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Estate of Powell v. Commissioner, 148 T.C. 392 (May 18, 2017)

June, 2017

FLP Assets Included in Estate Under Section 2036(a)(2) Even Though Decedent Just Owned Limited Partnership Interests; Possibility of Double Inclusion of Partnership Assets Under Section 2036 and Partnership Interest Under Section 2033

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February 22, 2019

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Synopsis

This "reviewed" Tax Court decision may be the most important Tax Court case addressing FLPs and LLCs in the context of estate planning since the *Bongard* case (124 T.C. 95 (2005) 12 years ago. The Tax Court breaks new ground (1) in extending the application of §2036(a)(2) to decedents owning only limited partnership interests, and (2) in raising the risk of double inclusion of assets under §2036 *and* a partnership interest under §2033, which may (in the court's own words) result in "duplicative transfer tax." (The case was decided on cross motions for summary judgement, and is not an opinion following a trial.)

The facts involve "aggressive deathbed tax planning," and the fact that the taxpayer lost the case is no surprise. But the court's extension of the application of §2036(a)(2) and the extensive discussion of possible double inclusion for assets contributed to an FLP or LLC are surprising (but whether a majority of the judges would apply the double inclusion analysis is not clear).

The decedent's son, acting in her behalf under a power of attorney, contributed about $10 million of cash and marketable securities to a limited partnership (FLP) in return for a 99% limited partnership (LP) interest. Her two sons contributed unsecured notes in return for the 1% general partner (GP) interest. The partnership agreement allowed for the partnership's dissolution with the written consent of all partners. The same day, the son who was the agent under the power of attorney (acting under the power of attorney) transferred the decedent's 99% LP interest to a charitable lead annuity trust (CLAT) paying an annuity to charity for the decedent's life with the remainder passing to the decedent's two sons (the remainder was valued by assuming a 25% discount for lack of control and marketability of the 99% LP interest). (A problem with the transfer to the CLAT is that the power of attorney only authorized gifts to the principal's issue up to the federal gift tax annual exclusion amount. (The taxpayer argued that gifts were authorized under the power of attorney under general state case law where the gifts were consistent with the estate plan.)

The decedent died 7 days later. [Counsel has indicated that the decedent was recovering nicely from a broken hip, and the CLAT was planned during that recovery, but the decedent contracted an infection after she had been cleared for a hospital discharge and died shortly thereafter from ensuring sepsis. At the time the FLP was funded and the CLAT was funded, counsel indicates that the serious infection had not yet occurred, the decedent was expected to be discharged from the hospital, and a medical opinion was received reflecting a greater than 50% likelihood of surviving a year.]

The IRS claimed that the $10 million of assets contributed to the FLP were includible in the decedent's estate (without a discount) under §§2036(a)(1) (retained enjoyment or income), 2036(a)(2) (retained right in conjunction with any person to designate who could enjoy the property or its income), or 2038 (power to alter, amend, revoke, or terminate the transfer at the decedent's death), or under §2035(a) (transfer of property within three years of death that otherwise would have been included in the estate under §§2036-2038 or 2042) if the transfer to the CLAT was valid. The opinion indicates that the taxpayer did not contest the application of §2036(a)(2) [counsel has reportedly stated that he did *not* concede that issue], or contest that the bona fide sale for full consideration exception to §2036 was not applicable. The taxpayer merely argued that §§2036 and 2038 could not apply because the decedent no longer owned the LP interest at her death (despite the fact that the interest had been transferred within 3 years of her death and §2035(a) would then apply).

Section 2036(a)(2) Issue

The majority and concurring opinions both agreed that §2036(a)(2) applied (though the concurring opinion did not address the reasoning for applying §2036(a)(2)). The majority opinion reasoned (1) that the decedent, in conjunction with all the other partners, could dissolve the partnership, and (2) that the decedent, through her son as the GP and as her agent, could control the amount and timing of distributions. The opinion adopted the analysis in *Strangi* as to why the "fiduciary duty" analysis in the Supreme Court *Byrum* case does not apply to avoid inclusion under §2036(a)(2) because under the facts of this case any such fiduciary duty is "illusory."

The §2036(a)(2) issue is infrequently addressed by the courts; it has only been applied with any significant analysis in four prior cases (*Kimbell* and *Mirowski* [holding that §2036(a)(2) did not apply], and *Strangi* and *Turner* [holding that §2036(a)(2) did apply]). In both *Strangi* and *Turner*, the decedent was a general partner (or owned a 47% interest in the corporate general partner). *Powell* is the **first case to apply §2036(a)(2) when the decedent merely owned a limited partnership interest**. In this case the decedent owned a 99% LP interest, but the court's analysis drew no distinction between owning a 99% or 1% LP interest; the court reasoned that the LP "in conjunction with" all of the other partners could dissolve the partnership at any time. (Whether the court would have applied §2036(a)(2) had the decedent owned only a small LP interest is not known, but the court's reasoning does not draw any distinction based on the amount of LP interest owned by the decedent.)

Because §2036(a)(2) applied, the court did not address §2036(a)(1) or §2038.

"Double Inclusion" Issue

The majority opinion raised, on its own with no argument or briefing from any party, how §2036 or §2038 operate in conjunction with §2043 ostensibly to avoid double inclusion. The consideration received in return for the contribution to the FLP (i.e. the 99% LP interest) is subtracted under §2043 from the amount included in the gross estate under §2036. In effect, the value of the discount is included under §2036/§2043 (i.e., the value of the assets contributed to the FLP minus the value of the 99% LP interest considering lack of control and marketability discounts). The opinion refers to this amount colloquially as the "doughnut hole." In addition, the 99% LP interest itself is included in the gross estate (if the gift is not authorized under the power of attorney) or is included in the gift amount if the gift is recognized, and the court referred to this as the "doughnut." That analysis avoids double inclusion IF the assets have not appreciated (and because the decedent died only 7 days later, the parties stipulated that the contribution values were also the date of death values). But if the assets have appreciated, footnote 7 of the "majority" opinion acknowledges that "duplicative transfer tax" would apply because the date of death asset value is included in the gross estate under §2036 offset only by the *date of contribution* discounted value of the partnership interest. The date of death value of the LP interest also would be included under §2033, so all of the post-contribution appreciation of the assets would be included under §2036 AND the discounted post-contribution appreciation also would be included under §2033. As a result, more value may be included in the gross estate than if the decedent had never contributed assets to the FLP. (Similarly, footnote 17 acknowledges that a "duplicative reduction" would result if the assets depreciated after being contributed to the FLP.) Whether a court would actually tax the same appreciation multiple times (or whether the IRS would even make that argument), in a case in which the majority's analysis is applied is (hopefully) doubtful, but the majority opinion did not even hint that the court would refuse to tax the same appreciation twice in that situation.

The concurring opinion (joined by seven judges) reasoned that the inclusion of the partnership assets in the gross estate under §2036 meant that the partnership interest itself was merely an alter ego of those same assets and should not also be included in the gross estate. That approach has been followed by the prior FLP cases in which §2036 was applied, and indeed even in this case the IRS did not argue that the asset value/partnership value should be included under both §2036 and §2033, offset by the partnership value at the date of the contribution. (That argument would have been meaningless in this case [because the date of contribution values and date of death values were the same], but the IRS has not made that argument in *any* other FLP cases even though substantial additional estate tax liability would have resulted in situations involving significant appreciation of partnership assets.)

The opinion leaves uncertainty, particularly as to the double inclusion issue, because the "majority" opinion (that espoused the double inclusion analysis) was joined by only 8 judges (one of whom was Judge Halpern, who is a Senior Judge and not one of the 16 current "regular" Tax Court judges), a concurring opinion (that rejected the double inclusion analysis) was joined by 7 judges, and 2 judges concurred in the majority opinion in result only.

The fact that eight judges adopted the double inclusion analysis may embolden the IRS to take that position in future cases, even though we do not yet know how a majority of the Tax Court judges would rule as to that issue. This raises a risk that contributing assets to an FLP (or for that matter, any entity) may leave a taxpayer in a significantly worse tax position than if the taxpayer merely retains the assets.

Rejection of Gift to CLAT

The court concluded that the gift to the CLAT was not valid, and therefore denied the IRS's additional gift tax deficiency and also the addition to the gross estate of additional gift tax on the gift made within three years of death.

Increased Significance of Bona Fide Sale for Full Consideration Exception

The combination of applying §2036(a)(2) even to retained *limited partnership* interests and the risk of "duplicative transfer tax" as to future appreciation in a partnership makes qualification for the bona fide sale for full consideration exception to §§2036 and 2038 especially important. In one respect, this means that *Powell* does not reflect a significant practical change for planners, because the §2036 exception has been the primary defense for any §2036 claim involving an FLP or LLC.

This case was appealable to the Ninth Circuit Court of Appeals, but the case was not appealed.

Estate of Powell v. Commissioner, 148 T.C. No. 18 (May 18, 2017) (Halpern [Senior Judge], joined by Vasquez, Thornton, Holmes, Gustafason, Morrison, Buch, and Ashford, with Foley and Paris concurring in the result only) (concurring opinion by Lauber, joined by Marvel, Gale, Kerrigan, Nega, and Pugh).

For an excellent discussion of the *Powell* case, *see* Todd Angkatavanich, James Dougherty & Eric Fisher, *Estate of* Powell: *Stranger Than* Strangi *and Partially Fiction*, TR. & ESTS. 30 (Sept. 2017).

Basic Facts

1. The decedent's son, as her attorney-in-fact under a power of attorney, contributed about $10 million of cash and marketable securities (managed by the son's wealth management firm) to an FLP on August 8, 2008 in return for a 99% LP interest. Two sons contributed unsecured promissory notes in return for a 0.5% GP interest held by the agent-son) and a 0.5% LP interest (held by another son).
2. The partnership agreement gave the GP the sole discretion to determine the amount and timing of distributions. In addition, the agreement permits the dissolution of the partnership with the consent of all partners (but even without that specific provision in the partnership agreement, all of the partners could get together at any time to dissolve the partnership or amend the agreement).
3. Also on August 8, 2008, the son as agent under a power of attorney transferred all of the decedent's 99% LP interest to a CLAT that would pay an annuity to charity for the decedent's life and pay the remainder to her two sons. However, the power of attorney only authorized gifts to the decedent's issue "to the full extent of the federal annual gift tax exclusion." In determining value of the remainder interest gift that resulted from the creation of the CLAT, a 25% discount for lack of control and lack of marketability was used to value the 99% LP interest. The estate took the position on its gift tax return that the 99% limited partnership interest (valued at a 25% discount pursuant to a Duff & Phelps, LLC appraisal) was $7,516,773, and that the gift tax value of the remainder interest of the CLAT was equal to $1,661,422, thus reflecting that the actuarial value of the charitable interest was 22.1% of the value contributed to the CLAT.
4. The decedent died on August 15, 2008. [Counsel has reportedly indicated that the decedent was recovering nicely from a broken hip, and the CLAT was planned (and a medical opinion was received reflecting a greater than 50% likelihood of surviving a year) during that recovery, but the decedent contracted an infection after she had been cleared for a hospital discharge and died shortly thereafter from ensuing sepsis.]
5. The decedent and the son, who was the executor of the estate, resided in San Francisco when the petitions were filed (meaning that the case would be appealable to the Ninth Circuit Court of Appeals).
6. The IRS issued an estate tax notice of deficiency for about $5.88 million, resulting from an increase in the gross estate of $12.98 million ($10.02 million from the assets included under §2036 or §2038 and $2.96 million from additional gift tax resulting from the gift to the CLAT that would be includable under §2035(b) -- but for some reason without allowing an additional deduction under §2053(a)(3) for the additional gift tax [see footnote 12 of the opinion]).

