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KIMBELL V. UNITED STATES: THE RISE AND APPARENT FALL OF THE SECTION 2036 ARGUMENT AGAINST FLPs

By Brant J. Hellwig

Brant J. Hellwig is an assistant professor at the University of South Carolina School of Law. The author is grateful to Gregg Polsky and Howard Zaritsky for their comments and suggestions on earlier drafts of this article. The author also wishes to recognize the valuable research assistance provided by Jeffrey Allen. The opinions expressed herein do not necessarily represent the views of anyone other than the author.

In this report, Professor Hellwig examines the application of section 2036 to family limited partnerships in the context of the Fifth Circuit's recent opinion in *Kimbell v. United States*. After describing how the government developed section 2036 into an effective tool in combating the use of family limited partnerships to generate transfer tax savings, the report details how the Fifth Circuit's interpretation of the "adequate and full consideration" exception to section 2036 in *Kimbell* severely curtails the government's position. The report concludes with criticisms of the *Kimbell* decision, namely that the court failed to properly follow its own precedent in *Wheeler v. United States* and that the court failed to consider the legislative purpose behind section 2036 in interpreting the adequate and full consideration exception.

Table of Contents

I. **Introduction** . . . 517
II. **Background** . . . 518
   A. Factual Setting . . . 518
   B. The District Court Opinion in *Kimbell* . . . 518
   C. Intervening Tax Court Decisions . . . 521
III. **The Fifth Circuit Decision** . . . 524
   A. Adequate and Full Consideration Exception . . . 524
   B. Retained Powers . . . 527
IV. **Assessment of the Fifth Circuit Decision** . . . 527
   A. Avoiding the No-Gift-on-Formation Argument . . . 528
   B. 'Classic Mixing of Apples and Oranges' . . . 530
   C. Proper Analytical Framework . . . 530
V. **The Business Purpose Inquiry** . . . 532
   A. The Fifth Circuit Approach . . . 532
   B. Distinguishing Among Nontax Justifications . . . 532
   C. The Merits of Vagueness . . . 533
VI. **Conclusion** . . . 534

I. Introduction

The government for years has engaged in a litigation campaign seeking to stem the hemorrhaging of the transfer tax base that has occurred through the widespread use of family limited partnerships to obtain valuation discounts. While the result of this campaign had been largely unfruitful, the government did mount a slow but steady argument against family limited partnerships under section 2036. The early victories under section 2036 involved decedents who had failed to respect the partnership as an entity separate and distinct from their personal affairs. Thus, the government's success in arguing that the taxpayer had retained the beneficial enjoyment of the property transferred to the partnership under section 2036(a)(1) did not come as much of a surprise. But in two court victories in 2003, the government appeared to significantly expand the reach of its section 2036 argument. In *Kimbell v. United States*[1] and *Estate of Strangi v. Commissioner*,[2] the government successfully argued that section 2036(a)(1) and (a)(2) applied to pull the partnership property back into the decendent's gross estate based on the decedent's retained right to distribute income generated from the partnership property to herself and other beneficial owners of the entity. This broader application of section 2036, potentially reaching any partnership in which the decedent had retained a general partner interest, sent a significant shock through the estate planning community.[3]

The broad-based threat of section 2036 to family limited partnerships, however, may very well have been short-lived. The Fifth Circuit recently issued its opinion

[1]244 F. Supp. 2d 700, *Doc 2003-2946, 2003 TNT 22-12* (N.D. Tex. 2003).

[2]85 T.C.M. (CCH) 1331, *Doc 2003-12584, 2003 TNT 98-16* (2003).

[3]*See* Anne Turgesen, "A Tax Deal Too Good to Be True?" *BusinessWeek*, Aug. 4, 2003, at 102 (describing the Tax Court's decision in *Strangi* on remand as having "rocked the quiet world of estate planners").

on appeal in *Kimbell*[4] and, in the process, took most of the wind out of the government's section 2036 argument. The Fifth Circuit held that the decedent's transfer of property to the partnership in exchange for a 99 percent interest in the entity constituted a "bona fide sale for an adequate and full consideration in money or money's worth," thus satisfying the internal exception to the application of the statute. In reaching that conclusion, the Fifth Circuit saw no problem with the estate's assertion that the retained partnership interest — measured against the value of property contributed to the entity — was worth roughly 50 cents on the dollar. Furthermore, the court's interpretation of the business purpose for the formation of the partnership that is necessary to satisfy the adequate and full consideration exception to section 2036 set the bar so low that the only taxpayers who will fail to satisfy the exception are those who don't bother to pick up their feet. Therefore, if the Fifth Circuit's decision in *Kimbell* is followed by other circuits,[5] the section 2036 argument will be reduced to a whimper.

> ***If the Fifth Circuit's decision in Kimbell is followed by other circuits, the section 2036 argument will be reduced to a whimper.***

The purpose of this report is to evaluate the Fifth Circuit's decision in *Kimbell*. After describing the background of the section 2036 argument that led up to the Fifth Circuit's decision, the report will examine the manner in which the court interpreted the adequate and full consideration exception to section 2036(a) in the partnership context. The report concludes that the court not only failed to properly follow its own precedent interpreting the exception to section 2036, but it also failed to appreciate the overall purpose of section 2036 in determining the degree of nontax justifications necessary for the partnership formation to constitute a bona fide sale.

II. Background

A. Factual Setting

Because the *Kimbell* case has earned a measure of notoriety in the tax community, many are already familiar with the circumstances surrounding the formation of the partnership at issue in the case. Nonetheless, additional facts concerning the transaction were revealed in the Fifth Circuit opinion. If nothing else, a brief recitation of the facts is offered for the uninitiated.[6]

The case concerns the formation and operation of the R.A. Kimbell Property Co., Ltd., named on account of the decedent in the case, Ruth A. Kimbell. Before the formation of the partnership, Mrs. Kimbell held the majority of her assets through a previously existing revocable trust. Mrs. Kimbell and her son served as cotrustees of the trust, with her son managing the trust assets for a monthly fee. On January 29, 1998, Mrs. Kimbell, through the trust, transferred assets having an approximate value of $2.5 million to the partnership in exchange for a 99 percent interest as limited partner. The remaining 1 percent general partner interest was held by R.A. Kimbell Management Co., LLC which acquired the interest by contributing $25,000 in cash. Mrs. Kimbell owned a 50 percent interest in the LLC, while the remaining 50 percent interest was owned equally by her son and her daughter-in-law. The LLC was manager-managed, with Mrs. Kimbell's son serving as the sole manager.

The precise makeup of the assets Mrs. Kimbell contributed to the partnership remains somewhat of a mystery, at least to one relying on the reported decisions in the case. The Fifth Circuit opinion indicates that the assets contributed from Mrs. Kimbell's trust to the partnership consisted of cash, oil and gas interests, securities, notes, and other assets. The court emphasized that the oil and gas *working* interests constituted 11 percent of the contributed property, while oil and gas *royalty* interests constituted another 4 percent of the contributed property.[7] If Mrs. Kimbell's partnership is similar to the prototypical family limited partnership, then the bulk of the remaining property contributed to the partnership consisted of marketable securities and other liquid assets. Mrs. Kimbell did not, however, make the mistake of contributing all of her property to the partnership; rather, she retained more than $450,000 in assets outside of the partnership and the LLC for her personal expenses.

Mrs. Kimbell died at the age of 96 on March 25, 1998, less than two months after the partnership was formed. At the time of her death, the partnership assets were valued at approximately $2.4 million. In valuing the decedent's 99 percent interest in the partnership and 50 percent interest in the LLC, the estate claimed a combined 49 percent discount for lack of control and lack of marketability. If successful, Mrs. Kimbell would have reduced the value of her gross estate for federal estate tax purposes from roughly $2.4 million to $1.2 million through the mere expediency of transferring the majority of her investment assets to the partnership.

B. The District Court Opinion in *Kimbell*

The case came before the district court on the parties' cross-motions for summary judgment on the issue of whether section 2036(a)[8] operated to pull back into Mrs. Kimbell's gross estate the property she transferred to the

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[4]*Kimbell v. United States*, 371 F.3d 259, *Doc 2004-10976, 2004 TNT 100-9* (5th Cir. 2004).

[5]The next appellate case on this issue lies with the Third Circuit. *See Estate of Thompson v. Commissioner*, Docket No. 03-3173 in the Third Circuit Court of Appeals, on appeal from 84 T.C.M. (CCH) 374, *Doc 2002-22023, 2002 TNT 188-7* (2002).

[6]The summary of facts that follows is based on *Kimbell v. United States*, 244 F. Supp. 2d 700, 701-02 (N.D. Tex. 2003) and *Kimbell v. United States*, 371 F.3d 257, 259-60 (5th Cir. 2004).

[7]As explained in the Fifth Circuit opinion, a working interest in an oil and gas lease is a cost-bearing operating interest in the property. The owners of a working interest have the exclusive right to exploit the minerals on the land. A royalty interest, on the other hand, represents a passive right to receive a share of production, if any, free of costs. *See Kimbell*, 371 F.3d at 267.

[8]Section 2036(a) provides as follows:

(Footnote continued on next page.)

partnership. Section 2036 was a potentially powerful argument for the government. If successful, the value of the gross estate would be determined by reference to the date-of-death value of the assets Mrs. Kimbell had transferred to the partnership as opposed to the value of her partnership interests (determined through the application of various discounts). In other words, section 2036 would enable the government to disregard the partnership form in valuing Mrs. Kimbell's gross estate, thereby accomplishing statutorily what the government had previously failed to accomplish under common-law tax doctrines.[9]

> ***The precise makeup of the assets Mrs. Kimbell contributed to the partnership remains somewhat of a mystery, at least to one relying on the reported decisions in the case.***

Regarding the specifics of the section 2036 argument, the government asserted that section 2036(a) applied to the transfer of property to the partnership because Mrs. Kimbell, through her ability to name herself as general partner,[10] retained discretion over the timing and amounts of income distributions from the partnership. Mrs. Kimbell's ability to cause income to be distributed to herself implicated section 2036(a)(1), whereas her ability to cause income to be distributed to the other beneficial owners (in this case, the 1 percent LLC general partner) implicated section 2036(a)(2). The estate countered that section 2036(a) had no application to the transfer of property to the partnership, citing two principal grounds. First, the estate argued that section 2036(a)(1) and (a)(2) could not apply to any powers that Mrs. Kimbell held as a fiduciary in a business-related entity, citing the landmark Supreme Court decision in *United States v. Byrum*.[11] Yet even if the specific elements of section 2036(a)(1) and (a)(2) were satisfied, the estate argued that Mrs. Kimbell's transfer of property to the partnership in exchange for her 99 percent partnership interest constituted a "bona fide sale for an adequate and full consideration in money or money's worth," thereby satisfying the statute's internal exception.

The district court began its discussion of the section 2036 issue by portraying the statute as a broad rule of inclusion subject to two exceptions. As described by the court, the general rule under section 2036(a) is to capture in the gross estate any property of which the decedent has at any time made a transfer. If that rather broad general rule were implicated, the statute could be avoided if the transfer of property to the partnership satisfied the parenthetical exception for a "bona fide sale for an adequate and full consideration in money or money's worth," or the decedent retained neither the "possession or enjoyment of, or the right to income from the property" under section 2036(a)(1) nor the "right . . . to designate the persons who shall possess or enjoy the property or the income therefrom" under section 2036(a)(2).[12] Because Mrs. Kimbell had transferred property to the partnership, the district court immediately proceeded to address whether either of the two exceptions was satisfied.

