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Kimbell: Is the Party Over for Family Limited Partnerships?

By Brant J. Hellwig

I. Introduction

What a difference a couple of years makes. Toward the end of 2000, the Tax Court issued back-to-back opinions in *Estate of Strangi v. Commissioner*[1] and *Knight v. Commissioner*[2] holding that no business purpose was needed for a limited partnership to be respected for transfer tax purposes. Rather, all the taxpayer had to do was form a valid limited partnership under state law (not exactly tough) and the transferred partnership interests would be valued at whatever discounts the taxpayer's expert could defend.[3] After *Estate of Strangi* and *Knight*, it appeared that taxpayers could use limited partnerships to unilaterally reduce their effective transfer tax rate at the expense of relatively nominal transaction costs.[4]

While *Estate of Strangi* and *Knight* were certainly taxpayer-friendly decisions, the Tax Court did sound one cautionary note in *Estate of Strangi*. The court stated that the facts surrounding that case "suggest the possibility" of including the assets transferred to the partnership in the decedent's gross estate under section 2036.[5] Yet the Tax Court declined to address this argument, contending that the Commissioner had raised it too late in the game.[6] The Fifth Circuit, however, placed this issue back in the Tax Court's lap by affirming the Tax Court's decision in *Estate of Strangi* in all respects except one.[7] After noting that "the tax court suggested that if the Commissioner had timely filed his notice to amend to add an I.R.C. § 2036 claim, it probably would have used that section to include in the estate the assets [the decedent] transferred to [the partnership],"[8] the Court of Appeals reversed the Tax Court's denial of leave for the Commissioner to amend his answer to raise the section 2036 argument.[9] The *Estate of Strangi* case is currently pending before the Tax Court on remand.

In the meantime, a recently federal district court has decided the section 2036 issue on facts similar to those of *Estate of Strangi*. In *Kimbell v. United States*,[10] the court determined that the property transferred to the partnership by the decedent was included in the decedent's gross estate at its date-of-death value under section 2036(a)(1) and (a)(2).[11] As described in this article, the *Kimbell* opinion has the potential to level the playing field for the Service in its ongoing struggle against the use of family limited partnerships to depress transfer tax valuation.

II. The *Kimbell* Decision

A. Facts

The facts of *Kimbell* made it an excellent case for the government to litigate. During January 1998, the decedent formed an LLC with her son and daughter-in-law.[12] The decedent owned a 50 percent interest in the LLC,[13] and her son and daughter-in-law owned the remaining 50 percent interest in equal shares.[14] The LLC was manager-managed, and the decedent's son served as the sole manager.[15] Shortly after the LLC was organized, the decedent and the LLC formed a limited partnership under Texas law.[16] The LLC contributed 1 percent of the capital of the partnership for a 1 percent interest as general partner, while the decedent contributed 99 percent of the property for a 99 percent interest in the partnership as limited partner.[17] The decedent died approximately two months after the partnership was formed, at the age of 96.[18]

The opinion does not describe the property that was used to capitalize the partnership. Nonetheless, it is clear that the amount of property involved was substantial. The Service valued the decedent's 99 percent limited partner interest at $2.463 million.[19] The estate

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[1] 115 T.C. 478, 486-87, *Doc 2000-31014 (48 original pages), 2000 TNT 232-12* (2000).

[2] 115 T.C. 506, 513-14, *Doc 2000-31015 (29 original pages), 2000 TNT 232-11* (2000).

[3] In *Estate of Strangi*, the Tax Court explained its holding on this issue as follows:

> [The partnership] was validly formed under State law. The formalities were followed, and the proverbial "i's were dotted" and "t's were crossed." The partnership, as a legal matter, changed the relationships between decedent and his heirs and decedent and actual and potential creditors. Regardless of subjective intentions, the partnership had sufficient substance to be recognized for tax purposes. Its existence would not be disregarded by potential purchasers of decedent's assets, and we do not disregard it in this case.

Estate of Strangi, 115 T.C. at 486-87.

[4] *See, e.g., Estate of Jones v. Commissioner*, 116 T.C. 121, 139, *Doc 2001-6611 (34 original pages), 2001 TNT 45-12* (2001) (40 percent combined discount); *Estate of Strangi v. Commissioner*, 115 T.C. 478, 491-93 (2000) (31 percent combined discount), *aff'd in part and rev'd in part* 293 F.3d 279, *Doc 2002-14498 (4 original pages), 2002 TNT 118-10* (5th Cir. 2002); *Estate of Dailey v. Commissioner*, T.C. Memo. 2001-263, *Doc 2001-25453 (7 original pages), 2001 TNT 193-8* (40 percent combined discount); *Estate of Weinberg v. Commissioner*, T.C. Memo. 2000-51, *Doc 2000-4664 (31 original pages), 2000 TNT 32-10* (approximately 50 percent combined discount).

[5] *Estate of Strangi*, 115 T.C. at 486.

[6] *Id.*

[7] *Estate of Strangi v. Commissioner*, 293 F.3d 279 (5th Cir. 2002).

[8] *Id.* at 281.

