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Adequate and Full Uncertainty: Courts' Application of Section 203(a)(1) of the Internal Revenue Code to Family Limited Partnerships

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"Adequate and Full" Uncertainty: Courts' Application of Section 2036(a)(1) of the Internal Revenue Code to Family Limited Partnerships

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INTRODUCTION

Consider two retired neighbors each having about $4 million in assets.[1] One of these neighbors goes to her lawyer, who encourages

1. Assume neither of these neighbors is married. If either were, all property included in the gross estate that passed to the surviving spouse would be eligible for the marital deduction in computing the taxable estate for federal estate tax purposes. *See* I.R.C. § 2056 (2000). Other deductions available to reduce the federal estate tax include charitable deductions, mortgages and debt, and the estate's administration expenses and

her to transfer most of these assets to a family limited partnership ("FLP"), a limited liability entity recognized under the laws of all fifty states that can be used for facilitating asset protection, asset pooling, and centralizing investment management. This neighbor takes her lawyer's advice, and when she dies in 2006, her estate claims a fifty percent discount for lack of control and marketability[2] of the taxpayer's family limited partnership interests. After the discount, her estate is valued at about $2 million. The estate pays no estate tax in 2006[3] because a tax credit of $2 million is applied to the estates of decedents dying in the year 2006.[4] Two years later, this neighbor's children liquidate the family limited partnership and, disregarding any appreciation and income, are left with $4 million—the same amount they would have inherited if their mother had not placed her assets into a family limited partnership but with the benefit of the valuation discount that allowed her estate to escape estate taxation.

The other neighbor does not go to a lawyer. He also dies in 2006, but because he did not transfer his assets to a family limited partnership like his neighbor, he can claim no valuation discounts. Two million dollars of his estate is exempted from estate taxation,[5] but the other $2 million will be taxed at a marginal rate of forty-six percent.[6] His estate will pay over $900,000 in taxes. This triumph of

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losses during estate administration. *See* Internal Revenue Service, Estate Tax Questions, http://www.irs.gov/businesses/small/article/0,,id=108143,00.html (last visited Dec. 9, 2005).

2. Because a hypothetical willing buyer would be unwilling to pay the fair market value of underlying assets where he lacks control or cannot sell his interest in those assets, a discount for lack of control and marketability is appropriate. *See* Bradford Updike, *Making Sense of Family Limited Partnership Law After* Strangi *and* Stone: *A Better Approach to Planning and Litigation Through the Bona Fide Transaction Exception*, 50 S.D. L. REV. 1, 7–8 (2005).

3. Internal Revenue Code § 2001(a) imposes a tax "on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States." I.R.C. § 2001(a). To determine the taxable estate, the Code defines "gross estate" as "the value at the time of [the decedent's] death of all property, real or personal, tangible or intangible, wherever situated." *Id.* § 2031. Then, exemptions and credits are allowed from the gross estate. *See* Brent R. Bissonnette, *Getting It Right: Avoiding the Seven Deadly Sins in the Formation and Management of the Family Limited Partnership*, 30 OHIO N.U. L. REV. 59, 60 (2004). The most significant credit is the "unified credit," which for decedents dying in 2006 is an exclusion of $2 million from the estate. *See* § 2010.

4. Thus, any decedent dying in 2006 with a gross estate of $2 million or less will not owe any federal estate tax. *See* § 2010(c) (defining the applicable credit amount, that is, the amount of an estate's assets exempted from estate taxation).

5. *See id.* The $2 million will be exempted from estate taxation because it represents the "applicable credit amount." An estate is essentially credited with that amount. Estates smaller than $2 million pay no estate tax and estates larger than $2 million do not pay tax on the first $2 million.

6. *See* § 2001(c). The "marginal rate" of tax is "the applicable rate of tax at each bracket level." *Id.* A taxpayer's "marginal rate" generally refers to the highest marginal

form over substance[7] has the Internal Revenue Service (the "IRS") grasping at the Internal Revenue Code (the "Code") for any plausible relief.

The discrepancy in the taxes paid by the hypothetical retired neighbors is a national concern. The estate tax is an important revenue-raising tool for the federal government.[8] As wealthy baby boomers age, the estate tax's potential for revenue-raising will only grow. Therefore, as years go by and more Americans accumulate wealth, age, and die, the government either will or will not be able to collect federal estate taxes depending on the form in which the neighbors hold their assets, not on the substance of what they own. Thus, how FLP assets are treated for estate tax purposes in the years ahead will make a significant difference in the estate tax revenue that the federal government can collect.

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rate of tax that taxpayer pays. Contrast "marginal rate" with the "effective rate" of tax, which is the rate "applicable to the taxpayer's income as a whole." *See* MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION 5–6 (9th ed. 2002).

7. The triumph of form over substance is a result that the Internal Revenue Service generally seeks to avoid. *See* Elaine Hightower Gagliardi, *Economic Substance in the Context of Federal Estate and Gift Tax: The Internal Revenue Service Has It Wrong*, 64 MONT. L. REV. 389, 389–90, 396–97 (2003). Rather, to be respected for federal tax purposes, a transfer must have economic substance beyond simply tax avoidance. *Id.* at 390. Professor Gagliardi argues for a different approach to economic substance in the context of estate planning. *Id.* at 391–94, 401–34. She suggests that in the context of estate planning, wealth transfer tax savings are necessarily a motivating factor and transfers have a donative, rather than business, purpose. *Id.* at 392. Thus, her approach favors objective factors including whether an economic benefit has been transferred, whether that benefit is based on an enforceable legal right, and whether objective actions of the parties implement these rights and respect the economic benefits. *Id.* at 393, 401–15.

8. Repealing the estate tax would cost the federal government an estimated $256 billion over the years 2006–2015. *See* U.S. TREASURY DEP'T, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2006 REVENUE PROPOSALS 159 (2005); *see also* Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 901, 115 Stat. 38, 150 (codified in scattered section of 25 U.S.C.) (providing that the 2001 Tax Act will not apply to estates of decedents dying after December 31, 2010). Some critics of the estate tax state that it represents a very small part of federal revenues. *See* JOEL SLEMROD & JON BAKIJA, TAXING OURSELVES: A CITIZEN'S GUIDE TO THE DEBATE OVER TAXES 295 (3d ed. 2004) (pointing out, in a discussion of the pros and cons of the estate tax, that the estate tax brought in only about 1.4 percent of federal revenues in 2001 but that this represented a "nontrivial portion of the tax burden placed on upper-income people"). Eliminating transfer taxes—of which the estate tax is one—however, would require additional taxes elsewhere to make up these lost revenues or would result in cutting government spending on programs or increasing national debt. *See* Charles Davenport & Jay A. Soled, *Enlivening the Death-Tax Death-Talk*, 84 TAX NOTES 591, 593 (1999); *see also* John G. Steinkamp, *A Case for Federal Transfer Taxation*, 55 ARK. L. REV. 1, 7–8 (2002) (arguing, while not wholeheartedly endorsing the current federal transfer tax system, that such a tax on wealth is an appropriate way to "contribute to greater progressivity in taxation, ... encourage charitable contributions, and raise significant revenues").

Beyond the lost revenue for the government that FLPs allow, abuses of FLPs offend principles of fairness and equity. Like the example of the neighbors offered in this Introduction, sophisticated taxpayers with savvy lawyers have an unfair advantage over others in that by choosing the right form in which to hold their assets, they can avoid or minimize estate taxation.

FLPs are popular estate planning tools that have been used to substantially reduce estate, gift, and income taxes[9]; to protect assets from creditors[10]; and to expediently transfer wealth.[11] Estate planners advise their clients to put assets, including "cash, stock, and real estate," into these limited partnerships and then to claim large valuation discounts for estate and gift tax purposes.[12] Limited partnership interests are valued for tax purposes "at what a hypothetical, unrelated buyer would pay for them" and, thus, are discounted because the limited partners lack control of the underlying assets and because the limited partnership interests are not readily marketable.[13] Starting in the mid-1990s, the IRS began aggressively targeting FLPs using various provisions of the Code to attempt to eliminate these valuation discounts or to return the gifted limited partnership interests to an estate, largely without success.[14]

After years of unsuccessful challenges to FLPs, the IRS seems to have discovered a weapon that can be successful if properly wielded—§ 2036(a)(1)[15] of the Internal Revenue Code.[16] Section 2036(a)(1) operates to include in the gross estate of a decedent the value of all property transferred during the decedent's life over which the decedent maintained the possession or enjoyment or the right to income, unless such transfer was a bona fide sale for adequate and

9. *See generally* Troy Renkemeyer, Comment, *The Family Limited Partnership: An Effective Estate Planning Tool*, 64 UMKC L. REV. 587 (1996) (offering an overview of FLPs and comparing them to similar entities).

10. *See* S. Stacy Eastland, *Family Limited Partnerships: Non-Transfer Tax Benefits*, PROB. & PROP., Mar.-Apr. 1993, at 10, 11.

11. Reed W. Easton, *Courts Disagree on Application of Section 2036 Exception to FLPs*, PRAC. TAX STRATEGIES, Jan. 2005, at 35, 41.

12. Janet Novack, *Cut Your Estate Tax in Half*, FORBES, Oct. 19, 1998, at 160, 160.

13. *Id.* (emphasis omitted).

14. Louis A. Mezzullo, *Fifth Circuit's Remand in* Kimbell *Does Not Provide Carte Blanche for All FLPs*, 101 J. TAX'N 41, 41 (2004); Leslie A. Droubay, Comment, *The Certainty of Death and Taxes for Family Limited Partnerships*, 7 J. SMALL & EMERGING BUS. L. 523, 526–28 (2003) (summarizing unsuccessful IRS challenges to FLPs); John W. Porter, *FLP Wars Update*, TR. & EST., July 2005, at 49, 49–50 (discussing unsuccessful IRS challenges to FLPs).

15. Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended.

16. I.R.C. § 2036(a)(1) (2000); Droubay, *supra* note 14, at 528.

full consideration.[17] Thus, the IRS has argued in certain cases that decedents "effectively retained the possession or enjoyment of, or the right to the income from, the property transferred to the partnership."[18] Therefore, in cases addressing the application of § 2036(a)(1) to FLP assets, the issues usually are: "(1) whether the creation of the partnership and transfer of assets to it was a 'bona fide sale for full and adequate consideration' and, if not, (2) whether the decedent retained the possession or enjoyment of, or the right to the income from, the property transferred to the partnership."[19]

This Comment suggests that FLPs can be used abusively as tax shelters but that the IRS's latest weapon against FLPs, § 2036, is an inappropriate way to deal with the problem. As this Comment will show, whether § 2036 applies in any given context is a heavily fact-dependent inquiry[20] with the IRS seemingly targeting only those cases presenting "bad facts,"[21] courts awkwardly shoehorning the facts into § 2036(a), and courts defining the bona fide sale exception in different ways. With guidance from the various courts that have addressed the issue, sophisticated estate planners and their clients can still structure an FLP or a similar entity to accomplish tax avoidance goals. A

17. *See* § 2036(a), (a)(1).

18. Porter, *supra* note 14, at 50.

19. *See id.* at 50, 54 n.6 (emphasis omitted) (citing Harper v. Comm'r, 83 T.C.M. (CCH) 1641 (2002); Estate of Strangi v. Comm'r, 115 T.C. 478 (2000), *aff'd in part, rev'd in part sub nom.* Gulig v. Comm'r, 293 F.3d 279 (5th Cir. 2002); Reichardt v. Comm'r, 114 T.C. 144 (2000)).

20. *See* J. Joseph Korpics, *How Estate Planners Can Use* Bongard *To Their Advantage*, EST. PLAN. J., July 2005, at 32, 38; Droubay, *supra* note 14, at 532.

21. *See, e.g.*, Strangi v. Comm'r, 417 F.3d 468, 472, 478 (5th Cir. 2005) (holding that § 2036(a)(1) applied where the ailing decedent transferred over $10 million worth of assets into FLPs, which made monetary and in-kind outlays to the decedent to meet his needs); Estate of Thompson v. Comm'r, 382 F.3d 367, 369–70 (3d Cir. 2004) (holding that § 2036(a)(1) applied where the decedent was ninety-five years old when two FLPs were created, he transferred nearly all his assets to the FLPs, and there was little economic purpose for the FLPs beyond tax avoidance); Kimbell v. United States, 371 F.3d 257, 259 (5th Cir. 2004) (holding that § 2036(a)(1) did not apply where the IRS sought to return assets that an elderly decedent had transferred to an FLP late in her life).

Generally, facts referred to as "bad facts"—those that can entice the IRS to challenge an FLP under § 2036 and courts to accept such a challenge—include: (1) the decedent's transfer of nearly all of her assets to the FLP; (2) the decedent's transfer of her residence to the FLP while continuing to live in it without paying rent to the FLP; (3) the decedent's commingling of her assets with those of the FLP; (4) the decedent or her estate's use of the FLP's assets; and (5) a lack of change in management of the property after it is transferred to the FLP. *See* Ronald H. Jensen, *The Magic of Disappearing Wealth Revisited: Using Family Limited Partnerships To Reduce Estate and Gift Tax*, 1 PITT. TAX REV. 155, 183–85 (2004). By contrast, § 2036's application to FLPs is unlikely if the above "bad facts" are avoided through careful and diligent planning. *See infra* notes 162–67, 264–68 and accompanying text.

remedy for the potential abuses of FLPs is desirable; however, such a remedy should be legislative and come from Congress, not from the IRS simply reviewing estates to find those with facts bad enough to warrant § 2036(a)(1) application.

Part I of this Comment discusses FLPs in greater detail, explaining how they are formed and how FLP interests are valued.[22] Part II chronicles the IRS's failed attacks on valuation discounts of FLP interests. These attacks include arguments that FLPs lack economic substance and that decedents make taxable gifts upon formation of an FLP; the IRS has also tried to use specific Code provisions to defeat FLPs. Part III discusses § 2036(a)(1)'s early application to FLP interests and the IRS's success in the Tax Court using § 2036(a)(1). Part IV discusses the uncertainty as to what "bona fide sale for adequate and full consideration" means in § 2036(a)(1) after recent decisions in the Fifth and Third Circuits and the Tax Court have come to seemingly different results. In *Kimbell v. United States*[23] and *Strangi v. Commissioner*,[24] the Fifth Circuit held that receipt of proportionate interests in an FLP for transferred assets constitutes "adequate and full consideration" under § 2036.[25] However, the Third Circuit may require that the interests received by a decedent who transfers assets to an FLP have the same value as the transferred assets.[26] Because FLP interests are not readily marketable and an owner does not necessarily possess the right to control the underlying assets, proportionate interests will usually have less monetary value than the transferred assets unencumbered by the partnership agreement.[27] Furthermore, these decisions along with the recent Tax Court case *Estate of Bongard v. Commissioner*[28] create

22. For a discussion on FLPs, trusts, and limited liability corporations and their desirability for tax and estate planning purposes, including asset protection, tax savings, and control issues, see generally Timothy R. Baumann, Note, *Family Limited Partnerships, Trusts, or Limited Liability Corporations: Which Should the Elderly Choose?*, 3 ELDER L. J. 111 (1995).