(a) General Rule. — The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death —

(1) the possession or enjoyment of, or the right to the income from, the property, or

(2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

[9]In the original Tax Court opinion in *Estate of Strangi* (reviewed by the entire court), the court rejected the government's argument that the partnership should be disregarded for valuation purposes on grounds that it lacked sufficient economic substance. The court reasoned that because the partnership had been validly formed under state law and would not be disregarded by potential purchasers of the decedent's assets, the partnership had sufficient substance to be recognized for estate tax purposes. *See Estate of Strangi v. Commissioner*, 115 T.C. 478, 486-87, *Doc 2000-31014, 2000 TNT 232-12* (2000). The Fifth Circuit affirmed on this issue. *See Estate of Strangi v. Commissioner*, 293 F.3d 279, 281-82, *Doc 2002-14498, 2002 TNT 118-10* (5th Cir. 2002).

[10]At the time of Mrs. Kimbell's death, she was not serving as general partner of the partnership. Rather, the LLC of which her son was the sole manager served as the general partner. However, the partnership agreement provided that 70 percent of the limited partners in interest could remove the general partner and a majority of the limited partners in interest could name a replacement. *See Kimbell*, 244 F. Supp. 2d at 705. Thus, as 99 percent limited partner, Mrs. Kimbell retained the ability to remove the LLC as general partner and name herself in its place.

[11]408 U.S. 125 (1972). The specifics of the estate's argument under *Byrum* are not entirely clear. While the *Byrum* case is usually cited by taxpayers for the proposition that the general partner's fiduciary duty to the partnership prevents any discretionary powers over income distributions from constituting the requisite rights under section 2036(a)(1) or (a)(2), the estate would have had a difficult time making that argument. That is because the partnership agreement in *Kimbell* provided that "[t]he General Partner will not owe a fiduciary duty to the Partnership or to any Partner." *Kimbell*, 244 F. Supp. 2d at 705. Thus, the estate apparently argued that Mrs. Kimbell's fiduciary powers as majority partner prevented her from unilaterally naming herself as general partner in the first place. *See id.* ("[The estate] contends that Decedent did not have the power to take over the partnership because she had fiduciary duties. [The estate] makes much of a Supreme Court case, *United States v. Byrum*. . . .").

[12]This manner of approaching the statute is inappropriate because the general rule has unduly broad effect. Correctly analyzed, the elements articulated in section 2036(a)(1) and (a)(2) serve as predicates to the statute's application. Thus, as a general rule, section 2036(a) applies to any property which the decedent at any time made a transfer, provided the decedent retained for the requisite period either (a) the possession or enjoyment of the property, or the right to the income from the

(Footnote continued on next page.)

1. Bona fide sale exception. The district court opinion stated that for a transfer of property to constitute a "bona fide sale for an adequate and full consideration in money or money's worth" in terms of the statute, the transfer had to pass a two-part test. First, the transfer had to be a bona fide sale resulting from an arm's-length transaction. Second, the sale had to be for full and adequate consideration. The court found both elements lacking.

Regarding whether the transaction was a bona fide sale in terms of an arm's-length transaction, the court resorted to *Black's Law Dictionary* for the proposition that an arm's-length transaction is one between unrelated parties who are presumed to have roughly equal bargaining power. The court determined that not only did the transaction (that is, the transfer of property to the partnership) lack two unrelated parties, it lacked two parties altogether. Because Mrs. Kimbell retained a 99 percent interest as limited partner and a 50 percent interest in the 1 percent general partner, the court determined that she not only stood on both sides of the transaction but rather "was both sides of the transaction."[13]

The district court further explained that even if the transfer of property to the partnership had been the product of an arm's-length transfer, the decedent failed to receive adequate and full consideration. Relying on the Tax Court's analysis in *Estate of Harper*,[14] the court determined that "adequate and full consideration" for purposes of section 2036(a) does not include mere "paper transactions."[15] After noting that Mrs. Kimbell's son had managed the partnership property in the same way he had done before its contribution to the partnership, the court remarked that nothing appeared to have changed as a result of the transaction.[16] The district court proceeded to adopt the "recycling of value" theory previously articulated by the Tax Court in *Estate of Harper v. Commissioner* by quoting from the case:

> [A]ll decedent did was change the form in which he held his beneficial interest in the contributed property. . . . Essentially the value of the partnership interest the [t]rust received derived solely from the assets the [t]rust had just contributed. Without any change whatsoever in the underlying pool of assets or prospect for profit . . . there exists nothing but a circuitous "recycling" of value. We are satisfied that such instances of pure recycling do not rise to the level of a payment of consideration. To hold otherwise would open section 2036 to a myriad of abuses engendered by unilateral paper transformations.[17]

In this manner, the district court in *Kimbell* concluded that the partnership interest received by Mrs. Kimbell on account of the contribution of property to the entity did not constitute consideration whatsoever for section 2036(a) purposes, much less adequate and full consideration in money or money's worth. Rather, the partnership interest served as mere evidence of the decedent's continued beneficial interest in the transferred property.

2. Section 2036(a)(1)/(a)(2) analysis. After determining that the formation of the partnership did not satisfy the adequate and full consideration exception, the court addressed whether the specific elements of section 2036(a)(1) and (a)(2) were satisfied. The court disposed of the issue in short order. Noting that the partnership agreement provided Mrs. Kimbell (in her capacity as 99 percent limited partner) with the right to remove the LLC as general partner and to name herself in its place, the court concluded that the decedent retained the right to personally benefit from the income of the partnership and to determine if and when other beneficial owners of the entity would receive income distributions.[18] The former power implicated section 2036(a)(1), the latter section 2036(a)(2).

The district court then proceeded to explain that the Supreme Court's decision in *United States v. Byrum*[19] did not shield the application of section 2036(a) in the case by pointing out that the partnership agreement had expressly waived the general partner's fiduciary duties. The court did not base its decision on this waiver alone,

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property under section 2036(a)(1), or (b) the right to designate the persons who shall possess or enjoy the property or income therefrom under section 2036(a)(2). The district court analysis converts these predicates into negative exceptions. Although this analytical framework is flawed, it nonetheless was followed by the Fifth Circuit. *See Kimbell v. United States*, 371 F.3d 257, 261 (5th Cir. 2004).

[13]*Kimbell*, 244 F. Supp. 2d at 704.

[14]83 T.C.M. (CCH) 1641 (2002).

[15]*Kimbell*, 244 F. Supp. 2d at 704.

[16]*Id.*

[17]*Id.* at 704-05 (quoting *Estate of Harper v. Commissioner*, 83 T.C.M. (CCH) 1641, 1653, *Doc 2002-11394, 2002 TNT 95-11* (2002)). The "recycling of value" analysis first articulated in *Harper* was later followed by the Tax Court in *Estate of Thompson v. Commissioner*, 84 T.C.M. (CCH) 374, 388-89 (2002), and *Estate of Strangi v. Commissioner*, 85 T.C.M. (CCH) 1331, 1343-44 (2003), while being distinguished by the Tax Court in *Estate of Stone v. Commissioner*, 86 T.C.M. (CCH) 551, 579-80, *Doc 2003-24235, 2003 TNT 217-26* (2003).

[18]To be precise, the district court opinion concluded that section 2036(a)(2) was implicated because the decedent's potential powers as general partner allowed her to "designate the persons who would benefit from the income of the partnership." *Kimbell*, 244 F. Supp.2d at 705. The court's explanation of why section 2036(a)(2) applied is not technically correct. Assuming the partnership agreement provided for income distributions, if declared, to be made pro rata to all of the partners, Mrs. Kimbell did not in fact have the ability to pick and choose which partners would receive income payments. However, it is well-settled that the ability of a decedent to determine when and in what amounts income from transferred property will be distributed implicates section 2036(a)(2). *See United States v. O'Malley*, 383 U.S. 627 (1966). Had Mrs. Kimbell named herself as general partner, she clearly would have possessed this right.

[19]408 U.S. 125 (1972). In *Byrum* the Supreme Court held that the decedent's retention of the majority voting rights over stock transferred in trust for his children did not provide him with a section 2036(a)(2) right concerning distributions of income from the stock, citing the decedent's fiduciary obligations to determine the corporate dividend policy in the best interests of the entity.

however. Rather, the court said that any fiduciary duties the decedent may have possessed as general partner would have run to herself as 99.5 percent beneficial owner of the entity. That led the court to conclude that "[t]he fiduciary argument falls flat."[20]

C. Intervening Tax Court Decisions

1. *Estate of Strangi* on remand. Following the district court's decision in *Kimbell*, members of the tax community debated whether the decision was a mere aberration or an indication that the government had finally mounted a successful broad-based argument against the family limited partnership discounting strategy.[21] Most of the attention focused on the district court's application of section 2036(a) based on the powers the decedent had retained over income distributions and its comments regarding the status of the *Byrum* defense. Little attention was devoted to the court's holding on the adequate and full consideration issue.[22] During this time frame, the *Estate of Strangi* case was pending before the Tax Court on remand specifically for the consideration of the government's section 2036 argument.[23] While it was widely anticipated that the court would rule in the government's favor on the issue,[24] it was unclear whether the court would do so based on the narrow basis of the decedent's retained beneficial enjoyment of the partnership property or the much broader basis (as seen in *Kimbell*) of the decedent's retained discretionary authority over partnership income distributions.

Just a couple of months after the district court's decision in *Kimbell*, the Tax Court issued its decision on remand in *Estate of Strangi*.[25] The opinion can fairly be described as a resounding victory for the government on its section 2036(a) argument. On facts similar to those at issue in *Kimbell*,[26] the Tax Court determined that there existed an implied agreement among the parties that the decedent, Mr. Strangi, would retain the economic benefit of the property transferred to the partnership, thereby implicating section 2036(a)(1). This was consistent with a line of cases applying section 2036(a)(1) to cases in which decedents had continued to use partnership assets for personal purposes or otherwise failed to respect the partnership as an entity separate and distinct from their personal affairs.[27] Yet the Tax Court decision went much further. The court determined that the discretionary powers that Mr. Strangi had retained (through his son-in-law as his attorney-in-fact) over income distributions from the partnership implicated both section 2036(a)(1) and (a)(2). In the process of that analysis, the court undertook a thorough rejection of the estate's argument that the *Byrum* decision served as an absolute defense to applying section 2036(a)(1) and (a)(2) based on the decedent's discretionary powers over partnership distributions (exercised through the general partner).

After determining that the predicates for inclusion under section 2036(a) had been satisfied, the Tax Court addressed the estate's argument that the formation of the partnership constituted a bona fide sale for an adequate and full consideration in money or money's worth that, if satisfied, would have taken the entire transaction outside the scope of section 2036. In resolving that issue, the court reverted to the two-part inquiry it had articulated in *Estate of Harper*. First, the transfer had to constitute a bona fide sale, meaning an arm's-length transaction. Second, the decedent had to receive adequate and full consideration for the transferred property. Here again, the court found both elements lacking.

Regarding the bona fide sale prong of the analysis, the court determined that there existed no arm's-length transaction that led to the formation of the partnership. Rather, the entity was formed and funded through the acts of one person, Mr. Strangi's attorney-in-fact. Echoing the district court decision in *Kimbell*, the Tax Court concluded that the transaction failed as a bona fide sale because Mr. Strangi stood on both sides of the transaction.[28]

Regarding the existence of adequate and full consideration, the court returned to the "recycling of value"

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[20]*Kimbell*, 244 F. Supp. 2d at 706.