[9] *Id.* at 282. While the Fifth Circuit left some room for the Tax Court to maintain its denial of the Commissioner's motion to amend, the tone of the appellate opinion certainly suggests that the court intended for the section 2036 argument to be addressed on remand. *Id.*

[10] 2003 WL 138081, *Doc 2003-2946 (6 original pages), 2003 TNT 22-12*, (N.D. Tex. 2003).

[11] *Id.* slip op. at 4.

[12] *Id.* slip op. at 1.

[13] The decedent's interest actually was owned by her revocable trust. For simplification purposes, this article will treat all property titled in the decedent's revocable trust as owned by her personally.

[14] *Id.*

[15] *Id.*

[16] *Id.*

[17] *Id.*

[18] *Id.*

[19] *Id.*

reported the value of this interest on the estate tax return at $1.257 million.[20]

A few specifics of the partnership agreement are mentioned in the court's analysis. The general partner had "sole discretion" to decide on distributions of income from the partnership.[21] The general partner could be removed by a vote of 70 percent in interest of the limited partners.[22] If the general partner was removed, a majority in interest of the limited partners could elect a replacement.[23] Last, the partnership agreement waived any fiduciary duty of the general partner to the partnership or to any partner.[24]

B. Court's Analysis

The court began its analysis of the section 2036(a) issue by noting that the purpose of that section is "to prevent individuals from avoiding estate tax by transferring their assets to others prior to death."[25] After quoting the text of the statute,[26] the court framed the section 2036(a) inquiry in a somewhat nonconventional manner:

> [U]nder the plain language of section 2036(a), "all property to the extent of any interest therein" which Decedent had "at any time" transferred is part of the estate unless the property interest qualifies for an exception to the general rule of inclusion. The two exceptions provided by section 2036(a) are (1) transfers which are "bona fide sale[s] for an adequate and full consideration" (the "Bona Fide Sale Exception") and (2) transfers after which the decedent retains neither the "possession or enjoyment of, or the right to income from the property" nor "the right, either alone or in conjunction with any other [sic] person, to designate the persons who shall benefit [sic] or enjoy the property" (the "Retained Income or Rights Exception").[27]

Thus, because the decedent had transferred her property to the partnership, the court started with the assumption that the property would be included in her gross estate under section 2036(a) unless one of its articulated exceptions applied.[28]

Following this analytical framework, the court first addressed whether the statute was inapplicable because the capitalization of the partnership constituted a bona fide sale for an adequate and full consideration in money or money's worth. Not surprisingly, the court followed the Tax Court in holding that this exception does not apply to consideration received on the formation of a family limited partnership.[29]

The more interesting part of the court's opinion concerns its discussion of what it labeled the "Retained Income or Rights Exception." After citing precedent for the proposition that section 2036(a)(1) applies if there exists an express or implied agreement at the time of the transfer that the transferor will retain the current economic benefits of the transferred property,[30] the court noted that "[i]n this case, there is no need to search for an implied agreement" among the parties.[31] Rather, the partnership agreement itself was sufficient.[32] The court noted that pursuant to the partnership agreement, the decedent possessed the ability to remove the LLC as general partner and to name herself in its place. The general partner had "sole discretion" over distributions of income from the partnership. Because the decedent had the ability to designate the general partner, she retained the power "to either personally benefit from the income of the partnership or to designate the persons who would benefit from the income of the partnership."[33] The court therefore concluded that the partnership property was included in

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[20] *Id.*

[21] *Id.* slip op. at 4. In footnote 5, the court notes that the partnership agreement placed certain restrictions on distributions by the general partner. However, the court does not elaborate on what those restrictions entailed.

[22] *Id.*

[23] *Id.*

[24] *Id.*

[25] *Id.*, slip op. at 2 (citing *Estate of Harper v. Commissioner*, T.C. Memo. 2002-121, 83 T.C.M. (CCH) 1641, *Doc 2002-11394 (75 original pages), 2002 TNT 95-11*). The Tax Court in *Harper* stated that "The general purpose of [section 2036] is 'to include in a decedent's gross estate transfers that are essentially testamentary' in nature." *Estate of Harper v. Commissioner*, T.C. Memo. 2002-121 (quoting *Ray v. United States*, 762 F.2d 361, 1362 (9th Cir. 1985)). The *Kimbell* court's description of the purpose of section 2036(a) is overbroad, because making outright transfers of one's property during life is a perfectly legitimate way to avoid the estate tax. Of course, avoiding the estate tax in this manner comes at the expense of potentially triggering gift tax.

[26] Section 2036(a) reads as follows:

> (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 the 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 which is 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.

[27] *Kimbell*, slip op. at 2.

[28] This description of the operation of section 2036(a) is nonconventional because the existence of the circumstances under subsections (a)(1) and (a)(2) generally is viewed as a prerequisite to inclusion under section 2036.

[29] *Id.* slip op. at 3-4. The court relied heavily on the Tax Court's resolution of this issue in *Estate of Harper v. Commissioner*, T.C. Memo. 2002-121, 83 T.C.M. (CCH) 1641. The Tax Court reached a similar conclusion in *Estate of Reichardt v. Commissioner*, 114 T.C. 144, 155-56, *Doc 2000-6219 (24 original pages), 2000 TNT 42-11* (2000), and *Estate of Thompson v. Commissioner*, T.C. Memo. 2002-246, 84 T.C.M. (CCH) 374, *Doc 2002-22023 (50 original pages), 2002 TNT 188-7*.