23. 371 F.3d 257 (5th Cir. 2004).

24. 417 F.3d 468 (5th Cir. 2005).

25. *See Strangi*, 417 F.3d at 478; *Kimbell*, 371 F.3d at 265.

26. *See Thompson*, 382 F.3d at 381; *id.* at 386–87 (Greenberg, J., concurring). In some literature, *Thompson* is referred to as *Turner v. Commissioner*. *See, e.g.*, Porter, *supra* note 14, at 51 (referring to *Thompson* as the *Turner* case). Theodore Thompson was the decedent in the case; Betsy Turner, his daughter, was the executor of the estate. *Thompson*, 382 F.3d at 369. In this Comment, the case will be referred to consistently as *Thompson*.

27. *See Thompson*, 382 F.3d at 381.

28. 124 Tax Ct. Rep. Dec. (RIA) ¶ 124.8, at 124-54 (T.C. Mar. 15, 2005). The *Bongard* decision will be found in the United States Tax Reports at *Estate of Bongard v.*

uncertainty regarding what motivation or purpose a transfer must have to be considered a "bona fide sale" under § 2036.[29] After these cases, it is, of course, still possible to form an FLP that would withstand scrutiny by the IRS or a court.[30] However, at the margins, uncertainty reigns.[31] Therefore, Part V of this Comment provides suggestions for what Congress should do to change the current law to resolve the uncertainties and to prevent possible abuses of FLPs and similar entities, proposing that a new Code provision that limits discounts for family entities when they are used as tax shelters is in order.

I. FAMILY LIMITED PARTNERSHIPS EXPLAINED

A. *Formation of a Family Limited Partnership*

FLPs, along with other limited partnerships, are defined by state statutes, often modeled after the Revised Uniform Limited Partnership Act.[32] An FLP is formed when at least two people file a certificate that meets state law requirements with the Secretary of State's office in a jurisdiction.[33] The FLP will usually have one or more general partners and one or more limited partners.[34] Typically, tax planning with an FLP involves a transfer of assets to a partnership by the senior generation in exchange for two types of partnership

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Commissioner, 124 T.C. 95 (2005), but citations to that source were not available at the time of printing.

29. *Id.* at 124-69. To be a bona fide sale, the Tax Court held that there must be a "legitimate and significant non-tax reason" for the FLP's creation. *Id.* It is not entirely clear what reasons will suffice as "legitimate and significant" or what constitutes a "bona fide sale" in the Fifth and Third Circuits. *See* J. Joseph Korpics, *Qualifying New FLPs for the Bona Fide Sale Exception: Managing* Thompson, Kimbell, Harper, *and* Stone, 102 J. TAX'N 111, 112 (2005).

30. *See* Korpics, *supra* note 29, at 112; *see, e.g.*, Estate of Schutt v. Comm'r, 89 T.C.M. (CCH) 1353, 1367–68 (2005) (determining that the decedent's transfer of assets to two family entities were bona fide sales because there existed a "legitimate and significant non-tax reason"—perpetuation of a long-standing investment philosophy—for the transfer).

31. For example, although *Kimbell*, *Thompson*, and *Bongard* indicate that any "non-tax benefit" is a legitimate business reason sufficient to satisfy the bona fide sale exception, the courts often find on the facts that such benefits are insufficient. *See* Korpics, *supra* note 29, at 116–17.

32. *See generally* REVISED UNIF. LTD. P'SHIP ACT (1976) (amended 1985); Baumann, *supra* note 22 (comparing several entities and their benefits, including potential valuation benefits, and drawbacks).

33. REVISED UNIF. LTD. P'SHIP ACT § 201.

34. *See* THOMAS LEE HAZEN & JERRY W. MARKHAM, CORPORATIONS AND OTHER BUSINESS ENTERPRISES 65 (2003) (explaining that limited partnerships have two classes of partners, including one or more general partners and one or more limited partners).

interests: general partnership interests and limited partnership interests.[35]

The general partner or partners have the power to do anything partners in a partnership without limited partners can do.[36] However, general partners, unlike limited partners, are personally liable for the partnership's debts.[37] Limited partners contribute assets, including cash or other property or services, in exchange for partnership interests but have no control over partnership affairs.[38] Usually, the general partnership interests have very little economic value but carry with them plenary control of the FLP.[39] The limited partnership interests are just the opposite—no control whatsoever but most of the economic value.[40] The limited partnership interests may be retained by the senior generation until death or given to a younger generation during the senior generation's lifetime.[41]

B. Valuation Discounts

One of the primary reasons for forming an FLP, and the one with which this Comment is most concerned, is the potential valuation discounts available for estate and gift tax purposes.[42] However, there are also other benefits to using FLPs, including creditor protection,[43] promotion of wealth retention within families,[44] administrative expediency,[45] and avoidance of probate.[46] Valuation discounts are

35. *See* Updike, *supra* note 2, at 5–7; Droubay, *supra* note 14, at 525.

36. HAZEN & MARKHAM, *supra* note 34, at 65 (noting that general partners in a limited partnership have "complete control").

37. *Compare* REVISED UNIF. LTD. P'SHIP ACT § 303 *with id.* § 403 (contrasting powers and liabilities of general partners with those of limited partners).

38. *See* Barry S. Engel & Ronald L. Rudman, *Family Limited Partnerships: New Meaning for "Limited,"* TR. & EST., July 1993, at 46, 47.

39. *See, e.g.*, Estate of Strangi v. Comm'r, 85 T.C.M. (CCH) 1331, 1333 (2003), *aff'd sub nom.* Strangi v. Comm'r, 417 F.3d 468 (5th Cir. 2005) (noting that the corporate general partner had "sole, exclusive, and absolute right and authority" to control the FLP).

40. *See, e.g., id.* (noting that the ninety-nine percent limited partnership interest included no "authority or right to take part in the management" of the FLP).

41. *See* Updike, *supra* note 2, at 7 (stating that the federal gift tax exclusion "can be used to gradually transfer ownership of the FLP to younger generation partners over time"); Droubay, *supra* note 14, at 524 (noting that a traditional use of FLPs involves the senior generation gifting limited partnership interests to their children).

42. Eric Thomas Carver, *Probate Law: A Valuation Primer: Trends and Techniques for Estate Planners*, 77 MICH. BAR J. 1304, 1304 (1998).

43. *See* Easton, *supra* note 11, at 41.

44. *See id.*

45. *See id.*

46. *See* Carver, *supra* note 42, at 1304.

important because federal estate and gift taxes are based upon the fair market value of the property transferred.[47]

Because of the lack of control[48] and lack of marketability,[49] a willing buyer would pay less for the limited partnership interests than the underlying assets are actually worth.[50] In other words, the value of these interests may be discounted.[51] Consequently, if the limited partnership interests are gifted during lifetime, the value of the gift may be discounted for federal gift tax purposes to reflect the lack of marketability and control.[52] Similarly, if the limited partnership interests are retained by the senior generation until death, as the sophisticated neighbor did in the introductory example, their value may be discounted for federal estate tax purposes.[53] It is the IRS's assault on the availability of the discount for federal estate tax purposes of retained limited partnership interests that is the subject of this Comment.

Valuation of an interest in an FLP is determined using the hypothetical "willing buyer-willing seller" test.[54] This test is articulated in the following way: "the fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of the relevant facts."[55] Again, the reason valuation is so important is that taxes are imposed on the "transfer of property by gift . . . by an individual"[56] and on "the transfer of the taxable estate of every decedent."[57]

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47. *See id.*

48. Also known as minority discounts, the IRS has recognized that an interest in an entity that does not represent a controlling interest may be worth less than the underlying value of the assets composing that interest. *See* Rev. Rul. 93-12, 1993-1 C.B. 203.

49. The lack of marketability discount refers to the fact that an interest in a closely-held entity is worth less than the value of the underlying assets composing the interest because the interest is not readily marketable or liquid. Updike, *supra* note 2, at 7–8.

50. *Cf.* James R. Repetti, *It's All About Valuation*, 53 TAX L. REV. 607, 612–13 (2000) (discussing a wealth tax and the problems annual valuations would cause for such a tax, and suggesting that use of the willing buyer-willing seller valuation method would encourage further use of FLPs and similar entities designed to "reduce" weath).

51. *Id.*

52. *See id.*

53. *See id.*

54. Treas. Reg. § 25.2512-1 (2005). *See generally* D. John Thornton & Gregory A. Byron, *Valuation of Family Limited Partnership Interests*, 32 IDAHO L. REV. 345 (1996) (explaining principles of transfer tax valuation).

55. Treas. Reg. § 20.2031-1(b) (2005).

56. I.R.C. § 2501(a)(1) (2000); Thornton & Byron, *supra* note 54, at 346.

57. § 2001(a); Thornton & Byron, *supra* note 54, at 346. Because it is a direct tax on a decedent's wealth, the estate tax has been attacked as an "unapportioned direct tax" in violation of Article I, Section 9, Clause 4 of the United States Constitution. To address

Under the willing buyer-willing seller test, valuation discounts for FLP interests are taken. First, FLP interests lack marketability; a willing buyer would pay less than the full fair market value of the underlying assets of the FLP.[58] A limited partnership interest in an FLP is less attractive than publicly traded stock, for example, because the FLP interest, unlike the stock, is highly illiquid.[59] Furthermore, because limited partners may not participate at all in management decisions, and the partnership agreements typically restrict the limited partners' rights to transfer their interests and to withdraw from the partnership, a buyer would pay even less for these interests.[60]

Substantial discounts have been allowed.[61] However, the use of these discounts, and the burgeoning popularity of FLPs,[62] caused the IRS to take notice and to begin searching for law to support its contention that the IRS was getting too little when it came time for taxpayers to pay their gift and estate taxes.[63] Scouring the Code for alternatives, the IRS found little success before latching onto § 2036, a provision it had previously conceded was inapplicable to FLPs.[64] These concessions, though coming in the form of non-precedential Technical Advice Memoranda and Private Letter Rulings,[65] suggest that even the IRS once felt that § 2036 is not appropriate for

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issues related to constitutionality, the estate tax has been framed "not as a property or inheritance tax, but as a tax imposed upon the transfer of property." Thornton & Byron, *supra* note 54, at 346–47 (discussing Article I, Section 9, Clause 4 of the United States Constitution).

58. *See* Mandelbaum v. Comm'r, 69 T.C.M. (CCH) 2852, 2863–64 (1995) (involving valuation of stock in a closely-held family corporation), *aff'd*, 91 F.3d 124 (3d Cir. 1996); Moore v. Comm'r, 62 T.C.M. (CCH) 1128, 1128–33 (1991) (involving valuation of interests in an FLP of which the taxpayers made gifts to the "younger generation").

59. *See* Thornton & Byron, *supra* note 54, at 363.

60. *See, e.g.*, Shepherd v. Comm'r, 283 F.3d 1258, 1267–68 (2003) (Ryskamp, J., dissenting) (outlining the willing buyer-willing seller test and arguing that restrictions imposed by the partnership agreement in that case "would affect the price that a buyer would be willing to pay" for certain assets).

61. *See, e.g.*, Peracchio v. Comm'r, 86 T.C.M. (CCH) 412, 417–19 (2003) (allowing a total discount of 31%, where the underlying assets were worth over $3 million); Lappo v. Comm'r, 86 T.C.M. (CCH) 333, 339–40 (2000) (allowing a 15% discount for the lack of control and a 24% discount for the lack of marketability for a total of a nearly 40% discount).

62. *See* Rebecca B. Hawblitzel, Note, *A Change in Planning:* Estate of Strangi v. Commissioner*'s Effect on the Use of Family Limited Partnerships in Estate Planning*, 57 ARK. L. REV. 595, 602–03 (2004); Novack, *supra* note 12, at 160.

63. *See* Hawblitzel, *supra* note 62, at 602; Janet Novack, *Partners, but Not with the IRS*, FORBES, Apr. 17, 2000, at 450, 450.

64. *See infra* notes 124–26, 292–93 and accompanying text.

65. *See* I.R.C. § 6110(k)(3) (2000).

regulating FLPs. The provision has not changed since the IRS asserted it did not apply to FLPs; perhaps the IRS now uses § 2036 because it has gained some traction where other arguments have not and not because it really is an appropriate way to deal with abuses of FLPs.

II. EARLY, UNSUCCESSFUL IRS ATTEMPTS TO STOP FLPS

Prior to its success under § 2036, the IRS advanced other arguments for inclusion of the undiscounted, underlying FLP assets in estates.[66] Three such arguments were: (1) FLPs lack economic substance; (2) the special valuation rules of chapter 14 of the Internal Revenue Code[67] should apply to FLPs; and (3) an immediate gift upon formation of an FLP is made by reason of the diminution in value resulting from the discount. With few exceptions,[68] these arguments have not been successful.[69] The IRS's approach to targeting FLPs—by throwing multiple arguments at them until one, § 2036, resonated with courts—suggests that the IRS did not feel that any Code provision specifically and adequately addressed the problem of FLPs. As estate planners take note of the various courts' pronouncements on the bona fide sale exception, they will begin structuring FLPs that avoid application of § 2036 and the IRS will once again be left to scour the Code for relief that it currently cannot provide. Unless new legislation is passed, § 2036 may find its way to the graveyard where other unsuccessful IRS arguments reside.

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66. *See* Gagliardi, *supra* note 7, at 434–45 n.173 (detailing the IRS's attacks on FLPs, particularly those attacks based on the special valuation rules of chapter 14 of the Internal Revenue Code); Daniel H. Ruttenberg, *The Tax Court's Execution of the Family Entity: The Tax Court's Application of Internal Revenue Code Section 2036(a) to Family Entities*, 80 N.D. L. REV. 41, 47–51 (2004) (summarizing the IRS's major arguments for inclusion of FLP assets); Droubay, *supra* note 14, at 526–28; Courtney Lieb, Comment, *The IRS Wages War on the Family Limited Partnership: How to Establish a Family Limited Partnership That Will Withstand Attack*, 71 UMKC L. REV. 887, 894–906 (2003) (detailing IRS attacks on FLPs and their efficacy).

