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

The fair market value of gifts of family limited partnership interests must consider appropriate discounts for minority interest and lack of marketability.

Summary

In Knight v. Commissioner, the Tax Court recognized a family limited partnership for federal gift tax purposes and upheld the validity of applying discounts when valuing gifts of partnership interests. Herbert and Ina Knight formed a partnership, transferring assets including real property and securities, and gifted 22. 3% interests to trusts for their children. The court determined that a 15% discount for minority interest and lack of marketability was appropriate, valuing each gift at $394,515. The decision clarified that the economic substance doctrine does not apply to disregard partnerships recognized under state law in gift tax valuation, impacting how similar estate planning strategies are evaluated.

Facts

In December 1994, Herbert and Ina Knight created a family limited partnership, transferring assets valued at $2,081,323, including a ranch, two residential properties, and financial assets. They established a management trust as the general partner and gifted 22. 3% interests in the partnership to trusts for their adult children, Mary and Douglas. The partnership operated passively, with the Knights retaining control over management. The gifts were reported on their federal gift tax returns, and the IRS challenged the valuation, arguing for a higher value without recognizing the partnership.

Procedural History

The IRS issued notices of deficiency to the Knights, asserting gift tax deficiencies due to undervaluation of the gifts. The Knights petitioned the Tax Court, which consolidated their cases. The court heard arguments on whether to recognize the partnership for gift tax purposes and the appropriate valuation discounts. The court ultimately recognized the partnership and determined the applicable discounts.

Issue(s)

1. Whether the family limited partnership should be disregarded for federal gift tax valuation purposes.
2. Whether portfolio, minority interest, and lack of marketability discounts totaling 44% apply to the valuation of the gifts.
3. What is the fair market value of each gift made by the Knights to their children’s trusts?
4. Whether section 2704(b) of the Internal Revenue Code applies to the transaction.

Holding

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1. No, because the partnership was valid under Texas law and should not be disregarded based on the economic substance doctrine.
2. No, because the portfolio discount was not supported by evidence, but a 15% discount for minority interest and lack of marketability was appropriate.
3. The fair market value of each gift was $394,515, reflecting the 22. 3% interest in the partnership's assets after applying a 15% discount.
4. No, because the partnership agreement's restrictions were not more restrictive than those under Texas law, as established in Kerr v. Commissioner.

Court's Reasoning

The court recognized the partnership for gift tax purposes because it was valid under Texas law and the economic substance doctrine was not applicable to disregard it. The court rejected the portfolio discount due to lack of evidence but found that a 15% discount for minority interest and lack of marketability was appropriate, considering the partnership's similarity to a closed-end fund. The court emphasized that the willing buyer, willing seller test is used to value the partnership interest, not to determine the partnership's validity. The court also found that section 2704(b) did not apply because the partnership agreement's restrictions were not more restrictive than those under Texas law, following the precedent set in Kerr v. Commissioner.

Practical Implications

Knight v. Commissioner provides guidance on valuing family limited partnership interests for gift tax purposes, affirming that such partnerships can be recognized if valid under state law. The decision clarifies that while the economic substance doctrine may not be used to disregard these partnerships, appropriate discounts for minority interest and lack of marketability must be considered in valuation. This impacts estate planning strategies involving family limited partnerships, as taxpayers can utilize these discounts to reduce gift tax liabilities. The ruling also reinforces the application of state law in determining the validity of partnerships and the limitations on using section 2704(b) to challenge partnership restrictions. Subsequent cases, such as Estate of Thompson v. Commissioner, have cited Knight in determining similar valuation issues.

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