time the
property is transferred into the partnership and the donor is the sole
general partner, the restrictions should be disregarded because the do-
nor's death will cause a dissolution of the partnership224 thereby elimi-
nating the restrictions. In most situations, as long as the donor is in
good health, it will be relatively easy to comply with these
requirements.

Another potential argument available to the Service to challenge a
gift of a limited partnership interest is to argue that §§ 2036(a) or
2038(a) will cause the transferred partnership interest to be included
in the donor's estate. This would occur if the donor's retained control
of the partnership as a general partner constituted the retention of the
right to enjoy or designate who could enjoy the transferred inter-
ests.225 This effectively would defeat the benefit of making lifetime
gifts of the limited partnership interests. In most situations, however,
§§ 2036(a) and 2038(a) should not apply because the donor's control
as general partner is subject to fiduciary obligations owed to the lim-
ited partners. If the partnership agreement precludes the general
partner from altering or terminating the limited partners' interest and

222 674 F.2d at 1210.
223 Id. at 1210-11.
224 RULPA § 801(4).
225 See IRC §§ 2036(a), 2038(a)(1).
from amending the agreement, the fiduciary duties should sufficiently constrain the donor’s retained control such that it does not constitute the retention of enjoyment of the transferred interests.\footnote{226 See, e.g., Ltr. Rul. 9415007 (Jan. 12, 1994); Ltr. Rul. 9131006 (Apr. 30, 1991); Ltr. Rul. 8611004 (Nov. 15, 1985); see also United States v. Byrum, 408 U.S. 125 (1972); Estate of Gilman v. Commissioner, 547 F.2d 32 (2d Cir. 1976); Estate of Roddenbery v. Commissioner, 8 T.C.M. (CCH) 781 (1949).}

One situation, however, in which § 2036 may require a transferred limited partnership interest to be included in the donor’s estate is where the partnership’s assets consist of stock in a “controlled corporation.”\footnote{227 Section 2036(b) defines a “controlled corporation” as a corporation in which the donor “at any time after the transfer of the property and during the 3-year period ending on the date of the [donor’s] death, the [donor] owned (with the application of section 318) or had the right (either alone or in conjunction with any person), to vote, stock possessing at least 20% of the total combined voting power of all classes of stock.”} Section 2036(b) would require the donor to include the value of such stock owned by the partnership in her estate where she has retained “directly or indirectly” the right to vote such stock. Where the donor is a general partner or owns voting stock in a corporate general partner of the limited partnership, she should be viewed as having retained the right to vote “directly or indirectly” the stock owned by the partnership.\footnote{228 See Rev. Rul. 80-346, 1980-2 C.B. 271 (ruling decedent possessed indirect right to vote stock in trust where trustee was required to consult with decedent before voting and to vote only with decedent’s consent).} The fact that her right to vote may be constrained by fiduciary duties is probably irrelevant in the context of § 2036(b) because the legislative history suggests that Congress intended § 2036(b) to apply even where the donor’s retained control might be circumscribed by fiduciary duties.\footnote{229 See Staff of Joint Comm. on Tax’n, 94th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1976, at 588-89 (Comm. Print 1976) (stating that § 2036(b) is intended to overrule United States v. Byrum, 408 U.S. 125 (1972), in which Court held that stock of closely held corporation was not includable in decedent’s gross estate despite retention of voting power).}

In summary, it will be difficult to apply the substance-over-form doctrine to gifts of interests in family partnerships so long as a valid business purpose exists for a gift of a partnership interest in lieu of a direct gift of the partnership’s assets, and so long as the partnership engages in a profit seeking activity. In many circumstances, careful planning should eliminate the statutory threat of § 2703 to family partnerships. Only § 2036(b) in narrow circumstances unequivocally eliminates the utility of family partnerships for obtaining minority discounts.
B. Step Transaction Doctrine

The courts also have used the step transaction doctrine to combine gifts made during a short period of time. While the substance-over-form doctrine disregards a transfer, the step transaction doctrine combines a series of transfers into one. Thus, where a majority owner has made a series of transfers to a single donee, the step transaction approach combines those transfers in order to deny a minority discount.

In applying the step transaction doctrine, the courts have not provided detailed analysis comparable to the step transaction analysis in the corporate reorganization area. For example, in Driver v. United States,230 the court refused to apply a minority discount where the taxpayer transferred a majority interest in a closely held corporation to her nephew by making two gifts on December 31, 1968 and January 2, 1969. The court characterized the gifts as "an effort to convert a transfer of a majority interest into one of a minority interest by effecting it in two installments two days apart."231 The court cited Gregory v. Helvering232 but provided no additional analysis.

The decision in Driver begs the question of how much time should elapse between gifts. The court's failure to articulate a complete rationale makes it difficult to obtain any useful guidance. In general, the courts apply the step transaction doctrine in three forms—the binding commitment test, the end result test or the mutual interdependence test. The binding commitment test combines two separate events if, at the time of the first event, there was a binding commitment to take the next step.233 The end result test combines separate steps where it appears that the taxpayer intended the separate steps to be component parts of a single transaction.234 The mutual interdependence test combines steps if the steps are "so interdependent that the legal rela-

231 Id. at 85,699.
233 See, e.g., Commissioner v. Gordon, 391 U.S. 83, 96 ("[I]f one transaction is to be characterized as a 'first step' there must be a binding commitment to take the later steps."); Hazeltine Corp. v. Commissioner, 89 F.2d 513, 518 (3d Cir. 1937) (declining to find 80% control of corporation because acquiror was obligated to transfer stock representing control); Intermountain Lumber Co. v. Commissioner, 65 T.C. 1025, 1032-34 (1976) (holding taxpayers did not acquire control of corporation for purposes of § 351 because they were obligated to sell 50% of their stock).
234 See, e.g., King Enters., Inc. v. United States, 418 F.2d 511, 516 (Cl. Cl. 1969) (stating that under end result test "purportedly separate transactions will be amalgamated into a single transaction when it appears that they were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result"); Penrod v. Commissioner, 88 T.C. 1415, 1429 (1987) ("[T]he step transaction doctrine will be invoked if it appears that a series of formally separate steps are really prearranged parts of a single transaction intended from the outset to reach the ultimate result.").
tions created by one transaction would have been fruitless without completion of the series."235 The binding commitment test would not apply to Driver because the taxpayer was not obligated to make the January 2 transfer. Similarly, it is unlikely that the mutual interdependence test would apply because the first gift would not have been "fruitless" without the second gift. The first gift was a completed gift that vested ownership in the donee. Thus, the court in Driver implicitly must have applied the end result test, determining that the short period of time that elapsed between the two gifts meant that the donor intended the separate gifts to be part of the same transaction.

The difficulty with applying the end result test to donative transfers, however, is that most donors probably intend to make additional gifts to donees since the donees are usually natural objects of the donor's bounty. Thus, application of the end result test could result in all gifts made over a period of years to a single donee being stepped together. Analogy to the corporate reorganization area suggests that subsequent gifts should be combined with a previous gift only where, at the time of the current gift, the taxpayer already had decided to make the subsequent gifts and the time between gifts was so short that it was unlikely that the subsequent gift was motivated by nontax considerations. In the corporate reorganization area, the Service has ruled that the step transaction doctrine will not apply to combine a series of steps where each step has independent economic significance and was taken for a valid business purpose.236 Independent economic significance should exist where the gift has affected the donor's beneficial interest.237 Moreover, "business purpose" would exist if the gifts are made to provide a smooth transition of management of a family business.238 In situations where the purpose of the gift is to effect a

235 American Bantam Car Co. v. Commissioner, 11 T.C. 397, 405 (1948), aff'd per curiam, 177 F.2d 513 (3d Cir. 1949), cert. denied, 339 U.S. 920 (1950); Redding v. Commissioner, 630 F.2d 1169, 1177 (7th Cir. 1980) (declining to integrate issuance and subsequent exercise of stock warrants under step transaction doctrine because issuance of warrants had independent economic significance), cert. denied, 450 U.S. 913 (1981); Culligan Water Conditioning of Tri-Cities, Inc. v. United States, 567 F.2d 867, 869 n.2 (9th Cir. 1978) (noting that court "should remain free to examine all the facts in order to determine whether there exists a plan or agreement to dispose of control regardless of the formalities with which the parties may choose to clothe their intentions").