67. I.R.C. §§ 2701–2704.

68. *See* Shepherd v. Comm'r, 155 T.C. 376, 385–86 (2000), *aff'd*, 283 F.3d 1258 (11th Cir. 2002); Gagliardi, *supra* note 7, at 440 (discussing the IRS's success in *Shepherd* in arguing that "a gift occurs on the formation of the limited partnership").

69. Ruttenberg, *supra* note 66, at 47–51. Part of the reason that the IRS has been unsuccessful may be that estate planners continued to set up FLPs for their clients, meaning that there were more FLPs for the IRS's gift and estate tax auditors to deal with, and fewer auditors to deal with the FLPs. *See* Novack, *supra* note 12, at 161 (noting that in 1998, the IRS had 480 estate and gift tax auditors to deal with 45,000 taxable estates). But the bigger problem for the IRS has been the "dubious" legal grounds for its attacks. *Id.*

All three of these arguments—that FLPs lack economic substance, that the special valuation rules should apply, and that an immediate gift on formation occurred—were advanced by the IRS in *Estate of Strangi v. Commissioner* ("*Strangi I*"),[70] the first of many decisions regarding the estate of Albert Strangi, a Texas millionaire.[71] Just a few months before the elderly and ill decedent's death, his son-in-law as attorney in fact set up an FLP with the decedent contributing nearly $10 million in exchange for a ninety-nine percent partnership interest.[72] In addition to paying for the back surgery for the decedent's home health care provider, the FLP also made payments to the decedent's estate to pay federal estate taxes as well as to provide gifts for the decedent's children.[73] The FLP also extended lines of credit to the Strangi children.[74] Although the value of the assets of the FLP was over $11 million at the time of the decedent's death, the estate reported the discounted fair market value of the decedent's interest in the FLP at about $6.5 million.[75] The Tax Court refused to accept the IRS's arguments for disregarding the FLP and also noted its denial of the IRS's requested leave to amend its petition to include an argument under § 2036.[76] The denial of leave to amend was ultimately overruled by the Fifth Circuit, so the IRS was able to successfully advance the § 2036 argument against the Strangi FLP.[77]

Strangi I provides an excellent illustration of the IRS's failed arguments that FLPs lack economic substance, that the special valuation rules of chapter 14 of the Internal Revenue Code should apply to FLPs, and that a gift on formation of the FLP is made. Thus, this Comment will recall these arguments using *Strangi I* as an illustration.

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70. 115 T.C. 478 (2000), *aff'd in part, rev'd in part sub nom.* Gulig v. Comm'r, 293 F.3d 279 (5th Cir. 2002).

71. *Strangi I* was reversed in part and remanded by the Fifth Circuit in *Gulig v. Comm'r*. *See* Gulig v. Comm'r (*Strangi II*), 293 F.3d 279, 282 (5th Cir. 2002). Then, the Tax Court ruled that the value of the assets transferred to an FLP and its corporate general partner were includable in the decedent's gross estate under either § 2036(a)(1) or § 2036(a)(2). *See* Estate of Strangi v. Comm'r (*Strangi III*), 85 T.C.M. (CCH) 1331, 1337–46 (2003). The Fifth Circuit affirmed the Tax Court's holding under § 2036(a)(1). *See* Strangi v. Comm'r (*Strangi IV*), 417 F.3d 468 (5th Cir. 2005).

72. *Strangi I*, 115 T.C. at 480–81.

73. *Id.* at 482–83.

74. *Id.* at 483.

75. *Id.*

76. *Id.* at 486–87.

77. *Strangi II*, 293 F.3d 279, 282 (5th Cir. 2002).

A. *Economic Substance Doctrine*

The economic substance doctrine states that "transactions which have no economic purpose or substance other than the avoidance of taxes will be disregarded."[78] In *Strangi I*, the IRS argued that Albert Strangi's FLP "lacked economic substance"[79] and "should be disregarded in valuing the assets in decedent's estate."[80] The Tax Court conceded that the Strangi FLP's alleged business purposes were flimsy and difficult to believe,[81] but, "[r]egardless of subjective intentions, the partnership had sufficient substance to be recognized for tax purposes."[82] A buyer of the decedent's assets would certainly not disregard the FLP's existence, the Tax Court noted.[83] Thus, the willing buyer-willing seller test makes it unlikely that the economic substance doctrine will result in a court disregarding any FLP that is validly formed under state law.[84] Indeed, the Tax Court has continued to hold that it will not disregard FLPs for lack of economic substance where they meet state partnership law requirements.[85]

B. *Special Valuation Rules of Chapter 14 of the Internal Revenue Code*

Next, the IRS has challenged FLPs under § 2703(a)[86] and § 2704(b),[87] the special valuation rules of chapter 14 of the Internal Revenue Code. Both sections curb the abuses of provisions in partnership agreements restricting partners' rights, whose purposes are "to lower the value of the partnership interests."[88] Section

78. *Strangi I*, 115 T.C. at 484 (citing Gregory v. Helvering, 293 U.S. 465, 469–70 (1935); Merryman v. Comm'r, 873 F.2d 879, 881 (5th Cir. 1989)).

79. Ruttenberg, *supra* note 66, at 48.

80. *Strangi I*, 115 T.C. at 484.

81. *Id.* at 485.

82. *Id.* at 486–87.

83. *Id.* at 487.

84. *See id.* at 486–87 (declining to disregard an FLP where the partnership complied with formalities and was sufficiently substantive); *see also* Estate of Thompson v. Comm'r, 84 T.C.M. (CCH) 374, 385 (2002), *aff'd*, 382 F.3d 367 (3d Cir. 2004) (concluding that the Thompson FLPs had sufficient substance to be recognized for federal estate and gift tax purposes where they were validly formed under state law); Knight v. Comm'r, 115 T.C. 506, 514 (2000) (refusing to disregard an FLP formed validly under state law where "[there is] no reason to conclude . . . that a hypothetical buyer or seller would disregard it").

85. *See Thompson*, 84 T.C.M. (CCH) at 385; *Knight*, 115 T.C. at 514.

86. I.R.C. § 2703(a) (2000).

87. *Id.* § 2704(b).

88. Lieb, *supra* note 66, at 901; *see also* John A. Miller & Jeffrey A. Maine, *Fundamentals of Estate Tax Planning*, 32 IDAHO L. REV. 197, 231–32 (1996) (summarizing the special valuation rules, including the rules regarding when restrictions relating to the property will be disregarded for valuation purposes).

2703(a)(2) states that the value of transferred property is to be determined without regard to restrictions on the rights to sell or use the property except in certain situations.[89] In *Strangi I*, the Tax Court rejected the IRS's contention that the "property" transferred was the underlying partnership assets and not just the decedent's discounted partnership interest.[90] Section 2704(b) states that "applicable restriction[s]" should be disregarded in valuing the transferred interest in the FLP to a family member of the transferor.[91] An applicable restriction is defined as a restriction on the ability to liquidate the FLP that is more restrictive than state law.[92] The IRS has consistently lost in its attempts to disregard restrictions in valuing FLP assets, with the courts holding that the FLP agreements were no more restrictive than state law or that FLP agreement restrictions are not "applicable restrictions."[93]

C. *Gift on Formation*

Finally, the IRS has argued that "the decedent ... made a taxable gift upon the creation of the [FLP]."[94] The taxable gift would be valued at the "fair market value of the assets transferred to the partnership ... less the fair market value of the partnership ... interest" that the decedent received upon contributing his assets.[95] The idea is that the decedent made a taxable gift to the other partners of the difference between the value of the underlying assets and the value of the partnership interests.[96] Here, the IRS has had limited success. In *Shepherd v. Commissioner*,[97] the Tax Court held that if a partner contributes assets to an FLP, which are then allocated to that partner's account as well as to other noncontributing partners'

89. § 2703(a)(2); *id.* § 2703(b)(1)–(3).

90. *Strangi I*, 115 T.C. 478, 488–89 (2000), *aff'd in part, rev'd in part sub nom. Strangi II*, 293 F.3d 279 (5th Cir. 2002).

91. § 2704(b)(1).

92. Treas. Reg. § 25.2704-(2)(b) (2005).

93. *See, e.g.*, Kerr v. Comm'r, 292 F.3d 490, 494–95 (5th Cir. 2002) (holding that the restrictions at issue are not "applicable restrictions"); Estate of Jones v. Comm'r, 116 T.C. 121, 130 (2001) (holding that the FLP restrictions were no more restrictive than state law); Knight v. Comm'r, 115 T.C. 506, 519–20 (2000) (same).

94. *See* Lieb, *supra* note 66, at 896–98; *see also* Porter, *supra* note 14, at 49 (noting that the IRS has argued that a "gift on formation" is the result of FLP formation).

95. *See* Lieb, *supra* note 66, at 896 (quoting Dennis I. Belcher & David T. Lewis, *Gift on Creation: The IRS Attacks Family Limited Partnerships*, 13 PROB. & PROP. 13, 13–14 (1999)); *see also* I.R.S. Tech. Adv. Mem. 98-42-003 (July 2, 1998) (in which the IRS argued the "gift on formation" theory for the first time).

96. *See* Porter, *supra* note 14, at 49; Lieb, *supra* note 66, at 896.

97. 115 T.C. 376 (2000), *aff'd* 283 F.3d 1258 (11th Cir. 2002).

accounts, the transfers to the partnership are gifts to the noncontributing partners.[98] However, in spite of this holding, in *Strangi I* the Tax Court declined to apply the gift on formation theory, noting: "[T]he disparity between the value of the assets in the hands of decedent and the alleged value of his partnership interest reflects on the credibility of the claimed discount .... It does not reflect a taxable gift."[99] The Tax Court also distinguished *Shepherd*, because in that case the transferring partner's contributions to the FLP were allocated to the noncontributing partners' capital accounts.[100] The transfer of Strangi's assets to the FLP were all credited to the decedent's capital account; thus, it is difficult to argue that the decedent made a gift to the noncontributing partners.[101]

While the above arguments have proven largely unsuccessful for the IRS,[102] in the past few years it has searched its arsenal and found a new weapon in § 2036. The Tax Court has been willing to include an FLP's underlying assets in a decedent's estate, thereby ignoring claimed valuation discounts.[103] When this occurs, "the assets the

98. *Id.* at 389.

99. *Strangi I*, 115 T.C. 478, 490 (2000), *aff'd in part, rev'd in part sub nom. Strangi II*, 293 F.3d 279 (5th Cir. 2002).

100. *See id.* at 490 (citing *Shepherd*, 115 T.C. at 389).

101. *Id.* The Tax Court in *Strangi I* also cites *Kincaid v. United States*, an "analogous" case in which a taxpayer donated land to a family corporation in exchange for stock and in which the court held that she had made a gift of the difference in the value of the land and the stock. *See id.* at 484–90 (citing Kincaid v. United States, 682 F.2d 1220, 1226 (5th Cir. 1982)). However, the court distinguishes *Kincaid*, because in that case it appeared that the other shareholders in the family corporation's interests in the land were greatly enhanced. *See Kincaid*, 682 F.2d at 1224. In *Strangi I*, by contrast, the decedent maintained an interest in the transferred assets, and the other partners (his children) did not receive an interest in those assets until his death. *Strangi I*, 115 T.C. at 490.

102. *See Strangi I*, 115 T.C. at 486–87, 488–89, 489–90 (rejecting all three discussed arguments); *see also* Kerr v. Comm'r, 292 F.3d 490, 494 (5th Cir. 2002) (refusing to disregard restrictions in valuing the FLP assets); Estate of Thompson v. Comm'r, 84 T.C.M. (CCH) 374, 385 (2002), *aff'd* 382 F.3d 367 (3d Cir. 2004) (rejecting the argument that the decedent's FLP lacked economic substance); Estate of Jones v. Comm'r, 116 T.C. 121, 130 (2001) (refusing to disregard restrictions in valuing the FLP assets and likening the result to that reached in *Kerr*); Knight v. Comm'r, 115 T.C. 506, 514 (2000) (rejecting both the economic substance and special valuation rule arguments); Church v. United States, 2000-1 U.S. Tax Cas. (CCH) ¶ 60,369, at 84,778, 84,780–81 (T.C. 2000) (holding no gift on formation was made where each partner contributed to the FLP), *aff'd*, 268 F.3d 1063 (5th Cir. 2001). *But see Shepherd*, 115 T.C. at 389 (holding an indirect gift on formation was made where the assets contributed to an FLP are credited not only to the transferring partner's capital account but also to the noncontributing partners' accounts).

103. *See, e.g.*, Estate of Harper v. Comm'r, 83 T.C.M. (CCH) 1641, 1652 (2002) (illustrating the Tax Court's willingness to include an FLP's underlying assets in a decedent's estate and thereby ignoring claimed valuation discounts); *Thompson*, 84 T.C.M. (CCH) at 387 (same); Estate of Reichardt v. Comm'r, 114 T.C. 144, 158 (2000) (same); Estate of Schauerhamer v. Comm'r, 73 T.C.M. (CCH) 2855, 2858 (1997) (same).

donor-decedent contributed to the [FLP] are included in his gross estate for estate tax purposes, including those representing assets that were previously gifted away."[104] In the next Part of this Comment, the legislative history, purpose, early interpretations, and Tax Court applications of § 2036(a) will be discussed. This discussion reveals that despite evidence that § 2036 should not apply to FLPs—and reliance on this evidence by estate planners—§ 2036 has proven to be the IRS's most successful weapon yet against FLPs.

III. THE IRS FINDS WAYS TO WIN WITH SECTION 2036

A. Legislative History

Section 2036 of the Internal Revenue Code, governing transfers with retained life estate, provides in part:

> (a) General rule. The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration . . .), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death . . .—
>
> (1) the possession or enjoyment of, or the right to the income from the property, or
>
> (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.
>
> (b) Voting rights.
>
> (1) In general. For purposes of subsection (a)(1), the retention of the right to vote (directly or indirectly) shares of stock of a controlled corporation shall be considered to be a retention of the enjoyment of transferred property . . . .[105]

In order for § 2036(a)(1) to apply to a lifetime transfer, such as the transfer of assets to an FLP, two conditions must be met: (1) the transfer must not be a "bona fide sale for an adequate and full consideration in money or money's worth" and (2) the decedent-

104. Ruttenberg, *supra* note 66, at 51.
105. I.R.C. § 2036(a)–(b) (2000).

transferor must have retained "the possession or enjoyment of, or the right to the income from, the property."[106] By using § 2036 to attack the bona fides of the creation of an FLP, the IRS seeks to bring the undiscounted, underlying assets of an FLP back into the transferor's estate.[107] Thus, in applying § 2036, the IRS attempts to restore substance over form and to treat the two neighbors discussed in the Introduction to this Comment in identical fashion.

