FIFTH CIRCUIT DECISION VALIDATES SIGNIFICANT ESTATE TAX DISCOUNT FOR FAMILY LIMITED PARTNERSHIP

by

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INTRODUCTION

In May of 2004, the United States Court of Appeals for the Fifth Circuit rendered a decision of significant importance to estate tax planners by elucidating what is required to obtain a valuation discount for estate tax purposes with respect to an interest in a family limited partnership to which the bulk of a decedent's assets had been transferred. The decision provides considerable reassurance to estate tax planners who, based on some recent decisions favoring the Internal Revenue Service in this area, quite understandably may have been concerned that the technique of forming a family limited partnership in order to discount the value of the estate was perhaps no longer a viable estate planning tool.

Moreover, the case in point, *Kimbell v. United States*,[1] provides estate tax planners with the *keys to success* when utilizing a family limited partnership in order to achieve significant estate tax savings through discounting.

Representing the taxpayer in the case were two major Texas law firms supported, Amicus Curiae, by the American College of Trust and Estate Counsel, reflecting the importance of the case to estate tax planners.

BACKGROUND

The *cutting edge* of estate planning in recent years has been the promotion of stratagems to transfer property (e.g., marketable securities, real estate, a closely-held business) at a discounted value, and consequently a reduced gift and/or estate tax burden. In general, the procedure used to realize this goal is to fragment property interests by transferring fractional parts of the property, and/or to die owning only a fractional part. In some planning situations, a family limited partnership ("FLP") or, more currently, a family limited liability company ("FLLC") is formed to facilitate the transfer of fractional interests.[2]

When utilizing a FLP, typically a parent or parents will transfer property in exchange for a small general partnership interest and larger limited partnership interests. Quite often, for liability reasons, the general partner is a corporation or LLC. When utilizing a FLLC, property is transferred for membership interests. Limited partnership interests in the FLP, or membership interests in the FLLC, are then gifted, perhaps over time, to family members, or trusts for their benefit.[3] The partnership or membership interests gifted are valued independently of one another utilizing various discount valuation theories fashioned by estate planners over the years.

The concept underlying use of a FLP or FLLC in gifting is that, as a consequence of discounting, the sum of the value of the separate FLP or FLCC interests gifted is less than the value of the entity as a whole (or the property held by such entity). The discount theories for the limited partnership or membership interests that have gained credibility are: lack of marketability, lack of control (or minority interest), blockage (the inherent difficulty in selling large blocks of stock in one fell swoop), transferability restrictions, discount for dependence of the business on a key person and, more recently, a discount for built-in capital gains tax.[4] Moreover, the mere exchange of assets for partnership or membership interests arguably results in a reduction in value (i.e., the interests received are worth less than the transferred property) where restrictions are placed on the assignment of the limited partnership interests.

In addition to valuation discounts that may be applicable in a gift situation, it is important to recognize that valuation discounting may be relevant where the property interest being valued is included in a decedent's gross estate. For instance, it would be appropriate to apply a minority discount or lack of control discount (and perhaps an additional marketability discount) to a minority or non-controlling interest owned at death, even where the decedent had given away the majority interest during lifetime, and even though the partnership assets came largely from the decedent.

Although the Internal Revenue Service ("IRS") has frequently challenged discounting, it had fared rather badly in the courts. As a result, the IRS seemed to have accepted the concept of valuation discounting, albeit reluctantly. Accordingly, when an estate or gift tax return was audited, the taxpayer was fairly well assured that some type of discount(s) would be allowed for fractional interests that were transferred or that were held at death; it was just a matter of negotiating the appropriate discount percentage to apply. If a settlement could not be reached and the matter was litigated, it seems that the

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courts had a tendency to *cut the baby in half* or close thereto, frequently coming up with a valuation somewhere between the valuation proposed by the taxpayer's expert and that proposed by the IRS's expert. Whether utilization of a FLP or FLLC was successful in obtaining a discounted value on the transfer of property interests depended on the terms of the partnership agreement, the provisions of state law, the provisions of the Internal Revenue Code and, perhaps most importantly, the particular facts and circumstances, especially the nature of the assets being transferred.

As noted, however, the IRS has had some recent victories in waging its war against discounting to the considerable consternation of estate planners for whom discounting is a much beloved estate planning technique. Accordingly, the *Kimbell* decision, which offers some comfort that discounting is still alive and well, becomes an important precedent.

