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THE MAGIC OF DISAPPEARING WEALTH REVISITED: USING FAMILY LIMITED PARTNERSHIPS TO REDUCE ESTATE AND GIFT TAX

Ronald H. Jensen*

Medieval alchemists strived to transmute base metals into gold. Today, taxpayers seek a reverse transmutation: to *reduce* the value of their property—at least when it is being valued for gift and estate tax purposes. Taxpayers have achieved notable success in their quest by employing family limited partnerships (FLPs).¹ Use of this entity has enabled taxpayers to reduce the values that would otherwise be taxed by discounts generally ranging from 25% to 35%.² On occasion, even larger discounts have been allowed.³ However, a recent case, *Estate of Strangi v. Commissioner*,⁴ has thrown considerable doubt on the continuing viability of this planning

* Professor of Law, Pace University School of Law. I would like to thank my colleague, Professor Bridget Crawford, for her help and insightful comments and Shiohban O'Grady for her excellent research assistance. I am dedicating this article to the memory of Albert R. Mugel—scholar, teacher, lawyer, and friend.

1. The same tax savings could also be achieved by using a limited liability company that has either elected or acquiesced to be treated as a partnership for federal tax purposes. See Treas. Reg. § 301.7701-3 (as amended in 2001). One commentator has therefore used the term “family limited liability entity” when discussing the techniques and issues examined in this article. See generally Walter D. Schwidetzky, *Last-Gasp Estate Planning: The Formation of Family Limited Liability Entities Shortly Before Death*, 21 VA. TAX REV. 1, *passim* (2001) (using the term “family limited liability entity” throughout). However, this article will use the more traditional term “family limited partnership,” or its abbreviation “FLP,” since that is the term commonly used in the literature, but with the understanding that the discussion in this article also applies to limited liability companies.

2. KATHRYN G. HENKEL, ESTATE PLANNING AND WEALTH PRESERVATION: STRATEGIES AND SOLUTIONS ¶ 16.03[1][c] (1997).

3. See, e.g., *Estate of Dailey v. Comm'r*, 82 T.C.M. (CCH) 710, 712, 2001 T.C.M. (RIA) ¶ 2001-263, at 1977 (allowing a 40% discount); *Estate of Jones v. Comm'r*, 116 T.C. 121, 138-41 (2001) (allowing a 45% discount); *Estate of Harrison v. Comm'r*, 52 T.C.M. (CCH) 1306, 1310, 1987 T.C.M. (P-H) ¶ 87,008, at 41 (allowing a 45% discount); *Estate of Church v. United States*, 2000-1 U.S.T.C. (CCH) ¶ 60,369, at 84,779-80 (W.D. Tex. 2000), *aff'd*, 268 F.3d 1063 (5th Cir. 2001) (allowing a 58% discount; government presented no evidence on valuation).

4. *Estate of Strangi v. Comm'r*, 85 T.C.M. (CCH) 1331, 2003 T.C.M. (RIA) ¶ 2003-145 [hereinafter *Strangi I*]. The taxpayer has appealed the decision. Rachel Emma Silverman, *Popular Tool for Estate Plans Under Scrutiny*, WALL ST. J., Dec. 2, 2003, at D1. The Tax Court had previously decided the case in the taxpayer's favor, but the Fifth Circuit reversed the Tax Court's decision in part and remanded the case. *Estate of Strangi v. Comm'r*, 115 T.C. 478 (2000), *aff'd in part, rev'd and remanded in part sub nom. Gulig v. Comm'r*, 293 F.3d 279 (5th Cir. 2002) [hereinafter *Strangi II*].

technique.⁵ It is therefore an opportune time to reconsider the FLP—both in terms of its continuing efficacy as an estate planning tool and the substantial policy issues it raises.

Part I of this article will describe the techniques for using FLPs to reduce gift and estate taxes. Part II will discuss the economic validity of the discounts that are allowed under current law. Part III will examine the current status of the law regarding FLPs. Finally, Part IV will discuss the need for reform and will analyze and evaluate the various proposals for reform put forth to date. Part IV will conclude with a new recommendation for curtailing the abusive use of FLPs.

I. HOW TO USE FLPs TO REDUCE GIFT AND ESTATE TAXES

A. *When Death Is Not Imminent*

If death is not imminent, the plan will normally be implemented along the following lines: the taxpayer will transfer the assets she wishes to qualify for discount to an FLP, taking back a general partnership (GP) interest representing a minute portion of the FLP's equity (say, 1%) and limited partnership (LP) interests representing the balance of the FLP's equity (say, 99%).⁶ The taxpayer will then embark on a gift program designed to eliminate all of her LP interests at little or no gift tax cost. Thus, her estate at death will consist of only a GP interest representing a mere one percent of the FLP's equity. The taxpayer may of course also give away the GP interest if she wishes, thereby totally eliminating the FLP from her estate.

5. Louis A. Mezzullo, *Is Strangi a Strange Result or a Blueprint for Future IRS Successes Against FLPs*, 99 J. TAX'N 45, 45 (2003) (stating that decision "could pose a substantial impediment to the traditional design of FLPs for estate planning"); Elaine Hightower Gagliardi, *Strangi III: Right Answer, Wrong Reason? Or Just Plain Wrong?*, 100 TAX NOTES 373, 373 (2003) (stating that "[s]ome attorneys have questioned whether *Strangi III* summons the end of the FLP as an estate planning tool" but others "hail the opinion as providing guidelines for the effective use of the FLP"); Susan Kalinka, *Estate of Strangi II: IRS Wins Another Battle in Its War Against FLPs*, 100 TAX NOTES 545, 556 (2003) (stating that if decision is affirmed, it will be difficult to obtain discounts unless FLP conducts an active business); Mitchell M. Gans & Jonathan G. Blattmachr, *Strangi: A Critical Analysis and Planning Suggestions*, 100 TAX NOTES 1153, 1154 (2003) (stating that decision poses a "critical threat" to tax-saving potential of FLPs but "can be neutralized" if proper steps taken).

6. Frequently, the taxpayer, instead of transferring assets directly to the FLP in return for the GP interest, will transfer them to a limited liability company or a corporation of which he is the sole owner, and the entity will then transfer the assets to the FLP in exchange for the GP interest. This approach provides the taxpayer with limited liability.

What makes this approach appealing is that the LP interests will be valued for tax purposes at a substantial discount from the value of the underlying assets that they represent. The purported justification for these discounts is that the LP interests lack both control and marketability. These discounts will be discussed in more detail in the next section, but a brief explanation of their rationale is appropriate here.

State law prohibits the limited partners of an FLP from participating in the management of the business.⁷ Consequently, a buyer of an LP interest will be at the mercy of the general partners with respect to all decisions regarding the FLP's operations and earnings (e.g., whether the FLP distributes its earnings to the partners or retains them in the business). Obviously, a buyer will pay less for such an interest than he would for an interest that confers control. This reduction is usually referred to as a discount for *lack of control*.⁸

Unlike stocks traded on the New York Stock Exchange, LP interests in a closely-held business are not traded on an active market. The owner of an LP interest wishing to dispose of that interest cannot sell it simply by telephoning her broker. To sell the interest, the limited partner must locate

7. Most states have enacted the Revised Uniform Limited Partnership Act (RULPA) as adopted by the National Conference of Commissioners on Uniform State Laws (NCCUSL) in 1976 or as amended in 1985. See REVISED UNIF. LTD. P'SHIP ACT, 6A U.L.A. 126, historical notes (2003), and the table of jurisdictions that have adopted one or the other of these versions. *Id.* at 125-26, tbl. Section 303 in both versions provides that a limited partner who "in addition to the exercise of his [or her] rights and powers as a limited partner . . . participates in the control of the business" is liable for the partnership's obligations. REVISED UNIF. LTD. P'SHIP ACT § 303 and REVISED UNIF. LTD. P'SHIP ACT § 303 (amended 1985), 6A U.L.A. 324-25 (2003). This makes it clear that participation in the control of the business is beyond the "rights and powers . . . [of] a limited partner." *Id.*

In 2001, the NCCUSL adopted an entirely new RULPA. See REVISED UNIF. LTD. P'SHIP ACT, 6A U.L.A. 2-8, prefatory note (2003). Unlike its predecessors, section 303 of the 2001 version provides that a limited partner is not liable for the partnership's obligations "even if the limited partner participates in the management and control of the limited partnership." REVISED UNIF. LTD. P'SHIP ACT § 303 (amended 2001), 6A U.L.A. 46 (2003). However, the official Comment to section 302 states that a limited partner's position is "analogous to a shareholder in a corporation; status as owner provides [no] right to manage." REVISED UNIF. LTD. P'SHIP ACT, 6A U.L.A. 45 cmt. (2003). This suggests that RULPA (2001) contemplates that a limited partner will not participate in managing the partnership unless specifically authorized to do so. However, prudence suggests that parties wishing to qualify an LP interest for a lack-of-control discount should specify in the partnership agreement that limited partners have no management powers.

8. See generally SHANNON P. PRATT ET AL., VALUING A BUSINESS: THE ANALYSIS AND APPRAISAL OF CLOSELY HELD COMPANIES 363-90 (4th ed. 2000); Alan L. Feld, *The Implications of Minority Interest and Stock Restrictions in Valuing Closely-Held Shares*, 122 U. PA. L. REV. 934, 934-38 (1974); Mary Louise Fellows & William H. Painter, *Valuing Close Corporations for Federal Wealth Transfer Taxes: A Statutory Solution to the Disappearing Wealth Syndrome*, 30 STAN. L. REV. 895, 903-16 (1978); James R. Repetti, *Minority Discounts: The Alchemy in Estate and Gift Taxation*, 50 TAX L. REV. 415, 423-31 (1995).

potential buyers and convince one of them to buy it. This means providing a potential buyer with financial statements and explaining to him the FLP's business, its prospects for the future, its competition, and its management. Since the buyer of the LP interest will have no say in the management of the FLP,⁹ he will want to meet the general partner to evaluate his competency and honesty and to determine if the general partner's plans for the business' future are satisfactory. All of this requires time and effort, and time and effort mean money. The rationale for allowing a discount for *lack of marketability* is that a potential buyer will discount, that is, pay less for an interest that he cannot readily resell.¹⁰

As stated above, courts have generally allowed combined discounts for lack of marketability and control ranging from 25% to 35% and sometimes even more.¹¹ These discounts, when used in conjunction with the gift tax annual exclusion¹² and the gift tax unified credit,¹³ can result in very substantial amounts of wealth being transferred without any transfer tax liability.

Consider the following case. Father (*F*) and Mother (*M*) own equally an unincorporated business worth \$4,000,000. They have two children and four grandchildren. The following plan will enable them to give virtually their entire business away over a six year period without paying any transfer tax. *Step 1:* *F* and *M* transfer their interests in the business to an FLP and each takes back a GP interest representing 0.5% of the FLP's equity and LP interests representing 49.5% of its equity. Assuming a combined lack-of-control and lack-of-marketability discount of 30% for the LP interests and a 10% lack-of-marketability discount for the GP interests, the interests will have the values shown below:

9. See *supra* note 7 and accompanying text.

10. See generally PRATT ET AL., *supra* note 8, at 391-423; Fellows & Painter, *supra* note 8, at 916-21.

11. See *supra* notes 2-3 and accompanying text.

12. I.R.C. § 2503(b).

13. *Id.* § 2505(a).

Partner's interest	Percentage	Value of assets represented by interest	Discount— GP interest: 10% discount; LP interest: 30% discount	Value of interest after discount
Mother's GP interest	0.5%	\$20,000	\$2,000	\$18,000
Father's GP interest	0.5%	\$20,000	\$2,000	\$18,000
Mother's LP interest	49.5%	\$1,980,000	\$594,000	\$1,386,000
Father's LP interest	49.5%	\$1,980,000	\$594,000	\$1,386,000
Total	100.0%	\$4,000,000	\$1,192,000	\$2,808,000

Step 2: *M* and *F* give away their LP interests to their children and grandchildren. This can be accomplished over a six-year period without paying any gift tax.

Gifts in Year 1: *F* and *M* each make gifts of \$177,666 to each child and grandchild, resulting in total gifts by each donor of \$1,065,996. These gifts are not taxable because of the gift tax unified credit that shelters \$1,000,000 from tax in the case of each donor¹⁴ and each donor's annual gift tax exclusion of \$11,000 per donee.¹⁵ [\$1,000,000 +

14. *Id.* The amount that is sheltered from the gift tax is denominated as the "applicable exclusion amount" in the current statute. *See id.*; *see also id.* § 2010(c).

15. *Id.* § 2503(b)(1); Rev. Proc. 2002-70, 2002-2 C.B. 845, § 3.24(1) (inflation adjusted annual exclusion for gifts made in 2003 is \$11,000). Whether LP interests in an FLP, as they are now generally structured, will continue to qualify for the annual exclusion has been questioned in view of the Tax Court's decision in *Hackl v. Commissioner*, 118 T.C. 279 (2002), *aff'd*, 335 F.3d 664 (7th Cir. 2003). In that case, the court disallowed the annual exclusion with respect to a limited liability company unit, because it found that the unit did not confer a "present" economic benefit. *Id.* at 299. The court based this finding, *inter alia*, on provisions in the operating agreement that prohibited a member from withdrawing his capital contribution or selling or otherwise transferring his unit unless approved by the manager. Commentators have suggested that the result in *Hackl* may be avoided by one or more of the following strategies:

(a) Allow the donee to sell his interest to outside parties, subject, however, to a right of first refusal that would allow the entity or the other equity holders to buy the donee's interest on the same terms and conditions as those in the outsider's offer. *See* Steve R. Akers et al., *Valuation of Closely-Held Business Interests for Federal Tax Purposes*, 61 N.Y.U. ANN. INST. ON FED. TAX'N § 15.05[6][a] (2003); John W. Porter, *Current Valuation Issues*, 61 N.Y.U. ANN. INST. ON FED. TAX'N § 24.05[7][f] (2003); Thomas S. Flickinger, Comment, *Gifts of Family LLC*

(\$11,000 x 6 donees) = \$1,066,000]. The combined gifts of *F* and *M* during Year 1 amount to \$2,131,992 [2 x \$1,065,996].

Gifts in Years 2-5: *F* and *M* each make gifts of \$11,000 to each child and grandchild during each year in this period, resulting in total gifts by each donor of \$264,000 [\$11,000 per year x 6 donees x 4 years]. These gifts are sheltered from tax by reason of the annual exclusion. The combined gifts of *F* and *M* during Years 2-5 amount to \$528,000 [2 x \$264,000].

Gifts in Year 6: *F* and *M* each make gifts of \$9,334 to each child and grandchild, resulting in total gifts during Year 6 of \$112,008 [2 donors x \$9,334 per donee x 6 donees]. Assuming that the values have remained constant over the six year period, *F* and *M* will have completely divested themselves of LP interests. The gifts in Year 6 are completely sheltered from gift tax by the annual exclusion.

Thus, *F* and *M* will have transferred LP interests representing 99% of the FLP's equity, which is equivalent to \$3,960,000 of value in the underlying assets, completely free of any gift tax.¹⁶ Of this amount, \$1,188,000 escaped taxation by reason of the discounts.

This plan can be implemented regardless of which spouse holds title to the property if the other spouse is willing to cooperate. If, for example, *F* owned 100% of the business, the plan could still be implemented by having *F* transfer 50% of the business to *M* and then proceeding as outlined above. *F*'s transfer to *M* would be tax free because of the unlimited gift tax marital

Units in a Post-Hackl Era: Present Interests or Future Interests?, 8 FORDHAM J. CORP. & FIN. L. 853, 862 (2003).

- (b) Give the donee the right to require the entity, for a limited period (e.g., 90 days), to redeem his interest for its fair market (i.e., its discounted) value (determined as though the put right did not exist), or the amount of the annual exclusion, if less. See Akers et al., *supra*, § 15.05[6][c]; Porter, *supra*, § 24.06[7][f]; Flickinger, *supra*, at 862.
- (c) Have the donor transfer cash, in an amount equal to the discounted value of the interest to be transferred, to a defective grantor trust (i.e., a trust which the donor will be treated as "owning" for income tax purposes) of which the donee is the beneficiary, and then have the trust buy such interest from the donor for its discounted value. See Akers, *supra*, § 15.05[6][b]; Flickinger, *supra*, at 862.

16. The gifts over the six-year period are summarized below:

Amounts	Explanation
\$2,772,000	Value of LP interests after 30% discount
-2,131,992	Gifts in Year 1
-528,000	Gifts in Years 2-5
-112,008	Gifts in Year 6
-0-	All LP interests given away without gift tax

deduction.¹⁷ Alternatively, the same result could be achieved by *M*'s consent to have one-half of *F*'s gifts treated as made by her.¹⁸

B. When Death Is Imminent

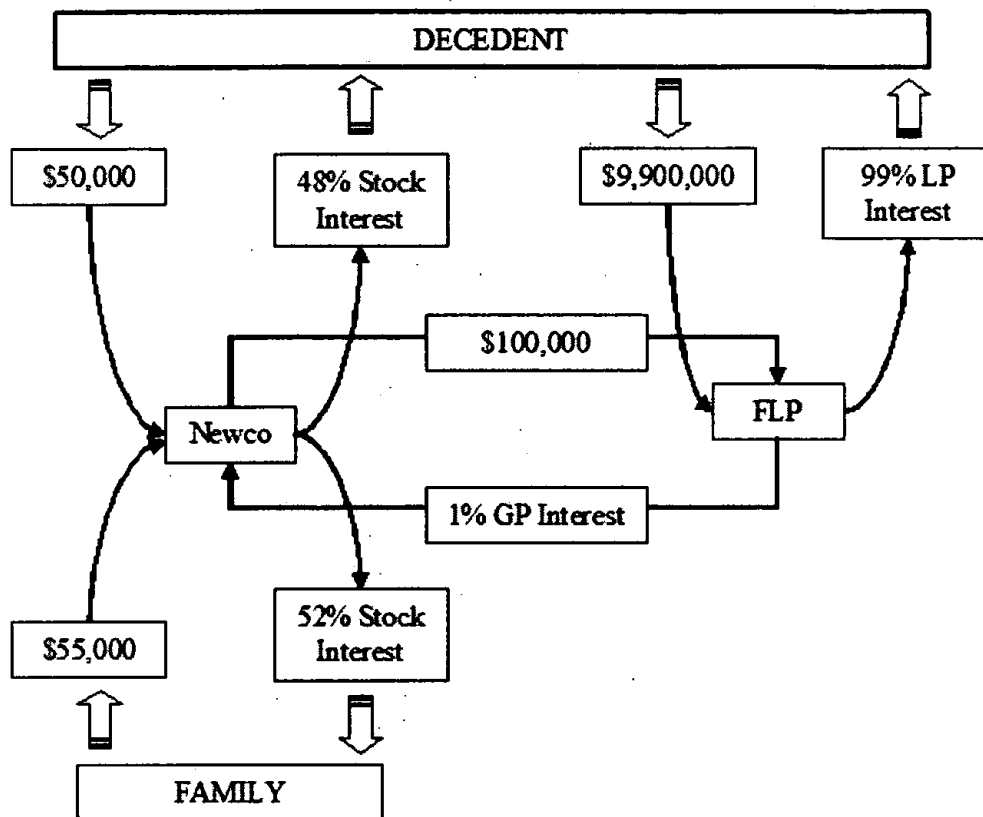
If death is imminent, the plan described above will not be feasible, since there will be no time for the taxpayer to "dribble out" his LP interests in a string of annual gifts, each in the amount of the annual exclusion. Instead, what is required is a plan that *immediately* converts the taxpayer's interest in his property to a noncontrolling and difficult-to-market interest.

The following plan, based on the facts of *Estate of Strangi v. Commissioner*,¹⁹ illustrates how this may be accomplished. Assume taxpayer *D* has assets, in the form of cash and publicly traded securities, with a value of \$9,950,000. In the first step of the plan, *D* transfers \$50,000 in cash or securities to a newly formed corporation, Newco, in exchange for a 48% stock interest in Newco. Concurrently, members of *D*'s family transfer \$55,000 in cash to Newco for a 52% stock interest. In the next step, *D* transfers assets worth \$9,900,000 to a newly-formed FLP in exchange for an LP interest representing 99% of its equity, while Newco transfers \$100,000 to the FLP in exchange for a GP interest representing 1% of its equity. The transactions are graphically illustrated below:

17. I.R.C. § 2523(a).

18. *Id.* § 2513.

19. *Strangi I*, 115 T.C. 478 (2000), *aff'd in part, rev'd and remanded in part sub nom. Gulig v. Comm'r*, 293 F.3d 279 (5th Cir. 2002).



Notice what has happened. *D* started out with absolute control over \$9,950,000 of assets. He ended up with minority interests in both Newco and the FLP, thereby losing control of those assets. Instead of owning cash and readily marketable securities, *D* ended up owning interests in two closely held entities, which, like all closely held interests, will be difficult to market. *D*'s estate can now claim substantial discounts for both lack of control and lack of marketability. In *Strangi*, the Service's own expert testified on facts similar to those above that the LP interest should be discounted by 31%.²⁰ The Tax Court grudgingly accepted this discount.²¹ If this discount is used in the above example, the \$9,900,000 of assets that *D* transferred to the FLP would be

20. *Id.* at 491-92.

21. *Id.* at 492-93 (stating that discount found by Service's expert may be "overgenerous" to taxpayer but was required by the evidence). On remand from the Fifth Circuit, the court held that the assets the decedent had transferred to the FLP were includible in his gross estate per § 2036. *Strangi II*, 85 T.C.M. (CCH) 1331, 2003 T.C.M. (RIA) ¶ 2003-145. Consequently the size of any discount with respect to his LP interest became irrelevant.

replaced with an LP interest worth \$6,831,000—a reduction of \$3,069,000 in the size of *D*'s gross estate!