   The IRS also issued a gift tax notice of deficiency for $2.96 million as a result of the creation of the CLAT (determining the gift amount using a 15% discount rather than a 25% discount in valuing the 99% LP interest) and treating the decedent as being terminally ill when the gift was made. The IRS valued the 99% limited partnership interest at $8,518,993 (applying a 15% discount) and valued the remainder interest in the CLAT at $8,363,095, thus reflecting that the actuarial value of the remainder interest (assuming the decedent was terminally ill) was only 1.56% of the value contributed to the CLAT.

7. Counsel has reportedly stated that the estate attempted to settle the case, agreeing with §2036 inclusion, but not having to pay any gift tax with respect to the CLAT transfer, but the IRS examining agent's calculations refused to reduce the amount of adjusted taxable gifts by the amount of the gifts included in the estate under §2036 in calculating the estate tax, as required by the last sentence of §2001(b).
8. The estate sought summary judgment that no estate or gift tax deficiency existed. The IRS moved for partial summary judgment that the value of assets contributed to the FLP is includable under §§2036(a)(1), §2036(a)(2), or 2038(a), or because the gift of the 99% LP interest to the CLAT was not authorized.
9. The opinion indicates that the taxpayer did not contest the application of §2036(a)(2) [counsel has reportedly stated that he did *not* concede that issue], or contest that the bona fide sale for full consideration exception to §2036 was not applicable.

Analysis – Majority Opinion

1. **Failure to Contest That Section 2036(a)(2) "Right to Designate" Elements Apply and That the Bona Fide for Full Consideration Exception Does Not Apply**. did not refute the IRS argument that the "right to designate" requirements in §2036(a)(2) are satisfied or that the bona fide sale for full consideration exception to §2036 does not apply. The estate merely argued that §§2036 and 2038 could not apply because the decedent no longer owned the LP interest at her death (despite the fact that the interest had been transferred within 3 years of her death and §2035(a) would then apply).
2. **Section 2035**. In light of the estate's argument that the decedent no longer owned any interest in the FLP at her death, the opinion analyzes whether estate inclusion results even if the gift to the CLAT was valid (despite that the gift exceeded the agent's authority under the power of attorney). Section 2035(a) provides that if a decedent makes a transfer or relinquishes a power over property within three years of death and if the property would have been included in the decedent's gross estate under §§2036-2038 or §2042 at her death if the transfer had not been made, the value of any property that would have been so included is included in the gross estate under §2035. Therefore, if §2036(a)(2) would apply if the decedent had still owned the LP interests at her death, the property contributed to the partnership would be included in the decedent's estate under §2035 if the gift is valid because the gift was made within three years of her death.
3. **Section 2036(a)(2) Applies**. Section 2036(a)(2) provides that if the decedent has made a transfer of property (other than a bona fide sale for adequate and full consideration), the property is included in the decedent's gross estate if the decedent controlled "the right, either alone or in conjunction with any other person, controlled the power to designate the persons who shall possess or enjoy the property or the income therefrom." The IRS argues that the decedent transferred property to the FLP and that the decedent still had the ability to designate who could possess or enjoy the property or its income.

   The court in *Estate of Strangi v. Commissioner*, T.C. Memo. 2003-15, *aff'd*, 417 F.3d 468 (5th Cir. 2005) held that §2036(a)(2) (as well as §2036(a)(1)) applied to a situation in which the taxpayer's son funded an FLP on behalf of the taxpayer, with the decedent owning a 99% limited partnership interest and owning 47% of an S corporation that was the 1%

general partner. The *Powell* majority opinion adopted the analysis from *Strangi*, both in reasoning why §2036(a)(2) applies and why the *Byrum* Supreme Court holding (discussed in Paragraph 4 below) should be distinguished. (While the Fifth Circuit affirmed the *Strangi* case, it did not address the §2036(a)(2) issue, finding that inclusion under §2036(a)(1) was sufficient to dispose of the case.)

If the decedent in *Powell* owned the LP interest at her death, §2036(a)(2) would apply for two different reasons. First, the decedent, in conjunction with the other partners, could all agree together to dissolve the partnership at any time. That would revest the property in decedent and she could then designate who could enjoy the property or its income. That alone is "sufficient to invoke section 2036(a)(2)," but the court also applied a second reason (also used in *Strangi).* Second, the decedent had the right, through her son who was a general partner and her agent under the power of attorney, to determine the amount and timing of distributions. The *Powell* court pointed out similarities with the *Strangi* facts and reasoning [but the opinion failed to mention that part of the analysis in *Strangi* was that the decedent in that case also owned 47% of the corporate general partner and the *Strangi* court made reference to the powers of the general partner].

4. "**Fiduciary Duty" Limitation on Applicability of Section 2036(a)(2) Under *Byrum* Is Distinguished.** The U.S. Supreme Court held in *United States v. Byrum*, 408 U.S. 125 (1972) that retaining the right to vote shares of stock in corporations that a decedent had transferred to a trust did not require that the shares be included in his estate under §2036(a)(2). In *Strangi,* the estate argued that if the mere fact that a decedent "could band together with all of the other shareholders of a corporation" is sufficient to cause inclusion under §2036(a)(2), the Supreme Court could not have reached its decision in *Byrum*. The estate in *Strangi* argued that the decedent's authority over the partnership, through her son-in-law, was subject to state law fiduciary duties and therefore insufficient under *Byrum* to invoke §2036(a)(2). The *Strangi* court responded with an analysis of the additional constraints in *Byrum* that were not present under the *Strangi* facts. The *Powell* majority opinion adopted reasoning from *Strangi* to distinguish why the "fiduciary duty" analysis in *Byrum* did not apply under the facts of this case because any such fiduciary duty is "illusory."

   - The son, in carrying out duties to the partnership as general partner, also owed duties to the decedent as her attorney-in-fact under the power of attorney and could not act in ways "that would have prejudiced decedent's interests." (In *Byrum*, dividend distributions would have been made to the trust, and distribution decisions from the trust were made by an independent trustee.)
   - The decedent owned the 99% LP interest, so any fiduciary duties that limited the son's discretion as general partner in making partnership distributions "were duties that he owed almost exclusively to decedent herself." (*Strangi* had observed a distinction for "intrafamily fiduciary duties.")
   - The FLP did not conduct meaningful business operations and was merely an investment vehicle for decedent and her sons. (*Strangi* concluded "Intrafamily fiduciary duties within an investment vehicle simply are not the equivalent in nature to the obligations created by the United States v. Byrum … scenario.")

5. **Limit Imposed by Section 2043 on Amount Includible Under Section 2036; "Double Inclusion" Issue.** The majority opinion, on its own without argument by any of the parties or any briefing, analyzed how §2036 is applied, in conjunction with §2043, in the context of assets contributed to an FLP (or LLC). The analysis is not central to the conclusion that §2036(a)(2) applies, and in that respect may be treated as dictum.

   If §2036 applies, the assets contributed to an FLP are included in the estate, but if the decedent continues to own the LP interest, that interest is also included under §2033 (according to the majority opinion), and the majority opinion has an extended analysis to explain why this does not result in "double inclusion." The majority opinion observes that prior cases have not articulated "the precise legal grounds that prevent such illogical 'double taxation'" from inclusion of "both the assets transferred to a family limited partnership and the partnership interest received in return." The majority opinion views this case as "the opportunity to fill that lacuna and explain why a double inclusion in a decedent's estate is not only illogical, it is not allowed." [For those, who like me, have no idea what a "lacuna" is, it is "an unfilled space or interval, a gap."]

   Section 2043 provides:

   > If any of the transfers, trusts, interests, rights, or powers enumerated and described in sections 2035 to 2038, inclusive, and section 2041 is made, created, exercised, or relinquished for a consideration in money or money's worth, but is not a bona fide sale for an adequate and full consideration in money or money's worth, there shall be included in the gross estate only the excess of the fair market value at the time of death of the property otherwise to be included on account of such transaction, over the value of the consideration received therefor by the decedent.

   Broken down in the context of assets contributed to an FLP that are included in a decedent's gross estate under §2036:

   - If any transfer, interest, or power that would cause inclusion in the gross estate under §2036 is relinquished
   - for consideration,
   - but the consideration is not a bona fide sale for an adequate and full consideration (meaning that the "bona fide sale for full consideration" exception under §2036 does not apply to pre-empt the application of §2036),
   - then the amount included under §2036 is reduced such that the amount included is
     - the fair market value, at the time of death, of the property that would otherwise be included, minus
     - the value of the consideration received for such relinquishment by the decedent.

   The purpose of §2043(a) is to complement the bona fide sale exception in each of §§2035-2038. The bona fide sale exception limits the application of §§2035-2038 to transactions that deplete a decedent's estate. If some consideration is received, but not enough to prevent depletion of the estate, §2043(a) "limits the inclusionary rules so that they apply only to the extent necessary to prevent depletion of the transferor's estate." Section 2043(a) attempts "to provide a measure of relief from double taxation of the same economic interest" [quoting *Estate of Frothingham v. Commissioner*, 60 T.C. 211, 216 (1973)] and "limits the required inclusion to the amount by which the transfer depletes the decedent's estate."

In the context of applying §2036 to the transfer of the $10 million to the FLP by the decedent, the amount included under §2036 is "only the excess of the fair market value at the time of her death of the cash and securities transferred to [the FLP] over the value of the 99% limited partner interest in [the FLP] issued in exchange for those assets" (but footnote 7 observes that the reduction is just the value of the 99% LP interest "on the date of the transfer" of assets to the FLP). The bona fide sale exception under §2036 and 2038 with respect to transfers to an FLP has two requirements – (i) a bona fide sale (meaning "the existence of a legitimate and significant nontax reason for creating the family limited partnership") and (ii) adequate and full consideration (meaning "the transferors received partnership interests proportionate to the value of the property transferred") [footnote 6 quoting *Estate of Bongard v. Commissioner*, 124 T.C. 95 (2005)]. Under *Bongard*'s proportionality test for what satisfies the second "adequate and full consideration" prong, a transfer of assets to an FLP can be treated as being made for full consideration even if discounts for lack of control or marketability "cause the value of the partnership interest received by a decedent to be less than the value of the assets he transferred to the partnership." [Footnote 6] Therefore, transfers to an FLP can result in some depletion of the estate but only if the partnership was created for a legitimate and significant nontax reason, thus causing the exception under §2036 to prevent §2036 from applying. If the bona fide sale test is not met (i.e., if there is no legitimate and significant nontax reason for creating the partnership), the net effect is that §2036 as limited by §2043(a) "includes in the value of decedent's gross estate the amount of any discounts applicable in valuing the 99% limited partner's interest in [the FLP] issued in exchange for the cash and securities [assuming the assets have not appreciated] (an amount that could colloquially be characterized as the 'hole' in the doughnut)." The date of death value of the 99% LP interest itself, if still owned by the decedent, would be included in the gross estate under §2033 (or under the facts of *Powell,* if the transfer to the CLAT were either void or revocable, would be included under §2038).

