Death and Taxes: The Family Limited Partnership and Its Use in Estate Planning after the Third Circuit's Ruling in Estate of Thompson v. Commissioner

Lauren E. Bishow

Follow this and additional works at: https://digitalcommons.law.villanova.edu/vlr

Part of the Business Organizations Law Commons, and the Estates and Trusts Commons

Recommended Citation
Available at: https://digitalcommons.law.villanova.edu/vlr/vol50/iss5/2

This Issues in the Third Circuit is brought to you for free and open access by Villanova University Charles Widger School of Law Digital Repository. It has been accepted for inclusion in Villanova Law Review by an authorized editor of Villanova University Charles Widger School of Law Digital Repository.
Issues in the Third Circuit

DEATH AND TAXES: THE FAMILY LIMITED PARTNERSHIP AND ITS USE IN ESTATE PLANNING AFTER THE THIRD CIRCUIT’S RULING IN ESTATE OF THOMPSON V. COMMISSIONER

I. INTRODUCTION

In the last decade, courts have increasingly scrutinized the use of the family limited partnership ("FLP") as an estate-planning device.1 While most limited partnerships are formed primarily for business purposes, the formation of an FLP is often motivated by the client’s desire to relieve the burden of the federal estate tax.2 An FLP is a family operated limited partnership that enables the taxpayer to reduce the size of his or her taxable estate.3 The technique for deriving this tax benefit is simple: a taxpayer forms an FLP with family members and contributes assets to the FLP.4 In exchange for this contribution, the taxpayer receives a limited


3. See TOP TAX ISSUES FOR 2005 132 (George G. Jones et al. eds., 2005) [hereinafter TOP TAX ISSUES] (providing definition of FLP); Bowen & Bailey, supra note 2, at 308 (delineating potential FLP members); Daniel H. Ruttenberg, Internal Revenue Code Section 2036(a) and Its Application to Family Entities, at www.smolenplevy.com/2036_paper.pdf (last visited Apr. 11, 2005) (reviewing estate tax advantages accompanying family entities); see also Family Limited Partnerships, supra note 2 (noting nine advantages of FLPS). For a complete discussion of the formation of an FLP, see infra notes 25-36 and accompanying text. For discussion of the tax benefits of forming an FLP and use of an FLP to reduce federal estate taxes, see Bissonette, supra note 1, at 59 and Top Tax Issues, supra note 3, at 140.

4. See LEWIS & CHOMAKOS, supra note 2, at 89, 96-98 (detailing process of contributing assets to FLP). For further discussion of how assets are typically contributed to FLP, see infra notes 33-36 and accompanying text.

(1183)
partnership interest in the FLP.\textsuperscript{5} Upon death, the taxpayer's gross estate includes the value of the limited partnership interest instead of the value of the transferred assets.\textsuperscript{6} A non-controlling interest in a family entity is worth very little on the open market; as such, the estate will apply substantial valuation discounts to the taxable value of the FLP interests, thereby reducing the amount of tax owed at the taxpayer's death.\textsuperscript{7}

The Internal Revenue Service (IRS) argues that discount valuations are abusive in this context because many FLPs are nothing more than tax shelters for affluent taxpayers.\textsuperscript{8} As a result, the IRS has fought vigilantly to curtail this abuse by including the entire value of the assets transferred to the FLP in the decedent's gross estate under Internal Revenue Code (IRC) Section 2036(a).\textsuperscript{9} Section 2036(a) includes all property transferred during the decedent's lifetime in the decedent's gross estate when the decedent failed to abdicate enjoyment of or control over the assets subsequent to the transfer.\textsuperscript{10}

Courts have increasingly favored the IRS's argument in cases where it is clear that a decedent's transfers to an FLP were illusory.\textsuperscript{11} Although

\begin{itemize}
  \item \textsuperscript{5} See \textit{Top Tax Issues}, supra note 3, at 131-32 (discussing formation of FLP through contribution of assets).
  \item \textsuperscript{6} See \textit{Top Tax Issues}, supra note 3, at 140 (noting that estate tax applies to value of partnership interest, not contributed assets).
  \item \textsuperscript{7} See infra notes 56-59 and accompanying text (explaining rational behind lack of control discount for FLP interests); see also Bissonette, supra note 1, at 59 (noting use of family limited partnerships as means of "obtaining a valuation discount for their clients' estates in order to ultimately reduce the estate tax to be paid at death").
  \item \textsuperscript{8} See Terry Eyberg & Barbara J. Raasch, \textit{FLP Planning After Strangi}, Kimbell and Thompson, Tax Adviser, Dec. 2004, at 750 (noting that IRS "litigates FLP cases it perceives as being highly abusive"); Ruttenberg, supra note 3, at 2 (stating that "IRS has found many of these claimed valuation discounts abusive").
  \item \textsuperscript{9} See 26 U.S.C. § 2036(a) (2004). To read the statute in its entirety, see infra note 71 (providing text of Section 2036(a)).
  \item \textsuperscript{10} See Eyberg & Raasch, supra note 8, at 750 (providing brief overview of retained interest argument under Section 2036(a)). For a summary of cases addressing retained interest under Section 2036(a), see infra notes 74-87 and accompanying text. For an analysis of the Third Circuit's interpretation of retained interest under Section 2036(a), see infra notes 139-43 and accompanying text.
  \item \textsuperscript{11} See Estate of Harper v. Comm'r, 83 T.C.M. (CCH) 1641 (2002) (holding Section 2036(a) included assets transferred to FLP in gross estate on grounds that donor/decedent retained lifetime enjoyment of assets and FLP offered no non-tax advantages); Estate of Strangi v. Comm'r (Strangi I), 115 T.C. 478 (2000), aff'd in part, rev'd in part and rem'd in part, (Strangi II), 293 F.3d 279 (5th Cir. 2002) (applying Section 2036(a) in absence of non-tax benefit from transfer); Estate of Reichardt v. Comm'r, 114 T.C. 144 (2000) (holding same as Harper); Estate of Schauerhamer v. Comm'r, 73 T.C.M. (CCH) 2855 (1997) (holding same); cf. Estate of Kimbell v. Comm'r, 371 F.3d 257, 270 (5th Cir. 2004) (holding Section 2036(a) did not include transferred assets in decedent's gross estate where decedent relinquished sufficient control over assets); Estate of Church v. United States, 85 A.F.T.R.2d (RIA) 2000-804, 2000-1 (W.D. Tex. 2000) (holding Section 2036(a) did not apply in absence of finding that donor/decedent retained right to control or enjoyment of transferred assets). For a discussion of the reasoning behind Church's refusal to apply Section 2036(a) to a transfer made to an FLP, see infra
\end{itemize}
transfers to most limited partnerships involve legitimate business objectives, estate-planning goals motivate many FLP related transfers.\textsuperscript{12} When tax advantages motivate a transaction and the donor retains an interest in the transferred property, the courts categorically refuse to include discounted FLP interests in the decedent's gross estate, choosing instead to include the full value of the transferred assets.\textsuperscript{13}

The IRS's Section 2036(a) argument won a recent victory in \textit{Estate of Thompson v. Commissioner}.\textsuperscript{14} a case of first impression for the Third Circuit.\textsuperscript{15} Although the Third Circuit considered Section 2036(a) in other contexts, it never squarely addressed whether Section 2036(a) applied to assets transferred to an FLP prior to \textit{Thompson}.\textsuperscript{16} This Casebrief considers the Third Circuit's interpretation of Section 2036(a) in \textit{Thompson}.\textsuperscript{17} First, Part II explains the procedure for forming an FLP.\textsuperscript{18} Part III then considers the tax and non-tax benefits of forming an FLP.\textsuperscript{19} Part IV discusses prior litigation against FLPs and considers the Tax Court and the Fifth Circuit's conflicting interpretations of Section 2036(a).\textsuperscript{20} Part V discusses the facts in \textit{Thompson} and summarizes the Third Circuit's analysis, with particular emphasis on its interpretation of the bona fide sale exception to

notes 177-81 and accompanying text (providing argument against appropriateness of Section 2036(a) in context of transfers made pursuant to formation of FLP).

12. For further discussion of the IRS's argument, see \textit{supra} notes 8-10 and accompanying text and \textit{infra} notes 69-73 and accompanying text (discussing IRS's preference to include value of assets transferred to FLP in decedent's gross estate under Section 2036(a)).

13. For a further discussion of valuation discounts, see \textit{infra} notes 43-59 and accompanying text (discussing court's refusal to include discounted FLP interests in gross estates).

14. 382 F.3d 369 (3d Cir. 2004).


16. \textit{See Thompson}, 382 F.3d at 369 (considering application of Section 2036(a) to assets transferred to FLP). The only Third Circuit case addressing the application of Section 2036(a) to assets transferred to a family entity is \textit{Estate of D'Ambrosio v. Commissioner}, 101 F.3d 309, 311 (3d Cir. 1996). In \textit{D'Ambrosio}, the court held that assets transferred by the decedent to a family-owned corporation were included in the decedent's gross estate under Section 2036(a). \textit{See id.} (stating holding).

17. For an analysis of the Third Circuit's reasoning and the factors that influenced its application of Section 2036(a), see \textit{infra} notes 135-63 and accompanying text.

18. For an explanation of how to form an FLP, see \textit{infra} notes 25-36 and accompanying text.

19. For an overview of the tax benefits of an FLP, see \textit{infra} notes 41-59 and accompanying text. For an overview of the non-tax advantages of an FLP, see \textit{infra} notes 60-68 and accompanying text.

20. For a narrative of prior litigation against FLPs, see \textit{infra} notes 69-112 and accompanying text (considering precedent for application of Section 2036(a) to assets transferred to FLP). For a discussion of conflicting interpretations of Section 2036(a)'s bona fide sales exception between the Tax Court and Circuit Courts, see \textit{infra} notes 88-112 and accompanying text.
Section 2036(a). Part VI offers a critique of the application of Section 2036(a) to FLP transfers. Finally, Part VII provides a guide for practitioners to follow when forming an FLP in light of Thompson. Overall, this Casebrief argues that, despite the Third Circuit’s strict interpretation of Section 2036(a), the FLP is still an effective estate-planning device when formed for a legitimate business purpose and operated in accordance with the guidelines set forth in Thompson.

II. FORMING AN FLP

An FLP is a limited partnership formed by members of a family. Like all partnerships, FLPs are formed pursuant to state partnership law. There are three steps to forming an FLP: (1) determining partners; (2) drafting a partnership agreement; and (3) funding the FLP. First, the prospective partners must determine which member(s) will act as general partner(s) and which will act as limited partners. As explained below, to

21. For a detailed analysis of the Third Circuit’s opinion in Thompson, see infra notes 135-63 and accompanying text.

22. See infra notes 164-85 and accompanying text (raising argument that Section 2036(a) should not be applied in FLP cases on grounds that transfer of assets to FLP is not type of transfer addressed in Section 2036(a)).

