Family Limited Partnerships: Taxes, Courts, and an Uncertain Future—Part I

by Carol Warnick

This column is sponsored by the CBA Trust and Estate Section. The column focuses on trusts and estate law topics, including estate and trust planning and administration, elder law, probate litigation, guardianships and conservatorships, and tax planning.

This article discusses the Internal Revenue Service's recent successes in attacking family limited partnerships using the IRC § 2036 or "retained interest" argument. Part I reviews case law and analyzes the Service's position. Part II of the article will address the Fifth Circuit Court's *Kimbell* decision and suggest ideas for protecting family limited partnerships during this period of uncertainty.

The family limited partnership ("FLP") has ascended to the summit of favored estate planning techniques in the past decade or so.[1] For years, the FLP appeared to be almost invincible, although the Internal Revenue Service ("Service") volleyed numerous attacks at the FLP, only to be repeatedly defeated by the courts—that is, until recently. In several recent cases, the Service has successfully flung the so-called "§ 2036" argument at the FLP.

The § 2036 argument involves transfers by a taxpayer that normally would place transferred assets out of the taxpayer's estate. Under § 2036 of the Internal Revenue Code ("Code"),[2] in certain instances where the taxpayer retains an interest in a transferred asset, the asset is brought back into the estate for estate tax purposes. Due to the Service's success with the § 2036 argument, many practitioners are wondering if the golden age of FLPs finally has come to an end.

Part I of this article briefly examines several § 2036 cases. It also discusses current concerns that now fit hand-in-glove with the FLP. Part II of the article, which will appear in this column later this year, will examine the Fifth Circuit Court of Appeals' holding on an important § 2036 case, *Kimbell v. U.S.*,[3] on which the court is expected to rule in 2004. Part II also will discuss what that holding may mean for the future of FLPs and other like entities, suggest ways to protect established FLPs, and address what to consider when establishing new FLPs.

FLPs and Discount Planning

The FLP has proven to be an efficient, custom-designed vehicle to own and manage family property or business enterprises.[4] Limited Liability Companies ("LLCs") can be set up to operate in the same manner as FLPs, and this discussion is equally applicable to LLCs set up in this fashion. The FLP structure traditionally has given the family patriarch or matriarch the ability to begin passing ownership on to the next generation, while maintaining control of assets in the FLP through the general partnership interest.

Although that feature alone has made the FLP appealing, another touted virtue is the FLP's ability to posture family assets for discounts, both for gifting of FLP interests and at death. Valuation discounts may attach to FLP interests because various restrictive FLP characteristics usually cause FLP interests to be worth less than the aggregate value of its underlying assets. Typically, discounts would be given for lack of marketability and for a minority interest.

Column Editor:

David W. Kirch, of David W. Kirch, P.C., Aurora—(303) 671-7726, dkirch@qwest.net

About The Author:

This month's article was written by Carol Warnick, Denver, Of Counsel with Holland & Hart LLP—(303) 295-8359, cwarnick@hollandhart.com.

The test used to determine what percentage discount would be applied to the FLP interest often is referred to as the "willing buyer, willing seller" test. This refers to the amount a willing buyer would pay a willing seller for the FLP interest, where neither party is under compulsion to buy or sell and both are knowledgeable with regard to the relevant issues of the transfer.[5]

A discount for lack of marketability is based on the premise that the transfer restrictions applicable to the limited partnership interest make such interest less attractive than comparable publicly traded assets under the "willing buyer, willing seller" test. This discount often is determined by comparable sales of restricted stock of publicly traded companies.

The minority interest discount applies to FLP interests because of the limited partner's limited rights with regard to the FLP's management. A limited partner typically has no voice in the FLP's day-to-day business, no power to force distributions, no ability (or a restricted ability) to withdraw from the FLP, and no rights in the FLP's underlying assets. In addition, he or she is restricted on the ability to transfer an FLP interest. Again, these restrictions make the FLP interest less attractive under the "willing buyer, willing seller" test.

FLPs and the § 2036 Argument

After being struck down in various other attempts to stop the steady march of FLPs, the Service presented an argument that the Tax Court seemed willing to accept. In *Estate of Strangi* ("*Strangi I*"),[6] the Tax Court initially raised the issue by stating that the facts of the case might "suggest the possibility" of including the assets transferred by the decedent into the partnership in the decedent's gross estate pursuant to § 2036.[7] Although the Tax Court declined to consider this argument in its opinion because the Service had raised this issue too close to the trial date,[8] the court suggested that

> [a]pplying the economic substance doctrine in this case on the basis of decedent's continuing control would be equivalent to applying § 2036(a) and including the transferred assets in decedent's estate.[9]

This statement foreshadows the Tax Court's blurring of the distinction between the "lack of economic substance" and the § 2036 arguments.

The Fifth Circuit Court affirmed the Tax Court's decision on appeal and reversed the Tax Court's denial of the Service's motion for leave to amend to raise the § 2036 argument, even hinting that it might favorably consider such an argument.[10] The Service polished up its § 2036 argument and ultimately prevailed in *Strangi II*.[11] Thus continued the downward spiral of cases in which the Service emerged victorious at an enormous cost to taxpayers. This is because of a Code section that was likely never contemplated by the taxpayers or seldom discussed by their attorneys as presenting a possible risk when considering the formation of the FLP.