II. ARE THE DISCOUNTS “FOR REAL”? DO THEY HAVE “ECONOMIC SUBSTANCE”?

A. The “Fair Market Value” Standard

Under the regulations, “fair market value” is the applicable standard for valuing property for gift and estate tax purposes.²² “Fair market value” is defined as “the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts.”²³

The “willing buyer” and the “willing seller” referred to in the regulations are hypothetical constructs and not actual persons.²⁴ In particular, they are neither the actual transferor nor the actual transferee, and no account may be taken of the specific circumstances of the actual parties.²⁵ This rule can have a significant impact on valuation. For example, assume that of the one hundred outstanding shares of XYZ, Inc., father (*F*) owns 40, unrelated shareholders own 30 and *F*'s son (*S*) owns the remaining 30. *F* dies and bequeaths his 40 shares to *S*. These 40 shares, when added to the 30 shares *S* already owns, give him full control of XYZ, Inc. and thus have much greater value to him than to an outsider. Nevertheless, under existing law, no account may be taken of the shares the transferee already owns, and because the 40 shares are only a minority interest, their value will be discounted for lack of

22. Treas. Reg. § 20.2031-1(b) (as amended in 1965); Treas. Reg. § 25.2512-1 (as amended in 1992).

23. Treas. Reg. § 20.2031-1(b) (as amended in 1965). Treasury Regulation section 25.2512-1 (as amended in 1992) contains virtually the same definition.

24. *Propstra v. United States*, 680 F.2d 1248, 1251-53 (9th Cir. 1982); *Estate of Bright v. United States*, 658 F.2d 999, 1005-06 (Former 5th Cir. 1981); see also *Estate of Lee v. Comm'r*, 69 T.C. 860 (1978).

25. See, e.g., *Estate of McClatchy v. Comm'r*, 147 F.3d 1089 (9th Cir. 1998) (holding it was irrelevant in valuing stock that that estate was a “nonaffiliate” and thus not subject to SEC rule restricting sale of stock); *Estate of Robinson v. Comm'r*, 69 T.C. 222 (1977) (holding it irrelevant that note received in an installment sale would be subject to substantial income tax if collected by the estate or a beneficiary; proper test is what an unrelated party would pay for note). But cf. *Rothgery v. United States*, 475 F.2d 591 (Ct. Cl. 1973) (holding that in valuing father's 50% stock interest he left to son, fact that such interest when combined with son's 49.6% interest would enable son to liquidate corporation and realize shares' liquidation value should be considered; however, court noted that even if son's specific situation could not be considered, any other buyer of father's interest would be able to force liquidation and thus would pay same amount).

control.²⁶ In effect, the transferred interest is valued by what an outsider would pay for it. This rule has been justified on the ground that it provides an “objective standard by which to measure value”²⁷ and saves the courts from being drawn into “boundless”²⁸ inquiries as to the “feelings, attitudes, and anticipated behavior” of the actual parties.²⁹

The “willing buyer-willing seller” rule is applied differently to inter vivos gifts than it is to testamentary transfers.³⁰ The estate tax is assessed on the basis of the entire interest that the decedent possesses in a given property at

26. See, e.g., *Propstra*, 680 F.2d at 1251-52 (valuing husband’s bequest of his one-half community property interest in real property to his wife as a noncontrolling 50% interest entitled to lack-of-control discount even though bequest made wife sole owner of the property); *Bright*, 658 F.2d at 1001-02, 1007-08 (valuing wife’s bequest of her one-half community property interest in a controlling bloc of stock to a trust of which her husband was a trustee as a minority interest even though bequest gave husband control of corporation); *Estate of Lee v. Comm’r*, 69 T.C. 860, 875-77 (1978) (valuing wife’s bequest to her husband of her one-half community property interest in 80% bloc of stock as a 40% minority interest). In *Estate of Mellinger*, the court refused to aggregate for valuation purposes stock passing under the decedent’s probate estate with stock in the same company passing under a QTIP trust even though all the stock was included in the decedent’s gross estate. 112 T.C. 26, 38 (1999), *acq. in result*, 1999-2 C.B. xvi.

The result should be the same if *F* gave the 40 shares to *S* instead of bequeathing them, although no case has so held. See *Fellows & Painter*, *supra* note 8, at 896-97 (treating father’s gift of two shares to son as a minority interest qualifying for a lack-of-control discount even though transfer gave son a majority stock interest in the company); *Repetti*, *supra* note 8, at 432-33 (“[M]inority discount should apply.”). Indeed, an inter vivos gift in this situation presents a stronger case for the allowance of a lack-of-control discount than a bequest, since the gift tax focuses on each separate transfer while the estate tax focuses on the total shares held by the decedent. See *infra* notes 29-31 and accompanying text. In special cases, the courts have sometimes disallowed a minority interest discount by aggregating the transferred shares with other shares. *Feld*, *supra* note 8, at 939-40; see, e.g., *Estate of Murphy v. Comm’r*, 61 T.C.M. (CCH) 645, 659-64, 1990 T.C.M. (RIA) ¶ 90,472, at 2243 (discussed *infra* Part III.E). Some courts have aggregated the transferred shares with shares owned by other members of transferee’s family. See, e.g., *Blanchard v. United States*, 291 F. Supp. 348 (S.D. Iowa 1968). However, the Service, reversing its former position, has ruled that a minority discount will not be disallowed “solely because a transferred (i.e., gifted) interest, when aggregated with interest held by family members, would be part of a controlling interest.” Rev. Rul. 93-12, 1993-1 C.B. 202, 203; see also Priv. Ltr. Rul. 94-32-001 (Mar. 28, 1994).

27. *Propstra*, 680 F.2d at 1252.

28. *Id.* at 1252 n.5.

29. *Id.* at 1252. Judge Posner criticized as “exaggerated” the concern about the boundless nature of the inquiries the courts would be drawn into if they examined the actual facts surrounding the gift or bequest, at least in some instances:

[The decision in *Bright*] seems driven by an overmastering desire for simplicity, achieved by always valuing a transfer as if the parties were strangers rather than members of the same family or otherwise entangled in a web of relationships that might change the actual value of the gift in either direction This concern with simplicity is made explicit in *Propstra v. United States*, 680 F.2d 1248, 1252 (9th Cir. 1982), yet seems exaggerated in [*Bright*] itself, where Mrs. Bright’s will created the trust that assured the continuation of the control bloc after her death.

Citizens Bank & Trust Co. v. Comm’r, 839 F.2d 1249, 1253 (7th Cir. 1988).

30. William S. Blatt, *Minority Discounts, Fair Market Value, and the Culture of Estate Taxation*, 52 TAX L. REV. 225, 234 (1997).

the time of his death regardless of how that property is ultimately divided among his heirs or legatees.³¹ In contrast, the gift tax is imposed on the value of the separate interest passing to each donee.³² For example, assume *D* has three children, *A*, *B* and *C*, and that he owns all 99 shares of XYZ, Inc. If *D* gives 33 shares to each of his children, each gift will be valued as a minority interest and will qualify for a lack-of-control discount. On the other hand, if *D* retains the stock until his death and bequeaths 33 shares to each child, the estate tax will be imposed on the value of all 99 shares with no discount for lack of control.

The interaction of the rules discussed above makes it possible for a taxpayer to convey control to a transferee and yet qualify for a lack-of-control discount. Assume *A* owns all 100 shares of XYZ, Inc. In Year 1, *A* gives 35 of these shares to *D*, her daughter. Since the shares constitute a minority interest, they qualify for a lack-of-control discount. In Year 4, *A* gives *D* an additional 40 shares. These shares provide *D* with total control of the corporation, but as explained above, no account may be taken of the shares *D* already owns. The 40 shares are thus valued as a minority interest and are entitled to a lack-of-control discount.³³ Finally, in Year 7, *A* dies and bequeaths her remaining shares to *D*. Since no account may be taken of the shares *D* already owns, the bequest will be treated as a minority interest and will qualify for another lack-of-control discount.³⁴ Obviously, this result cries out for reform. Part IV will discuss various solutions to this problem.

31. *Ahmanson Foundation v. United States*, 674 F.2d 761, 768-69 (9th Cir. 1981); *Estate of Curry v. United States*, 706 F.2d 1424, 1426-30 (7th Cir. 1983).

32. See, e.g., *Calder v. Comm'r*, 85 T.C. 713 (1985); *Rushton v. Comm'r*, 60 T.C. 272 (1973), *aff'd*, 498 F.2d 88 (5th Cir. 1974); *Avery v. Comm'r*, 3 T.C. 963 (1944); *Phipps v. Comm'r*, 43 B.T.A. 1010 (1941), *aff'd*, 127 F.2d 214 (10th Cir. 1942). These cases involved unsuccessful attempts by taxpayers to treat gifts to multiple donees occurring on or about the same time as a single gift so that they would qualify for a blockage discount. In part, the decisions are based on the language of Treasury Regulation section 25.2512-2(e) (as amended in 1976), which states that the availability of a blockage discount is to be determined "with reference to each separate gift." This raises the possibility that determining value on the basis of "each separate gift" is limited to blockage situations. However, the Service has never made that assertion, and its rulings implicitly acknowledge that the gift tax is to be computed with reference to "each separate gift." See, e.g., Rev. Rul. 93-12, 1993-1 C.B. 202 (holding that minority discount will not be disallowed where parent gives away all the stock in a company by making simultaneous gifts of twenty percent of the stock to each of his five children "solely because a transferred interest, when aggregated with interests held by family members, would be part of a controlling interest").

In *Whittemore v. Fitzpatrick*, 127 F. Supp. 710 (D. Conn. 1954)—not a blockage case—the court held that a transfer of 600 shares to a trust for the benefit of three beneficiaries equally should be treated as three gifts of 200 shares each, *id.* at 713-14, and allowed a 32.2% discount for lack of control. *Id.* at 721-22; see also *Estate of Bosca v. Comm'r*, 76 T.C.M. (CCH) 62, 1998 T.C.M. (RIA) ¶98,251.

33. See *supra* note 25 and accompanying text.

34. See *supra* note 25 and accompanying text.

B. Validity of Discounts Under Existing Rules

If a business interest must be valued by what a *stranger* would pay for it, and if the interests that the transferee already owns must be disregarded, as existing law requires, allowing discounts for lack of marketability and lack of control is justified.

No one, including critics of the existing law, seriously denies that interests in a closely-held business are more difficult to sell than publicly-traded securities and that a buyer of such an interest will discount it, that is, pay less for it to reflect its lack of liquidity.³⁵ Indeed, Service experts routinely allow discounts for lack of marketability.³⁶ Allowance of the discount is also supported by studies showing that stock for which transferability was restricted by rules of the Securities and Exchange Commission (i.e., so-called “letter stock”) sold for substantially less than the price at which unrestricted stock in the corporation sold for on the same day.³⁷

Likewise, everyone acknowledges the propriety of allowing a discount for minority or noncontrolling interests given the existing valuation rules³⁸ and

35. George Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance*, 77 COLUM. L. REV. 161, 196 (1977) (“Stock of a closely-held corporation, which is not normally traded and therefore not well known to prospective buyers, may accordingly suffer in sale value.”); Fellows & Painter, *supra* note 8, at 917 (“Courts properly have viewed the lack of a ready market for closely held shares as a factor that diminishes a stock’s value.”).

36. See, e.g., *Estate of Jones v. Comm’r*, 116 T.C. 121, 138 (2001) (Service expert allowed 7.5% marketability discount); *Strangi I*, 115 T.C. 478, 491-92 (2000), *aff’d in part, rev’d and remanded in part, all on unrelated issues, sub nom. Gulig v. Comm’r*, 293 F.3d 279 (5th Cir. 2002) (Service expert allowed a 25% marketability discount on decedent’s LP interest and a 15% marketability discount on his shares in corporate general partner); *Estate of Dailey v. Comm’r*, 82 T.C.M. (CCH) 710, 712, 2001 T.C.M. (RIA) ¶ 2001-263, at 1977 (Service expert allowed 14.1% marketability discount).

37. See generally PRATT ET AL., *supra* note 8, at 395-411. Although letter stock may not be sold to the “public,” it may under certain conditions be sold in private transactions, *id.* at 395-96, and it is these private sales that provide the basis for computing the discounts. *Id.* The average discount on the sale of letter stock, as found in nine studies, ranged from 23.0% to 33.8%. *Id.* at 404. Two other studies found median discounts of 31.2% and 45.0%. *Id.*

Analysts generally believe that price discounts for lack of marketability for interests in closely held companies are greater than those for restricted shares of publicly held companies, since the interests in the closely held companies do not have an established market in which they can be sold following the removal of certain trading restrictions. *Id.* at 403-04. Two studies attempted to test this proposition by comparing the sale price of stock in a closely-held business prior to the company’s initial public offering, that is, when there was no established market for its stock, with the price the stock sold for in the offering. *Id.* at 404-11. These studies showed discounts ranging from 40% to 63%. *Id.* at 411.

38. Cooper, *supra* note 35, at 197 (“The lack of voting control . . . may be a substantial problem for a stranger to a family corporation . . .”); Feld, *supra* note 8, at 937 (“[I]t is fair to conclude that the price obtainable by the outsider for the minority shares normally will be substantially less than the pro rata asset

Service experts routinely allow such discounts.³⁹ Allowance of such discounts is supported by data showing that a party acquiring control of a publicly-traded company (i.e., the target) will usually pay a premium, which is often substantial, over the price that noncontrol shares of the target were trading for prior to the announcement of the takeover offer.⁴⁰

A discount for lack of control simply recognizes that a buyer of a noncontrolling interest will pay less for that interest, on a per share or per unit basis, than a buyer of a controlling interest. This is because a buyer of a noncontrolling business interest has little or no say in the way the business' assets and earnings (including his share of those assets and earnings) are managed and disbursed. Those who have control, however, can "institute ideas and programs in their self-interest but, more importantly, they can ensure that others cannot use the business and its assets in ways that are contrary to the [controlling party's] needs and desires."⁴¹

Consider the position of an outsider who buys a minority interest in a closely held family business. In many firms, family members hold all the executive positions, for which they receive compensation, and any earnings remaining after payment of that compensation are reinvested in the business.⁴²

and income values."); Fellows & Painter, *supra* note 8, at 904 ("[C]ontrolling shares are valued more highly than minority shares."); Repetti, *supra* note 8, at 425-27 (describing value of control).

39. See, e.g., *Jones*, 116 T.C. at 138-39 (Service expert allowed a 38% secondary market discount that encompassed both marketability and lack-of-control discounts.); *Strangi I*, 151 T.C. at 491-92 (Service expert in his appraisal allowed an eight percent lack-of-control discount on decedent's LP interest and a five percent lack-of-control discount on his shares in corporate general partner.).

40. A study by Mergerstat Review covering the period 1990 to 1999 showed that the average premium offered ranged from a low of 35.1% in 1991 to a high of 44.7% in 1995. PRATT ET AL., *supra* note 8, at 354-56. The study was limited to takeovers where the purchase price was at least one million dollars, the shares to be acquired represented at least ten percent of the company's equity, and where at least one of the parties was a United States entity. *Id.* at 354. This data should be viewed cautiously since the premium may reflect elements of value in addition to a pure "control" premium. For example, part of the premium may reflect synergies that the acquirer expects to result from the combination of its business with that of the target. *Id.* at 353-54.

A study undertaken by a trust officer of 30 actual sales of noncontrolling interests in closely-held businesses showed that only 20% of them were made at a discount of less than 20%, 53 1/3% were made at discounts ranging from 22% to 48%, and 23 1/3% were made at discount ranging from 54.4% to 78%. H. Calvin Coolidge, *Fixing Value of Minority Interest in Business: Actual Sales Suggest Discounts as High as 70%*, 2 EST. PLAN. 138, 141 (1975). The discounts were computed by reference to the companies' adjusted book value. *Id.*

See generally PRATT ET AL., *supra* note 8, at 379-82, for other data showing the sale of noncontrolling interests at discounts from net asset value in the case of holding companies (including closed-end mutual funds) and limited partnerships.

41. Fellows & Painter, *supra* note 8, at 904.

42. There are various reasons why the controlling shareholders may prefer to pay the shareholder-employees compensation rather than distribute earnings to the shareholders generally. In some businesses,

A stranger who buys a minority interest in such a business has no assurance that he will receive an income-paying position in the firm⁴³ or that the business will start distributing its earnings. His only realistic hope for a cash return on his investment (other than by selling it) is that at some indefinite time in the future, the business will be sold or liquidated, or will start distributing earnings. Given the uncertainty of when, if ever, this will occur, an outsider buying a minority interest will heavily discount the price he is willing to pay.

The above analysis does not necessarily mean that those who control the business are "cheating" the outsider.⁴⁴ The compensation they are paying themselves may be reasonable, and their decision to reinvest the earnings in the business may simply reflect their preference for future growth rather than an immediate return. (Of course, that preference may be influenced by the fact that their current needs are taken care of by the compensation they receive from the business).⁴⁵ On the other hand, there is always the danger of

the "controlling shareholders and company managers feel that the company belongs to those shareholders who work for it. As a New York court observed, shareholder-employees 'think that as they do the work and have the responsibility, they are entitled to keep to themselves and divide among themselves all, or the substantial part, of the profits or gains of the business.'" 1 F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S OPPRESSION OF MINORITY SHAREHOLDERS: PROTECTING MINORITY RIGHTS IN SQUEEZE-OUTS AND OTHER INTRACORPORATE CONFLICTS § 2:09 (2d ed. 2001) (quoting *Godley v. Crandall & Godley Co.*, 139 N.Y.S. 236, 244 (1st Dept. 1912), *modified*, 105 N.E. 818 (1914)).

The controlling shareholders, being adequately compensated and having no current need for additional income, may also prefer to plow excess earnings back into the business, rather than distribute them in the form of dividends, to generate future growth.

Historically, the principal motivation for paying compensation to shareholders rather than distributing earnings was to avoid the "double taxation" of corporate earnings in a C corporation. Corporate earnings are taxed when earned by the corporation and are taxed again when distributed to shareholders in the form of dividends. I.R.C. § 61(a)(7). Although compensation is taxed to the employee, *id.* § 61(a)(1), it, unlike dividends, is deductible by the corporation. *Id.* § 162(a)(1). The "double taxation" factor is much less significant today because many closely-held businesses operate as "pass-thru" entities (e.g., Subchapter S corporations, limited liability companies taxed as partnerships, limited partnerships, etc.) that pay no tax. This may be less of a factor even in a traditional C corporation since most dividends will now be taxed at a maximum rate of 15%, *id.* § 1(h), while compensation is taxed at a maximum rate of 35%, *id.* § 1(a)-(d), (1).

43. The current shareholders may view the corporation as belonging to their family. See 1 O'NEAL & THOMPSON, *supra* note 42, § 2:10. Consequently, they may be extremely reluctant to have the corporation hire an outsider.

44. See William D. Andrews, *The Stockholder's Right to Equal Opportunity in the Sale of Shares*, 78 HARV. L. REV. 505, 526 (1965) (arguing that control is valuable even though holder thereof does not abuse minority shareholders and even though the "minority stockholder receives exactly the same return per share as does the controlling stockholder").

45. This conflict between owners who participate in running a business and derive compensation from it and those who are inactive in the business and must therefore rely upon the distribution of earnings also occurs where co-owners operate a business and one of them dies. The surviving co-owner and his family continue to derive compensation from the business, while the heirs of the deceased co-owner who

overreaching by the majority, and that danger provides a further reason why the buyer of a minority interest will discount the price he is willing to pay.⁴⁶

Many persons who accept this analysis when a business interest is placed in an FLP find it difficult to believe that placing cash (or other liquid assets) in an FLP has a similar effect. Yet a moment's reflection demonstrates this is so. Consider the following question: Would you prefer \$10,000 outright, or would you prefer a 1% LP interest in a \$1,000,000 fund where you have no control over how the funds are invested or otherwise used, where your interest will be difficult to sell and where you have no assurance that you will ever receive any distributions, or if made, when that will occur? The question answers itself.

Although the discounts are justified under the existing "fair market value" standard, the question remains whether that standard accurately values gifts. That issue is explored below.

C. *Why Do They Do It?*

If the issuance of LP interests in an FLP results in a loss of "fair market value"—as asserted above—why do taxpayers do it? Why would a taxpayer undertake actions that result in the destruction of value? There are four principal reasons:

- (1) The taxpayer's dispositive plan makes a loss of value unavoidable;
- (2) The taxpayer may like the effect of a loss in value;
- (3) The loss in value is intended to be temporary;
- (4) The "fair market value" standard understates actual value.

do not work in the business depend solely on distributions of earnings. As explained by the court in *Mountain State Steel Foundries v. Commissioner*:

This sort of situation leads to demands for dividends out of consideration of the [inactive] stockholders' personal financial need On the other hand, those stockholders active in the management of the business deriving salaries from it may be able to afford indulgence of an ambition to enlarge future earnings through still larger current capital expenditures, an indulgence which the other stockholders may ill afford.

284 F.2d 737, 744-45 (4th Cir. 1960).

46. Legal remedies exist where the majority shareholders, acting as directors, unreasonably withhold dividends or siphon off business earnings by awarding themselves unreasonable compensation. However, such claims are very difficult to establish because of the wide discretion that courts allow directors under the business judgment rule. Even if successful, prosecuting such claims is likely to be very expensive. See generally 1 O'NEAL & THOMPSON, *supra* note 42, §§ 3:04, 3:05, 3:07, 3:08.

(1) The Taxpayer's Dispositive Plan Makes a Loss of Value Unavoidable

Suppose a parent, *P*, wishes to give away her unincorporated business to her three children in equal shares. Carrying out her plan will inevitably result in a loss in the aggregate fair market value of the ownership interests. Suppose the proprietorship in *P*'s hands is worth \$300. The interest received by each child will be a minority interest and accordingly will be entitled to a lack-of-control discount. If the appropriate discount is 30%, the aggregate fair market value of these interests will now be \$210. This will be true regardless of whether ownership interests in her business are transferred directly to the children or are conveyed to them through an FLP. It is the dispositive terms of the plan that produce the loss in fair market value—not the type of entity used to effect that plan.⁴⁷

(2) The Taxpayer May Like the Effect of a Reduction in Value

Critics of current law contend that a taxpayer never willingly destroys value. Therefore, the argument goes, the discounts presently allowed in valuing LP interests must be illusory. However, in many cases the taxpayer may actually like the consequences that result from a loss in value.