Only one previous FLP Tax Court case (*Estate of Harper v.* Commissioner, T.C. Memo. 2002-121) that applied §2036 has addressed the impact of §2043(a), and the *Powell* majority opinion said it concluded that a partnership interest did not qualify as "consideration," for purposes of either section 2036(a) or section 2043(a), if the formation of the partnership did not involve a genuine pooling of assets, but is nothing other than circuitous "recycling of value" that does not "rise to the level of a payment of consideration."

The entire reference to §2043 in *Harper* is as follows: "Furthermore, although section 2043 can entitle taxpayers to an offset for partial consideration in cases where a transfer is otherwise subject to section 2036, this section, too, is inapplicable where, as here, there has been only a recycling of value and not a transfer for consideration." The majority opinion has an extended 8-page discussion to rebut the assertion that §2043(a) does not apply to FLP-§2036 transfers because of that one sentence statement in *Harper*. It concludes that the "pooling of assets" and "recycling of value" discussion in *Harper* "is more germane to the first prong (the bona fides of the transaction) than to the second (adequacy of consideration)" of the bona fide sale for full consideration exception in §2036. Similarly, a comment in *Estate of Thompson v. Commissioner*, T.C. Memo. 2002-246, *aff'd*, 382 F.3d 367 (3d Cir. 2004) that "the decedent's receipt of a partnership interest in exchange for his testamentary assets is not full and adequate consideration within the meaning of section 2036," was likely related to the bona fide sale prong of the §2036 exception, and the Third Circuit's affirmance "referred only to the absence of 'any valid, functioning business enterprise' rather than on the proportion of partnership assets contributed by the decedent."

[Observation: Despite the lengthy explanation and attempt to distinguish the statement in *Harper* that §2043(a) is inapplicable "where, as here, there has been only a recycling of value and not a transfer for consideration," the majority opinion's rationale that the "pooling" and "recycling of value" comments in *Harper* relate to the first leg of the bona fide sale for full consideration exception in §2036 does not explain why §2043(a) would not apply because §2043(a) makes no reference to the bona fides of the transaction.]

6. **Double Inclusion Issue; "Duplicative Transfer Tax" *Does* Exist to the Extent of Post-Contribution Appreciation.** The purpose of the court's lengthy discussion of the manner in which §2043 limits double taxation if §2036 includes assets contributed to a partnership AND the partnership interest itself also is included in the estate is to demonstrate that double inclusion does not really result. (The majority opinion fills the "lacuna and explain[s] why a double inclusion in a decedent's estate is not only illogical, it is not allowed.") The majority opinion itself, however, acknowledges that "duplicative transfer tax" can result to the extent of post-contribution appreciation of assets in the FLP/LLC:

> Changes in the value of the transferred assets would affect the required inclusion because sec. 2036(a) includes in the value of decedent's gross estate the date-of-death value of those assets while sec. 2043(a) reduces the required inclusion by the **value of the partnership interest on the date of the transfer**. To the extent that any post-transfer increase in the value of the transferred assets is reflected in the value of the partnership interest the decedent received in return, the appreciation in the assets would generally be subject to a duplicative transfer tax. (Conversely, a post-transfer decrease in value would generally result in a duplicative reduction in transfer tax.) Footnote 7 (emphasis added).

The majority opinion's §2043(a) analysis avoids double taxation of the same value IF the assets have not appreciated (and because the decedent died only 7 days later, the parties stipulated that the contribution values were also the date of death values). But if the assets have appreciated, footnote 7 of the majority opinion acknowledges that "duplicative transfer tax" would apply because the date of death asset value is included in the gross estate under §2036 offset only by the *date of contribution* discounted value of the partnership interest. The date of death value of the LP interest also would be included under §2033, so all of the post-contribution appreciation of the assets would be included under §2036 AND the discounted post-contribution appreciation would also be included under §2033. More value may be included in the gross estate than if the decedent had never contributed assets to the FLP. (Similarly, footnote 17 acknowledges that a "duplicative reduction" would result if the assets depreciated after being contributed to the FLP.)

7. **No Consideration of §§2036(a)(1) or 2038(a)**. Because §2036(a)(2) applied, the majority opinion did not consider the arguments for inclusion under §§2036(a)(1) or 2038(a). [Observation: §2036(a)(1) may have been be a difficult argument for estate inclusion. All of the decedent's partnership interests were transferred to the CLAT with **no retained interest** for the decedent. If the decedent had retained substantial assets outside the FLP, the IRS may not have had a strong retained implied interest argument. Maybe that is why the court applied §2036(a)(2) and not §2036(a)(1). The more likely practical reason, though, is that the taxpayer's brief addressed §2036(a)(1), but it did not address §2036(a)(2).]

Analysis – Concurring Opinion

1. **Aggressive Deathbed Tax Planning**. The concurring opinion viewed this as a case of "aggressive deathbed tax planning," and observed that the IRS "had available a number of theories on which to challenge the transactions."

2. **Possible Invalidity of Partnership.** A possible theory to challenge the transaction is that the "partnership was invalid ab initio" because "the other two supposed partners—her sons and heirs—contributed nothing more than unsecure promissory notes." The son, acting under a power of attorney, negotiated with himself, signing the partnership agreement as general partner and for his mother. The majority opinion does not address this "partnership invalidity" theory, perhaps because the IRS did not clearly articulate it and because it could require resolving disputed issues of fact which could preclude a summary judgment resolution of the case.

   Even if the partnership interest is recognized, the concurring opinion expresses skepticism that any lack of marketability discount would have been allowed. ("This theory validates the estate's claimed discount for lack of marketability, which seems highly suspect on the facts presented.")

3. **Section 2036(a)(2) Inclusion**. The concurring opinion also agrees that §2036(a)(2) applies. The concurring opinion's full discussion of why §2036(a)(2) applies is as follows:

   > The Court correctly concludes that section 2036(a)(2) applies here. [Citations to majority opinion page numbers and the *Strangi* case omitted] The decedent clearly "made a transfer" of the $10 million in cash and securities. And she clearly retained the proverbial "string" that pulls these assets back into her estate.

   This acknowledgement of the application of §2036(a)(2), however brief, is important, reflecting that 15 of the 17 judges participating in this decision explicitly recognized that §2036(a)(2) applies. (The other two judges concur in the result only of the majority opinion. Because the result is that the assets contributed to the partnership were included in the decedent's estate under §2036(a)(2) and on no other grounds, they must also have agreed that §2036(a)(2) applied.)

4. **Reject Double Inclusion Analysis.** "This is where I part company with the Court, because I do not see any 'double inclusion' problem." The concurring opinion disagrees with the court's analysis of including assets under §2036 (reduced by the discounted value of the partnership interest) AND also including the partnership interest itself under §2033. If the assets contributed to the partnership are included under §2036, the partnership interest itself should not also be included in the estate under §2033. "Once that $10 million is included in her gross estate under section 2036(a)(2), it seems perfectly reasonable to regard the partnership interest as having no distinct value because it was an alter ego for the $10 million of cash and securities."

   The concurring opinion points out that the "double inclusion limited by §2043" approach was not suggested by either party in the case and §2043 was not mentioned in either party's briefs. It observes that merely including assets under §2036 without also including the partnership interest in the gross estate under §2033 is the approach has been followed by all of the prior FLP/LLC cases that have applied §2036.

   > The Court's exploration of section 2043(a) seems to me a solution in search of a problem. It is not necessary; the parties did not think it was necessary; and our prior cases show that it is unnecessary.

Furthermore, the concurring opinion questions whether §2043(a) would apply in this situation:

> And even if the section 2043 issue were properly presented, I am not sure the Court's application of that provision is correct. It is far from clear to me that the decedent's partnership interest--a consequence of the now-disregarded transfer—can constitute "consideration in money or money's worth" within the meaning of section 2043(a).

In support of the concern that §2043 might not apply in this situation, the concurring opinion cites the *Harper* and *Thompson* cases (discussed in the majority opinion) and *Estate of Gregory v. Commissioner*, 39 T.C. 1012, 1020 (1963) (holding that a decedent's retained interest in her own property cannot constitute consideration under section 2043(a)).

Also, the concurring opinion observes that the possibility of a "duplicative reduction in transfer tax" [to the extent of post-contribution *depreciation* of partnership assets] may invite overly aggressive tax planning." [Observation: That seems an overreach; no one would purposefully hold onto assets hoping that they would decline in value.]

Finally, the concurring opinion believes the new approach risks creating new problems and prefers following the approach used in all of the prior §2036 FLP/LLC cases:

> By adopting an untried new theory without first hearing from the parties, we risk creating problems that we do not yet know about. The more prudent (and conservative) approach in my view would be to adhere to the letter and spirit of our precedent, leaving the law in the relatively stable position that it appears to occupy now.

Observations

1. "**Overly Aggressive Deathbed Tax Planning.**" The court's refusal to allow valuation discounts is not surprising. The case involves a number of bad (or at least suspicious) factors:

   - Funding of the entity only by the soon-to-be decedent;
   - With only cash and marketable securities;
   - A mere 7 days before death;
   - By the decedent's son acting under a power of attorney;
   - With a subsequent transfer to a CLAT and a retained charitable annuity for the life of the apparently soon-to-die donor, resulting in a substantial value shift to the agent and his brother.

   That the taxpayer lost the case is not surprising.

2. **Significant Extension of Application of §2036(a)(2) to Retained Limited Partnership Interests.** The §2036(a)(2) issue is addressed infrequently by the courts; it has been applied with any significant analysis in only four prior cases (*Kimbell* and *Mirowski* [holding that §2036(a)(2) did not apply], and *Strangi* and *Turner* [holding that §2036(a)(2) did apply]). In both *Strangi* and *Turner*, the decedent was a general partner (or owned a 47% interest in the corporate general partner). *Powell* is the **first case to apply §2036(a)(2) when the decedent merely owned a limited partnership interest**. In this case the decedent owned a 99% LP interest, but the court's analysis drew no express distinction between

owning a 99% or 1% LP interest (although the distinction from *Byrum*'s limitation on the application of §2036(a)(2) because of fiduciary duties would not be as strong if other significant partnership interests existed, particularly if they were unrelated parties, and any fiduciary duties were not "owed to herself"). The court reasoned that the LP "in conjunction with" all of the other partners could dissolve the partnership at any time. (Whether the court would have applied §2036(a)(2) had the decedent owned only a small LP interest is not known, but the reasoning allowing the ability to dissolve the entity by acting "in conjunction with" other partners would not change based on the amount of LP interest owned by the decedent.)

The net effect is that, under this analysis, §2036 will apply to almost all FLPs/LLCs, whether or not the client retains a general partner or managing member interest, unless the bona fide sale for full consideration exception to §2036 applies. Furthermore the same reasoning would seem to apply to practically any enterprise or investment involving other parties. For example, interests in C corporations, S corporations, or undivided interests in real estate would be subject to the same reasoning that the decedent could join with the other shareholders/co-owners (perhaps even if unrelted?) and dissolve the entity/co-ownership, with all parties receiving their pro rata share of the assets.

3. **Bad Facts Make Bad Law.** To a degree, this may be a "bad facts make bad law" case. The court may have stretched to find that §2036(a)(2) applied to avoid estate tax discounts for this deathbed transaction that lacked any non-tax purposes, even though the decedent received only limited partnership interests, because of the difficulty of applying §2036(a)(1) when the decedent did not intend to retain ANY interest in the FLP. A consideration of "sham transaction" or "void partnership" theories may have involved fact issues that would have precluded a summary judgment.

