

New Golden Rule For Partnerships

How to handle FLPs in the wake of *Thompson and Kimbell*

On May 20, the U.S. Court of Appeals for the Fifth Circuit delivered good news to estate planners with its long-awaited holding in *Kimbell v. U.S.*¹ The court cut back on the Tax Court's *Strangi II*² decision. Of course, *Kimbell* applies directly only to taxpayers in the Fifth Circuit, that is Louisiana, Mississippi and Texas. But it can be cited in other jurisdictions. And its conclusions, reasoning and implications for estate planners dealing with family limited partnerships (FLPS) are all favorable.

Unfortunately, just four months after *Kimbell*, on Sept. 1, the U.S. Court of Appeals for the Third Circuit in *Thompson* contradicted *Kimbell*.^{3,4}

So now the question is: What's an estate planner to do? Read together, the decisions show that, even though the Fifth and Third Circuits disagree about the application of Internal Revenue Code Section 2036, there is still some room to structure FLPs under both cases's holdings, as long as planners can show that the partnership has real economic purpose.

FACTS

Kimbell's fact pattern is similar to the ugliness found in the infamous *Strangi* case. As in *Strangi*, the decedent in *Kimbell* was elderly (age 96) when the partnership in question was established. Ruth Kimbell

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transferred substantial passive assets to the partnership (greater than 85 percent of her total wealth). She acted primarily through her son, who was a co-trustee of her living trust. Non-tax reasons were proffered in the partnership agreement, but they strained credulity. Through her living trust, Kimbell transferred the majority of the equity to the partnership, retaining a 99 percent limited partnership interest and a 50 percent interest in a limited liability company that acted as general partner of the partnership (the other 1 percent equity holder). She died within two months of creating the partnership. On her estate tax return, her executor argued that the 99 percent limited partnership interest was entitled to a 49 percent reduction in value.

The Internal Revenue Service denied the reduction, arguing 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 Service, finding that the transfer of assets to the partnership was within the reach of IRC Section 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.

In *Thompson*, the facts were no better. Again, the decedent, Theodore Thompson, was elderly (age 95) when two partnerships were created. To one partnership, involving the decedent and his son, Thompson transferred \$1,118,500 in marketable securities and notes receivable of \$293,000. Thompson received a 62.27 percent limited partnership interest. He also received a 49 percent interest in the corporation that served as general partner. His son contributed mutual funds worth \$372,000 and a Colorado ranch valued at \$460,000, which the son used as his residence. The son received a limited partnership interest of 36.72 percent and 49 percent of the "corporate general partner," which itself held a 1.01 percent general partnership interest.

To the other Thompson partnership, which involved the decedent, his daughter and his daughter's husband, Thompson contributed

\$1.286 million in marketable securities and \$125,000 in notes receivable in exchange for a 95.4 percent limited partnership interest. The son-in-law contributed cash of \$1,000 and real estate in Vermont valued at \$49,000; he received a 3.54 percent limited partnership interest. The corporate general partner held a 1.06 percent general partnership interest. This corporation was owned: 49 percent by the decedent, 24.5 percent by the decedent's daughter, 24.5 percent by the daughter's husband and 2 percent by an unrelated charity.

The funding is interesting. First, the decedent transferred to the partnerships \$2.8 million, retaining only \$153,000 in personal assets, enough to cover three years of living expenses.⁷ Yet, the court noted, the decedent had a life expectancy of 4.1 years when the partnerships were created. Also, even though the decedent contributed the majority of assets to the partnerships, he did not retain the majority control of the general partnership interests; he had less than a 50 percent interest in each corporate general partner. The Service could argue that gifts on formation arguments were made.

On top of this, the majority of the decedent's contributions were marketable assets. And even though the other partners contributed illiquid assets, there was nothing significant about the mix of assets in the partnerships sufficient to create the appearance that the partnerships were established for any particular reason. In this regard, it may have been more justifiable had the decedent just contributed assets to the partnerships, for reasons relating to shifting investment control to a third party.

A lack of a real economic purpose to the partnership was further demonstrated when significant distributions of assets were made to the decedent before his death, just two years after the partnerships were formed. Moreover, there were not many reinvestments of partnership assets and those assets did not change in character very much.