[21]*See* Brant J. Hellwig, "*Kimbell*: Is the Party Over for Family Limited Partnerships?" *Tax Notes*, Mar. 24, 2003, p. 1871; Jerry A. Kasner, "*Byrum* Is Alive and Well!" *Tax Notes*, Apr. 21, 2003, p. 394; J. Joseph Korpics, "For Whom Does *Kimbell* Toll — Does Section 2036(a)(2) Pose a New Danger to FLPs?," 98 *J. Tax'n* 162 (2003); Burgess J.W. Raby and William L. Raby, "Section 2036 and the Family Limited Partnership," *Tax Notes*, Feb. 24, 2003, p. 1241.

[22]Most of the attention to the adequate and full consideration exception did not arise until after the Tax Court released its decision in *Estate of Strangi v. Commissioner*, 85 T.C.M. 1331 (2003). *But see* Beverly R. Budin, "Some Thoughts on *Strangi*, *Byrum* and Section 2036," 28 *Tax Mgmt. Est. Gifts & Tr. J.* 120 (Mar.-Apr. 2003) (raising the adequate and full consideration issue in the family partnership context at an early stage).

[23]*Estate of Strangi v. Commissioner*, 293 F.3d 279 (5th Cir. 2002), *remanding* 115 T.C. 478 (2000).

[24]In the original Tax Court opinion in the case, the court said the facts of the case "suggest the possibility of including the property transferred to the partnership in decedent's estate under section 2036." *Estate of Strangi v. Commissioner*, 115 T.C. 478, 486 (2000). The Fifth Circuit, in its decision to remand the case for consideration of the section 2036(a) claim, remarked that the Tax Court "probably would have used that section to include in the estate the assets Strangi transferred to SFLP." *Estate of Strangi*, 293 F.3d at 281.

[25]*Estate of Strangi v. Commissioner*, 85 T.C.M. (CCH) 1331 (2003).

[26]Mr. Strangi transferred about $10 million of assets (mostly cash and securities) to a partnership in exchange for a 99 percent interest as limited partner roughly two months before he died of cancer at the age of 81. The partnership was formed and funded by Mr. Strangi's son-in-law, who years before had assumed management of his assets pursuant to a power of attorney. The son-in-law continued to manage the assets transferred to the partnership in his capacity as an employee of the corporate general partner. The estate valued Mr. Strangi's 99 percent partnership interest by applying a combined 33 percent valuation discount to the proportionate net asset value. *See id.* at 1332-35.

[27]*See, e.g., Estate of Reichardt v. Commissioner*, 114 T.C. 144, *Doc 2000-6219, 2000 TNT 42-11* (2000); *Estate of Schauerhamer v. Commissioner*, 73 T.C.M. (CCH) 2855, *Doc 97-15298, 97 TNT 103-7* (1997); *Estate of Rapelje v. Commissioner*, 73 T.C. 82 (1979).

[28]*Estate of Strangi*, 85 T.C.M. (CCH) at 1343-44.

analysis that it had first articulated in *Estate of Harper*, quoting the following passage from the case:

> To call what occurred here a transfer for consideration within the meaning of section 2036(a), much less a transfer for an adequate and full consideration, would stretch the exception far beyond its intended scope. . . . Without any change in the underlying pool of assets or prospect for profit, as, for example, where others make contributions of property or services in the interest of true joint ownership or enterprise, there exists nothing but a circuitous "recycling" of value.[29]

In measuring the partnership at issue in *Strangi* against that standard, the court determined that the partnership arrangement "patently fail[ed] to qualify as the sort of functioning business enterprise that could potentially inject intangibles that would lift the situation beyond mere recycling."[30] Therefore, the court concluded that the formation of the partnership constituted a mere change in the form of the beneficial ownership of the partnership property, and not the sort of consideration that would potentially render section 2036 inapplicable.

The Tax Court's acceptance of the government's application of section 2036 based on the decedent's retained powers over partnership distributions and the court's rejection of *Byrum* as an unqualified defense to the application of section 2036 in the partnership context sparked a flood of commentary on the decision, the majority of it critical.[31] One of the primary arguments raised in that round of commentary was that the Tax Court failed to properly interpret the adequate and full consideration exception to the statute. Many looked to the Fifth Circuit to clean up the alleged error on appeal. Yet as it turns out, the Tax Court would soon interpret that exception in the taxpayer's favor in *Estate of Stone v. Commissioner*.[32]

2. *Estate of Stone*. In the midst of a wave of momentum in favor of the government's use of section 2036 to combat the use of family limited partnerships for discounting purposes, along came the court's decision in *Estate of Stone* to stem the tide. The case involved a decedent (Eugene E. Stone III) who, with his wife (Allene W. Stone), had started a small apparel manufacturing company that eventually grew to become the worldwide distributor of Umbro soccer clothing.[33] Mr. Stone had recapitalized the corporation at an earlier point, retaining the preferred stock while transferring the majority of the common shares to trusts benefiting his children and grandchildren of which his two sons served as trustees. Mr. Stone's sons were active in the family business; his two daughters were not. Hence, the recipe for disaster. After the trusts failed to produce an income distribution for almost 20 years, the sisters sued to remove the brothers as trustees. This set off a torrid round of litigation among the children that ultimately led to the creation of the family limited partnerships at issue in the estate tax case.

As the trust litigation proceeded toward settlement, the children became concerned about what effect their participation in the dispute would have on their future inheritance. Even though Mr. and Mrs. Stone were not parties to the trust litigation, the various settlement proposals that were negotiated among the children addressed the manner in which their parents' estates would be distributed. As the trust litigation wound down, the aging Mr. and Mrs. Stone became less interested in managing their property. After a few failed settlement proposals, one of the son's business associates suggested that family limited partnerships could be used to serve the parties' goals. After conferring with their attorney, Mr. and Mrs. Stone followed through on this tip. In short, they resolved to create a separate partnership for each of their children.[34] After the children negotiated an agreement regarding how their parents' assets would be divided among the partnerships, Mr. and Mrs. Stone funded the partnerships with the designated property.[35] While Mrs. Stone took a minor interest in the entities as limited partner,[36] Mr. Stone retained the bulk of the limited partnership interest along with a 1 percent interest as general partner. The day before the partnership funding, Mr. Stone transferred to the child 1 percent of the property to be contributed to the partnership. That permitted the child to contribute this property to the partnership in exchange for a 1 percent general partnership interest. Each child for whom a partnership was

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[29] *Id.* at 1344 (quoting *Estate of Harper v. Commissioner*, 83 T.C.M. (CCH) 1641, 1653 (2002)).

[30] *Id.*

[31] *See, e.g.*, Christopher P. Bray, "Was *Strangi II* a Setup?" *Tax Notes*, Feb. 16, 2004, p. 888; Elaine Hightower Gagliardi, "*Strangi III*: Right Answer, Wrong Reason? Or Just Plain Wrong?" *Tax Notes*, July 21, 2003, p. 373; Mitchell M. Gans and Jonathan G. Blattmachr, "*Strangi*: A Critical Analysis and Planning Suggestions," *Tax Notes*, Sept. 1, 2003, p. 1153; Susan Kalinka, "*Estate of Strangi II*: IRS Wins Another Battle in Its War Against FLPs," *Tax Notes*, July 28, 2003, p. 545; J. Joseph Korpics, "The Practical Implications of *Strangi II* for FLPs — A Detailed Look," 99 *J. Tax'n* 270 (Nov. 2003); Louis A. Mezzullo, "Is *Strangi* a Strange Result or a Blueprint for Future IRS Successes Against FLPs?" 99 *J. Tax'n* 45 (July 2003); Michael D. Mulligan, "Courts Err in Applying Section 2036(a) to Limited Partnerships," 30 *Est. Plan.* 486 (Oct. 2003); Donald C. Poole, "Family Limited Partnerships Need an Exodus From Section 2036(a)," *Tax Notes*, Oct. 27, 2003, p. 541; Burgess J.W. Raby and William L. Raby, "Permissible Control in FLPs, LLCs, and Family Corporations," *Tax Notes*, Sept. 22, 2003, p. 1555.

[32] 86 T.C.M. (CCH) 551 (2003).

[33] As an interesting aside, the soccer stadium at the University of South Carolina (the institution at which the author teaches) is named after the decedent in this case.

[34] Mr. and Mrs. Stone also created a partnership in which all of their children would hold an interest. For purposes of convenience, that partnership is not addressed in this report.

[35] Because the children negotiated the manner in which their partnerships would be funded, the court thought itself compelled to explain that "[t]he Stone family understood . . . that Mr. Stone and M[r]s. Stone would make the ultimate decision as to which, if any, of their respective assets to transfer to each of the Five Partnerships." *Estate of Stone*, 86 T.C.M. (CCH) at 579.

[36] Mrs. Stone's limited partner interest ranged from 0.5 percent to 8 percent in the children's partnerships. *See id.* at 571-72.

created assumed management of the partnership property immediately on formation.

A few other details of the *Stone* case are worth noting. Mr. and Mrs. Stone retained accountants to advise them on the amount of property they needed to retain outside of the partnerships to finance their personal expenditures, and they followed that advice. Nonetheless, the settlement agreement executed by the children (and signed also by Mr. Stone in his capacity as shareholder of the company) provided that the partnerships would pay for the health, maintenance, and other reasonable expenses of Mr. and Mrs. Stone should their individual assets prove insufficient.[37] Furthermore, Mr. Stone's will provided that if the residual assets of his estate should be insufficient to pay the debts, administrative expenses, and taxes due in his estate, then the deficiency was to be "paid out of and charged equally against the limited partnerships established by me for my children."[38]

Having been previously diagnosed with gall bladder cancer, Mr. Stone died just two months after the partnerships were formed.[39] He was 89 years old at the time. Mr. Stone's estate valued his partnership interests through the application of a combined 43 percent valuation discount. The IRS audited the return and determined that the full date-of-death value of the partnership assets contributed by Mr. Stone should have been included in his gross estate, citing a number of theories. Before trial, the government dropped all of its arguments for inclusion except the application of section 2036(a)(1). Thus, the Tax Court case proceeded on that narrow ground.

Rather than addressing whether Mr. Stone had retained the sufficient rights to the beneficial enjoyment of the property transferred to the partnership for purposes of section 2036(a)(1),[40] the court began by considering whether the transfer of property to the partnerships satisfied the adequate and full consideration exception. In holding that the terms of the exception were satisfied, the court first found that the partnership formations constituted bona fide, arm's-length transfers. The court cited, among other things, the following justifications for this conclusion: each party was represented by independent counsel in the formation of the partnership; Mr. and Mrs. Stone did not transfer all of their assets to the partnerships; and Mr. and Mrs. Stone did not use partnership funds for personal purposes, but rather respected the partnership as a separate entity at all times.[41]

Regarding the presence of adequate consideration, the court first distinguished the case from the "recycling of value" situations described in *Estate of Harper* and its progeny. The court determined that each of the partnerships at issue in the case "had economic substance and operated as joint enterprises for profit through which the children actively participated in the management and development of the respective assets of those partnerships during their parents' lives (and thereafter)."[42] Because the children contributed only nominal amounts of property — which they had received from the decedent the day before partnership formation — their activities in managing the partnership property as general partners constitute perhaps the most important factual aspect of the case.[43] The court relied heavily on the children's management activities in concluding that each partnership constituted a "genuine pooling of property and services."[44]

Having determined that the partnership interests received by Mr. Stone should be treated as consideration for the transfer of property to the partnerships rather than disregarded for this purpose, the court addressed whether the consideration satisfied the statutory standard of "adequate and full consideration in money or money's worth." In making that determination, the court highlighted the following characteristics of the partnerships: each partner received a partnership interest proportionate to the fair market value of the contributed property; each partner's contribution was credited toward his or her capital account; and each partner was entitled to payment of his or her capital account balance on liquidation.[45] Citing the particular circumstances of the case, the court determined that the partnership interests received by Mr. Stone in exchange for his contribution of property to the partnerships constituted "adequate and full equivalents reducible to a money value."[46] The court closed by addressing the government's argument that the estate could not have it both ways; that is, the estate could not argue that the decedent's partnership interests constituted full and adequate consideration in money or money's worth while also

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[37]*Id.* at 562-63.

