SECTION 2036 OF THE INTERNAL REVENUE CODE: A PRACTITIONER'S GUIDE

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Author's Synopsis: This Article summarizes the current law and issues surrounding section 2036 of the Internal Revenue Code (Code). Specifically, this Article examines retained rights that trigger section 2036. It also addresses the issues surrounding the definition of a "bona fide sale" and the different tests employed by different courts. Lastly, this Article examines the definition of "adequate and full consideration in money or money's worth" and two highly debated issues in that area. It concludes that understanding the Internal Revenue Service's (Service) position on the issues involving section 2036 can reduce the likelihood of a Service audit and lead to substantial estate tax savings.

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I. INTRODUCTION

This Article attempts to summarize current law and issues surrounding section 2036 of the Code. Section 2036 addresses the government's concern that people may attempt to use lifetime transfers as a substitute for testamentary dispositions in order to avoid estate taxes. Without section 2036, people could retain life estates in property and gift the remainders to their children so that they did not own the property at the time of death, and thus, the property would not be includable in their taxable estate.[1] To that end, section 2036(a) states:

> The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—
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> (1) the possession or enjoyment of, or the right to the income from, the property, or
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> (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.[2]

A transferor retains "possession or enjoyment"[3] of property, within the meaning of section 2036, if he retains a "substantial present economic benefit"[4] from the property, as opposed to "a speculative and contingent benefit which may or may not be realized."[5] An estate can avoid the operation of section 2036(a)(1) by demonstrating that the

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[1] *See* I.R.C. § 2033. All statutory citations in this Article refer to the current statute unless otherwise indicated.

[2] I.R.C. § 2036(a).

[3] *Id.* at § 2036(a)(1).

[4] United States v. Byrum, 408 U.S. 125, 145 (1972).

[5] *Id.* at 150.

decedent did not retain any of the enumerated rights.[6] Even if the transferor retains one of the enumerated rights, section 2036 will not bring assets back into the estate if the transfer is "a bona fide sale for an adequate and full consideration in money or money's worth."[7]

II. HISTORY

The underlying principles of section 2036 have been around (in one form of another) for quite some time.[8] These principles, however, have gained importance in the last twenty-five years or so because Congress has recognized that allowing such transfers under section 2036 "would undermine the effectiveness of the federal estate tax" and the Service's ability to raise revenue.[9]

Under the precursors to section 2036 (i.e. section 811 of the former Code of 1939), the courts' analyses tended to favor the Service and simply examined the facts of each case to determine if an exchange or quid pro quo had occurred. Often, opinions simply made conclusory statements such as "the facts show no consideration in money or money's worth"[10] or "a release of dower and of the right to support are not adequate considerations 'in money or money's worth . . . .'"[11] Such cases were few, contained less analysis than current cases, and made no effort at creating unifying standards or rules. The precursor to section 2036 was not thought of as a complicated provision.

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[6] *See* I.R.C. § 2036(a).

[7] *Id.*

[8] *See* I.R.C. § 811(c), Pub. L. No. 76-1, 53 Stat. 119, 121 (1939) ("That the value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated—to the extent of any interest therein of which the decedent has at any time made a transfer, or with respect to which he has at any time created a trust, in contemplation of or intended to take effect in possession or enjoyment at or after his death (whether such transfer or trust is made or created before or after the passage of this Act), except in case of a bona fide sale for a fair consideration in money or money's worth"); Revenue Act of 1932, § 803(a), Pub. L. No. 72-154, 47 Stat. 169, 279; Revenue Act of 1924, § 302(c), Pub. L. No. 68-176, 43 Stat. 253, 304; Revenue Act of 1918, § 402(c), Pub. L. No. 62-254, 40 Stat. 1057, 1097. The underlying principles were first codified in its current form in the 1954 Acts, H.R. REP. NO. 1337, at 316 (1954), S. REP. NO. 1622 § 2036, at 469 (1954); *see also* H.R. REP. NO. 2543 (1954) (Conf. Rep.), *as reprinted in* 1954 U.S.C.C.A.N. 4456, 5113.

[9] Estate of Bigelow v. Comm'r, 503 F.3d 955, 963 (9th Cir. 2007).

[10] Giannini v. Comm'r, 148 F.2d 285, 287 (9th Cir. 1945).

[11] Adriance v. Higgins, 113 F.2d 1013, 1016 (2d Cir. 1940).

In the second half of the 20th century, more sophisticated estate planning and tax-avoidance mechanisms began to emerge. Practitioners began to take advantage of how the Service values assets. Assets are valued at the amount that they would garner when changing hands between a hypothetical, disinterested, willing buyer and a hypothetical, disinterested, willing seller. This objective standard allows estate planners to put assets into business entities that purposefully make them less attractive to third parties (typically because the entity applies restrictions on management or transferability).[12] The value of these entities is discounted from the sum value of their underlying assets, even if assets are never offered to third parties, and even though the value of the underlying assets has not changed.[13] Assets in a closely held corporation or limited partnership can be discounted for purposes of income, gift, or estate taxes by as much as forty percent, if not more.[14] Further, the transferring party can still manage the assets by retaining voting power or the general partnership interest, even if they give away some of the other beneficial or ownership interests.[15]