[30] *Kimbell*, slip op. at 4.

[31] *Id.*

[32] *Id.*

[33] *Id.*

the decedent's gross estate under section 2036(a)(1) and (a)(2).[34]

The estate argued that the Supreme Court decision in *United States v. Byrum*[35] prevented the application of section 2036(a) to the property transferred to the partnership because of the decedent's fiduciary duties. The court dispensed with this argument in summary fashion. The court noted that *Byrum* "is not only distinguishable on the facts from our case, but was expressly overruled by Congressional enactment of section 2036(b)."[36] The estate had a difficult time making the *Byrum* argument, given that the partnership agreement waived the general partner's fiduciary duty to the partnership and other partners. Yet this was not the sole basis on which the court found *Byrum* distinguishable. The court asked the following rhetorical question: "Assuming such fiduciary duties exist, to whom does a party which owns 99% of the Partnership owe them?"[37] The court concluded that "[t]he fiduciary argument falls flat."[38]

III. Analysis of the *Kimbell* Opinion

For a five-page slip opinion, the decision in *Kimbell* packs quite a punch. If the decision holds up on appeal and is followed by other courts, then the government will have gained significant ground in its ongoing struggle against the use of limited partnerships to generate valuation discounts. The *Kimbell* decision and its potential impact on other family limited partnerships are analyzed below.

A. Decedent's Control Over Distributions

The *Kimbell* decision is by no means the first time the Service has successfully argued that assets transferred to a limited partnership should be included under section 2036(a). The Service has won a handful of decisions under section 2036(a)(1). Yet these victories generally resulted from fact-intensive cases in which the Service was able to establish evidence that the taxpayer continued to use property transferred to the partnership as if it were her own. For instance, in *Estate of Reichardt v. Commissioner*,[39] the decedent deposited partnership income to his personal account, used the partnership checking account as a personal account, and lived in a residence transferred to the partnership without paying rent.[40] In *Estate of Harper v. Commissioner*,[41] income from securities transferred to the partnership was deposited to the decedent's personal checking account for several months before a partnership checking account was established. In addition, distributions were made from the partnership to the decedent for personal purposes.[42] In *Estate of Thompson v. Commissioner*,[43] the partnership distributed significant amounts to the decedent so that the decedent could make annual-exclusion gifts to his family members.[44] Additional distributions were made to the decedent to cover his living expenses.[45] In cases such as these, courts have little difficulty in finding the existence of an implied agreement or understanding among the parties that the taxpayer retained the enjoyment and economic benefit of the property transferred to the partnership sufficient to trigger inclusion under section 2036(a)(1).

The government's victory in *Kimbell* is quite different from prior victories under section 2036(a)(1). The decision did not depend on facts surrounding the operation of the partnership that suggested the decedent actually retained the beneficial enjoyment of the property transferred to the partnership. Rather, the court determined *on summary judgment* that section 2036(a) applied based on the structure of the partnership arrangement. The basis for inclusion was the decedent's retained power over distributions from the partnership. *Kimbell* was the first case in which a court held that the powers held by a general partner in a family limited partnership were sufficient to trigger inclusion under section 2036.

1. Section 2036(a)(1). The court's determination that the decedent retained "the possession or enjoyment of, or the right to income from" the property that she transferred to the partnership within the meaning of section 2036(a)(1) results from a straightforward application of the statute. Although section 2036(a) is typically associated with transfers in trust, the statute encompasses transfers "by trust or otherwise."[46] In addition, a "right to income" exists not only in the situations where the transferor has expressly reserved the income stream generated by the transferred property, but also in situations where the transferor retains the

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[34] *Id.* This was the first family limited partnership case to use section 2036(a)(2) as the ground for inclusion. The Tax Court apparently considered section 2036(a)(2) in *Estate of Thompson v. Commissioner*, but declined to address it since the parties had limited their arguments to section 2036(a)(1) — which the court found applicable. *See* T.C. Memo. 2002-246, n. 11. The court stated "we leave to another day the application of sec. 2036(a)(2) to family limited partnerships such as those existing in this case." *Id.*

[35] 408 U.S. 125 (1972).

[36] *Kimbell*, slip op. at 4.

[37] *Id.*

[38] *Id.*

[39] 114 T.C. 144 (2000).

[40] *Id.* at 152.

[41] T.C. Memo. 2002-121, 83 T.C.M. (CCH) 1641.

[42] *Id.* at 1645.

[43] T.C. Memo. 2002-246, 84 T.C.M. (CCH) 374).