[38]*Id.* at 566.

[39]Unlike many other reported family limited partnership cases, however, Mr. Stone decided to proceed with the partnerships strategy before being diagnosed with a terminal illness. *See id.* at 560.

[40]Given that a secondary life estate is sufficient to implicate section 2036(a)(1), Mr. Stone's contingent ability to look to the partnership assets to pay his personal expenses — evidenced by the parties in writing — most likely would have been sufficient to trigger section 2036(a)(1).

[41]*See Estate of Stone*, 86 T.C.M. (CCH) at 558-60, 568-70. The court nowhere discussed the provision of the settlement agreement that required the children to use partnership assets to support Mr. and Mrs. Stone should their individual assets prove insufficient. Needless to say, a transferor's ability to recover the transferred property if he runs out of money is not a hallmark of an arm's-length transaction.

(Footnote continued in next column.)

[42]*Id.* at 580.

[43]The court described each child as "actively participating in the management" of their respective partnerships. *Id.* at 581. That characterization was more convincing for certain children than for others. For instance, the children whose partnerships received real estate immediately began developing the property. The daughter whose partnership received marketable securities switched brokers and sold a number of stocks at a substantial gain. Yet the primary asset received by one son's partnership consisted of preferred stock in the closely held manufacturing company. It is hard to imagine how one can actively manage this asset as a general partner. That did not bother the court, however. *See id.* at 555, 560 (describing the son as having "a particular interest in managing, and maintaining the value of, the preferred stock of Stones, Inc.").

[44]*Id.* at 581.

[45]*Id.* at 580-81.

[46]*Id.* at 581.

claiming that the partnership interests were worth 43 percent less than the contributed property. The court rejected that argument by accusing the government of trying to read the adequate and full consideration exception out of the statute for any bona fide transfer of property to a business entity.[47]

The Tax Court's decision in Estate of Stone was pivotal in the struggle regarding the application of section 2036(a) in the family limited partnership context.

The Tax Court's decision in *Estate of Stone* was a pivotal development in the ongoing struggle between taxpayers and the government regarding the application of section 2036(a) in the family limited partnership context.[48] From a nonsubstantive but practical standpoint, the case stemmed the tide of victories for the government in its expanded application of the statute. Beyond changing the momentum, however, the case shifted the debate under section 2036(a) to the friendlier terms of the adequate and full consideration exception. In that manner, *Estate of Stone* served as the ideal setup for the Fifth Circuit's decision in the appeal of *Kimbell*.

III. The Fifth Circuit Decision

The appeal of the first decision to apply section 2036(a)(1) and (a)(2) based on the decedent's retained powers over partnership distributions in the family limited partnership context was much anticipated by the tax community. Given the extent to which family limited partnerships had become a staple in the estate planning industry, it came as no surprise that the American College of Trust and Estate Counsel (ACTEC) weighed in with an *amicus* brief.[49] Many in the tax community, citing the Fifth Circuit's reputation as a safe haven for taxpayers and the perceived weakness of the district court opinion in *Kimbell*, counted on the Fifth Circuit to correct the alleged overbroad application of section 2036(a) in the family partnership context. In that regard, the Fifth Circuit did not disappoint.

A. Adequate and Full Consideration Exception

After reciting the central facts of the case and summarizing the district court opinion below, the Fifth Circuit began its analysis of the case by considering whether the formation of the partnership constituted a "bona fide sale for an adequate and full consideration in money or money's worth" that would render section 2036(a) inapplicable. In resolving that issue, the court placed considerable reliance on its prior decision in *Wheeler v. United States*,[50] which addressed the adequate and full consideration exception in a different context. Given the influence the *Wheeler* decision played in the Fifth Circuit's resolution of the *Kimbell* case, a brief review of the *Wheeler* opinion is provided below.

1. Revisiting *Wheeler*. The decedent in *Wheeler* conveyed his ranch to his two sons but retained a life estate in his favor. As consideration for the transfer, the sons executed a note in favor of the decedent for the actuarial fair market value of the remainder interest in the ranch that they received by way of the conveyance.[51] Because the decedent had retained beneficial ownership of the ranch until the date of his death, the government included the full value of the property in his gross estate under section 2036(a)(1). The dispute in the case centered on whether the decedent's prior sale of the remainder interest in the ranch for its actuarial fair market value constituted a "bona fide sale for an adequate and full consideration" that prevented the remainder (at that point, the full value of the ranch) from being included in the decedent's gross estate under section 2036. The district court in *Wheeler* ruled for the government on two grounds.[52] First, the district court followed the Federal Circuit decision in *Gradow v. United States*[53] for the proposition that the sufficiency of the consideration for purposes of the exclusion to section 2036(a) must be measured against the value of the property that otherwise would be included in the decedent's gross estate.[54] Under that analysis, a payment equal to the actuarial fair market value of a remainder interest in the property during the decedent's lifetime could never constitute "adequate and full consideration" for the entire amount of property that would otherwise be included in the decedent's gross estate at death. Second, noting that all payments on the sons' promissory note resulted from gifts from the decedent or

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[47] *Id.*

[48] For more detailed discussions of the decision in *Estate of Stone*, see John A. Bogdanski, "Section 2036 and Family Limited Partnerships: How Much Is Etched in *Stone*?," 31 *Est. Plan.* 92 (Feb. 2004); J. Joseph Korpics, "Mining *Stone* for Material Direction Regarding the Bona Fide Sale Exception (and More) as Applied to FLPs," *Tax Notes*, Mar. 1, 2004, p. 1123; Louis A. Mezzullo, "*Estate of Stone*: Successful Defense to an IRS Section 2036(a) Attack," 6 *Bus. Entities* 36 (March-April 2004).

[49] Brief for American College of Trust and Estate Counsel, *Kimbell v. United States*, 371 F.3d 257 (5th Cir. 2004) (No. 03-10529), available at 30 *ACTEC J.* 47 (2004). [Hereinafter ACTEC Brief.] The brief did not purport to support either party; rather, the brief was filed to express concern about the legal standards relating to section 2036 as employed in the district court decision in *Kimbell* and as argued in the government's brief. That being said, it is difficult to read the brief as arguing for anything other than reversal. As an interesting aside, the ACTEC *amicus* brief was not originally intended to be drafted for the *Kimbell* appeal. Rather, as expressly indicated in the editorial notes to the brief and as strongly suggested in the brief content, the brief was intended to be filed in the second appeal of *Estate of Strangi*. *See* 30 *ACTEC J.* at 47.

[50] 116 F. 3d 749, *Doc 97-19675, 97 TNT 129-14* (5th Cir. 1997).

[51] The principal amount of the note was determined with reference to the Treasury regulations governing the valuation of future interests in property. Also, the note bore adequate interest. *See id.* at 751-52.

[52] *Wheeler v. United States*, 77 AFTR2d 96-1405, 1996 WL 266420, *Doc 96-8731, 96 TNT 57-23* (W.D. Tex. 1996) (unpublished opinion), *rev'd*, 116 F.3d 759 (5th Cir. 1997).

[53] 897 F.2d 516 (Fed. Cir. 1990).

[54] *Wheeler*, 1996 WL 266420 at p. 5.

bonus payments from the decedent's closely held company, the district court determined that the sale of the remainder was not the product of a bona fide transaction. Rather, the court concluded that the evidence yielded a "clear impression" that the purported sale of the remainder interest was intended to avoid the payment of estate taxes.[55]

On appeal, the Fifth Circuit reversed in favor of the decedent's estate. In rejecting the interpretation of the adequate and full consideration exception articulated by the Federal Circuit in *Gradow*, the Fifth Circuit reasoned that the *Gradow* court "lost sight of the very principle the court was trying to apply; namely, the notion that adequate and full consideration under the exception to section 2036(a) requires only that the sale not deplete the gross estate."[56] Agreeing with the principle that "'it is not unreasonable to require that, at a minimum, the sale accomplish an equilibrium for estate tax purposes,'"[57] the Fifth Circuit explained that a sale of a remainder interest for its actuarial value does not, in fact, deplete the transferor's estate. Rather, if the assumptions incorporated into the actuarial tables held true, the sale proceeds would grow to an amount equal to the value of the property that would pass to the remaindermen at the decedent's death.[58] Therefore, the court determined that the promissory note principal balance, determined under the Treasury actuarial tables, constituted adequate and full consideration for the sale.

Next, the Fifth Circuit addressed what is required for a sale to be "bona fide" in terms of the statute. The court firmly rejected the notion that the bona fide qualifier in the statute was meant to impose an "additional wicket reserved exclusively for intrafamily transfers that otherwise meet the Treasury Regulations' valuation criteria."[59] Rather, having found that the terms of the transaction called for payment of adequate and full consideration for the transfer, the court explained that the only possible grounds for challenging the legitimacy of the sale were "whether the transferor actually parted with the remainder interest and the transferee actually parted with the requisite adequate and full consideration."[60] Thus, the primary purpose of the "bona fide sale" qualifier was to guard against sham or illusory transactions.

2. Two-part test. After reviewing its prior decision in *Wheeler* along with earlier cases addressing the application of section 2036 in the family limited partnership context, the Fifth Circuit specified the standards it would apply in determining whether the partnership formation in *Kimbell* satisfied the exception to section 2036(a). The court first recognized that it had adopted the "equilibrium rule" in *Wheeler*, meaning that "unless a transfer that depletes the transferor's estate is joined with a transfer that augments the estate by a commensurate (monetary) amount, there is no 'adequate and full consideration' for purposes of either the estate or gift tax."[61] Summarizing this rule, the court in *Kimbell* determined that the asset the decedent's estate received must be "roughly equivalent to the asset it gave up" to supply the transferor with sufficient consideration.[62]

If the partnership formation provided the decedent with adequate and full consideration under the "roughly equivalent" test, then the transaction would satisfy the exception to section 2036(a) so long as the decedent's transfer to the entity was the product of a "bona fide sale." Based on its prior decision in *Wheeler*, the primary "bona fide sale" inquiry would involve determining whether the decedent actually parted with her interest in the property and whether the partnership actually parted with the partnership interest issued in exchange.[63] Yet because the transaction was between related parties, the Fifth Circuit resolved to subject the transaction to heightened scrutiny to ensure that, based on the examination of objective facts, the partnership formation did not constitute a sham transaction or disguised gift.[64]

a. Adequacy of consideration. The Fifth Circuit began its discussion of whether the partnership interests received by the decedent on formation of the partnership constituted adequate and full consideration in money or money's worth by first responding to the government's inconsistency argument; that is, the partnership interests could not constitute sufficient consideration given that the estate claimed the interests were worth only 50 percent of the value of the property contributed to the partnership. The court adopted the reasoning of the Tax Court in *Estate of Stone*, quoting that case's determination that the government's argument:

> in effect reads out of section 2036(a) the exception for a 'bona fide sale for an adequate and full consideration in money or money's worth' in any case where there is a bona fide, arm's length transfer of property to a business entity (e.g. a partnership or a corporation) for which the transferor receives an interest in such entity (e.g. a partnership interest or stock) that is proportionate to the fair market value of the property transferred to such entity and the determination of the value of such interest takes into account appropriate discounts.[65]

The Fifth Circuit expanded on the Tax Court's rejection of the argument by describing it as a "classic mixing of apples and oranges."[66] The Fifth Circuit viewed the government as inappropriately attempting to equate the "willing buyer-willing seller" valuation standard under

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[55] *Id.* at p. 6.

