

Family Limited Partnerships: The Beat Goes On

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Introduction

Several years ago I wrote an article that discussed the estate tax consequences of family limited liability entities (“FLLE’s”).¹ An FLLE is a family limited partnership (“FLP”) or family limited liability company (“FLLC” or “LLC”) formed for family estate planning purposes. (Under the default rule, an LLC that has two or more members is considered to be a partnership for federal tax purposes.²) FLLEs are used for estate planning purposes that can be wide-ranging and often perfectly legitimate. FLLEs can be used to provide a family business with a liability shield or be a vehicle for distributing ownership interests in family assets. But often the primary purpose for their use is the reduction of estate taxes.³ Using an FLP as an example, commonly a parent contributes assets to the FLP and takes back the limited partnership interests. Others, typically children or other relatives, but sometimes banks or other independent persons, hold the general partnership interests (in an FLLC it would be the managerial interests). The parent usually does not control the FLP in an attempt to avoid the contributed assets being included in her estate under I.R.C. § 2036, though as I will discuss, courts have been applying I.R.C. § 2036 even where the parent does not have technical control. The bulk of the value in the FLP is represented by the limited partnership interests. Valuation discounts may be available because the parent’s limited partnership interests lack control and are usually not as readily marketable as the

¹ Last Gasp Estate Planning: The formation of Family Limited Liability Entities Shortly Before Death, 21 Virginia Tax Rev. 1 (2001) (hereinafter “Last Gasp”). In writing this article, I at times borrow from that article as well as from chapter 4 of The Limited Liability Company Handbook co-authored by Dean Mark Sargent and myself and published by West. West has graciously consented to this use.

² See Treas. Reg. § 301.7701-2(b), -3(c)(1)(v).

³ Estate taxes are taxes imposed on the value of the new assets owned by a decedent at death. See I.R.C. § 2001, 2051.

underlying assets would have been. It is not unusual for the FLP interests to be included in the parent's estate at a 35% or greater discount from the value of the contributed assets.⁴ Thus, property that would have an estate tax value of \$100,000 if owned by the parent directly, might be exchanged for limited partnership interest worth only \$65,000. There should ordinarily be no gift on the formation of the FLE as typically the parent receives a capital account credit⁵ equal to the full value of what she contributed.⁶ If there were a liquidation of the FLE, the parent would be normally entitled to be paid her capital account balance.⁷ Further, the children commonly contribute their own funds in exchange for the controlling interest.⁸ Thus, normally on formation, no value has been shifted to others that could trigger a gift and the consequent gift tax.⁹

Additionally, the parent could, but often does not, make gifts of the FLP interests

4 Kathryn G. Henkel, Estate Planning and Wealth Preservations: Strategies and Solutions ¶ 16.03[1][c].

5 Generally, a owner's capital account is increased by the fair market value of the contributed property. As an owner is also generally entitled to the full balance in the capital account on liquidation of the ownership interest, normally no value should be shifted to others. See Treas. Reg. §§ 1.704-1(b)(2)(iv)(b) and -1(b)(2)(ii).

6 Some have argued that there may be a gift at this point even though there is no ascertainable donee. See Karen Burke and Grayson McCouch, Family Limited Partnerships: Discounts, Options, and Disappearing Value, 6 Fla. Tax Rev 649, 651-652 (2004) (hereinafter "Burke and McCouch"). In this fine piece of scholarship, Professors Burke and McCouch, while acknowledging the capital account issue, argue that the donor should be treated as making a gift as she has relinquished dominion and control in exchange for a property of lesser value. They note that in the trust context, this can trigger a gift citing *Smith v. Shaughnessy*, 318 U.S. 176 (1943). But in a trust, the donor does not receive a capital account credit. Trusts and FLEs are different beasts, and the capital accounts of the partners are, to my mind, not something that can be ignored. While it is beyond the scope of this article to discuss the rules of partnership taxation, suffice it to note that capital accounts are a corner stone of the partnership taxation rules. Further, if they are ignored in this context to a taxpayer's disadvantage, what is to keep the taxpayer from arguing they should be ignored when it is to her advantage. Creating a gift at the formation stage would, to my mind, require a statutory or regulatory change.

7 See Treas. Reg. § 1.704-1(b)(2)(iv)(b).

8 Of course, if the funds for the contribution are first gifted to the children by the parents, a gift tax could apply to that transaction if the gift exceeds \$11,000. See I.R.C. §§ 2501(a), 2503(b).

9 But see Burke and McCouch supra note 6 at 652.

to her children (and possibly pay a gift tax). The discounts for lack of control and lack of marketability generally also apply to the gifted interests, except the lack of control discount would be less if the child is a general partner. A general partner has fiduciary duties to the limited partners to protect their interests, which keeps the general partner's control from being unfettered. Thus the lack of control discount would still not be zero.¹⁰

If unqualifiedly allowed, this technique would be an estate tax bonanza. With a bit of slight of hand, the value of an estate could be dramatically reduced with perhaps little change in the underlying beneficial ownership or use of the assets. Tax advisors and their clients loved it. The Service did not.¹¹ The Service understandably did not think a decedent should so easily reduce the estate taxes owed. At the time of my prior article, the focus of the Service's efforts was on FLLEs formed shortly before death. The Service had issued a number of technical advice memoranda and there were a few cases on point. Since then, the number of cases has grown dramatically and are not limited to FLLEs formed shortly before death, but also include FLLEs that meaningfully predate the decedent's death and until recently might have been thought by many to be "safe." As I discuss below, the Tax Court has taken a tough line, usually applying I.R.C. § 2036 to ignore the FLLE and include the contributed assets in the decedent's estate. The 3rd and 5th Circuits (and to a much lesser extent the 1st Circuit) have had something to say on the subject as well. They have not been particularly taxpayer-

¹⁰ See *United States v. Byrum*, 408 U.S. 125 (1972).

¹¹ After *United States v. Byrum*, 408 U.S. 125 (1972), see text as notes to *infra*, the Service initially tended to give this structure a pass. See, e.g., Priv. Ltr. Rul. 97-10-021 (Mar. 7, 1997); Priv. Ltr. Rul. 95-46-007 (Nov. 17, 1995); Priv. Ltr. Rul. 93-10-039 (March 12, 1993). See Brant J. Hellwig, *Revising Byrum*, 23 Va. Tax Rev. 275 (2003) at 332-334 (hereinafter "Hellwig").

friendly either. The 5th Circuit seems to be somewhat more generously inclined, but in the final analysis its approach may not lead to different outcomes.

I.R.C. § 2036 includes in the estate of the decedent assets transferred during life, if the decedent retains the right to income, possession, or enjoyment or the right to say who can receive income, possession or enjoyment. The purpose of I.R.C. § 2036 is to prevent decedents from excluding assets from their estates by transferring legal title, but maintaining substantial rights.¹²

Given the plethora of new cases, in particular recent pronouncements of the 5th Circuit in *Kimbell v. United States*,¹³ the 3rd Circuit in *Estate of Thompson v. Commissioner*¹⁴ and the Tax Court in *Estate of Bongard v. Commissioner*,¹⁵ and the tack those cases have taken, the area is worthy of a fresh look.¹⁶ I ultimately conclude that a modified version of my original proposal, which would generally bring property transfers to FLEEs back into the decedent's estate if made within three years of death, could successfully address the principal concerns this area raises.

The Sham-Tams

¹² *United States v. Estate of Grace*, 395 U.S. 316 (1969).

¹³ 371 F.3d 257 (5th Cir. 2004).

¹⁴ 382 F.3d 367 (3d Cir. 2004).

¹⁵ 124 T.C. 95 (2005).

¹⁶ My fellow members of the academy have not been idle since my first article was published. For articles predating the 3rd Circuit's decision in *Estate of Thompson* and the Tax Court's decision in *Bongard*, see *Burke and McCouch supra* 6 note which does an excellent job of reviewing possible partnership tax ramifications and makes cogent recommendations for reform; another fine article: Ronald Jensen, *The Magic of Disappearing Wealth Revisited: Using Family Limited Partnerships to Reduce Estate and Gift Taxes*, 1 *Pitt. Tax Rev.* 155 (2004) (hereinafter "Jensen").

In 1997, the Service issued a series of technical advice memoranda.¹⁷ Typically, family members created an LLC or limited partnership shortly before a parent's death, when it was apparent that the parent did not have long to live. In one case, a limited partnership was created within two days of the parent's death and after the parent had been removed from life support. A substantial portion of the parents' assets were transferred to FLEEs in exchange for FLEE interests, and the FLEEs interests were included in the parents' estates at a substantial discount from the fair market value of the contributed assets. Typically, the children created FLEEs on behalf of the parent using either a power of attorney granted them by the parent or their powers as trustees of a trust created for the benefit of the parent.

The Service made several arguments for its holdings. One of the arguments, in essence, was that given the proximity of the death and the lack of direct involvement by the decedent, the FLEEs were shams. The Service cited *Estate of Murphy v. Comm'r* as authority for its position.¹⁸ In that case, eighteen days before the decedent died, she had transferred to her two children less than a 2% stock interest in a family-run, closely held corporation. The transfer reduced the decedent's ownership interest in the corporation to just below 50%. The estate claimed a minority-interest discount for the remaining stock. A minority interest discount is the same as a lack of control discount. A minority interest is worth less than a majority interest, because the minority interest holder often cannot control who the officers and directors of the corporation are and

¹⁷ See TAMs 9719006, 9723009, 9725002, 9730004, 9735003, and 9736004.

¹⁸ T.C. Memo 1990-472.

what direction the corporation should take. The Tax Court denied the discount, stating that “a minority-interest discount should not be applied if the explicit purpose and effect of fragmenting the control block of stock was solely to reduce federal tax.” The court did allow a discount for lack of marketability.¹⁹

The TAMs differ from Estate of Murphy in an important respect. Commonly in the TAMs, there was little change in the beneficial ownership of the underlying assets, and the decedent continued to hold the majority of the beneficial interests in the FLEEs. The discounts were claimed in large part because the decedent had interposed an FLEE in the chain of ownership. In some of the TAMs, however, the decedent did in fact transfer a substantial portion of the FLEE interests, and the IRS nonetheless attacked the transactions.²⁰

The Service did not try to argue for the application of I.R.C. § 2036, perhaps because it was unduly intimidated by the Supreme Court’s decision in *Byrum*,²¹ which I discuss below. Instead, the Service made an apparently unprecedented (and ultimately unsuccessful) argument stating that I.R.C. § 2703(a)(2) applied. That code section

¹⁹ Estate of Murphy should be contrasted with the more recent case of Estate of Frank. T.C. Memo 1995-132. In Estate of Frank, the son of the decedent held the decedent’s power of attorney. Two days before the decedent’s death, pursuant to the power of attorney, the son transferred stock owned by the decedent to the decedent’s wife. The transfer reduced the decedent’s ownership interest in the family corporation from more than 50% to 32%. The court held that the transfer was valid and allowed a 20% minority-interest discount and a 30% lack-of-marketability discount on the remaining stock included in the estate. The Service argued that the court should apply the substance over form doctrine and ignore the transfer. See text at note infra and accompanying text with regard to the step transaction. The court refused to do so, however, noting that if tax avoidance was the sole motive, a substantially smaller number of shares could have been transferred.

²⁰ See TAMs 9719006 and 9736004.

²¹ *United States v. Byrum*, 408 U.S. 125 (1972).

provides that the value of property for estate and gift tax purposes is “determined without regard to ...any restriction on the right to sell or use such property.” In the Service’s view, the “partnership wrapper” covering the decedents’ assets was a restriction within the meaning of I.R.C. § 2703(a)(2) and, therefore, was ignored. Of course, without the partnership wrapper, the discounts disappear, as the underlying assets are included in the decedent’s estate and not the interests in the FLLEs.²²

The legislative history to I.R.C. § 2703(a)(2) does not appear to contemplate the manner in which the Service was applying its provisions.²³ The Code section appears to be intended to prevent buy-sell agreements among family members from reducing the value of the interests the family members hold rather than provide an opportunity to ignore the formation of an FLLE altogether. And indeed, as I discuss below, the courts ultimately rejected the Service’s I.R.C. § 2703 argument.