[44] One year, the partnerships distributed $40,000 to the decedent so he could make Christmas gifts to his family members. Two years later, $45,000 was distributed to the decedent for this purpose. *Id.*

[45] There was evidence that a $12,500 distribution was made to the decedent to provide him with sufficient funds to meet his living expenses. *Id.*

[46] Section 2036(a).

discretionary ability to pay that income to herself or for her benefit.[47]

The *Kimbell* opinion does not discuss whether any distributions of income were made from the partnership to the decedent. Given that the partnership was in existence for only two months before the decedent's death, there very well may have been no distributions whatsoever. Yet the existence of actual distributions to the decedent is immaterial. As explained by the Tax Court in *Estate of Pardee v. Commissioner*, section 2036(a)(1) is not limited to situations in which income was actually distributed to the decedent during life:

> [S]ection 2036(a)(1) refers not only to the possession or enjoyment of property, but also to "right to income" from property. The section does not require that the transferor pull the "string" or even intend to pull the string on the transferred property; it only requires that the string exist.[48]

In the *Kimbell* case, the decedent's "string" was her ability to appoint herself as general partner in which capacity she would have possessed sole discretion over distributions of partnership income. In this manner, the decedent retained the ability to distribute the income generated by the partnership assets to herself as 99 percent limited partner.

2. Section 2036(a)(2). Section 2036 not only applies where a transferor retains the right to the income from transferred property, it also applies in situations where the transferor has retained the ability to affect the income interests of other beneficiaries. Specifically, section 2036(a)(2) applies when the transferor retains the "right . . . to designate the persons who shall possess or enjoy the property or the income therefrom." The Supreme Court has stated that the term "right" as used in subsection (a)(2) "connotes an ascertainable and legally enforceable power."[49]

At first glance, these ground rules make it appear as if section 2036(a)(2) may not be applicable to the facts at issue in *Kimbell*. Because the decedent was not serving as general partner at the time of her death, she did not actually possess authority over distributions of partnership income. Furthermore, if the partnership agreement specified the manner in which distributions of partnership income would be made if they were declared, then any discretion over partnership distributions would not involve determining which particular partner would receive the income. Yet the scope of section 2036(a)(2) exceeds what one may expect on first reading the statute.

To start, the ability to accumulate income from transferred property as opposed to making a current distribution of that income constitutes the right to "designate the persons" who shall possess or enjoy the income from the transferred property under section 2036(a)(2).[50] Thus, even if the partnership agreement in *Kimbell* specified the manner in which any distributions from the partnership had to be made, the mere ability to delay the beneficial enjoyment of partnership income is sufficient to trigger inclusion under section 2036(a)(2).

In addition, the level of participation in a decision concerning the income from transferred property that triggers the application of section 2036(a)(2) is quite low. For instance, a section 2036(a)(2) power exists even if it must be exercised in conjunction with another person or persons.[51] In this regard, it is immaterial whether the person with whom the power has to be exercised has an interest adverse to the exercise of the power.[52] Furthermore, a section 2036(a)(2) power exists even if the actual exercise of that power is subject to a contingency beyond the decedent's control that did not occur before the decedent's death.[53]

In *Kimbell*, the decedent's authority over distributions of partnership income was subject to a condition precedent within her control — the ability to remove the LLC as general partner and to name herself in its place. This power is akin to the situation contemplated in the regulations in the context of a trust:

> If the decedent reserved the unrestricted power to remove or discharge a trustee at any time and appoint himself as trustee, the decedent is considered as having the powers of the trustee.[54]

Accordingly, the court's determination that the decedent in *Kimbell* should be charged with the powers held by the general partner even though she was not serving as general partner at the time of her death is consistent with the regulations interpreting section 2036(a)(2).

B. Rejection of *Byrum* Defense

The estate argued that section 2036(a) could not apply to the partnership arrangement on account of the decedent's fiduciary duties. The estate relied on the Supreme Court decision *United States v. Byrum*,[55] which

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[47] *Estate of Pardee v. Commissioner*, 49 T.C. 140, 147-48 (1967) (holding that the decedent's ability as trustee to use trust income to discharge his legal obligation of supporting his children constituted the retention of the right to the income of property the decedent transferred to the trust for purposes of section 2036(a)(1)).

[48] *Id.* at 148 (citing *Estate of McNichol v. Commissioner*, 265 F.2d 667, 671 (3d Cir. 1959)). The Third Circuit in *McNichol* noted that Congress inserted the phrase "right to" before "income" to make clear that the statute should apply in situations where the decedent was entitled to income even though he did not actually receive it. *McNichol*, 265 F.2d at 671.

[49] *See Byrum*, 408 U.S. at 136. The Supreme Court in *Byrum* rejected the government's argument that the decedent possessed a section 2036(a) power over a corporation's distribution policy through his ability to elect the corporate directors. *Id.* at 136-37; *see also Estate of Tully v. United States*, 528 F.2d 1401, 1404-05 (Ct. Cl. 1976) (holding that a section 2038 power to revoke does not include "powers of persuasion" over a corporation held by a 50 percent shareholder).

[50] *See Struthers v. Kelm*, 218 F.2d 810, 814 (8th Cir. 1955); *Estate of Alexander v. Commissioner*, 81 T.C. 757, 763-65 (1983); *Estate of O'Connor*, 54 T.C. 969, 973 (1970); *see also United States v. O'Malley*, 383 U.S. 627, 631 (1966) (describing as well-settled the principle that the power to accumulate trust income constitutes the power to designate under section 2036(a)(2)).

[51] Section 2036(a)(2); reg. section 20.2036-1(b)(3).

[52] Reg. section 20.2036-1(b)(3)(i).

[53] Reg. section 20.2036-1(b)(3)(iii).

[54] Reg. section 20.2036-1(b)(3).