To understand § 2036, it is helpful to examine the legislative history of the provision and its purpose. The purpose of § 2036's predecessors[108] was to prevent estate tax avoidance by those who transferred their property before death but retained a life estate in that property.[109] In the case where a donor-decedent did this, "the value of the entire asset, not just the life estate, was included in a donor-decedent's gross estate."[110] However, a flurry of Supreme Court per curiam opinions in 1931 stating unambiguously that remainder interests would avoid estate taxation under the precursor of § 2036, § 302(c),[111] caused Congress to quickly amend § 302(c) to substantially its current version in § 2036.[112]

B. The Genesis of FLPs

The Supreme Court's last look at § 2036 came in 1972, in *United States v. Byrum*.[113] In that case, the decedent, Byrum, transferred stock from three corporations he controlled into an irrevocable trust

106. *Id.*

107. *See, e.g.*, *Strangi IV*, 417 F.3d 468, 475–76 (5th Cir. 2005); Estate of Thompson v. Comm'r, 382 F.3d 367, 372–81 (3d Cir. 2004); Kimbell v. United States, 371 F.3d 257, 260 (5th Cir. 2004).

108. *See* Revenue Act of 1916, Pub. L. No. 64-271, § 202(b), 39 Stat. 746, 777–78 (codified as amended at I.R.C. § 2036 (2000)), *amended by* Revenue Act of 1926, Pub. L. No. 69-20, § 302(c), 44 Stat. 9, 70. Section 302(c), as amended, was re-codified as § 811(c)(1)(B) of the Internal Revenue Code of 1939. Then it was re-codified as § 2036(a) of the Internal Revenue Code of 1954. For a detailed history of § 2036, see Ruttenberg, *supra* note 66, at 51–55.

109. *See* Helvering v. Bullard, 303 U.S. 297, 298 (1938).

110. Ruttenberg, *supra* note 66, at 52.

111. *See* McCormick v. Burnet, 283 U.S. 784, 784 (1931) (per curiam); Morsman v. Burnet, 283 U.S. 783, 783–84 (1931) (per curiam); Burnet v. N. Trust Co., 283 U.S. 782, 783 (1931) (per curiam). Under § 302(c) remainder interests were not made part of the donor-decedent's gross estate for taxation purposes because, although the statute was clear that a retained life estate in an asset constituted "possession and enjoyment" of an asset, it was not clear that a remainder interest did so. Ruttenberg, *supra* note 66, at 52–53.

112. The same day that *McCormick*, *Morsman*, and *North Trust Co.* were handed down, both houses of Congress unanimously passed an amendment to § 302(c), which the President also signed that day. Revenue Act of 1932, Pub. L. No. 72-154, 47 Stat. 169; Ruttenberg, *supra* note 66, at 54–55.

113. 408 U.S. 125 (1972).

for the benefit of Byrum's children and with a bank as trustee.[114] Byrum retained the right, however: (1) to vote the shares of stock transferred to the trust; (2) to object to the transfer or sale of any trust assets; (3) to approve investments; and (4) to discharge the trustee and select another.[115] The IRS sought to have the value of the stock transferred included in the value of Byrum's estate on the grounds that he had retained the right to designate who enjoyed the income from the property pursuant to § 2036(a)(2).[116] The Supreme Court held in favor of the estate,[117] in part because Byrum's fiduciary duty to the corporations and their other shareholders limited his right to designate who possessed or enjoyed the income from the stock under § 2036(a)(2).[118] Unhappy with the result in *Byrum*,[119] Congress amended § 2036 and added subsection (b), which expressly states that the retention of the right to vote shares of stock in a controlled corporation will be considered retention of the enjoyment of such property.[120]

But even though Congress overruled *Byrum* by statute, § 2036(b) by its terms does not apply to noncorporate entities such as FLPs. So after *Byrum*, estate planners began widely using FLPs for their clients, relying on the fiduciary duty idea in *Byrum* to "keep the FLP's underlying assets out of their [clients'] gross estates."[121] They reasoned that the general partner of an FLP owes a fiduciary duty to the FLP and its limited partners that is similar to the fiduciary duty owed to the corporation and its shareholders by the corporate directors.[122] This fiduciary duty limited the general partners' power to control the FLP and, therefore, "was not a legal right to designate

114. *Id.* at 126.

115. *See id.* at 126–27; Ruttenberg, *supra* note 66, at 57.

116. *Byrum*, 408 U.S. at 131–32.

117. *Id.* at 136–37.

118. *Id.* at 142.

119. H.R. REP. NO. 94-1380 at 65, *as reprinted in* 1976 U.S.C.C.A.N. 3356, 3419.

120. I.R.C. § 2036(b) (2000). Compare the *Byrum* situation with one in which parents control a corporation and retain only voting common shares, giving away nonvoting common shares. The parents have not retained the right to vote under § 2036(b) because the shares given away never had voting rights. *See* I.R.S. Notice 89-99, 1989-2 C.B. 422, at 428–39. Chapter 14 of the Internal Revenue Code (special valuation rules) also exempts this type of situation from its reach. *See* S. REP. NO. 95-745 at 82–85 (1978); I.R.S. Tech. Adv. Mem. 1999-38-005 (June 7, 1999); I.R.S. Priv. Ltr. Rul. 90-04-017 (Oct. 27, 1989). *See generally* 5 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS ¶ 126.6.5 (2d ed. 1989) ("[I]f the decedent transferred voting and nonvoting stock, reserving the right to vote, only the voting stock is included under §2036(b).").

121. *See* Ruttenberg, *supra* note 66, at 59–60.

122. *See id.* at 59–60 & n.117.

under section 2036(a)(2)."[123] The IRS also approved these transactions in fifteen years' worth of Private Letter Rulings and Technical Advice Memoranda,[124] which, though lacking precedential value,[125] created reliance among estate planners.[126]

C. *Early Tax Court Opinions on Section 2036 in the FLP Context*

However, this reliance may have been misplaced, as the Tax Court[127] has become more and more willing to apply § 2036 to FLPs.[128] The first time a court held that an FLP's assets fell within § 2036(a)(1) was in 1997, when the Tax Court issued a Memorandum Opinion in *Estate of Schauerhamer v. Commissioner*.[129] In that case, the decedent, Schauerhamer, had established three FLPs[130] but during her lifetime she disregarded them and did not respect their existence, making the Tax Court's decision much easier. For example,

123. *See id.* at 60.

124. *See* I.R.S. Tech. Adv. Mem. 91-31-006 (Aug. 2, 1999); I.R.S. Priv. Ltr. Rul. 97-10-021 (Mar. 7, 1997); I.R.S. Priv. Ltr. Rul. 94-15-007 (Apr. 15, 1994); I.R.S. Priv. Ltr. Rul. 93-10-039 (Mar. 12, 1993); I.R.S. Tech. Adv. Mem. 86-11-004 (Nov. 15, 1985).

125. I.R.C. § 6110(k)(3) (2000).

126. *See* Mario A. Mata, *Use of FLPs and LLCs in Asset Protection Planning*, PRAC. TAX LAW., Winter 2004, at 15, 15–30. Interestingly, the IRS once acknowledged that the fiduciary duties of the general partner of an FLP were a sufficient restraint on the general partner so as to "preclude inclusion of the transferred interests in the general partner transferor's gross estate." *See* I.R.S. Priv. Ltr. Rul. 94-15-007 (Jan. 12, 1994); I.R.S. Priv. Ltr. Rul. 93-10-039 (Dec. 16, 1992); I.R.S. Priv. Ltr. Rul. 93-32-006 (Aug. 20, 1992); I.R.S. Priv. Ltr. Rul. 91-31-006 (Apr. 30, 1991); Gagliardi, *supra* note 7, at 435 n.175.

127. The United States Tax Court is an administrative court established by Congress under Article I of the Constitution. *See* United States Tax Court, About the Court, http://www.ustaxcourt.gov/about.htm (last visited Dec. 9, 2005). Nineteen presidentially appointed judges serving fifteen-year terms make up the Tax Court. *See* Stephen C. Gara, *Challenging the Finality of Tax Court Judgments: When Is Final Not Really Final?*, 20 AKRON TAX J. 35, 39–40 (2005). In addition to those judges, senior judges sitting by designation and special trial judges conduct trials. *See* United States Tax Court, About the Court, http://www.ustaxcourt.gov/about.htm (last visited Dec. 9, 2005). A taxpayer may petition the Tax Court within ninety days of a deficiency notice from the IRS; after ninety days have passed, the Tax Court loses jurisdiction. I.R.C. § 6213(a), (c). The taxpayer must then pay the tax and then sue in the United States Claims Court or in a district court for a refund. *See* David P. Korteling, Comment, *Let Me Tell You How It Will Be: Here's One for You, Nineteen for Me: Modifying the Internal Revenue Service's Approach to Resolving Tax Disputes*, 7 ADMIN. L.J. AM. U. 659, 666 & n.41–42 (1993). Thus, one reason the Tax Court is an attractive forum for litigating tax disputes is that the taxpayer does not have to pay the disputed amount before receiving a judgment. *See* Gara, *supra*, at 35. Appeals from the Tax Court are to the United States Court of Appeals for the circuit in which the taxpayer resides. I.R.C. § 7482.

128. *See* Ruttenberg, *supra* note 66, at 67–90 (discussing several Tax Court holdings applying § 2036(a)(1) to FLPs).

129. 73 T.C.M. (CCH) 2855, 2858 (1997).

130. *Id.* at 2856.

Schauerhamer commingled partnership and nonpartnership funds in her personal bank account, she paid her personal and partnership expenses from this bank account, and she maintained no records to account for the separate funds.[131] In holding that § 2036(a)(1) applied, the Tax Court found that the partners had an implied agreement that Schauerhamer would retain the economic benefits of the transferred property for her life.[132]

This implied agreement theory was also important to the Tax Court in *Estate of Reichardt v. Commissioner*,[133] in which a widower formed an FLP with his two children and transferred substantially all of his property to that FLP.[134] As was the case in *Schauerhamer*, the decedent in *Reichardt* commingled personal and partnership funds and retained control of investments.[135] Furthermore, Reichardt transferred his personal residence to the FLP but never paid the FLP rent for the use of such residence thereafter.[136] The Tax Court held that § 2036(a)(1) was applicable to all the property Reichardt transferred to the FLP.[137] The court reasoned that the only real change to the property Reichardt transferred to the FLP was a change in legal title and that Reichardt and his children had an implied agreement that for Reichardt's lifetime he would retain the economic benefits from the transferred property.[138]

The Tax Court again applied the implied agreement theory in *Estate of Harper v. Commissioner*.[139] In that case, the decedent contributed the majority of his assets to an FLP, of which his two children were general partners and a revocable trust was the limited partner.[140] However, the general partners could not act on a number of issues without written consent from the limited partner trust, of which the decedent was the trustee and primary beneficiary.[141] This arrangement, coupled with the same commingling of funds that occurred in *Schauerhamer* and *Reichardt*, led the Tax Court to find there was an implied agreement between Harper and his children that

131. *Id.* at 2857.
132. *Id.*
133. 114 T.C. 144 (2000).
134. *Id.* at 147–48.
135. *Id.* at 148–49.
136. *Id.*
137. *See id.* at 158.
138. *See id.* at 152–55; *see also* Droubay, *supra* note 14, at 534 (discussing the holding in *Reichardt*).
139. 83 T.C.M. (CCH) 1641, 1650 (2002).
140. *Id.* at 1642.
141. *Id.* at 1642–43.

Harper would retain the economic benefits of the property he transferred to the FLP.[142] Thus, § 2036(a)(1) operated to include the value of the transferred property in the decedent's gross estate.[143]

Also in *Harper*, the Tax Court introduced its "recycling of value" theory by which it has continued to apply § 2036(a)(1) to FLP assets.[144] Under the recycling theory, a transaction is not "bona fide" and, thus, is not excepted from § 2036(a)(1)'s reach[145] if the taxpayer acts as both transferor and controlling partner of the transferee entity.[146] The Tax Court found that the decedent in *Harper* had merely "change[d] the form in which he held his beneficial interest in the contributed property."[147] In other words, the Tax Court found that he had just "recycled" it.[148]

However, there were still some instances when the Tax Court refused to apply § 2036(a)(1) to an estate. Retention of enjoyment of the transferred property proved to be the downfall of the estates of Schauerhamer, Reichardt, and Harper. But § 2036(a) also includes a parenthetical exception "to the general rule of inclusion in a decedent's gross estate under subsections 2036(a)(1) or (2)."[149] Basically, a transfer falling within subsections 2036(a)(1) or (2) "does not cause inclusion in the decedent's gross estate"[150] if it is a "bona fide sale for an adequate and full consideration in money or money's worth."[151] In *Harper*, the Tax Court stated that the two requirements for exception were: "(1) [a] bona fide sale . . . and (2) adequate and full consideration."[152] Such requirements were met in *Estate of Stone v. Commissioner*,[153] wherein a husband and wife set up five FLPs for their children just seven months before the husband's death and two years before the wife's.[154] The Tax Court distinguished *Stone* from *Schauerhamer*, *Reichardt*, and *Harper* because the *Stone* "partnerships were created as a result of arm's-length negotiations, in

142. *Id.* at 1649–50.
143. *Id.* at 1649.
144. *Id.* at 1653.
145. *See* I.R.C. § 2036(a) (2000) (excepting a "bona fide sale for an adequate and full consideration").
146. Mitchell M. Gans & Jonathan G. Blattmachr, Strangi: *A Critical Analysis and Planning Suggestions*, 100 TAX NOTES 1153, 1163 (2003).
147. *Harper*, 83 T.C.M. (CCH) at 1653.
148. *Id.*
149. *See* Ruttenberg, *supra* note 66, at 93.
150. *Id.* at 94.
151. I.R.C. § 2036(a) (2000).
152. *Harper*, 83 T.C.M. (CCH) at 1653.
153. 86 T.C.M. 551 (2003).
154. *Id.* at 552, 560; *see also* Easton, *supra* note 11, at 36–37 (summarizing *Stone*).

which each family member was represented by independent counsel" and were "motivated by investment and business concerns."[155]

These early Tax Court cases not only gave practitioners illustrations of bad facts to avoid regarding the formation and operation of FLPs but also illustrated the importance of the bona fide sale exception.[156] Before the circuit courts had weighed in on the meaning of the exception, the Tax Court seemed to require evidence of "(1) legitimate negotiations during formation of the FLP, and (2) with respect to funding and operation, something more than a mere recycling of value."[157] To avoid recycling, there must be a "legitimate pooling of assets and/or the presence of a legitimate business."[158]

D. Qualifying for the Bona Fide Sale Exception to Section 2036

After these early Tax Court decisions, one goal for estate planners using FLPs was to qualify for the bona fide sale exception.[159] The meaning of that exception is currently unclear, however, as evidenced by the conflict in recent decisions by the Fifth and Third Circuits. These decisions are discussed in Part IV of this Comment. There are, however, certain guidelines that commentators and practitioners agree should be followed in structuring an FLP today.[160] An FLP should be operated "in a businesslike and formal manner, with real transactions for real purposes, other than mere tax savings."[161] The decedent should avoid the commingling of funds that the Tax Court relied on in *Schauerhamer*, *Reichardt*, and *Harper* as evidence of retaining enjoyment by transferring contributed property immediately to the partnership and keeping partnership and personal accounts separate.[162] The other partners should participate in the formation of the FLP to the extent possible so as to avoid the implication that the FLP's formation was simply an alternate method of ensuring that the decedent's testamentary wishes were carried

155. Easton, *supra* note 11, at 37.

156. *See* Korpics, *supra* note 29, at 111–12.