236 See Rev. Rul. 79-250, 1979-2 C.B. 156, 157 (respecting independence of (1) creation of two controlled subsidiaries to obtain product liability insurance at reasonable rates; (2) merger of unrelated target into one subsidiary to obviate leasing of land and facilities; and (3) reincorporation of parent corporation in another state to reduce corporate tax); cf. Rev. Rul. 83-38, 1983-1 C.B. 77, 77 (integrating steps of a transaction in which an unrelated corporation made a tender offer for parent company stock and then acquired subsidiary's stock in exchange for parent company stock).


smooth transition, whether sufficient time between gifts has elapsed should be measured in terms of the gift's role in effectively transferring the business from one generation to the next.

Gifts also may be made where transferring control is not the motivation and, therefore, a valid business purpose does not exist. In these circumstances, a comparable standard, "altruistic purpose," should apply to determine when gifts should be stepped together. The economic literature suggests that donors make gifts in order to induce the donee to perform services\textsuperscript{239} in exchange for the gift, to obtain the "warm glow" attendant to the act of giving or to enhance the well-being of progeny.\textsuperscript{240} The first two motivations indicate that gifts beyond a relatively short period of time should not be stepped together because it is likely that such gifts are supported by independent altruistic purposes; that is, the donor is making a series of gifts in order to induce the donee to continue to perform services or to receive the warm glow. Moreover, the third motivation, to enhance well being of progeny, would suggest that changed financial circumstances of the donee would support gifts separated by a relatively short period of time.

The second context in which the step transaction doctrine has been used to deny a minority discount is where the actions of the donors indicate that they intended to act together to retain control or where the donees at the time of the gift already planned to sell control jointly. In \textit{Blanchard v. United States},\textsuperscript{241} the court refused to apply a minority discount for the donor's gifts of minority interests in a family-owned corporation to her children where the family sold all the stock to a single buyer less than three weeks later. The court noted that the sale was being negotiated at the time the gifts were made.\textsuperscript{242}

\textsuperscript{239} The "services" might include weekly visits, helping in household chores and the like.

\textsuperscript{240} The term "altruism" might include weekly visits, helping in household chores and the like.

\textsuperscript{241} 291 F. Supp. 348 (S.D. Iowa 1968).

\textsuperscript{242} Id. at 352.
Similarly, in *Estate of McMullen v. Commissioner*, the Tax Court disallowed a minority discount for the decedent’s beneficial interest in an undivided interest in real estate where the instrument forming the trust that held the land directed that the land be sold as a single parcel. The court stated that the trust instrument assured that the gifted beneficial interest would share in the control premium.

Another case in which a minority discount was not permitted is *Citizens Bank & Trust Co. v. Commissioner*. Four siblings transferred their respective shares of a wholly owned family corporation to four separate trusts. All the siblings were co-trustees of each trust and the siblings’ descendants were the beneficiaries. The court refused to allow a minority discount for each minority block of stock transferred to each trust because it felt that the four siblings had acted together to perpetuate control and so should be treated as one person who had made a single gift of all the stock of the corporation. Perhaps this puzzling holding is based on a belief that the identity of the co-trustees in each trust made it likely that all the stock would be sold as part of a control block and, therefore, a minority discount was not appropriate. As discussed earlier, although the courts frequently have refused to assume that donees would work in concert with other owners because of the willing buyer-willing seller standard, they have considered whether owners, other than the donee, would work with one another. The court in *Citizens Bank* implicitly may have determined that all the co-trustees, who were not donees and who had worked together in the past, would continue to work together in the future to maximize the value of the trusts.

In summary, the step transaction doctrine, like the substance-over-form doctrine, is not an effective tool to combat minority discounts. Planners may avoid the step transaction doctrine by providing suffi-
cient time between transfers and by structuring the gifts in such a way that a joint sale of the gifts is not inevitable.

C. Swing Vote

A third tool available to the Service to try to capture some of the value of an opportunity is "swing vote" valuation. Even though a block of stock may not represent majority ownership, it still may have disproportionately more value than a smaller block of stock because of the possibility of forming coalitions with other shareholders. The Service has ruled in a technical advice memorandum that it will consider "swing vote" attributes in valuing stock.251

Valuing the relative bargaining posture of a block of stock is difficult, however, because the value depends not only on the size of the block being valued but also on the distribution of the other shares.252 To date, only one court has applied the swing vote doctrine.253 In Estate of Winkler v. Commissioner,254 the Tax Court found that swing vote value existed where a decedent owned 10% of the stock of a closely held corporation, members of one family held 50%, and members of another family held 40%. Although the record did not dis-

251 T.A.M. 9436005 (May 26, 1994).
252 Pratt et al., note 61, at 527, states:
If one person owns 49 percent of the stock and another owns 51 percent, the 49 percent holder has little or no control of any kind; however, if two stockholders own 49 percent each and a third owns 2 percent, the 49 percent stockholders may be on a par with each other, depending on who owns the other 2 percent. The 2 percent stockholder may be able to command a considerable premium over the pro rata value for that particular block of stock because of its swing vote power.

If each of three stockholders or partners owns a one-third interest, no one has complete control, but no one is in a relatively inferior position, unless two of the three have close ties with each other, which are not shared by the third. Normally, equal individual interests are each worth less than a pro rata portion of what the total enterprise would be worth, so that the sum of the values of the individual interests is normally less than what the total enterprise could be sold for to a single buyer. However, the percentage discount from pro rata value for each of such equal interests would not normally be as great as for a minority interest that had no control whatsoever.

Each situation has to be analyzed individually with respect to the degree of control, or lack of it, and the implications for the value of the minority interest. See also Desmond & Kelley, note 38, at 234 (stating that if minority block would enable another minority holder to achieve majority with control, or if minority were needed to reach percentage of ownership needed to merge or file consolidated statements, stock would have added value).

253 Two other cases have briefly discussed the concept. See Estate of Davis v. Commissioner, 37 T.C.M. (CCH) 341, 345 (1978) (criticizing expert witness for failing to consider swing vote value of block of stock); Estate of Bright v. United States, 658 F.2d 999 n.9 (5th Cir. 1981) (referring to swing vote concept).
254 57 T.C.M. (CCH) 373 (1989).
close the configuration of ownership among the families, the court concluded that a 10% premium should be added to the value of the stock that had been determined as though the stock were minority stock with no swing vote value. The court explained the "swing vote" value as follows:

This 10 percent block of voting stock could become pivotal in this closely held corporation, where members of one family held 50 percent and members of another family held 40 percent. By joining with the . . . family [which held 50%], a minority shareholder could effect control over the corporation and by joining the . . . family [which held 40%], such a minority shareholder could block action.

There are two defects in the Winkler court's reasoning. First, by aggregating the stock ownership of members of each family to create two family units, the court engaged in family attribution, which it has rejected as too speculative in the context of measuring control. Second, the concept of swing value assumes that the owner of the stock being valued will be able to form a coalition with other stockholder groups. An analysis of the likelihood of such a coalition is also very speculative.