ESTATE OF KIMBELL

In *Kimbell*, the Internal Revenue Service assessed a deficiency against the estate as a result of disallowing discounts that were claimed. The estate paid the assessment and sued for a refund in the United States District Court for the Northern District of Texas. That court denied the estate's refund claim and granted summary judgment to the government.[5] The estate appealed.

Facts

Ruth A. Kimbell (the "Decedent") died testate on March 25, 1998, at the age of 96. Her son, David A. Kimbell ("David") was the executor of her estate. In 1991, the Decedent transferred the bulk of her assets to the R.A. Kimbell Living Trust (the "Trust"), a revocable trust. She and her son were designated as co-trustees.

In January of 1998, David and his wife formed a limited liability company, the R.A. Kimbell Management Co., L.L.C. (the "LLC"). The Trust contributed $20,000 for a 50% interest and David and his wife each contributed $10,000 for 25% interests each. David was the sole manager of the LLC.

Later in January of 1998, the Trust and the LLC formed the R.A. Kimbell Property Co., Ltd., a Texas limited partnership (the "Partnership"). The Trust contributed approximately $2.5 million in cash, oil and gas working interests and royalty interests, securities, notes and other assets for a 99% pro-rata limited partnership interest. The LLC contributed approximately $25,000 in cash for a 1% general partnership interest. Although the bulk of the Decedent's assets wound up in the LLC and the Partnership, it is important to note that she retained over $450,000 in assets outside of these entities for her personal expenses. About 11% of the assets transferred to the Partnership were oil and gas *working* interests, and 4% were oil and gas royalty interests. Consequently, the Decedent effectively owned 99.5% of the Partnership (99% through her interest in the Trust and ½ of 1% through her 50% interest in the LLC, which owned 1%). The term of the Partnership was 40 years. As noted, the Decedent died on March 25, 1998, which was shortly after formation of the LLC and the Partnership in January of 1998.

As the general partner, the LLC managed the Partnership and had exclusive authority to make distributions. The Partnership Agreement stated that the general partner owed no fiduciary duty to the Partnership or to any partner, but owed a duty of loyalty and a duty of care to the Partnership. The Trust, holding the limited partnership interest, could not withdraw from the partnership or receive a return of contributions until the Partnership terminated, which required unanimous consent of the partners. The general partner, the LLC, could be removed by vote of 70% of the limited partners and a majority of the limited partners could then elect a new general partner.

The Partnership Agreement set forth several non-tax business reasons for setting up the Partnership.[6] These reasons were confirmed by credible and unchallenged testimony in the District Court by David and the family's financial advisor.

At the time of the Decedent's death, the Partnership assets were valued at approximately $2.4 million. On the estate tax return, however, the estate claimed a 49% discount for lack of control and lack of marketability of the partnership interests. Accordingly, it valued her 99% partnership interest at approximately $1.2 million and her 1% interest in the LLC at approximately $17,000.

The District Court found as a matter of law that the transfers of the assets were subject to Internal Revenue Code ("IRC") §2036(a), which recaptures into the gross estate assets transferred during lifetime (except in the case of a bona fide sale for an adequate and full consideration in money or money's worth) where the decedent retained until death (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 or determine who shall possess or enjoy the transferred property.[7]

Fifth Circuit Opinion

The Fifth Circuit observed that IRC §2036(a) "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."[8] The statute provides two exceptions that allow a transferor to avoid the section. A bona fide sale for adequate and full consideration, and not retaining a prohibited interest in the assets transferred.

1. Bona Fide Sale for Adequate and Full Consideration:

A bona fide sale for adequate and full consideration in money or money's worth is one of the exceptions to the pullback of assets transferred during lifetime into the gross estate. The District Court, however, found that this exception was inapplicable. In reaching its conclusion, the District Court said that there were two essential elements that must be present for this exception to be applicable: (1) There must be an *arm's length* transaction for it to be bona fide sale and (2) the consideration must be adequate and full. Significantly, but as it turned out erroneously, the District Court held that a transaction is arm's length only if it involves "two parties who are not related or not on close terms," using BLACK'S LAW DICTIONERY as a reference. Because members of the Kimbell family were on both sides of the transaction, the District Court found that the transfer was not arm's length and thus not bona fide. The District Court also determined that the consideration received for the partnership interests was not adequate and full.