23. For a description of the criteria of a successfully formed and operated FLP, see infra notes 186-215 and accompanying text.

24. For sources supporting the proposition that FLPs remain vital estate planning tools, see infra note 218.

25. See Bowen & Bailey, supra note 2, at 308 (describing FLP as species of partnership formed by family members). FLPs often span generations. See id. (discussing intergenerational nature of many family limited partnerships); see also infra notes 52-54 (discussing relationship between restrictions on right to transfer interests and lack of marketability discounts).

26. See Bowen & Bailey, supra note 2, at 308 (noting state law governs formation of family limited partnerships); see also Lewis & Chomakos, supra note 2, at 100 (stating courts generally respect FLP properly formed under applicable state law).

27. See Bowen & Bailey, supra note 2, at 308-13 (discussing steps necessary to form valid FLP).

28. See id. (characterizing delegation of authority among partners as preliminary concern for FLP formation); see also id. at 308-09 (emphasizing importance of carefully selecting general partner). The distinction between a general partner and a limited partner is primarily one of liability. See Louis A. Mezzullo, Family Limited Partnerships and Limited Liability Companies, 812 TAX. MGMT. (BNA), at A-2 (2004) (recognizing general partner’s liability for debts, obligations and liabilities of limited partnership). To avoid exposing a family member to the liability of general partnership, many families form a second business entity to serve as the general partner. See Top Tax Issues, supra note 3, at 134 (noting that use of general corporate partner can protect personal assets of individual members from creditors); see also Mezzullo, supra, at A-2 (advocating use of entity as general partner to limit liability of individuals). When a limited liability entity serves as general partner, the partners only risk the capital contributed to the corporation or Limited Liability Company (LLC). See Jeffery J. Radowich, Family Limited Partnerships and Other Estate Planning Techniques, in ESTATE PLANNING FOR THE OWNER OF A FAMILY BUSINESS 286, 299 (1998), reprinted from FAMILY LIMITED PARTNERSHIPS, PBI Publication No. 1997-1353 (1997) (discussing use of corporation as general partner).
ensure the availability of certain valuation discounts, it is imperative that
the decedent acted as a limited partner during his or her lifetime.\(^{29}\) Sec-
ond, the partners must draft a partnership agreement.\(^{30}\) The partnership
agreement should clearly state the purpose of the partnership, the rights
and responsibilities of the partners and the allocation of profits and
losses.\(^{31}\) Additionally, the partnership agreement should address the part-
ners’ rights to transfer their partnership interests.\(^{32}\) The third and final
step in forming an FLP is to fund the FLP, which generally occurs in one
of two ways.\(^{33}\) First, the senior family member (usually the mother or fa-
thor) may transfer assets into the partnership in exchange for all of the
interests in the FLP.\(^{34}\) When using this method, the senior member then
gifts his or her limited partnership interest to younger family members.\(^{35}\)
Alternatively, each of the prospective partners may transfer assets into the
FLP in exchange for proportionate partnership interests.\(^{36}\)

29. For a discussion of the relationship between limited partner status and
availability of valuation discounts for lack of control, see infra notes 56-59 and ac-
companying text.

30. See Radovich, supra note 28, at 312 (commenting on partnership agree-
ment). Most states will recognize an oral partnership agreement, but authorities
recommend that the agreement be in written form. See, e.g., Top Tax Issues, supra
note 3, at 139 (recommending that partners draft written partnership agreement);
Radovich, supra note 28, at 297 (detailing aspects of written FLPs); see also Bowen &
Bailey, supra note 2, at 312 (highlighting advantages of written FLPs compared
with oral FLPs).

31. See Top Tax Issues, supra note 3, at 133 (summarizing typical terms of FLP
partnership agreement); see also Lewis & Chomakos, supra note 2, at 160-74 (pro-
viding two sample FLP partnership agreements); Mezzullo, supra note 28, at B-301-
14 (same).

32. See Top Tax Issues, supra note 3, at 133 (discussing transfer rights agree-
ment provision). “This provision on transfer rights is typically highly restrictive—
both to keep ownership within the family and to create discounts for lack of mar-
ketability . . . in valuing the limited partnership interests for . . . tax purposes.” Id.
For a full discussion on the relationship between transfer rights restrictions and
valuation discounts, see infra notes 57-59 and accompanying text.

33. See Lewis & Chomakos, supra note 2, at 89 (discussing methods for fund-
ing FLPs). For a precise description of the criteria of a successfully formed and
operated FLP, see infra notes 186-215 and accompanying text.

34. See Lewis & Chomakos, supra note 2, at 89 (noting that “[m]ost FLPs are
formed by a husband and wife (the initial partners) contributing assets to the FLP
in exchange for all of the interests in the FLP”); see also Top Tax Issues, supra note
3, at 132 (discussing senior members contribution of assets in exchange for bulk of
partnerships interests).

35. See id. (describing gifting of partnership assets as method of transferring
wealth to next generation). For an overview of the gift tax, see Britker et al., Fed-

36. See Lewis & Chomakos, supra note 2, at 89 (discussing partner contribu-
tions to FLP). Under these circumstances, “the other partners are contributing
assets of relatively nominal value in proportion to the value of the assets contrib-
uted by the initial partners.” Id. This approach to funding the FLP allows younger
partners to “take[ ] advantage of the discounts applicable to the partnership valua-
tion and consolidated their investments with the family and the overall strategy of
gifting.” Id.
III. THE TAX AND NON-TAX BENEFITS OF FORMING AN FLP

The FLP is one of many family-run business entities used to accomplish family planning goals.\(^{37}\) Forming an FLP provides significant tax advantages for its members by reducing the amount of estate taxes owed at death.\(^ {38}\) In addition, forming an FLP offers a number of non-tax benefits.\(^ {39}\) As a result, the FLP is an effective vehicle for families with multiple tax, business and estate planning objectives.\(^ {40}\)

A. Tax Benefits

There are two ways in which forming an FLP reduces the taxable value of the decedent’s gross estate.\(^ {41}\) The first method is by gifting partnership interests to younger family members, thereby reducing “the donor’s gross estate by the amount of the gift.”\(^ {42}\) The second and more

37. See Mezzullo, supra note 28, at A-1 (describing business entities commonly used for estate planning). The first and most traditional alternative to the family limited partnership is the trust. See id. (summarizing use of trust in estate planning). A second and increasingly popular entity used to accomplish family planning goals is the LLC. See id. (explaining structure of LLC). In fact, some authorities consider the LLC to be superior to the FLP for family planning purposes. See id. at A-3 (arguing LLC is most beneficial entity for estate planning); see also Lewis & Chomakos, supra note 2, at 2 (suggesting structure of LLC is “simpler and more advantageous in the estate planning context” than FLP). For a summary of the structure of a LLC, see id. at 2 (discussing LLC); Mezzullo, supra note 28, at A-1-3 (same).

38. See Bissonette, supra note 1, at 59-61 (discussing estate tax advantages of FLP); Top Tax Issues, supra note 3, at 140 (illustrating how use of FLP might decrease estate tax burden). For further discussion of the use of FLP interests to reduce the estate tax paid at death, see infra notes 41-59 and accompanying text.

39. See Lewis & Chomakos, supra note 2, at 3 (discussing achievement of lifetime financial goals); Top Tax Issues, supra note 3, at 133 (noting FLPs provide “a number of nontax benefits that suit the goals of the family irrespective of the substantial tax savings realized”); Mezzullo, supra note 28, at A-37-40 (describing business reasons for FLP formation); see also Bowen & Bailey, supra note 2, at 339-40 (discussing use of FLP to achieve business planning objectives). For examples of FLP non-tax advantages, see infra notes 60-68 and accompanying text.

40. See Bowen & Bailey, supra note 2, at 306 (noting FLP is important instrument for “1) reducing . . . estate and other taxes, 2) preserving the family business, 3) satisfying desires regarding the disposition of property, and 4) protecting assets from unnecessary liability exposure to creditors”).

41. See Top Tax Issues, supra note 3, at 135 (considering tax benefits of FLP). An FLP offers a number of tax benefits to its members, but many are extrinsic to the dispute in Thompson. See Estate of Thompson v. Comm’r, 382 F.3d 367, 373 (3d Cir. 2004) (discussing use of FLP interests to reduce decedent’s federal estate tax). Accordingly, this Casebrief focuses on the tax benefit disputed in Thompson—the use of to reduce the taxable value of a decedent’s gross estate. See id. (same). In addition to reducing the estate tax, an FLP also offers gift tax and income tax benefits. See Top Tax Issues, supra note 3, at 135-40 (noting numerous tax benefits of FLP formation). For more information on these benefits, see id.

42. Ruttenberg, supra note 3, at 6. The decedent’s gross estate is further reduced by gifting because the income generated by the gifted asset is also excluded. See id. (describing various methods for reducing gross estate through gifting). The IRC also provides the taxpayer with annual gift tax exclusions. See id. at 6 n.9
contentious way that an FLP reduces the taxable value of a decedent’s
gross estate is through the application of valuation discounts to his or her
taxable estate.\footnote{43}

Valuation discounts reduce the taxable value of an asset.\footnote{44} Valuation
discounts work to reduce the taxed owed on an FLP interest because “the
lack of a ready market for the interest and the inability of its owner to
assert control over management of the enterprise” diminishes the inter-
est’s value.\footnote{45} As a result, the two primary valuation discounts available
to FLP interests are the marketability discount and the lack of control dis-
count.\footnote{46} These valuation discounts are premised on fair market value,
which is defined as “the price at which the property would change hands
between a willing buyer and willing seller, neither being under any com-
pulsion to buy or sell and both having reasonable knowledge of relevant
facts.”\footnote{47} A limited partner in an FLP has neither the ability to transfer his
or her interests to a third party nor the right to participate in certain as-
pects of the FLP’s management; accordingly, these factors substantially di-
minish the fair market value of the limited partner’s interest in an FLP.\footnote{48}

(discussing annual gift tax exclusion). In addition, the IRC provides a credit for
the gift taxes imposed on the first $1,000,000 gifted in excess of the donor’s annual
exclusion. \textit{See id.} (discussing cumulative lifetime credit).