1. Game Theory

Game theory, a form of analysis that helps to understand how coalitions are built, illuminates the problems with the Winkler analysis. To illustrate the applicability of game theory, consider a variation of the classic prisoner's dilemma hypothetical. Suppose that A and B have each been given 50% of the stock of a company. If A and B cooperate in selecting a highly skilled management team, their respective blocks of stock each will be worth $100. If, however, A exploits the corporate assets for his personal benefit, to the extent permitted by law, while B does not engage in exploitive behavior, A's stock will be worth $120 while B's stock will be worth $50. If both A and B engage in exploitive behavior, each will own stock worth only $50. Thus, the possible outcomes are:

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255 Id. at 382.
256 Id. at 383.
257 Id. at 381.
258 This example is based on a variation of the prisoner's dilemma described in David M. Kreps, Game Theory and Economic Modeling 28-30 (1990).
### Player A

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<th>Exploit</th>
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<tr>
<td>Cooperate</td>
<td>A=$100, B=$100</td>
<td>A=$50, B=$120</td>
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<tr>
<td>Exploit</td>
<td>A=$120, B=$50</td>
<td>A=$50, B=$50</td>
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Note that each player will have either $100 or $50 if he cooperates, or $120 or $50 if he exploits. Under classic game theory, if we assume that A and B cannot make credible commitments to each other, A and B each will decide to exploit rather than cooperate because the expected gain is higher. This results in the irony of the Prisoner’s Dilemma, because, by each electing to engage in exploitative behavior, both players end up with only $50. In contrast, had they both elected to cooperate, each would have had $100.

This situation arises when the parties cannot make credible promises to each other, or enter into enforceable agreements with one another.259 A commonly accepted hypothesis of game theory is that the more participants involved in a transaction, the more difficult it becomes to create credible commitments.260 Thus, the court in Winkler, by aggregating the members of the two families that held the 40% block and 50% block, increased the probability that either block could make a credible commitment to the owner of the 10% block. This, of course, also would increase the value of the 10% block.

Game theory also reveals, however, that to calculate the actual swing vote value of a block of stock, the courts will have to analyze the shareholders’ relationship to one another. The concept of swing vote in game theory is captured in an index, either the Shapley-Shubik Power Index or the Banzhaf Swing Probability Index. In very general terms, the Shapley-Shubik Power Index measures the percentage of permutations in which a given shareholder contributes to that permu-

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259 See Anatol Rappaport, Prisoner's Dilemma—Recollections and Observations, in *Rational Man and Irrational Society?: An Introduction and Sourcebook* 72, 80-81 (Brian Barry & Russell Hardin eds., 1982) (noting that enforceable agreements “would turn the non-cooperative game into a cooperative game”); John C. Coffee, Jr., Unstable Coalitions: Corporate Governance as a Multi-Player Game, 78 Geo. L.J. 1495, 1537 (1990) (“[I]f the various sides in a complex negotiation over corporate control cannot make credible commitments to each other, the Prisoner’s Dilemma may arise.”).

260 See Cristina Bicchieri, Rationality and Coordination 236-37, 247 (1993) (doubting whether a norm of cooperation can emerge in a large population where “an individual’s choice has an insignificant impact on the collective outcome, and defection is likely to go undetected”); see also Mancur Olson, The Logic of Collective Action: Public Goods and the Theory of Groups 2, 36 (1968) (stating that the larger the group, the less likely the group will act to achieve groups interests). But see John Chamberlin, Provision of Collective Goods as a Function of Group Size, 68 Am. Pol. Sci. Rev. 707, 715 (1974) (arguing that while large groups may perform suboptimally relative to small groups, they in certain circumstances may still be effective).
1995] MINORITY DISCOUNTS 465

tation obtaining a majority vote.261 The Banzhaf Swing Probability Index measures the proportion of combinations in which a given shareholder contributes to that combination obtaining a majority vote.262 One of the significant distinctions between the two indices is that, since the Shapley-Shubik Index considers permutations of shareholders, in effect, it considers the order in which shareholders join the coalition.263 It measures a shareholder's power based upon the frequency in which the shareholder is able to affect the outcome as the last member to join a coalition and to cause that coalition to obtain a majority.264 In contrast, the Banzhaf Index disregards ordering and simply measures the proportion of combinations of shareholders that have a majority in which a particular shareholder participates.265

Game theorists recognize that the indices make no contribution in measuring the value of a block's swing vote feature unless assumptions are made about the costs of forming various coalitions.266 They are, however, pessimistic about quantifying the costs. One game theorist has stated:

These costs depend on the capacity of leading shareholders to collude and depend on sociological as well as organizational factors. They are probably unquantifiable in practice even with good quality shareholding data or in a case study. However, qualitative statements about them can be made. They will be considerably reduced by personal contact which allows the perception and pursuit of common interests. Thus they will be lower for a coalition which contains members of the same family or associated families than for one consisting of unrelated individuals.267

Family members have an advantage in forming coalitions because group members are more likely to make credible promises when they have a history of dealing with one another and are likely to continue

262 Shubik, note 261, at 202; Leech, Relationship, note 261, at 510-12; Leech, Ownership, note 261, at 228.
263 Shubik, note 261, at 203-04; Leech, Relationship, note 261, at 511.
264 See Shubik, note 261, at 203 ("[T]he probability model for the Shapley-Shubik index considers all possible orders in which a vote can take place.").
265 Id. at 202.
266 Leech, Ownership, note 261, at 231-32.
267 Id.
to do so in the future.\textsuperscript{268} Repeated contact allows the creation of credible commitments because nonexploiters are able to retaliate in the future against a person who breaks the commitment.\textsuperscript{269} Some commentators also have asserted that homogeneity in preferences is another factor likely to result in a stable coalition.\textsuperscript{270} Because of shared experiences, family members probably are more likely to have similar preferences.

This learning from game theory has an interesting implication for the current state of law. It shows that in order to determine a realistic swing vote value, the courts must explore two sets of relationships: (1) the relationship of a donee or legatee to the other owners and (2) the relationship of the other owners to one another. The proscription of the willing buyer-willing seller rule that the identity of the transferee cannot be considered means that it will be difficult, if not impossible, to measure swing vote value because the relationship of the transferee to the other owners cannot be considered. Thus, after closer scrutiny, the courts should reject the legitimacy of swing vote value so long as the willing buyer-willing seller rule exists.

If the courts, however, continue to consider swing vote value, there is a distinct possibility that this will result in lower valuations, not higher valuations, as the Service hopes. This will occur if the courts do not focus on the relationship of the transferee to the other owners because of the willing buyer-willing seller rule, but instead focus solely on the relationship of the other owners to each other. The focus on the relationship of the other owners can cause the court to conclude that the other owners will form coalitions. This will further diminish the value of the transferee's stock because, rather than merely being one of several minority owners with no one exerting control, the transferee would be the only minority shareholder with no hope of joining a control coalition.

\textsuperscript{268} Robert Axelrod, The Evolution of Cooperation 126-32 (1984) (noting that implicit threats of retaliation may promote cooperation if parties will interact frequently in future); Kreps, note 258, at 65-71 (explaining how incentive to protect one's reputation restraints exploitation of opponent); Marleen A. O'Connor, The Human Capital Era: Reconceptualizing Corporate Law to Facilitate Labor-Management Cooperation, 78 Cornell L. Rev. 899, 928-31 (1993) (noting that "interpersonal trust" is necessary for party to provide credible commitments).

\textsuperscript{269} See Kreps, note 268, at 66-70, (explaining that exploited employee may ruin employer's reputation, requiring employer to pay premium wages to attract new employees); O'Connor, note 268, at 927 ("The combination of the fear of retaliation for defecting and the prospect of future benefits from cooperating may cause the players to reach a mutually beneficial solution.").

\textsuperscript{270} See Gabrielle Demange, Intermediate Preference and Stable Coalition Structures, 23 J. Mathematical Econ. 45, 45-46 (1994) ("[T]hose who are close together either in their location or in their revenues or in their tastes form subcoalitions.").
One court already has employed such reasoning. In Moore v. Commissioner,271 the Service argued that no minority discount should be allowed for an interest in a partnership in which several of the other partners were related because there was no majority partner. The Tax Court stated, “we believe that a hypothetical buyer would realize that the other partners were all related and thus, in effect, a majority interest.”272 Although the Service’s argument that no minority discount should be allowed where there are no majority partners is incorrect,273 the court’s willingness to treat the related partners as one control coalition resulted in a discount larger than what otherwise would have been available.

