



Estate & Succession

Planning Corner



By Louis S. Harrison

Kimbell: Reprieve for the FLP Fugitive

On May 20, 2004, the Fifth Circuit delivered good news to estate planners with its holding in the long awaited *D.A. Kimbell* case.¹ In *Kimbell*, the Fifth Circuit considered and in principle cut back on the Tax Court's *Strangi IP* decision (discussed in this column in the May–June edition of this JOURNAL).³ Its holding, reasoning and implications to estate planners in the family limited partnership (FLP) setting are all good news.

But, first, *caveat emptor*. The holding applies to taxpayers who are in the Fifth Circuit (the States of Louisiana, Mississippi and Texas) and can be cited in other jurisdictions. However, it is not binding precedent on the Tax Court (outside of the Fifth Circuit) or other Circuits. It is possible that other Circuits will hold differently than the Fifth Circuit, such as has been done with establishing the rules for the deductibility of administration expenses under Code Sec. 2053.⁴ For now, regardless, the *Kimbell* case provides an excellent roadmap as to how to structure partnerships in order to avoid Code Sec. 2036 arguments to ignore the partnership at death.

So the column this month focuses on the *Kimbell* case and its holding: first the facts, then the reasoning and holding, and finally the roadmap as to how to structure partnerships to come within the reasoning of the *Kimbell* case.

The Facts

The *Kimbell* background has similarities to the ugliness that was the *Strangi* fact pattern. Like *Strangi*, the decedent in *Kimbell* was rather elderly, at age 96, when the partnership was set up. Mrs. Kimbell transferred substantial passive assets to the partnership (greater than 85 percent of total partnership funding). Mrs. Kimbell acted primarily through her son, who was a co-trustee of her living trust. Nontax reasons were proffered in the partnership agreement, but these reasons strained credulity, in an objective world, as to why a 96-year-old would

create a partnership. Through her living trust, the decedent transferred the majority of the equity to the partnership, retaining a 99-percent limited partnership interest and a 50-percent interest in an LLC that acted as general partner of the partnership (the other one-percent equity holder). The decedent died within two months of the creation of the partnership, and on her Form 706, her estate argued that the 99-percent limited partnership interest was entitled to a 49-percent reduction in value.

The IRS denied the reduction and argued that the partnership should be ignored, and the assets in the partnership valued at their underlying value without any discounts. The District Court⁵ granted summary judgment in favor of the IRS (*i.e.*, no discount), finding the transfer of assets to the partnership was within the reach of Code Sec. 2036(a) and did not constitute a sale for full and adequate consideration because family members did not (and probably as a matter of reality could not) enter into a bona fide transaction.

The Holding

The Fifth Circuit reversed the summary judgment holding and remanded the case back to the lower court. It held that the consideration received by the decedent in setting up the partnership constituted full and adequate consideration and, therefore, excepted the transaction from the reach of Code Sec. 2036.

The Reasoning

One difficulty of the *Strangi* case was its harsh application of the term “*bona fide*” in the full and adequate consideration exception. As discussed in the May–June column,⁶ the Tax Court basically was looking for actual negotiations between family members to demonstrate and satisfy this requirement, and in the absence of such negotiations, refused to imple-

Louis S. Harrison is a Partner in the firm of Harrison & Held in Chicago, Illinois.

ment the full and adequate consideration exception to Code Sec. 2036 (see also *Stone*).⁷

In contrast, the Fifth Circuit focused its holding and reasoning on its prior decision in *J.M. Wheeler*.⁸ In *Wheeler*, the Fifth Circuit held that the *bona fide* full and adequate consideration exception applied if the transaction was not a sham or illusory and if *objective* facts demonstrated that the transfer was made for full and adequate consideration.

In reaching its holding, the *Kimbell* court emphasized:

However, we made it clear that just because a transaction takes place between family members does not impose an additional requirement not set forth in the statute to establish that it is bona fide. *Id.* at 764. A transaction that is a bona fide sale between strangers must also be bona fide between members of the same family. In addition, the absence of negotiations between family members over price or terms is not a compelling factor in the determination as to whether a sale is bona fide, particularly when the exchange value is set by objective factors. *Id.* at 769. In summary, the *Wheeler* case directs us to examine whether “the sale ... was, in fact a bona fide sale or was instead a disguised gift or a sham transaction. *Id.* at 767.”⁹

To satisfy the adequate consideration requirement, the *Kimbell* court emphasized, “[i]n 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.”¹⁰

This can be substantiated by making sure “the transaction was entered into for substantial business and other non-tax reasons.”¹¹ The Court seemed to go a bit further than its *Wheeler* holding, and expressed that there must be substantial non-tax and business reasons for the partnership. However, in application, and when the facts in the case are examined for what they were, this added requirement is not a far extension of the *Wheeler* application of the exception.