These facts suggest the question: Why contribute assets to a partnership if you will get quite a bit back immediately, and there is

Why contribute assets to a partnership if you get quite a bit back immediately and there is no investment or other purpose?

no investment or other purpose, other than to create discounts?

If there were any doubts about the lack of a real purpose to the partnership, post-mortem events would have dispelled them. Within two weeks of Thompson's death, the partnerships sold \$700,000 in securities to pay bequests and estate taxes. The estate tax return said the limited partnership interests were entitled to a 40 percent reduction in value.

HOLDINGS

In *Kimbell*, the Fifth Circuit reversed a summary judgment and remanded the case back to the Tax Court. It held that the consideration received by the decedent in setting up the partnership did constitute full and adequate consideration and, therefore, excepted the transaction from the reach of Section 2036.⁹

In *Thompson*, the Third Circuit affirmed the Tax Court's decision, finding that Section 2036(a)(1) applied and that the estate did not fall within the exception for a bona fide sale for full and adequate consideration. That court did not address the question of whether the assets were includible under Section 2036(a)(2), because of a retained power to control beneficial enjoyment.

Note that *Thompson* includes both an opinion by the court and a concurring opinion by two of the three judges of the appellate court.¹⁰ Also, the court said over and over again that the partnership did not have "legitimate business operations." It is unfortunate that the judges chose this language, because it created the impression that what they were looking for was some kind of operating business. But what the court really found was that the partnership lacked any *raison d'être*, other than tax savings.

REASONING

The *Thompson* court accepted the Tax Court's finding that there was an "implied agreement" between the decedent and the other partners, that

the decedent would retain the lifetime benefits of the assets transferred. The appellate court emphasized that, without such an understanding, it would be difficult to explain why a 95-year-old would transfer 95 percent of his assets to such partnerships, not even retaining enough assets to meet his monthly expenses for the term of his life expectancy. Support for this proposition was plentiful: The decedent's children had sought assurances from

There's disagreement about the full and adequate consideration exception to 2036.

the financial advisors that the decedent would be able to withdraw assets from the partnership. There also was evidence that the decedent's children would not refuse a request by the decedent for distributions, and that the partnership did not enter into any transactions with anyone outside the family.

The *Thompson* court next turned to whether to apply the exception to Section 2036 for bona fide sales for adequate and full consideration. This involved a two-part analysis: First, was there a transfer for full and adequate consideration? And if there was, was it a bona fide sale?

The court concluded there was not full and adequate consideration for the transfers to the partnerships for three reasons: First, although the partnership engaged in economic activities, these did not constitute "the type of legitimate business operations that might provide a substantive non-tax benefit" for the transfers. (It would be hard to argue with this conclusion, though there is still the predicate ques-

tion as to whether it should matter). Second, the type of assets that constituted most of the transfers (marketable securities) made it appear unlikely that there were any significant "potential non-tax benefits." (Apparently, non-tax factors such as consolidated management and creditor protection were either not significant to these judges or were not demonstrated with enough credibility to rule the day.) And third, the reduction in value that occurs when assets are contributed to a partnership reduces the possibility of full and adequate consideration being paid. The court referenced *Wheeler*,¹⁰ perhaps not entirely honestly, for this proposition. *Wheeler* noted that, for the exception to apply, a transfer out of the estate had to be accompanied with a corresponding transfer to "augment the estate by a commensurate (monetary) amount,"

otherwise, it could not be for full and adequate consideration. The *Wheeler* opinion intended to create the rule that "the asset the estate receives must be roughly equivalent to the asset it gave up." And further, the *Wheeler/Kimbell* line of cases acknowledges that, as long as pro rata value is received in the initial establishment of the partnership, this will satisfy the "roughly equivalent" standard announced in *Kimbell*.