\footnote{43} \textit{See Lewis \& Chomakos, supra} note 2, at 11-19 (explaining valuation dis-
counts); \textit{Top Tax Issues, supra} note 3, at 139-41 (noting tax advantages); Mezzullo,
\textit{supra} note 28, at A-8-14 (explaining valuation discounts); \textit{Valuation Discounts—Gifts
of Partial Interests or Units of Family Limited Partnerships or LLCs} (Apr. 22, 2004), at
http://www.perkinscoie.com/content/ren/updates/pp/042004.htm [hereinafter
\textit{Valuation Discounts}].

\footnote{44} \textit{See Top Tax Issues, supra} note 3, at 140 (noting use of FLP interests to
reduce decedent’s gross estate). The following example demonstrates the effect of
valuation discounts on a decedent’s gross estate:

[A]ssume a decedent’s gross estate included a 70% interest in an FLP.
Further assume that the FLP owns assets with a fair market value of
$1,000,000. Without the discounting, the decedent’s interest in the FLP
would be valued at $700,000 ($1,000,000 * 70\%). However, if a 40% dis-
count applies to the interest, its value would be reduced by $280,000
($700,000 * 40\%) to $420,000, thereby creating a significant tax savings.

\textit{Ruttenberg, supra} note 3, at 7-8.

\footnote{45} \textit{Valuation Discounts, supra} note 43.

\footnote{46} \textit{See generally Lewis \& Chomakos, supra} note 2, at 11-19 (distinguishing lack
of control discount from lack of marketability discount); \textit{Top Tax Issues, supra
note 3, at 139-41 (same); Bissonette, supra} note 1, at 62-65 (same); Bowen & Bailey,
\textit{supra} note 2, at 339-35 (same); Forbat, \textit{supra} note 2 (same); Mezzullo, \textit{supra} note
28, at A-8-14 (same); Ruttenberg, \textit{supra} note 3, at 7-8 (same); \textit{Valuation Discounts,
supra} note 45 (same). These discounts are not cumulative. \textit{See Lewis \& Chomakos,
supra} note 2, at 14 (discussing discounts). “[O]ne discount is applied
to reduce the value and the resulting valuation is subject to the second discount.” \textit{Id.}


\footnote{48} \textit{See infra} notes 49–59 and accompanying text (explaining impact that re-
strictions on limited partners have on market value of partnership interests).
1. Lack of Marketability Discount

An FLP interest is discounted because the interest’s lack of marketability reduces its fair market value. An FLP interest is discounted because the interest’s lack of marketability reduces its fair market value. The first factor affecting the marketability of an FLP interest is the difficulty in finding a third party who wants to own an interest in a closely-held family entity. This is because buyers are wary of the potential problems stemming from the family dynamic inherent in an FLP. Another factor impacting an FLP interest’s marketability is the presence of a “restrictive transfer rights” provision in the partnership agreement. Many FLP partnership agreements contain a provision that bars partners from assigning their FLP interests to unrelated third parties. This further restricts the transferability of partnership interests and subsequently reduces the value of the donor’s partnership interests. The lack of marketability discount typically ranges from twenty to forty percent.

2. Lack of Control Discount

The lack of control discount, which also reflects the reduced fair market value of an FLP interest, accounts for the restricted role a limited part-

---

49. See Lewis and Chomakos, supra note 2, at 14 (discussing lack of marketability discount within “willing buyer” framework). For an explanation of this framework, see supra note 47 and accompanying text (providing explanation of “willing buyer” framework used to determine fair market value of asset).

50. See Top Tax Issues, supra note 3, at 139 (arguing that interest in family entity is “less attractive than an interest in an entity unsaddled with a ‘family dynamic’”); see also Martha A. Zatezalo, Valuation Methods and Issues, in ESTATE-PLANNING FOR THE OWNER OF A FAMILY BUSINESS 389, 401 (1998), reprinted from FAMILY LIMITED PARTNERSHIPS, PBI Publication No. 1997-1353 (1997) (noting that stranger “might be unwilling to buy into family owned business”).

51. See Zatezalo, supra note 50, at 401 (discussing FLP’s inherent lack of marketability).

52. See Top Tax Issues, supra note 3, at 134 (explaining that restrictive transfers rights provision in FLP partnership agreement create discounts for lack of marketability).

53. See Mezzullo, supra note 28, at A-6 (stating that owners of closely held entities often desire to restrict transferring interests to third party). Alternatively, an FLP partnership agreement may permit assignment of interests, but deny the assignor the right to make the assignee a partner. Id. This also makes the FLP interest difficult to transfer under the willing buyer analysis because the buyer could not be guaranteed partnership status. Id.

54. See Lewis & Chomakos, supra note 2, at 121 (stating that transfer rights restriction achieves dual goals of creating discount for lack of marketability and preventing transfer to individuals outside family).

55. See Top Tax Issues, supra note 3, at 139 (providing percentage of discount for lack of marketability); see also Michael Bourland et al., The Family Limited Partnership, GIFT PLANNER’S DIG. (June 6, 1999), at http://www.pgdc.net/BRAF/GPD-19990602152554 (noting that “[t]he amount of the lack of marketability discount is determined by comparable sales of restricted stock of publicly traded companies”).

https://digitalcommons.law.villanova.edu/vlr/vol50/iss5/2
ner plays in an FLP.56 Specifically, a limited partner has no control over issues concerning distribution of profits and losses, forced liquidation and the election of management.57 Control over such managerial decisions is an attractive feature for potential buyers; therefore, under the fair market value analysis, a non-controlling interest in an FLP is worth less than a controlling interest.58 As a result, the IRS allows a twenty to forty percent discount for limited partnership interests.59

B. Non-Tax Benefits

In addition to the tax benefits already discussed, the FLP also offers a number of non-tax advantages that relate to both the family’s businesses and estate-planning goals.60 One significant business advantage the FLP offers is ensuring the vitality of the family business after the senior member’s death.61 Additional business advantages include consolidating management of family businesses, pooling the assets of family members, reducing the expenses of managing assets and limiting the liability of individual partners.62 For example, if the family members jointly own apartment buildings or other ventures requiring ongoing management, transferring the business into an FLP would be an ideal method for ensuring cohesive and efficient management.63

56. See Lewis & Chomakos, supra note 2, at 11 (explaining discount for lack of control). Further, a lack of control over management results in a lack of control over the asset contributed to the FLP which includes an inability to influence decisions related to the asset’s disposition. See id. (highlighting fact that owner of limited partnership interest “lacks complete control over assets”).

57. See id. (providing examples of limitations to limited partner’s control over FLP management).

58. See Bowen & Bailey, supra note 2, at 334 (stating that non-controlling limited partnership interest is worth less than controlling interest).

59. See Lewis & Chomakos, supra note 2, at 11 (discussing percentage for lack of control discount); see also id. at 11-13 (noting that percentage of discount allowed is context sensitive). The amount of the lack of control discount depends upon “the amount of distributions made from the limited partnership to its partners, the financial risk associated with the limited partnership’s assets and the terms of the limited partnership agreement.” Bourland, supra note 55.

60. See Mezzullo, supra note 28, at A-1 (discussing tax and non-tax benefits of using family limited partnerships to hold family businesses, investments and assets); see also Lewis & Chomakos, supra note 2, at 3-4 (noting that FLPs serve multiple ends for client seeking estate-planning advice).

61. See Bowen & Bailey, supra note 2, at 316 (describing FLP as method of preserving family business).

62. See Lewis & Chomakos, supra note 2, at 2-3 (discussing business advantages of FLP); Top Tax Issues, supra note 3, at 133-35 (specifying benefits of FLP formation); Bowen & Bailey, supra note 2, at 339 (describing FLPs as “valuable tool”); Ruttenberg, supra note 3, at 4-6 (noting non-tax advantages of FLPs); Mezzullo, supra note 28, at A-21, A-37 (analyzing FLP advantages); Radowich, supra note 28, at 290-96 (noting “specific goals achieved by Family Limited Partnerships”).

63. Interview with James C. Fee, Jr., Associate Area Counsel, representative for IRS in Thompson, in Villanova, Pa. (Mar. 31, 2005) [hereinafter Fee Interview] (discussing IRS position on FLPs).
The FLP also provides estate-related benefits. First, FLP membership protects assets from creditors by restricting asset transferability. Although a creditor will be able to seize the indebted limited partner's FLP interests, it will be unable to access the full value of the assets owned by the FLP. In addition, forming an FLP consolidates assets under a single entity, which subsequently simplifies estate administration, diminishes the burden of probate and protects assets from irresponsible family members. Although tax advantages often induce FLP formation, the presence of these non-tax motivations—perhaps not surprisingly—is ultimately the saving grace for an FLP under attack by the IRS.

IV. The IRS's Attack on FLPs Under Section 2036(a)

The IRS contends that using valuation discounts to reduce the value of the decedent's gross estate abuses the purpose of an FLP. It has successfully argued that Section 2036(a) operates to include the assets transferred to the FLP, and not the FLP interests received in exchange, in the decedent's gross estate. Section 2036(a) provides that the "gross estate shall include the value of all property . . . which the decedent has . . . transfer[red] (except in the case of a bona fide sale for an adequate and

64. See Lewis & Chomakos, supra note 2, at 2-3 (discussing estate related benefits of FLP
65. See Lewis & Chomakos, supra note 2, at 4 (explaining that restricting transferability of assets protects assets from creditors); see also Top Tax Issues, supra note 3, at 134 (noting creditors that sue FLPs cannot reach personal assets of limited partners).


67. See Ruttenberg, supra note 3, at 5 (discussing non-tax benefits of FLP); see also id. (discussing "spendthrift protection"). One method for protecting against irresponsible spending is to create an "agreement among the owners of a family entity . . . [that] give[s] a manager of the entity the discretion to decide when income or principal should be distributed to the owners. This allows a family entity to control the access a financially irresponsible member has to his assets . . . ."

68. For a detailed discussion of the IRS argument in favor of including assets transferred solely for tax purposes in decedent's gross estate under Section 2036(a), see infra notes 69-110 and accompanying text.

69. See Ruttenberg, supra note 3, at 2 (discussing IRS litigation against valuation discount for FLP interests).

70. Estate of Strangi v. Comm'r (Strangi I), 115 T.C. 478 (2000), aff'd in part, rev'd in part and rem'd in part, (Strangi II), 293 F.3d 279 (5th Cir. 2002) (holding Section 2036(a) included assets transferred to FLP in gross estate); Estate of Harper v. Comm'r, T.C.M. 2002-121, Doc. 2002-11394 (holding limited partnership property includable in gross estate); Estate of Reichardt v. Comm'r, 114 T.C. 144 (2000) (holding existence of implied agreement that decedent would retain lifetime enjoyment of property made transferred assets includable in gross estate under Section 2036(a)); Estate of Schauerhamer v. Comm'r, T.C.M. 1997-242, Doc. 97-15298 (holding value of FLP assets includable in gross estate).
full consideration in money or money’s worth), . . . [in] which he has retained for his life . . . the possession or enjoyment of [the property].”