If the courts follow the course set in Moore, there will be an even greater schism between the value of a transferred asset to the transferee and the value for estate and gift tax purposes. The courts will not consider the value added by virtue of the transferee being able to participate in coalitions because of the willing buyer-willing seller rule, but, at the same time, the courts will consider the negative effect of the other shareholders participating in coalitions against the transferee.

**D. Summary**

In summary, the current tools available to the Service to address the transfer of control are woefully inadequate. Swing vote value, once fully understood by the courts, may actually increase the size of a minority discount. The substance-over-form and step transaction doctrines will help only in limited situations. The failure of these remedies is attributable to the willing buyer-willing seller standard. Because the standard precludes consideration of the relationship of the transferee to the other owners, the Service and the courts cannot consider the likelihood that the transferee will be able to enter a control coalition.

**VII. A Tax Policy Critique of the Statutory and Judicial Responses**

**A. Introduction**

The reluctance of the courts and the legislature to tax the transfer of the opportunity to recombine control creates a significant discontinuity...
ity between the gift and estate taxes. A taxpayer can avoid the inclusion of the control premium in her estate simply by making lifetime transfers to the same individuals to whom she would have bequeathed the stock.

The discontinuity suggests that either the opportunity to participate in control should be eliminated from the estate tax base where the decedent's bequest divides control among several legatees or, conversely, that the value of the opportunity should be included in the gift tax base where the donor divides control by inter vivos gifts. The gift tax base currently does not include the transfer of other types of opportunities. For example, it generally is thought that parents may direct business opportunities to children without incurring a gift tax liability.274 Similarly, it generally is accepted that providing free advice and guidance is not subject to a gift tax.275

The exclusion of transfers of business opportunities or personnel services from the gift tax, however, does not necessarily support the exclusion of transfers of the opportunity to participate in control from the gift tax. Transfers of business opportunities and services are distinguishable from transfers of control opportunities because the former normally can occur only as inter vivos gifts, not as bequests by a decedent. To the extent that the gift tax exists to serve as a backstop to the estate tax, it may make sense to exclude transfers from the gift tax base that could not be made in a decedent's will and that may be particularly difficult to value.276 For example, transferring to children opportunities to conduct business with a third party can occur only while the parent is able to persuade the third party to conduct busi-

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275 5 Bittker & Lokken, note 12, ¶ 121.3.6; Caron, note 274, at 356, 358-59; Dodge, Rethinking, note 117, at 205; Gingiss, note 274, at 402-03. In Commissioner v. Hogle, 165 F.2d 352, 353-54 (10th Cir. 1947), the court held that services rendered by the settlor of a trust to the trust in managing the trust's investments were not taxable gifts. Courts subsequently have cited Hogle as holding that the rendition of free services is not subject to the gift tax. See, e.g., Crown v. Commissioner, 585 F.2d 234, 236 n.6 (7th Cir. 1978); Estate of Childers v. Commissioner, 10 T.C. 566, 579-80 (1948); see also Rev. Rul. 70-237, 1970-1 C.B. 20 (ruling executor's waiver of fee does not result in taxable gift); Rev. Rul. 66-167, 1966-1 C.B. 13 (ruling trustee's waiver of increase in statutory commission does not result in taxable gift). It could be argued that the inter vivos gift of advice should be subject to the gift tax to the extent that the gift tax serves as a back stop to the estate tax. For example, suppose a parent has an estate of $1,000. He can work and earn $100 after tax and bequeath $1,100 to his child, who will then use $100 for business advice. Conversely, he can provide the business advice for free himself, and his estate will be taxed on only $1,000. Such advice should not be subject to the gift tax, however, because it is difficult to value, and would represent too great a governmental intrusion on personal relationships.

276 See Gingiss, note 274, at 399.
ness with the children. It is unlikely that the parent could cause such a transfer to occur at death, because the parent's influence probably would terminate at death. Similarly, rendering advice or other personal services to children usually will occur only while the parent is alive. Because advice must be altered as circumstances change, it would be difficult to render valuable advice in a will. In contrast, by careful selection of the transferees, it is possible for a person who owns a controlling interest in property to create in a will, or through inter vivos gifts, circumstances that will make it highly probable that transferees of minority interests will participate in control. By selecting legatees who can work together, the decedent can make it likely that the transferees will share control even though she will not be present to guide them or cajole them.

Over the past 20 years, several proposals have been offered for including the opportunity to participate in control in the gift tax base. These proposals have not been accompanied by a rigorous tax policy analysis using the traditional tools of efficiency and equity. These tools are controversial unless their underlying assumptions are explicitly identified and employed in the analysis.

B. Efficiency

Efficiency can have several different meanings depending on the context in which it is used. For purposes of analyzing whether the transfer tax base should include the transfer of the opportunity to participate in control, I define efficiency in two ways. First, the allocational inefficiency of the disparate treatment should be considered. For purposes of this Article, allocational inefficiency is defined as the extent to which individuals alter their economic behavior so as to avoid paying tax. Second, the administrative costs of including or excluding such opportunity from the tax base should be considered.

277 See Section III.A.


279 See Treasury Dep't, Blueprints for Basic Tax Reform 49 (1977); John F. Witte, The Politics and Development of the Federal Income Tax 30 (1985); McCaffery, note 278, at 1293; Zelinsky, note 278, at 980-86.
1. Allocational Inefficiency

The current discontinuity between the gift and estate tax treatment may create a significant allocational inefficiency if it encourages taxpayers to divide ownership of their companies or other assets in order to reduce transfer taxes in situations where they otherwise would not have done so. This allocational inefficiency would decrease social welfare to the extent the decline in value achieved for gift tax purposes by dividing up an asset reflects a real economic decline in value rather than a transformation of the value.280

In order to determine whether the discontinuity between the gift and estate taxes distorts the behavior of donors, it is first necessary to engage in the difficult, if not impossible, task of determining what motivates gifts and bequests.281 The economic literature suggests that lifetime gifts are made because the act of giving increases the donor’s utility by an amount greater than the donor’s decline in utility resulting from the transfer of wealth to the donee.282 There are several sources of the increase in utility that are not related to taxes. They may include the expectation that the donee will perform services in exchange for the gift283 or the “warm glow” attendant to the act of giving284 or enhancing the well being of progeny.285

Counterbalancing the utility of lifetime gifts are several nontax sources of disutility. The disutilities are attributable to the fact that the reduction in wealth of the donor may have several negative implications. First, to the extent the donor expects services in exchange for the gift, the donor will have lost some leverage to enforce his expectation because the gift already has been made.286 Second, the gift will have reduced the opportunity to have deployed the gifted assets in

280 There always should be some diminution of real economic value when ownership is divided up among donees because, regardless of the relationship among donees, some transactional costs will have to be incurred to recombine control.


283 See, e.g., Altonji et al., note 240; Bernheim et al., note 240, at 1046-47; Donald Cox, Motives for Private Income Transfers, 95 J. Pol. Econ. 508, 540 (1987); Donald Cox & Mark R. Rank, Inter-Vivos Transfers and Intergenerational Exchange, 74 Rev. Econ. & Stat. 305, 310 (1992).


286 See Gary S. Becker & Kevin M. Murphy, The Family and the State, 31 J. Law & Econ. 1, 7 (1988).
another manner, such as consumption or generating more wealth.\textsuperscript{287} Third, to the extent the lifetime gifts resulted in the donor relinquishing control, the donor will have given up the premium associated with control.