   The IRS's real concern is that the transaction was merely a gimmick to produce discounts and lacked economic substance, but the Tax Court had previously rejected the authority of the IRS to merely disregard transfers to partnerships because of the decedent's "subjective intentions" as long as the partnership was validly formed and changed relationships between the decedent and his heirs and creditors. *Estate of Strangi v. Commissioner*, 115 T.C. 478, 486-87, *rev'd on other grounds*, 293 F.3d 279 (5th Cir. 2002).

4. **Increased Significance of Bona Fide Sale for Full Consideration Exception to §2036.** The combination of applying §2036(a)(2) even to retained *limited partnership* interests and the risk of "duplicative transfer tax" as to future appreciation in a partnership makes qualification for the bona fide sale full consideration exception to §§2036 and 2038 especially important. Make sure that a legitimate and significant nontax purpose for creating the FLP/LLC exists to satisfy the bona fide prong of the exception, but also be sure that proper capital accounts are maintained to satisfy the full consideration prong of the exception as interpreted by *Joanne Stone*, *Kimbell* and *Bongard.* *See Estate of Beyer v. Commissioner,* T.C. Memo. 2016-183 (full consideration prong of §2036 exception did not apply because of the failure to maintain proper capital accounts).

   In one respect, this means that *Powell* does not reflect a significant practical change for planners, because the §2036 exception has been the primary defense for any §2036 claim involving any FLP or LLC. Almost all of the taxpayer victories against a §2036 claim have been based on the bona fide sale for full consideration exception to §2036. (Several exceptions are *Estate of Kelly v. Commissioner*, T.C. Memo. 2012-73 and *Estate of Mirowski v. Commissioner,* T.C. Memo. 2008-74, which both refused to apply §2036 to gift transactions that did not qualify for the full consideration exception. In addition, *Kimbell v. U.S.*, 371 F.3d 257, 268 (5th Cir. 2004), refused to apply §2036 to transfers to an LLC without addressing whether the bona fide sale for full consideration exception applied to those transfers.)

5. **Elimination of Unanimous Partner Approval Requirement for Dissolution**. The partnership agreement in this case "allows for the partnership's dissolution with the written consent of all partners." Would the omission of this explicit requirement of unanimous consent for dissolution in the partnership or LLC agreements provide an argument against applying §2036(a)(2) under Powell? That would provide a factual distinction from Powell, but the court's reasoning for applying §2036(a)(2) made no reference whatsoever to the unanimous consent requirement for dissolution in the partnership agreement. The court made reference various times to the decedent's "ability to dissolve" the partnership in conjunction with her sons, but never made reference to the fact that the partnership could only be dissolved with her consent.

   If the partnership agreement is silent regarding dissolution, the Revised Uniform Limited Partnership Act provides various events that can cause the dissolution of the limited partnership, one of which is "the affirmative vote or consent of all general partners and of limited partners owning a majority of the rights to receive distributions as limited partners at the time the vote or consent is to be effective." Rev. Unif. Ltd. Ptnship. Act §801(a)(2). If the decedent owns a majority of limited partnership interests, the decedent would have the ability to act with others to dissolve the partnership in any event under the Uniform Act (unless the partnership agreement negated that provision). This same provision is included in the California limited partnership act. CALIF CODE CORPORATIONS §15908.01.

   If none of the permitted events that would cause dissolution of the partnership involve action by the limited partner, the argument that the decedent could dissolve the partnership in conjunction with others is more tenuous. For example, under the Revised Uniform Limited Partnership Act, if the partnership agreement does not address limited partnership consent regarding dissolution and if a decedent owned less than a majority of the limited partner interests entitled to distributions, the decedent would have no way to participate in the decision to dissolve the partnership. However, the decedent as a limited partner always could join with all the other partners to amend the partnership agreement and add provisions allowing the dissolution of the partnership. Id. at §406(b)(1) (affirmative vote or consent of all partners is required to amend the partnership agreement). If a court were inclined to employ common sense limitations in applying the "in conjunction with" phrase (see paragraph 17 below), the ability to join with other partners in amending the partnership agreement seems more remote than an explicit direct ability to join with others in dissolving the partnership.

   Indeed, the court in footnote 4 suggests that the application of §2036(a)(2) might have been avoided by a change in drafting of the partnership agreement. (Footnote 4 includes the following clause: "had NHP's limited partnership agreement been drafted in a way that prevented the application of sec. 2036(a)(2).") (How that drafting would have been accomplished under the court's reasoning is not clear. If the agreement had been silent regarding dissolution, the general partner and a majority of the limited partners (which would have included the decedent) could have dissolved the partnership under California law. Perhaps the court was suggesting that the partnership agreement could have provided that the limited partners would have had no input into the decision to dissolve.)

6. **Avoid Having Decedent's Agent as General Partner**. One of the court's reasons for apply §2036(a)(2) was that the son could make distribution decisions and also owed duties to the decedent under the power of attorney from the decedent, thus she had the ability through her agent to determine the amount and timing of distributions. That argument could be removed by having someone serve as general partner other than the decedent or an agent for the decedent under a power of attorney.

7. ***Special Voting Interests to Make Liquidation/Dissolution Decisions***. *One planning alternative may be to have a special partnership or member interest that would have the exclusive* ability to vote on liquidation or dissolution decisions. The first rationale of the court's reasoning under §2036(a)(2) would then no longer apply—the decedent could not participate with anyone in deciding when to dissolve the partnership/LLC. That is not a complete answer to the court's reasoning however; under state law, all of the partners/members presumably could agree to change the underlying formation documents any way they wanted, including the omission of the special voting interest. But having significant factual differences may be important if a court looks for ways to distinguish the *Powell* holding.

8. ***Trust Owners with Independent Trustee*****.** If all of the partners/members were irrevocable trusts with independent trustees, any dissolution proceeds would pass to the irrevocable trusts, and the decedent could not join with the trustee in making distribution decisions, so the court's "in conjunction with" analysis would no longer give the decedent the ability to designate who could receive the income or property contributed to the partnership/LLC. The decedent's interest could be held in an "incomplete gift" trust (for example if the trust was for the sole benefit of the decedent and the decedent had a testamentary power of appointment), but most clients would likely not be willing to be subject to that inflexibility.

9. **Transfer All Interests During Life**. If the client gives/sells all of his or her interests during the client's lifetime (and more precisely, more than three years prior to death to avoid §2035), §2036 should no longer apply. Clients sometimes made transfers to partnerships/LLCs anticipating that some of the interests will continue to be held until the client's death, and that a discount would apply in valuing the interest for estate tax purposes. In light of the result in *Powell* suggesting that §2036(a)(2) will always apply unless the bona fide sale for full consideration exception is applicable, clients in the future may consider only contributing to entities an amount for which the client would contemplate eventually giving or selling all of the retained interests (and having the foresight to do so at least three years before death). Appropriate discounts should apply in valuing the gifts or in determining sale prices, and §2036 would not apply to include the entity's assets in the estate (without a discount) under §2036.

10. "**Claim Victory" and Dissolve FLP/LLC with Prior Successful Transfers**. If a client has previously created an FLP/LLC and has made gifts or sales of interests in the entity to trusts that have experienced substantial appreciation, consider dissolving the entity so that the trusts would own the value apart from the FLP/LLC, thus negating any possible §2036 taint. Value attributable to interests that have been transferred at least three years earlier should not be subject to §2036(a)(1) if no implied agreement of retained enjoyment exists (*see* the *Jorgenson*, *Kelly*, and *Rosen* cases), but §2036(a)(2) might continue to apply to gifts of interests over which the decedent has a continued ability (in conjunction with others) to determine the amount or timing of distributions.

11. ***Rationale for Estate Inclusion for Basis Adjustment Purposes***. If a decedent dies without estate tax concerns and the estate would like to include the FLP assets in the estate without a discount for basis adjustment purposes, the *Powell* reasoning provides a rationale for including the assets in the estate (at least as to interests retained by the decedent or transferred within the prior three years) as long as the transfer to the partnership did not qualify for the bona fide sale for full consideration exception to §2036.

    This position may run into IRS objections, with the IRS arguing that the bona fide sale for full consideration exception prevents the application of §2036(a)(2). In Tech. Adv. Memo. 9515003, the grantor argued that voting stock that had been transferred to an irrevocable trust should be included in the grantor's estate under §2036(b), presumably in order to get a basis adjustment under §1014, because of an oral understanding that the trustee would consult with the grantor and abide by the grantor's decisions regarding voting the stock. The IRS observed that the form of the transaction involved an irrevocable transfer of voting stock in which the grantor clearly and unambiguously relinquished any and all of his rights in the stock, including the right to vote the stock or determine how it would be voted by the trustee. The IRS refused the taxpayer's right to assert substance over form "where the governing instrument is clear on its face and the estate seeks to disavow the unambiguous instrument based on agreements and information only available to the estate and the executrix and within the estate's control to make part of the record." The IRS also observed that the gift tax return filed by the donor did not report any retained interest in the transferred stock and contained no reference to any retained voting rights. The IRS did not believe that "the estate can gain a tax advantage by now disavowing the form of the transaction." *See also Mowry v. Commissioner*, T.C. Memo. 2018-105 ("Generally taxpayers are bound by the form of the transaction that they choose unless they can provide "strong proof" that the parties intended a different transaction in substance. *Schulz v. Commissioner*, 294 F.2d 52, 55 (9th Cir. 1961), aff'g 34 T.C. 235 (1960); *see also Vandenbosch v. Commissioner*, T.C. Memo. 2016-29, at *19-*20. There is no proof that either petitioner or G. Mowry intended an arrangement different from that which they agreed to and reported consistently on their tax filings.")

    Under the *Powell* analysis, however, the fact that the partnership can be dissolved by the decedent with some percentage or all of the other partners (either under the terms of the partnership agreement or under local law) is absolutely certain, and does not depend on facts known only to the taxpayer. Therefore, the rationale in TAM 9515003 for denying the taxpayer's position that assets should be included in the gross estate should not apply—the issue turns on whether Powell is correct, not on implied or side agreements of the taxpayer known only to the taxpayer and not the IRS.

    Regulations clarify that the basis adjustment under §1014 is permitted even though no estate tax return is filed and no estate tax is paid. Treas. Reg. §1.1014-2(a)(2). Therefore, the basis adjustment to 100% of the proportionate asset value (that 15 of the 17 Tax Court judges would include in the estate under §2036(a)(2)) should be allowed even if the estate is under the filing requirement and does not file an estate tax return.

    This approach should only be considered if the taxpayer is not relying on the marital deduction for avoiding estate tax payments. If partnership interests qualify for the marital deduction, the IRS may make the "marital deduction mismatch" argument, claiming that the undiscounted value of the partnership assets are included in the gross estate, but that only the discounted value of the partnership interests that pass to a spouse (or qualifying trust) qualifies for the marital deduction (as noted in dicta in *Estate of Black*, 133 T.C. 340 (2009) and *Estate of Shurtz*, T.C. Memo. 2010-21).