In sum, the *Kimbell* court reads out *bona fide* as requiring “actual negotiations,” and merely requires that the transactions are real and documentation evidences such.

Structuring Partnerships

In addition to the proper restrictions in the partnership agreements and proportional funding/equity interests, a partnership should focus on the follow-

ing actions, structuring (bulleted points 1 through 3) and administrative (next three bulleted points) actions, as a result of *Kimbell*:

- There must be demonstrated “substantial business and other non-tax reasons.”¹²
- There must be actual consideration received in terms of the partnership interests: equity interests, cash flow and tax implications should be proportional.¹³
- Outside of the partnership, partners should retain other assets for his or her support.
- There must be actual transfers: The assets have to be re-titled in the partnership name; the “i”s must be dotted and “t”s crossed.
- The partnership must be maintained as a separate entity; there can be no commingling.
- The requisite returns should be filed.

The partnership should actually be managed pursuant to the purposes set forth for its establishment.

Ancillary Ramifications

There were numerous interesting facts that the Court did not view as fatal.

First, the reasons for the partnership were objectively valid, and subjectively demonstrated, but do not hold up well under scrutiny. That is, was the partnership really set up for nontax reasons? One could argue no, and the *Kimbell* court demonstrates that effort should be taken at the set up stage to make sure that the partnership has defensible nontax reasons for its establishment. Even a marketable asset partnership has these nontax reasons.

More effort should be spent by practitioners examining and working on this area pre-partnership set-up. It is important to note that the Court uses the term “substantial” in reference to business purposes and nontax reasons for the partnership. In light of the reasons and fact pattern of this partnership, it is not certain whether the traditional connotative meaning should be given to the word “substantial.” Perhaps the court is using the term as a metaphor for merely something that is “real, actual and genuine.”

Second, *de minimis* contributions can be made by other partners (versus the decedent) without destroying the integrity of the partnership. This is important for three reasons: First, there may be the practical difficulty of not having enough capital with other family members to fund the partnership. Second, to avoid Code Sec. 721 (not having gain on the partnership funding), there is a safe harbor if the other partner contributes less than one percent of partnership capital.

Third, the fact that the “value” of what was received by the transferor of assets to a partnership is less than the “value” of what was put in, does not mean that full consideration was not received. The test is whether the “proportional” value of what was received equals the proportional value of what was put in and that this is truly reflective of each partner’s capital in the partnership. If one puts in 80 percent into the partnership, one should receive an equity interest of 80 percent from the partnership:

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 partnership, and (3) whether upon termination or distributions from the partnership in amounts equal to their respective capital accounts...The answer to each of these questions in this case is yes. Mrs. Kimbell received a partnership interest that was proportionate to the assets she contributed to the Partnership.¹⁴

Example. Decedent transfers \$1,000,000 to a limited partnership funded with \$3 million. The decedent retains a 33-percent limited partnership exchange for the contribution. This is one-third of the equity of the partnership, equivalent to the one-third of the equity that the decedent contributed to the partnership. Even though the immediate fair market value of a one-third limited partnership interest, valued at a discount from the liquidation value, plus one-third of the general partnership interests, are less than \$1 million, this receipt of the one-third interests would still constitute full and adequate consideration under the *Kimbell* test.

One item not answered is whether this proportionality needs to extend to each interest in the limited partnership. In an FLP, there will essentially be two partnership interests, the limited partnership interest and the general partnership interest. Can the 90-percent contributor receive 90 percent of the equity

of the partnership merely as limited partnership interests, with no retention of the general partnership interests, or must the 90-percent contributor retain 90 percent of the limited partnership and 90 percent of the general partnership interests? The Fifth Circuit seemed to indicate only the former, that 90 percent of the overall equity, not necessarily spread as between the general and limited partnerships, was all that was required. The court, by implication, held that equity did not have to be proportional among each type of partnership interest.