Consider *P*, who wishes to give *C*, her child, a financial interest in the business but wants to retain control. *P* therefore transfers the business to an FLP, takes back the GP interest for herself, and gives away, either currently or over time, the LP interests to *C*. Based on the analysis above, the value of the LP interests must be discounted to reflect their lack of control.

How does *P* feel about this purported lack of value in the LP interests? It may not bother *P* at all; she may, in fact, see it as an advantage. The lack of realizable value effectively “locks in” *C* in the FLP. This eliminates, or at least greatly lessens, the danger that *C* will sell his interest to outsiders. More significantly, the lack of realizable value will continue *C*'s financial dependence upon *P*. *C* will understand that he can realize the underlying value represented by his LP interests only if *P* ultimately gives him the GP interest. *C* will therefore try to please *P* out of fear that if he displeases her, *P* may end up not giving him the GP interest. Under these circumstances, it

47. It may be that the reduction in fair market value, as determined under current law, does not accurately reflect the “true” value of the interests to the children. See *infra* Part ILC.4.

is entirely plausible that *P* will undertake actions that reduce, at least in the short run, the aggregate market value of her business.⁴⁸

(3) *The Loss Is Intended to Be Temporary*

Suppose *P* operates a business worth \$3,000,000. *P* transfers the business to a newly formed FLP, takes back a 1% GP interest and 99% LP interests. She gives the 99% LP interests to her son, *S*. Years later, *P* dies and in accordance with her long-term plan, bequeaths the 1% GP interest to *S*. The business is still worth \$3,000,000. For purposes of this example, ignore the discount for lack of marketability.

Under current law, *P*'s gift of the LP interests to *S* will qualify for a substantial discount because they lack control. If a 30% discount is allowed, the 99% LP interests—which represents \$2,970,000 of underlying value in the partnership—will be valued at only \$2,079,000 for gift tax purposes.⁴⁹ However, this diminution in the value of the LP interests is merely temporary, since it will cease upon *P*'s death when *S* receives the 1% GP interest. *P* will then have full control of the FLP and, assuming no change in the value of the enterprise, will be able to sell the business for \$3,000,000: \$30,000 for the GP interest and \$2,970,000 for the LP interests.

By splitting the transfer of the business into two steps—inter vivos transfers of the LP interests and a testamentary transfer of the GP interest—\$891,000 of value will escape the transfer tax.⁵⁰ These tax savings might well induce *P* to proceed in this fashion since the loss in value is only temporary.⁵¹

48. Kenneth Kaye suggests that "[s]ome people bring their offspring into a business . . . in order to retard individuation," that is, to keep them in a state of dependency. Kenneth Kaye, *When the Family Business Is a Sickness*, 9 FAM. BUS. REV. 347, 359 (1996) (emphasis in original).

49. Equity represented by 99% LP interests: \$2,970,000 [99% of \$3,000,000]
 30% discount for lack of control: 891,000 [30% of \$2,970,000]
 Fair market value of 99% LP interests: \$2,079,000

50. Value of interests: \$3,000,000
 Amount taxed: 2,109,000 [\$2,079,000 (99% LP) + \$30,000 (1% GP)]
 Value not taxed: \$ 891,000

The above computation does not take account of any annual exclusion that may have been allowable on the inter vivos gifts of the LP interests and may therefore understate the amount of value that passed without tax.

51. In particularly egregious cases, the Service has attempted to combat this phenomenon by invoking the "step transaction" doctrine. See *infra* Part III.E.

(4) *The "Fair Market Value" Standard May Understate Actual Value*

The "fair market value" standard used to determine value for estate and gift tax purposes focuses exclusively on the price that an outsider would pay for the interest being valued. In doing so, it ignores other elements of value that *may* inhere in the ownership of the business interest when held by an "insider" and thus seriously understates its true value. This is particularly true in a family business whose members work together as a harmonious unit.

In such a case, even family members who hold minority or noncontrolling interests will often participate in the decision-making process and their views will be given serious consideration.⁵² In many cases, the business will afford noncontrolling family members employment, often at a higher rate of compensation than they would receive elsewhere.⁵³ Their needs are likely to be considered in determining whether the business's earnings will be distributed and, if so, to what extent.⁵⁴ If the family members that own the controlling interests decide to sell, they will most likely insist that the interests of the noncontrolling family members be included in the sale so that they too can participate in the control premium realized on the sale.⁵⁵

In contrast, an outsider with a noncontrolling interest will almost always be frozen out of the decision making process. It is highly unlikely that he will be offered a position in the business. His needs will almost certainly be ignored in setting policy on the distribution of earnings. In fact, frequently in these cases no earnings will be distributed. Instead, the family will derive a living from the compensation its members receive for running the business and any earnings above the amount needed to pay compensation will be reinvested in the business. The net result is that while family members are able to derive a living from the business, an outsider is deprived of any current return on his investment.⁵⁶

In light of an outsider's inability to derive any current benefit from his interest, it is reasonable to base the value of his interest on the amount he

52. Feld, *supra* note 8, at 937 (positing the case of a minority shareholder who participates in the decision making process as a member of the control group).

53. Some families adopt a "family first" approach where anyone who wants to work in the business is guaranteed an opportunity to do so, all family members receive equal compensation, and no family member is ever fired. JOHN L. WARD, KEEPING THE FAMILY BUSINESS HEALTHY: HOW TO PLAN FOR CONTINUING GROWTH, PROFITABILITY AND FAMILY LEADERSHIP 142-43 (1987).

54. Feld, *supra* note 8, at 937.

55. *Id.*

56. See *supra* note 42 and accompanying text.

could realize by selling it. In contrast, a noncontrolling family member will often derive considerable current benefits from holding his interest. By ignoring these benefits, the “fair market value” standard—which focuses exclusively on what can be realized in a hypothetical sale of his interest—may seriously understate the true value of the interest to a family member. If a family member’s views on the business are respected and given serious consideration, if the business provides him with employment at a satisfactory level of compensation, and if he derives satisfaction from his status as a partial owner of the business, he may be perfectly content to hold his interest in the business indefinitely. In that case, the amount he could receive on a hypothetical sale of his interest is of limited or no interest to him—it is simply beside the point.⁵⁷

III. THE SERVICE’S WEAPONS IN FIGHTING ABUSIVE FLPs: ARE THEY STRONG ENOUGH?

The preceding Part showed that the fair market value standard, as currently applied, often undervalues interests transferred to a donee or legatee.⁵⁸ Moreover, taxpayers, through careful sequencing of their gifts, may transfer control of an entity and yet obtain a lack-of-control discount for all or a substantial part of the property transferred.⁵⁹ This Part explores whether existing legal doctrine is adequate to deal with these issues.

A. *The Economic Substance, or Business Purpose, Test*⁶⁰

In *Strangi*, the Service asserted that the FLP lacked economic substance and had no business (i.e., a non-tax) purpose and thus should be disregarded for federal tax purposes.⁶¹ If this claim had succeeded, the decedent would have been treated as holding his proportionate share of the FLP’s assets directly, and the assets themselves—rather than his FLP interest—would have been included in his gross estate.⁶² To the extent those assets consisted of

57. See Cooper, *supra* note 35, at 197.

58. See *supra* Part II.C.4.

59. See *supra* Part II.A.

60. The terms “economic substance” and “business purpose” are generally used interchangeably. See, e.g., Robert Thornton Smith, *Business Purpose: The Assault Upon the Citadel*, 53 TAX LAW. 1, 1 (1999) (“The status of the business purpose, or economic substance, doctrine is solidly entrenched . . .”).

61. *Strangi I*, 115 T.C. 478, 484 (2000), *aff’d in part, rev’d and remanded in part sub nom.* Gulig v. Comm’r, 293 F.3d 279 (5th Cir. 2002).

62. Assets owned directly by a decedent at the time of his death are includible in his gross estate

cash and publicly traded securities,⁶³ there would have been no discount for either lack of marketability or lack of control.⁶⁴

The estate asserted that Strangi had three business purposes for forming the FLP,⁶⁵ but the Tax Court expressed great skepticism as to whether any of the purported purposes was genuine.⁶⁶ Nevertheless, it held that the FLP should be respected as a separate taxable entity:

[The FLP] was validly formed under State law. The formalities were followed, and the proverbial “i’s were dotted” and “t’s were crossed”. The partnership, as a legal matter, changed the relationships between decedent and his heirs and decedent and actual and potential creditors. Regardless of subjective intentions, the partnership had sufficient substance to be recognized for tax purposes. Its existence would not be disregarded by potential purchasers of decedent’s assets, and we do not disregard it in this case.⁶⁷

The Fifth Circuit sustained the Tax Court on this issue,⁶⁸ and to date every court confronting the issue has rejected the Service’s attempt to disregard an FLP.⁶⁹ Recently, the Service abandoned this issue in two cases where it had initially asserted the claim.⁷⁰ Under the current state of the law, an FLP will apparently be respected as a separate taxable entity so long as the parties

pursuant to § 2033 of the Code.

63. About 75% of the assets Strangi transferred to the FLP were cash or securities. *Strangi I*, 115 T.C. at 481. Although the opinion does not expressly state that the securities were publicly traded, the lack of any controversy over their value suggests they were.

64. Publicly traded securities do not qualify for a marketability discount because they may readily be converted into cash either on an exchange or the over-the-counter market. Publicly traded securities also do not qualify for a separate minority discount. They are valued on the basis of the prices at which small minority interests of the security were sold for on the applicable valuation date. Treas. Reg. § 20.2031-2 (as amended in 1992); *id.* § 25.2512-2 (as amended in 1976). Allowing a minority interest discount from these selling prices would therefore duplicate the discount.

65. *Strangi I*, 151 T.C. at 485.

66. *Id.* at 485-86.

67. *Id.* at 486-87. In *Strangi I*, two judges concurred in the result but would have held that the economic substance and business purpose doctrine was inapplicable where the issue is the value of an interest in the entity for estate and gift tax purposes. *Id.* at 493-94.

68. *Gulig v. Comm’r*, 293 F.3d 279, 281-82 (5th Cir. 2002).

69. See also *Knight v. Comm’r*, 115 T.C. 506 (2000); *Estate of Thompson v. Comm’r*, 85 T.C.M. (CCH) 374, 2002 T.C.M. (RIA) ¶ 2002-246; *Estate of Dailey v. Comm’r*, 82 T.C.M. (CCH) 710, 712, 2001 T.C.M. (RIA) ¶ 2001-263, at 1977. In a later proceeding in *Dailey*, the Service conceded that its position that the FLP in that case should be disregarded for tax purposes was not “substantially justified” within the meaning of § 7430(c)(4)(B) of the Code. 84 T.C.M. (CCH) 633, 2002 T.C.M. (RIA) ¶ 2002-301. Accordingly, the court awarded attorney’s fees to the estate for the time its counsel had properly and reasonably expended on that issue. *Id.*

70. *Peracchio v. Comm’r*, 86 T.C.M. (CCH) 412, 2003 T.C.M. (RIA) ¶ 2003-280; *Lappo v. Comm’r*, 86 T.C.M. (CCH) 333, 2003 T.C.M. (RIA) ¶ 2003-258.

observe all formalities regarding its separate existence, and the FLP actually carries on business or investment activities.⁷¹

B. Section 2703(a)(2)

Section 2703(a)(2) provides that the “value of any property shall be determined without regard to . . . any restriction on the right to sell or use such property.” The Service contends that the word “property,” as used in that section, encompasses assets that a taxpayer transfers to an FLP, and that the partnership form is a “restriction” on the taxpayer’s “right to sell or use” such property that must be disregarded for valuation purposes. Consider a taxpayer who transfers marketable securities to an FLP in exchange for an LP interest and then claims that the interest should be discounted for lack of control. The Service argues that the taxpayer’s lack of control results from a “restriction” imposed by the partnership form, namely, the provision of partnership law that prohibits a limited partner from managing the partnership’s business or assets. Consequently, according to the Service, the reduction in value resulting from that “restriction” must be disregarded in valuing the taxpayer’s interest.

In *Strangi*, the court held that the word “property” as used in § 2703(a)(2) refers only to the property that is to be valued for gift or estate tax purposes. Thus, in the above example, “property” means the taxpayer’s LP interest rather than the assets transferred to the FLP,⁷² and § 2703(a)(2) will not apply unless there are restrictions on the taxpayer’s right to sell or use his LP interest. Not one of the judges in *Strangi* adopted the Service’s reading of § 2703(a)(2). The Fifth Circuit affirmed the Tax Court’s ruling on this issue,⁷³

71. These decisions seem correct. The results are consistent with the rule that applies to corporations as stated by the Supreme Court in *Moline Properties v. Commissioner*: a corporation will be respected as a separate taxable entity as long as it was formed for a purpose that “is the equivalent of business activity or is followed by the carrying on of business by the corporation.” 319 U.S. 436, 439 (1943) (emphasis added). *Moline Properties* has been interpreted to mean that a corporation will be respected for tax purposes even if formed to avoid taxes so long as it actually conducts business. See, e.g., *Bass v. Comm’r*, 50 T.C. 595 (1968); *Nat Harrison Assoc., Inc. v. Comm’r*, 42 T.C. 601 (1964), acq. 1965-2 C.B. 5. Since § 7701(a)(2) of the Code includes as a “partnership” any entity through which “any business, financial operation, or venture is carried on,” the reference to business activity in *Moline Properties* should encompass “investing.” In sum, an FLP should be recognized as a separate entity for tax purposes so long as the partnership formalities are observed and it actually carries on a business or investing activity.

72. *Strangi I*, 115 T.C. 478, 487-89 (2000), *aff’d on this issue sub nom.* *Gulig v. Comm’r*, 293 F.3d 279 (5th Cir. 2002).

73. *Gulig v. Comm’r*, 293 F.3d 279, 282 (5th Cir. 2002).

and recently the Service abandoned its § 2703(a)(2) claims in two cases where it had initially asserted them.⁷⁴

C. Gift on Formation of FLP

In *Strangi*, the decedent transferred assets worth \$9.9 million to an FLP in exchange for a 99% LP interest⁷⁵ that had a value of about \$6.8 million, after allowance of a 31% discount for lack of marketability and lack of control.⁷⁶ The Service argued that if the court allowed the discount, it should find that the decedent made a gift equal to the difference between these two amounts.⁷⁷ The Service based its argument on § 2512(b), which, in general, defines a gift as the amount by which the value of the transferred property exceeds the consideration received in return.⁷⁸

The court rejected this contention, stating “we do not believe that decedent gave up control over the assets, his beneficial interest in them exceeded 99[%], and his contribution was allocated to his own capital account.”⁷⁹ The Fifth Circuit affirmed the Tax Court’s holding on this issue.⁸⁰ The quoted language left it unclear whether the transferor’s continued control over the transferred assets was essential to the finding of no gift. However, in the later case of *Estate of Jones v. Commissioner*, the Tax Court rejected the Service’s “gift on formation” argument even though it made no finding on whether the decedent continued his control of the transferred assets.⁸¹ It merely stated that “[a]ll of the [decedent’s] contributions of property were properly reflected in [his] capital accounts . . . and the value of the other partners’ interests was not enhanced by the contributions of decedent.”⁸²

74. See generally *Peracchio*, 86 T.C.M. (CCH) 412, 2003 T.C.M. (RIA) ¶ 2003-280; *Lappo*, 86 T.C.M. (CCH) 333, 2003 T.C.M. (RIA) ¶ 2003-258.

75. *Strangi I*, 115 T.C. at 481.

76. The Tax Court allowed an overall discount of 31% with respect to the LP interests. *Id.* at 491-93. Applying this discount, the fair market value of the 99% LP interest received by Mr. Strangi upon formation of the FLP was \$6.8 million:

Value of property transferred:	\$9.9 million
<u>Less 31% discount:</u>	<u>3.1 million</u>
Value of 99% LP interest received:	\$6.8 million

The Tax Court did not make the above computation, since it was valuing the LP interests at the time of Mr. Strangi’s death rather than at the time he received the LP interests.

77. *Id.* at 489.

78. I.R.C. § 2512.

79. *Strangi I*, 115 T.C. at 490.

80. *Gulig v. Comm’r*, 293 F.3d 279, 282 (5th Cir. 2002).

81. *Estate of Jones v. Comm’r*, 116 T.C. 121, 128 (2001).

82. *Id.*

The following example illustrates the court's point that a taxpayer's contribution of property to an FLP will not enhance the value of the other partners' interests so long as the taxpayer's account is properly credited with the full fair market value of the contributed property. Assume that *A* contributes property worth \$900,000 to a newly formed FLP in exchange for a 90% LP interest, while *B* contributes \$100,000 to the FLP in exchange for a 10% GP interest. To reflect their respective contributions, *A*'s capital account is credited with \$900,000 and *B*'s is credited with \$100,000. Assuming a combined discount of 30% for lack of control and lack of marketability, the fair market value of *A*'s LP interest is only \$630,000 even though he contributed property worth \$900,000. *A* has suffered a \$270,000 loss in value, but this loss in no way enhances or changes *B*'s interest. Since their respective capital accounts have been credited in the ratio of 9:1, all earnings and distributions will be allocated to *A* and *B* in a ratio of 9:1—no matter what value is ascribed to *A*'s LP interest. Thus, if the FLP is liquidated immediately after its formation, *A* and *B* will receive back their respective \$900,000 and \$100,000 contributions, and likewise any earnings of the FLP will be allocated to *A* and *B* in the ratio of 9:1. There is no gift because there is no transfer of value from *A* to *B*.⁸³ This hypothetical is essentially what

83. There is no gift to the FLP. Both the regulations and the case law recognize that a gratuitous transfer of property to an entity is not a gift to the entity but rather to the owners or beneficiaries of the entity (other than the transferor) to the extent of their interests therein. Treas. Reg. § 25.2511-1(h)(1) (as amended in 1997) (stating that a gratuitous transfer to a corporation is "generally" a gift to the shareholders (other than the transferor) to the extent of their interests therein rather than a gift to the corporation but stating there may be an exception for a transfer "to a charitable, public, political or similar organization"); *Helvering v. Hutchings*, 312 U.S. 393 (1941) (holding that for the purpose of the annual exclusion a transfer to a trust is not a gift to the trust or the trustee but to the beneficiaries to the extent of their interests in the trust); *Shepherd v. Comm'r*, 283 F.3d 1258 (11th Cir. 2002) (treating father's transfer of land to FLP as gift to sons who were partners in FLP); *Kincaid v. United States*, 682 F.2d 1220 (5th Cir. 1982) (treating transfer to corporation as gifts to other shareholders based on their respective stock interests); *Chanin v. United States*, 393 F.2d 972 (Ct. Cl. 1968) (treating a transfer to a subsidiary of a family holding corporation as gifts to individual shareholders of the holding company (other than the transferor) based upon their respective stock interests in the holding company).

Some earlier cases had treated a transfer to a corporation as a gift to the entity. See, e.g., *Thompson v. Comm'r*, 42 B.T.A. 121 (1940). In *Heringer v. Commissioner*, the court, acknowledging the earlier line of cases, sidestepped the issue of whether a contribution to a corporation was a gift to the corporation or to the shareholders, since it found that even if a gift to the shareholders, it would not qualify for the annual exclusion since it was a future interest. 235 F.2d 149 (9th Cir. 1956). However, Treasury Regulation section 25.2511-1(h)(1) and the other authorities cited above make it clear that the law today treats a gratuitous transfer to an entity as a gift to those owning or having beneficial interests in the entity (other than the transferor) based on their respective interests in the entity. See generally 5 BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* ¶ 124.2 (2d ed. 1993); RICHARD B. STEPHENS ET AL., *FEDERAL ESTATE AND GIFT TAXATION* ¶ 10.01[2][a]-[b] (6th ed. 1991).

occurred in *Strangi* and *Jones*.

No court has accepted the Service's "gift on formation" argument, and the Service abandoned this argument in a recent case before the Tax Court.⁸⁴

D. Section 2704(b)

Frequently the FLP agreement will prohibit a limited partner from withdrawing and liquidating his interest in the partnership prior to the FLP's dissolution, and another provision will set the date for dissolution sometime in the distant future (e.g., 50 years after the partnership's formation). The obvious purpose of these provisions is to depress the value of the LP interests by restricting a limited partner's ability to realize the liquidation value of his interest (i.e., the amount he could obtain if the FLP were liquidated).

The Service has argued that § 2704(b) requires such provisions to be disregarded in valuing the partnership interests. That section states that if a donor or decedent (i.e., the "transferor") transfers an interest in a partnership or corporation to a member of his family, and if the transferor and his family controlled the entity immediately before the transfer, then "any applicable restriction" shall be disregarded in valuing the transferred interest.⁸⁵

"Applicable restriction" is defined as any restriction that "effectively limits the ability of the corporation or partnership to liquidate,"⁸⁶ and which the transferor or any member of his family has a right, either individually or collectively, to remove following the transfer.⁸⁷ However, the statute excepts from this definition "any restriction imposed, or required to be imposed, by any Federal or State law."⁸⁸ The regulations add the following gloss to the statutory definition of "applicable restriction": "An applicable restriction is a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction."⁸⁹

In *Kerr v. Commissioner*, the partnership agreement provided, in pertinent part, that the partnership would dissolve and liquidate upon the earlier of December 31, 2043, (i.e., 50 years after formation of the FLP) or the

84. *Lappo v. Comm'r*, 86 T.C.M. (CCH) 333, 2003 T.C.M. (RIA) ¶ 2003-258.

85. I.R.C. § 2704(b)(1).

86. *Id.* § 2704(b)(2)(A).