The Fifth Circuit, however, disagreed. Relying on an earlier decision it rendered, *Wheeler v. United States,*[9] the Circuit Court observed that "adequate and full consideration under IRC §2036(a) 'requires only that the sale not deplete the gross estate.' ''[10] This is sometimes referred to as the *equilibrium rule*. In other words, the assets given and received in return must be roughly equivalent in value. Whether they are or not, the Court observed must be based upon an objective inquiry. In this regard, the Court observed that a tax savings motive does not automatically trigger IRC §2036(a) "if objective facts demonstrate that the transfer was for a full and adequate consideration."[11]

Significantly, the Fifth Circuit rejected the IRS argument, ratified by the District Court, that a transaction with family members on both sides of the transaction automatically cannot be arm's length. Although the Court noted that intrafamily transfers are subject to *heightened scrutiny*, it concluded that in this case the transfer was " 'real, actual, genuine and not feigned.' ''[12]

The District Court had concluded that Mrs. Kimbell's transfer of more than 99% or her assets to the Partnership was simply a *recycling* of value and that the partnership interests she received in exchange was not adequate and full consideration. The District Court essentially adopted the IRS position that it is inconsistent to claim that the value of the partnership interests she received was worth only 50% of the assets transferred (as a result of discounting the partnership interests for lack of control and marketability).

Relying on language in a recent Tax Court decision,[13] the Fifth Circuit in essence held that the government's position would effectively eliminate the exception for an adequate and full consideration where there is a transfer to an entity for an interest in the entity (proportionate to the value of the property transferred) and the interests in the entity are discounted. This was perceived by the Fifth Circuit to be a classic mixing of *apples and oranges*. The Court observed that there is a difference between *fair market value* and *adequate and full consideration*. The former is applicable in computing the estate and gift tax. With respect to the latter, the Court observed that "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 trade off." The Court pointed out that this rule is applicable where the parties are related although subject to closer scrutiny. The business decision to exchange cash and other assets for a transfer-restricted, non-managerial interest in a limited partnership involves financial considerations other than the transferor's ability to immediately sell the newly acquired partnership interests for 100% on the dollar.

Accordingly, the Court addressed three key questions: (1) whether the interest credited to the partners was proportionate to the fair market value of the assets each transferred, (2) whether the assets transferred were properly credited to the partners' capital accounts, and (3) whether on termination or dissolution of the partnership the partners were entitled to distributions equal to their capital accounts. Since the Court concluded that the answer to each of these questions was yes, it held that the transaction was for adequate and full consideration.

Bona Fide Sale. Having concluded that the transfer by Mrs. Kimbell was for adequate and full consideration, the Fifth Circuit further considered whether the transaction was *bona fide*. As noted, in this regard, the Court rejected the District Court's holding – which it noted ignored Circuit precedent – that an arm's length transaction as a matter of law is one between unrelated persons. The Circuit Court remarked that the District Court's conclusion that there was only a *recyling* of value was erroneous in that it ignored the estate's argument that there were substantial business and other non-tax reasons for the transaction, which were not refuted by the government. The Court then went on to list the reasons supporting a bona fide sale. In summary, these were:

a. Mrs. Kimbell retained sufficient assets for her own support, and there was no commingling of partnership assets with her own.

b. Partnership formalities were adhered to in that there was an actual assignment of assets to the Partnership.

c. The assets contributed to the Partnership included *working* interests in oil and gas properties requiring *active* management.

d. Several credible and unchallenged non-tax business reasons for forming the Partnership, that could not be accomplished with the Trust, were presented by David and the family financial planner: legal protection from creditors, concern over personal liability relating to environmental issues, pooling capital in one entity to foster preservation of family assets for descendants, better management of the family assets, concern over divorce or illness of family members, and provision in the Partnership Agreement for mediation and arbitration in the even of family disputes. These reasons were also set forth in the Partnership documents.

In conclusion, the Fifth Circuit found, based on the objective evidence, "that the transaction was not a disguised gift or sham transaction."[14] Thus, it held the transaction was bona fide. Accordingly, it vacated the District Court's judgment granting the government's motion for summary judgment, concluding that the transfer was bona fide for adequate and full consideration, and granted the taxpayer's motion for summary judgment to the contrary.

2. Retained Interest:

The second exception under IRC § 2036(a) permits a transfer to escape the section if the transferor did not retain any interest in the transferred assets. The inquiry is whether the transferor retained the possession, enjoyment or right to income from the transferred property or retained the right to designate who could possess, enjoy or receive income therefrom. A prohibited retained right is present where there is an express or *implied* agreement regarding the retention, including control over the entity to which property is transferred.[15]

Having found that the transaction was a bona fide sale for adequate and full consideration, it wasn't necessary for the Fifth Circuit to address the retained interest exception. Nevertheless, it did so holding that since Mrs. Kimbell had only a 50% interest in the LLC, and that since her son had sole management powers, she did not retain the right to enjoy or designate who would enjoy the LLC property. The holding of the District Court to the contrary on this issue was vacated.