12. **Impact of Retaining 99% Limited Partnership Interest on §2036(a)(2) Analysis**. Is the extension of §2036(a)(2) to retained limited partnership interests related to the fact that the decedent held 99% of the LP interests? The majority opinion has two references to the retention of most of the interests in the partnership. First, retaining most of the partnership interests is a reason that the *Byrum* opinion's discussion of fiduciary duties as a limitation of the application of §2036(a)(2) is not applicable because "any fiduciary duties … were duties he owed 'essentially to himself.'" The second reference addresses a concern that retaining almost all of the partnership interests could be a potential problem in applying the §2043 analysis and the double inclusion approach. Retaining most of the of partnership interests suggests no "pooling" of assets which some cases (including in *Harper*) cited as a reason that the bona fide sale for full consideration exception to §2036 does not apply. However, the court reasoned that the "degree of pooling is relevant to the question of the nontax bona fides of the transaction," not the degree to which "a partnership interest received in exchange for transferred assets should be treated as consideration received for those assets in applying section 2036(a) or section 2043(a)." The majority opinion reasoned that the "proportion of partnership assets contributed by the decedent" was not a factor in determining whether the receipt of a partnership interest could be treated as consideration under §2043(a).

    The majority opinion has no discussion directly commenting on the decedent's retention of a 99% LP interest rather than a smaller interest as the reason that the court applied §2036(a)(2) to the retention of mere LP interests, or suggesting that the result would have been different if the decedent had retained a much lower LP interest. (Whatever LP percentage is retained could be used "in conjunction with any person" to dissolve the partnership.) One of the reasons given for rejecting the *Byrum* reasoning refusing to treat certain retained authorities as constituting retained "rights" because of fiduciary limitations was that any fiduciary duties were "illusory" because the duties were merely owed to Ms. Powell herself (as the 99% limited partner.) That is the only aspect of the analysis suggesting that retaining a large limited partnership interest versus a smaller interest would have an impact on the §2036(a)(2) analysis.

    Contributing assets to an FLP/LLC in return for almost all of the interests may affect the "gut reaction" impact of viewing the transaction as mere paper shuffling by a decedent without any reasons for the contribution other than generating valuation discounts.

13. **Double Inclusion Analysis**. The majority opinion's summary of how §2043 applies in the context of §2036 FLP cases is similar to what Professor Jeffrey Pennell has been telling planners for the last decade. *See e.g.,* Pennell, *Recent Wealth Transfer Developments*, ABA REAL PROP., PROB. & TR. LAW SECTION 14TH ANN. EST. PL. SYMPOSIUM, at 21-23 (2003). Up to this point, however, the IRS and all of the prior §2036 FLP cases have avoided that technical analysis by merely including assets contributed to an FLP in the estate under §2036 and not *also* including the retained partnership interest itself in the estate under §2033. (Indeed, even in this case, the IRS did not argue that the assets should be included under §2036 and that the 99% interest should also be included under §2033 to the extent the transfer under the power of attorney was not valid (because gifts were authorized only up to the annual exclusion amount).)

The IRS has previously ruled that life insurance proceeds received by a partnership should be not includible in the gross estate *both* under §2042 and under §2033 as to the decedent's partnership interest under the reasoning that "unwarranted double taxation" would otherwise result. Rev. Rul. 1983-147 (quoted below). Similarly, the regulations regarding GRATs state that if the GRAT assets are included under §2036, the retained annuity interest payments that are payable after the decedent's death are not also included under §2033 "because they are properly reflected under this section." Reg. §20.2036-1(c)(1)(i).

Dictum. The analysis is not central to the conclusion that §2036(a)(2) applies, and in that respect may be treated as dictum.

Appreciation. The big distinction of applying the §2036/2043 and §2033 inclusion analysis is that future appreciation of assets contributed to the FLP/LLC will result in double taxation. See Paragraph 6 above of the Analysis of the Majority Opinion. More value may be included in the gross estate than if the decedent had never contributed assets to the FLP. That issue was not raised in this case, because the parties stipulated that the date of contribution value and the date of death value (7 days later) were the same. Whether a court would actually tax the same appreciation multiple times (or whether the IRS would even make that argument), in a case in which the majority's analysis is applied is (hopefully) doubtful. For example, in Revenue Ruling 1983-147, the IRS refused to include life insurance proceeds payable to a partnership both as part of a partner's interest in the partnership and under §2042 as a result of incidents of ownership attributed to the decedent as partner of the partnership, because doing so would result in "unwarranted double taxation":

> In *Estate of Knipp v. Commissioner*, 25 T.C. 153 (1955), *acq. in result*, 1959-1 C.B. 4, *aff'd on another issue* 244 F.2d 436 (4th Cir. Cir), *cert denied*, 355 U.S. 827 (1957), a partnership held 10 policies on the decedent's partner's life, at his death…. The court found that the decedent, in his individual capacity, had no incidents of ownership in the policies, and held that the insurance proceeds were not includible in the gross estate under the predecessor to section 2042(2) of the Code. The Service acquiesces in the result of *Estate of Knipp* on the basis that in that case the insurance proceeds were paid to the partnership and inclusion of the proceeds under the predecessor of section 2042 would have resulted in the **unwarranted double taxation** of a substantial portion of the proceeds because the decedent's proportionate share of the proceeds of the policy were included in the value of the decedent's partnership interest. See also section 20.2042-1(c)(6) of the regulations (which adopts a similar rule with regard to life insurance proceeds paid to or for the benefit of a corporation). (Emphasis added)

Judge Counting. The *Powell* opinion was a plurality opinion in that the majority opinion was not joined in by a majority of the judges. Seven judges joined Judge Halpern's majority opinion espousing double inclusion with 2 judges concurring in result only. Six judges joined Judge Lauber's concurring opinion rejecting double inclusion. Therefore, the vote was 8-7-2, and Judge Halpern is a Senior Judge who is not one of the 16 "regular" Tax Court judges. Therefore, we do not yet know how a majority of the Tax Court judges would rule regarding the double inclusion issue.

Emboldened IRS? The fact that eight judges adopted the double inclusion analysis may embolden the IRS to take that position in future cases, even though we do not yet know how a majority of the Tax Court judges would rule as to that issue. This raises a risk that contributing assets to an FLP (or for that matter, any entity) may leave a taxpayer in a significantly worse tax position than if the taxpayer merely retains the assets.

14. **Reduced Emphasis on Not Retaining Any Interest as General Partner or Manager.** As a result of concerns raised by the *Strangi* and *Turner* cases applying §2036(a)(2) when the decedent held an interest as general partner or manager, planners have discouraged clients from keeping any interest as a general partner or manager of an FLP or LLC. If a client insists on having some participation in management of the FLP/LLC, planners have encouraged the client to minimize the interest as general partner or manager as much as possible. The importance of eliminating or minimizing management participation by the client may be reduced under *Powell*, to the extent it is interpreted as applying §2036(a)(2) in any event as long as the client continues to hold any limited partnership or member interest in the FLP/LLC. All seventeen of the judges participating in the *Powell* decision agreed that §2036(a)(2) should apply in a situation in which the decedent held NO interest as general partner. One possible approach in light of this result is to emphasize reliance on the bona fide sale for full consideration exception rather than avoiding "strings" that could trigger the application of §2036(a)(2). (However, the transferor's retention of substantial control of the FLP/LLC may color the court's perception of whether a legitimate and significant nontax reason existed for creating the FLP/LLC, depending on the nontax reasons for which the entity is created.)

15. **Basis Implications**. To the extent that partnership assets are included in a decedent's estate under §2036, the assets should receive a basis adjustment inside the partnership "to reflect the value of the property that was included in … the estate" even without a §754 election for the partnership. *Hurford Investments No 2, Ltd. v. Commissioner*, Tax Court Docket No. 23017-11 (Order dated April 17, 2017); Letter Ruling 200626003. *See* Gorin, *Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications*, ¶ II.Q.8.e.iii.(b) at 928 n.3635 (June 2017).

    Prof. Elaine Gagliardi has observed that differing basis results could occur under Judge Halpern's "double inclusion" analysis (including the amount of the discount under §2036(a)(2) and including the discounted value of the partnership interest under §2033) and under Judge Lauber's concurring opinion analysis (including all of the partnership asset value under §2036(a)(2) and not also including the partnership interest because it is "an alter ego" of the partnership assets). See Elaine Gagliardi, *Planning With Family Limited Liability Entities in 2018 and Beyond*, SEATTLE 63RD ANN. EST. PL. SEMINAR, ch. 5 at 5-21 to 5-27 (November 2018).

    Judge Lauber Approach (The Traditional Approach). The partnership **assets** included in the estate without a discount should receive a basis adjustment under §1014(b)(9) (for the undiscounted value of assets included in the decedent's gross estate). The retained partnership **interest** should also be adjusted to the date of death value of the interest (reflecting any appropriate discounts). Even though the interest is not included in the gross estate for estate tax purposes, it is still property owned by the decedent under state law and that is "acquired from" the decedent, so the basis is adjusted under §1014(b)(1). (*See* Rev. Rul. 84-139 & General Counsel Memo 39320 (1985) (foreign property not in the U.S. gross estate still entitled to basis adjustment under §1014(b)(1). Prof. Gagliardi raises the interesting issue of how the "zero basis rule" announced in the basis consistency proposed regulations, Prop. Reg. §1.1014-10(e), would be applied in this context, in which the partnership interest is not also included in the decedent's gross estate.). Thus, the estate's share of the "inside basis" of partnership assets may be greater than the estate's "outside basis" in the partnership interest, suggesting that a §754 election should not be made if that can be avoided. Prof. Gagliardi applies these results to a simplified example, assuming the decedent had transferred assets worth $100 and having a basis of $40 to the partnership in return for a partnership interest worth $75 (25% discount). The inside basis of the estate's interest in the partnership assets would be $100, and the outside basis in the partnership interest would be $75.

Judge Halpern Approach. In determining the inside basis of partnership **assets**, only the portion of the assets attributable to the discount on the date of the transfer is included in the estate under §2036(a)(2). That portion of the assets is adjusted to the date of death value, but the balance of the assets attributable to the decedent's interest keeps the same basis as before death. The estate's outside basis in the partnership **interest** is the discounted fair market value of the partnership interest at death. Applying this result to Prof. Gagliardi's simplified example, the inside basis of the estate's interest in the partnership assets would be comprised of two elements. The $25 amount included in the estate under §2036(a)(2) would have a basis of $25, and the remaining 75% of the assets would have a proportionate basis of $30 (75% of the original $40 basis), for a total of $55 ($25 + $30). The outside basis of the estate's partnership interest would be $75. (In that situation, a §754 election would be desirable, to step up the inside basis of the estate's interest in partnership assets to $75.)

16. **Summary of Practical Planning Implications**. Lou Harrison (Chicago, Illinois) provides an outstanding summary of the practical planning implications of *Powell*:

> The holding in the case is bad, but in many regards restates the Tax Court's antipathy toward sham partnerships. Essentially, the court expands the potential reach of 2036(a)(2) to just about any family partnership. This conclusion is a result of a limited partner's ability to participate in the liquidation decision of the partnership (and of course this will be based on what the default rule and state law provides).
>
> But do not fret. To get out of 2036, and therefore, to have the discount respected, the partnership can still fall within the "bona fide sale for an adequate and full consideration" exception. To be bona fide, the partnership has to have economic substance apart from the tax savings. In essence, then, the Court is merely restating its prior view and holding towards partnerships.
>
> In months to come, practitioners will slice and dice the meaning of this opinion in their various Planning Vegematics. But realistically, the court could have saved us a lot of agony by just saying what was on their mind, specifically: "A family partnership that is clearly a sham, such as a 99% retained marketable asset partnership, will not be respected for discounting purposes." But then again, if lawyers and courts could talk like most human beings, what would be the value of having law schools?
>
> The good news from this case is that a partnership that has economic substance will likely still enjoy the discounting benefit. Louis S. Harrison, *Stupid Is As Stupid Does: Does the* Powell *Case Spell The Demise of Discount Partnership Planning or Does It Merely Restate What We Already Know?*, 20 J. PASSTHROUGH ENTITIES (July/Aug. 2017).