157. *See id.* at 112 (citing *Harper* and *Stone*, as well as the Tax Court dispositions of *Thompson* and *Strangi*).

158. *See id.*

159. Lance S. Hall, Estate of Stone *Brings Sanity to § 2036*, VALUATION TODAY ARCHIVE, Feb. 7, 2003, http://www.fmv.com/data/ValuationToday_Archive_11_7_03.php?x=1.

160. *See* Louis S. Harrison & Charles F. "Monty" Newlin, *New Golden Rule for Partnerships*, TR. & EST., Oct. 2004, at 20, 23.

161. *Id.*

162. *See* Bissonnette, *supra* note 3, at 77; Lieb, *supra* note 66, at 910.

out.[163] The decedent should also retain sufficient assets to support himself rather than transferring substantially all of his assets to the FLP.[164] Finally, if the decedent continues to possess partnership assets, he should pay the partnership for their use.[165]

Further evidence that § 2036 is inappropriate for application to FLPs lies in the fact that President Bill Clinton's administration tried several times to motivate Congress to pass a statute expressly dealing with FLPs.[166] If the Clinton administration had felt that an existing provision of the Internal Revenue Code effectively dealt with FLPs, it would not have been logical for the Administration to seek legislation.[167]

IV. UNCERTAINTY AMONG THE CIRCUITS AND THE TAX COURT

While it is clear that the bona fide sale exception still exists in the context of § 2036(a),[168] courts are defining what constitutes "a bona fide sale for an adequate and full consideration in money or money's worth"[169] in different terms, causing confusion among practitioners and commentators.[170] The Fifth and Third Circuits seem to disagree on whether a decedent who has received proportionate interests in an FLP for her contributions to the FLP has received full and adequate

163. *See* Bissonnette, *supra* note 3, at 77; Updike, *supra* note 2, at 38; Lieb, *supra* note 66, at 910.

164. *See* Bissonnette, *supra* note 3, at 78; Lieb, *supra* note 66, at 910.

165. *See* Bissonnette, *supra* note 3, at 78 (noting that a downside to such an arrangement is that it results in taxable income for the partnership, with the result being "that the client will be taxed on the income resulting from the rent he has paid"); Lieb, *supra* note 66, at 910.

166. *See* U.S. TREASURY DEP'T, GENERAL EXPLANATION OF THE ADMINISTRATION'S REVENUE PROPOSALS 167 (1999); STAFF OF THE J. COMM. ON TAXATION, 106TH CONG., DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2000 BUDGET PROPOSAL 291–93 (Comm. Print 1999).

167. *See* Christopher P. Bray, *Was* Strangi II *a Setup?*, PLANNED GIVING DESIGN CENTER, Feb. 10, 2004, http://www.pgdc.com/usa/item/?itemID=106229#fn22. Bray's references to *Strangi II* refer to *Estate of Strangi v. Comm'r*, 85 T.C.M. (CCH) 1331 (2003), which this Comment refers to as *Strangi III*. *See supra* note 71.

168. *See* Estate of Stone v. Comm'r, 86 T.C.M. 551, 578 (2003).

169. I.R.C. § 2036(a) (2000).

170. *See* Korpics, *supra* note 20, at 34–35 (discussing pre-*Bongard* and post-*Bongard* approaches to the bona fide sale exception); Korpics, *supra* note 29, at 112–13 (discussing the differences between the Tax Court's, the Third Circuit's, and the Fifth Circuit's approaches to recognizing the bona fide sale exception). *Compare* Estate of Thompson v. Comm'r, 382 F.3d 367, 381 (3d Cir. 2004) (finding where the partnership interests do not have the same value as the transferred assets that heightened scrutiny of whether full and adequate consideration has been paid is triggered), *with* Kimbell v. United States, 371 F.3d 257, 266 (5th Cir. 2004) (holding decedent's receipt of proportionate interests in the FLP meant she had received full and adequate consideration).

consideration.[171] Furthermore, both circuits and the Tax Court use different language to define the bona fide sale exception, causing confusion, uncertainty, and inconsistency.[172]

The battle over FLPs came to a head in the fall of 2004 when the Court of Appeals for the Third Circuit decided in *Estate of Thompson v. Commissioner*[173] that § 2036(a)(1) applied to a transfer by a ninety-five year old decedent of about $2.8 million to two FLPs.[174] Applying § 2036(a)(1), the Third Circuit determined that no "bona fide sale for adequate and full consideration"[175] took place, in part because the reduction in value that occurs when assets are contributed to a partnership (i.e., the difference between the value of the underlying property transferred to the partnership and the value of the partnership interests received) reduces the possibility of full and adequate consideration being paid.[176] This appears to conflict with the Court of Appeals for the Fifth Circuit's decision on this issue.

Just a few months before *Thompson* was decided, the Fifth Circuit in *Kimbell v. United States*[177] held that § 2036(a)(1) did not apply where a ninety-six year old woman transferred nearly all of her assets to an FLP and died within two months of its creation, and her executor claimed that her ninety-nine percent limited partnership interest should be discounted by nearly half.[178] There, the Fifth

171. While the Fifth Circuit found that the decedent's receipt of proportionate interests in the FLP meant she had received full and adequate consideration, the Third Circuit stated that full and adequate consideration does not exist unless the partnership interests had the same value as the transferred assets. *Compare Thompson*, 382 F.3d at 381, *with Kimbell*, 371 F.3d at 266. The *Thompson* concurrence more explicitly disagreed with *Kimbell*, quoting the Fifth Circuit and suggesting that the *Kimbell* court "does not take into account that . . . the property transferred must be 'replaced by property of equal value that could be exposed to inclusion in the decedent's gross estate.' " *Thompson*, 382 F.3d at 387 n.24 (Greenberg, J., concurring) (quoting Estate of D'Ambrosio v. Comm'r, 101 F.3d 309, 313 (3d Cir. 1996)).

172. *See Thompson*, 382 F.3d at 378–79, 383 (discussing the idea that there is no consideration where there is a "mere recycling of value" and that a bona fide sale requires "good faith"); *Kimbell*, 371 F.3d at 265–67 (suggesting that a sale between family members can be bona fide if it is not a "sham transaction" and that objective facts such as donors receiving proportionate interests in the partnership based on assets contributed inform the consideration question); Estate of Bongard v. Comm'r, 124 Tax Ct. Rep. Dec. (RIA) ¶ 124.8, at 124-54, 124-68 (T.C. Mar. 15, 2005) (defining the requirements for a bona fide sale as "a legitimate and significant nontax reason for creating the [FLP]" and "partnership interests proportionate to the value of the property transferred").

173. 382 F.3d 367 (3d Cir. 2004).

174. *Id.* at 369.

175. Where there is a bona fide sale, the transfer is excepted from § 2036's reach. *See* I.R.C. § 2036(a) (2000).

176. *Thompson*, 382 F.3d at 381.

177. 371 F.3d 257 (5th Cir. 2004).

178. *Id.* at 259–60.

Circuit said that there is full and adequate consideration if each partner receives partnership interests in proportion to the value of the property that partner contributed.[179] The *Thompson* court rejected this idea unless the transaction was a commercial one, that is, that the primary purpose of the partnership arrangement was a business, nontax purpose.[180] The estates in both cases presented similar "ugliness,"[181] but the courts reached different results, applying § 2036(a)(1) to return the FLP's assets to the estate in *Thompson*[182] but refusing to do so in *Kimbell* where the court found full and adequate consideration.[183]

In the summer of 2005, the Fifth Circuit weighed in on the FLP debate again in *Strangi v. Commissioner* ("*Strangi IV*"),[184] affirming the Tax Court's conclusion that § 2036(a) requires a decedent's estate to include assets transferred by him during his life to an FLP.[185] After first rejecting the estate's argument that the decedent did not maintain "possession or enjoyment" of the property he transferred to the FLP, the Fifth Circuit conceded that the decedent received "adequate and full consideration" because he received proportional interests in the FLP in exchange for the assets transferred.[186] However, because the Tax Court rejected each of the estate's proffered nontax purposes for the transfers and these rejections were not clearly erroneous, the sale was not bona fide.[187] Under the Third Circuit's reasoning, it is not clear even that "adequate and full consideration" would be found in *Strangi IV*.[188]

Further adding to the uncertainty about § 2036(a)(1)'s application to FLPs, the full Tax Court in *Estate of Bongard v. Commissioner*[189] determined that the "bona fide sale for adequate and full consideration exception is met" where there is a "legitimate and significant non-tax reason" for the FLP's creation and where the "transferors received partnership interests proportionate to the value

179. *Id.* at 262.
180. *See Thompson*, 382 F.3d at 383; *see also* Harrison & Newlin, *supra* note 160, at 32 (describing the different interpretations of the Third and Fifth Circuits).
181. Harrison & Newlin, *supra* note 160, at 20 (referring to the bad facts in both cases).
182. *Thompson*, 382 F.3d at 369.
183. *Kimbell*, 371 F.3d at 262.
184. 417 F.3d 468 (5th Cir. 2005).
185. *Id.* at 472.
186. *Id.* at 478–79.
187. *Id.* at 481–82.
188. *See* Estate of Thompson v. Comm'r, 382 F.3d 367, 387 (3d Cir. 2004).
189. 124 Tax Ct. Rep. Dec. (RIA) ¶ 124.8, at 124-54 (T.C. Mar. 15, 2005).

of the property transferred."[190] However, the Tax Court in *Bongard* also determined the nontax reasons for forming the FLP were not legitimate or significant enough on the facts of that case.[191]

After *Kimbell*, *Thompson*, *Bongard*, and *Strangi IV*, it is, of course, still possible to form an FLP that would withstand scrutiny by the IRS or a court.[192] However, uncertainty reigns at the margins.[193] In the Sections that follow, these cases will be discussed in further depth to illuminate the uncertainty and inconsistency regarding the bona fide sale exception to § 2036 and underscore the need for corrective legislation.

A. Kimbell

Ruth Kimbell died at age ninety-six.[194] Two months before her death, an FLP was created by two entities: (1) a trust of which Kimbell and her son were co-trustees; and (2) a limited liability corporation ("LLC") owned by the trust and by Kimbell's son and daughter-in-law.[195] The LLC contributed one percent of the FLP's assets and was the FLP's general partner, while the trust contributed ninety-nine percent of the FLP's assets and was the FLP's only limited partner.[196] When the IRS audited Kimbell's estate tax return, it found the value of her limited partnership interest to be $2.4 million, double the $1.2 million the estate reported.[197]

Kimbell's son paid the extra tax and then sued for a refund in federal district court in Texas.[198] When addressing the bona fide sale exception, the district court relied on *Harper* for the proposition that two requirements must be met for that exception to apply: "(1) a bona fide sale, meaning an arm's length transaction, and (2) adequate and full consideration."[199] The district court found that neither

190. *Id.* at 124-68. The Tax Court further went on to discuss certain nontax reasons that might satisfy the bona fide sale exception: investment management, creditor protection, and pooling of assets. *See id.*

191. *Id.* at 124-73.

192. *See* Korpics, *supra* note 29, at 111; *see also* Estate of Schutt v. Comm'r, 89 T.C.M. (CCH) 1353, 1367–68 (2005) (determining that the decedent's transfer of assets to two family entities were bona fide sales because there existed a "legitimate and significant non-tax reason"—perpetuation of a long-standing investment philosophy—for the transfer).

193. *See supra* note 31.

194. Kimbell v. United States, 371 F.3d 257, 259 (5th Cir. 2004).

195. *Id.*

196. *Id.*

197. *Id.* at 260.

198. *See* Easton, *supra* note 11, at 38.