[56] *Wheeler v. United States*, 116 F.3d 749, 759 (5th Cir. 1997).

[57] *Id.* at 759 (quoting *Gradow v. United States*, 11 Ct. Cl. 808, 813-14 (1987)).

[58] *See Wheeler*, 116 F.3d at 762. Of course, this analysis ignores any appreciation in the transferred property.

[59] *Id.* at 764.

[60] *Id.*

[61] *Kimbell*, 371 F.3d 257, 262 (5th Cir. 2004) (quoting *Wheeler v. United States*, 116 F.3d 749, 762 (5th Cir. 1997)).

[62] *Id.*

[63] *See id.* at 265.

[64] *See id.*

[65] *Id.* at 265-66 (quoting *Estate of Stone v. Commissioner*, 86 T.C.M. (CCH) 551, 578 (2003)).

[66] *Id* at 266.

the estate and gift taxes with the proper test for consideration under section 2036(a). The court's explanation of why "[t]his conflation misses the mark" is noteworthy:

> The business decision to exchange cash or other assets for a transfer-restricted, non-managerial interest in a limited partnership involves financial considerations other than the purchaser's ability to turn right around and sell the newly acquired limited partnership interest for 100 cents on the dollar. Investors who acquire such interests do so with the expectation of realizing benefits such as management expertise, security and preservation of assets, capital appreciation and avoidance of personal liability. Thus there is nothing inconsistent in acknowledging, on the one hand, that the investor's dollars have acquired a limited partnership interest at arm's length for adequate and full consideration and, on the other hand, that the asset thus acquired has a present fair market value, i.e., immediate sale potential, of substantially less than the dollars just paid — a classic informed tradeoff.[67]

The court explained that this reasoning, applicable to wholly unrelated buyers and sellers of interests in limited partnerships, must also apply to buyers and sellers of limited partnership interests who happen to be related unless the evidence demonstrates the absence of good faith, that is, "a sham transaction motivated solely by tax avoidance."[68] In that manner, the court rejected the government's argument that the estate could not have its cake and eat it too.

The court next set its sights on articulating why the formation of the partnership supplied the decedent with adequate consideration. Again borrowing from the Tax Court opinion in *Estate of Stone*, the Fifth Circuit determined that the analysis of this issue should focus on the following three factors: whether the interests credited to each of the partners were proportionate to the fair market value of the contributed assets; whether the assets contributed by each partner were credited to his or her capital account; and whether the partners were entitled to distributions of their capital account balances on termination or dissolution of the partnership.[69] Because all of those inquiries were satisfied in the estate's favor — as they would be in the formation of any pro rata partnership — the court concluded that the formation of the partnership in *Kimbell* was for adequate and full consideration.

Whereas the district court in *Kimbell* had adopted the Tax Court's reasoning in *Estate of Harper* that, in some cases, the receipt of a partnership interest in exchange for a contribution of property to the entity should be disregarded as a separate item of consideration altogether for purposes of section 2036(a), the Fifth Circuit determined that the "recycling of value" argument had no relevance in the analysis of whether the decedent received adequate consideration. Instead, the court viewed the inquiry as properly bearing on the second prong of the statutory exception — whether the formation of the partnership was the product of a bona fide sale.[70]

b. Bona fide sale. After highlighting the district court's error in interpreting the bona fide sale prong of the statutory exception as requiring an arm's-length transaction between unrelated parties, the court described a variety of reasons why the formation of the partnership in *Kimbell* constituted a bona fide transaction. To start, the transactions at issue actually took place. The decedent formally assigned the contributed property to the partnership, and the partnership actually credited her with the requisite pro rata partnership interest.[71] Furthermore, the parties respected the partnership as a separate legal entity. Mrs. Kimbell did not transfer all of her assets to the entity. Thus, she would not need to look to the partnership to provide for her personal support. To that end, Mrs. Kimbell at no time used partnership assets to satisfy her personal expenses.[72] In short, the parties conducted themselves in an arm's-length manner.

Responding to the district court's determination that the partnership formation constituted nothing more than a paper transaction resulting in a recycling of value, the Fifth Circuit determined that that analysis ignored uncontradicted evidence in the record supporting the estate's assertion that the transaction was entered into for substantial business reasons. Among the evidence cited by the court were the following factors:

- The assets contributed to the partnership included working interests in oil and gas property that required active management;
- The limited partnership form provided additional legal protection from creditors, mitigating any potential liability for environmental issues that arose in connection with the oil and gas interests;
- The decedent's desire to consolidate the capital in one entity to increase the likelihood that the oil and gas operations could continue beyond her lifetime;
- The formation of the partnership served to reduce administrative expenses associated with the property;
- By transferring oil and gas properties to the partnership, future real property transfer costs would be avoided when the property passed down generations;
- The decedent wanted to keep the assets in an entity that would preserve the property for her descendants, a concern that was reinforced by the divorce of one of her grandsons;
- Transferring the assets to the entity provided a mechanism for the transfer of control in the event something happened to the decedent's son; and

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[67] *Id.*

[68] *Id.*; *see also id.* at 264 (noting that, for purposes of the bona fide sale analysis, a transaction "motivated solely by tax planning with no business or corporate purpose is nothing more than a contrivance without substance that is rightly ignored for purposes of the tax computation").

[69] *Id.* at 266 (citing *Estate of Stone v. Commissioner*, 86 T.C.M. (CCH) at 580).

[70] *Id.* at 267.

[71] *Id.* at 269.

[72] *Id.*

- The mediation and arbitration provisions of the partnership agreement served to avoid litigation costs in the event of a family dispute.[73]

The court was satisfied that those factors provided the requisite objective evidence that the partnership formation was not a disguised gift or a sham transaction.[74] Thus, the transaction surpassed the court's form of heightened scrutiny.

The Fifth Circuit decision in Kimbell is sure to be celebrated within the estate planning community.

In concluding that the formation of the partnership was the product of a bona fide sale, the Fifth Circuit was not troubled by the de minimis contribution made by the other partners. Mrs. Kimbell's son and daughter-in-law, through the LLC general partner, contributed only $20,000 of the partnership's $2.4 million in assets. The court responded to that fact by noting that it was aware of no principle of partnership law that would require the minority partner to own a minimum percentage interest in the partnership for the entity to be legitimate and its transfers bona fide.[75] Furthermore, the Fifth Circuit was not troubled by the fact that nothing changed with regard to the management of the decedent's assets by reason of the partnership formation. Before the partnership formation, Mrs. Kimbell's son managed her property in his capacity as co-trustee of her revocable trust. After the partnership formation, Mrs. Kimbell's son continued to manage the transferred property in his capacity as the sole manager of the LLC that served as the sole general partner. Citing the business reasons that led to the creation of the entity, the court viewed the son's precontribution management activities on behalf of the trust as irrelevant.[76]

B. Retained Powers

Because the Fifth Circuit found that the partnership formation constituted a bona fide sale for an adequate and full consideration in money or money's worth, there existed no need for it to examine whether Mrs. Kimbell retained sufficient control over distributions of partnership income to implicate section 2036(a)(1) and (a)(2) regarding the property she contributed to the partnership. However, the Fifth Circuit addressed the issue in the context of the decedent's 50 percent interest in the LLC that served as general partner. Although the inclusion of Mrs. Kimbell's LLC interest was not discussed in the reported district court opinion, the district court later amended its opinion by order to provide that section 2036(a) applied to her 50 percent interest in the LLC. In that manner, the district court indirectly included in Mrs. Kimbell's gross estate the 0.5 percent interest in the partnership assets that resulted from the LLC's ownership of the 1 percent general partner interest.

It is somewhat curious that the court did not engage in the same "adequate and full consideration" analysis for the LLC formation as it did for the partnership formation. After all, the formation of the LLC and the partnership were parts of a single, integrated transaction. Perhaps the court declined to do so because it would have proven difficult to articulate the business purpose of an entity whose sole purpose was to serve as the general partner of another. In any event, the court determined that even if the decedent's transfer of cash to the LLC did not constitute a bona fide sale for an adequate and full consideration in money or money's worth, the district court's application of section 2036(a) to the LLC was nonetheless erroneous. The court determined that the decedent did not retain sufficient control of the assets she transferred to the LLC, because her son was the sole manager of the entity and the decedent possessed only a 50 percent interest.[77]

IV. Assessment of the Fifth Circuit Decision

The Fifth Circuit decision in *Kimbell* is sure to be celebrated within the estate planning community, as the court's analysis of the internal exception to section 2036(a) considerably narrows the instances in which section 2036 will rear its head in the family limited partnership context. Although the court nominally retained a two-part test for satisfying the statutory exception, the court's determination that a transferor's beneficial interest in a pro rata partnership automatically constitutes "adequate and full consideration" for the transfer effectively provides taxpayers with a bye on the first prong. Taxpayers need only satisfy the second articulated requirement of the exception: that the partnership formation constitute the product of a "bona fide sale." This should not prove altogether difficult. According to the court, the standard is satisfied so long as the transferor actually parted with the property contributed to the partnership and the partnership parted with the equity interest in the entity. Although the court purports to subject intrafamily transactions to heightened scrutiny, that scrutiny entails determining whether the sale was a sham transaction or a disguised gift — by examining objective facts only. Presumably, that means that the transferor need only observe the partnership formalities and not use partnership assets to satisfy personal expenses.[78] Taking those rules together, any taxpayer who forms a pro rata family limited partnership and heeds the

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[73]*See id.* at 267-68.

[74]*Id.* at 269.

[75]*Id.* at 268. This portion of the Fifth Circuit opinion is reminiscent of the original Tax Court opinion in *Strangi*, in which the Tax Court rejected the government's economic substance argument by noting that, because the partnership was validly formed under state law, it had sufficient substance to be recognized for estate tax purposes. *See Estate of Strangi v. Commissioner*, 115 T.C. 478, 486-87 (2000).

[76]*Kimbell*, 371 F.3d at 268.

[77]*Id.* at 269-70. Presumably, then, the decedent did not have the authority as a 50 percent member in the LLC to remove and replace her son as manager. If she did, then all powers held by the manager would be attributed to the decedent for purposes of section 2036. *See* Treas. reg. section 20.2036-1(b)(3).

[78]*Kimbell*, 371 F.3d at 269.

advice of his or her attorney to respect the partnership as a separate entity will safely avoid the section 2036 minefield. In this manner, the statute is reduced to little more than a trap for the sloppy.