17. **Prior Cases That Have Limited the Broad Application of the "In Conjunction with" Phrase in §§2036 and 2038**. Section 2036(a)(2) was enacted with almost identical "in conjunction with" language as in §2038. Several §2038 cases have limited the application of this provision in determining whether a decedent held a joint power to terminate a trust. For example, a power conferred by state law to revoke or terminate a trust with the consent of all beneficiaries is not taxable. *Helvering v. Helmholz*, 296 U.S. 93 (1935), *aff'g* 75 F.2d 245 (D.C. Cir. 1934) (reasoning that this power exists under state law in almost all situations, and to hold otherwise would cause all trusts to be taxable). (This exception seems analogous to the power under state law of all partners to agree to amend the partnership agreement or to cause the liquidation of the partnership.) Another example is *Tully Estate v. Commissioner*, 528 F.2d 1401 (Ct. Cl. 1976). In *Tully*, decedent was a 50% shareholder. The corporation and decedent entered into a contract to pay a death benefit to

the decedent's widow. Even though the beneficiary designation was irrevocable, the IRS argued that it could be amended for several reasons, including that the decedent and the other 50% shareholder could cause the corporation to agree with the decedent to change the beneficiary. The court's analysis is analogous to the broad extension of §2036(a)(2) to FLPs:

> In light of the numerous cases where employee death benefit plans similar to the instant plan were held not includable in the employee's gross estate, we find that Congress did not intend the 'in conjunction' language of section 2038(a)(1) to extend to the mere possibility of bilateral contract modification. Therefore, merely because Tully might have changed the benefit plan 'in conjunction' with T & D and DiNapoli, the death benefits are not forced into Tully's gross estate. 528 F.2d at 1404-05.

Another example is *Estate of Bowgren v. Commissioner*, T.C. Memo. 1995-447, *rev'd and remanded on other grounds*, 105 F.3d 1156 (7th Cir. 1997). In *Bowgren*, the decedent transferred real estate to a land trust and later gave beneficial interests in the trust to her children. The court held that when

> the only method by which the decedent could have terminated or modified the beneficial interests of the children was to act not by herself … but as a beneficiary with the unanimous consent of the children, i.e., all the other beneficiaries … [s]uch a power is not a retained power under section 2036(a)(2), see Stephens, Maxfield, Lind & Calfee, Federal Estate and Gift Taxation 4-148 n.52 (6 th ed. 1991), and is a power to which section 2038(a) does not apply, see sec 20.2038-1(a)(2).

A possible distinction of applying the logic of these §2038 cases to the "in conjunction with" language in §2036(a)(2) is that the regulations under §2038 specifically state that a settlor's ability to act in concert with all donees/beneficiaries is not a retained power under §2038, but the analogous provisions in the regulations under §2036 regulations do not include that same statement. *See* Reg. §§20.2038-1(a)(2) (§2038 does not apply "[i]f the decedent's power could be exercised only with the consent of all parties having an interest (vested or contingent) in the transferred property, and if the power adds nothing to the rights of the parties under local law"); 20.2036-1(b)(3). However, applying the "in conjunction with" clause in a different manner in those two situations does not seem supportable under any policy rationale.

18. **Supreme Court's Refusal to Apply §2036(a)(2) in a Broad Manner in *U.S. v. Byrum*.** In *U.S. v. Byrum,* 408 U.S. 125 (1972), the Supreme Court held that a decedent's right to vote shares of stock in three corporations that he had transferred to a trust for the benefit of his children did not cause the value of those shares to be included in the value of his estate under §2036(a)(2). The Court rejected the government's argument that the decedent's ability to vote the transferred shares gave the decedent the power to impact the corporation's dividend policy and thus the trust's income (or the trust beneficiaries' ability to enjoy the income). Section 2036(a)(2) requires that the decedent retained the "right" to designate who could enjoy the transferred property or its income, and *Byrum* reasoned that the term "right" "connotes an ascertainable and legally enforceable power," and the power to use the ability to vote the majority shares to influence corporate directors regarding the flow of dividends "was neither ascertainable nor legally enforceable and hence was not a right in any normal sense of that term." The Court observed in footnote 14 of its opinion "that restraints on the exercise of power … deprive the person exercising the power of a 'right' to do so." Among other things, the Court noted that the decedent, as the controlling shareholder of each corporation, owed fiduciary duties to the minority shareholders that circumscribed his influence over the corporations' dividend policies. Furthermore, even if the corporation made dividend distributions, the trustee (not the decedent) would decide whether to make distributions to the trust beneficiaries.

The IRS's own published summary of *Byrum* is in Rev. Rul. 81-15, 1981-1 C.B. 457. That Revenue Ruling revoked Rev. Rul. 67-54, which had held that transferring nonvoting stock, while retaining voting stock, would result in the transferred nonvoting stock being included in the estate under §2036(a)(2). The prior Rev. Rul. was revoked in light of the *Byrum* case. The following is the complete discussion in Rev. Rul. 81-15 of the IRS's interpretation of the *Byrum* case:

> In *United States v. Byrum*, the Supreme Court addressed the issue of includibility of transferred stock where the decedent had transferred the stock in trust, retaining the right to vote the transferred shares, the right to veto the sale or acquisition of trust property and the right to replace the trustee.
>
> The court concluded that because of the fiduciary constraints imposed on corporate directors and controlling shareholders, the decedent "did not have an unconstrained *de facto* power to regulate the flow of dividends, much less the right to designate who was to enjoy the income." See *Byrum, supra* at 143.
>
> Thus, *Byrum* overruled the proposition on which Rev. Rul. 67-54 was based; that is, that a decedent's retention of voting control of a corporation, coupled with restrictions on the disposition of the stock, is equivalent to the right to designate the person who shall enjoy the income.

This statement was included in the Supreme Court's majority decision despite the Supreme Court's acknowledgement in footnote 25 that its conclusion was not based just on the premise that "the general fiduciary obligations of a director are sufficient to eliminate the power to designate with the meaning of § 2036(a)(2)."

Revenue Ruling 81-15 has not been modified or withdrawn. Therefore, the most recent official guidance as to the interpretation of the *Byrum* case is "that *because of the fiduciary constraints imposed on corporate directors and controlling shareholders*, the decedent did not have an unconstrained de facto power to regulate the flow of dividends, much less the right to designate who was to enjoy the income." (Emphasis added). Furthermore, under CC-2003-014, Chief Counsel attorneys cannot argue contrary to "final guidance," which includes Revenue Rulings.

19. **Detailed Discussion of Prior FLP/LLC Cases That Have Addressed §2036(a)(2**). Four cases have addressed the application of §2036(a)(2) to FLP/LLC assets, *Kimbell, Strangi, Mirowski, and Turner.* These four prior cases are summarized in some detail below.

    a. **IRS Previously Often Has Not Argued That §2036(a)(2) Applies.** As a practical matter, the IRS has not previously seemed to be pressing hard on §2036(a)(2) claims, but has generally attacked FLPs/LLCs using §2036(a)(1). For example, in *Mirowski v. Commissioner* the IRS did not even argue that the decedent's serving as the sole manager of the LLC by itself triggered §2036(a)(2). (Instead, the IRS tried to point to language in the agreement suggesting that the manager could make disproportionate distributions, and the court rejected even that argument and held that §2036(a)(2) did not apply to gifts of LLC member interests.) However, the IRS has sometimes made the §2036(a)(2) argument in addition to other arguments under §2036(a)(1).

    b. ***Strangi v. Commissioner***. In *Estate of Strangi v. Commissioner*, T.C. Memo. 2003-15, *aff'd*, 417 F.3d 468 (5th Cir. 2005), the Tax Court held that §2036(a)(1) applied and also held that §2036(a)(2) applied to transfers to the corporation that was the general partner and to the partnership. T.C. Memo 2003-145. (This is the Tax Court opinion on remand from the Fifth Circuit's initial decision in *Strangi*, directing the Tax Court to consider the §2036 issue.) Judge Cohen's discussion of §2036(a)(2) is the most expansive application of that section in any estate tax case up to that time, and drew considerable criticism from tax planners and academics. The Fifth Circuit's affirmance of *Strangi* did not address §2036(a)(2). (Because §2036(a)(1) applied, the court did not reach the alternative §2036(a)(2) issue.)

Factors Causing §2036(a)(2) Inclusion in *Strangi*. Judge Cohen analyzed in detail the facts of *Strangi* compared to the facts in the *Byrum* case. In *Strangi*, 98% of the decedent's wealth (about $10 million) was contributed to a partnership having a corporation as the 1% general partner and decedent as 99% limited partner. The corporation was owned 47% by the decedent, 52% by family members, and 1% by a charity (which the court ignored as de minimis).

Problematic Retained Powers. Judge Cohen concluded that the decedent retained legally enforceable rights to designate who shall enjoy property and income from the partnership and corporation. Judge Cohen emphasized that it is immaterial whether the documents and relationships create rights exercisable by decedent alone or in conjunction with other corporate shareholders and the corporation's president.

Partnership income — the agreement gave the general partner "sole discretion to determine distributions."

Partnership property — decedent can act together with the other shareholders to dissolve the partnership. (Under the partnership agreement, the partnership is dissolved by unanimous vote of limited partners and the general partner. Under the corporation's bylaws, all of the corporation's shareholders must consent to dissolution of the partnership. Thus, decedent could act in his capacity as a limited partner and shareholder with the other owners to dissolve the partnership.)

Corporation property and income (of the corporate general partner) — decedent "held the right, in conjunction with one or more other Stranco directors, to declare dividends."

"Banding together" is sufficient. Taxpayers argued that if the mere fact that a decedent "could band together with all of the other shareholders of a corporation" is sufficient to cause inclusion under § 2036(a)(2), then the Supreme Court could not have reached its decision in *Byrum*. The court responded with an analysis of the additional constraints in *Byrum* that were not present in *Strangi*.

Comparison to *Byrum*. Judge Cohen pointed to various additional constraints upon "rights to designate" in *Byrum.* Commentators, however, suggest that the key rule from *Byrum* is the announcement of a bright-line test turning on whether the grantor's retained powers were legally enforceable. "The [Supreme] Court's ensuing discussion of the variety of constraints that typically narrow the scope of a majority shareholder's ability to control the flow of dividends was an explication of the rationale for its bright-line test, not a listing of elements that must be present in every case if the section is to be rendered inoperative." Gans & Blattmachr, Strangi*: A Critical Analysis and Planning Suggestions*, 100 TAX NOTES 1153, at 1157 (Sept. 1, 2003).

- **Independent Trustee.** In *Byrum*, the decedent retained the right to vote stock, which could be used to elect directors, who decided what distributions would be made from the corporation. However, the stock was given to a trust with an independent trustee who had the sole authority to pay or withhold income. Under the *Strangi* facts, distribution decisions were made by the corporate general partner.