In each of this growing series of cases, the court upheld the Service's argument that IRC § 2036 should cause the inclusion in the decedent's estate of the value of the assets the decedent contributed to the FLP. By including in the decedent's estate the value of the assets contributed, instead of the value of the partnership interests, the courts ignored the separate existence of the FLP, thus removing the ability for the estate to discount these interests. All of these cases involved egregious facts, validating the old adage that "bad facts make bad law."

Case Law Involving FLPs And § 2036(a)(1)

IRC § 2036 includes two alternative arguments for inclusion of property in a decedent's estate, which, in most cases, significantly increases the estate's tax liability. Section 2036(a), "Transfers with retained life estate," provides:

> (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 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.[12]

The U.S. Supreme Court, in the *Estate of Grace*,[13] declared that the purpose of § 2036 is

> 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.[14]

It therefore follows that the Service would argue that transfers by the decedents in these cases were testamentary in nature and that the decedent retained the possession, enjoyment, or right to the income of the underlying FLP assets.

In two cases, *Kimbell* and *Strangi II*,[15] the courts even went beyond these arguments and looked to the § 2036(a)(2) "hook" of whether the decedent retained the right to designate the persons who would possess or enjoy such assets. Various courts also reviewed the bona fide sale exception contained within the parentheses in the body of § 2036, but have been unwilling to apply it in any of these cases, at least until *Estate of Stone v. Commissioner*,[16] which is discussed below.

To get the flavor of the evolution of the Service's success with the § 2036 cases leading up to the high-water mark of *Strangi II*, a brief discussion of several significant cases is in order. These include *Estate of Reichardt v. Commissioner*,[17] *Estate of Harper v. Commissioner*,[18] *Estate of Thompson v. Commissioner*,[19] and *Kimbell v. U.S.*[20]

Estate of Reichardt

In a 2000 case, *Reichardt*,[21] the decedent formed a limited partnership in June 1993 after being diagnosed with terminal cancer. He transferred substantially all of his assets to the partnership and formed a revocable trust to be the sole, one percent general partner.[22] He named himself and his two children to serve as co-trustees of the trust, but any trustee was authorized to act independently on behalf of the trust.[23] He actually was the only trustee to ever sign checks or execute documents.[24]

Four months after beginning the partnership, the decedent transferred a 30.4 percent limited partnership to each of his two children, reporting the value of the transfers on gift tax returns utilizing approximately a 40 percent discount. The assets in the partnership consisted of various real property (including the decedent's personal residence), investment accounts, cash, and a note receivable.[25]

Until the decedent's death in August 1994 (fourteen months after the partnership was formed), he continued to treat assets of the partnership as his own personal property. After his personal residence was transferred to the partnership, he continued living in it without paying rent; he used partnership funds to pay for his personal living expenses; and he blatantly deposited $20,000 of partnership funds into his own personal checking account.[26]

The Tax Court found there was an implied agreement among the parties when the decedent transferred assets into the partnership that he would be allowed to retain the economic benefits of the contributed property.[27] Once the Service alleges that such an implied agreement exists, the burden of proof shifts. The decedent's estate then must try to rebut the existence of such an agreement. The finding of an implied agreement will cause inclusion of the contributed property in the decedent's gross estate at date-of-death values.[28]

Because what is included in the decedent's estate is the actual property transferred, not the partnership interests, discounts applicable to those partnership interests fall by the wayside. In the *Reichardt* case, the Tax Court determined the date-of-death value of the contributed assets to be $1.6 million,[29] as opposed to the $359,000 value of the limited and general partnership interests used by the estate on the estate tax return.[30]

Estate of Harper

The 2002 *Harper*[31] case involved Morton Harper, who was already ill with cancer when he formed a limited partnership.[32] Approximately three weeks later, Harper's trust contributed its liquid assets to the FLP, taking back a 99 percent limited partnership interest. His son and daughter were named as the general partners, with his son holding 40 percent of the general partnership interest (and was also designated as managing general partner), and his daughter holding 60 percent of the general partnership interest.[33] Within a few weeks after formation of the partnership, Harper's trust assigned 24 percent of the limited partner interests to his son and 36 percent to his daughter.[34] Harper died approximately seven months after the creation of the partnership.[35]

Again, the Tax Court found that the decedent had retained the economic benefit of the contributed property, citing various facts to support its holding.[36] It called the FLP an "alternate testamentary vehicle to the Trust."[37] The FLP checking account was not set up for more than three months after the establishment of the partnership.[38] Other assets were not transferred to the partnership until four months had passed.[39]

Prior to the establishment of the checking account, income received from contributed assets was deposited into the decedent's checking account.[40] There were disproportionate distributions made to the decedent. In addition, various expenses of the estate (including the payment of the decedent's federal estate tax liability) were paid out by partnership distributions to the estate.[41]

The Tax Court believed there was basic indifference by the parties to the formal structure of the partnership. As such, the court concluded that there was an implied agreement among the family members that Harper would retain the economic benefit of the assets he transferred to the FLP.[42] As many practitioners tell their clients, if the parties do not respect the partnership structure, there is no reason to believe that the Service will respect it either.