In addition, there are several tax considerations. The current estate and gift tax regimes favor inter vivos gifts over bequests. First, annual gifts of $10,000 or less by a donor to each donee are excluded from the gift tax.\textsuperscript{288} This means that spouses can make combined gifts of $20,000 per donee on a tax-free basis each year. Second, gifts in excess of $10,000 nevertheless may not be taxable because the unified credit has the effect of allowing each donor to make an additional $600,000 of gifts during the donor's lifetime on a tax-free basis.\textsuperscript{289} Although inter vivos gifts exceeding the $10,000 annual exclusion reduce the amount of the $600,000 unified credit that will be available to allow bequests to escape estate taxation, inter vivos gifts are preferable if the gifts are expected to increase in value. For example, a parent could minimize estate and gift tax consequences by making a gift of an asset currently worth $600,000 that is expected to be valued at $1 million by the time of her death. The current gift would be tax-free because of the unified credit whereas a bequest of the asset would subject $400,000 of the bequest to the estate tax. Third, the gift tax is applied only to the amount transferred by gift, exclusive of amounts used by the donor to pay the gift tax.\textsuperscript{290} In contrast, the estate tax applies to all property transmitted at death, including property used to pay the estate tax. Thus, a donor can transfer more assets through inter vivos gifts than by bequests. For example, suppose that an individual has $150 and is subject to estate and gift tax rates of 50%.\textsuperscript{291} If she makes a lifetime gift, the donor can transfer $100 to the donee and pay the gift tax with the remaining $50. If, instead, she dies holding $150, her estate would pay an estate tax of $75, leaving only $75 for the donee. Fourth, as discussed above, properly structured inter vivos gifts allow donors to avoid paying a transfer tax on the control premium associated with closely held companies or other assets.

Somewhat counterbalancing the incentive for inter vivos gifts in the estate and gift tax is a disincentive in the income tax. If a donor dies holding an asset that has appreciated in value, the asset will obtain a

\begin{itemize}
\item \textsuperscript{287} This is the opportunity cost of the gift.
\item \textsuperscript{288} IRC § 2503(b). Only a gift of a "present interest" in property qualifies for the exclusion.
\item \textsuperscript{289} IRC § 2010(a) (granting $192,800 credit against estate tax).
\item \textsuperscript{290} IRC § 2035(c).
\item \textsuperscript{291} This example is from 5 Bittker & Lokken, note 12, at 120-12.
\end{itemize}
basis step up to its fair market value for federal income tax purposes. All appreciation in the asset up to the date of the owner's death will escape income taxation forever. In contrast, where an asset is transferred as an inter vivos gift, the basis of the asset usually is the same in the hands of the donee as it was for the donor. Thus, if the donee sells the asset during her lifetime, she will be taxed on the appreciation that accrued while the asset was held by the donor.

Because of these countervailing forces, it is clearly difficult to measure the allocational effect of the current treatment of minority discounts. While it seems reasonable to assume that, at the margin, the ability to avoid transfer taxes on control premiums would encourage more lifetime gifts of minority interests than otherwise would occur, it is difficult to assess the magnitude of the response. Moreover, it is also difficult to determine whether this impact at the margin has caused a significant decrease in social welfare. The economic literature generally supports the notion that companies with concentrated ownership perform better than companies with dispersed ownership. There is, however, no empirical evidence that companies controlled by a single shareholder perform better than companies controlled by a small group of owners. One study that compared a sample of corporations in which no shareholder owned more than 20% of the stock with a sample of corporations in which a single stockholder owned a majority of stock found that the mean "accounting rate of return" for the sample where a shareholder owned a majority of stock was 10.2% while only 8.7% for the other group. The results lacked statistical significance, however. It is possible, therefore, that the only adverse impact of the current status is the costs that minority owners will incur in forming a control coalition.

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292 IRC § 1014(a). This step up in basis is thought to be a significant factor in deterring older taxpayers from selling appreciated assets. See Yolanda K. Henderson, Capital Gains Rates and Revenues, 1989 New Eng. Econ. Rev. 3, 10 (Jan.-Feb.); Donald W. Kiefer, Lock-In Effect Within a Simple Model of Corporate Stock Trading, 43 Nat'l Tax J. 75, 84 (1990). There are no studies, however, that attempt to quantify the effect of the step up on inter vivos gifts.

293 IRC § 1015(a).


296 Id. at 343.
2. **Administrative Costs**

The analysis of the administrative costs of including an opportunity to participate in control in the gift tax base is comparative. The administrative costs of including the opportunity in both the gift and estate tax base are compared to (1) the administrative cost under the current regime of only including the opportunity in the estate tax base and (2) the administrative cost of not taxing the opportunity at all. The analysis considers the inclusion of the opportunity in the estate and gift tax bases in two forms. The first automatically assigns a portion of the control premium pro rata to minority interests that are transferred by a majority owner where the transferor and family members control the entity or assets both before and after the transfer. This is a form of irrebuttable presumption analogous to the type currently used by chapter 14 in narrow circumstances. The second form is a rebuttable presumption that assigns a portion of the control premium but allows the transferee to show that he will not participate in control. Table 1 summarizes the results. An irrebuttable presumption that includes the control opportunity in both the estate and gift tax bases would result in the lowest administrative costs as compared to the current regime.

<table>
<thead>
<tr>
<th>Exclude Opportunity from Estate and Gift Tax Base</th>
</tr>
</thead>
<tbody>
<tr>
<td>Irrebuttable Presumption</td>
</tr>
<tr>
<td>Gift Tax</td>
</tr>
<tr>
<td>Estate Tax</td>
</tr>
</tbody>
</table>

An irrebuttable presumption used to tax the transfer of the opportunity to participate in control would decrease the cost of administering the gift tax because it would relieve the courts, the Service and taxpayers of the obligation to calculate the amount of the minority discount. Instead, they simply would calculate the value of the donor's control block and assign a pro rata portion of that value to the portion transferred by the donor. They could omit the additional step of then calculating the size of the minority discount. The costs of calculating the estate tax should remain unchanged since this is the process that already is used. The estate tax values all the decedent's

297 See text accompanying notes 122-23, 142-44.
interests regardless of the manner in which the interests are divided up among legatees or heirs.

The rebuttable presumption would increase the cost of administering both the estate and gift taxes as compared to the current regime. The courts, Service and taxpayers would be required to explore the relationship of the transferee to the other owners and the relationship among the other owners in order to determine whether the presumption that the transferee would participate in control can be rebutted. Since the courts currently do not examine the relationship of the transferee to the other owners, this determination would increase the quantity of analysis required for both the estate and gift tax.298

Excluding the control opportunity from both the estate and gift tax base also would have the effect of increasing costs but not by as much as the rebuttable presumption. The costs of calculating the gift tax would remain unchanged since the gift tax base currently excludes the value of control opportunities. The costs of calculating the estate tax for the courts, Service and taxpayers, however, would increase. While under the current scheme, there is no need to calculate the minority discount for each bequest, under this alternative, they would have to calculate the minority discount for each bequest of a minority interest.

C. Equity

Equity usually is analyzed from two perspectives: horizontal equity and vertical equity. Horizontal equity examines whether similar taxpayers are treated similarly.299 Vertical equity seeks to insure that an "appropriate" distinction is made in the treatment of people who are dissimilar.300 Frequently, scholars view horizontal equity and vertical equity as asking the same question. Professor Musgrave pointed out that "[w]ithout a scheme of vertical equity, the requirement of horizontal equity at best becomes a safeguard against capricious discrimination [among equals]—a safeguard which might be provided equally well by a requirement that taxes be distributed at random."301 Scholars who view horizontal equity and vertical equity as asking different questions disagree about whether horizontal equity and vertical equity should be given equal weight. Some have suggested that horizontal equity should be given no weight independent of vertical equity be-

298 See text accompanying notes 155-63.
300 Kaplow, Measures, note 299, at 140; Musgrave, Horizontal Equity, note 299, at 113.
cause it lacks a normative base and whatever reasons support making a distinction among dissimilar taxpayers will require that identical taxpayers be treated in an identical manner.\(^{302}\) Others argue that horizontal equity should be given equal or, perhaps, greater weight because most formulations of distributive justice agree that equals should be treated equally.\(^{303}\) In contrast, most forms of distributive justice do not agree about the "appropriate" distinction to make among unequals.\(^{304}\)

