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Guest Article

5th Circuit Ruling Supports FLPs As Discount Tools

By Jeffrey A. Baskies

Let's score one for the good guys (the taxpayers) in the ongoing battle with the bad guys (the IRS) over discounts in the context of family limited partnerships ("FLPs").

After the taxpayer loss in the *Strangi* case, many planners began to openly wonder if the magic of FLP discounting was gone. *Estate of Strangi v. Commissioner* , T.C. Memo 2003-145 (2003).

However, the 5th Circuit's May 20 ruling in *Kimbell v. United States* is a clear victory for the taxpayer, and, since the *Strangi* case is on appeal to the same 5th Circuit, there is reason for optimism that the *Strangi* holding may be in trouble.

[EDITOR'S NOTE: Click here for a related article.]

'Kimbell' Facts

Ruth Kimbell died on March 25, 1998 at the age of 96. David Kimbell, her son, was the executor of her estate and the plaintiff in the case. The transactions that led to this case can be summarized as follows:

1. In 1991, Ruth created a revocable trust with herself and her son, David, as co-trustees. She transferred her assets into the name of the trust.

2. In January 1998, the trust, David and David's wife formed a limited liability company ("LLC"). The trust was 50 percent owner with David and his wife owning 25 percent each - and David serving as sole manager of the LLC.

3. Later in January 1998, the trust and the LLC formed the Kimbell Property Co., Ltd., a FLP under Texas law. The trust contributed $2.5 million in cash, oil and gas working interests and

royalty interests, securities, notes and other assets in exchange for a 99 percent FLP interest. The LLC contributed $25,000 in cash for a 1 percent general partner interest.

4. As a result of the transactions, Ruth owned 99.5 percent of the FLP through her trust interest in the FLP and the LLC. And David had control over the FLP and the LLC as the manager of both entities.

5. After all of the transactions, Ruth had about $450,000 of other assets remaining in her control outside of the FLP and LLC, which funds were available to pay for her personal expenses.

6. Ruth died within a few months of the formation of the FLP and LLC.

In addition to the transactions that occurred, there are a few points made in the decision about the terms of the FLP. Those included:

- The FLP had a laundry list of purposes - which the court noted provided non-tax-avoidance support for its creation.

- The LLC as manager of the FLP had exclusive authority to make distribution decisions.

- The FLP provided that the general partner had no fiduciary duty to the partnership but did owe a duty of loyalty and due care.

- The limited partners had no right to withdraw or get their principal back until the FLP terminated (it was scheduled to last 40 years), and earlier termination could occur only by unanimous consent of the partners.

- 70 percent in interest of the partners had the right to remove the general partner and a majority in interest of the partners had the right to elect a new general partner.

In December 1998, the estate filed a federal estate tax return showing the value of the assets in the partnership at approximately $2.4 million and taking a 49 percent discount on the value of the estate's interests (99.5 percent) for lack of control and lack of marketability.

The IRS audited the return and totally denied the discounts claiming the full value of the FLP assets should be in her estate under Sect. 2036(a) of the Internal Revenue Code.

The estate paid the tax and filed for a refund. On summary judgment, the District Court agreed with the IRS that Sect. 2036(a) applied and fully disregarded the discounts.

The estate appealed and the 5th Circuit ruled in its favor.

The Holding

First, the court said that the issue of includibility as presented in this case depended upon interpreting Sect. 2036(a).

"Whether the assets Mrs. Kimbell transferred to the Partnership must be recaptured into her estate for estate tax purposes depends on the application of Internal Revenue Code section 2036(a)," the court said.

It noted that IRC Sect. 2036(a) provides:

"(a) General rule. The value of the gross estate shall include the value of all property to the

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

"(1) the possession or enjoyment of, or the right to 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."

The statute, the 5th Circuit said, "recognizes that some assets transferred prior to death must be recaptured into the estate. By recapturing these transfers into the estate, this section of the code prevents the circumvention of federal estate tax by the use of inter vivos transactions which do not remove the lifetime enjoyment of property purportedly transferred by a decedent."

The court cited a 1973 ruling, *Estate of Lumpkin v. Commissioner*, 474 F.2d 1092, in which the 5th Circuit noted:

"[Section 2036 is] part of a Congressional scheme to tax the value of property transferred at death, whether the defendant accomplishes the transfer by will, by intestacy, or by allowing his substantial control over the property to remain unexercised until death so that the shifting of its economic benefits to the beneficiary only then becomes complete."

The *Kimbell* court wrote:

"The statute provides two exceptions that will allow a transfer to escape the operation of Sect. 2036(a). First, if the transfer is a bona fide sale for full and adequate consideration, then Sect. 2036(a) does not apply. See Treas. Reg. Sects. 20.2036-1(a), 20.2043-1(1) (as amended in 1960). If the transfer is not a bona fide sale for full and adequate consideration, then the transfer may still be excluded from the estate of the decedent under the second exception, if the decedent did not retain either the (1) possession, enjoyment or rights to the transferred property, or (2) the right to designate the persons who would possess or enjoy the transferred property."

Next, the court examined the transfer to the FLP to determine if it constituted a bona fide sale for adequate and full consideration in money's worth. Obviously, the District Court, which sided with the IRS on summary judgment, did not feel it constituted such.