Estate of Thompson

A 2002 case, *Thompson*,[43] involved FLPs formed by a 95-year-old decedent. A full two years before his death, he formed two separate FLPs, one for each child and the child's family.[44] He transferred the bulk of his wealth, primarily marketable securities and notes receivable, to the two partnerships.[45] However, the general partner of each of the limited partnerships was a separate corporation in which 49 percent of the interests were held by the decedent and the respective child or child's spouse. An unrelated party held the remaining 2 percent of each corporate general partner.[46]

The children or their spouses also made contributions to each partnership. The decedent's son-in-law made only a nominal cash contribution, along with some real property.[47] However, the decedent's son contributed significant assets to the partnership set up for his family, including $372,000 of mutual funds and a $460,000 ranch. Following such contributions, the son owned more than 36 percent of the partnership.[48]

In spite of these "positive" facts, the Tax Court found an implied understanding between the parties that the decedent would retain the economic benefit of the contributed property.[49] There was testimony that the daughter, prior to the establishments of the partnerships, inquired about whether her father could still draw funds from the brokerage accounts contributed to the partnerships to fund his annual gifting.[50] There were disproportionate distributions to the decedent to allow him to make annual gifts and Christmas presents to family members.[51] Shortly before the decedent's death, there was correspondence between the children regarding a need for a partnership distribution to pay the decedent's personal living expenses.[52]

The Tax Court held that none of the family members, including the decedent, treated the partnerships as true businesses. The court held the structure to be testamentary in nature, therefore applying § 2036(a)(1).[53] Again, the assets transferred by the decedent to the two partnerships were brought back, undiscounted, into his gross estate.

Case Law Including § 2036(a)(2) Issues

Up to this point, the lessons learned from these cases seem reasonable. First, not all of an individual's assets should be transferred to the FLP. Doing so would appear to make the FLP a testamentary substitute. Second, partnership formalities should be carefully respected. Thus, no funds should be commingled and the partnership should not be treated as just another pot of funds for the family matriarch or patriarch.

There are plenty of other precedents in the law for the establishment of these principles and these court decisions generally have been accepted as reasonable (although there were troubling *dicta* in *Thompson*).[54] However, many commentators felt the next case to appear on the scene went farther than necessary where the Service again latched onto a particularly bad set of facts. The *Kimbell* decision was the first to focus on § 2036(a)(2), in addition to § 2036(a)(1).[55]

Kimbell v. U.S.

In *Kimbell*,[56] Ruth Kimbell, her son, and daughter-in-law formed an LLC. Kimbell owned a 50 percent interest in the LLC; her son and daughter-in-law each owned a 25 percent interest.[57] Her son was the manager of the LLC.[58] Kimbell and the new LLC then formed an FLP, with the LLC contributing one percent of the capital and taking back a one percent general partnership interest. Kimbell contributed 99 percent of the capital and took back a 99 percent limited partnership interest.

Kimbell died two months later at the age of 96. The estate valued Kimbell's limited partnership interest at a discounted value of $1.257 million. However, the Service valued the same interest at $2.463 million.[59]

The issue came before the U.S. District Court on a motion for summary judgment filed by the government,[60] the only one of these cases not tried by the Tax Court. The Service argued that the property transferred by the decedent should be included in her estate under § 2036(a).[61]

The *Kimbell* court approached its analysis in a summary judgment decision in a manner very different from the Tax Court in the previous § 2036 decisions. Possibly because it was responding in the context of a motion for summary judgment, the *Kimbell* court declared that under the plain language of § 2036(a), "all property to the extent of any interest therein" the decedent transferred to the FLP is brought back into the decedent's estate unless an exception applied.[62]

According to the court, the two exceptions in § 2036 are the: (1) bona fide sale exception; and (2) "retained income or rights exception." The latter exemption involves transfers of property to which the decedent does not retain any right to the possession, enjoyment, or income. In addition, in the latter exception, the decedent does not retain the right, alone or in conjunction with another person, to designate the persons who will receive the possession, enjoyment, or income from the property.[63]

Thus, the *Kimbell* court started with the presumption that all the contributed property was brought back into Kimbell's estate unless one of the stated exceptions applied. This was a vast departure from the way the Tax Court previously had analyzed these cases.

The *Kimbell* court examined the bona fide sale exception. It held that it did not apply in the formation of an FLP because there was no "arm's length transaction."[64] The court also examined the "retained income or rights exception." The court stated there was no need to search for an implied agreement existing at the time of the transfer that the transferor will retain the economic benefit of the transferred property, because the partnership agreement itself was sufficient to show that this exception would not apply.[65]

The court cited several specifics of the partnership agreement to substantiate its conclusion that the second exception would not apply. For example, the general partner had the sole discretion to determine distributions. In addition, the general partner could be removed by a vote of 70 percent of the limited partnership interests and replaced by a majority of the limited partnership interests.