The Courts Have Their Say

²² In *Church v. United States*, 2000-1 U.S. Tax Cas. (CCH) ¶160,369 (W.D. Texas), *aff’d* without published opinion, 268 F.3d 1063 (5th Cir. 2001) however, the court held that a limited partnership met the I.R.C. § 2703 tests. Since the tests were met, the court did not need to address validity of the Service’s “partnership wrapper” arguments.

²³ I.R.C. § 2703(b) provides an exception to the application of I.R.C. § 2703(a)(2) if the following three tests are met. The arrangement (1) is a bona fide business transaction, (2) is not a device to transfer property to members of the family of the decedent for less than full consideration, and (3) has terms that are comparable to similar arrangements entered into by persons dealing at arm’s length. In the TAMs, the Service concluded that I.R.C. § 2703(b) did not apply. It would seemly be a rare FLLE that could meet its requirements, since typically the whole point of the transfer is to provide “a device to transfer property to members of the family of the decedent for less than full consideration,” *contra* to part 2 of the exception. Then again, as I discuss below, I.R.C. § 2036 contains a somewhat similar exception for a “bona fide sale for an adequate and full consideration” that has been held to apply in the family context. As I discuss below, the Service was ultimately failed in getting courts to apply I.R.C. § 2703, mooting the issue.

I will discuss Estate of Strangi,²⁴ a case with many lives, in some detail, as it discusses many issues that are relevant in subsequent cases. Mr. Strangi was a self-made millionaire who lived and died in Waco, Texas. He was a widower with children from his first marriage and stepchildren from his second marriage. Michael Gulig, his son-in-law and an attorney, prepared many of the estate planning documents and held the decedent's general power of attorney.²⁵

In August of 1994, after attending a seminar on the use of FLPs, the son-in-law formed a Texas limited partnership, SLFP, and its Texas corporate general partner, Stranco, Inc. At the time, Strangi was suffering from cancer and had a neurological disorder. The son-in-law handled all of the details of the formation and executed the documents in Strangi's name as his attorney-in-fact. The son-in-law assigned to SFLP about 98% of Strangi's assets with a combined fair market value of \$9,876,929 in exchange for a 99% interest in the partnership. Seventy-five percent of that value was attributable to cash and securities. Strangi acquired a 47% interest in Stranco for \$49,350, and his four children acquired the remaining 53% in equal shares for \$55,650. Stranco contributed \$100,333 to the limited partnership in exchange for a 1% partnership interest.²⁶ Since the children had control of Stranco, they technically also

²⁴ Estate of Strangi v. Commissioner, 115 T.C. 478 (2000) ("Strangi 1"), rev'd in part, aff'd in part, Gulig v. Commissioner, 293 F.3d 279 (5th Cir. 2002) ("Strangi 2"), focusing on I.R.C. § 2036 Estate of Strangi v. Commissioner, 85 TCM (CCH) 1331 (2003) ("Strangi 3"), aff'd 417 F.3d 468 (5th Cir. 2005) ("Strangi 4").

²⁵ Estate of Strangi v. Commissioner, 115 T.C. 478, 479-481 (2000).

²⁶ Estate of Strangi v. Commissioner, 417 F.3d 468, 472-473 (5th Cir. 2005).

had control of the limited partnership. All of these transactions were completed by August of 1994. In October of that year Strangi died of cancer at the age of 81.²⁷

Due to the appreciation in the securities SFLP held, at the date of death the assets of SFLP were worth over \$11 million, but the estate claimed that value of the SFLP interests was only about \$6.5 million.²⁸ At trial, the Service argued that the existence of SFLP should be disregarded because it lacked a business purpose and economic substance. The estate argued that by creating another layer through which creditors would have to bore, SFLP helped insulate Strangi from an anticipated tort claim from a caregiver and helped insulate the estate from a will contest from disinherited stepchildren. The estate also maintained that SFLP provided a joint investment vehicle for managing Strangi's assets. The Tax Court largely rejected the estate's arguments, stating that there was no realistic prospect of either a tort claim or a will contest. The court noted that Strangi ended up with 99.47% of the SFLP, directly or indirectly, and that three of the four Strangi children were not meaningfully involved in the affairs of SFLP until after Strangi died. The court therefore concluded that a joint-investment motive was not apparent either. Further, SFLP conducted no active business. Actual control was exercised by the son-in-law, via the power of attorney, perhaps meaning that technically Strangi remained in control.²⁹

The Tax Court, however, refused to disregard the entities that were created. It

²⁷ Estate of Strangi v. Commissioner, 417 F.3d 468, 474 (5th Cir. 2002), 115 TC 478, 482 (2000).

²⁸ Gulig v. Commissioner, 293 F.3d 279, 280 (5th Cir. 2002).

²⁹ Estate of Strangi v. Commissioner, 115 T.C. 478, 485-486 (2000).

rejection the Service's I.R.C. § 2703 argument as being unsupported by the statute or the regulations. The Service had also tried to argue I.R.C. § 2036 applied, but the Tax Court did not consider that argument because it was, curiously, raised only as a proposed amendment to the Service's pleadings "shortly" before trial.³⁰ In the first trial the Tax Court allowed the taxpayers significant discounts.³¹

The 5th Circuit reversed, holding that it was improper not to have considered I.R.C. § 2036. The 5th Circuit noted that the request to add a I.R.C. § 2036 claim was made 52 days before trial and that generally leave to amend should be freely given.³²

Upon remand, the Tax Court held that as a consequence of the application of I.R.C. § 2036, the entities were ignored and 99% of the net asset value of SFLP and 47% of the value of the assets held by Stranco (these percentages equal the percentages Strangi owned in the two entities) were included in the decedent's estate. As the assets held were included and not the ownership interests in the entities, the estate lost the benefits of the discounts, and the value of the estate was increased by about \$3 million.³³

30 Id. at 486-488.

31 About 31% for the SFLP interests, id. at 492.

32 Gulig v. Commissioner, 293 F.3d 279, 281 (5th Cir. 2002).

33 Estate of Strangi v. Commissioner, 85 TCM 1331 (2003).

Some additional background on I.R.C. § 2036: If a decedent has a mere life estate or other life interest in property that ends at death, the interest is not included in the decedent's gross estate under I.R.C. § 2033, in many respects the starting point for determining what is included in the decedent's estate.³⁴ In and of itself, this could mean that a decedent could gratuitously transfer property to a trust, retain the income from it, and avoid estate tax on the principal. If allowed, this could eviscerate the estate tax. Decedents would gleefully transfer property in trust, keep the income, and wave at the taxman as he passed by.³⁵ Congress addressed this issue early on. The 1916 estate tax rules provided that the estate included transfers "with respect to which the decedent had created a trust, in contemplation of, or intended to take effect in possession or enjoyment at or after his death."³⁶ What became I.R.C. § 2036 was actually a reaction by Congress to a Supreme Court decision.³⁷ In *May v. Heiner*,³⁸ the decedent made a lifetime transfer of securities in trust, with income payable to her husband for life and then to the decedent for life, with the trust corpus to be distributed to her children on her death. The Supreme Court ruled that the transfer was not made in "contemplation of death" under the statute and thus not included in the decedent's estate. Congress responded by addressing the issue more comprehensively in what became, with some additional downstream tweaking, I.R.C. § 2036(a):

34 I.R.C. § 2033 provides that "The value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death."; see Richard Stephens, Guy B. Maxfield, Stephen A. Lind, and Robert B. Smith, *Federal Estate and Gift Taxation*, ¶ 4.05[5][b] (hereinafter "E&G Taxation").

35 See E&G Taxation at ¶ 4.08.

36 Revenue Act of 1916, ch. 463, 39 Stat. 756, 777-778.

37 Supreme Court tax cases remind me of a comment by my friend and colleague at the University of Baltimore Law School, Prof. Jack Lynch: The Supreme Court decides four tax cases a year, two for the taxpayer, two for the government, and all wrong.

38 281 U.S. 238 (1930).

(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 in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before 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.

I.R.C. § 2036(a)(1) has two alternative tests, “possession or enjoyment” or “right to income.” Enjoyment has been defined as “synonymous with a substantial present economic benefit.”³⁹ Further, I.R.C. § 2036(a)(1) can apply if there is only an implied understanding that the decedent will retain possession or enjoyment, even if the right to do so is not legally enforceable.⁴⁰

³⁹ Estate of McNichol v. Commissioner, 265 F.2d 667, 671 (3d Cir. 1959).

⁴⁰ Estate of Maxwell v. Commissioner, 3 F.3d 591, 593 (2d Cir. 1993); Estate of Reichardt v. Commissioner, 114 T.C. 144 (2000); Estate of Schauerhamer v. Commissioner, TC Memo 1997-242.

The word “right” in I.R.C. § 2036(a)(2) connotes “an ascertainable and legally enforceable power.”⁴¹ The statute also adds that it is immaterial whether or not the right is exercised alone or in conjunction with others, or in what capacity it is exercised (e.g. individually or as a trustee).⁴²

The parenthetical language of I.R.C. § 2036(a) contains an important exception. I.R.C. § 2036(a) does not apply to transfers made “in case of a bona fide sale for an adequate and full consideration in money or money’s worth.” This is a sort of get-out-of-jail-free card. A taxpayer who falls within that exception wholly escapes the clutches of I.R.C. § 2036(a). This “I.R.C. § 2036 exception” has been the focus of a number of recent cases, as I will discuss.

On remand in *Strangi*, the Tax Court held that both I.R.C. § 2036(a)(1) and (2) applied and that the exception did not. An understanding of the role played by Mr. Strangi’s son-in-law, Mr. Gulig, is critical. Mr. Gulig held Mr. Strangi’s general power of attorney. The general partner of SFLP was Stranco, inc. Stranco signed a management agreement employing Mr. Gulig to manage the day-to-day business of SFLP.⁴³ Thus, as the Tax Court noted, “..the governing [Stranco] documents gave Mr. Gulig authority to specify distributions from SFLP, which is entirely consistent with his authority under the 1988 power of attorney.”⁴⁴ In the court’s view, the “income piece” of I.R.C. § 2036(a)(1) could be triggered simply because the decedent, acting through Mr.

41 *United States v. Byrum*, 408 U.S. 125, 136.

42 Also see *Treas. Reg. § 20.2036-1(b)(3)*.

43 85 TCM (CCH) 1331, 1337 (2003).

44 *Id.*

Gulig, could distribute SFLP or Stranco income to himself. As the Tax Court indicated, I.R.C. § 2036(a)(1) only requires that the decedent have a right to income, not that the decedent receive an actual distribution of income.⁴⁵ The estate's obvious retort is that Mr. Gulig could not so simply do that. He may have been Mr. Strangi's attorney in fact, but under the management agreement would have had fiduciary duties to the other shareholders of Stranco which would have restricted his ability to distribute income to Mr. Strangi. The Tax Court acknowledged that fact, but felt these fiduciary duties were entitled to relatively little weight. He also had fiduciary duties to the decedent, and "...to the extent that Stranco and SFLP's interests might diverge from those of decedent, we do not believe that Mr. Gulig would disregard his preexisting obligations to the decedent."⁴⁶ The court here seems to be finessing the Supreme Court's decision in *Byrum v. Commissioner*,⁴⁷ which I discuss below, though it did not actually discuss that case in this context.

In the Tax Court's view, the decedent retained possession and enjoyment of the relevant property in a manner that would trigger also I.R.C. § 2036(a)(1), emphasizing that the decedent retained essentially the same relationship to the assets he had before SFLP and Stranco were formed.⁴⁸ The Tax Court emphasized a number of facts in this regard. Mr. Strangi had contributed 98% of his assets to SFLP and Stranco and had retained only \$762 in truly liquid assets. Under these circumstances, the Tax Court

45 *Id.*

46 *Id.* at 1343.