- **Economic and Business Realities.** The flow of funds in *Byrum* was dependent on economic and business realities of small operating enterprises that impact the earnings and dividends. "These complexities do not apply to [the partnership or corporation], which held only monetary or investment assets."

- **Fiduciary Duties**. Judge Cohen distinguished fiduciary duties in *Byrum* because there were unrelated minority shareholders who could enforce these duties by suit. "Intrafamily fiduciary duties within an investment vehicle simply are not equivalent in nature to the obligations created by the *United States v. Byrum*, *supra*, scenario."

"In Conjunction With" Broad Application. The court, to a larger extent than any previous §2036(a)(2) case, interpreted the "in conjunction with" language in the statute and regulations very broadly. The court's analysis, when pushed to its extreme, would mean that any family entity could be ignored under §2036(a)(2) because the decedent — regardless how small of an interest that the decedent held — would hold the power, "in conjunction with others" to vote its interest as a member of the entity (i) to affect indirectly when income distributions would be made, and (ii) to liquidate the entity and distribute its assets. An extension of this analysis could ultimately lead to negating any fractionalization discounts where family members hold the other interests in an asset. (For example, the taxpayer could act "in conjunction with" other family owners to sell the asset, thus avoiding or minimizing any minority or marketability discounts. This basically yields the result — under §2036 rather than under a valuation approach — that the Treasury Department has pushed in several different legislative sessions, but that has, so far, been rejected by Congress.) It seems very doubtful that courts will extend the application of §2036 in this manner to negate fractionalization discounts.

c. **Attempt in *Strangi* to Limit *Byrum*'s Fiduciary Duty Analysis If There Are No Unrelated Owners**. *Byrum* was decided against the backdrop of numerous cases that had established that §2036(a)(2) would not apply if the decedent had the discretion to make distributions that were limited by an ascertainable standard. The IRS issued Rev. Rul. 73-143, 1973-1 C.B. 407 soon after *Byrum* was decided. That Revenue Ruling explicitly agreed to an ascertainable standard exception to §2038 where the decedent could make distributions for the support and education of the beneficiary, even though only family members are beneficiaries. Further, the fact that other partners were family members should not diminish the importance of the fiduciary duties.

> …a fiduciary duty is no less constraining simply because it is owed to a family member…Most critical, the Service appears to have endorsed this reading of *Byrum* in a published ruling as well. In Rev. Rul. 81-15, invoking *Byrum's* fiduciary-duty analysis, the Service concluded that § 2036(a)(2) did not apply in the case of corporate stock where the decedent had retained voting rights even though the only shareholders were apparently the decedent and a family trust created by the decedent. Gans & Blattmachr, *Strangi: A Critical Analysis and Planning Suggestions*, 100 TAX NOTES 1153, at 1159 (Sept. 1, 2003).

The Tax Court has previously rejected arguments by the IRS that the presence of unrelated minority shareholders lent substance to the decedent's fiduciary duty that was critical to the outcome of the *Byrum* case. *Estate of Gilman v. Commissioner*, 65 T.C. 296 (1975), *aff'd per cur.*, 547 F.2d 32 (2nd Cir. 1976) (no estate inclusion; decedent was co-trustee with power to vote stock; there was active conduct of a business and 40% of voting shares of corporation were held by sisters and there was family disharmony); *Estate of Cohen*, 79 T.C. 1015 (1982) (§2036(a)(2) did not apply to decedent as co-trustee of a Massachusetts real estate trust; because courts hold business trustees to a "fair standard of conduct," and the decedent and his sons [as co-trustees] did not have the power to withhold dividends arbitrarily).

Holding that fiduciary duties provide a limit on the right to designate who enjoys or possesses transferred property only if there are unrelated persons who can enforce those duties is inconsistent with many cases that have held that very broad administrative powers retained by a donor as trustee do not invoke §2036, primarily because of the restriction imposed by the fiduciary duties that were legally enforceable. Those cases involve trust transactions that do not involve any unrelated parties. *E.g. Old Colony Trust Co. v. U.S.*, 423 F.2d 601, 603 (1st Cir. 1970) (broad trustee administrative powers that could "very substantially shift the economic benefits of the trust" did not invoke §2036(a)(2) because such powers were exercisable by the donor-trustee in the best interests of the trust and beneficiaries, and were subject to court review).

Judge Cohen's narrow interpretation of the *Byrum* case in *Strangi* is far more restrictive than the IRS's published position on *Byrum* in Rev. Rul. 81-15, 1981-1 C.B. 457 (quoted in Paragraph 16 above).

d. ***Kimbell v. U.S.*** *Kimbell v. U.S.* refused to apply §2036(a)(2) to include LLC assets in the decedent's gross estate. *Kimbell v. U.S.,* 371 F.3d 257, 268 (5th Cir. 2004), *rev'g,* 244 F. Supp. 2d 700 (N.D. Tx. 2003). The decedent formed an FLP, retaining 99% limited partnership interest. The 1% general partner was an LLC, owned 50% by the decedent (her son and daughter-in-law each owned 25%). The son was manager of the LLC. The court addressed whether assets contributed to the FLP and to the LLC should be included in the decedent's estate under §§2036(a)(1) or (a)(2).

The district court concluded that the bona fide sale for full consideration exception under §2036 did not apply and that the FLP assets were included in the decedent's estate under §§2036(a)(1) and 2036(a)(2). (The district court did not specifically address the reasons that §2036 applied to the LLC assets.) As to the §2036(a)(1) & (a)(2) analysis, the district court reasoned that the partnership agreement provided that 70% of the limited partner interests could remove the general partner, so the decedent's 99% limited partnership interest allowed the decedent to remove the general partner and appoint herself or someone of her choosing as the new general partner, who in turn had the sole discretion to decide on distributions of income from the partnership. Therefore, the decedent "retained the power to either personally benefit from the income of the partnership or to designate the persons who would benefit from the income of the partnership, and thus runs afoul of both § 2036(a)(1) and § (2)." The taxpayer argued that *Byrum*'s fiduciary duty analysis should forestall the application of §2036, but the district court observed that the partnership agreement stated that the general partner did not owe a fiduciary duty to the partnership or other partners, and in any event the decedent could remove the general partner and appoint herself as general partner and "would not owe a fiduciary duty to the other Partners who, in any case, own only a miniscule share of the Partnership. Assuming such fiduciary duties exist, to whom does a party which owns 99% of the Partnership owe them?"

The Fifth Circuit reversed the district court's decision that "(1) family members cannot enter into a bona fide transaction, and (2) a transfer of assets in return for a pro rata partnership interest is not a transfer for full and adequate consideration." Because the bona fide sale for full and adequate exception applied for transfers to the partnership, the court did not need to address whether the decedent retained an interest to which §2036(a)(1) or (a)(2) would apply for transfers to the partnership.

In analyzing transfers to the LLC, however, the Fifth Circuit did not address whether the bona fide sale for full and adequate consideration exception applies to transfers. Instead, the court held that even if the exception does not apply, the decedent did not retain sufficient control of the assets transferred to the LLC to make her transfer subject to §2036(a), because she only held a 50% interest in the LLC and her son had sole management powers over the LLC. There was no specific discussion of the LLC transfers in the district court opinion. If the Fifth Circuit was suggesting that a pure control test should be used to gauge whether a decedent has retained a right to designate who can possess or enjoy property, that approach is suspect, because the *Byrum* decision rejected a "control" standard in applying §2036(a)(2):

> The 'control' rationale, urged by the Government and adopted by the dissenting opinion, would create a standard—not specified in the statute—so vague and amorphous as to be impossible of ascertainment in many instances.

A strict control test makes no sense, because many courts have blessed transfers to trusts, with the grantor as trustee with complete control over trust distributions, as long as distributions may be made only under a determinable standard. Perhaps the Fifth Circuit was just saying that the decedent had no ability at all to designate who could possess or enjoy property where she was only a 50% member and not the sole manager. Therefore, there was no need to address whether any power at all to designate would rise to the level of a "right to designate," taking into consideration any fiduciary or other limitations on the exercise of that power.

The Fifth Circuit's analysis of §2036(a)(2) is inconsistent with an extremely broad application of the "in conjunction with" language in §2036(a)(2) suggested in *Strangi*. Judge Cohen's *Strangi* analysis, if pushed to its limits, would suggest that retaining even a 1% limited partnership interest could risk inclusion of the entire partnership contribution because that 1% limited partner, in conjunction with all other partners, could dissolve and liquidate the partnership at any time. The *Kimbell* decision would not agree with that theory, indicating that even a 50% member interest in an LLC, where the decedent was not the sole manager, would not cause inclusion under §2036(a)(2).

The Fifth Circuit stayed the appeal of *Strangi* pending the resolution of *Kimbell.* Following the Fifth Circuit's decision in *Kimbell*, the Fifth Circuit subsequently affirmed *Strangi* based on §2036(a)(1)¸ without any discussion of the §2036(a)(2) analysis.

e. ***Estate of Mirowski v. Commissioner***. *Estate of Mirowski v. Commissioner*, T.C. Memo. 2008-74 addressed whether §2036 applied to original transfers to an LLC and whether §§2036 or 2038 applied to 48% gifts of LLC interests. The decedent was the sole general manager of the LLC. As to the original transfers to fund the LLC, the court determined that the bona fide sale for full consideration applied. As to the assets attributable to the 48% gifts of LLC interests, the full consideration exception obviously did not apply.

The IRS argued under §2036(a)(2) that the decedent kept the right to designate who could possess or enjoy the transferred property or the income therefrom as to the 48% interests that were given to the daughters' trusts. The IRS pointed to the decedent's right to dispose of assets in the ordinary course of business (with the approval of the daughters), and the decedent's power as majority member owner to determine the timing of the distribution of capital transaction proceeds. The IRS also argued that the LLC assets should be included in the decedent's estate under §2038.

[Observation: The IRS did not argue that merely being the sole general manager of an LLC results in keeping proscribed powers under §2036(a)(2) or §2038.]

The court said that it rejected that argument for the same reasons it gave for the similar argument as to the express retention of a §2036(a)(1) right under the same general reasoning. Similarly, the court rejected the government's argument under §2038 that the decedent had the power acting alone or in conjunction with another person to alter, amend, revoke, or terminate the transfer. The IRS gave the same reasons as under its §2036(a)(2) argument, and the court summarily rejected the arguments for the same reasons as under the §2036(a)(2) analysis.

The reasoning under the court's §2036(a)(1) analysis that it relied on to reject the application of §§2036(a)(2) and 2038 that the court relied on included that the decedent was the general manager, and the general manager had sole authority to manage the LLC affairs, including the authority to determine the timing and amounts of distributions. The LLC operating agreement said that except as otherwise provided, "the timing and the amount of all distributions shall be determined by the Members holding a majority of the Percentages then outstanding." The court responded that the general manager has a fiduciary duty under state law. Also, other provisions of the operating agreement require pro rata allocations of profit and loss and pro rata distribution of capital proceeds from capital transactions. Furthermore, the authority to determine the timing and amounts of all distributions was a power given to the majority members, not the general partner. Even as to the decedent's authority as the majority holder of the member interests, the section referring to determining the timing and amounts of distributions is subject to other provisions of the operating agreement, including pro rata distribution of "cash flow," pro rata allocation of profit and loss, and pro rata distribution of capital proceeds from capital transactions.

f. ***Estate of Turner v. Commissioner***. *Estate of Turner v. Commissioner*, T.C. Memo. 2011-209) followed *Strangi* in applying §2036(a)(2) in a broad manner to the decedent's interest as general partner (in addition to holding that the FLP assets would be included under §2036(a)(1)). (As in *Strangi*, the §2036(a)(2) discussion may technically be dictum in that the court had already decided that the assets would be included in the gross estate under §2036(a)(1). *Powell'*s application of §2036(a)(2) clearly is not dicta; the court declined to consider §§2036(a)(1) and 2038 because it had held that §2036(a)(2) applied.)