Finally, the partnership agreement contained the unusual provision that the general partner did *not* owe a fiduciary duty to the partnership or any of the partners.[66] Although the decedent was not the manager of the general partner, she possessed the right as a 99 percent limited partner to remove the LLC as the general partner and appoint herself.

Thus, because the general partner had the ability to determine distributions, she retained the power to either personally benefit from the income or to designate those who would.[67] Using this analysis with the facts in the *Kimbell* case, the court readily decided that the contributed property should be included in Kimbell's estate under both § 2036(a)(1) and (a)(2).

The partnership agreement specified that there was no fiduciary duty owed to the partners or the partnership by the general partner. However, the estate attempted to argue that the decedent's fiduciary responsibilities kept § 2036 from being applicable because of the precedent set forth by the U.S. Supreme Court in a 1972 decision, *U.S. v. Byrum*[68] (discussed below).

The district court made short shrift of the *Byrum* argument, not only because of the language of the partnership agreement, but also because Kimbell still owned 99 percent of the partnership. The court asked, "Assuming such fiduciary duties exist, to whom does a partner which owns 99 percent of the Partnership owe them?"[69] The district court apparently believed that *Byrum* was distinguishable from the facts in *Kimbell*. However, the *Kimbell* court also stated that *Byrum* had been overruled by Congress when it enacted § 2036(b).[70]

Fiduciary Duty Precedent in U.S. v. Byrum

Byrum,[71] a 1972 case, involved a decedent, Milliken Byrum, who had created an irrevocable trust for the benefit of his children and transferred to it stock in three closely held corporations.[72] Byrum retained certain powers with regard to the transferred stock. He kept the power to vote the shares, which, combined with the stock he owned, gave him the majority voting interest in each of the three corporations. He also retained the power to veto the sale of these shares of stock by the trustee, the power to remove the trustee and appoint a successor corporate trustee, and the right to approve all investments by the trustee.[73]

Byrum named an independent corporate trustee for the trust.[74] The corporate trustee had absolute and sole discretion to pay income and principal to the beneficiaries under ascertainable standards.[75]

The Service argued that *Byrum* retained control over corporate dividend policy, because he was the majority owner in all three of the corporations. Furthermore, he could regulate income flowing to the trust. Therefore, according to the Service, he retained the ability to "designate the persons who shall possess or enjoy the property or the income therefrom" under § 2036(a)(2).[76]

In a six-to-three decision, the U.S. Supreme Court held that although Byrum retained "something," it was not the legal "right" under § 2036(a)(2) to designate who would enjoy or possess the trust income. The Court noted that the powers Byrum retained, combined with what he already had, did not reach to the level of the enforceable "right" that would be required for § 2036 purposes.[77]

The Court distinguished what was held by Byrum as a "power" subject to outside constraints (such as fiduciary duties and other corporate interests), which did not rise to the level of a legally enforceable right contemplated by § 2036.[78] This is a critical distinction, and one that has served for years to keep the Service from using § 2036(a)(2) arguments with regard to "controls" by virtue of a general partnership interest in the realm of FLPs.

The majority commented that equating the position of a controlling owner to having a legally enforceable right under § 2036 (a)(2) "seems to us not only to depart from the specific statutory language, but also to misconceive the realities of corporate life."[79] The Court further noted that although a majority owner may have the advantage of a significant voice in corporate decision-making, the capability of a controlling stockholder to act in favor of himself or herself is limited by a variety of constraints.[80]

The Court also noted the many practical limitations imposed on directors of closely held businesses. In fact, in writing the decision, Justice Powell made the following insightful statement:

> At the outset we observed that this court has never held that trust property must be included in a settlor's gross estate solely because the settlor reserved the right to manage trust assets.[81]

Thus, although the Service attempted to show that the position of controlling shareholder gave an individual the legal "right" specified in § 2036(a)(2), the Supreme Court disagreed.

Strangi II

Strangi II came about in 2003, after the Fifth Circuit Court remanded the Tax Court's original opinion back to that court. The Fifth Circuit Court upheld the Tax Court's holdings on all but one issue: the denial of the Service's motion for leave to amend its pleadings to include a § 2036 argument as untimely.[82]

Albert Strangi was in failing health when his son-in-law took over management of his financial affairs through an existing durable power of attorney.[83] The son-in-law, Michael Gulig, who happened to be an attorney, formed two entities on behalf of his father-in-law the day after attending a seminar on FLPs. In addition to forming an FLP, he set up a corporation, Stranco, Inc. ("Stranco"), to be the FLP's general partner. The corporate general possessed sole authority to manage the FLP.[84] Stranco's board of directors consisted of Strangi and his children.[85]

Using the power of attorney, Gulig contributed $9.8 million of his father-in-law's assets into the FLP, taking back for the decedent a 99 percent limited partnership interest.[86] The decedent and his four children also contributed funds to Stranco (the corporate general), which in turn transferred approximately $100,000 to the FLP in exchange for a one percent general partnership interest.[87] Strangi owned 47 percent of Stranco stock; the rest was held by his children (except for 100 shares that the children donated to a local community college).[88]