199. *Kimbell*, 371 F.3d at 261.

requirement was met in *Kimbell*. First, because family members were on both sides of the transaction, the district court held that "the transfer was not at arm's length."[200] Also, if the transfer of assets to the FLP was a bona fide sale, the pro rata interest that Kimbell received in the FLP (a ninety-nine percent interest for ninety-nine percent asset contribution) was not adequate consideration.[201]

The Fifth Circuit reversed.[202] The court laid out the following principles:

> [W]hat is required for the transfer by Mrs. Kimbell to the Partnership to qualify as a bona fide sale is that it be a sale in which the decedent/transferor actually parted with her interest in the assets transferred and the partnership/transferee actually parted with the partnership interest issued in exchange. In order for the sale to be adequate and full consideration, the exchange of assets for partnership interests must be roughly equivalent so the transfer does not deplete the estate. In addition when the transaction is between family members, it is subject to heightened scrutiny to insure that the sale is not a sham transaction or a disguised gift. The scrutiny is limited to the examination of objective facts that would confirm or deny the taxpayer's assertion that the transaction is bona fide or genuine.[203]

In determining that adequate and full consideration was received by Kimbell in this case, the court focused on:

> (1) whether the interest credited to each of the partners was proportionate to the fair market value of the assets each partner contributed to the partnership, (2) whether the assets contributed by each partner to the partnership were properly credited to the respective capital accounts of the partners, and (3) whether on termination or dissolution of the partnership the partners were entitled to distributions from the partnership in amounts equal to their respective capital accounts. The answer to each of these questions in this case is yes.[204]

The Fifth Circuit went on to list several facts it found important in determining that Kimbell's transfer to the FLP was a bona fide sale.[205] These included the facts that Kimbell did not commingle

200. *Id.* at 262.
201. *Id.*
202. *Id.* at 269.
203. *Id.* at 265.
204. *Id.* at 266 (citation omitted).
205. *Id.* at 267.

personal and FLP assets and maintained sufficient assets outside the FLP for her support, that "[FLP] formalities were satisfied," that among the assets contributed to the FLP were working oil and gas interests, and that "several credible and unchallenged non-tax business reasons" existed for the formation of the FLP.[206] Thus, the court determined that adequate and full consideration could be found where a partner receives an interest in the FLP proportionate to the value of her contribution to the FLP, even though the fair market value of the FLP interest is lower than the fair market value of the contributed property.[207] This is so, the court reasoned, because deciding to exchange marketable assets for a "transfer-restricted, non-managerial interest in a limited partnership" is a business decision that involves "financial considerations other than the purchaser's ability to turn right around and sell."[208] Some of the benefits sought by investors in these types of transactions include "management expertise, security and preservation of assets, capital appreciation and avoidance of personal liability."[209] Thus, the Fifth Circuit determined that it was not inconsistent to acknowledge "that the investor[] . . . ha[s] acquired a[n] . . . interest at arm's length for adequate and full consideration and . . . that the asset thus acquired has a present fair market value . . . of substantially less than the dollars just paid—a classic informed trade-off."[210]

B. Thompson

Four months later, the Third Circuit disagreed with the Fifth Circuit's interpretation of what could constitute full and adequate consideration.[211] In *Thompson*, Theodore Thompson formed two FLPs—one for each of his children—two years before his death at age ninety-seven.[212] Thompson owned forty-nine percent of the minority corporate general partners of each FLP.[213] Thompson contributed just over $1.4 million to each FLP, retaining only about $153,000 in

206. *Id.*
207. *Id.* at 266.
208. *Id.*
209. *Id.*
210. *Id.*
211. *See generally* Harrison & Newlin, *supra* note 160 (comparing the competing interpretations of the "full and adequate consideration exception to 2036").
212. Estate of Thompson v. Comm'r, 382 F.3d 367, 370 (3d. Cir. 2004).
213. *Id.* The corporate general partners maintained only a one percent interest in each FLP, so Theodore Thompson owned forty-nine percent of the one percent general partners. *Id.*

personal assets.[214] His daughter contributed real estate interests to her FLP, and his son contributed some real estate interests and his interest in a mutual fund to his FLP.[215] On Thompson's estate tax return, the estate discounted the value of his interests in the two FLPs by forty percent.[216]

The Tax Court disallowed the discount under § 2036.[217] Facts important to the Tax Court's decision included: (1) evidence in the form of a letter from Thompson's financial advisor indicating that an FLP could be used to reduce taxes; (2) that the FLPs made distributions to Thompson to fund annual Christmas gifts; (3) that the daughter's FLP lent money to her children and grandchildren, which Thompson had done previously; (4) that the children retained income from property they contributed to their FLPs; and (5) that the assets of the FLPs were used to pay some of Thompson's bequests after his death as well as his estate taxes.[218]

On appeal, the Third Circuit affirmed the Tax Court.[219] In doing so, it concluded that the bona fide sale exception did not apply to the transfers of Thompson's property to the FLPs.[220] Because it found that the transactions "were not motivated by . . . legitimate business concerns," the court said that the FLPs served only as "a vehicle for changing the form in which the decedent held his property—a mere 'recycling of value.' "[221]

The Third Circuit distinguished *Kimbell*. First, in *Thompson*, "predominantly marketable securities" were transferred to the FLPs, which then engaged in little or no investment activities.[222] Parenthetically, the court indicated that in *Kimbell*, the bona fide sale exception was applied to "working oil and gas interests transferred to [an FLP] to provide, among other things, centralized management

214. *Id.*
215. *Id.* at 370–72.
216. *See id.* at 369.
217. *Id.*
218. *Id.* at 386–88; *see also* Easton, *supra* note 11, at 40 (summarizing the facts of *Thompson*).
219. *Thompson*, 382 F.3d at 369.
220. *Id.* at 383.
221. *Id.* at 378 (quoting Estate of Thompson v. Comm'r, 84 T.C.M. (CCH) 374, 388 (2002), *aff'd* 382 F.3d 367 (3d Cir. 2004)). The Tax Court first expressed the "recycling of value" idea in *Estate of Harper v. Commissioner*, in which the bona fide sale exception was denied. *See* Estate of Harper v. Comm'r, 83 T.C.M. (CCH) 1641, 1653 (2002) ("[S]uch instances of pure recycling do not rise to the level of a payment of consideration. To hold otherwise would open section 2036 to a myriad of abuses engendered by unilateral paper transformations.").
222. *See Thompson*, 382 F.3d at 380.

and protection."[223] Furthermore, in *Thompson* the court concluded that there was no purpose for the transfer other than tax savings and cited United States Supreme Court precedent for the proposition that such a transfer is not a "bona fide sale" within the meaning of § 2036.[224] Then the court noted that in *Kimbell*, a bona fide sale was found because the transaction was entered into for "substantial business and other non-tax purposes."[225]

However, the courts disagree about what can constitute full and adequate consideration. In *Kimbell*, the Fifth Circuit held there was full and adequate consideration if the donor-decedent received interests in the FLP proportionate to the property she contributed to the FLP, even if the fair market value of the FLP interests was less than the fair market value of the contributed property.[226] The Third Circuit disagreed that receipt of interests worth less than the fair market value of the transferred assets would always constitute full consideration so long as the interests received were proportionate.[227] The Third Circuit reasoned that if assets are transferred for assets of lesser value (e.g., limited partnership interests), "there is no transfer for 'adequate and full consideration' because the decedent has not replenished the estate with other assets of equal value."[228] Furthermore, the concurring opinion in *Thompson* directly questioned the Fifth Circuit's position.[229] Judge Greenberg quoted the *Kimbell* court's discussion of the "informed trade-off"[230] that a person makes when she transfers marketable assets for unmarketable, managed limited partnership interests and then queried whether the

223. *Id.*

224. *Id.* at 383 (citing Gregory v. Helvering, 293 U.S. 465, 469 (1935)).

225. *Id.* at 383 (citing Kimbell v. United States, 371 F.3d 266, 267 (5th Cir. 2004)).

226. *Kimbell*, 371 F.3d at 266.

227. *See id.* at 261–65 (discussing Wheeler v. United States, 116 F.3d 749 (5th Cir. 1997)). In *Kimbell*, the court relied on *Wheeler*, an earlier Fifth Circuit case applying § 2036(a) for the principle that a bona fide sale between family members is possible so long as the transaction is not a sham and "adequate and full consideration" is received such that the estate is not depleted. *Id.* at 262–63. The *Kimbell* court also pointed out that if FLP interests proportionate to the fair market value of the property transferred to the FLP are credited to the transferor, adequate and full consideration exists. *Id.* at 266. The Third Circuit in *Thompson* also cited *Wheeler* for the principle that for adequate and full consideration to be found, a transfer should not deplete the estate of the transferor. *Thompson*, 382 F.3d at 381. But then the *Thompson* court surmised that an estate has been depleted if what a transferor receives in exchange for assets transferred to the FLP is an interest "of lesser value" (for example, unmarketable minority interests). *Id.*

228. *Thompson*, 382 F.3d at 381.

229. *See id.* at 386–87 (Greenberg, J., concurring).

230. *See Kimbell*, 371 F.3d at 266. The *Kimbell* court recognized that market value is not the only measure of value to a transferor, who may value the management a partnership provides.

Fifth Circuit considered that to avoid § 2036(a) recapture, "the property transferred must be 'replaced by property of equal value that could be exposed to inclusion in the decedent's gross estate,' on a 'money or money's worth' basis."[231] Thus, the Third and Fifth Circuits are not aligned on what the meaning of "adequate and full consideration" means under § 2036(a).

C. Bongard

Further adding to the uncertainty about the meaning of the bona fide sale exception to § 2036 are the recent pronouncements by the full Tax Court in *Estate of Bongard v. Commissioner*.[232] In *Bongard*, some of the bad facts of earlier FLP cases were missing in that the decedent was middle-aged and not elderly when the FLPs in question were created, and he did not disregard the FLPs' existence before his unexpected death two years later at age fifty-eight.[233] Before his death, the decedent, Wayne Bongard, first set up an LLC as a holding company to which he transferred all of his and all of a preexisting irrevocable trust's shares of Empak, a successful closely-held corporation of which Bongard was the sole shareholder.[234] In return for transferring these shares, he received voting and nonvoting units in the LLC.[235] Later, Bongard created an FLP to which he transferred all of his nonvoting units in the LLC in exchange for a ninety-nine percent limited partner interest and some of the irrevocable trust's nonvoting units in the LLC in exchange for a one percent general partner interest.[236] After Bongard died unexpectedly while on a trip to Austria,[237] the IRS assessed his estate with a nearly $53 million federal estate tax deficiency.[238] The issues before the Tax Court were whether or not either the stock transferred to the LLC or the LLC

231. *Thompson*, 382 F.3d at 387 n.24 (Greenberg, J., concurring) (citations omitted).

232. A "reviewed decision," *Bongard* represents the views of seventeen Tax Court judges. Eleven judges comprised the majority opinion, with one of those concurring in the result only. *See* Estate of Bongard v. Comm'r, 124 Tax Ct. Rep. Dec. (RIA) ¶ 124.8, at 124-54, 124-26 (T.C. Mar. 15, 2005). Judge Laro wrote separately, concurring in the result but "uncomfortable with the analysis." *See id.* (Laro, J., with whom Marvel, J., joins, concurring). Judge Halpern and Judge Chiechi each wrote separate opinions concurring in part and dissenting in part, with two other judges agreeing with Judge Chiechi's opinion. *See id.* at 124-80 (Halpern, J., concurring in part and dissenting in part); *id.* at 124-85 (Chiechi, J., concurring in part and dissenting in part).

233. *Id.* at 124-55 to -57 (majority opinion).

234. *Id.* at 124-56.

235. *See id.* at 124-58 to -59.

236. *See id.* at 124-61.

237. *Id.* at 124-57.

238. *Id.* at 124-55.

units transferred to the FLP should be included in Bongard's estate under § 2036(a).[239] In determining that the transfer of Empak stock to the LLC was a "bona fide sale for adequate and full consideration" and thus outside § 2036, the Tax Court laid out a seemingly new standard for bona fide sales.[240] Finally, the Tax Court stated that the LLC units transferred to the FLP should be included in Bongard's estate under § 2036(a) because the bona fide sale exception did not apply and the decedent maintained "practical control" over the FLP, which the Tax Court determined was an appropriate basis for finding retained enjoyment under § 2036(a)(1).[241] In rendering these decisions, the Tax Court cited both *Kimbell* and *Thompson* but formulated a unique test for the bona fide sale exception.[242]

Regarding the bona fide sale exception, the *Bongard* majority stated that where the estate establishes "a legitimate and significant nontax reason for creating a family limited partnership, ... the adequate and full consideration exception is met if the transferors received partnership interests proportionate to the value of the property transferred."[243] The proportionate interest prong is similar to the test articulated in *Kimbell*,[244] but the "legitimate and significant

239. *Id.*

240. *See id.* at 124-68 ("[T]he bona fide sale for adequate and full consideration exception is met where the record establishes the existence of a legitimate and significant nontax reason for creating the family limited partnership, and the transferors received partnership interests proportionate to the value of property transferred."); Burgess J.W. Raby & William L. Raby, *Business Purpose, Bona Fide Sale, and Family Limited Partnerships*, Tax Notes Today (Tax Analysts) No. 2005-5964, at 1 (Mar. 22, 2005), *available at* http://www .lawprofessorblogs.com/taxprof/linkdocs/2005-5964.pdf.

241. *See Bongard*, 124 Tax Ct. Rep. Dec. (RIA) ¶ 124.8, at 124-73 to -74. After determining that the bona fide sale exception did not apply to the formation of the FLP (because the nontax reasons advanced by the estate for its formation were unpersuasive and not "significant"), the Tax Court went on to determine that § 2036(a)(1) did apply to the FLP assets, because Bongard maintained "practical control" over the FLP. *See id.* While the focus of this Comment is the confusion surrounding the meaning of the bona fide sale exception in § 2036, the use of a decedent's "practical control" over the assets of an FLP as a basis for returning those assets to the estate under § 2036(a)(1) is a new and controversial interpretation of retained enjoyment of the property under § 2036(a)(1). *See generally* Milford B. Hatcher, Jr. & Edward M. Manigault, *The Tax Court's 'Practical Control' Test in* Bongard*: More Than FLPs Are in the Balance*, 102 J. TAX'N 261 (2005) (criticizing the *Bongard* majority's analysis of "retained enjoyment"). An implied agreement of retained enjoyment of the assets is enough for a finding of retained enjoyment. *See* Treas. Reg. § 20.2036-1(a) (2005). However, in *Bongard*, the Tax Court elevated a "power of persuasion" on the part of the taxpayer to an implied agreement of retained enjoyment through "practical control" of the FLP. *See* Hatcher & Manigault, *supra*, at 268.

242. *Bongard*, 124 Tax Ct. Rep. Dec. (RIA) ¶ 124.8, at 124-72 to -73.

243. *See id.* at 124-76 (Laro, J., concurring).