47 408 U.S. 125 (1972).

48 *Estate of Strangi v. Commissioner*, 85 TCM (CCH) 1331, 1338-1339 (2003); also see *Estate of Reichardt v. Comm'r*, 114 T.C. 144 (2000).

concluded that Mr. Strangi and his children expected that SFLP and Stranco would be the primary source of his liquidity.⁴⁹ Further, Mr. Strangi remained in possession of his residence, one of the contributed assets. Mr. Strangi was obligated to pay rent on the residence, but the rent was not actually paid until January 1997, over two years after Mr. Strangi's death. While distribution of SFLP funds were made proportionately to Mr. Strangi and Stranco, in the Tax Court's view this did not distract significantly from finding Mr. Strangi had possession and enjoyment when Stranco's interest, at 1%, was minimal. Further, the assets Mr. Strangi retained were insufficient to meet the expenses he could reasonably be expected to incur given his poor health, again suggesting that in reality Mr. Strangi retained enjoyment of the assets. In the court's view, the structure looked more like one man's estate plan rather than a joint enterprise with the other partners, who had little input. Little changed in the decedent's relationship with his assets beyond transferring formal title.⁵⁰ As the other cases I will discuss will show, not keeping enough assets for the decedent's own support or meaningfully changing his relationship with the donated assets is invariably fatal.

Taking the belt and suspenders approach, the Tax Court also found that I.R.C. § 2036(a)(2) applied. In this regard the court discussed the Supreme Court's holding in *United States v. Byrum*⁵¹ in some detail.⁵² That case indeed plays an important role in this area, so I will discuss it as well. There, Mr. Byrum created an irrevocable trust, with

49 *Estate of Strangi v. Commissioner*, 85 TCM (CCH) 1331, 1338 (2003); *Estate of Strangi v. Commissioner*, 417 F.3d 468, 478 (5th Cir. 2005).

50 *Estate of Strangi v. Commissioner*, 85 TCM (CCH) 1331, 1338-1340 (2003).

51 408 U.S. 125 (1972).

52 Generally, see *Hellwig* supra note 12.

an independent trustee, for the benefit of his children. The principal of the trust was shares of stock of three closely held corporations. The corporations had a number of unrelated minority shareholders. Mr. Byrum retained the right to vote the shares he contributed to the trust. The trustee had the sole power to pay income or principal to the beneficiaries.⁵³ The Service had argued that the right Mr. Byrum retained to vote the stock required inclusion of the stock in his estate under I.R.C. § 2036(a)(2).⁵⁴ The Supreme Court had previously ruled that the power to accumulate rather than disburse triggers I.R.C. § 2036(a)(2).⁵⁵ The Service argued that Mr. Byrum, by keeping voting control, could elect directors and thereby control dividend payment, effectively giving him the right to choose whether corporate income would be accumulated or disbursed.⁵⁶ The Supreme Court disagreed, noting that there were a series of economic and legal constraints on Mr. Byrum. The trustee was independent and had the sole right to make or withhold distributions under the trust. Thus, even if Mr. Byrum could cause dividends to be paid to the trust, he had no power to cause the trustee to pay them to the beneficiaries. The right to elect directors did not insure dividend payment, which would be limited by the economic vicissitudes, policies, and needs of the business.⁵⁷ Further, and in the FLLE context more importantly, the Court noted that

“A majority shareholder has a fiduciary duty not to misuse his power by promoting his personal interests at the expense of corporate interest. However

53 Id. at 126-130.

54 Id. at 131-132.

55 *United States v. O'Malley*, 383 U.S. 627, 631 (1966).

56 408 U.S. 125, 131-132.

57 Id at 137-140.

great Byrum's influence may have been with the corporate directors, their responsibilities were to all stockholders and were enforceable according to legal standards entirely unrelated to the needs of the trust or to Byrum's desires with respect thereto.”⁵⁸

Congress actually overruled Byrum in the corporate context in I.R.C. § 2036(b), which provides that the retention of the right to vote stock in a controlled corporation constitutes retention of “enjoyment” of property for I.R.C. § 2036(a)(1) purposes. The Byrum decision remains viable in the FLLE context, however, hence the Tax Court’s discussion of it.

In concluding that I.R.C. § 2036(a)(2) also brought the relevant assets into the estate notwithstanding Byrum, the Tax Court honed in on several salient facts. The court did not state that any particular fact was fatal, but seemed to say that the facts in the aggregate crossed the I.R.C. § 2036(a)(2) line. It noted that Stranco, as the managing general partner, had the power to determine distributions. The Stranco shareholders had in turn delegated this authority to Mr. Gulig, who was the decedent’s attorney in fact, and who lacked the independence of the trustee in Byrum. Additionally, under the terms of the SFLP partnership agreement, the partnership could be dissolved and terminated upon a unanimous vote of the limited and general partners. This effectively gave the Mr. Strangi the power, along with the other players, the ability to revoke the SFLP agreement and thereby to bring about or accelerate present

⁵⁸ Id at 137-138.

enjoyment of the partnership assets, most of which would, of course, go to Mr. Strangi.⁵⁹

Stranco's bylaws authorized the board of directors to declare a dividend. There were five directors, a quorum was three of those five. A majority of the quorum was thus two directors. It troubled the court that a dividend could possibly be declared by the decedent and one other director. Also, while the minority shareholders in Byrum were unrelated to the decedent, in Strangi the other shareholders of Stranco were part of his family. Unlike in Byrum, there were none of the relevant "business realities" that might have constrained the parties' conduct.⁶⁰ Stranco indeed had a fiduciary duty to SFLP and the limited partners, but in the court's view, given Strangi's 99% limited partnership interest, "[t]he rights to designate traceable to decedent through Stranco cannot be characterized as limited in any meaningful way by duties owed essentially to himself."⁶¹ "To the extent that Stranco or SFLP's interests might diverge from those of decedent, we do not believe that Mr. Gulig would disregard his preexisting obligation to decedent."⁶² Further, in Byrum there were business and economic exigencies that restrained the corporation's conduct. If the corporation had income, before a dividend distribution, it would have to consider the needs of the corporation for working capital, modernization and growth. There were no such limits in the Strangi case.⁶³ The Tax Court said that the Byrum decision "does not require blind application of its holding to

59 Estate of Strangi v. Commissioner, 85 TCM (CCH) 1331, 1342 (2003).

60 Estate of Strangi v. Commissioner, 85 TCM (CCH) 1331, 1341-42 (2003).

61 Id at 1343.

62 Id.

63 Id at 1342.

scenarios where the purported fiduciary duties have no comparable substance.”⁶⁴

The Tax Court also somewhat summarily dismissed the possible application of the I.R.C. § 2036 exception based on holdings that it issued while the original Strangi decision wound its way through the appellate process, and a decision of the 3rd Circuit.⁶⁵ I will discuss this highly important issue below.

The Strangi case was again appealed. This time the 5th Circuit affirmed the Tax Court.⁶⁶ Essentially, the 5th Circuit concluded that the critical issues were ones of fact and there was no clear error on the part of the Tax Court that would justify reversal. The 5th Circuit also agreed with the Tax Court that the I.R.C. § 2036 exception did not apply. The 5th Circuit’s take on the exception is important, however. It concluded that there had indeed been “adequate and full consideration,” because assets were transferred in exchange for proportional interests in the FLP.⁶⁷ As I will discuss below, the 3rd Circuit does not agree with the 5th Circuit in this regard and the Tax Court may not either. The 5th Circuit, however, accepted the Tax Court’s holding that there was no bona fide sale. In particular, the 5th Circuit held that the “Tax Court did not clearly err in finding that Strangi’s transfer of assets to the [limited partnership] lacked a substantial business motive,” which distinguishes the case from the 5th Circuit’s decision in Kimbell, discussed below.

64 Id at 1341.

65 Id at 1343-1344. See Estate of Harper, 83 TCM 1641 (2002) and Estate of Thompson, 382 F.3d 367 (3rd Cir. 2004).

66 Estate of Strangi v. Commissioner, 417 F.3d 468 (5th Cir. 2005).

67 Id at 478.

Strangi pretty much rang the death knell for near-death FLLCs designed to save estate taxes as the decedent breathed her last. No case since then has sanctioned Strangi-type planning,⁶⁸ though the Kimbell case at least gets close to the line. These Strangi-type cases are at least getting to the right result. While doctrines such as substance over form and step transaction have not typically been applied in the estate and gift tax context, it encourages the Strangi conclusions.⁶⁹ Taxpayers should not be able to dramatically reduce their estate tax burden by the simple expedient of placing their assets in an FLLC shortly before they expect to die, where the estate tax savings is the primary motivation for the structure. To allow this would have the effect of making a meaningful percentage of the estate tax optional in a circumstance where the taxpayer is changing the form in which he holds his assets, but often little else. It makes good sense, therefore, to collapse the steps and treat the decedent as owning the assets.⁷⁰

An argument often made in favor of allowing the discounts is that you cannot

⁶⁸ See *Estate of Harper v. Commissioner*, 83 TCM (CCH) 1641 (2002).

⁶⁹ For example, in the first Strangi case, *Estate of Strangi v. Commissioner*, 115 T.C. 478 (2000), the majority did not attack the structure based on a step transaction analysis or apply other similar doctrines, such as substance over form. However, Judge Beghe, in a written dissent argued for application of the step transaction doctrine. See Jay A. Soled, *Use of Judicial Doctrines in Resolving Transfer Tax Controversies*, 42 B.C. L. Rev. 587 (2001) and Elaine Gagliardi, *Economic Substance in the Context of Federal Estate and Gift Tax: The Internal Revenue Service Has It Wrong*, 64 Mont. L. Rev. 389 (2003).

⁷⁰ And even if the taxpayer is an unusual one who not only changes the form but gives up significant benefits from the transferred assets by transferring interests in the FLLC to others, it is difficult to think of solid policy rationales to allow substantial estate tax savings for such last minute hocus pocus. The taxpayer is not giving up much by making transfers if he is near death, and other than the discounts there is likely to be no real reason for the FLLC structure. If the FLLC were respected, taxes likely will be about the same whether interests in the FLLC are given away or not. Values would not be likely to change much between the gift and death, and given our uniform gift and estate tax system, the tax rates on the gifts and on the estate are the same. Further, the estate includes gift taxes paid within three years of death. I.R.C. § 2035(b).

count on family members to get along. Thus, this line of reasoning goes, once you have placed property in an FLLE there may be a real shift. A minority interest in an FLLE is a lot different than an undivided tenant in common interest in an asset, where one could possibly get a court order requiring a sale and a distribution of the proceeds. This argument surely has some cogency, but in a last minute structure, which often can be unwound after the decedent's death in any event, it loses most of its power. Even estranged family members can typically hold it together until the near-term death of the decedent.

As the law developed, it became clear that under many of the FLLE structures used, I.R.C. § 2036(a)(1) or (2) would typically require inclusion of the assets contributed to the FLLE in the decedent's estate. As a consequence, estates resorted to the get-out-of-jail free card arguing that the swap of assets for FLLE interests should qualify under the I.R.C. § 2036 exception. The argument has some appeal. In the typical non-FLLE § 2036 case, the taxpayer receives nothing in exchange for the transferred assets. Here they are getting an asset in return, FLLE interests. Where this argument falls short is that the exception does not say it applies if the taxpayer receives "adequate and full consideration." If it just said that, the taxpayers' argument would indeed have some cogency, for the FLLE interests are in fact a type of consideration, and in fact may be adequate and full consideration as long as the taxpayers receive a percentage of the FLLE interests in exchange proportionate to the property contributed. The exception, however, also says that there must be "a bona fide sale." It is on this point that the Service has often carried the day, though the cases often blur the line

between the two parts of the exception. Further, precisely because of this issue, the cases have developed in a way highly dangerous to the use of FLLEs in estate planning. No longer must an FLLE be organized near death to fall within at least the Tax Court's interpretation of I.R.C. § 2036. Virtually any FLLE formed at any time could run afoul of I.R.C. § 2036. The Service so far has litigated cases where the FLLE was funded no more than about three years before death, though the decedent may have been in good health at the time the FLLE was formed.