Gulig was designated by vote of the Stranco directors (comprised of the decedent and his children) to manage the affairs of both the FLP and the corporate general, including the sole discretion to determine distributions.[89] The assets contributed by Strangi to the FLP included the bulk of his wealth, as well as his personal residence.[90] Approximately 75 percent of the value was in marketable securities and cash.[91]

Distributions during the two months of the FLP's existence prior to Strangi's death were made *pro rata* to him, as the sole limited partner, and to Stranco, as general partner. The distributions were all proven to be made due to Strangi's personal needs or, after his death, the needs of the estate.[92]

The Tax Court found that Strangi's contributed assets came back into his estate under both §§ 2036(a)(1),[93] and 2036(a)(2).[94] In making the § 2036(a)(1) argument, the Tax Court, as the district court had in *Kimbell*,[95] stated that the documents themselves gave Strangi the right to income; therefore, it was not necessary to find an implied agreement among the family members.[96]

The Tax Court, however, did note numerous facts supporting the finding of an implied agreement. For example, the decedent retained the same relationship to his assets that he had before the formation of the FLP; he contributed 98 percent of his wealth, including his personal residence; and he continued to occupy his personal residence without paying rent.[97] Although distributions made out of the FLP were *pro rata* because Strangi owned more than 99 percent of the FLP, the arrangement looked more like a decedent's estate plan than an arm's-length business enterprise.[98]

The Tax Court's discussion of the § 2036 (a)(2) issue has engendered much controversy. First, it has been considered overreaching. It was not necessary for the court to discuss the § 2036(a)(2) issue because the § 2036(a)(1) discussion would have been sufficient to trigger inclusion in the decedent's gross estate.

Second, the Tax Court made comments about the U.S. Supreme Court's decision in *Byrum*.[99] The Tax Court cited several factors it felt were present and important in the Supreme Court's decision in *Byrum* that were distinguishable in *Strangi*, including: (1) fiduciary duties in *Byrum* owed to unrelated shareholders; (2) the fact that there was an independent trustee in *Byrum* with the right to determine distributions; and (3) the business complexities of operating businesses, compared to the *Strangi* FLP, which held mostly passive investments.[100] The Tax Court stated:

> [The] arrangement placed decedent in a position to act, alone or in conjunction with others, through his attorney in fact, to cause distributions of property previously transferred to the entities or of income therefrom. Decedent's powers, absent sufficient limitation as discussed *infra,* therefore fall within the purview of § 2036(a)(2).[101]

The taxpayer in *Strangi* also raised the fiduciary duty argument. The Tax Court responded that the

> fiduciary duties present in [*Byrum*] ran to a significant number of unrelated parties and had their genesis in operating businesses that would lend meaning to the standard of acting in the best interest of the entity. . . . Given the emphasis that the Supreme Court laid on these factual realities, *Byrum* simply does not require blind application of its holding to scenarios where the purposed fiduciary duties have no comparable substance.[102]

The Tax Court also discussed the fiduciary duties Gulig owed to Strangi by virtue of being his agent under the power of attorney. The court made the judgment call that Gulig would likely honor those fiduciary duties as a priority if the interests of the partnership and corporate general were to diverge from Strangi's interests.[103] In short, the Tax Court stated that the Supreme Court's opinion in *Byrum* provides

> no basis for "presuming" that fiduciary obligations will be enforced in circumstances divorced from the safeguards of business operations and meaningful independent interests or oversight.[104]

The Tax Court also stated that "the facts of this case belie the existence of any genuine fiduciary impediments to the decedent's rights."[105]

The Tax Court noted that it needed to address consideration in terms of the bona fide sale exception. However, the court concluded that this exception did not apply because Gulig prepared all the documents and made all decisions without any meaningful negotiation or bargaining among family members.[106] Finally, the court stated that there was no meaningful consideration, but merely a recycling of value.[107]

Analysis of Strangi II *And* Byrum

It is not clear whether the court in *Strangi II* properly dispenses with the *Byrum* fiduciary-duty argument or whether the *Strangi* court misconstrues the Supreme Court's holding in *Byrum*. A 2003 article published in the *Journal of Taxation* ("*Journal* article")[108] examines *Byrum* and suggests that some commentators, presumably including the majority of the tax court in *Strangi II*, misread the Supreme Court's fundamental analysis in *Byrum* and rely on a questionable interpretation of a footnote in the opinion.[109]

According to the *Journal* article, if *Byrum* does not provide a fiduciary defense to § 2036(a)(2), it must be reasoned that the Supreme Court's holding in *Byrum* was based solely on the existence of an intervening third-party trustee and that fiduciary considerations must not have been factored into the holding. Thus, although the

> Supreme Court did hold alternatively that the *Byrum* trust provided sufficient interference, the Court likewise held that the fiduciary constraints *alone* provide fatal to the Service's position.[110]

The *Journal* article notes the majority's analysis of Byrum's obligations as a fiduciary is a "telling excerpt."[111] The article quotes the *Strangi II* court:

> It must be conceded that *Byrum* reserved no [§ 2036(a)(2)] "right" in the trust instrument *or otherwise*. . . . Here, the right ascribed to *Byrum* was the power to use his majority position and influence over the corporate directors to "regulate the flow of dividends" *to the trust*. That "right" was neither ascertainable nor legally enforceable and hence was not a right in any normal sense of that term. . . . Whatever power *Byrum* may have possessed with respect to the flow of income *into the trust*, was derived not from an enforceable legal right . . . , but from the fact that he could elect a majority of the directors of the three corporations. The Government seeks to equate the *de facto* position of a controlling stockholder with the legally enforceable "right" specified by the statute. . . . This approach seems to us . . . to depart from the specific statutory language. . . . (*Emphasis added; footnotes omitted.*)[112]

All of this seems to clearly support the fiduciary duty argument as a defense to the Service's § 2036 argument.[113] It appears then, by definition, the "unconstrained *de facto* power" is the § 2036(a)(2) "right." The *Journal* article suggests that the Supreme Court "without question, primarily held that Byrum did not have a § 2036(a)(2) right because of the fiduciary constraints on his decision making power."[114]

However, this was not the conclusion reached by the *Strangi II* court. The *Journal* article suggests that such an argument must rely on an incorrect analysis of a footnote in *Byrum*.[115] Footnote 25 quotes the dissenting opinion's discussion of the majority's supposedly incompatible views regarding the settlor's position as a director to control income allocation and his fiduciary obligations being sufficient to insulate him from a § 2036 argument.[116]

In other words, the settlor could retain the power to allocate income by regulating dividends, but remain immune from a § 2036 argument by funding with closely held stock. Footnote 25 goes on to discuss the dissent's statement:

> This statement, which assumes the critical and ultimate conclusion, incorrectly states the position of the Court. We do not hold that a settlor "may keep the power of income allocation" in the way Mr. Justice White sets out; we hold, for the reasons stated in this opinion, that this settlor did not retain the power to allocate income within the meaning of the statute.[117]

The Journal article argues that the *Byrum* majority makes a substantial effort throughout the body of the opinion—rather than in a footnote—to underscore that because of his fiduciary duties, Byrum did not control the flow of income by virtue of his position.[118] The differing approaches to the analysis taken by the majority and the dissent lead to strikingly opposite conclusions.

An argument for a favorable reading of *Byrum* in Colorado may be found in the Colorado statutes, which essentially do not allow the partners of an FLP or the members of an LLC in either a partnership agreement or an operating agreement to waive fiduciary duties.[119] However, these statutes do not provide a viable counter to the *Strangi II* court's assertion that the facts of the case, as presented, essentially eviscerate any fiduciary duty argument due to a lack of meaningful independent interests or oversight.

Stone v. Commissioner

In *Stone*,[120] a 2003 Tax Court case, the court looked to the bona fide sale exception and upheld the taxpayer's position rather than that of the Service. Mr. and Mrs. Stone formed five FLPs just two months prior to Mr. Stone's death.[121] Mrs. Stone died six months after formation of the partnerships.[122] At Mr. Stone's death, he held the majority of the general partnership and limited partnership interests in all of the partnerships.[123]

The day before formation of the partnerships, the Stones made small, undivided interest gifts to each child. The next day, when the partnerships were formed, each of the Stone children received small general partnership interests in exchange for their contributions of the gifted interests, although Mr. Stone held a majority interest in the general partner.[124] After Mr. Stone's death, four of the five partnerships made non-*pro rata* distributions to his estate to pay his estate tax.[125]

The Service argued in Tax Court that the bona fide sale exception should not apply. However, the Tax Court concluded that the transfers by Mr. and Mrs. Stone "were for adequate and full consideration in money or money's worth."[126] In addition, the court stated that

> unlike the transfers involved in *Estate of Harper* and other cases factually similar to that case, the respective transfers at issue by Mr. Stone and Mrs. Stone did not constitute circuitous recycling of value.[127]

The factors related by the court in reaching this conclusion are extremely important to distinguish this case from *Harper*, *Strangi II*, and the other cases discussed in this article. These factors are:

1. Each member of the Stone family was represented independently by his or her own attorney and had input into the structuring of each partnership.[128] Although Mr. and Mrs. Stone were not bound by any agreements reached during negotiations by the children,[129] the fact that negotiations occurred apparently was important.

2. Mr. and Mrs. Stone did not transfer all of their assets into the partnership. They retained sufficient assets to enable them to maintain their standard of living in the manner in which they had become accustomed.[130]

3. The transfers were motivated primarily by investment and business concerns relating to management of assets during the parents' lives.[131]

4. All five partnerships had economic substance, and the children actively participated in the management of the assets of the partnerships.[132]

5. There was a genuine pooling of property and services.[133]

The Tax Court further stated that because the Stone partnerships met the requirements for the bona fide sale exception, it was not necessary for the court to look at the § 2036(a)(1) issues.[134]

Summary of Current Case Law

The challenge for practitioners is to make sense of the cases described above to formulate a way to approach the FLP with some degree of confidence. Few clients want the "honor" of having their names in lights by being named parties in Tax Court decisions. It should be helpful to take a brief look at what the courts seemed to focus on in some of the recent cases.