[55] 408 U.S. 125 (1972).

held that a decedent's influence over a corporation as majority shareholder was not sufficient to include transferred stock of that corporation in his gross estate under section 2036(a). The *Byrum* decision has long been viewed as shielding owners of a closely held business entity from the application of section 2036. Yet the court in *Kimbell* rejected the estate's argument under *Byrum* for two reasons. First, the court stated that *Byrum* was distinguishable on its facts.[56] Second, the court described *Byrum* as having been overruled by the enactment of section 2036(b).[57]

1. Conclusion that *Byrum* is distinguishable. While the district court in *Kimbell* did not describe the basis on which it found *Byrum* distinguishable, the court's conclusion to that effect is justifiable.[58] *Byrum* involved a decedent who created an irrevocable trust for the benefit of his children and funded the trust with shares of stock that he owned in three closely held corporations.[59] The decedent named an independent corporation as trustee, and the trust instrument provided that the trust was authorized, in its sole discretion, to pay income and principal of the trust to or for the benefit of the trust beneficiaries.[60] Nonetheless, the decedent retained the right to vote the shares of closely held stock that he transferred to the trust, as well as the right to veto any sale or other transfer of the stock by the trust.[61] The trust retained the corporate stock until the decedent's death, at which time the decedent possessed the right to vote not less than 71 percent of the stock of each corporation.[62] Each corporation had minority shareholders unrelated to the decedent.[63]

The government argued that the stock of the closely held corporations owned by the trust should have been included in the decedent's gross estate under section 2036(a)(2).[64] The specifics of the government's argument were as follows: Through his ability to vote a majority of the shares of each corporation, the decedent was able to select the corporate directors. The ability to determine board membership gave the decedent effective control over the corporate dividend policy. According to the government, the decedent's ability to control the flow of dividends to the trust provided the decedent with the power to shift the beneficial enjoyment of trust income between the current trust beneficiaries and the remaindermen.[65] This latter power falls within the scope of section 2036(a)(2).

The Court soundly rejected the government's argument. First, the Court explained that the "right" under section 2036(a)(2) to designate the persons who shall possess or enjoy the income from property "connotes an ascertainable and legally enforceable power."[66] The Court pointed out that any influence the decedent may have had over the corporate directors as the majority shareholder "was neither ascertainable nor legally enforceable and hence was not a right in any normal sense of that term."[67] The Court further noted that a majority shareholder's influence over a corporation is limited by the shareholder's fiduciary duty not to misuse his power by promoting his personal interests at the expense of the corporation, as well as the fiduciary duty owed by the directors to promote the corporation's best interests.[68]

While it appears the Court could have ended its analysis there, it went on to further discredit the government's argument on grounds that it "misconceive[d] the realities of corporate life."[69] The Court noted that in a typical small business, there is no guarantee that funds will exist for distribution in the first place:

> There is no reason to suppose that the three corporations controlled by Byrum were other than typical small businesses. The customary vicissitudes of such enterprises — bad years; product obsolescence; new competition; disastrous litigation; new, inhibiting Government regulations; even bankruptcy — prevent any certainty or predictability as to earnings or dividends. There is no assurance that a small corporation will have a flow of net earnings or that income earned will in fact be available for dividends. Thus, Byrum's alleged de facto "power to control the flow of dividends" to the trust was subject to business and economic variables over which he had little or no control.[70]

The Court stressed that even if funds were available for distribution, the directors of the closely held corporation would expose themselves to derivative suits if they subordinated the interests of the corporation to the will of the majority shareholder.[71] To bolster this argument, the Court reiterated that in each of the corporations at issue there existed a substantial number of minority shareholders unrelated to the decedent who would have had a cause of action against the decedent and the corporate directors had they violated their fiduciary duties.[72] Accordingly, the Court concluded that the decedent's ability to elect the board of directors was not tantamount to the power to regulate the flow of dividends to the trust.[73]

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[56] *Kimbell v. United States*, 2003 WL 138081 slip op. at 4 (N.D. Tex. 2003).

[57] *Id.*

[58] In a prior article, I argued that *Byrum* should not protect the powers held by the transferor over distributions of partnership income as the general partner from the application of section 2036(a)(2). *See* Brant J. Hellwig, "*Estate of Strangi*, Section 2036, and the Continuing Relevance of *Byrum*," *Tax Notes*, Aug. 26, 2002, p. 1259.

[59] *Byrum*, 408 U.S. at 126.

[60] *Id.* at 126-27.

[61] *Id.* at 127.

[62] *Id.* at 128-29.

[63] *Id.* at 130, 142.

[64] *Id.* at 131-32.

[65] *Id.* at 132.

[66] *Id.* at 136.

[67] *Id.* at 136-37.

[68] *Id.* at 137-38.

[69] *Id.* at 139.

[70] *Id.* at 139-40.

[71] *Id.* at 141.

[72] *Id.* at 142.

[73] *Id.* at 143.

The Supreme Court's decision in *Byrum* bears little resemblance to the facts of the *Kimbell* case. Perhaps most significantly, the partnership agreement in *Kimbell* expressly waived the general partner's fiduciary duty to the partnership and the remaining partners. Yet the court in *Kimbell* did not base its distinction of *Byrum* on this fact alone. Rather, the court questioned to whom a fiduciary duty would be owed by a 99 percent partner of the partnership, assuming that such fiduciary duty existed.