The Bone Fide Sale Cases

The first case to look at the I.R.C. § 2036 exception in the FLLE context was *Harper v. Commissioner*.⁷¹ Five years before his death, the decedent created a revocable living trust to hold the bulk of his assets. The decedent was the trustee. This type of trust has no estate tax benefits. Since it is revocable, its assets would be included in the decedent's estate under I.R.C. § 2038. But the assets held by the trust can avoid probate, and for that reason this structure is commonly used. About a year before his death, at a time when he was suffering from cancer, the decedent formed an FLP to which the trust contributed about 94% of its assets. His two children were the general partners and the trust was the sole limited partner. Because it was a revocable trust, the transfer by the trust was seen as a transfer by the decedent. About seven months before the decedent's death, the trust transferred 60% of the trust's FLP

⁷¹ 83 TCM (CCH) 1641 (2002).

interests to the decedent's two children. There were numerous irregularities, including a co-mingling of funds, and in a number of areas the general partners of the partnership could not take action without the consent of the trust (meaning the decedent).⁷² The Tax Court concluded that there was an implied agreement that the decedent would retain control and enjoyment of the property. (The Tax Court had previously held in *Reichardt and Schauerhamer* that such an agreement required the inclusion of the partnership's assets in the estate under I.R.C. § 2036.⁷³) Up to this point there was nothing new or particularly surprising about the case.

What was new, was the court's analysis of the I.R.C. § 2036 exception. The estate argued that the decedent (acting through the revocable trust) contributed 99% in value of the partnership assets and received 99% of the partnership interests, and that therefore the I.R.C. § 2036 exception should apply. In effect, the estate was arguing that as long as the decedent receives a proportionate FLP interest, the exception should apply.⁷⁴ But the court said that the exception has two requirements: "(1) A bona fide sale, meaning an arm's length transaction, and (2) adequate and full consideration."⁷⁵ The court concluded that the taxpayer fell short of meeting the first part of the test. This required an arm's length bargain, which could not exist in a transaction where decedent "stood on both sides [of it]."⁷⁶ Further, the Tax Court held that the second part of the test was not met either:

⁷² Id at 1641-1646.

⁷³ Id at 1648-1649; *Estate of Reichardt v. Commissioner*, 114 T.C. 144 (2000); *Estate of Schauerhamer v. Commissioner*, T.C. Memo 1997-242.

⁷⁴ 83 TCM (CCH) 1641, 1653 (2002).

⁷⁵ Id at 1652.

⁷⁶ Id at 1653.

“Without any change whatsoever in the underlying pool of assets or prospect for profit, as, for example, where others make contributions of property or services in the interest of a true joint ownership or enterprise, there exists nothing but a circuitous *“recycling” of value*. We are satisfied that such 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.”⁷⁷

This is a highly important holding, and likely the case should not have come out as a Tax Court Memorandum decision, theoretically reserved for cases applying established law, but instead as a Tax Court decision, where, again theoretically, new issues are to be addressed.⁷⁸ The Tax Court ultimately did come out with a Tax Court decision in this regard in *Bongard*,⁷⁹ discussed below. Putting aside for a moment how the court breaks down the bona fide/consideration parts of the test, the court came to the correct holding. To say the structure used in *Harper* would fall within the exception would indeed open the door wide for abuse and bring virtually any FLLE use within its fold, including the one in *Strangi*. To allow these structures would have the effect of severely undercutting I.R.C. § 2036 and could not have been intended by Congress.

While hardly the norm, there are cases where the FLLE structure is organized on

⁷⁷ Id at 1653 (emphasis supplied).

⁷⁸ Though the case found some support in *Estate of Reichardt*, 114 T.C. 144 (2000), the *Harper* case expressed its perspective in new and important way.

⁷⁹ *Estate of Bongard v. Commissioner*, 124 T.C. 95 (2005).

a more arm's-length basis. The Tax Court gave us an example in *Estate of Stone v. Commissioner*.⁸⁰ This highly complex case involved the estate of the patriarch of a wealthy family whose children could not get along. The primary source of the family's wealth was a sports apparel manufacturing business. Bitter litigation had arisen between the children about the management of the sports apparel company, and there were strong rivalries among the children as to who would succeed to which of their parents' assets. The decedent and his wife, who were elderly, also wanted help in managing their own assets, which were substantial and diverse. There was some suggestion in the case that the parents truly needed help in managing their assets and that the children were concerned that their parents not dissipate their wealth. Legitimate negotiations took place that involved the children and their parents, all of whom were represented by counsel.⁸¹

To resolve these issues, the Stones transferred substantial assets to a series of FLPs in exchange for limited partnership interests. Different children made different and meaningful contributions to different FLPs in exchange for general and limited partnership interests, the idea being that on their parents' deaths, a given child would receive much of her share of the parents' assets based on the assets held by the FLP in which she held an interest. The children were actively involved in the FLPs as general partners.⁸² The court found that the primary reason the Stone family became interested in exploring the use of family limited partnerships was to resolve the

⁸⁰ 86 TCM (CCH) 551 (2003).

⁸¹ *Id.* at 552-578.

⁸² *Id.*

children's concerns regarding their parents' assets.⁸³ The court specifically found that the transfers by the decedent and his wife were not gifts to their children, and that there were legitimate nontax reasons for the transfers. Further, the decedent retained substantial assets for the support of him and his wife and he and his wife were in good health during most of the negotiations.⁸⁴ The fact that the decedent died four months after the FLEEs were funded was not considered to be significant.⁸⁵

Under these circumstances, the Tax Court held that the I.R.C. § 2036 exception applied to the exchange of property for interests in several FLPs.⁸⁶ The Tax Court's decision was consistent with its holding in Harper. In Stone you could not say the decedent was on both sides of the transaction. His children were actively involved in the negotiations. The transfer was motivated by investment and business concerns, and indeed probably would not have happened but for those concerns. The fact that the Stones kept substantial assets for themselves undermined any argument that there was an implied agreement that the assets of the FLPs would be used primarily for their benefit, which caused the decedents to lose in cases like Reichardt, Schauerhamer, and Harper. The estate tax savings were likely not a meaningful factor in the decision to form the FLPs, making Stone a truly unusual case.

A rather more typical case is Estate of Kimbell v. United States.⁸⁷ This case was

83 Id at 557.

84 Id at 579-580.

85 Id at 569-573.

86 Id at 580-581.

87 371 F.3d 257 (5th Cir. 2004).

first litigated in Federal District Court, and thus did not come up through the Tax Court.⁸⁸ While the facts were in some respects reminiscent of those in Strangi, and the case was far closer to the line than Stone, there were important differences.

Here the crucial entities were formed about two months before the decedent died at the age of 96. Unlike in Stone, there was no suggestion of legitimate negotiations between the parties. As in Harper, the decedent had years earlier formed a revocable trust to hold the bulk of her assets. About two months before her death (doubtless under direction from her son), the decedent, her son, and her son's wife formed two other entities. The most important of these was an FLP to which the trust contributed cash and assets worth \$2.5 million. The contributed assets included oil and gas working interests,⁸⁹ royalty interests, securities, and notes. In exchange the trust received a 99% limited partnership interest. An LLC, of which her son was the sole manager, became the general partner of the FLP. A likely important fact was that the decedent retained \$450,000 in assets for her own support. When the estate filed its federal estate tax return, it took a 49% discount on the value of the decedent's interest in the partnership. On cross summary judgment motions the district court held for the Service. The 5th Circuit reversed and held that the I.R.C. § 2036 exception applied.⁹⁰

This exception again was seen as having two parts: (1) There must be a "bona

⁸⁸ Estate of Kimbell v. United States, 244 F. Supp 2nd 700 (N.D. Texas 2003).

⁸⁹ Working interests are those charged with developing an oil and gas well.

⁹⁰ Estate of Kimbell v. United States, 371 F.3d 257, 257-260 (5th Cir. 2004). Also see Church v. United States, 2000 U.S. Dist. LEXIS 714 (W.D. Texas 2000), aff'd without published opinion 268 F.3d 1063 (5th Cir. 2001).

fide sale” and (2) the bona fide sale must be for “an adequate and full consideration in money or money’s worth.” The 5th Circuit focused on the second part of the test first, holding that there is adequate and full consideration if the transfer does not deplete the estate. Further, as it had in *Strangi*, the court concluded that there is no depletion if the decedent receives a proportionate share of the FLP interests in exchange for the assets contributed.⁹¹ In the court’s view, the fact that in *Kimbell* the decedent’s FLP interest was discounted for valuation purposes did not prevent a finding that the consideration was adequate. The court noted that investors who acquire partnership interests do so knowing they cannot sell it for 100 cents on the dollar and with the expectation of realizing benefits of management expertise, security, preservation of assets, capital appreciation, and avoidance of personal liability.⁹²

In the typical FLLE, about the only way the decedent will not get a proportionate interest in exchange for his assets is if there is malpractice of fraud. If the decedent does not receive a proportionate interest, it means that someone else received a disproportionate interest. Ordinarily the decedent would have made a gift of the “extra” interest the other person received, generating a possible gift tax. Typically, one would not want to create a gift tax on formation of an FLLE, so if it happens, there is likely malpractice. The decedent can also be defrauded, shifting an extra interest to another without intending to do so. That is even less likely than a gift. Thus, the 5th Circuit

⁹¹ *Estate of Kimbell v. United States*, 371 F.3d 257, 262, 265-266 also required that the assets contributed by a partner be properly credited to his capital account and that on termination of the partnership the partners be entitled to a distribution of an amount equal to the capital account balance, 371 F.3d 257, 266 (2004). These requirements would normally be met in any well-drafted partnership agreement in this context.

⁹² *Estate of Kimbell v. United States*, 371 F.3d 257, 266 (5th Cir. 2004).

made this part of the test a “gimme.”

For the consideration part of the exception, the 5th Circuit’s decision in Kimbell is consistent with its decision in Strangi. In Strangi, as I discussed above, the 5th Circuit also said the consideration part of the I.R.C. § 2036 exception was met. There is significant tension between the 5th Circuit and the Tax Court with regard to what constitutes adequate consideration. The 5th Circuit view is that the consideration test is met when proportionate interests are received by the contributing partners. The Tax Court said that simply receiving proportionate interests was not enough. There had to be more than “mere recycling.”⁹³ In neither Harper nor Strangi did the Tax Court say how one would avoid mere recycling. Stone, in some ways the polar opposite of Harper and Strangi, said consideration was adequate where the FLPs were formed with little, if any, concern for the tax consequences. Facts like Stone, where there is indeed little concern for the tax consequences, are rare, making the case of little value as a precedent. As I will discuss, at the end of the day there is no real practical alternative to the 5th Circuit’s “gimme” approach to the consideration part of the exception. Subsequently in Bongard (discussed below), the Tax Court almost comes around to the 5th Circuit’s view, but not quite.