244. *See* Kimbell v. United States, 371 F.3d 257, 266 (5th Cir. 2004).

nontax reason" prong may broaden the circumstances under which taxpayers may evade § 2036(a)(1).[245]

In applying the "legitimate and significant nontax reason" rule to the Bongard family entities, the Tax Court implied some of the nontax purposes it would consider legitimate enough to make a transfer to a family entity bona fide. First, the Tax Court addressed the LLC holding company to which the bona fide sale exception did apply. The court found that "the positioning and structuring of Empak to facilitate a corporate liquidity event" was a "legitimate and significant nontax reason" motivating the decedent to create the LLC holding company.[246] The Tax Court also discussed asset pooling as a significant nontax reason for formation of the LLC.[247]

Then, the Tax Court addressed the FLP to which it found the bona fide exception did not apply. The estate advanced several nontax reasons for forming the FLP to which the Tax Court determined the bona fide sale exception did not apply.[248] The nontax reasons proffered by the estate included investment management, credit protection, facilitation of a postmarital agreement, and facilitation of gift-making.[249] Although the Tax Court rejected each of these rationales for forming the FLP on the *Bongard* facts, by addressing them, the Tax Court intimated that under the right factual circumstances they might qualify as significant and legitimate nontax reasons.[250]

In addition to providing yet another explication of the bona fide sale exception to § 2036, the *Bongard* case also featured four separately authored opinions by judges weighing in on the majority's reasoning. A brief analysis of a couple of these opinions illustrates further that the meaning of the bona fide sale exception under § 2036 is unsettled. Judge Laro's concurring opinion indicated he would require, for adequate and full consideration, not only proportionate interests to be transferred to the party making a transfer to an FLP but also that the transferor's estate not be depleted by the transfer.[251] This appears similar to the requirements of the Fifth Circuit in

245. *See* Korpics, *supra* note 20, at 34–35.

246. *Bongard*, 124 Tax Ct. Rep. Dec. (RIA) ¶ 124.8, at 124-69 to -70.

247. *Id.* at 124-70 to -71.

248. *See id.* at 124-70 to -73.

249. *Id.*

250. *See* Korpics, *supra* note 20, at 34–35. Courts often reject mundane nontax reasons on the facts before them, as the Tax Court did in *Bongard* with respect to the FLP. *Id.* at 35. *Kimbell* is a notable exception, but there the court focused extensively on the actual business operations of the FLPs. *Id.*

251. *See Bongard*, 124 Tax Ct. Rep. Dec. (RIA) ¶ 124.8, at 124-76 to -77.

Kimbell.[252] Furthermore, Judge Laro would adhere to the business purpose test of *Gregory v. Helvering*[253] rather than the "legitimate and significant nontax reasons" test. Judge Laro notes that the Third Circuit applied the business purpose test in *Thompson*.[254]

Another judge, Judge Halpern, concurred in part and dissented in part, noting that in determining whether the bona fide sale exception applied, he would first ask if the transfer to the FLP was made in the ordinary course of business.[255] If not, he would then only consider the transfer a bona fide sale if it was made for "full value (i.e., [if] the value of the transferred property at most equaled the cash value of the consideration received therefor)."[256] Judge Halpern apparently rejected the proportionate interest test that the majority espouses and demanded even more than Judge Laro would under the depletion test.[257]

Adopting much of the reasoning of *Kimbell* but offering a different and potentially broader way for taxpayers to come within the bona fide sale exception to § 2036, the Tax Court in *Bongard* has further fanned the flames of uncertainty surrounding § 2036. Furthermore, *Bongard* illustrates once again that the manipulation of facts and a court's whims can make or break an FLP for purposes of § 2036(a)(1).

D. *Recent Applications of Section 2036(a)(1):* Bigelow, Korby, Schutt, *and* Strangi IV

Since *Kimbell*, *Thompson*, and *Bongard*, both the Fifth Circuit and the Tax Court have reviewed FLP cases under § 2036(a). This Section of the Comment will briefly review these recent decisions interpreting the major cases and conclude that, far from clarifying the uncertainty in the courts' language and tests, these decisions illustrate the ambiguity.

First, the Tax Court has continued to find, citing *Kimbell*, *Thompson*, and *Bongard*, that assets held by FLPs should be returned to estates.[258] In two "bad facts" Tax Court cases, *Estate of Korby v.*

252. *See* Kimbell v. United States, 371 F.3d 257, 265 (5th Cir. 2004).
253. 293 U.S. 465 (1935).
254. *Bongard*, 124 Tax Ct. Rep. Dec. (RIA) ¶ 124.8, at 124-79 (Laro, J., concurring).
255. *Id.* at 124-81 (Halpern, J., concurring in part and dissenting in part).
256. *Id.* at 124-83.
257. *See id.*
258. *See* Estate of Korby v. Comm'r ("*Korby I*"), 102 T.C.M. (RIA) 697, 706 (2005); Estate of Korby v. Comm'r ("*Korby II*"), 103 T.C.M. (RIA) 707, 716 (2005); Estate of Bigelow v. Comm'r, 65 T.C.M. (RIA) 431, 441 (2005).

Commissioner[259] and *Estate of Bigelow v. Commissioner*,[260] the court found on those bad facts that the bona fide sale exception did not apply.[261]

However, in a May 2005 decision, *Estate of Schutt v. Commissioner*,[262] the Tax Court found that § 2036 did not apply to two Delaware business trusts formed only a year before a decedent's death.[263] Other than the decedent's advanced age at the time of the formation of the trusts, the facts in *Schutt* were not as ugly as in other § 2036 cases.[264] Like in *Thompson*, the Schutt trusts, which held stock, did not engage in trading or other investment activity, but unlike in *Thompson*, Schutt maintained assets outside of the trusts for his own needs and did not commingle his assets with those of the trusts.[265] Addressing the bona fide sale exception, the Tax Court noted that an appeal in *Schutt* would go before the Third Circuit, and suggested that the Third Circuit's approach of requiring a transfer to be made in good faith "correlates with" the Tax Court's requirement of a legitimate and significant nontax purpose for a transfer.[266] The court then accepted the estate's argument that a significant nontax purpose for the transfer of long-held stock to the two trusts was the furtherance of the decedent's "buy and hold investment philosophy."[267] The court then concluded that the decedent had received full and adequate consideration for the transfer of stock to the trusts because the factors enumerated in *Bongard* were met.[268] One of these factors is that the decedent "received an interest proportionate in value to [his] contribution."[269] This aspect of the

259. 102 T.C.M. (RIA) 697 (2005); 103 T.C.M. (RIA) 707 (2005) (involving the estates of both a husband and a wife, hence two cases and two opinions).

260. 65 T.C.M. (RIA) 431 (2005).

261. *See Korby I*, 102 T.C.M. (RIA) at 704–05 (focusing on facts like the Korbys' use of the FLP assets for basic living expenses in finding the transfer of assets to the FLP not a bona fide sale); *Bigelow*, 65 T.C.M. (RIA) at 440–41 (finding that the transfer of real property to a partnership was not a bona fide sale where the partnership formalities were not respected and no nontax benefit flowed to the transferor).

262. 126 T.C.M. (RIA) 989 (2005).

263. *See id.* at 1003, 1012.

264. *See id.* at 990–1003 (summarizing findings of fact).

265. *See id.* at 1001, 1003, 1011.

266. *Id.* at 1006.

267. *Id.* at 1007.

268. *See id.* at 1012.

269. *Id.* The *Schutt* court addressed *Thompson* briefly, stating that the Third Circuit's view is that "the dissipated value resulting from a transfer to a closely held entity does not automatically constitute inadequate consideration for section 2036(a) purposes." *Id.* at 1011 (citing Estate of Thompson v. Comm'r, 382 F.3d 367, 381 (3d Cir. 2004)). However, the *Schutt* court ignored the *Thompson* concurrence, in which two of the three judges indicated that receipt of proportionate interests in the family entity where the value of the

holding is troubling in light of the fact that the Third Circuit is unclear on whether receipt of proportionate interests is full and adequate consideration or a mere recycling of value. Thus, it is possible that the Third Circuit would have reached a different conclusion in *Schutt* on the question of whether the decedent received full and adequate consideration for the transfer of stock to the business trusts.

The Fifth Circuit also took another look at an FLP case in the summer of 2005 in *Strangi IV*.[270] *Strangi IV* was, however, familiar to the Fifth Circuit as the court had earlier remanded the case to the Tax Court in *Strangi II*.[271] On remand, the Tax Court ruled in *Strangi III* that the value of the assets transferred to an FLP and its corporate general partner were includable in the decedent's gross estate under either subsection 2036(a)(1) or (2).[272] While some commentators suggested that the Fifth Circuit after *Kimbell* would reverse the Tax Court on all counts,[273] the Fifth Circuit affirmed the Tax Court's holding, reasoning that § 2036(a)(1) applied to return the underlying assets of the FLP to the Strangi estate.[274]

The *Strangi IV* court used the *Kimbell* formulations of what constitutes "adequate and full consideration" and "bona fide sale."[275]

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interests received was less than the value of the underlying assets represented a mere recycling of value and not full and adequate consideration. *See Thompson*, 382 F.3d at 386 (Greenberg, J., concurring) (quoting and rejecting language in Estate of Stone v. Comm'r, 86 T.C.M. (CCH) 551, 581 (2003)).

270. The Fifth Circuit heard oral arguments in *Strangi IV* on March 8, 2005. *See* Fifth Circuit Oral Argument Calendar, http://www.ca5.uscourts.gov/clerk/calendar/0503/24.htm (last visited Dec. 9, 2005). The court announced its decision in *Strangi IV* in July 2005. *Strangi IV*, 417 F.3d 468 (5th Cir. 2005).

271. *See Strangi II*, 293 F.3d 279, 282 (5th Cir. 2002) (finding that the Tax Court had abused its discretion in failing to grant the IRS leave to amend its petition to include a claim under § 2036).

272. *See Strangi III*, 85 T.C.M. (CCH) 1331, 1340, 1343 (2003), *aff'd sub nom. Strangi IV*, 417 F.3d 468 (5th Cir. 2005). The holding that § 2036(a)(2) applied, "because as a limited partner [Strangi] could join with other partners to liquidate the entity," shocked commentators and practitioners, because it went so much further than previous decisions applying § 2036. Bray, *supra* note 167, at 1; *see* Gans & Blattmachr, *supra* note 146, at 1170 (concluding that *Strangi III*'s alternative holding is of "doubtful validity").
Because no other case has followed *Strangi III*'s alternative holding and the Fifth Circuit affirmed the judgment applying § 2036 on other grounds, its possible effect on FLPs is beyond the scope of this Comment. *See Strangi IV*, 417 F.3d at 482 (affirming the Tax Court on its § 2036(a)(1) holding and not addressing § 2036(a)(2)).

273. *Cf.* Jonathan G. Blattmachr & Michael L. Graham, Estate of Kimbell: *Its Potential Effect on* Strangi *Type FLPs* (2004), http://www.ilsdocs.com/docs/alerts/estate_of_Kimbell.pdf (stating that while "it is too early to make a definite call" regarding the outcome of *Strangi IV*, "many practitioners" believed *Kimbell* meant that the Fifth Circuit would reverse *Strangi III*).

274. *Strangi IV*, 417 F.3d at 481–82.

275. *Id.* at 478–79.

Because the donor received proportionate interests in the FLP for his transfer of assets to the FLP, the "adequate and full consideration" prong was met under *Kimbell*.[276] But in reviewing the Tax Court's decision on whether there had been a bona fide sale for clear error, the Fifth Circuit held that the Tax Court did not clearly err, finding that there was no "substantial business or other non-tax" purpose for the transfer.[277] Note that under *Thompson*, receipt of proportionate interests in the FLP may not constitute full consideration,[278] and under *Bongard*, a sale can purportedly be bona fide where there is any "legitimate and significant nontax reason" for the transfer, regardless of whether there is a business reason.[279]

E. What These Decisions Mean for Estate Planners

The different tests articulated by the circuit courts and the Tax Court pose problems for estate planners wishing to utilize FLPs for their clients.[280] Certainly, estate planners must be selective in presenting FLPs to their clients as planning vehicles.[281] The partnership should be respected and the letter of the agreement followed. The decedent should retain sufficient assets on which to live comfortably without resorting to the transferred assets.[282] Based upon *Bongard*, there should be "legitimate and significant nontax reason[s]" to form the FLP, and these should probably include business purposes.[283] These reasons should be documented and

276. *Id.* at 478 (noting that even the IRS conceded the decedent received proportionate interests in the partnership for the assets he transferred).

277. *Id.* at 479.

278. *See* Estate of Thompson v. Comm'r, 382 F.3d 367, 378–81 (2004).

279. *See* Estate of Bongard v. Comm'r, 124 Tax Ct. Rep. Dec. (RIA) ¶ 124.8 (RIA), at 124-54, 124-68 (T.C. Mar. 15, 2005).

280. *See* Harrison & Newlin, *supra* note 160, at 23–26.

281. *Id.* at 33.

282. *See* Bissonnette, *supra* note 3, at 78; Lieb, *supra* note 66, at 910.

283. *See* Korpics, *supra* note 20, at 34. Korpics notes that, while courts have intimated that they would accept a variety of "plain vanilla" nontax reasons, they often reject these on the facts before them as the Tax Court did in *Bongard* with respect to the FLP. *Id.* at 35. Korpics suggests that estate planners should ensure that FLPs have a "noteworthy purpose" like the creditor protection rationale in *Kimbell* where "potential environmental liability was a concern" or the preparation for an initial public offering successfully advanced in *Bongard* with respect to the LLC. *Id.*; *see* Harrison & Newlin, *supra* note 160, at 24–31. Note that the Fifth Circuit in *Kimbell* found on those facts that there were "substantial business and other non-tax reasons" to form the FLPs. *See* Kimbell v. United States, 371 F.3d 257, 267 (5th Cir. 2004). But when looking at the proffered reasons there and in *Thompson*, it is not clear how "substantial" Kimbell's other reasons really were. *See* Harrison & Newlin, *supra* note 160, at 31. Harrison and Newlin suggest that perhaps "substantial" is to be read as "real, actual and genuine." *Id.* But *Thompson* probably

actually addressed. Also, it is unclear how much and what type of an interest a decedent must receive in the FLP in exchange for her contribution.[284]

Under *Kimbell* or *Bongard*, a decedent could transfer $2.7 million to an FLP with a total of $3 million in funding and then retain a ninety percent limited partnership interest.[285] This interest, proportionate to the ninety percent of equity contributed to the FLP by the decedent, would constitute full and adequate consideration even though the limited partnership interest would be valued at less than $2.7 million.[286] Under *Thompson*, this would likely not be the case. It would seem that the decedent would have to retain something that had a fair market value of $2.7 million for there to be full and adequate consideration.[287] One way to do this would be for the decedent to "retain a general partner interest sufficient to allow termination of the partnership . . . to avoid the . . . argument that what was received back is less than what was contributed for purposes of section 2036's exception for adequate and full consideration."[288] Without knowing what constitutes adequate and full consideration under § 2036, using FLPs for estate planning may be more risky than beneficial.