In discussing the argument that the reduction in value that occurs when assets are contributed to a partnership prevents the possibility of full and adequate consideration, the concurring opinion in *Thompson* is careful to explain that the court is not holding that every transfer of assets to a partnership falls under Section 2036. It points out that this conclusion should not apply to ordinary commercial transactions, even within a family. The distinction, according to the concurring opinion, is that in ordinary commercial transactions the primary objectives are to engage in, or

acquire, active trades or businesses; in this case, the primary objective was estate planning. The gulf between these two extremes, an operating business alluded to by Judge Morton I. Greenberg of the Third Circuit, and the pure estate tax purpose attributed to the decedent in *Thompson*, is enormous. Suffice that, had the partnership demonstrated a reason for its existence greater than reducing the estate for tax purposes, the *Thompson* court may have had a harder time reaching its ultimate conclusion.

The concurring opinion also takes issue with *Kimbell's* endorsement of the principle that there is full and adequate consideration if each partner receives partnership interests in proportion to the value of the property that partner contributed."

The opinion of the *Thompson* court went on to address the issue of whether the transfers to the partnerships constituted bona fide sales. The Tax Court in *Strangi* used a harsh application of the term "bona fide" in the full and adequate consideration exception. It basically was looking for actual negotiations between family members to demonstrate and satisfy this requirement; and, if such negotiations were absent, refused to implement the full and adequate consideration exception to Section 2036."

In contrast, the Fifth Circuit in *Kimbell* focused on its prior decision in *Wheeler*, in which it had 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 . . . 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

Open question: What is needed to substantiate a partnership and satisfy the bona fide prong of the test?

the exchange value is set by objective factors. . . 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.'"

The *Kimbell* court emphasized: "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."⁵⁵ This argument can be substantiated by making sure "the transaction was entered into for substantial business and other non-tax reasons."⁵⁶ 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. But, 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 this area, the Third Circuit somewhat followed the Fifth Circuit's approach in *Kimbell*, which did not read "bona fide" as necessitating "actual negotiations," but merely required that the transactions are real

and documentation evidences the fact. Like *Kimbell*, the *Thompson* decision rejects the requirement of "actual negotiations" and sees "bona fide" or "good faith" as requiring substantial business and other non-tax reasons for the transaction. The emphasis on active business operations seems more important in the language of *Thompson* than it did in *Kimbell*. The question that remains: What is needed to substantiate a partnership, and therefore to satisfy the bona fide prong? The answer should be that the partnership is established, clearly and demonstrably, for a primary reason other than to save estate taxes.

STRUCTURING FLPS

In light of both *Kimbell* and *Thompson*, estate planners should ensure that partnerships, in addition to having proper restrictions to agreements and proportional funding/equity interests, also focus on structure and administration.

There are three important points regarding structure:

(1) There must be demonstrated "substantial business and other non-tax reasons" to satisfy the "bona fide" test expounded in *Kimbell* and *Thompson*—just in case the first prong of Section 2036 is implicated and a retained interest found.

(2) There must be actual consideration received in terms of the partnership interests: equity interests, cash flow and tax implications should be proportional." The question remains whether a decedent should retain a general partner interest sufficient to allow termination of the partnership. The purpose here is to avoid the *Thompson* argument that what was received back is less than what was contributed for purposes of Section 2036's exception for adequate and full consideration. But this is still an open issue and one in

which the *Kimbell* and *Thompson* courts are not aligned.

(3) Outside of the partnership, partners should retain other assets for their support.¹⁹ Reason: to avoid the argument that there is an implied retention sufficient to invoke Section 2036 (a)(1). But, beware, the Section 2036 (a)(2) argument, and the *Strangi II* reasoning, still looms out there, like a werewolf on a full moon.

There are six important points to keep in mind regarding administration:

(1) There must be actual transfers: The assets have to be re-titled in the partnership name; i's must be dotted and t's crossed. The purpose is to create credibility that the establishment of the partnership was really intended for economic purposes. Ignoring formalities creates the impression that the partners do not really intend to operate as a partnership. Further, ignoring partnership formalities makes it easier to argue that Section 2036 (a) (2) should apply.

(2) For the same reasons, the partnership must be maintained as a separate entity; there can be no commingling.

(3) Investments within the part-

There is still confusion about whether there must be operating business assets in the partnership.

nership should maintain some integrity: Who is monitoring them? Are they being re-invested and actively managed? Is this consistent with some end game on the investment world? There is a need to establish an economic justification for the partnership. Contributing assets to a

partnership that neither sells any of the assets nor changes the assets' management structure, suggests there was no reason for the partnership's existence. Of course, that is not always true; for example, the goal could have been to divest control simply to prevent third parties from exercising undue influence. Still, changing the investments within the partnership after contribution provides good indicia that the partnership was established for a real business reason.