Once Section 2036(a) includes the transferred assets in the decedent’s gross estate, valuation discounts become irrelevant because including both the transferred assets and the FLP interests received in exchange would constitute an impermissible double counting of the decedent’s assets. In sum, Section 2036(a) may negate the tax benefits of an FLP if (1) the donor/decedent retained an interest in the transferred property, and (2) the transfer does not comport with Section 2036(a)’s bona fide sale exception.

A. Retained Interest Under Section 2036(a)

Section 2036(a) applies when there is an express or implied agreement at the time of the transfer that the transferor will retain lifetime enjoyment or possession of the transferred assets. The existence of an implied agreement is a question of fact that must be determined in light of the surrounding facts and circumstances. Courts interpreting Section 2036(a) have indicated that the decedent retained an interest in the property if the decedent failed to respect the partnership form and used the

71. 26 U.S.C. § 2036(a) (2004). The full text of the statute provides: General Rule: The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in the case of a bona fide sale for an adequate and full consideration in money or money’s worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—

(1) the possession or enjoyment of, or the right to income from, the property, or

(2) the right, either along or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

Id.

72. See Ruttenberg, supra note 3, at 12 (noting that inclusion of assets under Section 2036(a) makes “any claimed valuation discounts irrelevant”).

73. Strangi, 85 T.C.M. (CCH) 1331, 1337 (2003) (holding assets transferred by decedent to FLP included in gross estate under Section 2036(a)); Harper, T.C.M. 2002-121 (holding property contributed to FLP includable in gross estate); Reichardt, 114 T.C. 144 (holding decedent’s assets includable in gross estate); Schauerhamer, T.C.M. 1997-242 (holding same). But see Donald C. Poole, Family Limited Partnerships Need an Exodus from Section 2036(a), TAX NOTES, Oct. 27, 2003, at 542 (arguing against application of Section 2036(a) to assets transferred to FLP on grounds that term “transfer” in Section 2036(a) “contemplates a transfer to another person in the nature of a gift” as opposed to transfer to business entity).

74. See Thompson v. Comm’r, 382 F.3d 367, 375 (3d Cir. 2004) (“An interest or right is treated as having been retained or reserved if at the time of the transfer there was an understanding, expressed or implied, that the interest or right would later be conferred.”) (quoting 26 C.F.R. § 20.2036-1(a) (2004))).


Published by Villanova University Charles Widger School of Law Digital Repository, 2005
partnership assets for personal benefit despite a change in legal ownership. The threshold inquiry is whether the facts suggest "the decedent's relationship to transferred assets remained the same after as it was before the transfer."

The first indication of an implied agreement is the commingling of personal and partnership assets. In *Estate of Schauerhamer v. Commissioner*, the Tax Court held that the donor/decedent violated the partnership agreement by transferring assets to an FLP and subsequently depositing the income generated from those assets into her personal account. This commingling of assets raised the inference of an implied agreement because the decedent continued to use and access the funds after the asset transfer. The Tax Court reached a similar conclusion in *Estate of Reichard v. Commissioner* when it held that commingling of assets suggested an implied agreement, despite "post mortem" accounting ad-

76. See infra notes 79-112 (summarizing reasoning supporting prior rulings in which courts applied Section 2036(a) to include transferred assets in decedent's gross estate).

77. *Thompson*, 383 F.3d at 377 (quoting Guynn v. United States, 437 F.2d 1148, 1150 (4th Cir. 1971) (emphasis added)); see also *Reichard*, 114 T.C. 144, 152 (citing *Guynn* for same proposition).

78. See *Lewis & Chomakos*, supra note 2, at 102 (defining commingling of assets as failure to acknowledge distinction between partnership and personal assets). For a discussion of the Third Circuit's response to commingling of assets, see infra note 140 and accompanying text (discussing Third Circuit's finding of implied agreement based on evidence that decedent commingled personal and FLP assets). For guidelines to follow to avoid commingling of assets, see infra notes 198-209 and accompanying text.

79. 73 T.C.M (CCH) 2855 (1997).

80. See id. at 4 (discussing decedents commingling of personal and partnership assets). In *Shauerhamer*, the decedent formed a separate FLP with each of her three children. See id. at 1 (discussing facts). The decedent contributed a one third undivided interest in her business holdings to each FLP. Id. The FLPs were validly formed and each FLP drafted a partnership agreement that set forth detailed provisions related to partnership records, allocations of profits and losses and agency relationships among partners. Id. at 2. The agreements also required that all partnership income be deposited in partnership accounts. Id. Despite this requirement, the decedent deposited both partnership and non-partnership income into partnership accounts. See id. (noting decedent's violation of partnership agreement). The decedent did not maintain records to account separately for partnership and non-partnership funds. Id. In addition, the decedent used the partnership account "as her personal checking account, and from this account she paid personal and partnership expenses." Id. The court concluded that this conduct raised an inference of an implied agreement that the decedent would retain lifetime enjoyment of the transferred assets. See id. (holding that Section 2036(a) applied to transferred assets).

81. See id. (finding implied agreement that "assets and income would be managed by the decedent exactly as they had been in the past"). As evidence of this agreement, the court pointed to the fact that the decedent's children each testified that the FLPs were formed to enable the decedent to assign partnership interests to family members. See id. (discussing testimony of decedent's children).

82. 114 T.C. 144 (2000).
justments that separated the decedent’s personal assets from those of the partnership. 83

A second indication of an implied agreement is the donor/decedent’s failure to retain sufficient funds for personal expenses. 84 In Estate of Strangi v. Commissioner, 85 the court concluded that the decedent’s failure to retain sufficient personal assets suggested that the FLP “would be a primary source of [the] decedent’s liquidity” following his transfer to the FLP. 86 Overall, Schauerhamer, Reichard and Strangi stand for the proposition that a transfer to an FLP will not withstand scrutiny under Section 2036(a) absent strict adherence to the partnership form. 87

B. Section 2036(a) Bona Fide Sale Exception

Section 2036(a) contains a significant exception: the decedent’s gross estate does not include transferred assets if the transfer was a “bona fide sale for an adequate and full consideration in money or money’s worth.” 88 There is, accordingly, a two-part inquiry into the applicability of this ex-

83. See id. at 155 (characterizing adjustments as nothing more than “a belated attempt to undo decedent’s commingling of partnership and personal accounts”). In this case, the decedent formed an FLP and a revocable living trust to serve as the FLP’s sole general partner. See id. at 147-48 (discussing formation of FLP and trust). The decedent transferred nearly all of his property to the FLP, with the exception of his car and a small amount of cash. Id. The decedent, however, continued to live rent-free in the residence that he contributed to the FLP. Id. at 149. In addition, the decedent deposited partnership assets in his personal accounts. See id. at 148 (discussing decedent’s commingling of assets). These facts led the court to conclude that the transferred assets should be included in the decedent’s gross estate under Section 2036(a). See id. at 153 (holding circumstances raised inference of implied agreement that decedent would retain lifetime enjoyment of transferred assets within meaning of Section 2036(a)).

84. For a discussion of the Third Circuit’s consideration of the decedent’s failure to retain sufficient personal funds in Thompson, see infra note 140 and accompanying text (noting Third Circuit’s conclusion that decedent’s failure to retain sufficient personal funds raised inference of implied agreement within meaning of Section 2036(a)).

85. 85 T.C.M. (CCH) 1331 (2003).

86. Id. at 1336. In this case, the decedent formed an FLP with his children and established a corporation to serve as its general partner. Id. The decedent contributed ninety-eight percent of his assets to the FLP, including his residence. Id. After the transfer, however, the decedent continued to live in the residence rent-free. Id. at 1336. In addition, more than $3,000,000 was subsequently transferred out of the partnership to pay for decedent’s healthcare, funeral and estate expenses. See id. (detailing use of partnership assets for personal expenses). These factors influenced the court’s conclusion that the decedent retained lifetime enjoyment of the transferred property for purposes of Section 2036(a). See id. at 1338 (stating holding).

87. See id. at 1338 (finding that “[a]lthough the proverbial i’s were dotted and the t’s were crossed . . . [t]hey do not preclude implicit retention . . . of [present] economic benefit from the transferred property”).

The first issue is whether the transfer was a bona fide sale. The second issue is whether the transfer was made for full and adequate consideration. It is important to note that the Tax Court and the Fifth Circuit are divided regarding the definition of a bona fide sale. Namely, the Tax Court’s interpretation categorically disqualifies FLP transfers from exclusionary treatment under Section 2036(a), while the Fifth Circuit approach only requires that the court determine whether the sale was made in good faith or was instead “a sham transaction.”

1. Bona Fide Sale

The first step in establishing whether a transferred asset falls within the scope of a bona fide sales exception is, clearly, determining whether the transfer was a bona fide sale. The Tax Court and the Fifth Circuit have set forth conflicting rules regarding the requisite elements of a bona fide sale. In Reichardt and Strangi, the Tax Court held that a bona fide sale required an arm’s length transaction. By contrast, in Wheeler, the Fifth Circuit explicitly refused to rule that a bona fide sale must be made at arm’s length. While the Fifth Circuit acknowledged that intra-family transfers should be subjected to heightened scrutiny, the court nevertheless concluded that a bona fide sale is any sale in which “the transferor...

89. See infra notes 90-112 and accompanying text (providing explanation of two-step analysis required by Section 2036 to determine whether assets transferred by decedent into FLP should be included in decedent’s gross estate).

90. See Section 2036(a) (providing that sale must be bona fide). For a discussion of the Third Circuit’s definition of a bona fide sale and the reasoning behind this definition, see infra notes 155-63 and accompanying text.

91. See Section 2036(a) (providing that sale must be made for full and adequate consideration). For further discussion of the Third Circuit’s interpretation of full and adequate consideration within the meaning of Section 2036(a), see infra notes 148-54 and accompanying text.

92. For a discussion of this conflict, see infra notes 95-102 (highlighting conflict between Tax Court and Fifth Circuit as to whether bona fide sale requires arm’s length transaction for purposes of Section 2036(a)).

93. Kimbell v. United States, 371 F.3d 257, 264 (5th Cir. 2004) (quoting Wheeler v. United States, 116 F.3d 749, 767 (5th Cir. 1997)); see also Thompson v. Comm’r, 382 F.3d 382, 382 (3d Cir. 2004) (stating arm’s length transaction requirement would “automatically defeat the Section 2036 exception for all intra-family transfers”).