In *Turner,* the decedent and his wife transferred marketable securities and investment assets to a family limited partnership in return for the 1% general partnership interest and 99% limited partnership interests (owned equally by them). They retained assets, the income from which was sufficient to provide their living expenses (but some partnership assets were used for the benefit of the decedent and his wife). In late 2002 and early 2003, the decedent and his wife made gifts of 43.6% limited partnership interests to family members.

The court (Judge Marvel) concluded that that one-half of the partnership assets (representing the decedent's one-half of the assets contributed to the partnership) were included in the decedent's estate under §2036(a)(1) and also under §2036(a)(2). The bona fide sale exception to §2036 did not apply. The court rejected the purported nontax reasons urged by the estate: asset consolidation and centralized management, resolving family disputes, and asset protection for one grandchild.

The *Turner* court acknowledged that a transferor's retention of the right to manage transferred assets does not necessarily require inclusion under §2036(a)(2), citing *Byrum* and *Schutt v. Commissioner.* However, the court gave no further analysis whatsoever of limits imposed by *Byrum,* in particular.

One of the reasons given by the court for applying §2036(a)(2) was that the decedent effectively was the sole general partner. (In footnote 28, the court acknowledged that the decedent's wife was an equal co-general partner, but the court concluded that even if it were to treat her as a "coequal" general partner, it would reach the same conclusion because §2036 (a)(2) applies if the power is held "alone or in conjunction with any person.") This again raises the specter of applying the "in conjunction with" language broadly that was addressed in *Strangi.*

The court mentioned three powers that the general partner had, without giving any weight to how important each was in triggering §2036(a)(2). Those powers were:

- The sole and absolute discretion to make pro rata distributions of partnership income (in addition to distributions to pay federal and state tax liabilities);
- To make distributions in kind; and
- To amend the partnership agreement at any time without the consent of the limited partners. (Even if the consent of limited partners had been required to amend the agreement, the court observed that the decedent and his wife retained more than 50% of the limited partnership interests and could make any decision requiring a majority vote of limited partners.)

Perhaps the court was focusing on the general partner's unilateral power to amend the partnership agreement, which is not a typical provision in family limited partnership agreements. If that is the case, the court conclusion would not have broad application to family limited partnership planning.

The most recent case in the *Turner* saga, *Turner III*, holds that the marital deduction that is allowed with respect to partnership interests owned by the decedent at death is not reduced by estate taxes on the assets attributable to limited partnership interests that had been given away to family members other than the spouse (included in the gross estate under §2036). The court reasoned that the executor has the right to recover estate taxes on §2036 property from persons who received the property during the decedent's lifetime, and the decedent's will expressed an intent that the marital deduction should not be reduced by estate tax liabilities. In addition, *Turner III* holds that the marital deduction is not increased by the amount of post-death income on the marital deduction property. *Estate of Turner v. Commissioner*, 151 T.C. No. 10 (November 20, 2018) (Judge Marvel).

g. **Section 2036(a)(2) Arguments Made in *Black v. Commissioner***. The IRS's brief in *Black v. Commissioner* [133 T.C. 340 (2009)] made the argument suggested in the lower court *Strangi* opinion that the decedent's power, "in conjunction with others" triggered §2036(a)(2). In *Black*, the decedent was the 1% general partner and his son was a 0.5% general partner. The decedent held 77% of the limited partner interests at his death. The brief argued that the FLP could be dissolved and liquidated on the approval of all partners, and the decedent, "in conjunction" with the other partners could have amended the partnership agreement or simply dissolved the partnership and accelerated the enjoyment of the partnership's assets. Furthermore, the IRS argued that the decedent, acting alone as the holder of a majority of limited partnership interests, retained the right to approve transactions not in the ordinary course of business.

> Each of these rights conferred by the BILP agreement constitutes the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the transferred assets or the income therefrom during the decedent's lifetime for purposes of §2036(a)(2)…. And none of these rights were circumscribed by any meaningful fiduciary duty [citing a provision in the agreement that the managing partner will be indemnified for all claims except those based on gross negligence, fraud, deceit or wrongful taking]…. Stated another way, on these facts, the existence of limited fiduciary duties is not a meaningful constraint on the powers conferred under the BILP agreement. Opening Brief of Respondent at 112 (Feb. 22, 2008), *Estate of Black v. Commissioner*, 133 T.C. 340 (2009).

Black held that the bona fide sale for full consideration exception to §2036 applied, so it did not address the government's §2036(a)(2) argument.

20. **"Scorecard" of §2036 FLP/LLC Cases (14-22, With 2 on Both Sides)**. Of the various FLP cases that the IRS has chosen to litigate, fourteen have held that at least most of the transfers to an FLP qualified for the bona fide sale exception —

(1) *Church v. United States,* 2000-1 USTC ¶60,369 (W.D. Tex. 2000) (preserve family ranching enterprise, consolidate undivided ranch interests);

(2) *Estate of Eugene Stone v. Commissioner*, T.C. Memo 2003-309 (partnerships to settle family hostilities);

(3) *Kimbell v. United States*, 371 F.3d 257 (5th Cir. 2004), *vacating and rem'g* 244 F. Supp. 2d 700 (N.D. Tex. 2003) ("substantial business and other nontax reasons" including maintaining a single pool of investment assets, providing for management succession, and providing active management of oil and gas working interests);

(4) *Bongard v. Commissioner*, 124 T.C. 95 (2005) (placing ownership of closely held company in a single entity for purposes of shopping the company by a single seller rather than by multiple trusts);

(5) *Estate of Schutt v. Commissioner*, T.C. Memo 2005-126 (maintaining buy and hold investment philosophy for family du Pont stock);

(6) *Estate of Mirowski v. Commissioner*, T.C. Memo 2008-74 (joint management and keeping a single pool of assets for investment opportunities);

(7) *Estate of Miller v. Commissioner*, T.C. Memo 2009-119 (continue investment philosophy and special stock charting methodology);

(8) *Keller v. United States*, 2009-2 USTC ¶60,579 (S.D. Tex. 2009) (protect family assets from depletion in divorces);

(9) *Estate of Murphy v. United States*, No. 07-CV-1013, 2009 BL 223971 (W.D. Ark. Oct. 2, 2009) (centralized management and prevent dissipation of family "legacy assets");

(10) *Estate of Black v. Commissioner*, 133 T.C. 340 (2009) (maintaining buy and hold investment philosophy for closely held stock);

(11) *Estate of Shurtz v. Commissioner*, T.C. Memo 2010-21 (asset protection and management of timberland following gifts of undivided interests);

(12) *Estate of Joanne Stone v. Commissioner*, T.C. Memo 2012-48 (desire to have woodland parcels held and managed as a family asset and various other factors mentioned);

(13) *Estate of Kelly v. Commissioner*, T.C. Memo 2012-73 (ensuring equal estate distribution, avoiding potential litigation, and achieving effective asset management); and

(14) *Estate of Purdue v. Commissioner*, T.C. Memo 2015-249 (centralized management and other factors).

All of the FLP cases resulting in taxpayer successes against a §2036 attack have relied on the bona fide sale exception to §2036 except these three cases, *Kelly*, *Mirowski*, and *Kimbell*. *Kelly* relied on the bona fide sale exception to avoid treating the contributions to partnerships as transfers triggering §2036, but reasoned that there was no retained enjoyment under §2036(a)(1) as to gifts of limited partnership interests [that obviously did not qualify for the bona fide sale for full consideration exception].*Mirowski* similarly relied on the bona fide sale exception with respect to contributions to the partnership, but not as to gifts of partnership interests. *Kimbell* relied on the bona fide sale for full consideration exception as to transfers to a partnership, but as to other transfers to an LLC, the Fifth Circuit refused to apply §2036 (the particular issue was about §2036(a)(2)) without addressing whether the bona fide sale for full consideration exception applied to those transfers.

Interestingly, six of those fourteen cases have been decided by (or authored by) two Tax Court judges. Judge Goeke decided the *Miller*, *Joanne Stone*, and *Purdue* cases and authored the Tax Court's opinion in *Bongard*. Judge Chiechi decided both *Eugene Stone* and *Mirowski*. (Judge Wherry decided *Schutt,* Judge Halpern decided *Black*, Judge Jacobs decided *Shurtz*, Judge Foley decided *Kelly*, and *Church* and *Kimbell* were federal district court opinions ultimately resolved by the Fifth Circuit. *Keller* and *Murphy* are federal district court cases.)

Including the partial inclusion of FLP assets in *Miller* and *Bongard*, 22 cases have applied §2036 to FLP or LLC situations: *Estate of Schauerhamer v. Commissioner*, T.C. Memo 1997-242, *Estate of Reichardt v. Commissioner*, 114 T.C. 144 (2000), *Estate of Harper v. Commissioner*, T.C. Memo 2002-121, *Thompson v. Commissioner*, T.C. Memo 2002-246, *aff'd*, 382 F.3d 367 (3d Cir. 2004), *Estate of Strangi v. Commissioner*, T.C. Memo. 2003-15, *aff'd,* 417 F.3d 468 (5th Cir. 2005), *Estate of Abraham v. Commissioner*, T.C. Memo 2004-39, *Estate of Hillgren v. Commissioner*, T.C. Memo 2004-46, Estate of *Bongard v. Commissioner*, 124 T.C. 95 (2005) (as to an LLC but not as to a separate FLP), *Estate of Bigelow v. Commissioner*, T.C. Memo 2005-65, *aff'd*, 503 F.3d 955 (9th Cir. 2007), *Estate of Edna Korby v. Commissioner*, T.C. Memo 2005-102, *aff'd*, 471 F.3d 848 (8th Cir. 2006), *Estate of Austin Korby v. Commissioner*, T.C. Memo 2005-103, *aff'd*, 471 F.3d 848 (8th Cir. 2006), *Estate of Rosen v. Commissioner*, T.C. Memo 2006-115, *Estate of Erickson v. Commissioner*, T.C. Memo 2007-107, *Estate of Gore v. Commissioner*, T.C. Memo 2007-169, *Estate of Rector v. Commissioner*, T.C. Memo 2007-367, *Estate of Hurford v. Commissioner*, T.C. Memo 2008-278, *Estate of Jorgensen v. Commissioner*, T.C. Memo 2009-66, *aff'd*, 431 Fed. Appx. 544 (9th Cir. 2011), *Estate of Miller v. Commissioner*, T.C. Memo 2009-119 (as to transfers made 13 days before death but not as to prior transfers), *Estate of Malkin v. Commissioner*, T.C. Memo 2009-212, *Estate of Holliday v. Commissioner*, T.C. Memo 2016-51, *Estate of Beyer v. Commissioner*, T.C. Memo 2016-183, and *Estate of Powell v. Commissioner,* 148 T.C. No. 18 (2017). In addition, the district court applied §2036 in *Kimbell*, but the Fifth Circuit reversed.