(4) All requisite returns should be filed.

(5) There's still confusion about whether there needs to be operating business assets, as opposed to passive investments, within the partnership. *Kimbell* hints at it; *Thompson* more so. We believe that operating assets are not imperative, but that it is paramount that a partnership have a real



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non-estate tax purpose. Clearly, the courts feel that the integrity of the partnership is more easily evidenced by having actual business operations as opposed to passive investments. But, one look at the revenue that investment bankers garner suggests that even passive asset management can be a valuable endeavor.

(6) A partnership should actually be managed pursuant to the purposes set forth for its establishment. After all, consistency will demonstrate the economic substance of the partnership.

MORE RAMIFICATIONS

There were numerous interesting facts that the *Kimbell* court did not view as fatal, but may assume larger importance under *Thompson*.

One of the key issues in each partnership involves the reasons for its creation. The reasons for the *Kimbell* partnership were objectively valid, and subjectively demonstrated, but

do not hold up well under scrutiny. That is, was the partnership really set up for non-tax reasons? The Third Circuit in *Thompson* found this question more important than the *Kimbell*

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court did, especially if the primary partnership assets are marketable securities. The *Kimbell* decision does demonstrate that effort should be made at the set-up stage to make sure that a partnership has defensible non-tax reasons for its establishment. Even a marketable-asset partnership has

these non-tax reasons. Practitioners should make more of an effort examining and working on this area before establishing the partnership.

It is important to note that the court uses the term "substantial" in reference to business purposes and non-tax reasons for the partnership. In light of the *Kimbell* partnership's reasons and fact pattern, one might say that it is uncertain whether the traditional, connotative meaning should be given to the word "substantial." Perhaps the *Kimbell* court was using the term as a metaphor for merely something that is "real, actual and genuine."

After *Thompson*, however, planners should not underestimate the quality and quantity of non-tax reasons necessary to avoid Section 2036.

Another important lesson to be

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gleaned from *Kimbell* is that other partners can make *de minimis* contributions without destroying a partnership's integrity. There is nothing in the *Thompson* opinions that would change that result. This is important for two reasons: First, there may be the practical difficulty of not having enough capital with other family members to fund the partnership. Second, to avoid IRC Section 721 (not having gain on the partnership funding), there is a safe harbor if the other partner contributes less than 1 percent of partnership capital.

Planners also should remember that *Kimbell* held that 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 court said, "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 dissolution of the partnership the partners were entitled to 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."⁸

So, for example, a decedent trans-

fers \$1 million to a limited partnership funded with a total of \$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-

The *Thompson* requirements should cause planners to be more selective in presenting family partnerships to clients.

third of the general partnership interests, is less than \$1 million, this receipt of the one-third interests would still constitute full and adequate consideration under the *Kimbell* test.

One issue still unresolved is whether this proportionality needs to extend to each interest in the limited partnership. In a family limited partnership, there essentially will 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: all that is required is that 90 percent of the overall equity, not necessarily spread as between the general and limited

partnerships. The court, by implication, held that equity did not have to be proportional among each type of partnership interest.

For example, using the same hypothetical, if, 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 over 99 percent of all limited partnership interests).

Warning: *Thompson* reaches a different conclusion. The two courts definitely disagree on this issue. The Third Circuit takes the position that proportional interests are not adequate consideration, unless the transaction falls under the "ordinary commercial" category. The taxpayer must show that the primary purposes of the partnership arrangement are business, non-tax purposes, as opposed to estate planning. Further, the inability to withdraw from the partnership and get value out of the limited partnership interests (through a decedent's control of the general partner) may mean that the consideration received, under the *Thompson* reasoning, is less than what was contributed. *Kimbell* did not reach that result.

Another point to note is that the *Kimbell* court held that 50 percent ownership in the LLC (as the general partner) was insufficient retention to bring the LLC back into the gross estate, in its entirety, under Section 2036 (a)(2). The court's reasoning here is not entirely clear. Was it because Ruth Kimbell did not retain control? Is the "in conjunction with" language under 2036 (a)(2) toned down? Was it because the decedent had fiduciary obligations as general partner? The court is not clear. In contrast, the *Thompson* court does

not address Section 2036(a)(2) at all.