3. Remand:

One issue was remanded to the District Court for determination – namely, whether Mrs. Kimbell's partnership interests were unrestricted partnership interests or merely assignee interests. This issue had to do with the valuation of the partnership interests, with assignee interests, due to restrictions on assignment, being valued less than unrestricted limited partnership interests.[16] This determination would have a bearing on the amount of discount ultimately allowed.

CONCLUSION

Recently, the government has had some notable successes in utilizing IRC §2036(a) to attack discounting through transfers to family limited partnerships. One major win for the government was *Estate of Thompson*, a 2002 Tax Court decision.[17] In *Thompson*, however, none of the individual partners were involved in the conduct of an active business. None of the parties involved in the partnership had joined together with the intent to conduct or form any trade of business. Thus, the activities of the partnership were found not to be for business purposes. Moreover, a key finding in *Thompson* was the Court's determination that the decedent had complete access to the assets he transferred to the partnership. Another government win was *Estate of Strangi*, a 2003 Tax Court decision.[18] In *Strangi*, the Court concluded that the partnership failed to qualify as the sort of functioning business enterprise that would lift the situation from mere *recyling*. Also relevant is the *Estate of Harper*, a 2002 Tax Court decision.[19] There, the Court held that the transaction involved only the genre of *value recyling* and did not appear motivated primarily by legitimate business concerns.

Accordingly, the *Thompson, Strangi* and *Harper* decisions are object lessons on what not to do, whereas *Kimbell* provides a possible formula for success. What were the key elements in *Kimbell* leading to the taxpayer win and the important sanctioning of a family limited partnership, under the right circumstances, to obtain significant discounting of an estate's value? One thing to note first off is that the Court did not feel anything was remiss because of the short time span between the establishment of the LLC and the Partnership (January, 1998) and the death of the Decedent (March, 1998). Also, her age, 96, was not relevant. One important favorable factor was that the Court determined that the assets retained by Mrs. Kimbell (about $450,000) were sufficient to meet her needs. This should be contrasted with *Thompson* where very little was retained thereby allowing the Court to conclude that there was an *implied* understanding that *all* the assets transferred were available for use by the transferor if needed. A second key factor in *Kimbell* was the finding that the Partnership was conducting an *active trade or business* by virtue of its operation of the *working* oil and gas interests, and that one of the partners (David) was actively managing the business. Interestingly, the working interests transferred were only 11% of the Partnership assets. The rest of the assets consisted of cash, royalty interests, securities, notes and other assets, totaling 89% of the assets. Nevertheless, the Fifth Circuit determined that there was a legitimate *business purpos*e for the Partnership despite the fact that the bulk of the assets seemed to be primarily portfolio or passive type investments. Accordingly, it could be maintained that the 11% business assets *sheltered* the 89% non-business assets, a seemingly strange result.

Another approach could have been to allow discounting only for 11% of the partnership interests and none for 89%. Or, the Court could have found that the Partnership was set up primarily for recycling portfolio or passive investments and only incidentally for business purpose, and thus denied any discount. Whether another circuit would rule this way on similar facts seems problematical. But the point seems to be that the Court's will recognize the legitimacy of a family limited partnership if it is actively engaged in a business and not merely holding passive investment assets. In the latter case, Courts seem to be more likely to find that there has been only a recycling of value. To what extent the partnership has to be engaged in an actual business is conjectural. In *Kimbell*, 11% apparently sufficed, although other non-tax reasons were clearly set forth in the Partnership Agreement and in testimony.

Other important keys to success to be gleaned from *Kimbell* are to follow the formalities (prepare the necessary corporate documents, have them properly executed and have the assets legally transferred to the entity), record the transfers in the partners' capital accounts, distribute partnership interests pro rata to the value of assets transferred to the partnership, assure that on liquidation or termination of the partnership distributions will be made pro rata based on the capital accounts, establish non-tax business and family-specific reasons in the partnership agreement for its formation – which, of course, should have some basis in reality, do not commingle personal assets and partnership assets and do not use partnership assets for personal expenses.

Those experienced in litigation also know that the credibility of witnesses is often an important factor in the findings of a judge or jury. So, evaluating how your witnesses will perform is an important consideration. In *Kimbell*, the Court seemingly found the testimony of David and the family financial advisor credible.