87. *Id.* § 2704(b)(2)(B)(ii). An applicable restriction also includes a restriction that effectively limits the ability of a corporation or a partnership to liquidate and that lapses, in whole or in part, after the transfer. *Id.* § 2704(b)(2)(B)(i).

88. *Id.* § 2704(b)(3)(B).

89. Treas. Reg. § 25.2704-2(b) (1992).

agreement of all the partners.⁹⁰ Applicable state law provided that a limited partnership would dissolve upon the earliest of the following: (1) the occurrence of events specified in the partnership agreement as causing dissolution; (2) the written consent of all partners to dissolution; (3) withdrawal of the general partner; or (4) entry of a decree of judicial dissolution.⁹¹

The court held that the partnership's provision on dissolution was not an applicable restriction because it was no more restrictive than state law (i.e., it did not make it more difficult to liquidate the FLP).⁹² The court did not explain its reasoning, but it may have found that state law, by stating that dissolution was to occur upon the events specified in the partnership agreement, in effect adopted whatever provision the partners chose regarding events of dissolution.⁹³ Consequently, any such provision would necessarily be no more restrictive than state law. Note also that under the state law in *Kerr* a partner might never receive the liquidation value of her interest, while under the partnership provision she was assured of receiving it no later than December 31, 2043.⁹⁴

The partnership agreement also provided that no limited partner could withdraw from the partnership prior to the partnership's dissolution and liquidation.⁹⁵ The Tax Court found that this was not an applicable restriction, even though applicable state law generally permitted a limited partner to withdraw upon six months written notice, since it was not a "limitation on the ability to liquidate the *entity*."⁹⁶ The court noted that "a limited partner may

90. *Kerr v. Comm'r*, 113 T.C. 449, 472 (1999), *aff'd*, 292 F.3d 490 (5th Cir. 2002) [hereinafter *Kerr*].

91. *Id.*

92. *Id.* at 473.

93. The partnership agreement may have omitted some of the events that would cause dissolution under state law (e.g., withdrawal of a general partner). Compare the state law provision, *id.* at 472, with the provisions in the partnership agreement. *Id.* at 455. This omission, if it occurred, would not make the partnership provisions more restrictive than the state law since the omitted state law provisions were binding on all partnerships in the state even if not set forth in the agreement. In other words, they were mandatory provisions rather than default provisions.

94. The Service adopted this reasoning in holding that a provision requiring the termination of a business trust on a certain date was not an applicable restriction where state law provided that business trusts were to have perpetual existence. Priv. Ltr. Rul. 97-10-021 (Dec. 6, 1996).

95. *Kerr I*, 113 T.C. at 455.

96. *Id.* at 473 (quoting Treas. Reg. § 25.2704-2(b) (1992) (emphasis added)). To be more precise, the Tax Court said the *state law* provision setting forth the withdrawal rights of a limited partner was not a "limitation on the ability to liquidate the entity." *Id.* However, both the Fifth Circuit in its decision affirming the Tax Court, 292 F.3d 490, 494 n.5, and the Tax Court in *Knight v. Commissioner*, 115 T.C. 506, 519-20 (2000), construed the Tax Court's decision in *Kerr* as holding that the provision in the

withdraw from a partnership without requiring the dissolution and liquidation of the partnership,⁹⁷ and thus a limitation on the right of a limited partner to withdraw is not a limitation on the ability to liquidate the partnership.⁹⁸

On appeal, the Fifth Circuit affirmed the Tax Court's decision but on a different theory.⁹⁹ The taxpayers in *Kerr* had donated small amounts of LP interests to the University of Texas.¹⁰⁰ Therefore, the University's written consent was required for the removal of the provisions discussed above.¹⁰¹ The Fifth Circuit concluded that such provisions were not applicable restrictions, because the taxpayers and their family members lacked the power *by themselves* to effect their removal as required by § 2704(b)(2)(B)(ii).¹⁰² The court rejected the Service's argument that the restrictions should be deemed removable because the evidence indicated that the University would not oppose their removal if proposed by the Kerr family: "The Code provides no exception allowing us to disregard nonfamily partners who have stipulated their probable consent to the removal of a restriction."¹⁰³

Several states have amended their limited partnership laws to prohibit a limited partner from withdrawing from his partnership prior to its dissolution unless the partnership agreement provides otherwise.¹⁰⁴ In those states, the issue of whether a restriction on a partner's power to withdraw is a "limitation on the ability to liquidate the partnership" is academic. Even if so considered, the restriction would not be an "applicable restriction" since it is no more restrictive than the state law rule generally applicable to limited partnerships.

It has been reported that the Service has asserted that a restriction on a partner's ability to withdraw is a restriction on his "right to sell or use" his partnership interest within the meaning of § 2703(a)(2) and hence must be

partnership agreement was not a "limitation on the ability to liquidate the entity."

97. *Kerr I*, 113 T.C. at 473.

98. The Tax Court followed its holding in *Kerr I* in *Knight*. 115 T.C. 506, 519-20 (2000). The court's reasoning in *Kerr I* might be questioned. It is true that a partner's withdrawal from a firm does not result in the liquidation of the firm as a whole. However, the definition of "applicable restriction" found in the regulations specifically refers to a liquidation of the entity "in whole or *in part*." Treas. Reg. § 25.2704-2(b) (1992) (emphasis added). The firm's payment to the withdrawing partner to buy out his interest—and the resultant diminution in the firm's assets—would seem to constitute a liquidation of the firm "in part." *Id.*

99. *Kerr v. Comm'r*, 292 F.3d 490 (5th Cir. 2002) [hereinafter *Kerr II*].

100. *Id.* at 491.

101. *Id.* at 494 n.7.

102. *Id.* at 494.

103. *Id.*

104. See, e.g., DEL. CODE ANN., tit. 6, § 17-603 (2003); N.Y. PARTNERSHIP LAW § 121-603 (McKinney Supp. 2003). New York made a corresponding change with respect to limited liability companies. N.Y. LTD. LIAB. CO. LAW § 606 (McKinney 2003).

disregarded in valuing the partner's interest.¹⁰⁵ No case has yet ruled on this theory.

E. Step Transaction Doctrine

In *Estate of Murphy v. Commissioner*, the decedent held a general power of appointment over (and thus was considered for transfer tax purposes as owning)¹⁰⁶ 51.41% of a company's stock.¹⁰⁷ Eighteen days before her death, she gave a 0.88% stock interest to each of her two children reducing her interest to 49.65%.¹⁰⁸ The purpose of the gift was to enable her estate to claim a minority interest discount.¹⁰⁹ In her will, she bequeathed her remaining 49.65% interest to trusts established for her two children.¹¹⁰

The court refused to allow a minority discount.¹¹¹ It treated the gifts of the two 0.88% interests and her bequest of her 49.65% stock interest as integral steps in a single plan to transfer control of the company.¹¹² By collapsing the two transactions into a single testamentary disposition, the court was able to treat them as a transfer of a majority interest (i.e., 51.41%) and thus not entitled to a minority discount.¹¹³

The difficulty with applying the step transaction doctrine and treating a deathbed gift as part of a *testamentary* transfer is that it seems to conflict with Congress's intent in amending § 2035 in 1981 to exclude gifts made within three years of the decedent's death—including deathbed gifts—from his gross

105. Porter, *supra* note 15, § 24.04[2][b] (2003). Mr. Porter argues that Congress never intended the word "use" as used in § 2703(a)(2) to encompass a partner's liquidation rights but instead intended the section to focus narrowly on abusive options and buy-sell agreements. *Id.*

106. See I.R.C. §§ 2041, 2514.

107. *Estate of Murphy v. Comm'r*, 60 T.C.M. (CCH) 645, 645, 1990 T.C.M. (P-H) ¶ 90,472, at 2243.

108. *Id.*, 1990 T.C.M. (P-H) ¶ 90,472 at 2244.

109. *Id.*

110. *Id.*

111. *Id.*

112. *Id.* at 662, 1990 T.C.M. (P-H) ¶ 90,472 at 2262.

113. Judge Colvin did not expressly state that the pre-death gifts and the bequest were part of a single *testamentary* transfer. However, that seems to be the necessary conclusion of his holding. He did not recognize the pre-death transfer of the two 0.88% interests as a relinquishment of control because it "lacked substance and economic effect." *Estate of Murphy v. Comm'r*, 60 T.C.M. (CCH) 645, 662, 1990 T.C.M. (P-H) ¶ 90,472, at 2262. If the purported gift lacked substance during the decedent's life, it follows that it became effective only after death and thus should be considered part of the testamentary transfer. The Service has construed *Murphy* as treating the lifetime gift and the bequest as parts of a single testamentary transfer. See, e.g., Tech. Adv. Mem. 98-42-003 (July 2, 1998) ("As was the case in [*Murphy*], the entire transaction . . . must be viewed as a single testamentary transaction occurring at Decedent's death.").

estate.¹¹⁴ Treating a transfer of property as a testamentary disposition is inconsistent with excluding the property from the transferor's gross estate.

The explanation for the holding may lie in the extreme facts of the case.¹¹⁵ The court emphasized: (1) the transfer occurred only eighteen days before death; (2) the transfer was made solely to qualify the shares passing at death for a minority interest discount;¹¹⁶ and (3) nothing really changed during the eighteen-day period.¹¹⁷ The court pointed out that during that period, decedent continued as chairman of the board and her two children continued to occupy top executive positions with the company. It concluded "that all concerned intended nothing of substance to change and [during that period] nothing of substance did change."¹¹⁸ Given these facts, it was easy to conclude that the two transfers were integral parts of a single testamentary disposition.

The Service has cited *Murphy* in many private letter rulings and technical advice memoranda as authority for disallowing discounts.¹¹⁹ By combining lifetime transfers with transfers at death, the Service is able to transform separate transfers of minority interests into a single transfer of a controlling interest and thereby render the transfer ineligible for a minority discount.

Surprisingly, the Service does not seem to have aggressively used *Murphy* in litigation. For example, it apparently did not attempt to apply the step transaction doctrine in *Strangi* even though the case shares many factors with *Murphy*: (1) only two months elapsed between the creation of the FLP and decedent's death;¹²⁰ (2) decedent's LP interests passed under his will to the

114. Economic Recovery Act of 1981, Pub. L. No. 97-34, § 424, 95 Stat. 173, 317 (1981) (codified at I.R.C. § 2035(d)). It appears that Congress clearly understood that even deathbed gifts would be excluded from the donor's gross estate under the revised version of § 2035. Thus the Senate raised objections to the House version—which was the version ultimately adopted—because of concern that it "would allow decedents to arrange their estates on their *death bed* in order to qualify for" favorable estate tax treatment. S.REP. NO. 97-144, at 138 (1981) (emphasis added); *see also* H.R. CONF. REP. NO. 97-215, at 255 (stating that the Conference agreed to follow the House's bill with respect to the amendment of § 2035). Judge Colvin, however, rejected the argument that the 1981 changes to § 2035 prevented the court from treating Mrs. Murphy's deathbed gift and her testamentary transfer as a single integrated transfer. *Murphy*, 60 T.C.M. (CCH) at 665, 1990 T.C.M. (P-H) ¶ 90,472 at 2264-65.

115. *Id.* at 658, 1990 T.C.M. (P-H) ¶ 90,472 at 2257 ("[T]he facts in this case are extreme.").

116. *Id.* ("A minority discount should not be applied if the explicit purpose and effect of fragmenting the control block of stock was solely to reduce Federal tax.").

117. *Id.* at 659, 1990 T.C.M. (P-H) ¶ 90,472 at 2258.

118. *Id.*

119. *See, e.g.*, Tech. Adv. Mem. 97-30-004 (Apr. 3, 1997); Tech. Adv. Mem. 98-42-003 (July 2, 1998); Tech. Adv. Mem. 97-19-006 (Jan. 14, 1997).

120. The FLP was formed on August 12, 1994, *Strangi I*, 115 T.C. 478, 480-81 (2000), *aff'd in part, rev'd and remanded in part sub nom. Gulig v. Comm'r*, 293 F.3d 279 (5th Cir. 2002), and the decedent died on October 14, 1994. *Id.* at 482.

same four children who held a controlling interest in the corporate general partner of the FLP (thus strengthening the argument that the two transfers should be integrated);¹²¹ and (3) nothing of substance changed during the two-month period.¹²²

The Service's reticence in invoking *Murphy* in litigation may stem from its realization that Congress generally intended lifetime gifts to be excluded from the gross estate and thus is reserving *Murphy* for only the most egregious cases.¹²³ But there is another possibility. Given its recent success in using § 2036, it may no longer feel the need to rely on amorphous judicial doctrines such as the step transaction doctrine when a statutory alternative is available. Indeed, Judge Colvin in *Murphy* hinted at the possible application of § 2036(a)(1) but did not reach that issue since neither party had raised it.¹²⁴

F. Section 2036

The Service has enjoyed great success in applying § 2036¹²⁵ to FLPs, having won every case but one in which it made that claim.¹²⁶ In each case that the Service won, the court found that the decedent had retained, for life, enjoyment of, or the right to the income from, the assets she had transferred to the FLP. This finding triggered § 2036(a)(1), causing the transferred assets to be included in her gross estate at their date-of-death values. However, in the recently decided *Strangi* case, the court also found that the decedent had retained for his life the right to determine who should enjoy or receive the income from the transferred property thereby making § 2036(a)(2)

121. The decedent's will named his children as the sole residual beneficiaries of his estate. *Id.* at 480. They also owned 53% of the stock of FLP's general partner. *Id.* at 481.

122. *Strangi II*, 85 T.C.M. (CCH) 1331, 1339, 2003 T.C.M. (RIA) ¶ 2003-145, at 740.

123. One commentator has noted that although *Murphy* is "often cited by the Service, . . . [it is] not often cited by the courts because of its focus on taxpayer motive, rather than on well-settled estate planning principles." Gagliardi, *supra* note 5, at 376.

124. *Estate of Murphy v. Comm'r*, 60 T.C.M. (CCH) 645, 665, 1990 T.C.M. (P-H) ¶ 90,472, at 2265.

125. I.R.C. § 2036.

126. The Service unsuccessfully tried to apply § 2036 in *Church v. United States*, 2000-1 U.S.T.C. (CCH) ¶ 60,369, at 84,781 (W.D. Tex. 2000), but succeeded in the following cases: *Kimbell v. United States*, 244 F. Supp. 2d 700 (N.D. Tex. 2003); *Estate of Reichardt v. Commissioner*, 114 T.C. 144 (2000); *Strangi II*, 85 T.C.M. (CCH) 1331, 2003 T.C.M. (RIA) ¶ 2003-145; *Estate of Thompson v. Commissioner*, 84 T.C.M. (CCH) 374, 2002 T.C.M. (RIA) ¶ 2002-246; *Estate of Harper v. Commissioner*, 83 T.C.M. (CCH) 1641, 2002 T.C.M. (RIA) ¶ 2002-121; *Estate of Schauerhamer v. Commissioner*, 73 T.C.M. (CCH) 2855, 1997 T.C.M. (RIA) ¶ 97,242.

applicable.¹²⁷ That holding is highly controversial and, according to some, may threaten the continued viability of FLPs as a tax-planning device.¹²⁸

(1) *Section 2036(a)(1)*

The courts have held that the following factors are indicia that the decedent continued to “enjoy” the assets she had transferred to the FLP within the meaning of § 2036(a)(1):

- (1) The decedent transferred substantially all her assets to the FLP.¹²⁹ This suggests there was an understanding that decedent was to have continued access to the FLP’s funds, since otherwise she would run the risk of having insufficient assets to live on.¹³⁰
- (2) The transfer of title from decedent to the FLP with respect to assets she had transferred to it was either improperly recorded or done so tardily.¹³¹
- (3) The decedent transferred her residence to the FLP but continued to live in it rent free.¹³² Even charging the decedent a fair market rental will not take the “curse” off this factor if the rent is not promptly paid in an arm’s length, business-like manner.¹³³
- (4) The decedent commingled her personal assets and those of the FLP.¹³⁴
- (5) The FLP distributions were disproportionately in favor of the decedent or her estate.¹³⁵
- (6) The FLP’s income and property were used to satisfy the contemporaneous needs of the decedent or her estate.¹³⁶

127. *Strangi II*, 85 T.C.M. (CCH) at 1340-44, 2003 T.C.M. (RIA) ¶ 2003-145, at 741-45.

128. *See supra* note 5 and accompanying text.

129. *Reichardt*, 114 T.C. at 153 n.7 (finding estimate that decedent transferred 98% of assets to FLP “reasonable”); *Strangi II*, 85 T.C.M. (CCH) at 1338, 2003 T.C.M. (RIA) ¶ 2003-145, at 739 (finding that decedent transferred about 98% of wealth to FLP); *Thompson*, 84 T.C.M. (CCH) at 386, 2002 T.C.M. (RIA) ¶ 2002-246, at 1524 (finding that decedent “parted with almost all of his wealth” when FLPs formed); *Harper*, 83 T.C.M. (CCH) at 1643, 2002 T.C.M. (RIA) ¶ 2002-121, at 710 (finding that decedent conveyed to FLP approximately 94% of his wealth).

130. *Reichardt*, 114 T.C. at 153; *Strangi II*, 85 T.C.M. (CCH) at 1330, 2003 T.C.M. (RIA) ¶ 2003-145, at 739; *Thompson*, 84 T.C.M. (CCH) at 386, 2002 T.C.M. (RIA) ¶ 2002-246, at 1524.

131. *Harper*, 83 T.C.M. (CCH) at 1648-49, 2002 T.C.M. (RIA) ¶ 2002-121, at 717-19.

132. *Reichardt*, 114 T.C. at 152.

133. *Strangi II*, 85 T.C.M. (CCH) at 1330, 2003 T.C.M. (RIA) ¶ 2003-145, at 739.

134. *Estate of Schauerhamer v. Comm’r*, 73 T.C.M. (CCH) 2855, 2857-88, 1997 T.C.M. (RIA) ¶ 97,242, at 1505; *Reichardt*, 114 T.C. at 152; *Harper*, 83 T.C.M. (CCH) at 1648-49, 2002 T.C.M. (RIA) ¶ 2002-121, at 717-18.

135. *Harper*, 83 T.C.M. (CCH) at 1650, 2002 T.C.M. (RIA) ¶ 2002-121, at 719.

136. *Reichardt*, 114 T.C. at 152 (finding that decedent used partnership’s checking account as his personal account); *Strangi II*, 85 T.C.M. (CCH) at 1339, 2003 T.C.M. (RIA) ¶ 2003-145, at 739-40 (finding that FLP funds were used to pay for decedent’s nursing care); *Thompson*, 84 T.C.M. (CCH) at 386-87, 2002 T.C.M. (RIA) ¶ 2002-246, at 1524 (finding that funds were provided to decedent so he could continue his practice of making annual gifts and to cover his anticipated expenses); *Harper*, 83 T.C.M.

- (7) The transferred property was managed the same way as it was before the transfer.¹³⁷

One cannot read these cases without sensing the courts' hostility toward the discounts made possible by the use of FLPs and concluding that the courts will seize upon any taxpayer misstep, no matter how small, to apply § 2036(a)(1). Indeed, some arguments the courts have used seem unjustified. For example, the courts have sometimes treated funds that the FLP advanced to the decedent's estate so it could pay estate expenses as, in effect, payments to the decedent.¹³⁸ This is unjustified. The issue under § 2036(a)(1) is whether there was an implicit understanding that the *decedent* would continue to enjoy the transferred property during *her* life. The use of the FLP's funds *after the decedent's death* is irrelevant to this issue. Moreover, in most of these cases, the other partners of the FLP were *also* the residuary beneficiaries of the decedent's estate and as such were responsible for payment of these expenses. Thus, it is more realistic to say that using FLP funds to pay that liability effectively benefited the other partners—not the decedent.¹³⁹

In practice, § 2036(a)(1) is simply a trap for the unwary. By scrupulously observing the formalities and avoiding the pitfalls mentioned above, that section may be easily avoided. Nothing in these cases creates an

(CCH) at 1650, 2002 T.C.M. (RIA) ¶ 2002-121, at 719 ("Similarly significant is the evidence that certain of the distributions to the Trust were linked to a contemporaneous expense of decedent personally or of his estate.").

137. *Strangi II*, 85 T.C.M. (CCH) at 1339, 2003 T.C.M. (RIA) ¶ 2003-145, at 740 ("[V]irtually nothing beyond formal title changed in decedent's relationship to his assets."); *Thompson*, 84 T.C.M. (CCH) at 386-87, 2002 T.C.M. (RIA) ¶ 2002-246, at 1524; *Schauerhamer*, 73 T.C.M. (CCH) at 2858, 1997 T.C.M. (RIA) ¶ 97,242, at 1505; *Reichardt*, 114 T.C. at 152 ("Nothing changed except legal title.").

138. See, e.g., *Harper*, 83 T.C.M. (CCH) at 1641-50, 2002 T.C.M. (RIA) ¶ 2002-121, at 708-19. In *Harper*, the distributions were still disproportionately in favor of the decedent even if the distribution of funds to pay estate expenses is disregarded. *Id.* at 1650, 2002 T.C.M. (RIA) ¶ 2002-121, at 719. Decedent at the time of his death held a 39% interest in the FLP through his revocable trust while his children had a 61% interest. *Id.* at 1641-44, 2002 T.C.M. (RIA) ¶ 2002-121, at 708-09, 711-12. Before his death, the FLP distributed \$21,820 to the decedent's revocable trust out of total distributions of \$36,320, or 60%. *Id.* at 1644-46, 2002 T.C.M. (RIA) ¶ 2002-121, at 712-13. But the court in justifying its statement that the distributions were "heavily weighted in favor of decedent," *id.* at 1650, 2002 T.C.M. (RIA) ¶ 2002-121, at 719, states that through the end of October 1995, the FLP made distributions of \$231,820 to the decedent's revocable trust as compared with distributions of only \$14,500 to his children. *Id.* However, \$210,000 of the payments to the trust was for the payment of estate expenses. *Id.* at 1644-46, 2002 T.C.M. (RIA) ¶ 2002-121, at 712-13.