The 5th Circuit did allow that in reviewing the bona fide sale part of the exception, heightened scrutiny was appropriate for transactions between family members to insure that they are undertaken in good faith, were not a sham or a disguised gift, and had a

⁹³ 85 TCM (CCH) 1331, 1344.

business purpose. The court noted that the inquiry is an objective one, and that the fact that family members are involved does not create additional requirements. If a transaction passes muster between strangers, it will pass muster between family members. Having a tax savings motive is not fatal. The court held that the absence of negotiations between the parties was not a compelling factor, again putting it at odds with the holdings of the Tax Court in Harper and Strangi.⁹⁴

With regard to the bona fide sale part of the test, the 5th Circuit concluded that there was evidence that the transaction was entered into for substantial business and other non-tax reasons. The court noted the following: (1) The decedent retained sufficient assets for her own support and there was no commingling of partnership and personal assets; (2) partnership formalities were satisfied and the assets to be contributed were actually assigned to the partnership, (3) the oil and gas properties, which included working interests, required active management; (4) greater creditor protection was available to a limited partnership than to the trust structure the taxpayer had been using; (5) the decedent wanted the operation of the oil and gas properties to continue beyond her lifetime; (6) the decedent wanted to avoid the costs of recording the transfers of oil and gas properties as they are transferred from one generation to the next; (7) the decedent wanted to hold the assets in an entity that would preserve the property as separate property of her descendants, in the event, for example, of a divorce; (8) the decedent wanted to arrange for management of the assets if something should happen to her son; and (9) the decedent wanted to provide a means to avoid

⁹⁴ Estate of Kimbell v. United States, 371 F.3d 257, 266 (5th Cir. 2004).

interfamily litigation by providing for disputes to be resolved through mediation or arbitration.⁹⁵

In truth, most of these tests could be met by most partnerships. There are two that stand out, however: The fact that the decedent owned working interests in oil and gas wells, and the related fact that there was greater liability protection in the FLP than in her trust structure. Any time there is an actual business activity going on, as there are with working interests in oil and gas wells, there is a heightened liability exposure, and accordingly a legitimate nontax reason for using the FLLE. Wrapping a business into the FLLE package may be the way to the promised land of the I.R.C. § 2036 exception. It was also helpful to the decedent in Kimbell that, unlike in Reichardt, Harper, and Strangi, the decedent also retained enough assets for her support. This helps counter sham arguments, but as I will show in subsequent cases, this fact may be “necessary but not sufficient.”

While the 5th Circuit in Kimball appears to be more liberal in its holding than the Tax Court previously was in its decisions, the difference may be more superficial than substantive. The 5th Circuit can still point to the legitimate business needs for using the FLP in Kimbell. The taxpayers in Strangi or Harper could not show these types of business needs, though they could in Stone. Further, the 5th Circuit made a point of approving of the Tax Court’s holdings in Strangi and Harper. For example, it said of the Tax Court’s decision in Strangi, that the partnership there “patently fails to qualify as

⁹⁵ Id at 267-268.

the sort of functioning business enterprise that could potentially inject intangibles that would lift the situation beyond mere recycling.”⁹⁶ So it may be that the two courts would get to the same holding on the same facts, but just use different roads to get there.

The Third Circuit weighed in against the taxpayer in *Estate of Thompson v. Commissioner*.⁹⁷ The decedent, while in his nineties, transferred assets, mostly securities, to two FLPs, one for each of his two children. He contributed about \$1.4 million to each FLP, retaining personal assets worth only about \$153,000. Perhaps in an (ultimately unsuccessful) effort to make the FLPs appear more legitimate, his children and his daughter’s spouse made meaningful contributions to the FLPs, so that the decedent owned a 95.4% limited partnership interest in the FLP formed for his daughter and only a 62.27% interest in the FLP formed for his son. The decedent owned 49% of the corporate general partner, his two children jointly owned 49%, and a tax exempt entity owned 2%. The FLPs engaged in some fairly minor business activities, none of which were profitable. The daughter’s FLP made loans to members of the daughter’s family which were not repaid. The son’s FLP made some distributions to the decedent for his expenses, and both FLPs made distributions to the decedent which were used by him to make holiday gifts. None of the distributions were large. About two years after the formation of the FLPs, the decedent died at the age of 97. The estate took a 40% discount for lack of marketability and minority interest discounts

⁹⁶ *Estate of Kimbell v. United States*, 371 F.3d 257, 265 (5th Cir. 2004).

⁹⁷ 382 F.3d 367 (3d Cir. 2004).

on the interests the decedent held in the FLPs.⁹⁸

The Tax Court, unsurprisingly, held for the government.⁹⁹ The 3rd Circuit affirmed the Tax Court and held that § 2036(a)(1) included the full value of the transferred assets in the estate.¹⁰⁰ The decedent did not retain sufficient assets to support himself, a fact that, as the previously discussed cases point out, is invariably fatal.¹⁰¹ While the decedent lacked technical control of the FLPs, since others owned the majority of the stock in the corporate general partner, the 3rd Circuit agreed with the Tax Court that there was an implied understanding that his children would agree to his requests for money from the assets he contributed to the partnerships.¹⁰² As the court notes, and as I discussed above, this triggers the application of I.R.C. § 2036(a)(1) unless the I.R.C. § 2036 exception applies.

The 3rd Circuit concluded that the exception did not apply, essentially tracking the reasoning of the Tax Court. A key factor was the lack of significant business operations on the part of the FLPs, particularly outside the family. The children contributed significant amounts of real estate to the FLPs, but the partnership allocated income from those assets to the contributing child, which “denied the decedent any not-tax benefit

98 Id at 367-373,

99 Estate of Thompson v. Commissioner, 84 TCM (CCH) 374 (2002).

100 Estate of Thompson v. Commissioner, 382 F.3d 367, 383 (3rd Cir. 2004).

101 Similar issues arose in later cases, the taxpayer losing in each instance: Bigelow v. Comm’r, T.C. Memo 2005-65; Estate of Korby v. Comm’r, T.C. Memo 2005-102; Estate of Korby, T.C. Memo 2005-103 (the two Korby cases involve spouses that died within five months of each other).

102 Id at 376-377.

potentially derived from the assets collected in the partnership.”¹⁰³ The daughter’s FLP did make an \$186,000 real estate investment which the court acknowledged gave it some pause, but the court concluded that “the legitimizing effect of the ...investment...is overwhelmed by the testamentary nature of the transfer [by the decedent to the FLPs].”¹⁰⁴ Also damning in the court’s view was the fact that the decedent primarily transferred marketable securities, assets for which the FLPs offered little value.¹⁰⁵ This is, of course, distinguishable from *Kimbell*, where the decedent transferred working interests in oil and gas wells.¹⁰⁶

The court wondered if the receipt of discounted FLP interests in exchange for assets in and of itself precluded the existence of “adequate and full consideration” that the I.R.C. § 2036 exception requires. Noting the decisions that held that for such consideration to exist the estate could not be depleted, the 3rd Circuit wondered if the fact that the FLP interests were worth less than the contributed assets meant that the estate definitionally was depleted since the estate was not replenished with assets of equal value. The 3rd Circuit, however, acknowledged and implicitly agreed with Tax Court holdings that the potential for intangibles arising from the pooling of assets prevent this from being a hard and fast rule.¹⁰⁷ But the court also said that:

103 *Id.* at 380. The daughter contributed real estate worth \$49,000 initially and later contributed a 22 acre parcel adjacent to their residence. The son contributed real estate worth \$460,000. *Id.* at 370.

104 *Id.* at 380.

105 *Id.*

106 It also distinguished it from *Church v. United States*, 2000-1 U.S. Tax Cas. (CCH) ¶160,369 (W.D. Texas), *aff’d* without published opinion, 268 F.3d 1063 (5th Cir. 2001) which applied the exception to assets transferred to a limited partnership that consolidated administration and undivided ownership interests in a family ranch, as the court noted. *Thompson v. Commissioner*, 382 F.3d 367, 380 (3rd Cir. 2004).

107 *Thompson v. Commissioner*, 382 F.3d 367, 380 (3rd Cir. 2004).

Where, as here, the transferee partnership does not operate a legitimate business, and the record demonstrates the valuation discount provides the sole benefit for converting liquid, marketable assets into illiquid partnership interests, there is no transfer for consideration within the meaning of § 2036(a).¹⁰⁸

The 3rd Circuit's view stands, of course, in marked contrast to the 5th Circuit's decision in *Kimbell* which only required that the decedent receive a proportionate interest in the FLP based on the value of what he contributed to meet the consideration part of the test. I find the view of the 5th Circuit more persuasive. It has the advantage of simplicity and clarity and is easy to apply. The 3rd Circuit's view on the other hand is fuzzy. Sometimes receiving FLLE interests will constitute full and adequate consideration and sometimes it will not. The 3rd Circuit's view suggests that if the FLLE operates a business, *or* the valuation discount does not provide the sole benefit for the contribution, *or* the primary assets contributed is not marketable assets, than the consideration test can be met. This is an invitation to litigation, with estates arguing mightily that at least one of the three standards is met. At the same time, it often will not be all that difficult to vault the 3rd Circuit's hurdle, for example by making substantial contribution of assets other than marketable securities. Perhaps the 3rd Circuit did not mean to craft a rule that narrow and would not limit it to the contribution of marketable securities, but the opinion itself does not make that clear.

¹⁰⁸ Id at 381.

Further, looking to general contract law, courts are typically averse to weighing the quality of consideration. As generations of law students have learned, a peppercorn can be adequate consideration.¹⁰⁹ Second guessing the value of consideration where the decedent gets proportional FLLE interests is an invitation to trouble. To the extent the 3rd Circuit wants the FLLE to operate a business before the exception can apply, something it continually implies but never quite says, it should enunciate the rule as an interpretation of the bona fide sale part of the I.R.C. § 2036 exception generally, and not try to squeeze it into the consideration aspect of the test where it does not really fit.

Some might argue that Kimbell standard for the consideration part of the test will almost always be met and that makes the test almost meaningless. They might argue that Congress must surely have intended a higher hurdle. Admittedly, the Kimbell hurdle is not a high one, but nor is it a nonexistent one. It still excepts cases where the donor does not receive a proportionate interest. Further, it would not be the first time Congress created a test of a less than overwhelming nature. Finally, following the Kimbell test for consideration does not leave the Service impotent. It still has the bona fide sale part of the test, which is a more logical place for most of its arguments.

Interestingly, given how it otherwise seemed to track the Tax Court's opinions, the 3rd Circuit rejected the view of the Tax Court that the bona fide sale part of the exception required an arm's length transaction. It noted cases where a bona fide sale was found to exist in a harmonious family context including Kimbell,¹¹⁰ and that the

¹⁰⁹ Murray on Contracts § 59.

¹¹⁰ It also cited *Bank of New York v. United States*, 526 F.2d 1012, id.

Regulations did not require arm's length, instead defining a bona fide sale for adequate and full consideration as one made "in good faith" and for a price that is "adequate and full equivalent reducible to a money value."¹¹¹ In the court's view, in order for a transaction to be a bona fide sale, it must provide the transferor with some potential benefit other than estate tax savings. Since it saw that as the primary benefit received by the decedent, the 3rd Circuit concluded that this part of the exception was not met either and affirmed the Tax Court.¹¹²

The 3rd Circuit's test for the bona fide sale part of the test is a reasonable one and fairly straight forward to apply. There must be genuine nontax benefits for a sale to be bona fide. Indeed, as I will discuss, the Tax Court eventually moves in that same direction.

The First Circuit chimed in with *Abraham v. Commissioner*.¹¹³ The case, in truth, adds little to the discussion, but I will review it briefly since it was an appellate opinion. It is in many respects reminiscent of *Thompson*. The decedent, Mrs. Abraham, had suffered from Alzheimer's disease and a guardian had been appointed for her. Litigation ensued between several of her children over the amount needed for the decedent's protection. A court approved settlement was reached between the children and the guardian under which three commercial properties were placed in three

¹¹¹ *Thompson v. Commissioner*, 382 F.3d 367, 381 (3rd Cir. 2004) quoting Treas. Reg. § 20.2036-1(a).

¹¹² *Id.* at 383.

¹¹³ 408 F.3d 26 (1st Cir. 2005).

separate family limited partnerships (“FLPs”). Mrs. Abraham died about two years later.¹¹⁴ The court concluded that it was understood that the support of Mrs. Abraham would be the first claim against the funds of the FLPs, even though the FLP agreements might not have technically required that outcome, triggering the application of I.R.C. § 2036(a).¹¹⁵

The First Circuit did not discuss the I.R.C. § 2036 exception except in one narrow context. Two of the children purchased interests in the FLPs for \$160,000 each. The amount paid was held not to come within the I.R.C. § 2036 exception because the estate did not produce sufficient evidence to demonstrate the fair market value of the partnership interests on the dates of the purchases. Independent appraisals had not been obtained at that time. Had they been, the FLP assets associated with the purchased interests likely would have been excluded from the estate.¹¹⁶

The cases I have discussed to this point have all involved FLLEs that were formed toward the end of the decedent’s expected lifespan, though in Thompson the decedent lived for two years after the FLPs were formed. While the language of the cases could surely apply more broadly, many practitioners took solace from the fact that longer-standing FLLEs remained unscathed. The facts and the broadness of the Tax Court’s decision in Estate of Bongard v. Commissioner¹¹⁷ took away much of that solace

¹¹⁴ Id at 28-34.

