

THOMPSON, STRANGI, KIMBELL AND THE SERVICE'S SECTION 2036 ATTACK ON FLPs

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INTRODUCTION

The family limited partnership (FLP) is one of the most common intergenerational wealth transfer and estate planning techniques. FLPs are used by business owners and other high net worth individuals:

1. in the management and preservation of family wealth and
2. in the intergenerational transfer of family assets at appropriately "discounted" values for transfer tax purposes.

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The Service continues to modify its arguments in its attack on the use of (and the valuation of) FLPs. The most recent Service response to FLPs seems to be its attempt to include the transferred FLP assets in the estate of the contributing taxpayer.

Based on this argument, the Service would include the transferred assets in the taxpayer's estate at their respective fair market values. Of course, this means that the Service would not even have to argue over the appropriate amount of the valuation discount to apply to the FLP units for gift tax purposes.

In its recent challenges of FLPs, the Service has raised the following issues:

1. Did the contributing taxpayer respect the formality of the FLP both (a) in its formation and (b) in its operation?
2. Did the taxpayer contribute personal-use assets to the FLP (e.g., the taxpayer's personal residence)? and
3. Did the taxpayer retain sufficient assets outside of the FLP in order to maintain a pre-FLP level of lifestyle?

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FLPs AS AN ESTATE PLANNING TOOL

In the typical FLP, high net worth individuals (1) contribute various assets (e.g., business ownership interests, real estate, and marketable securities) to a partnership formed with their

children and (2) receive FLP ownership interests in exchange for their asset contribution.

Typically, parents (i.e., the contributing taxpayer) then periodically gift some or all of the FLP limited partner (LP) interests to their children. The parents retain control of the FLP assets through their ownership of the general partner (GP) interests (which frequently are as low as one percent of the total FLP units).

Accordingly, the children often receive a majority (or greater) ownership interest in the FLP. However, control over the FLP assets remains with the parents. This is because the parents retain the GP interests.

When the parents gift the LP interests (rather than the underlying assets), the fair market value of the gifted property is estimated with appropriate consideration to various valuation discounts. These valuation discounts may total 35 percent to 45 percent or more of the value of the contributed assets.

The application of these valuation discounts allows the parents to transfer assets from their estate to their children at appropriately reduced values for gift tax purposes.

This gift tax advantage occurs because the fair market value of the LP ownership interest is less than its proportionate share of the underlying partnership assets. This valuation phenomenon is due to the LP ownership interest:

1. lack of control and
2. lack of marketability.

And, these valuation adjustments are appropriate because of the LP interest's:

1. inability to affect the distribution of the FLP capital and profits and
2. transferability restrictions, related to the partner's inability to unilaterally sell the LP ownership.

THE SERVICE'S HISTORICAL POSITION

In order to eliminate (or at least reduce) the valuation discounts applied to gifts of LP interests, the Service has historically put forth various arguments. Some of these arguments presented by the Service have been based on general taxation concepts such as:

1. the business-purpose doctrine,
2. the step-transaction doctrine, or
3. the gift-on-creation of the FLP.

Some of the Service's historical FLP arguments are based on its interpretation of Sections 2703 and 2704.

For the most part, the Service has been unsuccessful in these historical arguments. This is because the Tax Court and other federal courts have typically sided with taxpayers regarding the application of valuation discounts (in principle, if not in magnitude) to FLP interests.

For example, the following cases would be considered taxpayer victories with regard to the FLP valuation discount issue: *Estate of W.W. Jones II v. Commissioner*, 116 T.C. 121 (2001), *Knight v. Commissioner*, 115 T.C. 506 (2000), *Church v. United States*, No. SA-97-CA-774-OG Dist. Ct. (W.D. Tex. Jan. 18, 2000), *Kerr v. Commissioner*, 113 T.C. 449 (1999), and *Estate of Strangi v. Commissioner*, 293 F.3d 279 (5th Cir. 2002).

Recently, however, three court cases suggest that the Service may have (1) changed its tactics regarding its attack on FLPs and (2) developed a more persuasive argument. The remainder of this article will discuss (1) the Service's recent Section 2036(a) arguments and (2) the Service's recent success in these three court cases.

THE SERVICE'S SECTION 2036 ARGUMENTS

Previously, the Service seemed to focus its arguments on the amount of the valuation "discount" that the taxpayers reported for their gifts of FLP interests. Recently, the Service seems to be focusing its attack on the inclusion—via Section 2036(a)—of the FLP underlying assets in the estate of the contributing taxpayer.

Under Section 2036, the decedent's gross estate includes any property that the taxpayer transferred during his/her lifetime (except when the transfer was "a bona fide sale for an adequate and full consideration") in which, at the time of death, the taxpayer retained:

1. the possession or enjoyment of, or the right to the income from, the property, or
2. the right . . . to designate the persons who shall possess or enjoy the property or the income therefrom.