94. See Kimbell, 371 F.3d at 264 (discussing bona fide sale).

95. See Thompson, 382 F.3d at 381-82 (discussing conflict between Tax Court’s and Fifth Circuit’s definition of bona fide sale).


97. See Wheeler, 116 F.3d at 764 (defining bona fide sale). The Fifth Circuit concluded that Section 2036(a) did not require “a dual system of valuation” for transfers “depending on the identity of the purchaser.” Id. at 765.
actually parted with the remainder interest and the transferee actually parted with the requisite adequate and full consideration."  

The Fifth Circuit solidified its Wheeler holding in Kimbell v. United States. In Kimbell, the court once again rejected the notion that an intra-familial transfer can never be bona fide, stating that a "transaction that is a bona fide sale between strangers must also be bona fide between members of the same family." The court refused to impose an additional requirement on intra-family transfers without a statutory basis for such action. In sum, the Tax Court narrowly defines a bona fide sale by focusing on the parties to the transaction, while the Fifth Circuit takes a broader approach that is more concerned with the substance of the transaction than the relationship between the parties.

2. Full and Adequate Consideration

The second determination for purposes of Section 2036(a)'s bona fide sales exception is whether the sale was made for full and adequate consideration. In Estate of Harper v. Commissioner, the Tax Court an-

98. Id. at 764.

99. 371 F.3d 257 (5th Cir. 2004). In Kimbell, the decedent formed an FLP with her son and contributed $2,500,000 in oil and gas interests and cash. See id. at 259 (summarizing formation of FLP). The decedent retained $450,000 in assets for personal expenses. See id. (noting that decedent retained considerable personal funds). The FLP partnership agreement clearly stated the purposes of formation, which included protection of partners from creditors, providing flexibility of business planning and consolidating family assets. See id. at 259-60 (discussing details of partnership agreement).

100. Id. at 263.

101. See id. (citing Wheeler, 116 F.3d at 764) (noting Wheeler established that "just because a transaction takes place between family members does not impose an additional requirement not set forth in the statute to establish that it is bona fide").

102. See id. (holding that key issue is not whether parties operated at arm's length but whether sale was based on legitimate business objectives). It is important to note that the Tax Court appears to have modified its arm's length requirement following the Third Circuit's ruling in Thompson. See Steven R. Akers, Bongard—"En Guard" to FLP Owners! 13-14 (2005), at http://www.abanet.org/rppt/cmtes/pt/c-group/BongardOverview.pdf (discussing new standard for bona fide sales set forth by Tax Court in Bongard v. Commissioner, 124 T.C. 8 (2005)). While prior Tax Court cases held that an arm's length transaction was a requisite element of a Section 2036(a) bona fide sale, the court in Bongard retreated from this position when it concluded that parties need not actually be strangers so long as an intra-familial transfer was "conducted as if the parties were strangers." Bongard, 124 T.C. at 8. This change in the Tax Court's analysis is likely the result of the fact that the prior approach conflicted with that of the Third and Fifth Circuits. See Akers, supra, at 13 (characterizing change in Tax Court's bona fide sale analysis as reaction to disagreement from circuit courts).


104. 83 T.C.M. (CCH) 1641 (2002). In Harper, the decedent formed an FLP with his children and contributed the majority of his assets to the FLP. Id. at 3. These assets were primarily marketable securities and the partnership agreement
nounced the "recycling of value" theory, which was subsequently adopted by the Fifth Circuit in Kimbell and the Third Circuit in Thompson.\footnote{See Estate of Thompson v. Comm'r, 382 F.3d 369, 378 (3d Cir. 2004) (applying recycling of value theory to determine whether transfer was made for full and adequate consideration); see also Kimbell, 371 F.3d at 262 (same). For a complete discussion of the Third Circuit's recycling of value analysis in Thompson, see infra notes 148-54 and accompanying text.} Under this theory, when a transfer serves only to "change the form in which [the donor] held his beneficial interest in the contributed property . . . [w]ithout any change whatsoever in the underlying pool of assets or prospect for profit . . . there exists nothing but a circuitous 'recycling of value.'"\footnote{Harper, 83 T.C.M. (CCH) 1641 at 17 (emphasis added). The court accepting the validity of such a transfer, "would open [S]ection 2036(a) to a myriad of abuses engendered by unilateral paper transformations." Id.}

The overriding issue under this theory is legitimate business concerns motivated the decedent's transfer.\footnote{See id. at 18 (holding no transfer for consideration occurs where transaction is not motivated by legitimate business concerns). For the Third Circuit's position on the legitimate business concern requirement set forth in Harper, see infra notes 144-47 and accompanying text (discussing Third Circuit's view that legitimate business purpose is essential element of full and adequate consideration within meaning of Section 2036(a)).} In Harper, the Tax Court concluded that the decedent's transfer was not motivated by a legitimate purpose because the FLP offered no prospect for profit.\footnote{See Harper, 83 T.C.M. (CCH) 1641 at 17 (noting that decedent derived no economic benefit from FLP aside from tax advantages).} Similarly, in Strangi, the Tax Court found that the FLP lacked a legitimate business purpose because the only economic activities conducted by the FLP related to the decedent's health, funeral and estate tax expenses.\footnote{See Estate of Strangi v. Comm'r, 85 T.C.M. (CCH) 1351, 1344 (2003) (concluding that FLP "patently fails to qualify as the sort of functioning business enterprise that could potentially . . . lift the situation beyond mere recycling").} In both cases, the Tax Court concluded that the transfers were not made for adequate consideration.\footnote{See Harper, 83 T.C.M. (CCH) 1641 at 17 (holding transfer not made for full and adequate consideration for purposes of Section 2036(a)); see also Strangi, 85 T.C.M (CCH) at 1344 (same).} By contrast, in Kimbell, the court found a legitimate business purpose thereby upholding the transfer where the FLP centralized management of the family business and protected the partners from tort liability.\footnote{See Kimbell, 371 F.3d at 269 (holding transfer was made for full and adequate consideration after concluding that centralizing management of family bu-
vantages when considering whether the transfer was made for full and adequate consideration.\textsuperscript{112}

V. \textit{Estate of Thompson v. Commissioner: The Third Circuit Tightens the Reigns but Does Not Close the Door}

A. Facts of Thompson

In 1993, the decedent Theodore Thompson established an FLP with each of his two children and created two corporations to serve as the FLP's general partners.\textsuperscript{113} The decedent formed the Turner FLP and the Turner Corporation with his daughter Betsy Turner and his daughter's husband George.\textsuperscript{114} The decedent contributed a considerable sum of marketable securities and notes receivable while the Turners contributed a comparatively nominal amount of cash and real estate.\textsuperscript{115} The parties received limited partner interests in exchange for these contributions.\textsuperscript{116} The FLP held the marketable securities contributed by the decedent but engaged in minimal "post-transfer trading."\textsuperscript{117} In 1994, the FLP agreement was amended to allocate the economic gains and losses from all contributed assets to the individual contributing partners as opposed to the FLP itself.\textsuperscript{118} From the time of formation, the FLP made a number of

\textsuperscript{112} See Howell, \textit{supra} note 15, at 734 (emphasizing importance of business purpose behind transfer and "transferee entity").

\textsuperscript{113} See Estate of Thompson v. Comm'r, 382 F.3d 367, 369–70 (3d Cir. 2004) (discussing formation of FLPs and corporate general partners). By the time the partnerships were formed, the decedent had transferred $2,800,000 to the Turner and Thompson partnership, $2,500,000 of which was comprised of marketable securities. \textit{See id.} at 370 (discussing total amount transferred by decedent to family limited partnerships). The decedent retained $153,000 in personal assets. \textit{Id.} The decedent also received an annual income of $14,000 from social security and two annuities. \textit{Id.} The decedent's annual expenses were $57,202 and his life expectancy was 4.1 years at the time of the transfer. \textit{Id.}

\textsuperscript{114} See \textit{id.} (discussing formation of FLP and corporation). The Turner Corporation held the sole general partner interest in the Turner FLP. \textit{Id.} at 370.

\textsuperscript{115} See \textit{id.} (discussing contributions to FLP). The decedent's contribution to the partnership totaled $1,286,000. \textit{Id.} George Turner contributed $1,000 in cash and a piece of real property in Vermont with a fair market value of $49,000. \textit{Id.}

\textsuperscript{116} See \textit{id.} (discussing partnership interests). The decedent received a 95.4\% limited partner interest in Turner Partnership. \textit{Id.} George and Betsy Turner received a 3.46\% limited partnership interest. \textit{Id.}

\textsuperscript{117} See \textit{id.} (noting that partnership did not actively trade securities transferred by decedent).

\textsuperscript{118} See \textit{id.} at 371 (discussing amendment of Turner Partnership agreement). The decision to amend the partnership agreement arose out of a concern about the taxation of the partnership, namely that the "initial capitalization of the partnership might present certain investment company issues pursuant to [I.R.C.] [S]ection 721(b) which could affect the intended nonrecognition treatment of capital contributions to the partnership." Estate of Thompson v. Comm'r, 84 T.C.M. 574 (2002). For more information on Section 721(b) and the definition of an investment company, see \textit{What You Should Know About Your Limited Partnership}, at
distributions of cash and FLP interests to the decedent from the FLP's account.119

The decedent also formed the Thompson FLP and the Thompson Corporation with his son Robert Thompson.120 The decedent contributed marketable securities and notes receivable to the FLP.121 Robert Thompson contributed mutual funds and real estate to the FLP.122 Although the Thompson FLP consisted primarily of marketable securities, as in the Turner FLP, there was little post-transfer trading activity.123 Moreover, the gain derived from the FLP's negligible business activities did not go to the FLP but went directly to Robert Thompson.124 In 1995, the FLP made several cash and partnership distributions to the decedent from the FLP's account, and the decedent used a portion of the cash distributions to pay personal expenses.125

The decedent died on May 15, 1995, at the age of ninety-seven.126 On February 21, 1996 the decedent's executors filed a federal estate tax return that valued the decedent's taxable estate at $1,762,219.127 This amount included the discounted value of the decedent's interests in the Thompson and Turner FLPs.128 In January 1999, the IRS filed a notice of deficiency in the amount of $707,054.129 The Commissioner's disallowance of the valuation discounts on the decedent's FLP interests was the most significant component of the deficiency.130

http://www.trustsandestates.net/Excel/MmCIInvestmentCoRulesRTF.htm (last visited Apr. 6, 2005) (discussing Section 721(b)).

