Estate of W. W. Jones II v. Commissioner, 115 T. C. 376 (U. S. Tax Court 2000)

In Estate of W. W. Jones II, the U. S. Tax Court determined the fair market value of gifts of limited partnership interests made by W. W. Jones II to his children. The court rejected the IRS's argument that contributions to the partnerships were taxable gifts and upheld the validity of the partnership agreements' restrictions on liquidation. The court valued the gifts based on the net asset value of the partnerships, applying discounts for lack of marketability but rejecting discounts for built-in capital gains, emphasizing the ability of a hypothetical buyer and seller to negotiate a section 754 election to avoid such gains. This decision underscores the importance of control and marketability in valuing partnership interests for gift tax purposes.

Parties

Plaintiff: Estate of W. W. Jones II, A. C. Jones IV, independent executor (petitioner at U. S. Tax Court). Defendant: Commissioner of Internal Revenue (respondent at U. S. Tax Court).

Facts

W. W. Jones II (decedent) was a cattle rancher who owned the Jones Borregos and Jones Alta Vista Ranches. In 1995, he formed Jones Borregos Limited Partnership (JBLP) and Alta Vista Limited Partnership (AVLP) to transfer these ranches to his children as part of his estate planning. Decedent contributed the surface estate of the Jones Borregos Ranch to JBLP in exchange for a 95. 5389% limited partnership interest and transferred an 83. 08% interest to his son, A. C. Jones. Similarly, he contributed the surface estate of the Jones Alta Vista Ranch to AVLP in exchange for an 88. 178% limited partnership interest and transferred 16. 915% interests to each of his four daughters. Both partnerships had restrictions on liquidation and transferability. The IRS challenged the valuation of these gifts, asserting that the contributions to the partnerships were taxable gifts and that certain partnership restrictions should be disregarded.

Procedural History

The IRS determined a deficiency of $4,412,527 in the decedent's 1995 Federal gift tax. The Estate of W. W. Jones II filed a petition with the U. S. Tax Court challenging this deficiency. The Tax Court heard the case, considering arguments on whether the contributions to the partnerships constituted taxable gifts, whether the period of limitations for assessment had expired, whether certain restrictions in the partnership agreements should be disregarded, and the fair market value of the partnership interests transferred.

Issue(s)

1. Whether the transfers of assets on the formation of JBLP and AVLP were taxable gifts pursuant to section 2512(b)?
2. Whether the period of limitations for assessment of gift tax deficiency arising from gifts on formation is closed?
3. Whether restrictions on liquidation of the partnerships should be disregarded for gift tax valuation purposes pursuant to section 2704(b)?
4. What is the fair market value of the interests in JBLP and AVLP transferred by gift after formation?

Rule(s) of Law

1. Section 2512(b) of the Internal Revenue Code addresses the valuation of gifts for tax purposes.
2. Section 2704(b) states that certain restrictions on liquidation of partnerships should be disregarded for valuation purposes if they are more restrictive than state law and can be removed by the transferor and family members after the transfer.
3. Section 2512(a) mandates that gifts are valued as of the date of transfer.
4. Fair market value is defined as the price at which property would change hands between a willing buyer and willing seller, both having reasonable knowledge of relevant facts, as per section 25. 2512-1 of the Gift Tax Regulations.

Holding

1. The court held that the contributions to the partnerships were not taxable gifts because the decedent received continuing limited partnership interests in return, and the contributions were properly reflected in his capital accounts.
2. The court did not decide whether the period of limitations for assessment had expired, as it was unnecessary given the holding on the first issue.
3. The court held that the restrictions on liquidation in the partnership agreements were not more restrictive than Texas law and should not be disregarded under section 2704(b).
4. The court determined that the interests transferred were limited partnership interests and valued the 83. 08% interest in JBLP at $5,888,990 and each 16. 915% interest in AVLP at $1,085,877, applying discounts for lack of marketability but rejecting discounts for built-in capital gains.

Reasoning

The court reasoned that the decedent’s contributions to the partnerships were not taxable gifts, as he received proportionate interests in return, aligning with the precedent set in Estate of Strangi v. Commissioner. The court distinguished this case from Shepherd v. Commissioner, where contributions were allocated to noncontributing partners’ capital accounts, thus constituting indirect gifts. Regarding section 2704(b), the court found that the partnership agreements’ restrictions on liquidation were not more restrictive than Texas law, following the reasoning in Kerr v. Commissioner. The court valued the partnership interests based on the net asset value, applying an 8% discount for lack of marketability to the JBLP interest due to the controlling nature of the interest and a 40% secondary market discount plus an additional 8% lack of marketability discount to the AVLP interests. The court rejected discounts for built-in capital gains, citing the ability of a hypothetical buyer and seller to negotiate a section 754 election to avoid such gains, and dismissed the testimony of A. C. Jones as an attempt to justify an unreasonable discount.

Disposition

The court entered a decision under Rule 155, upholding the validity of the partnership agreements' restrictions and determining the fair market value of the gifts based on the net asset value with specified discounts.

Significance/Impact

Estate of W. W. Jones II v. Commissioner has significant implications for the valuation of gifts of limited partnership interests. The decision clarifies that contributions to a partnership are not taxable gifts if the contributor receives a proportionate interest in return. It also reinforces the importance of control and marketability in valuing partnership interests, as well as the ability of parties to negotiate around built-in capital gains through a section 754 election. The case has been cited in subsequent decisions and remains relevant for estate planning involving family limited partnerships, emphasizing the need for careful drafting of partnership agreements to achieve desired tax outcomes.