Even had the partnership agreement in *Kimbell* not waived the general partner's fiduciary duty, there existed sufficient reason to determine that *Byrum* was not controlling precedent under the facts of the *Kimbell* case. First, the decedent in *Kimbell* possessed more than a right to influence the distribution policy of the partnership. The general partner possessed sole discretion over distributions of partnership income, and the decedent retained the unilateral right to appoint herself to serve in that capacity. Furthermore, whereas the Supreme Court in *Byrum* placed significant emphasis on the business and economic variables that the corporations at issue had to face in determining their dividend policy, there is no indication that the partnership in *Kimbell* operated a "typical small business" that would require the general partner to consider the "customary vicissitudes" of a business enterprise in determining the partnership's distribution policy. Last, unlike the corporations at issue in *Byrum*, the partnership in *Kimbell* was comprised only of parties related to the decedent. The decedent owned a 99.5 percent beneficial interest in the partnership (99 percent as limited partner, 0.5 percent through the LLC as general partner). Beneficial ownership of the remaining 0.5 percent rested with decedent's son and daughter-in-law. Accordingly, there existed no unrelated party to enforce the decedent's fiduciary duty if violated. Simply put, the facts that led to the Supreme Court's holding in *Byrum* were lacking in the *Kimbell* case.

2. Assertion that *Byrum* was overruled. The district court's assertion that *Byrum* had been overruled through the enactment of section 2036(b) is overbroad. Through the enactment of section 2036(b) as part of the Tax Reform Act of 1976,[74] Congress legislatively overruled the *Byrum* decision in certain situations where a taxpayer transfers voting stock in a corporation while retaining the right to vote the transferred stock.[75] Yet it is widely understood that *Byrum* remains valid precedent to the extent not expressly superceded by the statute.[76] In fact, not that long ago the Service agreed that *Byrum* prevented the application of section 2036(a)(2) to the powers of a general partner in a closely held limited partnership.[77] Given that the district court determined that *Byrum* was distinguishable on its facts, its overbroad description of the effect of section 2036(b) on the *Byrum* precedent may be inconsequential.

C. Impact of *Kimbell* on Other Cases

If *Kimbell* is upheld on appeal and followed by other courts, the decision could prove to be a powerful decision for the government. The reason is simple. Inclusion under section 2036(a)(1) based on the decedent's continued use of partnership property can be avoided by those taxpayers who respect the separate nature of the partnership and retain sufficient assets in their own name to ensure that potentially problematic distributions from the partnership are not made. On the other hand, inclusion under section 2036(a)(1) and (a)(2) based on the decedent's authority over distributions of partnership income cannot be so easily circumvented. For many individuals, the limited partnership arrangement is palatable only because it enables the transferor to retain control over the assets contributed to the partnership. As described above, the level of control over partnership income sufficient to trigger section 2036(a) is quite minimal. For instance, a transferor capitalizing a family limited partnership cannot avoid the application of section 2036(a) by serving as just one of several general partners.[78] Furthermore, if a corporation or LLC is named as general partner, then the decedent's appointment as a member of the board of directors of the corporation or as a manager of the LLC may itself be sufficient to trigger the application of section 2036(a) to the partnership assets.[79] In short,

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[74] Pub. L. No. 94-55, section 2009(a), as amended by Revenue Act of 1978, Pub. L. No. 95-600, section 702(i).

[75] Section 2036(b) provides that section 2036(a)(1) applies to a transfer of voting stock in a corporation if (a) the transferor retained the right to vote the stock (either directly or indirectly), and (b) at any time after the transfer and within the three-year period preceding the transferor's death the transferor possessed (either directly or through the stock attribution rules of section 318) the right to vote at least 20 percent of the total combined voting power of all classes of stock.

[76] *See* Joseph M. Dodge, "Transfers with Retained Interests and Powers," *50-5th Tax Management Portfolio (BNA)*, at A-47 (1992):

> [Section 2036(b)] leaves the *Byrum* holding as to section 2036(a)(2) undisturbed, so that it will continue to influence retained-powers doctrine. Moreover, the amendment does not really alter the *Byrum* holding as to section 2036(a)(1) (*i.e.*, namely, that a retained interest must involve substantial measurable economic enjoyment) except of course insofar as section 2036(b) applies by its terms.

[77] TAM 9131006 (Aug. 2, 1991). Apparently, the government has reconsidered whether *Byrum* has such wide-ranging impact. Pursuant to section 6110(k)(3), the TAM cannot be cited as precedent and therefore is not binding on the government.

[78] Reg. section 20.2036-1(b)(3)(i).