¹¹⁵ Id at 38-40.

¹¹⁶ Id at 37-39.

¹¹⁷ 124 T.C. 95 (2005); several subsequent Tax Court cases essentially follow the reasoning of Bongard, finding for the government: Two cases entitled Estate of Korby v. Commissioner, T.C. Memo

and raised questions about the efficacy of FLEEs as an estate planning tool.

The majority of the Tax Court judges adopted a two-part test.¹¹⁸ In sum, the court concluded that in order for family FLEEs to fall within the I.R.C. § 2036 exception, there must be meaningful *nontax* reasons for forming the FLEE (thereby tracking the 3rd Circuit's view in Thompson), and the transferors must receive partnership interests proportionate to the value of the property transferred (with qualifications, tracking the 5th Circuit's decision in Kimbell).¹¹⁹ The case did not involve a last-minute FLEE, but it also did not involve an FLEE of especially long standing. The decedent formed it about two years before he unexpectedly died while on a hunting trip in Austria. He was 58 when he died and appeared to be in good health.¹²⁰

The corporate and estate planning structures used were complex, and I will focus on the essentials. In 1980, Wayne Bongard formed, and until the last two years of his life controlled, Empak, a Minnesota corporation which ran a successful business manufacturing packaging for electronic media. Empak was the primary source of the taxpayer's wealth. In 1986, Bongard contributed shares of Empak stock to the "ISA Trust" for the benefit of his children and a daughter of his wife from a prior marriage. Bongard was never a trustee of the trust, but the trustees did make distributions of Empak stock to family member/beneficiaries at Bongard's request, whereupon the stock

2005-102 (husband), T.C. Memo 2005-103 (wife), and Estate of Bigelow v. Commissioner, T.C. Memo 2005-65.

118 Ten of the 17 voting judges signed the majority opinion.

119 Estate of Bongard v. Commissioner, 124 T.C. 95, 122-129 (2005).

120 Id at 97-98.

was redeemed. Eventually, Bongard's son, his attorney, and a close advisor became the trustees.¹²¹

Bongard wanted to eventually make a private or public offering of Empak stock and felt that investors would be more likely to invest in Empak if the Bongard family ownership were placed in a holding company. To this end in 1996, Bongard and the ISA Trust established WCB Holdings LLC. They contributed their Empak stock to the LLC in exchange for four classes of ownership units, one of which had governing control over the LLC ("Class A Governance units"). Bongard initially held the controlling interest in the LLC, but technically gave up that control with subsequent contributions of some of his Class A Governance units to trusts for his family. Bongard's son, brother, and close associates were the trustees of those trusts. By giving up control of WCB Holdings LLC, Bongard also technically gave up legal control of Empak, though he remained the sole director of Empak. As part of a corporate reorganization, two Japanese corporations, unrelated to Bongard, became minority stockholders of Empak.¹²²

In December 1996, Bongard and the ISA Trust formed the Bongard Family Limited Partnership ("BFLP") and contributed membership units (not including the Class A Governance units) in WCB Holdings LLC to BFLP. The ISA Trust was the 1% general partner and Bongard was the 99% limited partner.¹²³ Later, as part of a post-nuptial

121 Id at 96-109.

122 Id.

123 Id at 106-107.

agreement, Bongard gave a 7.72% limited partnership interest in BFLP to his wife.¹²⁴

In a letter from Bongard to family members, Bongard said WCB Holdings LLC and BLFP were being formed as a means of giving assets to Bongard's family members without "detering them from working hard and becoming educated,"¹²⁵ as well as providing a method for protecting Bongard's estate from frivolous law suits and creditors, providing tutelage with respect to managing the family's assets, and providing a more flexible vehicle than a trust afforded.¹²⁶ BFLP did not perform any activities and never acted to diversity its assets or make any distributions. The Service argued that both Bongard's share of the assets of WCB Holdings LLC and BFLP should be included in the estate under I.R.C. § 2036.¹²⁷

The court concluded that the I.R.C. § 2036 exception applied to the formation of WCB Holdings LLC. In initially focusing on the bona fide sale part of the exception, the court noted that the fact that an intrafamily transaction was involved required heightened scrutiny, but did not amount to an absolute bar. The court, therefore, to some extent backed off of its holding in Strangi that a party cannot be on both sides of a transaction for it to be "arm's length." It did not crisply say what would be required, but seemed to collapse this issue into another requirement it said must exist in order for the sale to be bona fide. That requirement is that there must be significant nontax motivations for the transaction, which aligned the Tax Court with the 3rd Circuit's view.

124 Id at 109.

125 Id at 107.

126 Id.

127 Id at 109.

For the WCB Holdings LLC transaction, the court found that a sufficient nontax motivation existed. The formation of WCB Holdings LLC was part of a plan to increase the liquidity of Empak and make it more attractive to potential investors. The LLC's funds were not commingled with those of Bongard, the members' capital accounts were properly credited and maintained, and all distributions that were made were pro rata, indicating to the court that there was a true "pooling of assets."¹²⁸

In reviewing the "full and adequate consideration" part of the test, the court noted that Bongard and the ISA trust each received an interest proportionate to what each contributed. The Tax Court, therefore, seemingly followed the 5th Circuit's decision in Kimbell in this regard, though it waffled somewhat. While the court cited Kimbell as part of a general review of the law in this area, it did not cite it for this holding. The Tax Court noted that receiving proportionate holdings "may not be sufficient evidence to meet the adequate and full consideration requirement," but that two additional facts supported this conclusion. These two facts were that the respective assets contributed by members were properly credited to their capital accounts and distributions from WCB Holdings LLC required a negative adjustment in the distributee member's capital account. Further, the court said (now adding a third fact), there were legitimate and significant nontax business reasons for the transaction.¹²⁹

This does not represent a high point of judicial erudition even without the bad

¹²⁸ Id at 122-124.

¹²⁹ Id at 124-125.

math. The “additional facts” add virtually nothing to the analysis. The Treasury Regulations typically require that a member’s capital account be credited for contributions and reduced for distributions,¹³⁰ so most well-drafted FLLE agreements will have those provisions irrespective of how abusive the underlying transaction might be. Further, the nontax business reasons were made part of the bona fide sale part of the test, and it is redundant to add them back to the consideration part of the test as well. Given that the first two facts will almost always exist if the agreement is competently drafted, and the third fact will exist if the bona fide sale part of the test is met, all that is left is that the FLLE interests received be proportionate to the assets contributed, precisely the holding of Kimbell. It is not clear why the Tax Court could not be as clear as the 5th Circuit was in Kimbell, but perhaps it was sympathetic to the 3rd Circuit’s view in Thompson (as well as in the concurrence and one of the dissents in Bongard)¹³¹ that receiving FLLE interests that have less value than the contributed property seems to be depleting the estate. As I noted in my discussion of Thompson, this position would make it highly unlikely for a substantial majority of FLLEs (legitimate or otherwise) to meet the consideration part of the test because typically some kind of discount will be there. Indeed, it would have meant the test was not met for WCB Holdings LLC, yet the court said it was. The court should have swallowed hard and just followed the holding in Kimbell. By not doing so cleanly, it created some uncertainty, yet at the end of the day the Kimbell holding is the only one that is workable across the FLLE landscape.

130 See Treas. Reg. § 1.704-1(b)(2)(iv).

131 See note infra and accompanying text. See concurrence of Judge Laro, *Bongard v. Commissioner*, 124 T.C. 95, 133-134 (2005) and dissent of Judge Halpern, *id.* at 141-150.

The court saw the BFLP part of the transaction quite differently. The court observed that on formation, Bongard received a 99% limited partnership interest in BFLP. The court did not say, but implied, that there was no genuine pooling of assets. The court noted that BFLP did not perform management functions for the assets it received, engage in any businesslike transactions, or attempt to diversify its assets. The court concluded that Bongard did not receive any benefit beyond the transfer tax savings; there was a mere “recycling” of his assets. In response to the estate’s argument that BFLP was formed, in part, to continue Bongard’s gift giving, the court noted that he did not make any gifts of BFLP interests. The only transfer was of a 7.72% interest to his wife as part of a post-nuptial agreement. The court did not mention that there had not been a great amount of time in which to make gifts, as Bongard died two years after BFLP was formed. Query if the result in the case would have been different if Bongard had had a program of regularly gifting interests? The court also rejected that BFLP served to protect Bongard from creditors, as WCB Holdings LLC already served that purpose. Given the noted factors, the court concluded that the transfer to BFLP did not satisfy the I.R.C. § 2036 exception.¹³²

Since the I.R.C. § 2036 exception did not apply, the final piece of the puzzle was to determine whether the general provisions of I.R.C. § 2036 applied to pull the BFLP assets into Bongard’s estate. While in many cases that result is automatic, it was not automatic here. Recall that I.R.C. § 2036 requires that the decedent retain possession or enjoyment of, or income from, the property. Alternatively, there must be a right to

¹³² Estate of Bongard v. Commissioner, 124 T.C. 95, 125-129 (2005).

designate who will possess or enjoy the property or receive income from it.

There was no commingling of funds, Bongard did not need the assets of BFLP to support his life style, and indeed did not directly benefit from them. Thus, there was no real way to say Bongard possessed or enjoyed the property or had income from it.

At first blush it might not appear that Bongard could designate who could possess or enjoy the property or receive its income either. He did not directly control BFLP, the ISA Trust did, and Bongard was not a trustee of that trust. In the court's view, however, this test was met, and I.R.C. § 2036 applied to include the BFLP assets in his estate. The court reasoned that this test was met because Bongard controlled whether or not BFLP could transform its interest in WCB Holdings LLC into a liquid asset and engage in any kind of asset management. Under the facts of the case, this was a bit of a leap and not necessarily true. While Bongard did control Empak, as its sole director, at the time of his death he no longer was in legal control of WCB Holdings, LLC. His son and close associates, as trustees of trusts holding the LLC interests, were in control of the LLC. The LLC in turned owned the majority of the stock of Empak and conceivable could have fired Bongard as director, though that was highly unlikely. While Bongard, in his capacity as director, had the literal ability to cause Empak to redeem its stock held by the LLC, he did not have the literal ability to cause the LLC to redeem its interests held by BFLP. Thus, technically at least, it was not just up to Bongard whether BFLP could convert its WCB Holdings, LLC interest into more liquid

assets.¹³³ Curiously, the majority opinion does not discuss this fact.¹³⁴ The court might have concluded that because Bongard's son and close associates controlled the trusts that controlled the LLC, Bongard had effective control of the LLC, but the court did not do so, at least not expressly. What the court did conclude, somewhat summarily, was that there was an implied agreement of the parties that the decedent retained practical control of the units transferred to BFLP, triggering the application of I.R.C. § 2036. The court did not clearly lay out how it reached that conclusion.

The estate argued, citing Byrum, that the general partner's state-law fiduciary duties to the limited partners prevents a finding of any implied agreement. The Tax Court concluded that this argument failed in light of the lack of activity following BFLP's formation, and BFLP's failure to perform any meaningful functions as an entity.¹³⁵

The majority's opinion rather perfunctory dismissal of the relevance of state-law fiduciary duties neither does them or the Supreme Court's holding in Byrum justice (which the majority opinion does not cite).¹³⁶ Empak had two Japanese companies as minority shareholders that were unrelated to Bongard. Bongard was the sole director of Empak. As a director, under Minnesota law he would have had a fiduciary duty to the corporation's shareholders, which included the unrelated minority shareholders as well

133 See notes 121-122 supra and accompanying text.

134 Judge Chiechi in his dissent does make note of this fact, however, Estate of Bongard v. Commissioner, 124 T.C. 95, 153-154 (2005).