Other scholars have suggested that horizontal equity, to the extent it merely asks whether equals are treated equally, and vertical equity, to the extent it merely asks whether an appropriate distinction is made among unequals, are not useful analytical tools.\(^{305}\) Horizontal equity used in this manner lacks normative content because its conclusion, that similar taxpayers should be treated similarly, is a tautology.\(^{306}\) Once one determines the criteria to use to ascertain whether two taxpayers are alike, one knows how they will be treated.\(^{307}\) Thus, the principle that similar taxpayers should be treated similarly is useless. The useful analytical inquiry is instead what criteria should be used to define the tax base.\(^{308}\) Similarly, the fundamental issue for vertical equity becomes which view of distributive justice and which economic assumptions will motivate the "appropriate" distinction in the treatment of unequals.\(^{309}\)

This Article adopts this latter view that the useful inquiry under horizontal equity pertains to the appropriate definition of the tax base and under vertical equity relates to the "appropriate" distinction to make among unequals. In order to determine the appropriate tax base and distinction to make among unequals in designing transfer

\(^{302}\) Kaplow, Measures, note 299, at 143.
\(^{303}\) Musgrave, Horizontal Equity, note 299, at 116-17.
\(^{304}\) Id.
\(^{309}\) See Griffith, note 305, at 1158; McDaniel & Repetti, note 306, at 613.
taxes, it is necessary to determine their purpose or purposes. The formulation of the tax base and appropriate distinction among unequals should be those that best achieve the objectives of the transfer taxes.

Policymakers have not agreed about the fundamental objectives of transfer taxes. Indeed, many have asserted that they should be repealed.310 I do not consider the repeal of the estate and gift taxes but instead assume their continuation and identify their objectives in order to determine whether the tax base should include the transfer of the opportunity to participate in control and what distinction should be made among unequals.

The estate and gift tax may seek to achieve four objectives: (1) to raise revenues, (2) to increase the progressivity of the income tax, (3) to prevent concentrations of wealth in a small segment of society and (4) to prevent families from establishing dynasties. Taxes on the transfer of wealth at death originally were imposed primarily to produce revenue during times of crisis.311 Death taxes were assessed in 1797 out of concern about deteriorating relations with France,312 in 1862 to fund the Civil War,313 in 1898 to finance the Spanish American War,314 and in 1916 to finance World War I.315 Prior to World War I, Congress repealed the tax each time the crisis passed.316 After World War I, the estate and gift taxes became permanent, although they have not contributed significantly to tax revenues. For example, in 1990 the estate and gift taxes contributed only 1.12% of total federal government receipts.317


312 Act of July 6, 1797, ch. 11, § 1, 1 Stat. 527, made effective on July 1, 1798 by Act of Dec. 15, 1797, ch. 1, § 1, 1 Stat. 536; see Eisenstein, note 311, at 225.


316 Eisenstein, note 311, at 225-30.

317 Office of Management and Budget, Budget of the United States Government, Fiscal Year 1992: Historical Tables, tbls. 1.1, 1.3, 2.5; see McCaffery, Uneasy Case, note 310, at 301.
The estate and gift taxes were continued, in part because the justification for the tax began to shift from merely raising revenue to also restricting large concentrations of wealth.\textsuperscript{318} In 1935, President Roosevelt justified proposed changes that would have increased the scope of the then existing transfer taxes by stating that large accumulations of wealth "amount to the perpetuation of great and undesirable concentration of control in a relatively few individuals over the employment and welfare of many, many others."\textsuperscript{319} Subsequent proponents of a transfer tax have continued to cite the role of the tax in preventing large concentrations of wealth as an important reason for its existence.\textsuperscript{320}

Using transfer taxes to prevent concentrations of wealth has been controversial, however. Studies suggest that the percentage of total wealth in the United States that is held by the richest 1\% varied very little through the 20th century up to 1982 and then increased through 1992.\textsuperscript{321} A significant difficulty in determining the usefulness of the estate and gift taxes in reducing the concentration of wealth is that it is not clear to what extent inherited wealth contributes to the concentration of wealth. The empirical estimates of wealth transferred from generation to generation vary widely based upon the measurements of inherited wealth that they employ. For example, Professor Modigliani argues that only 20\% of the aggregate of wealth in the United States is transferred intergenerationally using a measurement that excludes from transferred wealth income earned by a donee on the inherited wealth after inheritance and also excludes amounts paid for college tuition.\textsuperscript{322} The remainder is generated by individuals during their lifetimes.\textsuperscript{323} Another model that treats income on inherited wealth as itself inherited and treats a parent's payment of college tuition as transferred wealth concludes that approximately 78\% of a genera-

\textsuperscript{318} Eisenstein, note 311, at 235-38.


\textsuperscript{322} Aaron & Munnell, note 321, at 125-27; Graetz, note 321, at 271; Franco Modigliani, The Role of Intergenerational Transfers and Life Cycle Saving in the Accumulation of Wealth, 2 J. Econ. Perspectives 15, 29-32 (1988); Wolff, note 321, at 352.

\textsuperscript{323} Modigliani, note 322, at 29.
tion's wealth is inherited. A third study that treats income on inherited wealth as transferred, but excludes college tuition, suggests that 52% of wealth is inherited. Potentially significant sampling biases in the data further complicate the analysis.

Another objective of the estate and gift tax may be to prevent the concentration of wealth in the same families over a number of generations, in other words, to prevent the establishment of family dynasties. Statistics about the concentration of wealth would be irrelevant because although wealth would remain concentrated in the top 1% of the population, that 1% might consist of different families at different times. The estate tax therefore may still serve a useful purpose by preventing families from establishing dynasties even though it has little impact on the aggregate concentration of wealth. Concern about preventing the concentration of wealth and, therefore, political power in select families parallels the concern that has shaped American policy towards financial institutions. Professor Mark Roe has argued that the United States historically has sought to prevent the concentration of wealth in financial institutions due to a concern about the distortive efforts that the power of such institutions might have on the democratic process. Proponents of replacing the estate and gift tax with a consumption tax have not focused sufficiently on the usefulness of the transfer tax in preventing the disproportionate concentration of political power in specific families. Families possessing large amounts of wealth can exercise disproportionate political influence in a community without engaging in conspicuous consumption that would be subject to a consumption tax by virtue of their selection of investments and decisions about which factors of production they will employ.

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325 Aaron & Munnell, note 321, at 131.
329 See McCaffery, Uneasy Case, note 310.
330 See Roosevelt's Message, note 319, at 643 (stating that accumulations of wealth result in "concentration of control in relatively few individuals").
Finally, although an objective of transfer taxes may be to increase the progressivity of the income tax, the extent of their contribution is not clear. The contribution of the estate and gift tax to progressivity of the income tax is measured by comparing the amounts of estate and gift tax paid by high income individuals to the amount of income taxes paid by high income individuals that is in excess of the amounts that the individual would have paid using the average tax rate for all individuals.

For example, Professor Michael Graetz calculated that in 1970, high income individuals paid $12.5 billion of income tax in excess of what they would have paid using the average tax rate for all individuals. He also determined that high income individuals paid a total of $3.7 billion in estate and gift taxes in 1970. Thus, he concluded that in 1970, the estate and gift tax increased the progressivity of the income tax by approximately 30%. He calculated that in 1972, the estate and gift tax made a similar contribution to the progressivity of the income tax. Professor Harry Gutman, however, predicted that after the enactment of the Economic Recovery Tax Act of 1981, which significantly reduced the effective rate of the estate and gift tax, transfer taxes probably would contribute approximately only 4% as much to the progressivity of our tax structure as the income tax. Moreover, one economist has argued that the estate tax may result in a net decline of income and estate tax revenues because it motivates taxpayers to enter into transactions, such as charitable contributions, that decrease the amount of income taxes collected by more than the amount of estate taxes collected. If this assertion is true, the estate tax would not contribute to the progressivity of the income tax. The empirical evidence is weak, however, because of the unavailability of sufficient data.