[79] Pursuant to reg. section 20.2036-1(b)(3)(i), in determining whether a section 2036(a)(2) power exists it is immaterial what capacity the power was exercisable by the decedent. Furthermore, it is immaterial that the power could be exercised by the decedent only in conjunction with another person or persons. Thus, where a corporation or LLC exists only to serve as the general partner of a family limited partnership, the powers over distributions of partnership income held by the transferor as a director of the corporate general partner or as a manager of the LLC general partner appear to fall squarely within the scope of section 2036(a)(2). This argument, however, was implicitly rejected by the Supreme Court in *Byrum*. Although the decedent in *Byrum* was a director of the corporations at issue, the Supreme Court focused

(Footnote 79 continued on next page.)

if the Service has continued success in applying section 2036(a)(1) and (a)(2) to family limited partnerships based on the decedent's control over distributions of partnership income, many partnerships previously considered exempt from section 2036(a) will be caught in its net.[80]

Yet even if *Kimbell* is followed by other courts, family limited partnerships will still offer significant transfer-tax advantages to certain taxpayers. To start, those partnerships that conduct an actual business operation as opposed to serving as mere holding vehicles for the decedent's investment property will still be able to enjoy the protection that *Byrum* offers from section 2036(a). For those partnerships not falling under the *Byrum* umbrella, section 2036(a) will not apply if the transferor is content to relinquish authority over distributions of partnership income. Accordingly, those taxpayers who otherwise would be comfortable making an outright gift could utilize a family limited partnership to intentionally depress the value of the transfer. Furthermore, even if the transferor capitalizes a family limited partnership and retains authority over partnership distributions otherwise sufficient to trigger section 2036(a), that section will have no effect if the power is released prior to the decedent's death. (However, if the transferor releases the power within the three-year period preceding her death, section 2035(a) would operate to pull the partnership property back into the gross estate.[81]) Thus, the application of section 2036(a) to a decedent's retained powers over partnership income would not constitute the death knell of limited partnerships as an estate-planning tool altogether. But it would signal the end of the ability of taxpayers to have their cake and eat it too by retaining control over the beneficial enjoyment of transferred property while subjecting only their retained interest (valued on a discounted basis) to estate tax.

IV. Relation to *Estate of Strangi* Case

It will be interesting to see if the Tax Court reaches conclusions similar to that of the district court in *Kimbell* in deciding the *Estate of Strangi* case on remand. The two cases bear a strong factual resemblance. The decedent in *Estate of Strangi* contributed assets worth $9,876,929 (mostly in the form of cash and securities) to a limited partnership in exchange for a 99 percent interest as limited partner.[82] The decedent and his four children capitalized a corporation, which transferred approximately $100,000 to the partnership in exchange for a 1 percent general partner interest.[83] The decedent owned 47 percent of the stock of the corporate general partner, and the remaining 53 percent was held by the decedent's children equally except for 100 shares that the children donated to a local community college.[84] The transfers of the decedent's property to the partnership and the corporate general partner were effected by the decedent's son-in-law, who had assumed responsibility for the decedent's financial affairs pursuant to a preexisting power of attorney.[85] To round things out, the decedent and his children, as directors of the corporate general partner, executed a unanimous consent to employ the son-in-law to manage the day-to-day affairs of the corporate general partner and the partnership.[86]

At the time the partnership was formed, the decedent in *Estate of Strangi* required continuous home health care, as he suffered from a brain disorder.[87] Roughly two months after the partnership was formed, he died of cancer at the age of 81.[88]

Unlike the *Kimbell* case, it is not clear whether the decedent in *Estate of Strangi* possessed the power as 99 percent limited partner to remove the corporation as general partner and name a replacement. Yet perhaps there is no need to attribute the powers of the corporate general partner to the decedent in this manner. Assuming that the decedent's son-in-law possessed authority over the timing and amount of distributions from the partnership as the appointed manager of the day-to-day affairs of the corporate general partner, it is reasonable to attribute these powers to the decedent. The partnership and corporate general partner were formed by the son-in-law on behalf of the decedent pursuant to a power of attorney. Similarly, the son-in-law acting under the power of attorney capitalized the partnership almost exclusively with the decedent's assets. At the time these events took place, the decedent was in all likelihood incompetent as he suffered from

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only on the influence the decedent possessed over the corporations as a majority shareholder. Similarly, the Court of Claims in *Estate of Tully v. United States*, 528 F.2d 1401, 1404-05 (1976), held that the decedent's influence over a corporation in which he was a 50 percent shareholder did not provide the decedent with a section 2038 power to revoke a spousal death benefit offered by the corporation. Like *Byrum*, the Court of Claims in *Estate of Tully* did not expressly address the decedent's voting rights as a director. Nonetheless, where a corporation is formed for the sole purpose of serving as the general partner of a limited partnership which itself is used as a trust substitute, it is hard to meaningfully distinguish the roles played by the directors of the corporate general partner from the roles played by cotrustees of a trust. The ability to participate in decisions over trust income as a cotrustee is a classic example of a joint power encompassed by section 2036(a).

[80] *See* Burgess J.W. Raby and William L. Raby, "Section 2036 and the Family Limited Partnership," *Tax Notes*, Feb. 24, 2003, p. 1241, 1244 (stating that "If the involvement of unrelated third parties à la *Byrum* is essential for there to be a valid fiduciary obligation, then we suspect that a majority of the FLPs that have been created in the past decade or so are vulnerable to a section 2036 challenge when [the principal contributor] dies.")

[81] The three-year rule under section 2035(a) would also apply if the discretionary power over partnership income were terminated because the decedent, in conjunction with other partners, voted to liquidate the partnership. *See* TAM 199935003, *Doc 1999-28573 (7 original pages), 1999 TNT 172-21* (commutation of decedent's interest in grantor retained interest trust constituted a transfer for purposes of section 2035 because the commutation was effected by the trustee's actions with the consent of the decedent).