135 Id at 129-131.

136 See notes 52-58 supra and accompanying text. My discussion is informed by and similar to, but not identical with, the fiduciary duty discussion contained in the dissent of Judge Chechi, Bongard v. Commissioner, 124 T.C. 95, 150-155 (2005).

as Empak's majority shareholder, WCB Holdings LLC.¹³⁷ It would not have been consistent with that fiduciary duty to deplete the assets of Empak through a redemption of its stock for Bongard's personal financial estate planning purposes, particularly in light of the fact that the whole purpose of forming the LLC was to position Empak for a public or private offering. Presumably any substantial redemption would have undermined any such offering.

Further, going forward, the fiduciary duty of Bongard as a director might have included, for example, a possible obligation to cause Empak to pay dividends. Those dividends would mostly have been paid to WCB Holdings LLC interests. The trusts that controlled the LLC, in turn, may have had a fiduciary duty to its members, including BFLP, to make distributions to them. The distributions could have given BFLP the liquidity to diversify its holdings. Accordingly, again it was not necessarily the case that BFLP's liquidity was within Bongard's unbridled control. In *Byrum*, which also involved corporations with unrelated minority shareholders, the existence of that type of fiduciary duty caused the Court to rule in the taxpayer's favor. The fiduciary duties in *Bongard* were arguably comparable to those in *Byrum* and arguably could have caused the Tax Court to reach the same conclusion as the Supreme Court did in *Byrum*. A critical difference between the two cases, though, is that the trustee of the trust in *Byrum* was truly independent, whereas the parties that controlled WCB Holdings LLC arguably were not.

¹³⁷ See Minnesota Annotated Statutes § 302A.751; *Pedro v. Pedro*, 463 N.W.2d 285, Minn.App., Nov 20, 1990; *Pedro v. Pedro*, 489 N.W.2d 798 (Minn.App. Aug 11, 1992) review denied (Oct 20, 1992).

It was a profitable case for the Service. The original return reported a \$45.6 million estate. While the court allowed substantial discounts on the WCB Holdings LLC units, the Service's win increased the size of the estate to about \$108.2 million, or an actual estate tax increase of over \$50 million.¹³⁸

Estate of Schutt v. Commissioner¹³⁹ is a recent Tax Court case involving Delaware business trusts that were used to hold stock. The Tax Court held that the I.R.C. § 2036 exception applied. The facts are, however, unusual and provide little solace to those seeking tax savings with passive assets. The decedent had been married to, and had children with, an heir to the DuPont fortune and before his death had substantial assets of his own. The trusts were formed to protect "core holdings" of the family in DuPont and Phillip Petroleum Stock and insure they would not be sold, not your standard FLLE scenario.¹⁴⁰ Another unusual feature, was that the Service had failed to raise I.R.C. § 2036 in the estate's deficiency notice. As a consequence, the Service had the burden of proof that I.R.C. § 2036 required the inclusion of the FLP assets in the decedent's estate.¹⁴¹ (Otherwise, the burden of proof would have been on the taxpayer.¹⁴²)

¹³⁸ See John A. Bogdanski, "Bye Bye Byrum, Bonjour Bongard," 32 Est. Plan. 47 (2005).

¹³⁹ 87 RIA 2005-989 (TC Memo 2005-126). See Wendy Gerzog, Bongard's Nontax Motive Test: Not Open and Schutt, 107 Tax Notes 1711 (2005).

¹⁴⁰ Estate of Schutt v. Commissioner, 87 RIA 2005-989 (TC Memo 2005-126), 993-1003.

¹⁴¹ Id at 1005-1006.

¹⁴² Estate of Maxwell, 98 T.C. 594 (1992).

The decedent resided in the 3rd Circuit, and thus any appeal would have been to that circuit.¹⁴³ The Tax Court took note of the 3rd Circuit's decision in Thompson. The Tax Court pointed out that in Thompson, the 3rd Circuit had ruled that a sale is not bona fide if there is no discernable purpose other than tax savings. The Tax Court observed that this was consistent with its own views. It concluded that the major motivation for the transactions under review was not tax savings, but decedent's desire to prevent the sale of the core stock holdings. There was also no commingling of funds, and the decedent held sufficient assets outside the trusts to maintain his own support.¹⁴⁴ Finally, formation of the Delaware business trusts involved contributions from revocable trusts created by the decedent and also approximately equal contributions by other family trusts which had independent trustees.¹⁴⁵ The Tax Court concluded that legitimate negotiations took place with the trustees, which refuted the government's argument that the decedent stood on both sides of the transaction, a fatal flaw in Harper.¹⁴⁶

The facts of this case are a far cry from those involved in other cases I have discussed and those involved in a typical FLLE. The Tax Court itself emphasized the unusual nature of the facts in reaching its decision that the I.R.C. § 2036 exception applied.¹⁴⁷ Schutt is, in the context of this article at least, best thought of as a novelty that is outside the main thrust of the case law in this area and not one that meaningfully contributes to FLLE estate tax jurisprudence.

143 Technically, the appeal lies in the circuit where the petition was filed. See I.R.C. § 7482

144 Estate of Schutt v. Commissioner, 87 RIA 2005-989 (TC Memo 2005-126), 1003-1013.

145 Id at 1000-1003.

146 Id at 1011.

147 Id at 1010.

What To Do?

Since my last article, members of the academy have made thoughtful suggestions for reform. Some suggest that valuation rules be adopted that would prevent value from disappearing. This might occur by creating a taxable gift on formation, even if there is yet no donee. Alternatively, values for gift and estate tax purposes could be based not on the arguable value of the FLLE interest to a disinterested third party (the classic approach),¹⁴⁸ but on the value of the transferred capital accounts (which reflect the full value of the contributed assets).¹⁴⁹ These approaches would work, but could be overbroad.¹⁵⁰ Families are not invariably cooperative enterprises, as the Stone case demonstrates. Further, the discounts are real. An FLLE interest that a donee or devisee receives is truly not equal to the value of the associated capital account,¹⁵¹ and he may have no near-term access to the underlying assets. Further, fully eliminating the discounts for all families irrespective of how long the FLLEs have been in existence is likely not politically viable.¹⁵² The Clinton administration had no success with a somewhat less aggressive proposal. It would

148 Treas. Reg. § 2512-1 provides that the value of gifted property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts.

149 Generally, the partnership maintains a capital account for each partner that is credited with the fair market value of contributed property. See Treas. Reg. § 1.704-1(b)(2)(iv)(b).

150 See Burke and McCouch *supra* note 6. My brief description of their thoughtful proposals does not do them justice.

151 As I noted earlier, the capital account of the partner who contributed the assets to the partnership reflects the full value of the contributed assets. Treas. Reg. § 1.704-1(b)(2)(iv)(b). If a partnership interest is gifted, the donee receives a proportional share of the donor's capital account, i.e. one that may reflect the full value of underlying assets. Treas. Reg. § 1.704-1(b)(2)(iv)(l).

152 Professors Burke and McCouch acknowledge that their proposal could be controversial. See Burke and McCouch 6 note at 665.

have eliminated valuation discounts to the extent the value of an FLLE interest is attributable to nonbusiness assets.¹⁵³ One author suggests that discounts be disallowed if the taxpayer's primary purpose for using the FLLE to make gratuitous transfers is to qualify for the discounts. The burden of proof would be on the taxpayer.¹⁵⁴ Again, this fairly addresses the issue, but could make for significant amounts of litigation as taxpayers endeavor to prove that their primary purpose is not to qualify for the discounts and the Service resists that effort.

In 2005, the Joint Committee on Taxation updated the proposal made by the Clinton administration. Under the updated proposal, the value of a transferred interest would generally be the pro rata share of the fair market value of the entire interest owned by the transferor. Thus, if a mother owned an 80% interest in an FLLE and gifted or devised a 40% interest to her son, that gifted interest would be valued at one half of what the mother's entire interest was worth before the gift. In this example, there would thus be no lack of control discount. The proposal provides that if the donor or decedent does not own a controlling interest, but after the gift the donee or devisee does, the value the transferred interest is based on the pro rata share of the entire interest of the donee or heir. In the prior example, if the mother had gifted a 40% interest during life to her son and at death left that son the other 40% interest, there

¹⁵³ See, e.g., Cong. Budget Office, 106th Cong., Analysis of the President's Budgetary Proposals for FY2001, 93218 (Comm. Print 2000); H.R. Rep. No. 106-658, Providing for the Consideration of H.R. 8, The Death Tax Elimination Act of 2000, at 8-10 (Comm. Print 1998); Cong. Budget Office, 105th Cong., Analysis of the President's Budgetary Proposals for FY99, 93212 (Comm. Print 1998); Staff of the Joint Comm. On Tax'n, Description of Revenue Provisions Contained in the President's Fiscal Year 2000 Budget Proposal 291 (JCS 1-99, Feb. 22, 1999).

¹⁵⁴ See Jensen *supra* note 16.

again would be no lack of control discount for the devise. The interest the son is devised is valued in the hands of the son after he obtains the interest, at which point he has control (this assume control of the FLLE is based on the percentage owned). If the transferor has control before the transfer, or transferee has control after the transfer, a look through rule applies if at least one-third of the entity's assets consists of marketable assets. No discount applies to the portion of the value of the transferred interest attributable to the marketable securities. The part of the Joint Committee proposal dealing with marketable securities overlaps with my own, as I discuss below.

The Joint Committee proposal provides that a spouse is considered to own the interest owned by another spouse. The proposal does not provide a general family attribution rule.¹⁵⁵

The Joint Committee proposal has much to commend it. It is relatively straight forward and partially addresses the problem created by marketable securities. But, the proposal is in some ways too broad and in others too narrow. The fact that it applies irrespective of how long the FLLE has been in existence, raises doubts as to its political viability. Further, the spousal attribution rule provides a fairly large escape hatch. By spreading interests among nonspousal family members, control (and the problems it creates) can eventually be avoided. Admittedly, family members cannot always be expected to get along, but if the FLLE's assets consist primarily of marketable

¹⁵⁵ Joint Committee on Taxation, 109th Congress, Options to Improve Tax Compliance and Reform Tax Expenditures, 396-404.

securities, they may not need to. Under the Joint Committee's proposal, and FLLE could exclusively own marketable securities, and obtain all discounts, as long as ownership of the FLLE interests is sufficiently spread among family members. As the court noted in Thompson, there is usually little reason to put marketable securities in an FLLE except for the discounts.¹⁵⁶ My own proposal is time-restricted, hopefully making it more politically viable, but would more strictly limit discounts when an FLLE holds marketable securities.

In my previous article in 2001, I proposed that transfers of property to FLLEs be brought within the scope of section 2035.¹⁵⁷ The development of the law since I wrote the article in many ways further persuades me of the utility of the proposal, though I have refined it in a number of meaningful ways.¹⁵⁸ I have attempted to craft a proposal that is politically viable, fairly simple and easy to apply, and not overbroad.

Under my modified approach, any contributions made to an FLLE by a decedent within three years of death, where the decedent or any one or more members of his family controls the FLLE at the time of the decedent's death, would be a nonevent for Federal estate tax purposes. The property contributed by the decedent, and not the FLLE interests, would be included in the estate. A key word is contribution. I am assuming the decedent would contribute the property to the FLLE tax free under I.R.C. § 721(a), the general provision that provides that contributions to partnerships are not

¹⁵⁶ For a similar (and harsher) criticism, see Laura E. Cunningham, FLP Fix Must Be a Part of Transfer Tax Reform, 112 Tax Notes 937 (2006) (hereinafter "Cunningham")

¹⁵⁷ Currently, I.R.C. § 2035 requires inclusion in the decedent's estate, gift taxes paid within three years of death and transfers made within three years of death which, if they had not been made, would have resulted in the transferred property being included in the estate under sections 2036 through 2038, or 2042.