331 Graetz, note 321, at 271-72; Gutman, note 320, at 1188-89.
332 Kotlikoff & Summers, note 324, at 706.
333 Graetz, note 321, at 272.
334 Id.
335 That is, $3.7 billion divided by $12.5 billion. Id.
336 Prior to ERTA, the maximum marginal tax rate was 70% and the unified credit amount was only $47,000. IRC §§ 1, 2010(a) (before amendment in 1981).
337 Gutman, note 320, at 1195. Professor Gutman also points out that his methodology probably understates the extent of the transfer tax's contribution to progressivity because, as the population increases, the number of estates paying an estate tax in the current year is less than the number of estates that will pay in future years. Thus, Professor Gutman concludes, "current transfer tax receipts underestimate the aggregate amounts accrued annually by the living to discharge future transfer tax liability." Id. at 1196.
339 Bernheim, note 338, at 132 ("I caution against attaching too much importance to any particular set of numbers... [A]vailable data simply do not permit precise calculations.").
Viewed in light of the foregoing objectives, the current gift tax base is clearly incorrect. The exclusion of the opportunity to participate in control from the gift tax base is inappropriate because it conflicts with the underlying policy objectives of the transfer taxes. The exclusion is inconsistent with preventing the establishment of dynasties and the concentration of wealth in a small percentage of the population because it provides a method for transferring more wealth. Moreover, the current treatment is inconsistent with raising revenues and increasing the progressivity of the individual income tax unless an increase in the effective gift tax rate would have the effect of reducing estate and gift or income tax revenues. An increase in the effective gift tax rate could reduce estate and gift tax revenue if the revenue loss arising from the substitution of leisure for wealth-generating activities by wealthy taxpayers was greater than the revenue gain from the increased effective tax on gifts. There is, however, no strong empirical evidence that this, in fact, would occur.\footnote{It is likely that a significant amount of inter vivos gifts are motivated by the fact that the effective tax rate on gifts is lower than the effective tax rate on bequests. See McCaffery, Uneasy Case, note 310, at 316-18. I am not aware of studies that quantify the elasticity of taxpayers' responses to increased gift taxes by substituting leisure for wealth-generating activities. See Thomas A. Robinson, The Federal Wealth Transfer Taxes—A Requiem? 1 Am. J. Tax Pol. 25, 29 (1982) (noting lack of studies). Calculation of this elasticity would be necessary to determine the revenue loss from an increase in the gift tax rate. If taxpayers merely decrease inter vivos gifts in response to an increase in the gift tax, but continue to generate wealth at the same rate as before, the decrease in gift tax revenues will be offset by the increase in estate tax revenues.} It is also possible that an increase in the effective gift tax rate could reduce income tax revenues and progressivity because it would cause a reduction in income tax revenues greater than the increase in estate and gift tax revenues.\footnote{See Bernheim, note 338.} Again, however, there is no strong empirical evidence for this possibility.\footnote{See note 339.}

The current scheme of excluding the opportunity to participate in control from the gift tax base also fails to make an appropriate distinction among unequals. The objectives discussed above would be achieved best where those transferring larger amounts of wealth paid disproportionately larger amounts of wealth transfer taxes than those transferring smaller amounts of wealth. The ability to minimize the estate tax by making inter vivos transfers allows taxpayers with large estates and access to the best advisors to reduce their tax liabilities and thereby avoid paying a higher percentage of their wealth in transfer taxes compared to taxpayers with smaller amounts of wealth. Thus, under the current rule, taxpayers with the largest amount of wealth pay a smaller percentage of their wealth in transfer taxes than taxpayers with smaller amounts of wealth.
wealth are more likely to establish family dynasties, preserve larger amounts of wealth and reduce the progressivity of the taxes.

The alternative exclusion of the control opportunity from both the estate and gift tax bases similarly would be inconsistent with transfer tax objectives. Elimination of the control opportunity would conflict with preventing dynasties or concentration of wealth in a small percentage of the population since it would allow individuals to transfer more wealth. Also, elimination would be inconsistent with raising revenues and increasing progressivity unless it would result in wealthy taxpayers generating disproportionately greater wealth by substituting wealth generating activities for leisure or would result in an increase in income tax revenues by causing taxpayers to decrease charitable contributions. There is no strong evidence that such a substitution or revenue effect would occur.343

In summary, including the control opportunity in the gift tax as well as the estate tax base is the best alternative for achieving the objectives of the transfer taxes. Expanding the gift tax base would help prevent the creation of dynasties and concentrations of wealth since it would increase the transferor's gift tax liability. Moreover, expansion of the gift tax base should increase revenues and contribute to progressivity, although the lack of data creates some uncertainty.

D. Recommendations

Although the objectives underlying the transfer taxes are more likely to be achieved if the transfer of an opportunity to participate in control is included in the gift tax base using either a rebuttable or irrebuttable presumption, the latter is a better choice. An irrebuttable presumption that denied minority discounts for estate and gift tax valuation where control of an asset has been divided among related individuals would improve administrative efficiency, as compared to the current treatment. In contrast, a rebuttable presumption would decrease administrative efficiency, as compared to the current treatment. Weighing against the administrative efficiency of the irrebuttable presumption is the possibility that the irrebuttable presumption occasionally would be overinclusive since it would not distinguish situations where the transfer of control was not likely due to, for example, hostility among owners. Given that a donor is not likely to destroy value by dividing up control of an asset among donees who cannot work together, the instances in which the irrebuttable presumption would be overinclusive are probably minimal. Moreover, this overinclusivity also may be offset partially by cases where it is underinclusive, in

343 See text accompanying notes 338-42.
other words, where an asset is divided among nonfamily members who will cooperate. Therefore, the administrative efficiencies created by an irrebuttable presumption should outweigh any harm caused by its overinclusiveness.

Some may be concerned that enacting an irrebuttable presumption would hinder the efforts of families to retain small businesses. Such a concern would be addressed better by directly providing transfer tax exemptions for the transfer of small businesses to family members, rather than by continuing the present irrational policy towards minority discounts. An exemption would allow families to determine who will control the business based upon sound management principles, not estate and gift tax considerations.

VIII. CONSTITUTIONALITY OF TAXING THE TRANSFER OF AN OPPORTUNITY TO PARTICIPATE IN CONTROL

This Section analyzes whether the recommended taxation of the transfer of an opportunity to participate in control would be constitutional. Article 1, Section 9 of the Constitution requires that a “direct” tax be apportioned among the states in proportion to their populations. If a tax on the transfer of an opportunity to participate in control constituted a “direct” tax, the burden of apportioning the tax among the states in proportion to their population would render it impractical. Although the precise line that distinguishes a direct tax from other taxes is not clear, the Supreme Court consistently has held that a tax imposed upon a particular use of property or the exercise of a single power over property incidental to ownership is an excise tax, not a direct tax. 344 Moreover, the Court has held that the gift and estate taxes are not direct taxes because they merely impose a tax on the transfer of property. 345

Gift taxes on the transfer of an opportunity to participate in control similarly could avoid classification as direct taxes if the transfer of such an opportunity qualifies as a transfer of “property.” In Dickman v. Commissioner, 346 the Supreme Court interpreted the term “property” for purposes of the gift tax to include the economic value of an interest-free loan. The Court explained that the transfer of a right to use property, such as cash, without paying any consideration for such use, is tantamount to the transfer of a property interest. 347

345 Bromley, 280 U.S. at 127 (gift tax); N.Y. Trust Co. v. Eisner, 256 U.S. 345, 348-49 (1921) (estate tax).
347 Id. at 336-37.
ogy, the transfer of the opportunity to participate in exercising control of the underlying transferred property interest also should be viewed as tantamount to a transferred property interest since it is merely a component of the value of the transferred interest.