Again, the different language employed by the various courts in defining the contours of the bona fide sale exception to § 2036(a) illustrates the uncertainty about how and whether this Code provision should be applied to FLPs. If § 2036(a)(1) is applied to FLPs, the approach to full and adequate consideration laid out in *Kimbell* (and followed in *Strangi IV*) and the similar *Bongard* approach will likely win out over the more restrictive *Thompson* approach. If receipt of proportionate interests in the partnership for transferred assets is to be considered full and adequate consideration, as in *Kimbell* and *Bongard*, the problem for courts will be that so long as partnership formalities are observed it will be difficult to apply § 2036(a)(1) to return FLP assets to an estate. This is so because the donor-decedent will almost always receive proportionate interests in the FLP for his transferred assets. If receipt of proportionate interests in the

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requires something more, so planners should be careful to make sure these nontax reasons exist for their clients before suggesting FLPs. *See id.*

284. *See* Harrison & Newlin, *supra* note 160, at 32.

285. *See id.* (offering a similar illustration of the rule using slightly different numbers and referring only to *Kimbell*).

286. *Id.* (illustrating the *Kimbell* rule using different dollar values).

287. *See id.*

288. *Id.* at 24.

partnership for transferred assets is not considered full and adequate consideration (unless the fair market value of the interests is equal to that of the assets), as at least two judges on the *Thompson* panel advocate, § 2036(a)(1) may apply more often to FLPs. However, and unfortunately, this approach ignores the reality that even though FLP interests would not receive the same price on the market as would the underlying assets, partnership interests are valuable to the donor in other ways—including "management expertise, security and preservation of assets, capital appreciation and avoidance of personal liability."[289] While the result under a *Thompson* approach might be favorable to the government and to those who recognize the possible abuses of FLPs, the approach is not economically sensible because the only type of "value" it considers is the actual dollar value of the assets or interests exchanged. To accomplish the same result more appropriately while offering estate planners and taxpayers predictability and guidance, the only remedy is a Code provision expressly dealing with FLPs and similar family entities. Such a remedy is discussed further in Part V of this Comment.

V. LEGISLATIVE REMEDY

The best way to resolve these uncertainties, allow substance to prevail over form, and fairly treat similarly situated taxpayers the same is for Congress to add a Code provision that specifically addresses entities like FLPs. Family entities are potentially abusive, and it is inappropriate that whether § 2036 applies in a particular case depends more on the form in which the assets are owned and the court's view of the subjective motives for selecting such form rather than on the substantive nature of the party's relationship to the assets. Congress is better equipped than courts to change "generally accepted interpretations of tax law" that have been relied upon by taxpayers for years, because, among other reasons, Congress gives taxpayers notice of changes to the law.[290] Section 2036, while seemingly an effective weapon against FLPs right now, is weak and unfair,[291] as for years the IRS itself indicated it did not apply to FLPs[292] and its application seems dependent on bad facts like those in

289. Kimbell v. United States, 371 F.3d 257, 266 (5th Cir. 2004).

290. Ruttenberg, *supra* note 66, at 99.

291. *See id.* at 98; *see also* Jensen, *supra* note 21, at 184–86 (calling some courts' § 2036(a)(1) arguments "unjustified" and suggesting the section "may be easily avoided").

292. *See* I.R.S. Priv. Ltr. Rul. 94-15-007 (Jan. 12, 1994); I.R.S. Priv. Ltr. Rul. 93-10-039 (Dec. 16, 1992); I.R.S. Priv. Ltr. Rul. 93-32-006 (Aug. 20, 1992); I.R.S. Priv. Ltr. Rul. 91-31-006 (Apr. 30, 1991). Note that Private Letter Rulings have no precedential value and

Thompson and the *Strangi* cases.[293] With the possibility of the Supreme Court addressing the § 2036 issue,[294] the IRS should not be too confident that this weapon will remain in its arsenal.[295] Furthermore, even if § 2036 does remain an effective weapon against FLPs, sophisticated estate planners and clients are keeping their eyes on the pronouncements of the courts and are increasingly able to avoid the bad facts that plagued the estates in *Thompson*, the *Strangi* cases, and other cases.[296] In effect, practitioners can use the cases as blueprints and structure FLPs like those that have been respected by the courts to avoid the pitfalls that led to the disrespect of others. Legislation is preferable to ad-hoc, awkward application of § 2036 in the courts.

Legislation dealing with the problem of FLPs (and in fact proposing much of the same reform discussed above) has been attempted before with no resulting Code provision or regulations enacted.[297] In January 2005, the Joint Committee on Taxation, in its

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taxpayers are instructed not to rely on them, but they do offer taxpayers insight into how the IRS will apply the Code to fact patterns. *See* I.R.C. § 6110(k)(3) (2000).

293. *See* Jensen, *supra* note 21, at 185–86 (listing the facts present in § 2036 cases that support a finding of refusing a discount and suggesting these "pitfalls" are easily avoided). It remains unclear why § 2036 suddenly applies to FLPs, when for years even the IRS conceded it did not. *See* I.R.S. Tech. Adv. Mem. 91-31-006 (Aug. 2, 1999); I.R.S. Priv. Ltr. Rul. 97-10-021 (Mar. 7, 1997); I.R.S. Priv. Ltr. Rul. 94-15-007 (Apr. 15, 1994); I.R.S. Priv. Ltr. Rul. 93-10-039 (Mar. 12, 1993); I.R.S. Tech. Adv. Mem. 86-11-004 (Nov. 15, 1985); Jerry A. Kasner, *Applying* Byrum *to Family Business Entities*, 96 TAX NOTES 1741, 1741–43 (2002); Michael D. Mulligan, *Courts Err in Applying Section 2036(a) to Limited Partnerships*, 30 EST. PLAN. 486, 490–94 (2003); *see also* Novack, *supra* note 63, at 450 (suggesting that the IRS auditors seek out "taxpayers who make sloppy mistakes"); Harvey N. Shapiro, *The Many Advantages of Family Limited Partnerships*, LEGAL INTELLIGENCER, May 17, 2005, at 5, *available at* www.law.com/jsp/pa/index.jsp (noting that many estate tax returns with FLPs are audited but that where valid purposes for forming the FLP exist and the FLP is maintained properly, discounts will likely still be allowed).

294. *See* Easton, *supra* note 11, at 41; Larry E. Ribstein, *Family Limited Partnerships: The Latest Chapter*, IDEOBLOG, Sept. 22, 2004, http://busmovie.typepad.com/ideoblog/2004/09/family_limited_.html. Ribstein is a law professor at the University of Illinois College of Law. His scholarship focuses on unincorporated business entities and partnerships.

295. *See generally* Kasner, *supra* note 293, at 1743 (arguing that the *Strangi* and *Harper* courts have come "dangerously close" to expanding § 2036 so that its application conflicts with the holding in *Byrum*); Mulligan, *supra* note 293, at 494 (arguing that courts have misapplied § 2036 and advocating adoption of a substance over form analysis).

296. *See* Jensen, *supra* note 21, at 184–86; Korpics, *supra* note 20, at 32.

297. *See, e.g.*, J. COMM. ON TAXATION, 109TH CONG., OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 396–404 (Comm. Print 2005), *available at* http://www.house.gov/jct/s-2-05.pdf (proposing limiting the availability of minority and lack of marketability discounts through aggregation rules and a look-through rule); H. Amdt. 171 (Pomeroy) to Death Tax Repeal Permanency Act of 2003, H.R. 8, 108th Cong.

four-hundred plus page tome *Options to Improve Tax Compliance and Reform Tax Expenditures*, proposed limiting minority and lack of marketability discounts for transfers of interests in FLPs or similar entities.[298] The Joint Committee on Taxation's recent proposals generally deal with the transfer of an interest in an FLP by a donor-decedent and suggest situations in which the interests transferred by the donor or donor-decedent should be valued at their value before the underlying assets were transferred to the FLP.[299]

Besides adopting the Joint Committee on Taxation's recent proposals, there are a number of additional ways Congress could curtail the potential abuses of FLPs.[300] Practitioner and commentator Daniel H. Ruttenberg suggests that chapter 14 of subtitle B of the Internal Revenue Code, containing special valuation rules for transfer tax purposes,[301] might be an appropriate place to add legislation regarding FLPs and valuation discounts.[302] In such legislation, Congress could choose to "deny[] all valuation discounts when an entity is owned almost entirely by a donor-decedent" and members of his or her family.[303] An analogous issue is addressed in § 2036(b),

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(2003) (proposing to increase the estate tax exclusion amount to $3 million while curtailing the ability to claim valuation discounts on nonbusiness and family entities, but this proposal was defeated soundly in the House of Representatives on June 18, 2003).

298. J. COMM. ON TAXATION, *supra* note 297, at 402–03.

299. *See id.* at 403 (proposing aggregation rules and a look-through rule to value the partnership interests transferred by the donor or donor-decedent at what their value was in the hands of the transferor).

300. *See generally* Ruttenberg, *supra* note 66 (suggesting ways Congress could legislate to curb abuses of valuation discounts).

301. *See* I.R.C. §§ 2701–2704 (2000).

302. Ruttenberg, *supra* note 66, at 100. Ruttenberg's excellent article addresses § 2036 in more breadth than does this Comment; he discusses how both § 2036(a)(1) and § 2036(a)(2) can be applied to return FLP assets to the estate of the decedent. *See id.* at 55–65. However, Ruttenberg's article was published before the Fifth Circuit's decision in *Strangi IV*. *See Strangi IV*, 417 F.3d 468 (5th Cir. 2005). While affirming the Tax Court's § 2036(a)(1) holding, the fact that the Fifth Circuit did not address § 2036(a)(2) perhaps lessens the force of Ruttenberg's concerns regarding § 2036(a)(2)'s application to family entities. Furthermore, this Comment argues forcefully for legislation from Congress dealing with abuses of FLPs, while Ruttenberg seems to suggest that Congress should legislate only if it determines that valuation discounts generally are abusive—and that if it does not so find, the Tax Court should simply stop applying this inappropriate provision where it believes that claimed valuation discounts are abusive but there is no real retained "substantial present economic benefits from transferred assets" as § 2036(a)(1) requires. *See* Ruttenberg, *supra* note 66, at 98.

303. Ruttenberg, *supra* note 66, at 99. Ruttenberg suggests, persuasively, that the level of ownership by family members that should preclude valuation discounts should neither be too high that it renders the preclusion meaningless nor too low that it includes too many family entities and discourages their use for appropriate means. This bright line rule would either be under- or over-inclusive depending on where the line is drawn (e.g.,

dealing with when retention of voting rights in shares of stock will be considered "retention of the enjoyment of transferred property" for purposes of the § 2036(a)(1) inquiry.[304] Specifically, retention of voting rights will be considered retained enjoyment when the stock transferred is stock in a "controlled corporation," defined as a corporation in which the decedent owned or had the right to vote at least twenty percent of the voting stock at any time after the transfer of the stock and within three years of the decedent's death.[305] Furthermore, if the decedent's spouse, children, grandchildren, or parents own stock, such ownership will be aggregated and considered ownership by the decedent for purposes of § 2036(b)(2).[306] Such aggregation rules could also be applied in the case of an FLP, such that valuation discounts could be denied when an entity is substantially owned by a decedent and her family members.

Congress could alternately or also require that a certain amount of a family entity's assets consist of an active business before permitting valuation discounts.[307] It could require that unrelated owners hold a "substantial minority interest (e.g., ten percent) before a valuation discount is allowed."[308]

All of these proposed changes would limit abuses of FLPs. Particularly attractive are denials of discounts for entities owned mostly by family members with exceptions for those entities carrying on active business activities. Legislation could be drafted to allow legitimate nontax purposes to be served without also encouraging tax avoidance. Whatever approach Congress takes, the IRS and the Department of Treasury should then promulgate detailed, explanatory regulations that will provide guidance to taxpayers and practitioners seeking to form and operate family entities within the bounds of the law, currently a very difficult proposition given the inconsistency in the courts.

CONCLUSION

FLPs provide sophisticated taxpayers and their lawyers creative ways to potentially avoid estate taxation in addition to other benefits.

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whether fifty-one percent, seventy-five percent, ninety-nine percent, or some other level of ownership constituted enough ownership to trigger denial of discounts). *Id.* at 100.

304. *See* I.R.C. § 2036(b). Until now, this Comment has not addressed § 2036(b) because that section deals with corporate stock, not unincorporated family entities like FLPs.

305. *Id.* § 2036(b)(2).

306. *See id.* (referring to *id.* § 318).

307. Ruttenberg, *supra* note 66, at 100.

308. *Id.*

FLPs can easily be abused through savvy planning, especially where the laws regarding them are interpreted so inconsistently. There is a need for appropriate legislation that ensures that similarly situated taxpayers like the neighbors discussed in the Introduction of this Comment do not shoulder such differing tax burdens simply because one of them held her money in substantively the same way but in a different form than her neighbor. Currently, the IRS seems to value form over substance in attacking FLPs.

The Third and Fifth Circuits do not agree on what constitutes a "bona fide sale for adequate and full consideration" under § 2036(a) and thus do not agree on what an FLP must do to avoid § 2036 application. Adding to this uncertainty, the Tax Court, citing both Third and Fifth Circuit decisions, came up with yet a different permutation of the bona fide sale exception. All of these decisions create uncertainty for estate planners and for taxpayers.

The IRS is right to attack the valuation discounts being claimed by these taxpayers as abusive, but its new weapon-of-choice, § 2036, is being inappropriately and awkwardly applied to FLPs. The different and conflicting interpretations of the meaning of "bona fide sale for adequate and full consideration" in § 2036 reflect the fact that this section of the Internal Revenue Code is a poor fit for family entities. With only § 2036 in its arsenal, the IRS can never do more than target the most abusive of cases involving the worst fact patterns, and the courts must engage in an inappropriate guessing game regarding the subjective motives of the taxpayer. A properly planned and administered FLP can avoid § 2036 by taking the requirements of the various courts to address FLPs and tailoring FLPs to meet the most stringent requirements any court has enumerated. Thus, current application of § 2036 to an FLP depends on sloppy planning and administration of an FLP. The judicial uncertainty arising from conflicting precedent in *Kimbell*, *Thompson*, *Bongard*, *Schutt*, and *Strangi IV* necessitates legislative intervention. A more appropriate solution can be found through corrective action by Congress, which can pass legislation specifically addressing these family entities and limiting valuation discounts for such entities unless certain enumerated conditions are met.

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