On one hand, the Fifth Circuit's approach to determining the extent to which section 2036 can reach family limited partnerships is reasonable enough. Essentially, it is an embodiment of the notion, held by many, that section 2036 simply was not designed or intended to capture property transferred to a business-related entity — particularly given that the resulting beneficial interest in the entity would be captured in the gross estate under section 2033.[79] Rather, the statute was intended for and should be limited to transfers in trust where the testamentary character of the transaction is unmistakable. Consistent with this viewpoint, the Fifth Circuit's interpretation of the internal exception to section 2036(a) provides, in effect, that the transfer of property to a partnership will be respected as falling outside of section 2036(a) so long as the parties themselves respect the entity. That approach has the advantage of establishing relatively clear rules around which individuals can organize their estate planning affairs. The downside of that approach, of course, is that the estate tax implications of the transaction are driven entirely by form as opposed to substance. Given that many family limited partnerships are designed and marketed to serve as a trust substitute, this downside cannot be readily dismissed.

For all the chiding the Fifth Circuit handed to the district court for not heeding its prior decision in Wheeler, the Fifth Circuit itself failed to properly apply the principles of the Wheeler case to the situation before it.

The primary purpose of this section is to critique the Fifth Circuit's interpretation and application of the adequate and full consideration exception to section 2036(a) in the context of family limited partnerships. For all the chiding the Fifth Circuit handed down to the district court for not heeding its prior decision in *Wheeler*, the Fifth Circuit itself failed to properly apply the principles of the *Wheeler* case to the situation before it. The flaws in the decision, however, are not limited to doctrinal deficiencies. The Fifth Circuit also failed to appreciate the legislative purpose behind section 2036(a) in describing the nontax justifications for the partnership that it deemed sufficient to avoid the statute. Yet before examining the shortcomings of the *Kimbell* decision, this section first will highlight a popular taxpayer argument on which the Fifth Circuit appropriately passed.

A. Avoiding the No-Gift-on-Formation Argument

One of the arguments frequently made by those advocating that section 2036 should have no application in the context of family partnerships centers on the absence of a gift on formation of the entity. The argument proceeds as follows: Because the formation of the partnership did not result in a taxable gift from the transferor, the transferor must have received adequate and full consideration for the transfer.[80] Because the transferor received adequate and full consideration for purposes of the gift tax, the transferor also must have received adequate and full consideration for the transfer for purposes of section 2036(a). That argument typically is based on the Fifth Circuit's explanation in *Wheeler* that the gift and estate taxes must be construed *in pari materia,* explained below.

The government in *Wheeler* conceded that the decedent's sale of a remainder interest for its actuarial fair market value did not constitute a taxable gift to the transferees. Rather, the decedent by definition had received adequate and full consideration for the transfer within the meaning of section 2512(b). Nonetheless, the government argued that the decedent had not received adequate and full consideration for purposes of the internal exception to section 2036(a).[81] The Fifth Circuit

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[79]This is not to say that there would be double inclusion if section 2036(a) applied to include the partnership assets in the transferor's gross estate. As explained later in the report, the only way that section 2036(a) could apply to include in the transferor's gross estate the property he or she contributed to the partnership is if the partnership interest is viewed not as a separate asset constituting consideration, but rather as mere evidence of the transferor's retained beneficial interest in the transferred property. In short, if section 2036(a) applies to the partnership property, then the partnership interest is disregarded for estate tax purposes.

[80]The *amicus* brief filed in ACTEC in the *Kimbell* case provides a good illustration of how this assumption appears in the argument:

> On one hand, the gift and estate tax definitions of "adequate and full consideration" should be read *in pari materia* and should be accorded the same meaning. In *Kimbell*, the Government is not contending that a gift occurred upon formation of the partnership. In not raising a gift on formation argument, the Government is tacitly acknowledging that this argument has been rejected by all courts which have considered it, including this Court, where the decedent's capital account and interest in profits and losses were proportionate to the value of his or her capital contribution. Under *Wheeler*'s *in pari materia* standard, then, the existence of "adequate and full consideration in money or money's worth" for gift tax purposes should mean that there was also "adequate and full consideration in money or money's worth" for purposes of Section 2036(a).

ACTEC Brief, *supra* note 49, 30 *ACTEC J.* at 54 (citations omitted). For another example of how this assumption appears in the argument, see Gans and Blattmachr, *supra* note 31, at 1163: "In *Strangi*, given the court's earlier conclusion in its initial decision that no taxable gift had been made at the formation of the partnership — *implicitly recognizing that depletion had not occurred* — the estate qualified for the [adequate and full consideration] exception unless precluded from doing so by the [bona fide] phrase." (emphasis supplied; footnotes omitted).

[81]The government's explanation was that, in light of the legislative purpose of section 2036(a) to include in the transferor's gross estate any property of which the decedent had retained beneficial enjoyment, the "property" against which the

(Footnote continued on next page.)

found this inconsistency troubling. The court explained that because gift and estate taxes complement one another, the phrase "adequate and full consideration in money or money's worth" was to be afforded the same meaning for each.[82] The court supported its analysis by quoting the Supreme Court:

> Correlation of the gift tax and the estate tax still requires legislative intervention. [citations] But to interpret the same phrases in the two taxes concerning the same subject matter in different ways where obvious reasons do not compel divergent treatment is to introduce another and needless complexity into this already irksome situation.[83]

The Fifth Circuit then used its determination that "adequate and full consideration" carried the same meaning under both the gift and estate tax to support its conclusion that the sale of the remainder interest at issue satisfied the exception to section 2036(a).

Returning to the no-gift-on-formation argument in the family partnership setting, its flaw does not lie in the proposition that "adequate and full consideration" must be afforded the same meaning under both the gift tax and the estate tax. Rather, its flaw lies in its assumption that the reason no taxable gift results from the transfer of property to a partnership for a pro rata interest therein is because of the transferor's receipt of adequate and full consideration.[84] Two requirements exist for a transfer of property to result in a taxable gift. First, the transfer of property must be made in favor of a third-party donee. While the specific identity of the donee need not be known,[85] there must be a transfer of property to or for the benefit of a third party to trigger the tax.[86] If the first requirement is satisfied, then the transfer of property to the third-party donee nonetheless will not constitute a taxable gift if the transferor receives adequate and full consideration in money or money's worth in exchange for the transferred property.[87] The government's argument that the formation of a family limited partnership constitutes a taxable gift to the other beneficial owners has been rejected on the former ground as opposed to the latter.[88] While the transfer-tax value of the partnership interest received by the transferor may be considerably less than the transfer-tax value of the transferred property, the loss in objective value does not inure to the benefit of a third party. Rather, all beneficial owners of the closely held entity experience a similar loss in objective value when they contribute property in exchange for a transfer-restricted beneficial interest in the entity. Because of the absence of a third-party donee, the contribution of property to a pro rata partnership cannot yield a taxable gift. As that determination does not address or depend on the transferor receiving adequate and full consideration for the transferred property within the meaning of section 2512(b), no inference can be drawn from the absence of a gift on formation that the transferor received adequate and full consideration for purposes of section 2036(a).

A variant of the *in pari materia* argument described above previously had been accepted by a Texas district court in the context of a family limited partnership formation.[89] The Fifth Circuit was wise not to adopt that

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sufficiency of consideration was to be measured for section 2036 was the property that would be included in the decedent's gross estate (the entire amount) as opposed to the specific interest in that property that was transferred during the decedent's lifetime (the remainder interest). *See Wheeler v. United States*, 116 F.3d 749, 764 (5th Cir. 1997).

[82] *Id.* at 761.

[83] *Id.* (quoting *Merrill v. Fahs*, 324 U.S. 308, 313 (1945)).

[84] This fallacy was articulated by the Tax Court in *Estate of Harper*. *See* 83 T.C.M. (CCH) 1641, 1654 (2002) (noting that prior Tax Court cases rejecting the gift-on-formation argument "say nothing explicit about adequate and full consideration").

[85] *See* Treas. reg. section 25.2511-2(a).

[86] *See Commissioner v. Hogle*, 165 F.2d 352, 353 (10th Cir. 1947) (stating that the gift tax "cannot be sustained unless there was a transferor, a transferee, and an effective transfer of title or other economic interest or benefit in property having the quality of a gift").

[87] *See* section 2512(b).

[88] *See Estate of Jones v. Commissioner*, 116 T.C. 121, 127-28, *Doc 2001-6611, 2001 TNT 45-12* (2001); *Church v. United States*, 85 AFTR2d 2000-804, *Doc 2000-4369, 2000 TNT 30-56* (W.D. Tex. 2000), *aff'd* 268 F.3d 1063, *Doc 2001-21057, 2001 TNT 152-12* (5th Cir. 2001) (table). The author is aware of only one case in which a court rejected the government's gift-on-formation argument by concluding that the decedent had received adequate and full consideration for the transfer. In *Estate of Harrison v. Commissioner*, 52 T.C.M. (CCH) 1306 (1987), the Tax Court determined that the decedent's general partner interest in the partnership to which he contributed $60 million in property equaled the value of the contributed property. The court did so because the decedent, as general partner, reserved the right during his lifetime to dissolve the partnership and receive payment of his capital account balance — a right that lapsed on the decedent's death. Section 2704(a) later was enacted to address lapsing liquidation rights.

[89] *Church v. United States*, 85 AFTR2d 2000-804 (W.D. Tex. 2000), *aff'd* 268 F.3d 1063 (5th Cir. 2001) (table). The argument that prevailed in *Church*, however, did not focus on interpreting the phrase "adequate and full consideration" consistently for estate and gift tax purposes; instead, it focused on interpreting the word "transfer." The district court in *Church* properly recognized that the justification for rejecting the gift-on-formation argument was the absence of a transfer of property to a third-party donee through the formation of the partnership. Citing the *in pari materia* rationale articulated in *Wheeler*, the court in *Church* used the absence of a "transfer" for gift tax purposes to conclude that the partnership formation likewise did not constitute a "transfer" for purposes of section 2036(a). That is an absurd and illogical interpretation of the statute. Quite obviously, the contribution of property to a family-owned partnership involves a "transfer" of property. The issue under section 2036(a) is whether this transfer was made for an adequate and full consideration in money or money's worth so as to fall outside of the statute. Interpreting the word "transfer" as meaning only "gratuitous transfer" renders the parenthetical exception for a bona fide sale for an adequate and full consideration superfluous. *See* Mezzullo, *supra* note 48 at 42. The Tax Court in *Estate of Stone* implicitly rejected the "absence of a transfer" holding in *Church* when it treated the estate's concession that the decedent had in fact transferred property to the partnerships at issue as a concession that there had been a

(Footnote continued on next page.)

seemingly simple but flawed rationale for ruling in the estate's favor. However, not only did the Fifth Circuit properly decline to adopt the *in pari materia* argument in favor of the taxpayer in *Kimbell*, the court went one step further by failing to heed its own determination in *Wheeler* that the phrase "adequate and full consideration in money or money's worth" carries the same meaning under both the gift tax and estate tax. That issue is explored below.

B. 'Classic Mixing of Apples and Oranges'

One troubling aspect of the Fifth Circuit decision in *Kimbell* is the manner in which the court attempted to reconcile its determination that Mrs. Kimbell received adequate and full consideration for her contribution of property to the partnership with its prior decision in *Wheeler*. The court in *Kimbell* started off fine enough, recognizing its prior determination in *Wheeler* that "unless a transfer that depletes the transferor's estate is joined with a transfer that augments the estate by a commensurate (monetary) amount, there is no 'adequate and full consideration' for purposes of either the estate or gift tax."[90] Yet in the very next sentence, the *Kimbell* court rephrased the above-described standard as follows: "In other words, the asset the estate received must be *roughly equivalent* to the asset it gave up."[91] No further explanation was provided. In that manner, the court in *Kimbell* summarily converted the strict equal-value test articulated and applied in *Wheeler* to a vague standard that could be satisfied on the receipt of consideration the value of which was somewhere in the ballpark. By finding that partnership interests valued by the estate at about 50 percent of the value of the transferred property constituted adequate and full consideration, the court indicated that its notion of a "rough equivalent" was liberal, to say the least.