The fact that the transferee only has the opportunity, not the right, to participate in control should not defeat the concept that property has been transferred. The Eleventh Circuit has held that a legally unenforceable letter of intent obtained by a developer to finance the construction of a hotel qualified as "property" for federal income tax purposes.\textsuperscript{348} The court analogized the unenforceable letter of intent to goodwill, which, it noted, consistently has been treated by the courts as property for federal income tax purposes.\textsuperscript{349} Goodwill frequently derives from the relationship that a business has with its customers, not a binding right to deal with customers. Similarly, the opportunity to participate in control is dependent upon the relationship that the transferee has with other owners. Like goodwill, the opportunity to participate in control also should qualify as property.

Moreover, even if the transfer of the opportunity did not qualify as a transfer of property, it is unlikely that extending the gift and estate taxes to an opportunity to participate in control would constitute a direct tax. The transfer of property is not the only analytical framework for avoiding classification as a direct tax.\textsuperscript{350} In \textit{Tyler v. United States}\textsuperscript{351}, the Supreme Court rejected the argument that the inclusion in a decedent's gross estate of all the property held jointly by the decedent with his spouse as tenants by the entirety caused the estate tax to be a direct tax. The estate argued that the imposition of the estate tax on all the tenancy would constitute a direct tax because the decedent could not transfer all the property at death. The Court held that there need not be a transfer of property in order to avoid classification as a direct tax, reasoning that an indirect tax is "[a] tax laid upon the happening of an event."\textsuperscript{352} The Court further stated:

\begin{quote}
The question here, then, is, not whether there has been, in the strict sense of that word, a "transfer" of the property by the death of the decedent, or a receipt of it by right of succession, but whether the death has brought into being or ripened for the survivor, property rights of such character as to
\end{quote}

\begin{itemize}
\item \textsuperscript{348} United States v. Stafford, 727 F.2d 1043, 1053 (11th Cir. 1984).
\item \textsuperscript{349} Id. at 1052.
\item \textsuperscript{350} See 4 Bittker & Lokken, note 12, at 102-06; see generally Charles L.B. Lowndes, The Constitutionality of the New Federal Estate Tax Definition of a Transfer Taking Effect at Death, 3 Vand L. Rev. 203, 206-08 (1950).
\item \textsuperscript{351} 281 U.S. 497, 502 (1930).
\item \textsuperscript{352} Id.
\end{itemize}
make appropriate the imposition of a tax upon that result... to be measured, in whole or in part, by the value of such rights.\footnote{Id. at 503; see also Fernandez v. Wiener, 326 U.S. 340; 356-57 (1945), stating: "It is enough that death brings about changes in the legal and economic relationships to the property taxed."}

The language of \textit{Tyler} supports the conclusion that the taxation of the transfer of an opportunity does not constitute a direct tax, even if the opportunity is not property, because the gift of the minority interest itself has "brought into being" additional value. In effect, including the transfer of an opportunity in the tax base would represent a method for valuing the property that has been transferred. Thus, valuation of a minority interest based upon a rebuttable presumption that the transferee will participate in control should pass constitutional muster. In the event that the transfer of the opportunity is of minimal value, the transferor could show that it has minimal value to reduce the gift or estate tax.

If an irrebuttable presumption were adopted, however, the transferor would not be able to show that the transferred opportunity has minimal value. As a result, the transfer tax occasionally would be larger than the actual facts would warrant. This overinclusiveness should not be a violation of the due process clause of the fifth amendment, despite an early Supreme Court decision that suggests otherwise. In \textit{Heiner v. Donnan},\footnote{285 U.S. 312 (1932); see also Schlesinger v. Wisconsin, 270 U.S. 230 (1926) (holding that Wisconsin statute that created irrebuttable presumption that gifts made within six years of donor's death were in contemplation of death violated the due process clause of the fifth amendment. The Court stated that "a statute which imposes a tax upon an assumption of fact which the taxpayer is forbidden to controvert, is so arbitrary and unreasonable that it cannot stand..."\footnote{Heiner, 285 U.S. at 325.}} the Supreme Court held that an estate tax provision that created an irrebuttable presumption that gifts made within two years of the donor's death were in contemplation of death violated the due process clause of the fifth amendment. The Court stated that "a statute which imposes a tax upon an assumption of fact which the taxpayer is forbidden to controvert, is so arbitrary and unreasonable that it cannot stand..."\footnote{Laurence H. Tribe, American Constitutional Law § 16-32 n.25 (1978) (stating that holding of \textit{Heiner v. Donnan} is "plainly not good law today..."); see Estate of Ekins v. Commissioner, 797 F.2d 481, 486 (7th Cir 1986) (stating that it is "questionable whether 'irrebuttable presumption' doctrine has any continued vitality"); W. Leslie Peat, The Constitutionality of New Section 2035: Is There Any Room for Doubt, 33 Tax L. Rev. 301-03 (1977-78) (arguing that provision of § 2035(a) that gifts within three years of death automatically are included in donor's estate is constitutional); see also Sunshine Anthracite Coal Co. v. Adkins, 310 U.S. 381 (1940) (Congress may use power to tax to accomplish other permissible goals in addition to raising revenue.)}

It is likely that \textit{Heiner v. Donnan} is no longer valid law.\footnote{Lochner v. New York, 198 U.S. 45 (1905).} The Supreme Court decided \textit{Heiner} prior to the Court's post-\textit{Lochner}
rejection of substantive due process in areas not involving constitutionally protected liberties. In *Weinberger v. Salfi*\(^{358}\) the Supreme Court held that an irrebuttable presumption pertaining to the eligibility of a person for social security payments did not violate the due process clause because the presumption bore a rational relationship to a legitimate legislative purpose, the avoidance of the expense involved in engaging in individual factual determinations.\(^{359}\) Because the creation of an irrebuttable presumption about the transfer of an opportunity to participate in control would bear a rational relationship to a legitimate legislative purpose—the elimination of difficult factual determinations of interpersonal relationships, the irrebuttable presumption should not violate the due process clause of the fifth amendment under current law.\(^{360}\)

**IX. Conclusion**

This Article has shown that the current disparate treatment of minority discounts by the estate and gift taxes does not make sense from a tax policy perspective. It also has shown that the analytical tools, such as swing vote value, the substance over form doctrine and the step transaction doctrine, currently available to the Service to deal with practices exploiting the discontinuity, are ineffective. Consequently, I suggest that Congress should end the discontinuity.

Congress could deal with the problem in two alternative ways. First, Congress could create a rebuttable presumption that when a person who has owned a controlling interest in an asset transfers part of the asset to a donee or legatee, a pro rata portion of the control premium associated with the controlling interest also is transferred. The presumption could be rebutted by showing that the transferee will not participate in control. Alternatively, the Code could assign a portion of the control premium automatically to each transfer where the transferor and family members control the entity or asset both before and after the transfer. This is similar to the approach currently adopted by chapter 14 in narrow circumstances. In effect, this alternative would create an irrebuttable presumption that each transfer includes value attributable to control. Under this alternative, the transferee would not be permitted to reduce the value of the trans-

\(^{358}\) 422 U.S. 749 (1975).

\(^{359}\) Id. at 777.

\(^{360}\) See *Estate of Ekins*, 797 F.2d at 486; see also John E. Nowak, Ronald D. Rotunda & J. Nelson Young, *Constitutional Law* 351 (3d ed. 1986) (stating “If a law regulating all persons involves only matters of economics or social welfare, a court should defer to the legislature and uphold the law so long as it is rationally related to a legitimate interest of government.”).
ferred interest by showing that he or she could not participate in control.

Both alternatives would be constitutional. An irrefutable presumption, however, would be easier to administer than a rebuttable presumption, but also would have greater potential for being over-inclusive than a rebuttable presumption. Given that most rational donors would not destroy value by dividing up control among hostile donees who cannot work together, it seems likely that the harm arising from the over-inclusiveness of an irrefutable presumption is minimal. Consequently, this Article recommends that Congress adopt an irrefutable presumption that a transferor who has had a controlling interest in an asset transfers part of the value of the control with each gift or bequest. Any political concern that such a provision would impair the ability of families to retain small business should be addressed directly by providing exemptions. Such an exemption would allow families to determine who will control the business based upon sound management considerations, not estate and gift tax considerations.