In *Estate of Grace*, 395 U.S. 316 (1969), the U.S. Supreme Court suggested that the primary purpose of Section 2036(a) was "to include in a decedent's gross estate transfers that are essentially testamentary—i.e., transfers which leave the transferor a significant interest in or control over the property transferred during his lifetime."

According to the Service position, Section 2036(a) is intended to pull back into the decedent's estate property transfers:

1. in which nothing has really changed for the taxpayer control/use of the property, and
2. in which the taxpayer is simply trying to avoid the payment of estate taxes at death.

" . . . the Tax Court and other federal courts have typically sided with taxpayers regarding the application of valuation discounts. . . ."

ESTATE OF THOMPSON

The first case that illustrates the Service's success with the Section 2036(a) argument is the *Estate of Theodore Thompson v. Commissioner*, T.C. Memo 2002-246 (Sept. 26, 2002).

In *Estate of Thompson*, the decedent formed two FLPs: one with his son and the other with his daughter. There was an implied agreement among the family members that the decedent would continue to benefit from and enjoy the property that he had contributed to the FLPs.

In *Thompson*, the Tax Court concluded that, under Section 2036(a)(1), the date-of-death values of all of the assets the taxpayer contributed to the FLPs (approximately two years before his death) should be included in his estate.

The Tax Court also rejected the estate's arguments that (1) the decedent's original asset contributions to the FLPs—in exchange for LP interests—were bona fide sales for "adequate and full consideration" and (2) the contributed assets, therefore, avoided the Section 2036(a)(1) inclusion.

Rather, the Tax Court concluded that the decedent's receipt of the LP interests was merely a "recycling of value" (i.e., a mere change in the form of ownership of the contributed assets). Accordingly, the Tax Court concluded that the asset contributions had "no legitimate business purpose."

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The *Estate of Thompson* follows several other Service-favorable decisions regarding FLPs, including (1) *Estate of Morton B. Harper v. Commissioner*, T.C. Memo 2002-121 (May 15, 2002) (and its predecessors); (2) *Estate of Charles Reichardt v. Commissioner*, 114 T.C. 144 (2002), and (3) *Estate of Dorothy Morganson Schauerhamer v. Commissioner*, T.C. Memo 1997-242 (May 28, 1997). In these three cases, the Tax Court also found that assets contributed to an FLP were includible in the decedent's estate under Section 2036(a)(1).

However, the *Estate of Thompson* is a more significant victory for the Service than these other cases. This is because the facts in *Thompson* do not indicate the same degree of administrative shoddiness on the part of the taxpayer apparent in the other three cases (i.e., partners not respecting the partnership form, the late filing of an LP certificate, the commingling of personal and partnership funds, significantly disproportionate income distributions, etc.).

In *Estate of Thompson*, the taxpayer administratively respected the formation and operations of the FLPs. However, the Tax Court still ruled for the estate inclusion of the transferred assets under Section 2036(a)(1).

It is noteworthy that the *Estate of Thompson* is a Tax Court memorandum decision, rather than a regular decision. The format of the decision implies that, in the Tax Court's view, the Section 2036 issue does not involve a new or unusual point of law. Rather, the Section 2036 issue is merely the application of existing law or an interpretation of facts.

One lesson from the *Estate of Thompson* is that a taxpayer should retain at least enough assets outside the partnership to provide for personal financial support for a significant period of time after the FLP formation.

ESTATE OF STRANGI

The second case that illustrates the Service's Section 2036(a) argument is the *Estate of Strangi*. In the initial trial court decision, the Tax Court denied the Service's attempt to use the Section 2036(a) argument.

The Service appealed that decision to the Fifth Circuit. The Appeals Court remanded the case to the Tax Court with instructions to reconsider the matter in light of Section 2036(a).

Recently, the Tax Court issued a memorandum decision on its reconsideration of *Strangi*. In this memorandum decision, the Tax Court upheld the Service's Section 2036(a) argument.

STRANGI I TAX COURT DECISION

In *Estate of Albert Strangi*, 115 T.C. 478 (2000), two months before he died, the taxpayer formed the FLP. The decedent formed the FLP, with the assistance of his son-in-law, who was authorized to act as his attorney-in-fact. Albert Strangi contributed substantial assets to the FLP in exchange for (1) a 99 percent LP interest and (2) a 47 percent interest in the 1 percent corporate GP. Strangi's children contributed their own funds to the FLP in exchange for the other 53 percent interest in the 1 percent GP.

The partners then unanimously agreed to have Strangi's attorney-in-fact (i.e., his son-in-law) handle all matters with regard to the operation of both (1) the FLP and (2) the GP.

In the *Strangi I* decision, the Tax Court found in favor of the taxpayer on all of the FLP-related claims.