139. In *Harper*, the decedent's children were the other partners of the FLP. 83 T.C.M. (CCH) 1641, 1642, 2002 T.C.M. (RIA) ¶ 2002-121, at 711-12. As remaindermen of decedent's revocable trust, *id.*, 2002 T.C.M. (RIA) ¶ 2002-121, at 708, they were also the persons who would effectively bear the economic burden of the estate tax on the trust assets. See I.R.C. § 2207B. Thus, the use of the FLP's funds to help pay the estate tax benefited them.

insurmountable obstacle to the continued use of FLPs to save estate and gift tax.

(2) *Section 2036(a)(2)*

The Tax Court's holding in *Strangi* that § 2036(a)(1) applied was not surprising in light of its precedents, but its holding that § 2036(a)(2) applied was an unexpected "bombshell."¹⁴⁰

The court found that Strangi possessed a "legally enforceable power" to determine, in conjunction with the other partners, whether the FLP would distribute its earnings (and if so, the amount of the distribution) and whether the FLP would be liquidated.¹⁴¹ These powers, according to the court, enabled Strangi to determine who should possess or enjoy the property he transferred to the FLP and the income therefrom. They thus constituted § 2036(a)(2) powers, and the assets Strangi transferred to the FLP were includible in his gross estate at their date-of-death values.¹⁴²

The estate had relied on *Byrum v. United States*,¹⁴³ in which the decedent retained the right to vote stock that he had transferred to a trust.¹⁴⁴ In *Byrum*, the government had argued that the decedent possessed a § 2036(a)(2) power since he could control the payment of dividends through his voting control of the corporation and in that way could "regulate" the amount of income, if any, paid to the trust beneficiaries.¹⁴⁵ The Supreme Court rejected this argument pointing out, among other factors, that Byrum's voting power was constrained by his fiduciary duty to the corporation and its shareholders.¹⁴⁶ The tax bar felt confident that § 2036(a)(2) posed no threat to FLPs, because any power the decedent possessed as partner to make distribution or liquidation decisions was constrained by his fiduciary duty to the partnership and his other partners. The tax bar's confidence was bolstered by private letter rulings issued by the Service endorsing this analysis.¹⁴⁷

140. Gans & Blattmachr, *supra* note 5, at 1154-55 (stating that court's § 2036(a)(1) holding was "not unexpected" but its § 2036(a)(2) holding "took many in the estate-planning community by surprise").

141. *Strangi II*, 85 T.C.M. (CCH) at 1341-42, 2003 T.C.M. (RIA) ¶ 2003-145, at 742-44.

142. *Id.* at 1342, 2003 T.C.M. (RIA) ¶ 2003-145, at 746-47.

143. 408 U.S. 125 (1972).

144. *Id.* at 126-27.

145. *Id.* at 131-32.

146. *Id.* at 137, 142-43.

147. See, e.g., Priv. Ltr. Rul. 94-15-007 (Apr. 15, 1994); Priv. Ltr. Rul. 93-10-039 (Mar. 12, 1993); Tech. Adv. Mem. 91-31-006 (Aug. 2, 1991). It appears that only the decedent and members of his family were partners in the FLPs described in these rulings.

However, the court in *Strangi* held that *Byrum* was inapplicable because of crucial distinctions between the two cases.¹⁴⁸ In *Byrum*, the ultimate decision on whether income would be paid to the trust beneficiaries was vested in an independent trustee that had complete discretion to accumulate or distribute income.¹⁴⁹ Even if *Byrum* flooded the trust with dividends, he could not control whether those dividends would be distributed by the trust.¹⁵⁰ In contrast, there was no independent intermediary trustee in *Strangi*.¹⁵¹ The corporations involved in *Byrum* were operating businesses and thus their ability to distribute dividends was constrained by business and economic factors (e.g., the need to expend funds to meet competition; to make, and respond to, changes in product lines; to replace plant and equipment; and for growth and expansion).¹⁵² In contrast, these constraints did “not apply to [the FLP or the corporate general partner in *Strangi*], which held only monetary or investment assets.”¹⁵³ In *Byrum*, enforcement of the decedent’s fiduciary duty was a realistic possibility because there were a “significant number of unrelated parties,” while in *Strangi*, all parties were members of the decedent’s immediate family.¹⁵⁴

The court dismissed the private letter rulings holding to the contrary by simply noting that such rulings, by statute, had no precedential effect.¹⁵⁵

Critics have attacked the *Strangi* decision on several grounds:

- (1) The court misread and misapplied the Supreme Court’s holding in *Byrum*.¹⁵⁶

148. *Strangi II*, 85 T.C.M. (CCH) 1331, 1340-43, 2003 T.C.M. (RIA) ¶ 2003-145, at 744-45.

149. *United States v. Byrum*, 408 U.S. 125, 126-27, 143 (1972).

150. *Id.* at 143.

151. *Strangi II*, 85 T.C.M. (CCH) at 1342, 2003 T.C.M. (RIA) ¶ 2003-145, at 744.

152. *Byrum*, 408 U.S. at 139-41.

153. *Strangi II*, 85 T.C.M. (CCH) at 1342, 2003 T.C.M. (RIA) ¶ 2003-145, at 744.

154. *Id.* at 1342-43, 2003 T.C.M. (RIA) ¶ 2003-145, at 744-45.

155. *Id.* at 1343, 2003 T.C.M. (RIA) ¶ 2003-145, at 745. The relevant Code section is § 6110(k)(3).

156. Gans & Blattmachr, *supra* note 5, at 1156-59. The authors of the article assert that the Supreme Court “did not intend to adopt a facts-and-circumstances approach but rather to create a bright-line test turning on whether the grantor retained a legally enforceable right.” *Id.* at 1157. In their view, the Court’s reference to the substantial number of unrelated shareholders in *Byrum* was not intended to justify its ruling but rather was an “explication of the rationale for its bright-line test.” *Id.* This is a plausible, but hardly a necessary, reading of *Byrum*. The Court did state that it found the government’s de facto approach to “depart from the specific statutory language.” *Byrum*, 408 U.S. at 138-39. On the other hand, the Court quite clearly was saying that *even if* one applied a de facto approach, the decedent’s power did not amount to a § 2036(a)(2) power. *Id.* at 143 (“We conclude that *Byrum* did not have an unconstrained de facto power to regulate the flow of dividends to the trust . . .”). That the Court found it necessary to rebut at length the government’s position regarding the decedent’s de facto power suggests some unease in relying *exclusively* on its “legally enforceable right” test. Moreover, courts have frequently found it necessary in tax and other cases to “depart from the specific statutory language” to carry out the purposes of the law.

- (2) Section 2036(a)(2) did not apply because the decedent had received adequate and full consideration for his transfer of assets to the FLP;¹⁵⁷ and
- (3) Section 2036(a)(2) did not apply because there was no "transfer" within the meaning of that section.¹⁵⁸

It is too early to tell whether any of these objections will ultimately prevail. Until then, a planner must confront the possibility that *Strangi* will be sustained, followed, and maybe even extended. How can or should a planner respond? Two observations can be made:

- (1) The *Strangi* holding regarding § 2036(a)(2) apparently will apply *only* if a decedent has, at the time of his death, the power, either alone or in conjunction with others, to make distribution or liquidation decisions regarding the FLP.

157. Gans & Blattmachr, *supra* note 5, at 1161-63; Michael D. Mulligan, *Courts Err in Applying Section 2036(a)(2) to Limited Partnerships*, 30 EST. PLAN. 486, 490-94 (2003). The court in *Strangi* held that the decedent's transfer of property to the FLP did not qualify for the exception to § 2036(a) for a "bona fide sale for an adequate and full consideration in money or money's worth." *Strangi II*, 85 T.C.M. (CCH) at 1343, 83 T.C.M. (RIA) ¶ 2003-145, at 745-46. The court found that decedent's transfer to the FLP was not "a bona fide sale" because (1) the transfer was not conducted at arm's length and did not involve any "meaningful negotiation or bargaining with other anticipated interest-holders and (2) "was merely a 'recycling' of value through partnership or corporate solution." *Id.* at 1344, 85 T.C.M. (RIA) ¶ 2003-145, at 746. Similar holdings were made in *Kimbell v. United States*, 244 F. Supp. 2d 700, 704-05 (N.D. Tex. 2003); *Estate of Thompson v. Commissioner*, 84 T.C.M. (CCH) 374, 387-89, 2002 T.C.M. (RIA) ¶ 2002-246, at 1525-27; *Estate of Harper v. Commissioner*, 83 T.C.M. (CCH) 1641, 2002 T.C.M. (RIA) ¶ 2002-121, at 722-24.

The authors of the above-cited articles contend the exception should be considered satisfied whenever the amount received by the transferor equals the amount transferred, even if there is no arm's length bargaining and the exchange is a mere "recycling." They point out that the exception is intended to exempt transactions that do not deplete the transferor's gross estate; hence, the exception should be deemed satisfied whenever the amounts exchanged are equal. Gans & Blattmachr, *supra* note 5, at 1161-63; Mulligan, *supra*, at 492-94. The authors assert that since the court in *Strangi* found there was no gift when the decedent transferred his property to the FLP, it implicitly found that there was no depletion of his gross estate and hence the exception should apply. Gans & Blattmachr, *supra* note 5, at 1163.

I agree that the "adequate and full consideration" exception is satisfied whenever the amounts exchanged are equal. However, I do not believe the exception was satisfied in *Strangi*. The amounts exchanged were not equal; Strangi had transferred property worth approximately \$9.9 million in return for LP interests worth only about \$6.8 million, *see supra* note 76, and there would have been depletion of his gross estate had the court not applied § 2036. *But see infra* note 158.

158. Mulligan, *supra* note 157, at 490-92. I believe this is the best argument for attacking the court's § 2036(a)(2) holding in *Strangi*. Strangi's transfer of property in exchange for his LP interests did not transfer any value to anyone else, either at the time of the transfer, or upon his death. *See supra* Part III.C. Consequently, there is no reason to apply § 2036(a). There was a transfer of value at Strangi's death, but that transfer was effected by Strangi's will—not by his prior transfer to the FLP—and was fully taxable per § 2033. There was, of course, a "transfer" of value to the FLP, but case law and indeed a Treasury regulation treat a transfer to an entity as taxable only to the extent that the owners or beneficiaries of the entity (other than the transferor) benefit from the transfer. *See supra* note 83.

This suggests that a partner in an existing FLP can avoid § 2036(a)(2) simply by giving away all interests in the FLP that entitle him to participate in distribution and liquidation decisions. However, this approach will succeed only if the partner lives for more than three years following the gift. Otherwise the gifted interests will be brought back into the gross estate at their date-of-death values pursuant to § 2035.¹⁵⁹ The other potential problem with this approach is that the gift of the partner's interests may generate a gift tax liability. However, planners have devised techniques that can mitigate and even eliminate the potential gift tax liability.¹⁶⁰ Thus, except for the § 2035 risk, the impact of the *Strangi* decision can probably be avoided in the case of an existing partnership without much difficulty.

In the case of a new FLP, a favorable result could be achieved by having the taxpayer transfer property to the FLP in exchange for LP interests and a minority interest in the corporate general partner (i.e., the fact pattern of *Strangi*), but then prohibiting the taxpayer, in the governing documents, from participating in any distribution or liquidation decision. This could be bolstered by prohibiting amendment of this provision (or at least, prohibiting the taxpayer from participating in the amending process).¹⁶¹

If the contributing partner is married and is concerned about giving the problematic powers to an outsider, he might place the power to make distribution and liquidation decisions in his spouse. For example, he could transfer his property to the FLP but provide that the GP and LP interests

159. Section 2035 provides, inter alia, that if a decedent transferred property within three years of his death and if the value of the transferred property would have been included in the decedent's gross estate pursuant to § 2036 had the transfer not occurred, the transferred property will be included in the decedent's gross estate at its date-of-death value as though the transfer did not take place. See Gans & Blattmachr, *supra* note 5, at 1166-67 for a discussion of this issue in the context of an FLP.

160. Gans and Blattmachr confidently assert that "in the case of an existing partnership, *Strangi's* alternative holding (i.e., its holding regarding § 2036(a)(2)) can be easily avoided without incurring any gift tax liability." Gans & Blattmachr, *supra* note 5, at 1165. One technique they describe is for the partner to transfer his problematic interests to a trust in which the partner retains the power to modify the interests of the beneficiaries. "The retained modification power would render the gift incomplete and would therefore defeat the gift tax." *Id.* at 1164. At the same time, the partner would have divested himself of any power to affect liquidation and distribution decisions since all voting power in the interests would reside in the trustee. The *transferred interests* would be included in the partner's gross estate because of his retained modification power but they would be valued with the appropriate discounts. However, § 2036(a)(2) would not apply with respect to the value of the *underlying assets* because the partner had divested himself of all power over them. *Id.* at 1164-65.

Another approach they propose is to recapitalize the partner's interests into two classes: one class in which all voting and liquidation rights are reposed and the other with no voting or liquidation rights. If the class having the voting and liquidation rights constituted only a modest part of the FLP's equity, say, one percent, it could probably be given away with only a modest gift tax liability. *Id.* at 1164.

161. *Id.* at 1167-68.

received in return be issued directly to his spouse.¹⁶² Of course, the contributing partner and the spouse could not agree on how the spouse was to exercise that power nor could the spouse agree to follow the directions of the contributing partner.¹⁶³ However, assuming the contributing partner reposes trust and confidence in his spouse, such an arrangement should help assuage his concern about depriving himself of such powers.¹⁶⁴ Since the contributing partner would have no power to make distribution or liquidation decisions at the time of his death, § 2036(a) would not apply.¹⁶⁵ Moreover, there would be no gift tax liability by virtue of the marital deduction.¹⁶⁶

- (2) Strangi's § 2036(b)(2) holding should not extend to an FLP that operates an active business

One reason that the *Strangi* court declined to apply *Byrum* was that *Byrum* involved actively conducted businesses while the FLP in *Strangi* held "only monetary or investment assets."¹⁶⁷ This distinction bears crucially on the issue of constraint: one who operates an active business faces many demands for funds that significantly restrain his ability to distribute earnings (as the Court explained in *Byrum*), while such constraints do not exist, or exist to a much lesser degree, in the case of an FLP holding only monetary or investment assets.

The court could also have justified the distinction in terms of the "independent significance" doctrine. This doctrine, which the Service has recognized in certain instances, holds that a power to affect beneficial enjoyment will not be considered a taxable power if its exercise has a

162. *Id.* at 1168.

163. *Publicker v. Miles*, 48 A.F.T.R. 1968 (E.D. Pa. 1955) (holding that wife's transfer of property to trust was an incomplete gift where husband had agreed in advance that he would give his required consent to any change she wanted in the trust); *see also* *Camp v. Comm'r*, 195 F.2d 999, 1004 (1st Cir. 1952) (stating in dictum that husband's transfer of securities to wife would be a completed gift even if he were "confident that his wife would reconvey the securities to him if he ever asked for them" but that situation would be different if "there were an advance agreement" that wife would acquiesce to any change desired by husband).

164. *Gans & Blattmachr*, *supra* note 5, at 1168.

165. *Id.* *Gans and Blattmachr* also assert that § 2035 should not apply even if the contributing partner dies within three years of the issuance of the partnership interests, because he *never* possessed those interests. *Id.* at 1169. However, the Service could argue that initially the interests were constructively issued to the contributing partner and were constructively retransferred by him to his spouse. If that argument were successful, § 2035 would apply if the contributing partner died within three years of his contribution.

166. *Id.* at 1168; *see also* I.R.C. § 2523.

167. *Strangi II*, 85 T.C.M. (CCH) 1331, 1342, 2003 T.C.M. (RIA) ¶ 2003-145, at 744.

significance that is independent of its effect on such enjoyment. Thus, the Service ruled in the case of a trust that distributed its income equally among the grantor's children, including after-born children, that the grantor's ability to have additional children and thereby reduce the amount of trust income paid to his current children was neither a § 2036 power nor a § 2038 power, since having additional children had a significance that is independent of its effect on the distribution of trust income.¹⁶⁸ Likewise, deciding to distribute income of an active business affects not only the amount of income the owners of the business receive (i.e., their enjoyment of the property) but also the amount of money available for expansion of the business, the replacement of equipment and machinery, the ability to pay sufficient compensation needed to attract competent employees and executives, etc. In contrast, the effect of deciding to distribute income from a securities portfolio is principally confined to its effect on the recipient's current and future enjoyment of the property.

The constraints imposed by the operation of an active business *should* be sufficient to prevent the application of § 2036(a)(2). Nevertheless, one should keep in mind the possibility that the courts, motivated by a desire to rein in abusive FLPs, may refuse to apply *Byrum* unless *all* three of the following conditions are satisfied: (1) an independent trustee with a discretionary power to make distributions is interposed between the FLP and the beneficiaries; (2) the FLP consists solely of an active business; and (3) the FLP has a significant number of nonfamily partners.

G. Conclusion

Reports of the FLP's demise have been greatly exaggerated. On every issue discussed but § 2036, the authorities are favorable to the taxpayer, and even § 2036 can apparently be avoided if the FLP is properly structured. Some of the precautions needed to avoid § 2036(a)(2) (e.g., relinquishing power over distribution and liquidation decisions) will make FLPs less attractive to some taxpayers, but FLPs still offer substantial tax benefits and thus are likely to remain popular.

168. Rev. Rul. 80-255, 1980-2 C.B. 272; *see also* Rev. Rul. 72-307, 1972-1 C.B. 307 (holding that an employee's ability to terminate his coverage under his employer's group life insurance policy by quitting his job was not an "incident of ownership" under § 2042, since quitting his job had a significance that was independent of his coverage under the policy).

IV. SHOULD THE LAW ON DISCOUNTS BE REFORMED? IF SO, HOW?

Part II showed that the “fair market value” standard often understates the value of FLP interests, and that the lack of control used to justify the discount is often only temporary. Part III showed that current doctrine—even as extended by *Strangi*—is unlikely to end the use of FLPs. Thus, the need for reform must be addressed. This Part describes and critiques the two most popular reform proposals and concludes by making a new proposal.

A. The Attribution Approach

Under the “attribution approach,” a transferee of an interest in an entity is treated for valuation purposes as owning interests that are actually owned by other members of his family.¹⁶⁹ For example, the transferee might be treated as owning the interests owned by his spouse, siblings, parents, children, and grandchildren. This approach would substantially reduce the possibility of an interest qualifying for a minority or lack-of-control discount.

Suppose *T*’s father, *F*, owns 30% of ABC Corp.’s stock; his aunt *A* (*F*’s sister), owns 20%; his uncle *U* (his mother’s brother) owns 40%; and his cousin *C* (*U*’s child) owns 10%. Under the attribution rule suggested above and assuming reattribution, *F*’s gift of 10% of the company’s stock to *T* would not qualify for a minority discount, since *T*, in addition to the 10% stock interest he received as a gift, would also be treated as owning *all* the remaining stock in the company.¹⁷⁰

The rationale for this approach is that members of the same family generally cooperate with one another and act in concert as a single control group. Thus, its proponents assert, it is unrealistic to value an interest owned by a family member as though it were held by an unrelated outsider.

169. The attribution approach is discussed in Laura E. Cunningham, *Remember the Alamo: The IRS Needs Ammunition in Its Fight Against FLP*, 86 TAX NOTES 1461, 1466-67 (2000), and in Fellows & Painter, *supra* note 8, at 927-28.

170. Reattribution means that an interest that is constructively owned by a person under the attribution rules is considered *actually* owned by that person for purposes of reapplying the attribution rules. In the example in the text, the ten percent interest actually owned by *C* is attributed to *U* since *U* is *C*’s parent. That ten percent interest, which is now considered actually owned by *U*, is reattributed to *T*’s mother, since *T*’s mother is *U*’s sibling. Finally, the ten percent interest, which is now considered actually owned by *T*’s mother, is reattributed to *T* under the parent-child attribution rule. A similar process of attribution and reattribution causes all the remaining stock owned by *T*’s family to be treated as owned by *T*.

The House of Representatives passed an attribution rule like the one described above as part of the 1987 Omnibus Reconciliation Act, but neither the Senate nor the Conference Committee adopted it.¹⁷¹ The attribution approach has attracted only minimal support from the commentators.¹⁷² Many have rejected it, contending that the attribution approach makes assumptions about family solidarity that are often unjustified.¹⁷³ In the words of one commentator, “[f]or every family owned business in which siblings and in-laws cooperate and work as an economic unit, there is apt to be one in which relationships are strained, and cooperation is lacking.”¹⁷⁴

B. The Aggregation Approach

Under the “aggregation approach” a transferred interest is valued on the basis of its pro rata share of the fair market value of the transferor’s entire interest.¹⁷⁵ Thus, if *P* owns 80% of the stock in a corporation and gives a 10% stock interest in it to *C*, his child, the value of the gifted interest for tax purposes would be one-eighth (i.e., 10% out of 80%) of the fair market value of an 80% stock interest (i.e., *P*’s initial interest).¹⁷⁶ Even though *C* receives

171. See H.R. REP. NO. 100-391, at 1041-44 (1987); H.R. CONF. REP. NO. 100-495, at 994-95 (1987).

172. Professor Cooper tentatively suggested enactment of an attribution approach. See Cooper, *supra* note 35, at 232 (“In the case of minority discounts this [reform] might be accomplished by incorporating an attribution concept such as that embodied in present [§] 318 into the valuation determination.”). No other commentator appears to have endorsed this approach.

173. See, e.g., Cunningham, *supra* note 169, at 1471; Fellows & Painter, *supra* note 8, at 928 (“Application of the attribution rules, however, may create harsh results.”).