Remedial legislation to restrict the use of FLPs and FLLCs does not presently seem to be in the cards with both a Republican Administration and Congress in power, and especially since the estate tax laws are set for repeal in the year 2010 (but coming back in 2011). Of course, whether repeal in fact occurs, and whether the estate tax is reinstated in 2011, is pure conjecture. Accordingly, reducing estate and gift tax values through discounting in general, and in particular utilizing FLPs and FLLCs, seems to be an estate planning technique – the IRS might argue a tax evasion scheme or sham – that is alive and doing quite well, at least where there is valid business reason for establishing the entity.

To conclude, estate planners should get some encouragement from *Kimbell* that using a family limited partnership to obtain valuation discounts is still a viable estate planning tool.

Footnotes

[1] 371 F.3d 257; 2004 U.S. App. LEXIS 9911 (5th Cir. 2004).

[2] A FLP or FLLC is often used because direct fractional transfers of property may not be feasible or advisable. For instance, a FLP or FLLC would be necessary where the property desired to be transferred at a discount is marketable securities. Although fractional parts of real estate may be transferred, this would subject the property to a partition action, which would not be the case if the property was held by a FLP or FLLC.

[3] In a FLP, the transferors usually keep control through ownership of a general partnership interest. In a FLLC, control may be exercised by having the transferor named as manager in the operating agreement. Note that there must be at least two transferors to set up a FLP since by definition a partnership requires at least two partners. Most states, including New York, permit a FLLC to be formed by one person. *See*, Treas. Reg. § 301.7701-3. All references herein to "Treas. Reg. §" are to U.S. Treasury Department regulations interpreting the Internal Revenue Code of 1986, as amended. To avoid a *substance over form* charge that what is being gifted is really undivided interests in the property transferred to the entity, it is advisable for there to be a hiatus (commentators have suggested at least 6 months) between the transfer of the property and the gifting of the partnership or membership interests.

[4] Eisenberg v. Commissioner, 82 AFTR 2d 98-5757 (2nd Cir. 1998); Estate of Davis, 110 T.C. No. 35 (1998).

[5] Kimbell v. United States, 244 F. Supp. 2d 700, 2003 U.S. Dist. LEXIS 523 (N.D. Tex. 2003).

[6] The non-tax business purposes set forth in the Partnership Agreement were: to increase family wealth, provide a means to make annual gifts without fractionalizing assets, continue the ownership and operation of the family assets and prevent non-family members from acquiring interests, provide protection from claims against family members, prevent a transfer of an interest in case of divorce, provide flexibility and continuity in business planning not available through other entities, facilitate administration, promote knowledge of family assets, provide resolution of family disputes, and consolidate fractional interest in family assets.

[7] In pertinent part, I.R.C. § 2036 reads as follows:

Sec. 2036. TRANSFERS WITH RETAINED LIFE ESTATE.

(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.

[8] Kimbell v. United States, 371 F.3d 257, *261; 2004 U.S. LEXIS 9911, **8 (5TH Cir. 2004), *citing* Estate of Wyly v. Commissioner, 610 F.2d 1282, 1290 (5th Cir. 1980).

[9] 116 F.3d 749 (5th Cir. 1997).

[10] *Id*. at 759.

[11] Kimbell v. United States, 371 F.3d 257, *263; 2004 U.S. App. LEXIS 9911, **14 (5th Cir. 2004).

[12] *Id*. LEXIS cite at **16, citing *Wheeler* at 160.

[13] Estate of Stone v. Commissioner, T.C. Memo 2003-309; 2003 Tax Ct. Memo LEXIS 312.
[14] Kimbell v. United States, 371 F.3d 257, *269; 2004 U.S. App. LEXIS 9911, **33 (5th Cir. 2004).
[15] Estate if Reichardt v. Commissioner, 114 T.C. 144, 151-152 (2000); Estate of Strangi v. Commissioner, T.C. Memo 2003-145, 2003 Tax Ct. Memo LEXIS 144 (2003).
[16] For a more detailed discussion regarding this point, *see* Nowell v. Commissioner, T.C. Memo 1999-15; 1999 Tax Ct. Memo LEXIS 15 (1999).
[17] Estate of Thompson v. Commissioner, T.C. Memo 2002-246; 2002 Tax Ct. Memo LEXIS 127 (2002).
[18] Estate of Strangi v. Commissioner, T.C. Memo 2003-145; 2003 Tax Ct. Memo LEXIS 144 (2003).
[19] Estate of Harper, T.C. Memo 2002-121; 2002 Tax Ct. Memo LEXIS 127 (2002).