"Recycling of Value"

The phrase "mere recycling of value" has been referred to so frequently by courts in the recent string of cases that it now has an extremely negative connotation in the FLP world. It is a red flag that the FLP doesn't qualify for the bona fide sale exception in § 2036(a). For the deal to not be a "mere recycling of value," there must be actual consideration that is adequate for what is transferred.

Some of the cases highlighted in this article provide guidance into what the courts had in mind. In *Reichardt*,[135] for example, the court held that the full and adequate consideration exception did not apply because the children neither involved themselves in the partnership nor contributed anything to the partnership.[136]

In *Harper*,[137] the court focused only on pooling of assets, and not on the material participation aspect, by stating that the decedent merely changed

> the form in which he held his beneficial interest in the contributed property . . . without any change whatsoever in the underlying pool of assets. . . .[138]

The court termed this a "circuitous recycling of value,"[139] as opposed to other situations where the partnership entity served as the vehicle for a genuine pooling of interests.[140]

"Full and Adequate Consideration" Exception

Kimbell[141] seemed to follow the reasoning that both material participation and true pooling of assets in an arms-length transaction were critical factors in any application of the "full and adequate consideration" exception. In fact, the *Kimbell* court made the snide comment that in the instant case, "one cannot even find two parties, much less two parties conducting an arm's length negotiation leading to a 'bona fide sale.'"[142]

Strangi II[143] also discussed this exception, but seemed to indicate that a functioning business situation could "potentially inject intangibles that would lift the situation beyond mere recycling."[144] Therefore, to the *Strangi II* court, a functioning business enterprise in and of itself might be enough to solve the recycling problem. The court in *Thompson*[145] also clearly required a fully-functioning business enterprise.[146]

Bona Fide Sale Exception

It is not easy to extrapolate a hard and fast rule from the cases discussed in this article, inasmuch as the rulings have been inconsistent. The Tax Court's decision in *Stone*,[147] however, does provide clear guidelines for setting up a situation that will qualify for the bona fide sale exception. The *Stone* court looked at two aspects of the FLP in determining that the bona fide sale exception applied: (1) the existence of legitimate negotiations during the formation stage; and (2) more than a "mere recycling of value" in terms of funding and operating the entity.[148]

It also is clear that legitimate negotiations apparently mean just that. In *Stone*, the children all were represented by separate counsel and had been in litigation with each other previously.[149] To be legitimate, the negotiations should begin prior to the drafting of the partnership agreement. Further, all prospective partners should have input into the provisions. Attorneys for the various parties should negotiate items such as: (1) management and distribution issues; (2) partner/manager responsibilities; (3) identification of decisions that require all or a majority of approval by partners/managers; (4) transfer restrictions; (5) initial capital contributions; and (6) investment parameters.

Conclusion

It is hoped that the murky fog that now engulfs the area of the law pertaining to FLPs soon will be lifted. The district court's decision in *Kimbell* is on appeal to the Fifth Circuit Court, with oral arguments heard the first week of February 2004. Part II of this article will look at that court's decision and will set forth what that decision may teach about the continuing viability of FLPs in the estate planning arena.