174. Cunningham, *supra* note 169, at 1471.

175. The “aggregation approach” is discussed in Fellows & Painter, *supra* note 8, at 922-26, and Cunningham, *supra* note 169, at 1467-68. Professor Dodge has recommended enactment of an aggregation approach under which all gifts and testamentary transfers of fractional interests in property (e.g., shares in a corporation, FLP interests) would be taxed at death. Joseph M. Dodge, *Redoing the Estate and Gift Taxes Along Easy-to-Value Lines*, 43 TAX L. REV. 241, 254-56, 374-76 (1988). Their valuation would be based on the largest fractional interest that the decedent ever owned in that property. *Id.* at 255, 374-75. The Treasury proposed the adoption of an aggregation approach in 2 TREASURY DEP’T, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 386-88 (1984). The Treasury’s proposal was supplemented by an attribution rule under which stock owned by the transferor’s spouse would be attributed to the transferor. *Id.* at 387.

176. The Treasury explained the operation of its proposed aggregate approach by the following two examples:

Example 1. *A* owns 60% of the outstanding stock of a corporation worth \$100x. *A*, whose controlling interest is worth \$70x, transfers one-half of his interest to *B*. The value of the gift for gift tax purposes is \$35x (i.e., 50% of the value of *A*’s 60% block of stock). If *A* retains his remaining 30% block until his death, the estate tax value of such block will be 50% of the value of a 60% block of stock at the date of *A*’s death.

only 10% of the corporation's stock, the gift will not qualify for a minority discount because it is valued on the basis of *P*'s 80% majority stock interest. Unlike the attribution approach, the aggregation approach values property solely on the basis of property that is, or was, owned by the transferor.¹⁷⁷ In contrast, the attribution approach values property by reference to the holdings of both the transferor *and* his family.¹⁷⁸

The reach of the aggregation approach is extremely broad and extends far beyond exotic transactions involving FLPs. It applies whenever a person transfers a part interest in his property to someone else. Thus, it applies when a sole proprietor gives away a partial interests in his business to one or more donees. It applies regardless of how small the transferred interest is or whether it carries any voting rights.

C. Critique of the Aggregation Approach

As will become clear from the following discussion, I oppose the aggregation approach principally because it makes unwarranted assumptions about family cohesiveness. *A fortiori*, I oppose the attribution approach since it makes even more sweeping assumptions on that issue. The following discussion will therefore be limited to a critique of the aggregation approach, since the criticisms I make of the aggregation approach also apply to the attribution approach—only with more force.

(1) Eliminating a Discontinuity Between the Estate Tax and the Gift Tax

Some proponents of the aggregation approach justify it primarily on the ground that it eliminates a discontinuity in the tax treatment of gifts and

Example 2. *B* owns 40% of the outstanding stock of a corporation worth \$100x. *B*'s minority interest is worth \$30x, and *B* transfers one-half of her interest to *A*. The value of the gift to *A* would be \$15x (i.e., 50% of the value of the 40% block possessed by *B* immediately prior to the gift). However, if *B*'s spouse *S* owned stock representing 20% of the corporation, so that the combined interest of *S* and *B* was worth \$75x, the value of the gift to *A* would be \$25x, (i.e., 33 1/3% of the value of the 60% block held jointly by *B* and *S*).

TREASURY DEP'T, *supra* note 175, at 387. The second example shows the effect of the Treasury's proposed spousal attribution rule.

177. Where the taxpayer has made a number of transfers, some donative and others for consideration, and has also made a number of acquisitions, application of the aggregation approach can become very complicated. See Fellows & Painter, *supra* note 8, at 926 n.102.

178. Of course, the scope of the attribution could be narrowed if that were desired. For example, the attribution rule could provide that there is no attribution between siblings as § 318(a)(1)(a) of the Code does.

testamentary transfers.¹⁷⁹ They point out, correctly, that the gift tax is imposed on the value of the interest received by each donee, while the estate tax is imposed on the value of the entire interest passing under the decedent's estate.¹⁸⁰ Suppose *D* owns 80% of the stock of ABC, Inc., and gives half of his stock to son, *A*, and the other half to his daughter, *B*. Each gift will be valued separately and therefore will qualify for a lack-of-control discount because each is a minority interest. On the other hand, if *D* had retained his 80% stock interest for life and willed 40% of the stock to *A* and the other 40% to *B*, there would be no lack-of-control discount because the total amount passing through *D*'s estate, 80%, was a controlling interest.

Proponents point out that historically the primary purpose of the gift tax was to serve as a backstop for the estate tax by taxing transfers that depleted the amount that would otherwise be subject to estate tax.¹⁸¹ Current law, they argue, is inconsistent with this purpose, because it taxes a smaller amount if the transfer is made by lifetime gift than would be taxed if the transfer were made at death.

Changes made in the law in 2001 have significantly weakened the "backstop-to-the-estate-tax" rationale for the gift tax. Under those changes, the estate tax ends in 2010 while the gift tax continues in effect.¹⁸² Obviously, the gift tax cannot serve as a "backstop" for an estate tax that no longer exists. Moreover, from 2004 through 2009, the *estate tax* "exclusion amount" (i.e., the amount sheltered from estate tax by the unified credit) increases from \$1,500,000 to \$3,500,000 while the *gift tax* exclusion amount remains fixed at one million dollars.¹⁸³ The difference in the two exclusion amounts in any given year constitutes the amount of wealth that can be transferred tax free that year by a testamentary disposition but which would be subject to gift tax

179. Cunningham, *supra* note 169, at 1462-63, Repetti, *supra* note 8, at 417 ("This phenomenon [i.e., tax savings derived by making gift of minority interests] results from a fundamental discontinuity between the estate tax and the gift taxes.").

180. See *supra* notes 29-31 and accompanying text.

181. See, e.g., Sanford v. Comm'r, 308 U.S. 39, 44 (1939) ("An important, if not the main, purpose of the gift tax was to prevent or compensate for avoidance of death taxes by taxing the gifts of property *inter vivos* which, but for the gifts, would be subject in its original or converted form to the tax laid upon transfers at death.").

182. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 501, 115 Stat. 38, 69 (2001). All changes made by that Act, including repeal of the estate tax, will cease to be effective as of January 1, 2011, and the Code will revert to the way it was before the Act became effective. *Id.* § 901, 115 Stat. at 150. This "sunset" provision was adopted to ensure that the Act complied with the Congressional Budget Act of 1974. See H.R. CONF. REP. NO. 107-84, at 325-26 (2001).

183. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 521, 115 Stat. 38, 71-72 (2001).

if transferred by an inter vivos gift. Clearly, the gift tax does not backstop the estate tax for amounts that are not subject to the estate tax.¹⁸⁴

In any event, elimination of a discontinuity between the estate tax and the gift tax is an insufficient justification for the aggregation approach. To prevail, the proponents of this approach must do more than point out the discontinuity; they must demonstrate the superiority of the estate tax rule. In fact, the gift tax rule appears superior.

First, the gift tax rule is more consistent with the nature and underlying rationale of a *transfer* tax. A “transfer” is a conveyance of something from one person to another.¹⁸⁵ Both the estate tax and the gift tax are taxes on the *transfer* of value. The tax should be imposed on the value that is actually conveyed to the transferee.¹⁸⁶ The estate tax rule, however, may tax value that is not transferred.

Consider the case described above where the decedent owned 80% of the stock in ABC, Inc. and bequeathed half of his interest to *A* and the other half to *B*. Assume that the decedent’s 80% interest had a value of \$200,000 in his hands. Let’s also assume *arguendo* that the value of each legatee’s interest in their respective hands is only \$80,000 (rather than \$100,000), because their respective interests lack control. (Whether the discounts *accurately* value an interest passing to a taxpayer where the other interests are held by members of his family will be discussed in Part IV.C.2 below.) On these assumptions, the decedent’s estate has transferred only \$160,000 of value but estate tax will be computed as though it had transferred \$200,000 of value. The \$40,000 difference was not “transferred” but vanished or was destroyed in the process of being transferred.

184. It is generally assumed that the reasons for retaining the gift tax were (1) to reduce the overall revenue loss caused by the legislation and (2) to discourage taxpayers from shifting *income* from one taxpayer to another in an attempt to reduce their overall *income tax* liability. Henry J. Lischer, Jr., *Incomplete Transfer Tax Repeal: Should the Gift Tax Survive?*, 56 SMUL. REV. 601, 610-12 (2003). This may also explain why the exclusion amounts during the period 2004 through 2009 are smaller for gifts than for testamentary transfers.

185. THE RANDOM HOUSE COLLEGE DICTIONARY, REVISED EDITION (1988) defines “transfer” as meaning “to convey . . . from one . . . person, etc., to another.”

186. In the following cases, the court valued property for estate tax purposes on the value that passed to the estate rather than its value in the hands of the decedent: *United States v. Land*, 303 F.2d 170 (5th Cir. 1962) (disregarding agreement that permitted other partners to buy decedent’s interest at two-thirds of its calculated value that terminated upon decedent’s death); *Goodman v. Granger*, 243 F.2d 264 (3d Cir. 1957) (disregarding possibility of forfeiture that lapsed at decedent’s death); *Estate of Harrison v. Commissioner*, 52 T.C.M. (CCH) 1306, 1987 T.C.M.(RIA) ¶ 87,008 (disregarding decedent’s power of liquidation that lapsed at his death).

Second, the gift tax approach is more equitable. In the above example, the amount of estate tax imposed on the stock interests passing to *A* and *B*, which have a combined value of \$160,000, will be the same as the tax imposed on a \$200,000 bequest of cash. This is highly inequitable, especially if each legatee is required to pay the estate tax on his legacy under the applicable tax apportionment provision.¹⁸⁷

Third, the existing estate tax rule can result in the seeming absurdity where a bequest that qualifies as a deduction (e.g., a charitable or marital bequest) is included in the taxable estate, and therefore is taxed, at a different value than the amount of the corresponding deduction. In *Ahmanson Foundation v. United States*,¹⁸⁸ nonvoting shares bequeathed to a charity were included in the gross estate without a lack-of-control discount (since the estate also held all the voting shares of the corporation),¹⁸⁹ while the charitable deduction for the same bequest was reduced by a lack-of-control discount.¹⁹⁰ This discrepancy does not occur under the gift tax approach, because both the amount of the gift and the amount of the deduction will be discounted for lack of control.

Finally, the proponents of the aggregation approach exaggerate the difference between the gift tax approach and the estate tax approach. In fact, the estate tax approach is fully consistent with the gift tax approach if one views the estate—rather than the ultimate recipient of the property—as the decedent's transferee. In the above example, a controlling 80% stock interest passed to the estate, and if one views the estate as the transferee, no discount should be allowed for lack of control. This way of looking at the matter makes sense if the executor has the power to sell the entire 80% interest for then the estate can realize the full value of the bloc as a controlling interest. On the other hand, where the decedent carves up his controlling interest into

187. The Uniform Probate Code states that unless the will provides otherwise, each beneficiary of the estate is liable for the estate tax attributable to the interest he received. The amount of the beneficiary's liability is determined by using the values that were used in computing the tax. UNIF. PROBATE CODE § 3-916(b) (amended 1998), 8 (Pt. 2) U.L.A. 284 (2003). Under this approach, *A* and *B* in the example in the text would collectively have to pay the same amount of tax as the recipient of a \$200,000 bequest, even though the combined value of their respective stock interests was only \$160,000.

188. 674 F.2d 761 (9th Cir. 1981).

189. *Id.* at 765-69.

190. *Id.* at 771-72. In *Estate of Chenoweth v. Commissioner*, the decedent bequeathed 51% of his stock in a corporation to his wife and the remaining 49% to his daughter. 88 T.C. 1577 (1987). The bequest to his wife qualified for the marital deduction. The court recognized the possibility that the bequest might be included in the estate at one value while it might be valued at a different amount in computing the marital deduction. *Id.* at 1589-90. *Contra Provident Nat'l Bank v. United States*, 581 F.2d 1081, 1091-92 (3d Cir. 1978).

multiple minority interests and bequeaths them to different beneficiaries, as in the above example, the executor normally lacks a power of sale.¹⁹¹ Then the estate cannot realize the value of the 80% bloc *as a controlling interest*, and the case for viewing the estate as the transferee is much weaker.

There may be reasons for always treating the estate—rather than the ultimate recipients—as the transferee of all property passing through the probate estate. Deciding whether the executor has a power of sale in a given case may be costly and time consuming. It may require a construction of the will, and may depend on the state's law on abatement, the state's preference (or lack thereof) for in-kind distributions, whether a bequest is characterized under state law as a general or specific bequest, etc.¹⁹² The present rule, which treats all property passing under the will uniformly, can be defended on the basis of administrative convenience. However, these reasons, which are due to the nature of estate administration, do not justify applying the estate tax rule to inter vivos gifts where the rule for valuing interests passing to individual donees is more equitable and consistent with the nature of a transfer tax.

(2) Does the Aggregation Approach Accurately Value the Transferred Property?

Proponents of the aggregation approach assert that allowing lack-of-control discounts significantly understates the true value of business interests. This notion is based on the “happy family” scenario previously described in this article.¹⁹³ In the happy family scenario, family members act in harmony with each other for the good of the business. The views of each member are taken into account in the running of the business and are accorded respect. The needs of all family members are considered in determining possible distribution of earnings. In light of these benefits, a family member has no desire to sell notwithstanding his minority status. Consequently, the price at which he could sell his interest is of little moment to him. If a decision is

191. Under the Uniform Probate Code, a legatee of a specific devise is entitled to distribution of the thing devised to him. UNIF. PROBATE CODE § 3-906(a)(1) (amended 1987), 8 (Pt. 2) U.L.A. 272 (2003). Moreover, unless the will provides otherwise, specific devises are the last category of testamentary transfers to be liable for payment of administration expenses and debts. *Id.* § 3-902(a) (1969), 8 (Pt. 2) U.L.A. 268 (2003).

192. See generally WILLIAM M. MCGOVERN, JR. & SHELDON F. KURTZ, WILLS, TRUSTS AND ESTATES §§ 8.2, 12.6 (2d ed. 2001).

193. See *infra* Part II.C.2.

made to sell the business, he will be included in the selling group and thus will not suffer a minority discount for lack of control.

Unfortunately, as anyone familiar with family businesses can attest, the optimistic assumptions that underlie the happy family scenario are frequently not true. Judge Posner commented on a case where a donor had divided shares in a corporation equally among his children:

[I]t was speculative whether . . . (the grantor's children) would pull together, or, *as is not uncommon in closely held corporations*, pull apart. Since it is hard to sell stock in a closely held corporation to outsiders, there may be no easy solution if the siblings bicker. . . . [T]he possibility of bickering and dissension within a family *can never be excluded*.¹⁹⁴

Likewise, a consultant to family businesses has noted that “[g]reat battles go on in family businesses” and that “[f]ew businesses have profits to share after these lengthy internecine wars.”¹⁹⁵ The same consultant further noted that there are “countless stories of heirs to family fortunes or businesses who cannot agree on anything, who simply end up ‘pulling and tugging’ at each other like siblings or cousins at a family picnic”¹⁹⁶

Another business consultant states that “[f]amily discord is a primary factor preventing an estimated 65% of all family businesses from passing onto the next generation, according to figures obtained from the Wharton School at the University of Pennsylvania.”¹⁹⁷

The fact that a business is a “family” business often exacerbates, rather than ameliorates, disputes that inevitably arise in the course of business. In such cases, the business dispute is intensified by, and joined with, unresolved emotional issues within the family which the family members themselves may not even be aware of:

Members of a family . . . quite often are fighting about deeper issues than the ones they claim to be incensed about. . . . [I]t is never true that family members need only understand one another's positions, common interests, and respective differences to work rationally together toward an optimal resolution. Often, unfortunately, their reasons for sustaining their conflict—reasons probably not even clear to themselves—are stronger than their ostensible desires to resolve it.¹⁹⁸

194. *Citizens Bank & Trust Co. v. Comm’r*, 839 F.2d 1249, 1252-53 (7th Cir. 1988) (emphasis added).

195. DAVID BORK, *FAMILY BUSINESS, RISKY BUSINESS: HOW TO MAKE IT WORK* 78 (1985).

196. *Id.* at 118.

197. Howard Kapiloff, *Simplifying Business Succession: Understanding Family Dynamics Is the Key to a Smooth Transition*, 22 FIN. PLAN. 48 (1993).

198. Kenneth Kaye, *Penetrating the Cycle of Sustained Conflict*, BUS. HORIZONS, Spring 1991,

The aggregation approach is likely to apply to transactions that involve the two most troubled relationships: child-parent and sibling-sibling. In the stereotypical FLP scenario, one or both parents form an FLP and then give LP interests to their children, retaining for themselves the controlling GP interest. Thus, implementation of the standard FLP plan divides the family business between parent(s) and one or more children, and if LP interests are given to more than one child, between siblings. A huge body of literature exists on the problems arising when parents and children are involved in the family business.

Consider the parent-child relationship. One of the most common sources of conflict in a family business occurs where the parent and a child (or children) work together in the business the parent founded.¹⁹⁹ The parent may view the business as an extension of himself, the source of his gratification and achievement, and a monument to his life's work.²⁰⁰ As a result, he is reluctant to let go and characteristically has great difficulty in delegating.²⁰¹ The parent is resentful as the child seeks greater responsibility, viewing him as a threat to his continued authority. In turn, the child is resentful of the parent who, he feels, is keeping him in an infantile role with the "accompanying contempt, condescension[,] and lack of confidence" that frequently characterize the parent's attitude in these situations.²⁰² The result of these conflicting emotional currents is that the child—contrary to the assumption underlying the happy family scenario—is given no real authority or say in the running of the business. Moreover, the parent's failure to give

reprinted in FAMILY BUSINESS SOURCEBOOK II 355, 369-70 (Craig E. Aronoff et al. eds., 1996) [hereinafter SOURCEBOOK II].

199. John Davis & Renato Tagiuri, *Life Stages and Father-Son Work Relationships*, reprinted in SOURCEBOOK II, *supra* note 198, at 421; Harry Levinson, *Conflicts That Plague Family Businesses*, HARV. BUS. REV., Mar-Apr. 1971, reprinted in SOURCEBOOK II, *supra* note 198, at 378-79; Peter S. Davis & Paula D. Harveston, *In the Founder's Shadow: Conflict in the Family Firm*, 12 FAM. BUS. REV. 311, 314, 318-19 (1999) (finding statistically-significant greater conflict when founder is present than when he is not); Jim Grote, *Conflicting Generations: A New Theory of Family Business Rivalry*, 16 FAM. BUS. REV. 113, 118-20 (2003).

200. Levinson, *supra* note 199, reprinted in SOURCEBOOK II, *supra* note 198, at 378-79; Grote, *supra* note 199, at 118-20.

201. Levinson, *supra* note 199, reprinted in SOURCEBOOK II, *supra* note 198 at 379; Grote, *supra* note 199, at 119. Ivan Lansberg describes the "powerful emotional undercurrents" unleashed by the prospect of a transfer of power from senior leadership to a younger generation. IVAN LANSBERG, SUCCEEDING GENERATIONS 249, 251-55 (1999). He describes two types of leaders, "monarchs" and "generals," who are "unable to surrender control of their companies in earnest" and two types, "ambassadors" and "governors," who are able to leave "gracefully and constructively." *Id.* at 256.

202. Levinson, *supra* note 199, reprinted in SOURCEBOOK II, *supra* note 198, at 379.

the child real authority may mean that no one will be trained to take over the business when the parent finally departs the business, and as a result, the value of the business declines.²⁰³

Likewise, conflict among siblings is common.²⁰⁴ Interestingly, some proponents of the aggregation approach reject the attribution approach because of the likelihood of conflict between and among siblings. Two proponents rejected the attribution approach because family cooperation is “ephemeral and cannot always be presumed,” citing the famous New York case of *In re Radom & Neidorff, Inc.*,²⁰⁵ which involved a bitter dispute between a brother and a sister.²⁰⁶ Another proponent of the aggregation approach rejected the attribution approach because “[f]or every family owned business in which *siblings* and in-laws cooperate and work as an economic unit, there is apt to be one in which relationships are strained, and cooperation is lacking.”²⁰⁷ What these proponents seemingly overlook is that the aggregation approach will frequently apply where transfers are made to siblings. The aggregation approach may therefore have its greatest impact in the case of the very relationship that they find so problematic.

Some may feel that the conflicts described above are unlikely to occur because a donor will not give interests in his business to donees with whom he foresees future conflicts.²⁰⁸ Unfortunately, this facile assumption is often not the case. First, the donor is unlikely to be overly concerned about potential conflicts so long as he retains absolute control of the entity. This of course is true in the typical FLP scenario where the parent gives his child or children nonvoting LP interests but retains the controlling GP interest. Moreover, conflict may develop that the donor did not foresee. Furthermore, the “no-conflict assumption” overlooks the highly ambivalent relationship between the parent and his child.²⁰⁹ The parent loves the child and wants him

203. *Id.* at 378.

204. *See id.* at 382-83. Conflicts involving siblings are described and discussed in Kaye, *supra* note 198, and Richard B. Peiser & Leland M. Wooten, *Life-Cycle Changes in Small Family Businesses*, BUS. HORIZONS, May/June 1983, reprinted in SOURCEBOOK II, *supra* note 198, at 346, 349.

205. 119 N.E.2d 563 (N.Y. 1954).

206. Fellows & Painter, *supra* note 8, at 928 n.107.

207. Cunningham, *supra* note 169, at 1461, 1471; *see also* Fellows & Painter, *supra* note 8, at 928 (“Application of the attribution rules, however, may create harsh results.”).

208. This is apparently the position of Professors Fellows and Painter who, in support of the aggregation approach, argued that “[m]ajority owners of close corporations generally do not give stock to persons with interests adverse to the donor’s interest.” Fellows & Painter, *supra* note 8, at 922 n.93.