¹⁵⁸ I draw freely from Last Gasp supra note 1 at 36-41.

taxable events. If, alternatively, the decedent is paid a true arm's length price in other than FLLE interests for the property transferred to the FLLE and recognizes the gain or loss on the contributed property, my modified I.R.C. § 2035 would not apply.

The decedent cannot generally avoid inclusion of contributed property in his estate by gifting FLLE interests to family members, as the focus is on control by the family, not just the decedent. Note that if the decedent contributes property to the FLLE within three years of death and then gifts FLLE interests to others, a gift tax will apply to the gifts based on the value of the gifted interests. There is no objection to discounts applying to the gifted interests, assuming adequate proof is proffered, as the contributed property will be included in the decedent's estate in any event. Under current law, gift and estate taxes are unified and any gift taxes paid within three years of death are included in the estate and constitute a credit against any estate tax owed.¹⁵⁹ Those rules would continue to apply under my proposal. Thus, while the decedent might not improve his estate tax position by gifting interests within three years of death, neither would he worsen it.

While even those contributions made more than three years before death may involve the hopes of eventual estate tax savings, the structure is far more likely to bear the markings of legitimacy. Typically, the transferor after the formation of the FLLE will transfer interests to others, providing legitimate dispersion of interests. Also, my intent is to provide a bright-line rule that will stop most of the abusive use of FLLEs while avoiding the need to regularly litigate whether or not that use is abusive. The older the FLLE is, the more legitimate it is likely to be, but some well-planned illegitimate ones may slip through the cracks. That is a price I am willing to pay for a bright-line, easy to

¹⁵⁹ I.R.C. §§ 2035(b), 2001(a), (b), 2502(a).

apply rule. Further, I do not think a general ban on the use of FLEEs for estate tax savings purposes is politically realistic.

To minimize abuse, however, I add two additional rules which could bring assets back into the estate, even if they were contributed more than three years before death. This increases the complexity of the proposal, which I dislike, but the issues the rules address are important ones.

The first rule is that the decedent must keep sufficient assets for his support even if the contributions to the FLEE are made more than three years before death. If he does not, the contributed FLEE assets will be included in the decedent's estate even if made more than three years before death. I do not specify a fixed amount for support, so there is some risk of fudging and of litigation with the Service. The draconian nature of the penalty should insure that sufficient assets are retained outside of the FLEE for support. I would define support here as "ordinary support," so that the FLEE assets could be distributed to the decedent for extraordinary expenses, such as unexpected medical care (a heart transplant, for example). The Service by a revenue procedure could provide a safe harbor for both ordinary and extraordinary support.

The second rule involves marketable securities, which represent a unique opportunity for abuse, since there is usually little reason to place them in an FLEE except for the availability of discounts. Of course, even an FLEE operating a bona fide business might have some need for marketable securities. As did the 2005 Joint Committee Proposal, I have I have selected one-third as a threshold. To the extent that marketable securities average more than one-third of the value of the assets of the FLEE during the three years preceding the decedent's death, all marketable securities

contributed by the decedent to an FLLE controlled by the decedent's family as of the date of death will be included in the decedent's estate, irrespective of when they were contributed by the decedent. Generally, the contribution of property to an FLLE is tax free under I.R.C. § 721(a). However, gain can be recognized on the contribution of marketable securities to an FLLE that constitutes an "investment company," if the contribution has the effect of diversifying the contributor's interest in marketable securities.¹⁶⁰ Taxpayers actively try to avoid these rules for obvious reasons, and it is improbable that they would apply. But if gain is recognized under these provisions on the contribution of marketable securities to the FLLE, those marketable securities would be excluded both for purposes of the one-third threshold and inclusion in the estate.

Otherwise, property transfers to the FLLE more than three years before death would be respected. The FLLE interests would be included in the decedent's estate at whatever discounted value the estate can argue should apply with one limitation. If some property was contributed within three years of death and some more than three years before death, the former would be included in the decedent's estate. The value of the FLLE interest would thus have to be reduced to take that fact into account.

An FLLE for these purposes would include a limited partnership, LLC, or S-corporation. An S-corporation is an unlikely vehicle for this type of planning, because gain is recognized when an S-corporation distributes appreciated property to a shareholder (a FLLE taxed as a partnership generally does not recognize gain or loss

¹⁶⁰ I.R.C. §§ 351(e)(1) and 721(b). To be more specific, gain is recognized if the partnership or corporation would be treated as an "investment company." In very general terms, an investment company will exist if more than 80% of the value of the assets of the partnership or corporation consist of marketable securities and the contribution as the result of diversifying the transferor's interests. See Treas. Reg. § 1.351-1(c).

when distributing property to an owner).¹⁶¹ Nevertheless, like limited partnerships and LLCs, S-corporations typically impose a single level of taxation on income at the owner level and could conceivably be used in a manner comparable to limited partnerships and LLCs. S-corporations are included to restrict opportunities for end-running the proposal. The double-tax burden of c-corporations would make them an inappropriate vehicle for discount planning,¹⁶² and thus they would not be included in the definition of an FLLE.¹⁶³

For section 2035 to apply under this proposal, control of the FLLE must generally stay within the decedent's family. When taxpayers use FLLEs for estate planning purposes, they typically want the interests to stay in the family. If the interests are not mostly staying in the family, the FLLE is unlikely to be an estate planning device, which is why that circumstance is not covered by the proposal. Since I.R.C. § 2701 provides rules sometimes relevant for valuing FLLEs, it would seem an appropriate place to look for a definition of "family" for these purposes. I.R.C. § 2701 defines "family" to include the transferor; the transferor's spouse; a lineal descendant of the transferor or the transferor's spouse, and the spouse of any such descendant; the definition also includes an ancestor of the transferor or the transferor's spouse, and the spouse of any such ancestor.¹⁶⁴ This definition excludes collaterals such as uncles and nephews; but

¹⁶¹ See I.R.C. §§ 311(b) and 731(a).

¹⁶² C-corporations are subject to two levels of taxation, one at the corporate level and another at the shareholder level, when corporate income is distributed to shareholders as dividends. See I.R.C. §§ 11, 301, 316. Further, distributions of appreciated property by a C-corporation cause gain to be recognized by the corporation, and the shareholder receiving the property as a dividend has ordinary income to the extent of the fair market value of the property. See I.R.C. §§ 301, 311(b).

¹⁶³ A c-corporation can be converted to an s-corporation if it qualifies, but is subject to a corporate level tax for ten years after the election to the extent of the net gain inherent in the corporate assets at the time of the s-election, again making the c-corporation an unlike estate planning vehicle. See I.R.C. § 1374.

¹⁶⁴ See I.R.C. § 2701(e)(1), (2).

such persons are less likely to be involved, and a definition of family already in use in a related area is more likely to find acceptance than would a more expanded definition. Similarly, for purposes of determining whether the decedent and his family controls the FLLE, the definition of control contained in I.R.C. § 2701 could be used.¹⁶⁵ That section defines control for partnerships (including LLCs taxed as partnerships) as the holding of at least 50% of the capital or profit interests in the partnership.¹⁶⁶ In the case of a limited partnership, control is defined as the holding of any general partnership interest.¹⁶⁷ For corporations, control means the holding of at least 50% by vote or value of the stock of the corporation.¹⁶⁸ The control test would be met if the family in the aggregate met these 50% tests.

Transfer of interests to a strawman or similar figure would not be an easy way to avoid the control test as either adequate consideration would have to be paid or the transfer would be subjected to the rules for taxing gifts. Both can represent significant hurdles. Nonetheless, protection from this type of gambit is necessary. Accordingly, the family would be considered to have control regardless if it controls the FLLE directly or indirectly.

My proposal would have several advantages. While the marketable securities and “assets for support” aspects adds some complexity, the proposal on the whole is straight forward. As the law stands now, there is still plenty of room for litigation.¹⁶⁹ Strangi-type fact patterns, where mostly marketable securities are transferred to an FLLE shortly before death in exchange for most of the FLLE interests, will not work. But

¹⁶⁵ See I.R.C. § 2701(b)(2).

¹⁶⁶ See *id.*

¹⁶⁷ See I.R.C. § 2701(b)(2)(B)(ii).

¹⁶⁸ I.R.C. § 2701(b)(2)(A).

¹⁶⁹ See Cunningham *supra* note 154.

creative tax practitioners will develop alternatives. Of course, they will try to persuade their clients to form the FLEEs well before death. They likely will encourage them to have the FLEE own property other than marketable securities. Relatively low risk rental real estate might, for example, be added to the FLEE to justify the need for a liability shield. Will that be enough to survive scrutiny? What percentage of the FLEE must consist of rental real estate or property that justifies the need for the liability shield? The courts may well be asked to decide. The 5th Circuit in Kimbell felt that working interests in oil and gas wells sanctified the FLEE. Will other courts in other circuits agree? No one knows. To what extent should Byrum apply? Again, no one can say. The Tax Court resisted applying Byrum in Bongard, though there were good arguments that it should have been applied. Bongard was not appealed, but in a similar, future case, Byrum is sure to be argued and that argument may well be taken to the appellate level. This proposal would mostly end this type of litigation. Further, since it is fairly straightforward, it is not likely to generate much in the way of litigation itself.

My proposal is not as theoretically pure as some. Value can still “disappear” through discounts as long as there is sufficient advance planning. Nor does it prevent all injustice. A taxpayer in the prime of life and in all good faith could contribute business assets to an FLEE mostly because of the benefits of the liability shield, die unexpectedly within three years of death, and have the value of the assets fully included in her estate. Or FLEE interests may be sold in good faith for fair value to family members, but the assets contributed by the decedent to the FLEE could still be brought back into the estate if contributed within three years of death. But the proposal has the benefit of relative simplicity, and that more than offsets the disadvantages. In a Code that is of Kafkaesq complexity, simplicity is a major virtue and one we should seek.

The proposal may also well be politically viable. Practitioners at this point know what will not work: Forming FLLCs shortly before death where the decedent does not retain enough assets for his support (though somewhat longer standing FLLCs are now being challenged by the Service¹⁷⁰). What they do not know is what will work. Bongard did not suffer from the problems of most other cases, and the decedent still lost. Will the circuit courts of appeal agree with Bongard? How much safer does one have to be? Does the FLLC have to conduct a business and if so how much (barring weird Schutt-type fact patterns)? Thus, practitioners when they form an FLLC, even if well before death, cannot be sure it will survive scrutiny. Having a straight-forward approach which likely covers most of their needs may well find significant political support among them and the organizations to which they belong.

Finally, while I am not equipped to compute the costs to the fisc of this proposal, I doubt if it is significant. The cases have surely not shut down the FLLC industry, though they may require it to be more sophisticated. Current law does not suggest an FLLC structure will fail if there is legitimate need for the liability shield, and that is not hard to come by. As I noted above, rental real estate might be sufficient, though it is not clear what percentage the rental real estate has to be of the FLLC's assets. Taxpayers will continue to use FLLCs. The proposal sets reasonable standards for their use and it does not seem that the proposal will dramatically increase that use. The abusive cases tend to be formed when death is near, and the proposal would apply to them. Indeed, the proposal would cover almost all of the litigated cases to date and typically arrive at the same result, as the taxpayers usually lost.

¹⁷⁰ In *Estate of Korby v. Commissioner*, 89 TCM (CCH) 1150 (2005), about three years elapsed between funding of the FLLC and the decedent's death.

Conclusion

The FLLE problem has been brewing for some time. The litigation will not end anytime soon. Practitioners will adjust to the cases, push the envelope, and the Service will presumably push back. There are no perfect solutions to legal problems. As we get theoretically “purer,” we add complexity, which contributes its own host of problems. I believe my proposal provides a reasonable balance between the needs of the fisc to stop the abusive use of FLLEs as well as the needs of taxpayers to be able to take advantage of this long-standing estate planning device.