[82] *Estate of Strangi v. Commissioner*, 115 T.C. 478, 481 (2000).

[83] *Id.*

[84] *Id.* at 481-82. It is not clear from the opinion what percentage ownership the 100 donated shares represented.

[85] *Id.* at 480.

[86] *Id.* at 482.

[87] *Id.* at 480, 482.

[88] *Id.* at 482.

a brain disorder and required 24-hour home health care. Accordingly, the son-in-law's role in the partnership cannot be viewed as that of a disinterested third party. Rather, his role was that of the decedent's appointed agent.[89] In this manner, the decedent retained control over the distributions of income generated from the partnership property.[90]

The facts of *Estate of Strangi* provide the Service with a good argument for inclusion under section 2036(a) based on the decedent's control over distributions from the partnership. The following comments in the original Tax Court opinion in *Estate of Strangi* indicate that the court may be receptive to this argument:

> The actual control exercised by [the son-in-law], combined with the 99-percent limited partnership interest in [the limited partnership] and the 47-percent interest in [the corporate general partner], suggest the possibility of including the property transferred to the partnership in decedent's estate under section 2036.[91]

Furthermore, in rejecting the Commissioner's gift-upon-formation argument, the Tax Court stated that "we do not believe that decedent gave up control over the assets."[92] Assuming that the decedent's control over the partnership assets extended to decisions regarding the timing and amount of partnership distributions, then the decedent possessed the power to distribute income to himself as well as the other beneficial owners of the partnership. In that case, the property transferred to the partnership by the decedent should be included in his gross estate at its undiscounted date-of-death value under section 2036(a)(1) and (a)(2).

V. Conclusion

The decision by the district court in *Kimbell* presents the Service with a potentially significant victory in its ongoing battle against family limited partnerships. However, at this point it is not clear whether the decision will have any wide-ranging impact. Although the district court's conclusions regarding the application of section 2036(a)(1) and (a)(2) as well as the nonapplicability of *Byrum* appear correct, the opinion could have benefited from a more detailed analysis of the issues.[93] Given that there is more than $800,000 in estate tax at stake, the case surely will be appealed to the Fifth Circuit. Thus, the possibility exists that the district court's opinion in *Kimbell* will amount to nothing more than a flash in the pan for the government.

Nonetheless, the government's argument for including the assets transferred to a family limited partnership under section 2036(a)(1) and (a)(2) based on the decedent's retained control over partnership distributions has a sound legal foundation. The argument certainly would gain a good deal of traction if the Tax Court were to apply it on remand in *Estate of Strangi*. Given that section 2036(a) would operate to include the date-of-death value of all property transferred to the partnership by the decedent, what used to be the Service's best-case scenario in its struggle against family limited partnerships — including in the gross estate the value of the decedent's beneficial interest in the partnership at no discount — could suddenly become a reasonable settlement position.

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[89] The basis for attributing the powers held by the son-in-law to the decedent was articulated by Judge Beghe in his separate dissenting opinion:

> Against the grain of the majority's conclusions that the SFLP arrangements were neither a factual nor a substantive sham, I would observe that another "conceivable basis for concluding that decedent retained control over the assets that he contributed to the partnership" (Ruwe, J., dissenting op. p. 499 n. 2) are the multiple roles played by Mr. Gulig, who had decedent's power of attorney and caused himself to be employed by Stranco to manage the affairs of SFLP, and the tacit understanding of the other family members that he would look out for their interests.

Id. at 501 n.1 (2002) (Beghe, J., dissenting). In this regard, one would have to question the propriety of an agent transferring all of his principal's property to a limited partnership over which the agent did not maintain control of the transferred property.

[90] The decedent in *Strangi* was named as a director of the corporate general partner. *Id.* at 481. Thus, if authority over partnership distributions was not delegated to the son-in-law as the manager of the day-to-day affairs of the corporation, it is possible that the decedent's participation as a director of the corporate general partner in decisions regarding partnership distributions is itself sufficient to trigger section 2036(a). For a discussion of this issue, see *supra* note 79.

[91] *Id.* at 486.

[92] *Id.* at 490. Judge Ruwe, a proponent of the gift-upon-formation argument, questioned the majority opinion's statements regarding the decedent's control over SFLP:

> While the basis for finding that decedent did not give up control of the assets is not fully explained, it appears not to be based on the literal terms of the partnership agreement which gave control to Stranco, the corporate general partner. Decedent owned only 47 percent of the Stranco stock.

Id. at 499 n.2 (Ruwe, J., dissenting).

[93] Another aspect of the *Kimbell* opinion that calls the court's reasoning into question is the discussion contained in footnote 1. The court noted that it declined to address the issue of whether the transferred partnership interests should be valued as a limited partnership interest or an assignee interest. The court's reason for doing so was that the parties were nearing settlement of other aspects of the case, including this issue. Yet the court's conclusion under section 2036 rendered the limited partnership vs. assignee interest issue moot. If the property transferred to the partnership were included at its fair market value under section 2036, there would be no need to value the transferred partnership's interests whatsoever.

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