For example, in the example above, instead of retaining 33 percent of each class of partnership interest, the decedent could merely retain a 33-percent interest in the overall partnership represented by limited partnership interests (33 percent/99 percent of all limited partnership interests).

Fourth, the Court held that 50-percent ownership in the LLC (as the general partner) was not sufficient retention to bring the LLC back into the gross estate, in its entirety (one percent), under Code Sec. 2036(a)(2). The court’s reasoning here is not entirely clear. Was it because Mrs. Kimbell did not retain control? Is the “in conjunction with” language under Code Sec. 2036(a)(2) toned down? Was it because the decedent had fiduciary obligations as general partner?

Fifth, the *Kimbell* case is an estate tax case holding that the full and adequate consideration exception, once satisfied, takes the case out of Code Sec. 2036. Importantly, annual exclusion gifts during life would not fall within this exception (there is no adequate and full consideration); hence, Code Sec. 2036 could apply to bring those transfers back into the gross estate if the initial prongs of Code Sec. 2036 have been satisfied.

Conclusion

Kimbell provides that demonstrable, properly implemented, nontax purposes, proportionality, and administration as a partnership, will allow an FLP to avoid the application of Code Sec. 2036. However, if these standards are not met, typically occurring in those situations in which there are operational abuses, then the taxpayer will be subject to the *Strangi II* arguments of Code Sec. 2036 application.

The FLP landscape continues to evolve, rapidly. On July 12, 2004, the Tax Court held against the taxpay-

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ers in an *inter vivos* gifting situation. It held, citing *J.C. Shepherd*,¹⁵ that gifts of limited partnership interests should be valued at the value of the underlying interests, without regard to restrictions and discounts that would be applicable to a partnership.¹⁶

A golden rule is evolving: At all times (pre-set-up, set-up, and post-set-up), operate an FLP as one would a business, in a businesslike and formal manner.

ENDNOTES

¹ *D.A. Kimbell*, CA-5, 2004-1 USTC ¶ 60,486, 371 F3d 257.

² *A. Strangi Est. II*, Dec. 55,160(M), TC Memo. 2003-145.

³ Louis S. Harrison, Estate & Succession Planning Corner, *Raddling the Myths and Realities of Partnership Planning in a Strangi II World*, J. PASSTHROUGH ENTITIES, May-June 2004, at 5.

⁴ *Cf. Hibernia Bank*, CA-9, 78-2 USTC ¶ 13,261, 581 F2d 741; and *J.M. White*, CA-2, 88-2 USTC ¶ 13,777, 853 F2d 107. Since this column was completed, the Third Circuit has issued a holding against partnerships in *T.R. Thompson Est.*, 84 TCM 374, Dec. 54,890(M), TC Memo. 2002-246, *aff'd sub. nom.*, *B.T. Turner*, CA-3, 2004-2 USTC ¶ 60,489. This holding will be discussed in an upcoming edition of the JOURNAL.

⁵ *D.A. Kimbell*, DC Tex., 2003-1 USTC ¶ 60,455, 244 FSupp2d 700.

⁶ *Supra* note 3.

⁷ *Strangi II*, *supra* note 2. *E.E. Stone III Est.*, 86 TCM 551, Dec. 55,341(M), TC Memo. 2003-309.

⁸ *J.M. Wheeler*, CA-5, 97-2 USTC ¶ 60,278, 116 F3d 749.

⁹ *Kimbell*, *supra* note 1, at 262.

¹⁰ *Id.*, at 264.

¹¹ *Id.*, at 265.

¹² In *Kimbell*, nontax purposes were demonstrated by affidavits of parties involved in the establishment, administration of the partnership (emphasize "demonstrated," no credulity test was established): creditor protection, pooling of capital, reduced administrative costs, preservation of property for descendants and provision for management succession.

¹³ Mrs. Kimbell received back a proportion of the equity in the partnership equivalent to the proportion of the total capital in the partnership that she put in (more on this below).

¹⁴ *Kimbell*, *supra* note 1, at 266.

¹⁵ *J.C. Shepherd*, 115 TC 376, Dec. 54,098 (2000). *Aff'd*, CA-11, 2002-1 USTC ¶ 60,431, 283 F3d 1258.

¹⁶ See *M.W. Senda*, 88 TCM 8, Dec. 55,685(M), TC Memo. 2004-160.

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