119. See Thompson, 382 F.3d at 371-72 (noting partnership made annual distributions to decedent of $40,000 to $45,220).
120. See id. at 370 (discussing formation of Thompson Partnership and Thompson Corporation). The Thompson Corporation held the sole general partner interest in the FLP. Id.
121. See id. (summarizing decedent's contribution to FLP).
122. See id. (summarizing Robert Thompson's contribution to FLP).
123. See id. at 371 (discussing partnership's failure to actively trade securities contributed by decedent and Robert Thompson).
124. See id. (discussing Robert Thompson's use of contributed real estate to raise and sell mules despite fact that income generated by this activity did not benefit partnership).
125. See id. at 371-72. As with the Turner FLP, the Thompson FLP made annual distributions ranging from $40,000 to $45,220. See id. (summarizing cash distributions made to decedent from FLP account).
126. See id. at 372 (relating date of decedent's death).
127. See id. (stating initial valuation of decedent's taxable estate).
128. See id. (detailing valuation discounts applied to estate to decedent's FLP interests). For further discussion of valuation discounts, see supra notes 44-59 and accompanying text.
129. See id. (discussing substance of IRS notice of deficiency).
130. See id. (stating that Commissioner disallowed estate's twenty percent minority discount and twenty percent lack of marketability discount). The adjustment ultimately increased the value of the decedent's gross estate by $1,400,627. See id. (summarizing effect of IRS disallowance adjustment on decedent's gross estate).
The estate filed a petition for redetermination in the Tax Court.¹³¹ The Tax Court held that the transferred assets were included in the decedent’s gross estate under Section 2036(a) because the decedent and his children had an implied agreement that the decedent would retain lifetime enjoyment of the transferred assets.¹³² The Tax Court also found that the transfers to the FLP did not fall within Section 2036(a)’s bona fide sale exception because the transfers were 1) not made at arm’s length and 2) not made for adequate consideration.¹³³ The estate filed a timely notice of appeal with the Third Circuit.¹³⁴

B. Third Circuit’s Ruling in Thompson

The Third Circuit affirmed the Tax Court’s ruling after concluding that the decedent and his children had an implied agreement that he would retain lifetime enjoyment of the transferred property.¹³⁵ The Third Circuit further concluded that the decedent’s transfer did not fall within the Section 2036(a) bona fide sale exception, but it relied on different grounds than those proffered by the Tax Court.¹³⁶ Specifically, the Third Circuit rejected the Tax Court’s definition of a bona fide sale.¹³⁷ Despite this difference, the Third Circuit ultimately included the transferred assets in the decedent’s gross estate under Section 2036(a).¹³⁸

1. Retained Enjoyment Under Section 2036(a)

The Third Circuit found sufficient evidence that an implied agreement existed between the decedent and his children that enabled the decedent to retain lifetime enjoyment of the transferred assets.¹³⁹ First, at the age of ninety-five, the decedent transferred a majority of his assets to

¹³¹ See id. at 373 (relating estate’s petition for redetermination of decedent’s gross estate).
¹³² See id. (reviewing Tax Court’s application of Section 2036(a)).
¹³³ See id. (stating holding).
¹³⁴ See id. (noting estate’s appeal of Tax Court ruling).
¹³⁵ See id. at 377 (affirming Tax Court’s finding of implied agreement that decedent would retain lifetime enjoyment of transferred property within meaning of Section 2036(a)).
¹³⁶ See id. at 381 (holding that decedent’s transfer did not constitute bona fide sale for purposes of Section 2036(a)’s bona fide sale exception).
¹³⁷ For a discussion of the Third Circuit’s departure from the Tax Court’s reasoning, see infra notes 155-63 and accompanying text.
¹³⁸ See Thompson, 382 F.3d at 383 (stating holding).
¹³⁹ See id. at 377 (same). The court cited Reichardt for the proposition that an implied agreement may be inferred from the factual circumstances surrounding the transfer. See id. at 376 (citing Estate of Reichardt v. Comm’r, 114 T.C. 144, 151 (2000)). Accordingly, the Third Circuit reviewed the Tax Court’s factual findings for clear error. See id. at 374 (citing PNC Bancorp, Inc. v. Comm’r, 212 F.3d 822, 827 (3d Cir. 2000)) (stating appropriate standard of review).
the FLPs without retaining sufficient assets for personal expenses. In addition, the court noted that Betsy and George Turner consulted their financial advisors to ensure that the decedent would have access to the partnership assets. Finally, on more than one occasion, the FLP "infused" the decedent with funds when his personal assets diminished. In light of these facts, the court concluded that the decedent's "de jure" lack of control over the transferred property did not overcome the strong inference of an implied agreement that the decedent would retain lifetime enjoyment of the transferred property.

2. Section 2036(a) Bona Fide Sale Exception

The Third Circuit affirmed the Tax Court's finding that the transferred assets did not fall within the scope of Section 2036(a)'s bona fide sale exception. The court agreed that the transfers were not made for adequate consideration because the FLPs lacked a legitimate business purpose. The court also found that the transfers did not constitute bona fide sales, but it declined to impose the Tax Court's arm's length transaction requirement. Instead, the Third Circuit held that the transfers were not bona fide sales due to a lack of good faith.

a. Full and Adequate Consideration

The Third Circuit held that the transfers were not made for full and adequate consideration for purposes of Section 2036(a). Applying Harper's recycling of value theory, the Third Circuit found that the transfers were not made for adequate consideration because they were not motivated by legitimate business concerns. Neither FLP engaged in

140. See id. at 376 (concluding that failure to retain sufficient personal funds raised inference of implied agreement that decedent would retain lifetime enjoyment of transferred property).

141. See id. (finding concern about decedent's ability to access partnership assets as indicia of implied agreement).

142. See id. (referring to decedent's commingling of personal and partnership assets).

143. See id. at 376 (concluding that formal transfer of assets to partnership did not defeat argument that decedent and children had implied agreement that decedent would retain lifetime enjoyment of transferred assets). The court concluded that it was clear from the operation of the partnerships that "nothing beyond formal title changed in the decedent's relationship to his assets." Id. at 377.

144. See id. at 383 (affirming Tax Court's ruling on bona fide sale element of Section 2036(a) analysis).

145. For factors that influenced the Third Circuit's full and adequate consideration analysis, see infra notes 148-54 and accompanying text.

146. See Thompson, 382 F.3d at 381-82 (rejecting argument that bona fide sale required arm's length bargaining).

147. See id. at 383 (holding bona fide sale requires good faith dealing).

148. See id. at 381 (stating holding).

149. See id. at 378-79 (citing Estate of Strangi v. Comm'r, 85 T.C.M. (CCH) 1331, 1344 (2003); Estate of Harper v. Comm'r, 83 T.C.M. (CCH) 1641, 1653
significant business operations, and what little income the FLPs’ assets generated went directly to the other partners, not the decedent.¹⁵⁰

The Third Circuit also concluded that the decedent received no economic benefit from the transfers because the marketable securities remained largely untraded after the decedent transferred them to the FLP.¹⁵¹ Moreover, because the decedent transferred his liquid assets in return for illiquid partnership interests, the consideration the decedent received was of lesser value than the transferred assets.¹⁵² These factors, accompanied by the FLPs’ lack of legitimate business operations, led the court to conclude that the decedent received a tax benefit in consideration for the transfers.¹⁵³ Accordingly, the Third Circuit found that there was no transfer for full and adequate consideration within the meaning of Section 2036(a).¹⁵⁴

b. Bona Fide Sale

The Third Circuit also held that the transfers did not constitute a bona fide sale.¹⁵⁵ Following the Fifth Circuit’s ruling in Kimbell, the court conceded that, in light of the “mischief that may arise in the family estate-planning context,” intra-family transfers to FLPs must be reviewed with heightened scrutiny.¹⁵⁶ Notwithstanding this finding, the Third Circuit refused to adopt a per se exclusion of transfers to FLPs from Section 2036(a)’s bona fide sale exception.¹⁵⁷ The court emphasized that, despite contradictory case law from the Tax Court, there was no statutory basis for

(2002) (providing overview of prior litigation under recycling of value theory). The Third Circuit acknowledged that the partnerships did conduct some economic activity, but nonetheless concluded that these transactions “did note rise to the level of legitimate business operations.” Id. at 379.

¹⁵⁰ See id. at 380 (concluding that profit distributions “denied [the] decedent any non-tax benefit potentially derived from assets collected in the partnership”).

¹⁵¹ See id. (discussing lack of post transfer trading of marketable securities contributed by decedent).

¹⁵² See id. at 381 (reasoning that “[i]f assets are transferred inter vivos in exchange for other assets of lesser value, it seems reasonable to conclude there is no transfer for ‘full and adequate consideration’”).

¹⁵³ See id. at 379 (finding no substantive non-tax benefit justifying decedent contributions to FLPs).

¹⁵⁴ See id. (stating court’s holding).

¹⁵⁵ See id. at 381 (concluding that “decedent’s transfers to the family limited partnership do not constitute ‘bona fide sales’ within the meaning of 2036(a)”).

¹⁵⁶ See id. at 382 (acknowledging that “‘when the transaction is between family members, it is subject to heightened scrutiny’” (quoting Kimbell v. United States, 371 F.3d 257, 265 (5th Cir. 2004))). The Third Circuit found that this heightened scrutiny was necessary when reviewing intra-familial transfers in light of the “mischief that may arise in the family estate-planning context.” Id.

¹⁵⁷ See id. (rejecting uniform prohibition on transfers to FLPs). The court concluded that an estate’s claim will not fail solely on the grounds that the decedent “stood on both side[s] of the transaction” as transferor on the one hand and partner in the FLP on the other hand. Id. (quoting Estate of Strangi v. Comm’r, 85 T.C.M. (CCH) 1381, 1343 (2003)).
making an arm's length transaction requisite to a bona fide sale.\textsuperscript{158} Accordingly, the court adopted the Fifth Circuit's view in \textit{Kimbell} and held that a transfer constitutes a bona fide sale so long as the parties actually parted with their interests in the exchanged property.\textsuperscript{159}

This notwithstanding, the Third Circuit concluded that the transfer in \textit{Thompson} was not a bona fide sale because it was not made in good faith.\textsuperscript{160} The court stated that a transfer is made in good faith only if the transferor receives a genuine business-related benefit apart from estate tax advantages.\textsuperscript{161} As such, the same factors that indicated the transfer was not made for full and adequate consideration also led the court to conclude that the transfers were not made in good faith.\textsuperscript{162} Accordingly, the court held that the decedent's transfers to the FLPs were not bona fide sales for full and adequate consideration within the meaning of Section 2036(a).\textsuperscript{163}

\section*{VI. CRITICISM OF APPLICATION OF SECTION 2036(a) IN THOMPSON}

At least one practitioner in the estate planning field argues that it is inappropriate to apply Section 2036(a) to transfers made to an FLP.\textsuperscript{164} The practitioner claims that cases such as \textit{Thompson} applied the wrong law in deciding FLP cases because they failed to adhere to \textit{in pari materia}, a basic rule of statutory construction.\textsuperscript{165} Namely, when a section constitutes one part of a comprehensive statutory provision, that section should be

\textsuperscript{158} See \textit{id.} (reasoning that neither IRC nor applicable Treasury Regulations set forth arm's length transaction requirement when defining bona fide sale).