The court in Kimbell converted the strict equal-value test of Wheeler to a vague standard that may be satisfied by receipt of consideration the value of which was somewhere in the ballpark.

The *Kimbell* court's pronouncement of a "roughly equivalent" standard for testing the sufficiency of consideration is disconcerting. Suppose a transferor conveys a variety of listed securities valued at $1 million to his son in exchange for $950,000 in cash. One would be hard-pressed to say that the transferor did not receive roughly equivalent consideration for the transfer. Does it then follow that the transferor received adequate and full consideration for the transfer? Of course not. No one could reasonably dispute that the above-described hypothetical results in a taxable gift of $50,000 (annual exclusion aside). What, then, is to be made of the Fifth Circuit's "roughly equivalent" test for measuring the existence of adequate and full consideration for purposes of section 2036? Does it apply only in those situations in which the consideration consists of an illiquid, hard-to-value asset? While that would be more defensible, the Fifth Circuit never made that distinction in the *Kimbell* opinion. Instead, the court suggested that "adequate and full consideration" can take on different meanings for different provisions of the estate and gift taxes.

One of the government's main arguments in the case was that the partnership interests received by Mrs. Kimbell could not constitute adequate and full consideration given that the estate was arguing that the interests were worth only 50 percent of the value of the contributed property. The court addressed the government's inconsistency argument by labeling it a "classic mixing of apples and oranges."[92] The court explained that the government's attempt to equate the "willing buyer-willing seller" test for calculating the gift and estate tax with the proper test for adequate and full consideration under section 2036(a) constituted a "conflation [that] misses the mark."[93] To the extent the Fifth Circuit was implying that the willing buyer-willing seller test did not apply for measuring the sufficiency of consideration, it was misguided. Rather, section 2512(b) provides as follows: "[W]here property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift, and shall be included in computing the amount of gifts made during the calendar year."[94] Therefore, the Fifth Circuit's conclusion that the willing buyer-willing seller standard applies for purposes of the gift tax but not for purposes of section 2036(a) amounts to the court declaring that the phrase "adequate and full consideration in money or money's worth" has one meaning for purposes of section 2512 and another for purposes of section 2036(a). In this manner, the Fifth Circuit in *Kimbell* turned the *in pari materia* rationale of the *Wheeler* opinion on its head.

C. Proper Analytical Framework

The Fifth Circuit's articulation of the "roughly equivalent" standard for measuring the adequacy of consideration for purposes of the section 2036(a) exception apparently was the result of the court's attempt to fit its decision within the equilibrium rule adopted in *Wheeler*. Yet rather than butchering its prior holding in *Wheeler* that the adequate and full consideration exception requires only that the transfer not deplete the transferor's

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"transfer" to which section 2036(a) had potential application. *See Estate of Stone v. Commissioner*, 86 T.C.M. (CCH) 551, 578 (2003).

[90] *Kimbell v. United States*, 371 F.3d 257, 262 (5th Cir. 2004).

[91] *Id.* (emphasis supplied).

[92] *Id.* at 266.

[93] *Id.*

[94] *See also* Treas. reg. sections 25.2512-1 (general rule of valuation), 25.2512-8 (transfers for insufficient consideration).

gross estate, the Fifth Circuit simply could have recognized the obvious — that the formation of the partnership did reduce the size of Mrs. Kimbell's gross estate[95] — while still reaching its ultimate conclusion that the internal exception to section 2036(a) was satisfied. In fact, the *Wheeler* opinion laid out the road map for doing so.

According to the Fifth Circuit in *Wheeler*, the first and potentially last step in analyzing whether a transfer of property was part of a "bona fide sale for an adequate and full consideration in money or money's worth" is to determine whether the transferor in fact received adequate and full consideration for the transfer. If so, then the "bona fide sale" aspect of the exception would be satisfied so long as the purported transfers actually took place; that is, that the transaction was not a sham.[96] Furthermore, if the transferor received adequate consideration, then the identity of the parties (that is, related versus unrelated) would bear no relevance. Thus, the court recognized the simple fact that it is possible for related parties to enter into arm's-length agreements.[97]

The Fifth Circuit in *Wheeler* made abundantly clear that the standard for determining the phrase "adequate and full consideration" is to be afforded the same meaning under the gift tax and the estate tax. As a general rule, the value of consideration received for a lifetime transfer, both for purposes of determining the existence of a taxable gift and measuring the amount thereof, is the price at which the property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts.[98] Applying that standard, the estate in *Kimbell* valued the 99 percent limited partnership interest received by the decedent at 49 percent of the value of the contributed property. The partnership interests received on formation of the entity therefore failed to constitute adequate and full consideration. As a result, the formation of the partnership had the effect (most likely, intentional) of reducing the size of Mrs. Kimbell's gross estate. The transaction thus failed the equilibrium rule set out in *Wheeler*. That conclusion is inescapable.

Having determined that the partnership interests received on formation of the entity failed to constitute adequate and full consideration, however, does not foreclose application of the internal exception to section 2036(a). Although the Fifth Circuit in *Wheeler* interpreted the "bona fide sale" aspect of the exception as merely requiring that the transaction at issue not constitute a sham, the court explained that that particular phrase could operate as a safe harbor in the taxpayer's favor for situations in which the consideration was not technically adequate:

> To the extent the 'bona fide' qualifier in section 2036(a) has any independent meaning beyond requiring that neither transfers nor the adequate and full consideration for them be illusory or sham, it might be construed as permitting legitimate, negotiated commercial transfers of split-interests that would not otherwise qualify as adequate consideration using the actuarial tables set forth in the Treasury Regulations to qualify under the exception.[99]

While the court described the potential safe harbor application of the "bona fide sale" language under the exception to section 2036(a) in terms of the specific case before it (sale of a future interest), the passage above can reasonably be interpreted as permitting a safe harbor for transfers made in the ordinary course of business. Such an interpretation would be consistent with the safe harbor provided for gift tax purposes under the regulations on valuation:

> Transfers reached by the gift tax . . . embrace . . . sales, exchanges, and other dispositions of property for a consideration to the extent that the value of the property transferred by the donor exceeds the value in money or money's worth of the consideration given therefore. However, a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth.[100]

Thus, the Fifth Circuit in *Kimbell* could have held that the formation of the partnership satisfied the adequate and full consideration exception to section 2036(a) while at the same time conceding that the transaction resulted in a partial depletion of the decedent's gross estate. The court could have done so by finding that the partnership formation constituted a bona fide sale. While it may be tempting to point out that the court in *Kimbell* already made that finding, the determination of whether a transaction constituted a bona fide sale for purposes of excusing the inadequacy of the consideration received on a transfer necessarily would involve a more meaningful test than determining whether such consideration changed hands between the parties. Borrowing from the principles of reg. section 25.2512-8, the inquiry would involve determining whether the partnership was indeed formed in the ordinary course of business or, stated differently, for a meaningful business purpose. Given the

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[95]In this regard, it is worth noting that even the *amicus* brief filed on behalf of ACTEC in *Kimbell* conceded that the equilibrium rule under *Wheeler* was not satisfied. *See* ACTEC Brief, *supra* note 49, 30 *ACTEC J.* at 55 ("The allowable discounts for the equity interests received in exchange for the capital contributions would have the effect of reducing the decedent's estate for estate tax purposes, at least for the foreseeable future.").

[96]*Wheeler v. United States*, 116 F.3d 749, 763-64 (5th Cir. 1997).

[97]*See id.* at 764. In a separate but related context, the Treasury Department recently adopted a per se rule that a sale of nonstatutory stock options between an executive and his or her family limited partnership could not constitute an arm's-length transaction. *See* T.D. 9067, 2003-32 IRB 287 (announcing proposed and temp. Treas. reg. section 1.83-7T(a)).

[98]Treas. reg. section 25.2512-1.

[99]*Wheeler*, 116 F.3d at 763-64. It is worth noting that this interpretation of the statute converts a two-part conjunctive test for the adequate and full consideration exception to section 2036(a) into a test that, in some instances, is disjunctive.

[100]Treas. reg. section 25.2512-8.

overall tone of the *Kimbell* opinion and the manner in which it accentuated the business justifications for forming the partnership, it is reasonable to conclude that the court indeed would have found that the transaction satisfied the "bona fide sale" standard in the safe harbor sense. Whether the court would have been correct in doing so, however, is another matter.

V. The Business Purpose Inquiry

A. The Fifth Circuit Approach

Given the basic facts of *Kimbell* — a 96-year-old individual transferring the bulk of her assets to a partnership in exchange for a 99 percent interest in the entity as limited partner — the case did not strike many as the sort that would end up producing a favorable precedent for taxpayers. Rather, two leading commentators characterized the *Kimbell* case, together with *Estate of Harper* and *Estate of Strangi*, as "deserving of the label 'the unholy trio of family limited partnership cases.'"[101] The commentators said that the conclusions reached under section 2036 "were certainly justified under the facts and circumstances of those specific cases."[102]

The Fifth Circuit painted an entirely different image of the transaction, stressing several non-tax-related justifications for the entity in reaching its conclusion that the partnership was formed for substantial business reasons. Yet on close examination, many of the purported business or nontax justifications cited by the court relate to Mrs. Kimbell's desire to structure her continued ownership of the transferred property in a more efficient manner. For example, the court cited the following as supporting the bona fides of the partnership formation: The decedent sought additional protection from creditors; the decedent wanted to prevent her pool of capital from being subdivided as it passed to her descendants; the decedent wanted to protect the property from any claims made by the spouse of a descendant in the event of a descendant's divorce; the decedent sought to reduce administrative costs relating to the management of her property; and the decedent wanted to establish a plan of succession regarding the management of her property in the event something happened to her son.[103] While those factors indeed are legitimate nontax reasons for forming the partnership, they relate to Mrs. Kimbell's goal of organizing her property in a more advantageous manner for the benefit of herself and her heirs. Rather than establishing a business purpose for the entity, those nontax factors simply reinforce the notion that a closely held limited partnership can be employed as a substitute for a trust.

The Fifth Circuit cited few reasons for the partnership formation that relate to the notion of a partnership as a vehicle through which to exploit a business opportunity for profit. The court went to considerable lengths to stress the business advantages of managing the active oil and gas leases through the partnership form. However, the persuasiveness of those factors wanes when the value of the active oil and gas properties contributed to the partnership is placed in context — they constituted only 11 percent of the contributed property.[104] The court highlighted that Mrs. Kimbell's son contributed management expertise to the partnership. But then again, the decedent's son was already managing her assets in his capacity as co-trustee before forming the partnership.[105] Because Mrs. Kimbell was the only party to make a meaningful contribution of property to the entity, the court was unable to point to any sort of asset pooling that potentially would lead to new and better investment opportunities.

Thus, the most convincing nontax justifications for forming the partnership relate to Mrs. Kimbell's restructuring of her beneficial ownership of the transferred property. If these factors alone are sufficient to qualify a partnership under the "bona fide sale" safe harbor to the adequate and full consideration exception to section 2036(a), then the exception will be satisfied even in those situations in which the partnership is being used as a substitute for a trust. As discussed below, it is questionable whether a beneficial interest in such a partnership should be treated as a separate item of consideration for purposes of section 2036.