NOTES

1. For a discussion of FLPs and other family business entities, *see* Sparkman, "Family Business Entities: Preserving Wealth and Minimizing Taxes," 32 *The Colorado Lawyer* 11 (Nov. 2003).
2. Unless otherwise noted, all statutory provisions cited in this article are to the Internal Revenue Code ("IRC" or "Code") of 1986, as amended and codified at Title 26 of the United States Code ("U.S.C."). Regulatory provisions refer to Treasury Regulations promulgated under the Code.
3. The appeal of *Kimbell*, 244 F.Supp.2d 700 (N.D.Tex. 2003), App. No. 03-10529 (5th Cir. 2004) was argued in front of the Fifth Circuit Court in February 2004.
4. *See* Sparkman, *supra*, note 1.
5. Treas. Reg. § 20.2031-1(b).
6. *Estate of Strangi v. Comm'r*, 115 T.C. 478 (2000), *aff'd in part and rev'd in part*, *Gulig v. Comm'r*, 293 F.3d 279 (5th Cir. 2002), 89 AFTR2d 2002-2977 (CA-5 2002). These cases are sometimes collectively referred to as "*Strangi I*." The second Tax Court opinion is subsequently referred to as *Strangi II, infra*, note 11.
7. *Id*. at 486.
8. *Id*.
9. *Id*.
10. *Gulig, supra*, note 6.
11. *Estate of Strangi v. Comm'r*, 2003 RIA T.C.M. ¶ 2003-145 ("*Strangi II*").
12. IRC § 2036(a).
13. *Estate of Grace*, 395 U.S. 316 (1969).
14. *Id.* at 320.
15. *Kimbell, supra*, note 3; *Strangi II, supra*, note 11.
16. *Stone*, T.C.M. 2003-309; 2003 Tax Ct. Memo LEXIS 312 (Nov. 7, 2003).
17. *Reichardt*, ¶ 114.9 TC (2000).
18. *Harper*, 2002 RIA T.C.M. ¶ 2002-121.
19. *Thompson*, 2002 RIA T.C.M. ¶ 2002-246.
20. *Kimbell, supra*, note 3.
21. *Reichardt, supra*, note 17.
22. *Id.*
23. *Id*.
24. *Id*. at 92.
25. *Id.* at 90.
26. *Id.* at 92.
27. *Id.* at 93.
28. Treas. Reg. § 20.2036-1(a).
29. *Reichardt, supra*, note 17 at 95.
30. *Id.* at 90.
31. *Harper, supra*, note 18.
32. *Id.* at 708.
33. *Id.* at 709.
34. *Id.* at 712.
35. *Id.* at 713.
36. *Id.* at 717.
37. *Id.* at 722.
38. *Id.* at 717.
39. *Id.* at 718.
40. *Id.* at 719.
41. *Id.* at 720.
42. *Id.* at 717.
43. *Thompson, supra*, note 19.
44. *Id.* at 1512.
45. *Id.*
46. *Id.* at 1512-14.
47. *Id.* at 1512.
48. *Id.* at 1514-15.
49. *Id.* at 1525.
50. *Id.* at 1524.
51. *Id.*
52. *Id.*
53. *Id.* at 1526.
54. *Id*. at 1524 n.11. The *Thompson* court hinted that IRC § 2036(a)(2) also may be applicable to cause estate inclusion.
55. *Kimbell, supra*, note 3.
56. *Id.*
57. *Id.* at 702.
58. *Id.*
59. *Id.*
60. *Id.* at 701.
61. *Id.* at 703.
62. *Id.*
63. *Id.*
64. *Id.* at 704.
65. *Id.* at 706.
66. *Id.* at 705.
67. *Id.* at 706.
68. *Id*. at 705, *citing Byrum*, 408 U.S. 125, 126 (1972).
69. *Id.* at 706.
70. *Id*. at 705 ("the retention of the right to vote (directly or indirectly) shares of stock of a controlled corporation shall be considered to be a retention of the enjoyment of the transferred property").
71. *Byrum, supra*, note 68.
72. *Id.* at 126.
73. *Id.* at 127.
74. *Id.* at 126.
75. *Id.* at 127.
76. *Id.* at 132.
77. *Id.* at 143.
78. *Id.*
79. *Id.* at 139.
80. *Id.* at 137-38.
81. *Id.* at 132-33.
82. *Gulig, supra*, note 6.
83. *Strangi II, supra*, note 11 at 732.
84. *Id.*
85. *Id.* at 734.
86. *Id.* at 733.
87. *Id.* at 733-34.
88. *Id.* at 734.
89. *Id.*
90. *Id.* at 733.
91. *Id.*
92. *Id.* at 735.
93. *Id.* at 741.
94. *Id.* at 745.
95. *Kimbell, supra*, note 3.
96. *Strangi II, supra*, note 11 at 738.
97. Rent was not paid two-plus years, although it was accrued on the partnership's books. *Id.* at 739.
98. *Strangi* held a 99 percent limited partnership interest and a 47 percent interest in the corporate general partner. *Id.* at 733.
99. *Byrum, supra*, note 68.
100. *Strangi II, supra*, note 11 at 744.
101. *Id.*
102. *Id.*
103. *Id.* at 745.
104. *Id.*
105. *Id.*
106. *Id.* at 746.
107. *Id.*
108. Korpics, "The Practical Implications of *Strangi II* for FLPs—A Detailed Look," 99 *J. Taxation* 270, 279 (Nov. 2003) (discussing *Byrum, supra*, note 68 at 143 n.25).
109. *Id.*
110. *Id.*
111. *Id.*
112. *Id.*
113. *Id.* ("The Court's holding . . . could not be more clear: 'Byrum was . . . inhibited by a fiduciary duty from abusing his position as majority shareholder for personal or family advantage to the detriment of the corporation or other stockholders. . . [and] did not have an unconstrained *de facto* power to regulate the flow of dividends to the trust, much less the "right" to designate who was to enjoy the income from trust property.").
114. *Id.*
115. *Id.*
116. *Byrum, supra*, note 68 at 143 n.25.
117. *Id.*
118. Korpics, *supra*, note 108 at 279.
119. CRS §§ 7-80-108, 7-64-103(c), and 7-62-1104.
120. *Stone, supra*, note 16.
121. *Id.* at 46.
122. *Id.* at 118.
123. *Id.*
124. *Id.* at 121.
125. *Id.* at 48 n.18.
126. *Id.* at 158.
127. *Id.* at 157 n.75.
128. *Id.* at 153.
129. *Id.*
130. *Id.*
131. *Id.* at 154.
132. *Id.* at 155-56.
133. *Id.* at 160.
134. *Id.* at 162.
135. *Reichardt, supra*, note 17.
136. *Id.* at 93.
137. *Harper, supra*, note 18 at 723.
138. *Id.*
139. *Id.*
140. *Id.* at 724.
141. *Kimbell, supra*, note 3.
142. *Id.* at 704.
143. *Strangi II, supra*, note 11.
144. *Id.* at 746.
145. *Thompson, supra*, note 19.
146. *Id.* at 1526.
147. *Stone, supra*, note 16.
148. *Id.* at LEXIS *155.
149. *Id.* ■