The 5th Circuit examined several of the leading cases on the subject citing to the following as supporting the argument that an intra-family transfer can be for full and adequate consideration:

- *Wheeler v. United States*, 116 F.3d 749 (5th Cir. 1997).

- *Church v. United States.*, 85 AFTR 2d 804 (W.D. Tex. 2000), *aff'd without published opinion*, 268 F.3d 1063 (5th Cir 2001).

- *Estate of Stone v. Commisioner*, 86 T.C.M. (CCH) 551, 578 (T.C. 2003).

Tying the holdings of those cases together and distinguishing the holdings in cases such as *Strangi* and *Thompson v. Commissioner*, 84 T.C.M. 374 (2002) (holding that intra-family transactions were shams), the court found the following rule of thumb for determining the sufficiency of consideration:

"In summary, what is required for the transfer by Mrs. Kimbell to the Partnership to qualify as a bona fide sale is that it be a sale in which the decedent/transferor actually parted with her interest in the assets transferred and the partnership/transferee actually parted with the partnership interest issued in exchange. In order for the sale to be for adequate and full

consideration, the exchange of assets for partnership interests must be roughly equivalent so the transfer does not deplete the estate. In addition, when the transaction is between family members, it is subject to heightened scrutiny to insure that the sale is not a sham transaction or disguised gift. The scrutiny is limited to the examination of objective facts that would confirm or deny the taxpayer's assertion that the transaction is bona fide or genuine."

In applying that standard to the *Kimbell* transactions, the court held:

"The proper focus therefore on whether a transfer to a partnership is for adequate and full consideration is: (1) whether the interests credited to each of the partners was proportionate to the fair market value of the assets each partner contributed to the partnership, (2) whether the assets contributed by each partner to the partnership were properly credited to the respective capital accounts of the partners, and (3) whether on termination or dissolution of the partnership the partners were entitled to distributions from the partnership in amounts equal to their respective capital accounts."

The court then found that the answer to each of these questions in the *Kimbell* case was in the affirmative. And finally, the court examined the record to see if the estate offered objective facts to support its argument that the transfer was for full and adequate consideration.

The court looked to the following facts to support its conclusion:

1. Mrs. Kimbell retained sufficient assets outside the partnership for her own support and there was no commingling of partnership and her personal assets.

2. Partnership formalities were satisfied and the assets contributed to the partnership were actually assigned to the partnership.

3. The assets contributed to the partnership included working interests in oil and gas properties that do require active management.

4. David Kimbell and his business advisor advanced several credible and unchallenged non-tax business reasons for the formation of the partnership that could not be accomplished via Mrs. Kimbell's trust.

The Impact Or Meaning

First, the *Kimbell* case will allay the significant fears of many planners that the IRS finally had a winning argument in Sect. 2036(a). After the *Strangi* decision, many commentators and planners began warning clients that the FLP discounts may be in jeopardy. The decision in *Kimbell* should provide some calm, although who knows what will happen with the next IRS challenge.

But there are a few positive things to take from this decision.

1. The *Kimbell* FLP was not a great facts case. It was created very close in time to Ruth Kimbell's death (within only a few months). Those "deathbed" FLP cases have been hard to win in the past. So the fact that the family won with such facts is a positive for most clients who are not on their deathbeds.

2. The *Kimbell* decision is a stark reminder of the need to enunciate real, credible non-tax reasons for forming FLPs and having business advisors who can testify in support thereof. Having such available was obviously a key element in the decision.

3. Ruth Kimbell did not fund all of her assets into the FLP - although she did put in about 80 percent. However, clients should keep assets in their own names to pay their own expenses and not be totally dependent upon the FLP for living expenses. And clients should never use the FLP

to pay their bills directly (not an issue in *Kimbell*, but a good reminder from other cases).

4. Ruth Kimbell did not retain any management or control over the FLP. That may be a key issue for many clients. It seems that giving up control is an essential element for the courts. Now there are arguments that if the transfer is a bona fide sale or transaction in money's worth, then the client should be able to keep some control. But the cases and the tone of the IRS attacks seem to indicate that the prudent path is to allow a family member to control the FLP instead of the creator maintain control.

5. Having the oil and gas interests in the FLP seemed to help the court in this case. Maybe having some "actively" managed assets should be a consideration for FLPs. In *Kimbell*, they only represented about 15 percent of the assets, so clearly the FLP does not need to be predominantly actively managed, but having some actively managed assets seems to bolster the non-tax-avoidance purposes arguments. This is a worthy consideration for other clients forming (or already managing) FLPs.

6. As in all the other cases that taxpayers have won in the past, following the formalities for FLPs seems essential. In this case, the FLP was properly formed and funded. Separate accounts were maintained. Capital accounts were established and distributions were to be made accordingly. Personal expenses were not paid from the FLP. And formal accounting procedures (including tax return preparation, presumptively) were put in place.

The bottom line is that *Kimbell* is a very positive result for taxpayers. Had the IRS won that appeal, it would have had wide-spread application. Nevertheless, the IRS is still likely to fight FLP discounts, and it is likely to look for the "weakest" cases.

So for the sake of your clients, try to be sure they have valid non-tax-avoidance purposes for the FLPs enunciated, they have some actively managed assets in the FLPs and preferably they give up all management and control.

Finally, without any question, the formalities of the partnership (separate accounts, no commingling with the founder's funds, real capital accounts, formal accounting and tax preparation, etc.) must be respected and maintained.

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