209. The parent frequently has highly ambivalent feelings toward the child in these situations. Consciously, the parent wants the child to succeed, but unconsciously the parent “does not want his [child] to win, take away his combination baby and mistress, and displace him from his summit position.”

to succeed. Thus, he gives him interests in the business. At the same time, he is resentful and fearful of the child's taking over and displacing him in the business he built and developed; hence the conflict.²¹⁰ This ambivalence is often the key dynamic in the parent-child relationship and has been noted by many researchers. Finally, even if relations between the donor and the donees are, and remain, good, conflict may exist or develop between the donees.²¹¹ This frequently occurs where a parent divides his business among his children.²¹²

Even if the happy family scenario exists, a family member's noncontrolling interest is still less valuable to him than a controlling interest. Since he lacks control, he cannot unilaterally implement his views on how the business should be run. Implementation of his views is dependent upon his ability to persuade others, and he may not always succeed in doing this.

Moreover, even if one assumes that the family member's views, aspirations and needs are identical to those who control the business—and thus his lack of control makes no immediate difference to him—his noncontrolling interest still lacks the value of a controlling interest. People's attitudes, interests, and monetary needs change over time. A holder of a noncontrolling interest who is employed by the company and is receiving compensation may be perfectly content with a policy of plowing all the earnings back into the business. However, after retirement when he ceases to receive compensation, he might want the business to distribute earnings to him to recompense him for his lost income. A person who controls the business could change the business' policy to conform to his changing needs. A person holding a noncontrolling interest cannot. His inability to unilaterally determine policy, combined with his inability to realize "fair" value on a sale of his noncontrolling interest, constitute real limitations on the value of his interest. The fact is that valuing a noncontrolling interest as if its holder had control—the effect of the aggregation approach—will almost inevitably *overvalue* that interest.

Levinson, *supra* note 199, reprinted in SOURCEBOOK II, *supra* note 198, at 379; see also Grote, *supra* note 199, at 118-19 (noting that the parent frequently sends out double messages to the child, e.g., be assertive and succeed but at the same time do not upstage me).

210. See *supra* notes 199-203, 209 and accompanying text.

211. One study showed there was greater conflict in a family firm when headed by a second-generation member than when it was headed by the founder, although the difference was not statistically significant. Davis & Harveston, *supra* note 199, at 317. However, conflict was found to increase significantly as control of the business passed from the second generation to the third generation. *Id.* at 317-19; see also *supra* notes 204-07.

212. See Davis & Harveston, *supra* note 199, at 317-19; see also *supra* notes 204-07.

On the other hand, current law, which values a family member's noncontrolling interest as though the member were an outsider, will almost always *undervalue* the interest. In many cases, the holder's status as a family member will make his noncontrolling interest more valuable to him than it would be to an outsider. The gap between the actual value transferred and the value as determined under current law is likely to be especially large when the FLP was formed as part of the decedent's estate plan. It is simply incredible that taxpayers engage in transactions, on the advice of their business and tax advisors, that result in a 30% or more loss of value. Such taxpayers must believe that the value they are conveying exceeds the discounted value reportable for tax purposes; otherwise they would not undertake the transaction.

The ideal solution, of course, would be to value the interest as under current law and then increase it by the additional value, if any, attributable to the transferee's family status. This would require, among other things: identifying and evaluating the nature and quality of the transferee's relationships with other members of his family, particularly those involved in the business; the strength or fragility of those relationships; the extent to which the business is currently satisfying the transferee's economic and other needs and aspirations; and the extent to which the transferee's opinions are given weight in business decisions. An analysis of the time and manner in which these factors are likely to change would also be needed. For example, a transferee may currently have good relations with his parent who founded the business, but will he get along with his siblings who will control the business when his parent is no longer involved? After this analysis is completed, these items would somehow have to be quantified. Obviously, this is virtually an impossible task. Not surprisingly, no one seems to have recommended this approach.

Thus it appears that we must choose between two imperfect valuation methods: either allowing the discount in full or disallowing it in full. How can we decide which method to use in a way that is fair to both the taxpayer and the government?

D. A Proposed Solution

(1) The Primary Purpose Approach

This article proposes that discounts for lack of control and lack of marketability arising from the use of the FLP or other entity should be disallowed if the taxpayer's primary purpose for using the entity to make his

gratuitous transfers is to qualify the transfers for a valuation discount. (This approach will sometimes be referred to as the "primary purpose" approach.) The taxpayer would have the burden of proof under this test because of his greater knowledge of, and easier access to, the facts. This primary purpose approach is supplemented by special rules that take effect when a transferee obtains control. These rules are discussed in Part IV.D.4 below.

(2) Examples of Its Application

The following examples illustrate how the primary purpose test would be applied.

Case 1—The Inactive Party

P has owned and operated his business as a limited liability company (LLC) for the past ten years, and he now wishes to retire and turn the business over to his children. *P* has two children: *A*, who has both the aptitude and desire to work in the business, and *B*, who has neither. *P* wants to treat his children fairly but is hesitant to entrust the future of the business to *B*. *P* resolves his conundrum by giving *A* and *B* each a 50% interest in the LLC. However, *A*'s interest is a voting interest and therefore a controlling interest, while *B*'s is a nonvoting interest and thus a noncontrolling interest.

As shown above, *B*'s interest is less valuable than *A*'s given its lack of control, but no recognition is given to this fact under the aggregation approach. *B*'s interest will be valued exactly the same as *A*'s (i.e., one-half the value of a one hundred percent interest).²¹³ In contrast, *B*'s interest would qualify for a lack-of-control discount under the approach recommended in this article, since *P*'s primary purpose for using the LLC was not to create a lack-of-control discount for *B*'s interest; rather, his primary intent was to treat his children equitably and in a manner that would also protect the business.

A's and *B*'s interests will each qualify for a lack-of-marketability discount, since *P* did not use the LLC to create a lack-of-marketability discount. Interests in a closely-held business are always difficult to market, and it makes no difference whether the interests are in the form of corporate stock, partnership interests, or limited liability company interests.

Case II—Where Loss of Value Is Inherent in the Dispositive Plan

Assume the same facts as above in Case I except that *P* has three children, each of whom is competent and anxious to work in the family business. As before, *P* wishes to treat each of children equally, and he therefore gives each

213. See Part IV.C.2.

child a one-third voting interest in the LLC. Since each child has only a one-third voting interest and thus lacks control, each of their respective interests is less valuable than one-third the value of *P*'s one hundred percent interest before he made the gifts. Nevertheless, under the aggregation approach, each one-third interest would be valued at one-third the value of a one hundred percent interest. In contrast, each of their interests would qualify for a lack-of-control discount under the primary purpose approach, since *P*'s primary purpose in using the LLC was not to create lack-of-control discounts. Lack of control, and its resultant effect on value, did not arise from *P*'s use of the LLC but was inherent in his dispositive plan.

Case III—The Investment FLP

Suppose *P* transfers her portfolio of publicly traded securities worth \$10,000,000 to an FLP taking back 99% LP interests and a 1% GP interest. *P* values the LP interests at substantial discounts for both lack of control and lack of marketability. Using their discounted value, *P* gives away each year as many LP units as she can without generating a gift tax.

P will find it difficult to satisfy the primary purpose test. *P*, through her use of the FLP, has *created* two discounts where none existed before. Had *P* made an outright gift of her securities, the donee would acquire complete control over them, and the securities themselves would be marketable. However *P*, through her use of the FLP, has managed to give her donee an interest that both lacks marketability and control (i.e., over the securities).

Why did *P* take this route that purportedly results in less value for the donee when she could have easily made an outright gift of the securities without any loss of value? The natural conclusion is that *P* must have believed that the *actual* loss in value was far less than the amount determined under current law and that she was using the FLP primarily to avoid gift and estate tax.

P still has the opportunity to rebut this conclusion by showing that her use of the FLP was primarily for nontax purposes. One should, however, be cautious in weighing her asserted purposes, since frequently those objectives can be achieved in a manner that does not result in either a lack-of-marketability or a lack-of-control discount.

For example, *P* may be concerned that the donee lacks investment skills and thus is hesitant to give the donee investment power over the underlying securities. However, *P* can satisfy this concern by transferring her securities to a trust in which the donee is the beneficiary and by vesting the investment powers in an experienced fiduciary. *P* herself can be the trustee without

adverse tax consequences as long as her discretionary power is limited to investment and other management powers.²¹⁴

P may justify her use of the FLP because of her desire to protect her gift from the claims of the donee's creditors. However, asset protection can also be achieved by giving her donee an interest in a spendthrift trust, a support trust, or a discretionary trust.²¹⁵

P may argue that by using the FLP she has managed to keep her portfolio intact, and this makes it possible to have larger and more profitable investments. In contrast, an outright gift of some of her securities would split up the fund available for investment into smaller units that would be incapable of making such large-scale investments. One would be justifiably skeptical of this purported reason unless *P* had previously made such large-scale investments and unless they had produced superior returns. Moreover, giving the underlying securities to the donee either as outright gifts or in trust would not preclude joint investments with *P* when and if the opportunity arose.

Case IV—The Active Business

Father, *F*, transfers his unincorporated business worth \$4,000,000 to an FLP and takes back a 1% GP interest and 99% LP interests. *F*'s daughter, *D*, is working in the business and *F* intends for *D* to take it over when he dies or retires.

During each of the last three years, *F* has given *D* an LP interest that represents approximately \$34,000 of underlying value in the business but which, after discounts for lack of marketability and control, is valued at \$22,000. *F*'s wife, *W*, consents to having *F*'s gifts to *D* treated as being made one-half by her. By virtue of the \$11,000 annual exclusion, no portion of the gift is taxable.

Absent any other evidence, no discount for lack of control will be allowed. The apparent purpose of the FLP's capitalization is to enable *F* to transfer control to *D* and still claim a discount for lack of control on gifts to her representing approximately 99% of the FLP's equity (i.e., the gifts of LP interests). *F*'s primary purpose in using the FLP to carry out this plan is to

214. See, e.g., *Old Colony Trust Co. v. United States*, 423 F.2d 601 (1st Cir. 1970).

215. A spendthrift trust provides that a beneficiary's interest in income and/or principal is neither assignable by him nor subject to the claims of his creditors. 2A AUSTIN WAKEMAN SCOTT & WILLIAM FRANKLIN FRATCHER, *THE LAW OF TRUSTS* §§ 152-53 (4th ed. 1987). A support trust provides that the beneficiary shall be paid only so much income as is needed for his support. *Id.* § 154. A discretionary trust provides that the beneficiary shall be paid only so much income as the trustee in his absolute discretion determines. *Id.* In many states, the creditors of a beneficiary may not attach his interest in the above types of trusts. However, the degree of protection afforded the beneficiary varies widely from state to state. *Id.* §§ 152-57.

reduce his transfer tax liability. *F* would still be entitled to a discount for lack of marketability since this discount does not arise from the use of the FLP but is inherent in the disposition of any interest in a closely-held business.

Suppose *F* also makes gifts of LP interests to his son, *S*. *S* is a college professor and has no interest in entering *F*'s business. *F* does not intend to give *S* any GP interest in the FLP, since he believes that an inactive equity holder should not be permitted to "interfere" with those actually running the business. He is giving LP interests to *S* because he wants to treat all of his children equitably. Under these facts, the gifts of the LP interests to *S* would qualify for a lack-of-control discount, since *F*'s principal purpose in using the FLP to make gifts to *S* is not to secure a valuation discount.

(3) Rationale for the Primary Purpose Approach

Almost from the inception of the estate and gift tax laws, "fair market value" has been the standard used for valuing property.²¹⁶ This standard has many advantages. It provides an objective measure of value and thus eliminates the need to determine the subjective value of the property in the hands of the transferee.²¹⁷ Basing the tax on a property's subjective value to the transferee is highly problematic; indeed, it is difficult to imagine how one would go about determining this value. Moreover, given the amorphous nature of that inquiry, disparate results among similarly situated taxpayers would be inevitable. The "fair market value" standard has the further advantage of capturing an indisputably important aspect of a property's value: the amount the owner can realize by selling it.

Departure from the fair market value standard should therefore be made only where there are strong and compelling reasons for doing so. It is submitted that the principal purpose test proposed above provides a rational basis for deviation from the fair market value standard.

First, the mere fact that a transaction is primarily tax motivated is a strong indication that the gift's true value substantially exceeds its value as determined under current law. The tax avoidance purpose in these cases is to

216. The gift tax regulations adopted the "fair market value" standard substantially in its present form in 1924, and the estate regulations followed suit in 1926. Treas. Reg. 67, Art. 7(1), 26 Treas. Dec. Int. Rev. 1162, 1166 (1924) (gift tax); Treas. Reg. 70, Art. 13(1), 28 Treas. Dec. Int. Rev. 427, 440 (1926) (estate tax). However, the estate tax regulations had adopted the same concept in 1919, although in different words. Treas. Reg. 37, Art. 14, 21 Treas. Dec. Int. Rev. 752, 761 (1919) (stating the value to be used is "market, or sale, value").

217. See *supra* notes 23-28 and accompanying text.

transfer wealth without paying a tax on its full value. Therefore, the fact that the taxpayer undertook the transaction primarily for tax purposes means that he perceived that the true value of the gift exceeded the amount reportable for tax purposes (i.e., the amount determined under the fair market value standard). Furthermore, the fact that a tax-motivated taxpayer was willing to pay the substantial “upfront” costs typically involved in these transactions shows that he perceived the value escaping tax to be substantial.²¹⁸

In contrast, there is no basis for inferring that the true value of the transferred property exceeds its fair market value in a transaction where tax avoidance is not the primary purpose. Consider Case I above where *P* transferred a voting interest in the LLC to *A*, the child who had both the desire and the competence to operate the family business, and a nonvoting interest to *B*, who had neither the desire nor the competence to do so. These facts simply provide no basis for inferring that the fair market value standard undervalues *B*’s interest. *P* wanted to vest operating control of his business in competent hands, and he may have viewed the lower value of *B*’s nonvoting interest as a real but unavoidable consequence of achieving this result.

Indeed, *P*’s gifts have created a situation where conflict often occurs. *A* will undoubtedly receive compensation for his services to the LLC, while *B*, who is not actively involved in the business, will receive no compensation. Since *A*’s financial needs are being satisfied by his compensation, he may prefer to plow the LLC’s earnings back into the business while *B*, who receives no compensation, will press for distribution of the LLC’s earnings to its members. In this case, *A*’s control (and conversely, *B*’s lack of control) will have a clearly adverse effect on the value of *B*’s interest.

Recall Case II, in which *P* divided his business equally among his three children. *P*’s primary purpose in making this disposition was to treat his children equally and not tax avoidance. Again, these facts provide no basis for inferring that the true value of each child’s interest exceeded the amount as determined under the fair market value standard. The reduced value of each child’s interest because none of them possesses control may simply reflect a real but unavoidable consequence of *P*’s dispositive plan.

The primary purpose test also permits taxpayers to administer and deploy their assets in the most efficient manner possible—without a tax penalty. Most people would probably agree that, in general, it is a social good when

218. The *Wall Street Journal* reports that FLPs “don’t come cheap” and “can cost anywhere from about \$5,000 to \$30,000 to set up.” Silverman, *supra* note 4.

assets are employed in the most efficient manner possible.²¹⁹ Some might argue that the tax law should affirmatively encourage this objective while others might argue that the tax law should be neutral, but almost everyone would agree that the law should not discourage the efficient allocation of resources. However, the aggregation approach may well produce this result.

Consider again Case I, in which *P* gave control of his business to *A*, who had both the desire and competence to operate it, and a nonvoting interest to *B*, who had neither. This result is a social good. It is socially desirable for assets to be managed competently and socially undesirable for them to be managed incompetently. The aggregation approach would discourage *P* from undertaking his desirable plan, since it would overtax him on the value of *B*'s nonvoting interest.²²⁰ As shown above, *B*'s nonvoting interest is almost certainly less valuable than *A*'s voting interest, yet the aggregation approach would treat both equally. Indeed, the aggregation approach would value *B*'s interest as though he participated in the control of the LLC, since his one-half interest would be valued at one-half of a one hundred percent controlling interest. In contrast, the primary purpose approach would not penalize—and thus would not discourage—*P* from proceeding with his plan. Since *P*'s reasons for engaging in the transaction were primarily nontax, it would allow a lack-of-control discount for *B*'s nonvoting interest and thus recognize that *B*'s interest is less valuable than *A*'s.

Since individuals attempt to optimize their situation, one may presume that they will generally enter transactions that constitute the most efficient utilization of their assets.²²¹ However, this presumption is unjustified where a taxpayer enters a transaction primarily to avoid taxes. Tax considerations distort incentives and can lead to an inefficient allocation of resources. For example, a taxpayer who, lured by the prospect of avoiding estate and gift taxes, transfers her marketable securities to an FLP, will incur substantial

219. See RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 13 (5th ed. 1998) (stating that “most people would probably agree” that efficiency defined as the “allocation of resources in which value is maximized” is “an important criterion” of social choice).

220. If the aggregation approach is adopted, the taxpayer could not escape its effect forever since death is inevitable. However, he could delay its effect by holding onto his entire interest until death rather than disposing of it during life. The pressure to hold onto property until death is increased when, as under current law, gifts are taxed more severely than testamentary transfers. See *supra* notes 182-84 and accompanying text. Delaying needed and desirable changes is, of course, socially undesirable.

221. See POSNER, *supra* note 219, at 4 (describing as a basic assumption of economics that man “is a rational maximizer of his self interest”). Many have attacked this assumption of “rationality.” *Id.* § 1.3-.4. Although I recognize that irrationality plays a significant role in human decision making, I think that the assumption that human beings generally act rationally provides a workable assumption for determining tax policy.

costs in forming and maintaining the FLP—costs she would not have incurred had she retained the securities.²²² Thus, not only will the federal fisc be cheated of tax revenue, but the taxpayer will have expended and will continue to expend money on transaction costs that economically could have been better used elsewhere.

Another advantage of the “primary purpose” approach is that the courts, the Service and taxpayer representatives are experienced in determining a taxpayer’s business (i.e., nontax) and tax avoidance purposes. Under the “business purpose” and “economic substance” test, one must determine whether the taxpayer had a bona fide business (i.e., nontax) purpose for undertaking a transaction,²²³ and in the case of provisions like § 269, one must determine whether the taxpayer’s “principal purpose” was tax avoidance. Indeed, the Code makes the taxpayer’s “primary purpose” the basis for determining tax consequences in at least 49 different instances.²²⁴ Determining a taxpayer’s primary purpose is difficult, but it appears to be a more manageable test than determining the “true” value of a gift to the recipient.

Some may find the primary purpose approach objectionable on the ground that the process of determining a taxpayer’s primary purpose is excessively expensive and time consuming. This is a significant concern. Nevertheless, the primary purpose approach appears superior to its alternatives.

(a) The alternatives to the primary purpose test—as they have been presented to date—would either *always* allow a lack-of-control discount to a minority interest carved from a taxpayer’s controlling interest, as under current law, or *always* disallow it, as under the aggregation approach. Such categorical approaches are less expensive to administer and may indeed be justified where the vast overwhelming majority of cases fall in one category or the other. However, as shown above, the cases under discussion do not demonstrate the degree of uniformity that would justify a categorical

222. See *supra* note 218 concerning the substantial costs of forming an FLP. Operating and maintaining an FLP will also entail substantial costs. FLPs require continuing skilled professional oversight, since as partnerships they are subject to some of the most complex tax provisions in existence. There are many pitfalls that an FLP may fall into with adverse tax and nontax consequences. See Katherine D. Black et al., *When a Discount Isn't a Bargain: Debunking the Myths Behind Family Limited Partnerships*, 32 U. MEM. L. REV. 245 (2002).

223. See generally David P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 TAX LAW. 235 (1999), and Smith, *supra* note 60, for an analysis and discussion of the “business purpose” and “economic substance” tests.

224. Based on a Westlaw search made by the author on December 8, 2003, of the phrase “principal purpose” in the FTX-USCA database.

approach. There are many cases where a lack-of-control discount is unjustified, many where it is justified, and many that fall somewhere in between. Consequently, the demands of justice (i.e., judging each case on its particular merits) outweigh the claim of administrative convenience.

(b) The prophylactic effect of the primary purpose approach will reduce the costs. If that approach is adopted, a large number of taxpayers who, under current law, would be tempted to employ an FLP, will refrain from doing so. A taxpayer with a weak case under the primary purpose test would be unlikely to employ the FLP technique, because he knows that its use will trigger an expensive contest with the Service that he will almost surely lose. His chances of success are especially poor because the proposed approach places the burden of proof on the taxpayer. Thus the number of newly-formed FLPs (and the number of tax controversies involving them) is likely to drop significantly under the proposed approach.

(c) Given the generous unified gift tax credit and the even more generous unified estate tax credit, controversies over FLPs are likely to occur only in cases of very large gifts and estates. Hence, the cost of determining the taxpayer's purpose is likely to be relatively small in comparison to the amount of potential tax involved.

Some readers may be concerned that it would be too easy for taxpayers to avoid the transfer tax under the proposed approach simply by fabricating nontax purposes for utilizing the FLP. However, placing the burden of proof on the taxpayer in establishing his primary purpose guards against this possibility. Moreover, experience shows that courts examine a taxpayer's purported purpose with a healthy dose of skepticism. Thus the court in *Strangi* cursorily dismissed the three purported nontax reasons given for the decedent's formation and use of the FLP.

The primary purpose approach is not perfect, principally because there is no fixed relationship between the degree of tax avoidance in a transaction and the amount of justifiable discount for lack of control. Nevertheless, it represents a significant improvement over current law and is superior to the aggregation approach. The primary purpose approach strikes a pragmatic compromise between the taxpayer and the Service: it prohibits taxpayers from using FLPs primarily to reduce transfer taxes—the very cases where undervaluation is likely to be especially egregious; it allows taxpayers to seek socially beneficial solutions without the tax penalty of overvaluation; and it protects the public from the loss of tax revenue in socially wasteful activities.

(4) Special Rules for the Acquisition of Control

Current law should be revised to eliminate the lack-of-control discount in the case of a transfer that either confers control of an entity upon the donee or is made to a donee who already possesses control.