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

Finally, the requirements applied by the Third Circuit in *Thompson* should cause planners to be more selective in presenting family partnership planning to clients. A real purpose to the partnership, other than merely to create a discount, is going to be required if the facts otherwise would suggest a Section 2036(a)(1) problem. We expect far fewer clients will be candidates for family partnerships under this more rigorous standard.

NEW GOLDEN RULE

A golden rule is evolving: At all times (pre-set up, set up, and post-set up) operate a FLP as one would a business: in a businesslike and formal manner with real transactions for real purposes, other than mere tax savings. Many family partnerships can satisfy this standard—if the clients and practitioners are willing to do due diligence beforehand and spend more time on setting up the partnership. ■

Endnotes

1. 371 F.3d 257, (5th Cir. 2004).
2. 85 T.C.M. (CCH) 1331 (2003).
3. The Service has strategically chosen the most abusive partnership fact patterns to bring to litigation. Under the adage that "bad facts" make bad case law, the Service has attempted to have these bad fact cases establish precedent that would invalidate discounts for family partnerships. One such bad fact case that was lurking post-*Kimbell* was the *Thompson* case, then on appeal at the time the *Kimbell* holding was issued.
4. *Estate of Thompson v. Comm'r.*, T.C.

Memo 2002-246, aff'd sub. nom.

Turner v. Comm'r., 2004 WL 1933613, (3d Cir. 2004 No. 03-3173).

5. 244 F. Supp. 2d 700 (N. D. Tex. 2003).
6. There are now quite a few technical advice memorandums and cases dealing with elderly individuals setting up partnerships, all for generic often made-up reasons. One important justification that seems to go unaddressed, and probably the primary reason for an elderly person to establish a partnership, is to protect assets for that person, both investment and property-wise, from either bad investment advice by third parties, inability of the elderly person to manage his assets as a rational investor or the potential of third parties to get the elderly person to turnover those assets. The self-control aspect of a partnership, protecting one's assets, is probably justified and could be a primary motivation in just about all of these partnership cases. Practitioners should focus more heavily on this justification and whether it exists in a particular case. For a further discussion of this point, see Louis S. Harrison and John M. Janiga, "Justifying FLPs," *Trusts & Estates*, November 2003.
7. The partnerships thus received 95 percent of the decedent's total assets.
8. IRC Section 2036 was pivotal to the holding of the Tax Court that no discounts should attain to the partnership. Invocation of Section 2036 allowed the Tax Court to hold that the decedent was not entitled to discounts. Without the application of 2036, the decedent would now be entitled to a discount.
9. Both the court's opinion and the concurring opinion are important in analyzing the impact of this decision. *Wheeler v. U.S.*, 116 F. 3d 749 (5th Cir. 1997).
10. See *Kimbell* at 371 F.3d 262.
11. Cf. *Estate of Stone v. Comm'r.*, 86 T.C.M. (CCH) 551, 581.
12. See also *Stone*.
13. *Kimbell*, *infra*, at 262.
14. *Ibid.* at 264.
15. *Ibid.* at 265.
16. In *Kimbell*, non-tax purposes were demonstrated by affidavits of parties involved in the establishment and 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. Note, however, that under *Thompson* these may not be sufficient when a large portion of the partnership's assets consist of marketable securities.

17. Ruth 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). Under the *Thompson* analysis, however, the receiving back of proportional interests will not be full and adequate consideration unless there are enough non-tax benefits to take the matter out of "estate planning" and into "ordinary commercial transactions."
18. This is extremely important after the *Thompson* decision. One test of the sufficiency of the assets retained would be whether those retained assets would be adequate to support the decedent's monthly expenses through life expectancy.
19. *Kimbell*, *infra*, at 266.

COLLECTORS' SPOTLIGHT



Art from the 1904 St. Louis World's Fair. The Japanese style of large, flat patterns and matte colors influenced Peter Behrens' "The Kiss," a color woodcut originally reproduced for the German magazine *Pan*.