B. Distinguishing Among Nontax Justifications

In determining what type or degree of nontax purpose should be required for a formation of a family-owned entity to satisfy the "bona fide sale" safe harbor to the adequate and full consideration exception to section 2036(a), it is important not to lose sight of the overall legislative purpose behind the statute. As described by the Supreme Court, the purpose of section 2036(a) is to

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[101]Raby and Raby, *supra* note 21 at 1243.

[102]*Id.*; *see also* Lee A. Sheppard, "Economic Substance Comes to Estate Planning," *Tax Notes*, May 31, 2004, p. 1094, at 1101 ("Readers who are wondering what there was left to argue about in *Kimbell* should not represent rich people. Or practice in the Fifth Circuit.").

[103]*Kimbell*, 371 F.3d at 267-68.

[104]The question remains whether the presence of the active oil and gas leases in the transaction were crucial to the court's holding in *Kimbell*. In other words, what if the partnership in *Kimbell* had held only the decedent's marketable securities? Under the court's analysis, the formation of a pro rata partnership automatically constitutes adequate and full consideration for purposes of the statute. Therefore, the only open issue would be whether the partnership formation was the product of a "bona fide sale." While the Fifth Circuit conceivably could distinguish a partnership holding only passive investments from a partnership that held at least some assets requiring active management, the safer money would be on the Fifth Circuit finding the bona fide sale aspect of the exception satisfied in both cases provided that the parties actually transferred the property and observed the partnership formalities.

[105]In one respect, this reasoning makes perfect sense. Whether a transfer to a family limited partnership satisfies the adequate and full consideration exception to section 2036(a) should not depend on whether a relative had previously assumed responsibility for the management of the transferor's final affairs. On the other hand, if the relative steps in and simply conserves the transferor's property in the same capacity as would an agent under a durable power of attorney, then there is little reason to treat the transferor's partnership interest as anything more than evidence of the transferor's continued beneficial interest in the partnership property.

"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."[106] With that purpose in mind, the issue of whether to treat a partnership interest received in exchange for a contribution of property to the entity as consideration for purposes of section 2036(a) is complicated, to say the least. If the primary purpose of the partnership is to serve as a vehicle through which the transferor can better structure his or her investment holdings, then the partnership interest simply evidences the transferor's continued beneficial interest in or control over the transferred property.[107] If the partnership interest were treated as a separate item of consideration for purposes of section 2036(a) under those circumstances, then the very thing that served to implicate the statute also would serve to avoid it. Stated differently, the exception to the statute would meet the predicate coming.[108] That interpretation of the statute cannot be proper.

However, if the formation of the partnership is driven by substantial nontax factors that have a business-related motive, then it would be appropriate to view the partnership interest received on formation of the entity as a separate asset that would constitute consideration for the transfer in terms of section 2036(a). For example, suppose that two family members contribute cash and other liquid assets to a partnership with the goal of using those assets to fund the purchase of a parcel of real property that they will subdivide and develop. The formation of the partnership certainly would qualify as a "bona fide sale" that supplied deemed adequate and full consideration for the contribution of property to the partnership, because the purpose of the transaction was to yield a business investment that differed significantly from the contributed property. Furthermore, that result could obtain even if the partnership remained invested in marketable securities. For instance, if the securities contributed by each party consisted of concentrated holdings of one company or even one particular industry sector, then the pooling of those assets through the partnership would permit its members to reduce their risk exposure through diversification. In that case, the nature of the partnership interest received on formation of the entity would differ materially from the assets contributed to the entity. The heart of the issue is to determine whether there exists a substantive basis for treating the partnership interest as an asset that is separate and distinct from the contributed property, as opposed to a mere reflection of the transferor's continued beneficial interest in such property.[109] Nontax justifications that relate to a business or investment-related advantage to be achieved through the formation of the entity can supply this basis;[110] nontax justifications that serve only to improve the decedent's beneficial ownership of the partnership property or to enhance its future transmission should not.

C. The Merits of Vagueness

For the reasons described above, the "recycling of value" rationale first articulated by the Tax Court in *Estate of Harper* is a reasonable and well-considered approach to resolving the dilemma of how a beneficial interest in a closely held partnership should be regarded in terms of the adequate and full consideration exception to section 2036(a). By refusing to treat a partnership interest as consideration when there exists no change "in the underlying pool of assets or prospect for profit, as, for example, where others make contributions of property or services in the interest of a true joint ownership or enterprise,"[111] the analysis recognizes that the underlying purpose of section 2036(a) would be thwarted if a mere change in the form of beneficial ownership were sufficient to avoid the statute.

Of course, that approach to resolving the adequate and full consideration issue injects into the legal analysis the sort of vague standards that tax planners loathe.[112] The need for a meaningful business-related purpose for the partnership makes it increasingly difficult for estate planners to assure their clients that the use of a family limited partnership will produce the intended tax benefits. Nonetheless, the federal estate and gift taxes cannot

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[106] *United States v. Estate of Grace*, 395 U.S. 316, 320 (1969).

[107] While the transferor's interest in the partnership as limited partner would evidence her continued beneficial ownership of the property conveyed to the partnership, any interest held as general partner would go further and evidence the transferor's retained control over beneficial enjoyment of the partnership property (through the ability to determine the timing and amount of partnership income).

[108] For example, if a transferor contributes property to a trust in which he retains a life estate, clearly the transferor has received something in exchange for the transfer of property — the value of the retained life estate. If the transferor is young enough, the value of the retained life estate can come close to the full value of the transferred property. Yet no one would suggest that the adequate and full consideration exception under section 2036(a) prevented the inclusion of the trust property in the transferor's gross estate under section 2036(a)(1). From a functional perspective, the transfer of property to a limited partner in exchange for a 99 percent beneficial interest in the entity does not differ greatly from the trust situation described above.

[109] *See* Sheppard, *supra* note 102 at 1098 ("The nuisance factor of the partnership paper hardly constitutes a substantively changed relationship with the assets").

[110] A similar rule applies in the income tax area, where a partnership must be entered into for substantial business reasons to be respected. *See* Treas. reg. section 1.701-2(a)(1). Pointing to the elimination of family limited partnership examples from the partnership antiabuse regulations and their limitation to the income tax setting, some have argued that a similar rule has no place in the transfer tax setting. *See, e.g.*, Owen G. Fiore, "FLPs Are Good Business, Not a Party or Game," *Tax Notes*, Apr. 14, 2003, p. 289 (letter to editor). Nonetheless, regulatory silence on this topic in the transfer tax area should not prevent courts from incorporating a similar rule as a reasonable approach to determining whether a partnership formation is the product of a "bona fide sale" for purposes of the adequate and full consideration exception to section 2036(a).

[111] *Estate of Harper v. Commissioner*, 83 T.C.M. (CCH) 1641, 1653 (2002).

[112] *See* ACTEC Brief, *supra* note 49, 30 *ACTEC J.* at 49 ("Most estate planning advisers, including College members, and their clients, want to design and use such partnerships within known rules and boundaries . . . .").

be completely sanitized to a set of black-and-white rules, particularly in the context of adequate and full consideration. For instance, regarding a lifetime transfer of property for which the transferor receives something less than an adequate and full consideration in money or money's worth (as measured by the willing buyer-willing seller standard), the transfer nonetheless will not constitute a taxable gift if the transfer is made "in the ordinary course of business (a transaction which is bona fide, at arm's length, *and free from any donative intent*)."[113] Thus, the subjective intent of the transferor is inescapably relevant in some related-party transactions. There is no reason to believe that formations of closely held partnerships should be exempted from a similar inquiry into the substance of the transaction, particularly when the transaction fails to provide the transferor with adequate and full consideration under the objective "equilibrium rule." But even if the vague inquiries involved in applying the "bona fide sale" phrase in section 2036(a) as a safe harbor for partnership formations that fail to provide the transferor with objectively sufficient consideration could be eliminated, that does not necessarily mean they should.[114] Requiring a meaningful business purpose for the formation of a limited partnership to satisfy the exception to section 2036(a) provides the government and the courts with a necessary resource to address transactions that have an overriding tax-avoidance purpose. That, in turn, helps to preserve whatever integrity is left of the federal estate tax by preventing taxpayers from unilaterally lowering their estate tax exposure through the mere expedient of transferring the bulk of their investment portfolio to a closely held partnership.[115]

VI. Conclusion

The Fifth Circuit's decision in *Kimbell* may well signal the end of the government's ability to use section 2036 to challenge the valuation discounts associated with the use of family limited partnerships for estate planning purposes. While the case is not a complete home run for taxpayers and their estate planners — the court stopped short of holding that the formation of a pro rata partnership automatically satisfies the internal exception to section 2036(a) — the case is at least a stand-up triple with a hard turn at the bag. The court sidestepped the equilibrium rule it had previously espoused in *Wheeler* by holding that a beneficial interest in a pro rata partnership valued at roughly 50 percent of the value of the contributed property nonetheless constituted adequate and full consideration for the transfer. While that determination would have been defensible had there existed a meaningful business-related justification for forming the entity, the court determined that the bona fides of the transaction could be established on showing that the transfers incident to the partnership actually took place and that the parties did not disregard the partnership as a separate entity. Although the court purported to apply heightened scrutiny to the transaction, that scrutiny consisted only of ensuring that the partnership formation was not a sham transaction motivated solely by tax planning with no business or corporate purpose. Therefore, the standard set for taxpayers to avoid section 2036(a) in the family limited partnership context is by no means daunting.

Beyond setting an exceedingly low bar for a partnership interest to satisfy the adequate and full consideration exception to section 2036(a), the Fifth Circuit in *Kimbell* placed considerable reliance on a variety of nontax justifications offered for the partnership that related primarily to the decedent improving the form in which she continued to beneficially own the transferred property. By doing so, the court failed to appreciate that the legislative purpose of section 2036 is to include in a transferor's gross estate "transfers which leave the transferor a significant interest in or control over property transferred during his lifetime."[116] Because any family limited partnership will be able to recite a few nontax justifications for the formation of the entity, the Fifth Circuit opinion in *Kimbell* clears the way for the continued use of the family limited partnership as a trust substitute that happens to produce phenomenal transfer tax savings.[117] Thus, the family limited partnership continues to serve as a rare exception to the adage "If it sounds too good to be true, it probably is."

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[113]Treas. reg. section 25.2512-8 (emphasis supplied).

[114]*See* Martin J. McMahon Jr., "Beyond a GAAR: Retrofitting the Code to Rein in 21st Century Tax Shelters," *Tax Notes*, Mar. 17, 2003, p. 1721, at 1736 (arguing, in the income tax context, that uncertainty in the tax rules can be desirable).

[115]If transactions such as those in *Kimbell* are sufficient to produce valuation discounts on the order of 30 percent or 40 percent, a meaningful amount of deadweight loss could be eliminated by permitting estates to elect (in lieu of applying any available discounts) to reduce the size of the entire gross estate by the same proportionate amount. Not only would this obviate forming the partnership and then defending the claimed discounts with expensive appraisals, this solution would also make the benefits of the discounting strategy available to all people who died with substantial wealth, not just the well-advised. Such an election, of course, would be ludicrous, but perhaps not much more so the existing state of self-help estate tax relief offered by family limited partnerships.

[116]*Church v. United States*, 85 AFTR2d 2000-804 (W.D. Tex. 2000), *aff'd* 268 F.3d 1063 (5th Cir. 2001) (table).

[117]*See* Sheppard, *supra* note 102 at 1102 ("*Kimbell* is wonderful news for planners, because it means they can continue to sell these deals, and there will be no trouble if a client can afford not to tap the partnership assets, or can afford extensive babysitting by lawyers").