\textsuperscript{159} See \textit{id.} (quoting \textit{Kimbell}, 371 F.3d at 265).

\textsuperscript{160} See \textit{id.} at 383 (stating good faith requirement for bona fide transaction).

\textsuperscript{161} See \textit{id.} (discussing elements of good faith transfer). The court emphasized that a contrived transaction motivated exclusively by estate tax planning will not be recognized as a bona fide sale. See \textit{id.} (emphasizing that bona fide transaction requires benefit separate and apart from tax advantage). For an example of the business advantages offered by the formation of an FLP, see \textit{supra} notes 37-48 and accompanying text.

\textsuperscript{162} See \textit{id.} (noting that objective indicia of legitimate business operations provides "sufficient factual basis for finding a good faith transfer"). For the court's review of the FLPs' business operations, see \textit{supra} notes 150-51 and accompanying text (finding lack of legitimate business operations).

\textsuperscript{163} See \textit{Thompson}, 382 F.3d at 383 (stating holding).

\textsuperscript{164} See generally Donald C. Poole, \textit{Family Limited Partnerships Need an Exodus from Section 2036(a)}, \textit{TAX NOTES}, Oct. 27, 2003, at 541-47 (criticizing application of Section 2036(a) in FLP cases).

\textsuperscript{165} See \textit{id.} (citing \textit{Thompson}, 382 F.3d at 373; \textit{Kimbell} v. United States, 371 F.3d 257, 265 (5th Cir. 2004); Estate of Harper v. Comm'r, 83 T.C.M. (CCH) 1641 (2002); Estate of Strangi v. Comm'r (\textit{Strangi I}), 115 T.C. 478 (2000), \textit{aff'd in part, rev'd in part and rem'd in part}, (\textit{Strangi II}), 293 F.3d 279 (5th Cir. 2002); Estate of Reichardt v. Comm'r, 114 T.C. 144 (2000); Estate of Schauerhamer v. Comm'r, 73 T.C.M. (CCH) 2855 (1997)) (arguing that FLP cases applying Section 2036(a) have "totally missed the boat" by incorrectly interpreting Section 2036(a) as applicable to transfers made to FLP).
construed in light of the other sections to which it relates.\textsuperscript{166} The practitioner argues that FLP cases violated this principle by considering the meaning of the word "transfer" for purposes of Section 2036(a) without regard for how the word has been interpreted in related code sections.\textsuperscript{167} In doing so, the courts in these cases mistakenly applied Section 2036(a) in a manner that is incongruent with the legislative purpose of the statute.\textsuperscript{168}

The argument against application of Section 2036(a) to transfers made to an FLP is that it violates the rule of \textit{in pari materia}.\textsuperscript{169} This well-established principle of statutory construction provides that "statutes are not to be considered as isolated fragments of law, but as a whole, or as parts of a great, connected, homogeneous system."\textsuperscript{170} In \textit{Wheeler}, the Fifth Circuit noted that Supreme Court precedent supported its conclusion that the estate and gift tax sections of the IRC should be read \textit{in pari materia}.\textsuperscript{171} Accordingly, when applying Section 2036(a), the meaning of the word "transfer" should be construed as it is construed in code sections related to the taxation of gifts.\textsuperscript{172}

As a rule, cases interpreting the word transfer within the gift context contemplate a disposition of property made with a donative intent to another \textit{person}.\textsuperscript{173} Therefore, Section 2036(a) "was intended to apply to an inter vivos transfer in the nature a gift where the transferor has retained an interest in the gifted property."\textsuperscript{174} If this is true, then Section 2036(a)

\textsuperscript{166} See 73 A.M. Jur. 2d Statutes § 103 (2004) (providing summary of in pari materia rule of statutory interpretation). For more on the rule of in pari materia, see infra notes 169-71 and accompanying text (defining rule and detailing its application in context of Section 2036(a)).

\textsuperscript{167} See Poole, supra note 164, at 547 (characterizing cases applying Section 2036(a) in FLP context as examples of incorrect judicial interpretation of term "transfer"); see also id. (stating that expansive view of Section 2036(a) is "motivated by strong distaste for what they view as abusive FLPs").

\textsuperscript{168} See id. (reasoning that using Section 2036(a) as method of attacking FLPs "runs afoul of statutory scheme").

\textsuperscript{169} See id. at 541-42 (arguing that FLP cases applying Section 2036(a) ignored rule of \textit{in pari materia} when construing meaning of word "transfer").

\textsuperscript{170} 73 A.M. Jur. 2d Statutes § 103 (2004).

\textsuperscript{171} See Wheeler v. United States, 116 F.3d 749, 761 (5th Cir. 1997) ("The gift tax was supplementary to the estate tax. The two are \textit{in pari materia} and must be construed together.") (quoting Comm'r v. Wemyss, 324 U.S. 303, 307 (1945); Estate of Sanford v. Comm'r, 308 U.S. 39, 43-45 (1939))).

\textsuperscript{172} See Poole, supra note 164, at 542 (noting existence of analogy between meaning of "transfer" in Section 2036(a) and gift tax sections of IRC).

\textsuperscript{173} See Church v. United States, 85 A.F.T.R.2d (RIA) 2000-804, 2000-1 (stating that term "transfer" in context of gift taxation refers only to transfers that are gratuitous in nature).

\textsuperscript{174} Poole, supra note 164, at 542. The author provides three examples of transfers to which Section 2036 would properly apply: "(1) a transfer to a trust where a beneficial interest in another persona was created, (2) the transfer of a fee interest of property to another with the transferor retaining an actual or implied right to use the property, and (3) the contribution of assets to an entity that increases the equity of another owner." Id. at 547.
should not apply to transfers in the form of contributions made pursuant to formation of an FLP because such a transfer lacks the requisite donative intent. The ruling in Church v. United States supports this argument. In that case, the IRS argued that the transferor made a gratuitous transfer because the decedent’s partnership interests exceeded the value of the assets she contributed to the FLP. The district court rejected the IRS’s argument by citing Wheeler’s in pari materia interpretations of the term “transfer” in both the gift and estate tax sections of the IRC. The court reasoned that a gratuitous transfer could never result from the “formation of a business entity in which each partner’s interest is proportional to the capital contributed.” As a result, the court held that Section 2036(a) was not applicable to the assets transferred by the decedent to the FLP.

In Thompson, the decedent contributed the majority of his assets to the FLP and received a majority interest in both the Thompson and Turner FLPS. Therefore, according to the reasoning proffered in Church, the court in Thompson should not have applied Section 2036(a) to the decedent’s transfers to the FLPS because they were not gratuitous transfers. While this argument is legally and logically sound, neither the Tax Court nor the circuit courts have chosen to adopt Church’s analysis. As a result, the issue is likely to become ripe for Supreme Court review in the future.

175. See id. at 546 (noting that recent case law does not recognize transfers to FLP as meeting “lifetime gift” standard within meaning of Section 2036).
177. See id. (holding that, in absence of gratuitous transfer upon formation, Section 2036(a) does not apply to contributions made to FLP).
178. See id. (arguing in favor of applying Section 2036(a) to include assets transferred by decedent to FLP in decedent’s gross estate). Specifically, the IRS maintained that, because the decedent contributed assets worth $1,467,748 and received an FLP interest worth $617,591, someone must have received a gratuitous transfer of the difference between the two amounts. See id. (expounding upon IRS’s claim).
179. See id. (refusing to accept IRS’s argument).
180. Id.
181. See id. (stating holding).
182. See Estate of Thompson v. Comm’r, 382 F.3d 367, 370 (3d Cir. 2004) (discussing facts). For a more comprehensive summary of this information, see supra notes 113-34 and accompanying text.
183. See Poole, supra note 164, at 545 (criticizing application of Section 2036(a) to transfers similar to one at issue in Thompson).
184. See id. at 546 (noting that Church decision “has remained rather obscure”). Although the Fifth Circuit affirmed the district court’s ruling in an unpublished opinion, it nonetheless applied Section 2036(a) in an FLP case in Kimbell. See Kimbell v. United States, 371 F.3d 257, 265 (5th Cir. 2004) (holding that Section 2036(a) applies to transfers made to FLP). Thus, the Fifth Circuit’s decision in Kimbell represents an outlier of tax jurisprudence. For an analysis of the Fifth Circuit’s analysis in Kimbell, see supra notes 105-06, 111.
185. See Poole, supra note 164, at 447 (predicting that resolving Section 2036(a) conflict will require Supreme Court review).
VII. IMPACT: THE FUTURE OF FLPs AS AN ESTATE-PLANNING TOOL IN THE THIRD CIRCUIT

While the Third Circuit was clear that it would hold FLPs to a high standard, the court did not foreclose the possibility of using FLPs as a means of reducing estate taxes. As such, there are a number of lessons practitioners should take away from the Third Circuit’s ruling in Thompson in order to properly form, maintain and defend an FLP in the future. First, the client must retain sufficient funds for personal expenses. Second, the client must segregate personal assets from those belonging to the FLP. Last, the partners must establish and document a legitimate business purpose for the FLP. The IRS is willing to permit taxpayers to derive estate-tax benefits from transfers to an FLP when the FLP is formed and operated as a legitimate business entity. Accordingly, The Third Circuit’s analysis indicated that if clients and planners work together to follow the framework set forth below, an FLP is likely to withstand heightened scrutiny.

A. Retain Sufficient Funds for Decedent’s Personal Expenses

To avoid application of Section 2036(a) to assets transferred to an FLP, the client must retain sufficient funds to cover personal expenses.

186. See Thompson, 382 F.3d at 379 (concluding that bona fide sale exception requires identifiable components of objective business enterprise). The Third Circuit did not dispute that tax advantages may be derived as long as members of the partnership enter into the transaction “for substantial business and other non-tax reasons.” See id. at 383 (quoting Kimbell, 371 F.3d at 267).


188. For a discussion on the importance of retaining sufficient personal funds when contributing to an FLP, see infra notes 193-97 and accompanying text.

189. For a discussion on how to properly segregate personal and partnership assets, see infra notes 198-209 and accompanying text.

190. See Thompson, 382 F.3d at 379 (holding that FLP transfer is bona fide sale only for adequate consideration with legitimate business purpose). For a discussion on the legitimate business and non-tax benefits of forming an FLP, see supra notes 60-68 and accompanying text.