However, in the *Strangi I* decision, the Tax Court suggested that the Service should have raised the Section 2036(a) issue. In its published decision, the Tax Court noted:

. . . the actual control exercised by [the decedent's attorney-in-fact], combined with the 99-percent limited partnership interest in [the FLP] and the 47-percent interest in [the corporate GP], suggest the possibility of including the property transferred to the partnership in decedent's estate under section 2036.

"It is noteworthy that the Estate of Thompson is a Tax Court memorandum decision, rather than a regular decision."

"The Appeals Court remanded the case to the Tax Court for consideration of the Section 2036(a)(2) claim."

THE APPEALS COURT DECISION

In the Tax Court, the Service unsuccessfully challenged (1) the FLP's business purpose and (2) the validity of the entity valuation discounts under Chapter 14. In *Estate of Strangi* (293 F.3d 279 (5th Cir. 2002), the Fifth Circuit affirmed the Tax Court's reasoning on both (1) the Section 2703(a)(2) and (2) the business-purpose arguments in the taxpayer's favor.

However, the Appeals Court overturned the Tax Court's denial of the Service's motion to add a Section 2036(a)(2) claim. The Appeals Court remanded the case to the Tax Court for consideration of the Section 2036(a)(2) claim.

STRANGI II TAX COURT DECISION

On remand, the Tax Court specifically addressed the Section 2036 issue in *Estate of Strangi* (TC Memo 2003-145).

The Tax Court noted that the burden of proof under Section 2036 typically rests on the estate. However, because the Service raised the Section 2036 issue only after it had issued its deficiency notice, the Tax Court required the Service

to meet the burden. Despite this additional burden of proof, the Tax Court still held in the Service's favor.

The Tax Court found that efforts had been made to document the Strangi partnership's actions. However, Albert Strangi died before the first partnership year closed. As a result, the family members—and their advisors—were on notice that the Service would likely review the partnership's financial affairs in short order.

Despite the FLP's administrative bookkeeping, the Tax Court concluded that Albert Strangi continued to retain possession and enjoyment of the personal residence after he had transferred it to the FLP. Further, Strangi had derived all his support and liquidity from the entity.

While the FLP made pro rata distributions to all partners, only Albert Strangi held more than a *de minimis* partnership interest. Accordingly, the Tax Court ultimately concluded that the FLP lacked a business purpose.

DAVID A. KIMBELL SR.

David A. Kimbell, Sr. (244 F.Supp.2d 700 (N.D.Tex. 2003)), is the third case that illustrates the Service's recent success with its Section 2036(a) position.

The *Kimbell* case involves an expansion of the Service's strategy on two fronts. First, the *Kimbell* case advanced the Service's Section 2036(a)(1) argument into the District Court. Second, the Service added an additional challenge under Section 2036(a)(2).

Previous Service-favorable decisions (1) focused on the partnership's operational aspects and (2) demonstrated an implied understanding to retain enjoyment based on the manner in which the partnership was physically operated. This "implied" retention is at the core of the Service's Section 2036(a)(1) argument.

The *Kimbell* case shifts the Service's focus to the legal aspects of the documents under Section 2036(a)(2). The Service's argument claims that the decedent retained a "legal right" in the documents to control the partnership assets. The documents, not the partnership operational aspects, were the taxpayer's undoing in *Kimbell*.

Under the terms of the partnership agreement, Mrs. Kimbell retained the rights (1) to remove the general partner and (2) to name herself as the general partner. Also, the partnership agreement waived any fiduciary duty of the general

partner towards the other partners. This "waiver" language is typically not found in LP agreements.

In *Kimbell*, the District Court accepted the Service's argument to apply Section 2036(a)(2). The District Court concluded that the partnership agreement's unique features amounted to a retained right to control the beneficial enjoyment of the partnership assets. As a result, the District Court held that the assets should be included in the decedent's estate.

SUMMARY AND CONCLUSION

For years, the Service has consistently lost in the courts regarding its refusal to recognize valuation discounts for FLP ownership interests for gift tax purposes. It appears the Service may be abandoning its gift tax attacks regarding the application of reasonable valuation discounts to FLP interests.

Rather, the Service's principal attack on FLPs now appears to be for the inclusion of all contributed FLP assets in the decedent's estate under Section 2036(a). Accordingly, the Service's attack on FLPs may have shifted from a gift tax argument to an estate tax argument.

The Tax Court's recent decision in the remand of the *Estate of Strangi II* should encourage the Service to continue the Section 2036(a) estate tax argument that succeeded in *Thompson*.

In addition, the District Court's recent decision in *Kimbell* should encourage the Service to use both Sections 2036(a)(1) and 2036(a)(2) in its future attacks on FLPs.

Also, the *Kimbell* decision should encourage the Service that the Section 2036 arguments work as well in the U.S. District Court as they do in the U.S. Tax Court.

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