Consider the case previously discussed where *A*, who owned all one hundred shares of XYZ, Inc., gave 35 shares to her daughter *D* in Year One, another 40 shares in Year Four and bequeathed the remaining 25 shares to *D* when she died. Under current law, the gift of 40 shares in Year Four and the bequest of 25 shares each qualifies for a lack-of-control discount, because the number of shares involved in each transfer, considered separately, lacks control. Under the special rule proposed above, *A*'s gift of 40 shares would not qualify for the discount because it conferred control of XYZ, Inc. on *D*, and *A*'s bequest would not qualify because it was made when *D* already possessed control.

The results under current law cannot be justified, because they substantially understate the actual value of the gift and bequest. *A*'s gift of 40 shares in Year Four increased *D*'s stockholdings to a controlling interest. Hence the value of that gift to *D* is much greater than if she had no stock in the company. By virtue of that gift, *D* became entitled to all of the privileges and benefits accruing to a controlling shareholder. Moreover, she can now sell the gifted 40 shares without incurring a discount for lack of control. She can achieve this result simply by selling the 40 shares together with a sufficient quantity of her other XYZ, Inc. stock to give the buyer control.²²⁵ This analysis also applies to *A*'s bequest.

For purposes of the above special rule, control would be defined as more than 50% of the combined voting power in the entity. All voting interests that the transferee can sell or cause to be sold would be counted in applying this rule. Thus, in addition to the voting interests the transferee actually owns, voting interests that he has a legal right to obtain (e.g., under an option or through the exercise of a general power of appointment) and voting interests he can cause to be sold (e.g., stock in a trust of which the transferee is sole trustee) would be counted. The idea is that the lack-of-control discount should be disallowed whenever the transferee is in a position to transfer control.

225. The courts have recognized that when a taxpayer holds both controlling and noncontrolling interests in a company, both interests must be valued as an integrated bundle, and consequently no discount for lack of control can be allowed for the noncontrolling interest. *Estate of Curry v. United States*, 706 F.2d 1424, 1428 (7th Cir. 1983)

Recall that *A*'s initial gift of 35 shares to *D* qualified for a discount for lack of control. However, *D* subsequently acquired control of the company and thus became able to sell the 35 shares as part of a control bloc. Should *D* now be required to give back the benefit of that discount?

Such an approach can be justified by analogy to the Supreme Court's reasoning in *United States v. Tufts*.²²⁶ That case involved the sale of real property that was encumbered by nonrecourse debt.²²⁷ The Supreme Court ruled that the sellers, in computing their gain on the sale, had to report the entire remaining unpaid debt as part of the amount realized.²²⁸ The Court reasoned that when the sellers borrowed the money, they were allowed to exclude it from income because it was assumed they would repay it.²²⁹ However, when they sold the property, it became clear they would never repay the debt and thus the assumption that originally justified the debt's exclusion from income turned out to be wrong. The Court held that this prior mistake should now be rectified by treating the unpaid debt as part of amount realized on the sale.²³⁰ Otherwise, the sellers would have received tax-free income.²³¹

Similarly a lack-of-control discount was allowed on *A*'s original 35 shares, because it was assumed that the stock interest was only a minority interest and thus would be discounted by a prospective purchaser. However, once *D* acquired control of XYZ Inc., he became able to sell the 35 shares as a part of a control bloc. Thus the assumption that justified the discount ceased to be true, and under the reasoning of *United States v. Tufts*, the discount should no longer be allowed. This can be accomplished by treating the lack-of-control discount previously allowed as a gift by *A* in the year that *D* acquired control. (The gift tax on the recaptured discount will sometimes be referred to hereafter as the "recapture tax.")

Unless such a rule is adopted, donors will continue to be able, by careful sequencing of their gifts, to transfer control of an entity and yet have a substantial portion of the value transferred qualify for a lack-of-control discount. *A* donor may transfer LP interests representing 99% of the FLP's entity to a child, and then in a year following these transfers, transfer the 1% GP interest to the same child. Under current law, 99% of the FLP's equity will qualify for a lack-of-control discount even though once the donee

226. 461 U.S. 300 (1983).

227. *Id.* at 301-02.

228. *Id.* at 317.

229. *Id.* at 309, 312.

230. *Id.* at 309.

231. *Id.* at 310.

acquires control, he will be able to sell the LP interests without discount by selling them together with the 1% GP interest. The proposed rule would prevent this result

Some may argue that the proposed recapture tax is inconsistent with the nature of a transfer tax, since it is based on an event (i.e., the donee's acquisition of control) that occurs *after* the affected interest has already been transferred. This objection seems unwarranted. The recapture tax is attributable to the original *transfer* of the affected interest; there is no tax unless there is a transfer. It is not a tax on the mere ownership of property, but is attributable to an exercise of one of the powers flowing from such ownership, namely, the power to transfer the property. Moreover, the rule calls only for a recapture of a discount allowed *at the time of the transfer*. Thus it does not tax any appreciation occurring after the date of the transfer.

A number of provisions would be needed to implement the recapture tax proposed above. First, a mechanism would be needed to assure that the amount of the lack-of-control discount allowed could be determined. This could be accomplished by requiring donors to set forth on the gift tax return the amount of any lack-of-control discount claimed. If the Service challenges the value of the gift and the controversy is settled, the taxpayer and the Service would be required to designate the amount of the lack-of-control discount allowed in the settlement. If the amount of the discount is adjudicated, the court (or jury) would be required to specify the amount of the discount allowed.

As under current law, the Service should be permitted to collect the recapture tax from the donee as well as the donor.²³² This provision is important because in many cases the donor will be deceased and his property dispersed among numerous heirs or devisees, and thus collection of the tax from the donor's transferees would be difficult. However, the Code should grant the donee an explicit right to be reimbursed by the donor or the donor's transferees for any recapture tax that he pays.²³³

The recapture tax should be limited to the *lesser* of the amount of the lack-of-control discount previously allowed, or the amount by which the property's value at the time of the recapture exceeds the value previously used in computing the donor's gift tax liability. This limitation would assure that

232. Current law imposes liability for the gift tax on the donor. I.R.C. § 2502(c). However, if the donor does not pay the tax, the Service can collect the tax from the donee. *Id.* § 6324(b).

233. For similar provisions under current law in the case of the estate tax, see *id.* §§ 2206, 2207B.

the total amount taxed would never exceed the property's value at the date of recapture.²³⁴

V. CONCLUSION

The FLP continues to be a viable tax saving device even after the Tax Court's decision in *Strangi*. In many cases, use of FLPs enables taxpayers to transfer substantial amounts of value without such value being subject to either a gift tax or an estate tax. Reformers have generally proposed either the attribution approach or the aggregation approach to deal with this problem. However, analysis of these proposals shows that they are overly broad and will frequently tax gifts in excess of the value actually transferred.

This Article proposes that discounts be disallowed where the taxpayer's primary purpose in using the FLP or other entity to make his transfers is to secure a valuation discount. This proposal will strike at the cases where undervaluation is most likely to be egregious. At the same time, it will allow bona fide, socially desirable transfers to take place without being penalized by overvaluation.

This Article further proposes that no lack-of-control discount should be allowed when a gift either confers control of an entity on a donee or is made when the donee already controls the entity. In addition, the Article proposes that a lack-of-control discount previously allowed should be recaptured when and if the donee subsequently acquires control of an entity. Unless these provisions are adopted, taxpayers, by careful sequencing of their gifts, will still be able to transfer control and yet qualify the bulk of the transferred value for a lack-of-control discount.

ADDENDUM—*KIMBELL v. UNITED STATES*

After the foregoing article was written, the Court of Appeals for the Fifth Circuit reversed the district court's decision in *Kimbell v. United States*.²³⁵ The court's sweeping opinion constitutes a stunning taxpayer victory and may

234. These rules may need to be reinforced by attribution rules. This should be done with care since their purpose is to base the tax on clear, demonstrable economic power—not on speculations as to what others may do. Perhaps a sensible compromise is to have only spousal attribution, just as the Treasury had proposed in its recommendation of an aggregation approach. See *supra* notes 175-76 and accompanying text.

235. *Kimbell v. United States*, 2004 U.S. App. LEXIS 9911 (5th Cir. May 20, 2004), rev'g 244 F. Supp. 2d 700 (N.D. Tex. 2003) [hereinafter *Kimbell II*].

eliminate the threat posed by the *Strangi* decision²³⁶ to the continuing viability of the FLP.

At first blush, *Kimbell* appears to make it relatively easy for an estate to show that the decedent's transfer of property to an FLP was "a bona fide sale for adequate and full consideration in money or money's worth" and thus to come within the statutory exception to § 2036. If this is so, *Kimbell* renders *Strangi* and many of the other cases discussed in this article largely irrelevant. The focus of those cases was whether the decedent retained either the right to the income from the transferred property (§ 2036(a)(1))²³⁷ or the right to designate the person who will enjoy the property or the income therefrom (§ 2036(a)(2)).²³⁸ But if the exception applies, the transferred property will not be included in the decedent's gross income even if he retained such a power or interest.

(1) *Facts*. In 1998, two months before her death, a revocable trust that Mrs. Kimbell (the decedent) had previously established joined with her son and daughter-in-law to form a limited liability company (LLC) in which the trust took a 50% interest.²³⁹ Later in the same month, the LLC and Mrs. Kimbell's revocable trust formed an FLP.²⁴⁰ 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% LP interest, while the LLC contributed about \$25,000 in cash for a 1% GP interest.²⁴¹ Approximately eleven percent of the FLP's assets at its inception consisted of oil and gas working interests and four percent consisted of gas and oil royalty interests.²⁴²

Mrs. Kimbell died in March of 1998 at the age of 96.²⁴³ The estate valued her LP interest in the FLP (which she owned through her revocable trust)²⁴⁴

236. Estate of *Strangi* v. Commissioner, 85 T.C.M. (CCH) 1331, 2003 T.C.M.(RIA) ¶ 2003-145 [hereinafter *Strangi II*].

237. See *supra* notes 130-39 and accompanying text.

238. See *supra* notes 140-68 and accompanying text.

239. *Kimbell II*, 2004 U.S. App. LEXIS 9911, at *2.

240. *Id.*

241. *Id.*

242. *Id.* at *3.

243. *Id.* at *2.

244. Although the 99% LP interest in the FLP was owned by the trust rather than by the decedent, it is treated for estate tax purposes as owned by her. This is because the decedent retained the power to revoke the trust when she created it. I.R.C. § 2038. Thus, the trust's LP interest will sometimes hereinafter be referred to as the decedent's interest, and the trust's transfer of assets to the FLP will sometimes be described as a transfer by the decedent.

at \$1.257 million while the IRS valued her interest at \$2.463 million.²⁴⁵ The difference in valuations resulted principally from the IRS's finding that § 2036(a) applied to her transfer of assets to the FLP.²⁴⁶

The estate argued that the decedent's transfer of assets to the FLP (via her revocable trust) was not subject to § 2036(a) because it came within the statutory exception for "a bona fide sale for an adequate and full consideration in money or money's worth." The district court rejected this contention, but the court of appeals reversed and granted summary judgment to the estate.²⁴⁷

(2) *What is a "bona fide sale"?* Following several Tax Court decisions, including *Strangi*, the district court held that Mrs. Kimbell's transfer to the FLP (through her revocable trust) was not "a bona fide sale," because Mrs. Kimbell "stood on both sides of the transaction"²⁴⁸ and because the transaction was "nothing but a circuitous 'recycling' of value."²⁴⁹ The court noted that Mrs. Kimbell transferred her assets in exchange for a 99% interest in the FLP (plus an additional 0.5% interest in the FLP through the LLC).²⁵⁰ Thus, she "stood on both sides of the transaction"—indeed "was both sides of the transaction."²⁵¹ According to the district court, Mrs. Kimbell's retention of a 99.5% interest in the transferred assets also demonstrated that there was

245. *Kimbell v. United States*, 244 F. Supp. 2d 700, 702 (N.D. Tex. 2003), *rev'd*, 2004 U.S. App. LEXIS 9911 (5th Cir. May 20, 2004) [hereinafter *Kimbell I*].

246. Apparently, another—but subsidiary—reason for the difference in the valuations was the estate's contention that Mrs. Kimbell had received only an "assignee" interest rather than an LP interest in the FLP. *Kimbell II*, 2004 U.S. App. LEXIS 9911, at *36 (5th Cir. May 20, 2004) (remanding case to district court to determine whether decedent's interest was an assignee interest or an LP interest).

However, the difference in the valuations was primarily due to the parties' disagreement on whether § 2036(a) applied. The estate contended that § 2036(a) did not apply and hence the interest to be valued was Mrs. Kimbell's interest in the FLP. *Id.* at *5-*6. In valuing that interest, the estate claimed a 49% discount for lack of control and lack of marketability. *Id.* The Service, on the other hand, contended that § 2036(a) did apply and thus the interests to be valued were the assets Mrs. Kimbell had transferred to the FLP and not her LP interest; the Service apparently did not allow any discount in valuing those assets. *Id.*

247. *Id.* at *36.

248. *Kimbell I*, 244 F. Supp. 2d 700, 704 (N.D. Tex., 2003), *rev'd*, 2004 U.S. App. LEXIS 9911 (5th Cir. May 20, 2004) (citing *Estate of Harper v. Comm'r*, 83 T.C.M. (CCH) 1641, 2002 T.C.M. (RIA) ¶ 2002-121, at 722-24 (2002)); *see also Strangi II*, 85 T.C.M. (CCH) 1331, 1343, 2003 T.C.M. (RIA) ¶ 2003-145, at 746 (stating that "decedent essentially stood on both sides of the transaction").

249. *Kimbell I*, 244 F. Supp. 2d at 704 (citing *Estate of Harper v. Comm'r*, 83 T.C.M. (CCH) 1641, 1653, 2002 T.C.M. (RIA) ¶ 2002-121, at 722-24). Similar holdings and language appear in *Estate of Thompson v. Commissioner*, 84 T.C.M. (CCH) 374, 387-89, 2002 T.C.M. (RIA) ¶ 2002-246, at 1525-27 (describing transfer to an FLP as "mere 'recycling of value'") and in *Strangi II*, 85 T.C.M. (CCH) at 1344, 2003 T.C.M. (RIA) ¶ 2003-145, at 746 (describing transfers to an FLP and a corporation as "merely a 'recycling' of value through partnership or corporate solution").

250. *Kimbell I*, 244 F. Supp. 2d at 705 (stating that decedent owned "99% of the Partnership, and an additional 0.5% of the Partnership through her 50% interest in the LLC).

251. *Id.* at 704.

no real change in her relationship to the assets and that the “transfer” was merely a “circuitous ‘recycling’ of value.”²⁵² The district court also relied on the definition of “arm’s-length” in Black’s Law Dictionary as pertaining to dealings “between two parties who are not related or not on close terms.”²⁵³

The court of appeals, relying on one of its prior decisions, rejected the notion that a transaction between related parties could never be “a bona fide sale.”²⁵⁴ Although it conceded that a transfer between family members required “heightened scrutiny,” it held that a transaction that is “a bona fide sale between strangers must also be bona fide between members of the same family.”²⁵⁵ The court held that a transaction would be considered “bona fide” if it was made for “adequate and full consideration” (discussed below) and in “good faith.”²⁵⁶ The court apparently felt that the “good faith” requirement imposed only a minimal burden on the taxpayer. The court noted that a “transaction motivated *solely* by tax planning with *no* business or corporate purpose is nothing more than a contrivance that is rightly ignored for purposes of the tax computation.”²⁵⁷ Later in the opinion, the court stated that a transfer for “adequate and full consideration”—even between related parties—constitutes a “bona fide sale” unless the “evidence demonstrates the absence of good faith, i.e., a sham transaction motivated *solely* by tax avoidance.”²⁵⁸ The court specifically held that “tax planning motives do not prevent a sale from being ‘bona fide’ if the transaction is otherwise real, actual or genuine.”²⁵⁹

The court of appeals found that the transfer in *Kimbell* was a “bona fide sale” based on the following considerations, among others:

- (a) Mrs. Kimbell held back sufficient assets from the FLP to support herself, and there was no commingling of the FLP’s assets and her personal assets.²⁶⁰
- (b) Partnership formalities were observed and the assets contributed to the FLP were actually transferred to it.²⁶¹

252. *Id.* at 704-05.

253. *Id.* at 704 (citing BLACK’S LAW DICTIONARY 103 (7th ed. 1999)).

254. *Kimbell II*, 2004 U.S. App. LEXIS 9911, at *15 (5th Cir. May 20 2004) (citing *Wheeler v. United States*, 116 F.3d 749, 764-65 (5th Cir. 1997)).

255. *Id.*

256. *Id.* at *14-*16.

257. *Id.* at *16 (emphasis added).

258. *Id.* at *24 (emphasis added).

259. *Id.* at *16.

260. *Kimbell II*, 2004 U.S. App. LEXIS 9911, at *26 (5th Cir. May 20 2004).

261. *Id.* at *27.

- (c) The assets contributed to the FLP included working interests in oil and gas properties that required active management.²⁶² Presumably, the court considered this factor important, because the FLP format permitted unified management of an active business even though it was owned by multiple parties. This objective would not be so important if the assets merely consisted of passive investments.
- (d) The limited liability provided by a limited partnership was crucial to Mrs. Kimbell because she was investing as a working interest owner in oil and gas properties and could be held personally liable for any environmental damage that occurred in the operation of the properties.²⁶³
- (e) Mrs. Kimbell wanted to keep the oil and gas properties intact beyond her lifetime rather than subdivide them by distributions to subsequent generations. Keeping the properties together in a limited partnership (i) reduced accounting costs, (ii) avoided the costs of recording transfers of the properties as they passed from one generation to another, and (iii) preserved the properties as "separate property" in the hands of her descendants thereby protecting such interests from division in the event of divorce.²⁶⁴

(3) *What is "adequate and full consideration"?* Relying on one of its prior decisions,²⁶⁵ the court of appeals held that there is "adequate and full consideration" if "the asset the estate receives [is] roughly equivalent to the asset it gave up."²⁶⁶ The Service argued that it was "inconsistent for the estate to assert, on the one hand, that the value of Mrs. Kimbell's interest in the Partnership is worth only 50% of the assets she transferred (as discounted for lack of control and marketability), and on the other hand claim that the partnership interest Mrs. Kimbell received in exchange for the assets transferred was adequate and full consideration for the transfer."²⁶⁷

The court of appeals rejected this contention:

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 [one hundred] 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 trade-off.²⁶⁸

262. *Id.*

263. *Id.* at *28-*29.

264. *Id.* at *29. See *id.* at *3-*4 for the business purposes set forth in the partnership agreement.

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

266. *Kimbell II*, 2004 U.S. App. LEXIS 9911, at *12.

267. *Id.* at *22.

268. *Id.* at *23-*24.

The court then summarized its position on this issue as follows:

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.²⁶⁹

(4) *What are the implications of Kimbell?* The *Kimbell* decision will undoubtedly be hailed as a great taxpayer victory that removes the threats to the continuing viability of the FLP posed by the *Strangi* decision. Caution, however, is advisable.

A surprising result of *Kimbell* may be to resuscitate the “business purpose” test that the Tax Court seemed to put to rest in *Strangi*.²⁷⁰ A finding of “business purpose” (more accurately, a nontax purpose) served two purposes for the *Kimbell* court: (1) it helped establish that Mrs. Kimbell’s transfer to the LFP was a “bona fide sale”;²⁷¹ and (2) it helped establish that what she received in her transfer to the FLP (i.e., her LP interest) was “roughly equivalent” to the assets she transferred to the FLP, and thus constituted “adequate and full consideration.”²⁷² The court acknowledged that the “fair market value” (i.e., the immediate resale value) of the properties Mrs. Kimbell transferred to the FLP greatly exceeded the “fair market value” of the LP interest she received in return, but asserted that this apparent “deficit” in consideration was made up by “benefits such as management expertise, security and preservation of assets, capital appreciation[,] and avoidance of personal liability.”²⁷³

The *Kimbell* court, finding that the “government [had] raised no material issues of fact to counter the taxpayer’s evidence that the Partnership was entered into for *substantial* business reasons,” granted summary judgment to the taxpayer.²⁷⁴ The result conceivably could be different in *Strangi* where the

269. *Id.* at *24.

270. *Estate of Strangi v. Comm’r*, 115 T.C. 478, 484-87, *aff’d on this issue sub nom. Gulig v. Comm’r*, 293 F.3d 279, (5th Cir. 2002) [hereinafter *Strangi I*].

271. *Kimbell II*, 2004 U.S. App. LEXIS 9911, at *26-*30.

272. *Id.* at *12.

273. *Id.* at *22-*24

274. *Id.* at *32-*33 (emphasis added).

Tax Court expressed great skepticism that *any* of the purported nontax reasons for forming the FLP was genuine.²⁷⁵

The ultimate impact of *Kimbell* may therefore turn on how rigorously the courts apply the “business purpose” requirement. There are certainly statements in the opinion, quoted above, from which one may infer that the presence of *any* business purpose will suffice to satisfy this requirement.²⁷⁶ If so, it will be relatively easy for taxpayers to escape the clutches of § 2036(a), at least in the Fifth Circuit. However, given the court’s finding that the FLP in *Kimbell* was formed “for *substantial* business purposes,”²⁷⁷ such statements must be regarded as dicta. As with most decisions, the impact of *Kimbell* will be known only as it is applied in future cases.

275. *Strangi I*, 115 T.C. at 485-86 (stating that “[w]e agree with respondent that there are reasons to be skeptical about the nontax motives for forming [the FLP]”). *Strangi* may also be distinguished from *Kimbell* on the ground that some of the assets transferred in *Kimbell* consisted of working interests in oil and gas properties that required active management, *Kimbell II*, 2004 U.S. App. LEXIS 9911, at *27, while the assets transferred in *Strangi* consisted of “only monetary or investment assets,” *Strangi II*, 85 T.C.M. (CCH) at 1342, 2003 T.C.M. (RIA) ¶ 2003-145, at 744.

276. See *supra* notes 21-22 and accompanying text.

277. *Kimbell II*, 2004 U.S. App. LEXIS 9911, at *32-*33.