191. Fee Interview, supra note 63 (stating that IRS is willing to allow tax reduction for decedent’s estate if FLP did not exist primarily to provide tax shelter).

192. See Thompson, 382 F.3d at 383 (stating that “objective indicia . . . [of] a legitimate business” may provide sufficient evidence for bona fide sale under Section 2036(a)). It is important to note that the Tax Court appears to have modified its arm’s length requirement following the Third Circuit’s ruling in Thompson. See Akers, supra note 102, at 13-14 (discussing new standard for bona fide sales set forth by Tax Court in Bongard v. Commissioner, 124 T.C. 8 (2005)).

193. See Bissonnette, supra note 1, at 78 (discussing need to retain sufficient resources necessary to meet client’s basic living needs); see also Harrison & Newlin, supra note 187, at 35 n.18 (“One test of the sufficiency of assets retained would be
In *Thompson*, the decedent retained funds to cover his expenses for three and a half years, but the decedent’s life expectancy after the date of the transfer was greater than four years.\(^{194}\) Because the Third Circuit found the six-month discrepancy significant, it can be inferred that the Third Circuit will closely examine the timing of the transfer in future cases.\(^{195}\) Therefore, a practitioner should advise the client not to transfer funds to the FLP without first considering the amount the client will need to maintain his or her accustomed lifestyle.\(^{196}\) Determining the appropriate amount to transfer requires careful planning by a certified public accountant or financial planner, but it remains a crucial first step in establishing that the client intended to relinquish the right to enjoy the transferred property.\(^{197}\)

**B. Asset Segregation**

While the FLP is undoubtedly a unique estate planning device, the Third Circuit was clear that certain business principles must be upheld.\(^{198}\) Specifically, the court in *Thompson* emphasized the need to segregate the client’s personal assets from those belonging to the FLP.\(^{199}\) The court was adamant that commingling funds displays disrespect for the partnership whether those retained assets would be adequate to support the decedent’s monthly expenses.

\(^{194}\) See *Thompson*, 382 F.3d at 376 n.14 (providing calculations of funds needed to sustain decedent over span of expected life). The court explained that the “[d]ecedent retained assets of $153,000 and had an annual income of $14,000. These assets were sufficient to cover the decedent’s expenses of $57,202 for approximately three and a half years. That is: $153,000/($57,202-$14,000)= 3.4. Decedent had an actuarial life expectancy of 4.1 years at the time of the transfer.” Id.

\(^{195}\) See id. at 376 (noting that, despite “some change ensu[ing] in the formal relationship of decedent to the assets he contributed to the partnership, . . . [the] practical effect of these changes during decedent’s life was minimal” (quoting Estate of Thompson v. Comm’r, 84 T.C.M. (CCH) 374, 387 (2002))) (alterations in original).

\(^{196}\) See Top Tax Issues, supra note 3, at 149 (suggesting that FLPs are more likely to withstand judicial scrutiny if donor retains “adequate assets to cover all living expenses”); see also Bissonnette, supra note 1, at 78 (discussing need to retain sufficient resources necessary to meet client’s basic living needs); Eyberg & Raasch, supra note 8, at 755 (“It is clear from [this case] that an FLP creator should not transfer so much of his or her assets to raise the question whether there is an implied agreement for the transferor to have access to the assets.”).

\(^{197}\) See Eyberg & Raasch, supra note 8, at 755 (suggesting that financial planners should play role in “determining and documenting an individual’s cashflow needs for his or her remaining life expectancy”); see also Howell, supra note 15, at 733-34 (stating that estate planners should document client’s retention of personal assets).

\(^{198}\) See *Thompson*, 382 F.3d at 377 (indicating that Section 2036(a) applied when treatment of assets “is more consistent with an estate plan than with an investment in a legitimate business”).

\(^{199}\) See id. (concluding that decedent continued to be the primary beneficiary of transferred property despite its transfer to FLP). See generally Eyberg & Raasch, supra note 8 (discussing methods for segregating assets); Harrison & Newlin, supra note 187 (same); Howell, supra note 15 (same).
form and indicates that the donor/decedent transferred the assets with the intention of retaining post-transfer control. Therefore, it is important to segregate the client’s personal assets from those belonging to the FLP.

Further, the donor cannot use the FLP as a personal checkbook. This limitation not only precludes the donor’s direct withdrawal of FLP funds, but also bars other partners from distributing FLP funds to the donor for personal expenses. The use of FLP assets for personal purposes suggests that the donor/decedent’s relationship to the assets “remained the same before and after the transfer.” Additionally, a practitioner should advise his or her client that distributions of partnership income should only occur “after accounting has been made at the partnership level.”

As for the accounting aspects of maintaining the FLP, separate books and records should document the FLP’s financial affairs. Business transactions should be conducted with FLP funds and any income derived from FLP assets should be deposited in the FLP’s capital account. Additionally, each partner should establish a separate bank account for the FLP and pay all FLP expenses from that account. Following these steps will provide the FLP with ample evidence of asset segregation for purposes of Section 2036(a).

200. See Thompson, 382 F.3d at 376 (discussing facts that indicate commingling of assets and thereby raising inference of retained control over partnership assets).

201. See Lewis & Chomakos, supra note 2, at 102-03 (discussing need to respect partnership form through maintaining separate personal and FLP accounts).

202. See id. at 103 (discussing restrictions on donor’s use of FLP funds); see also Top Tax Issues, supra note 3, at 149 (arguing that FLP is more likely to withstand judicial scrutiny if donor abstains from personally using partnership assets).

203. See Top Tax Issues, supra note 3, at 149 (counseling general avoidance of personal use of funds by donor).

204. Lewis & Chomakos, supra note 2, at 103 (quoting Estate of Schauerhamer v. Comm’r, T.C.M. 1997-242, 1505-6 (1997) (discussing probability that court will find retentions of control if donor’s practical relationship to assets remains unchanged after transfer); see also Thompson, 382 F.3d at 377 (citing Guynn v. United States, 437 F.2d 1148, 1150 (4th Cir. 1971)) (noting that decedent’s relationship to assets remained unchanged after transfer).

205. Bissonnette, supra note 1, at 77.

206. See Lewis & Chomakos, supra note 2, at 103 (discussing technical aspects of accounting for FLP).

207. See id. (emphasizing need to separate partnership income by distributing income in separate FLP account).

208. See id. (stating that: (1) all financial transactions made on behalf of FLP must use funds from FLP’s account; and (2) all receipts by FLP must be deposited in FLP’s account).

209. Cf. Thompson, 382 F.3d at 376 (noting that lack of de jure control over transferred property alone does not defeat inference of implied agreement among partners for impermissible use of property).
C. **Legitimate Business Purpose/Non-Tax Benefits**

A transfer of assets to an FLP will only meet the *Thompson* criteria for a bona fide sale for full and adequate consideration if the estate can cite a business purpose or other non-tax benefit justifying the existence of the FLP.\(^{210}\) The Third Circuit indicated that consolidating family business assets, transferring management of the business to children and protecting family members from personal liability constituted sufficient business purposes.\(^{211}\)

Accordingly, it is imperative that the client identifies a legitimate business motivation for forming the FLP.\(^{212}\) Upon formation of an FLP, the practitioner should document the business purpose in the partnership agreement.\(^{213}\) Other non-tax reasons for forming the FLP should also be documented in detail.\(^{214}\) Such measures will provide a court with evidence that the decedent formed the FLP for legitimate reasons outside of receiving an estate-planning benefit.\(^{215}\)

**VIII. Conclusion**

It is undeniable that the ruling in *Thompson* will change the use of FLPs for estate planning in the Third Circuit.\(^{216}\) The standard is stringent

---

210. See Lewis & Chomakos, *supra* note 2, at 101 (explaining need for valid business purpose and respect for business form); Top Tax Topics, *supra* note 3, at 144-45 (discussing need for bona fide sale with full and adequate consideration); see also Eyberg & Raasch, *supra* note 8, at 755 (arguing that "it is imperative that FLPs operate like real businesses, in substance and in form"); Harrison & Newlin, *supra* note 187, at 31 (emphasizing need for substantive non-tax purpose for FLP); Howell, *supra* note 15, at 733-34 (stating importance of meeting "fundamental requirements for creation and operation of FLPs").

211. See *Thompson*, 382 F.3d at 380 (citing Kimbell v. United States, 371 F.3d 257, 259 (5th Cir. 2004)) (providing example of FLP with substantial business purpose).

212. For a summary of a number of business/estate related motivations for forming an FLP, see *supra* notes 60-68 and accompanying text.

213. See Eyberg & Raasch, *supra* note 8, at 755 (discussing placement of business purpose in partnership agreement). In addition to establishing the non-tax benefits for forming an FLP, a Certified Public Accountant (CPA) should also document the results to demonstrate that the decedent actually benefited from the FLP. See id. (stating "[a] CPA financial planner should quantify the cost savings and any other investment strategy benefits received as a result of transferring assets to the FLP").

214. See id. (adding that existing FLPs should also document non-tax benefits derived from FLP).

215. See Harrison & Newlin, *supra* note 187, at 33 (arguing that FLPs can meet Third Circuit standard "if the clients and practitioners are willing to do due diligence beforehand and spend more time on setting up the partnership"). For an example of an FLP likely to withstand judicial scrutiny, see Bissonnette, *supra* note 1, at 82-83.

216. See Harrison & Newlin, *supra* note 187, at 31-32 (noting that planners should not underestimate *Thompson's* "rigorous standard" for determining legitimate non-tax reasons motivating FLP formation for purposes of Section 2036(a)); see also Howell, *supra* note 15, at 734 (concluding that *Thompson* demonstrates need
and will likely result in a decrease in the number of taxpayers choosing to establish an FLP as a means of estate planning. Nevertheless, for clients with dual business and estate planning goals, the use of an FLP remains a viable means of reducing the burden of the estate tax.

Lauren E. Bishow

for estate planners’ adherence to fundamental requirements of forming and maintaining FLP).

217. See Harrison & Newlin, supra note 187, at 33 (noting Thompson requires that practitioners be more selective when choosing FLP as method of estate planning). For a detailed discussion on determining whether an FLP meets a particular client’s needs, see Lewis & Chomakos, supra note 2, at 5 (counseling that FLP is inappropriate estate plan for every client).

218. See Lewis & Chomakos, supra note 2, at 1 (maintaining that FLP remains valuable tool for addressing tax and non-tax objectives despite recent attacks by IRS); Eyberg & Raasch, supra note 8, at 755 (concluding that “[w]hen properly structured and administered, FLPs holding appropriate assets and created for the right reasons . . . can provide substantial tax savings”).