Congress enacted section 2036(b) as part of the Tax Reform Act of 1976 specifically to address the type of estate planning techniques mentioned above.[16] This subsection overturned Supreme Court precedent and specified that the power to directly or indirectly vote stock of a controlled corporation would cause that stock to be includable in the decedent's gross estate under section 2036.[17] Because this statute explicitly discussed corporations, and did not discuss partnerships, many practitioners increased their reliance on family limited partnerships (FLPs) to transfer assets out of the estate for less than their fair market value.[18]

Originally, the Service approved of such transactions through Technical Advice Memoranda and Private Letter Rulings, but it quickly

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[12] For a more detailed discussion of such estate planning techniques, see Brant J. Hellwig, *Estate Tax Exposure of Family Limited Partnerships Under Section 2036*, 38 REAL PROP. PROB. & TR. J. 169, 173–75 (2003).

[13] *See id.* at 175.

[14] *See id.* at 176–77.

[15] *See id.* at 173–74.

[16] *See* Andrea B. Short, *"Adequate and Full" Uncertainty: Courts' Application of Section 2036(a)(1) of the Internal Revenue Code to Family Limited Partnerships*, 84 N.C. L. REV. 694, 710–12 (2006).

[17] *See id.*

[18] *See id.*

changed course, filing notices of deficiency for estates that applied valuation discounts to partnerships and other entities.[19] The Service argued that FLPs had no economic substance, that FLPs included a taxable gift of the amount of diminution in value at the time of creation, and that the assets were subject to special valuation rules under the Code.[20] These initial arguments attacked the use of discounts and the use of business entities rather than the transfers out of the estate. Courts were unsympathetic to the Service's arguments until the Service began to use section 2036.[21]

The Service's first successful challenge to transfers of devalued FLP interests under section 2036 was *Estate of Schauerhamer v. Commissioner*,[22] a Tax Court memorandum opinion.[23] The decedent in *Schauerhamer* created three FLPs into which she transferred substantial assets.[24] She then gifted interests in the partnerships to family members, taking steep discounts on her gift tax returns.[25] During her life, she largely ignored the partnership structure: she used partnership assets as if she owned them outright and disregarded the partnership formalities.[26] After her death, the Service argued that all of the FLP assets should be included in her gross estate under section 2036 because she retained their possession and enjoyment.[27] The Tax Court agreed.[28] After *Schauerhamer*, estate audits based on section 2036 became more common and practitioners began to pay more attention to what would and would not trigger the applicability of section 2036.[29]

The result has been a flurry of cases (that are not always consistent) grappling with section 2036 generally, and the meaning of "bona fide sale" and "full and adequate consideration" more specifically.[30] This Article attempts to consolidate the case law into a usable package. It

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[19] *See id.*
[20] *See id.*
[21] *See id.* at 704.
[22] 73 T.C.M. (CCH) 2855 (1997).
[23] *See id.*
[24] *See id.* at 2856.
[25] *See id.*
[26] *See id.* at 2857.
[27] *See id.* at 2858.
[28] *See id.*
[29] *See* Short, *supra* note16, at 715.
[30] *See id.* at 716.

reviews the approaches of different jurisdictions and the factors that all courts seem to find probative. Section III examines retained rights that trigger section 2036, focusing on the common factors where retained rights are found. Section IV examines the definition of a bona fide sale and the different tests employed by different courts. Finally, Section V examines the definition of "adequate and full consideration in money or money's worth" and two highly debated issues in that arena.

III. RETAINED RIGHTS OF GRANTORS

Section 2036 does not pull property back into an estate unless the transferor retains one of two rights for a period not ascertainable without regard to his death.[31] Section 2036(a)(1) causes inclusion when the transferor retains "the possession or enjoyment of, or the right to the income from, the property."[32] Section 2036(a)(2) causes inclusion when the transferor retains "the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom."[33] Each is discussed in turn.

A. Possession or Enjoyment of Property and Right to Income

Section 2036 addresses the concern that *inter vivos* transfers often function as will substitutes, with the transferor continuing to enjoy the benefits of property during life, and the beneficiary receiving the property only upon the transferor's death. As such, section 2036(a)(1) includes property transferred *inter vivos* in the gross estate if the decedent retains possession, enjoyment, or the right to income from the property during his lifetime.[34] "As used in section 2036(a)(1), the term 'enjoyment' has been described as 'synonymous with substantial present economic benefit.'"[35]

Section 2036 will bring the fee value of the property back into the decedent's taxable estate if it appears that there was an agreement at the time of the transfer—regardless of it is was express or implied—that the decedent would in fact have one of these rights.[36] Section 2036(a)(1)

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[31] *See* I.R.C. § 2036(a).

[32] I.R.C. § 2036(a)(1).

[33] *Id.* § 2036(a)(2).

[34] *See* Estate of Thompson v. Comm'r, 382 F.3d 367, 375 (3d Cir. 2004).

[35] Estate of Harper v. Comm'r, 83 T.C.M. (CCH) 1641, 1648 (2002) (quoting Estate of McNichol v. Comm'r, 265 F.2d 667, 671 (3d Cir. 1959)).

[36] *See* Treas. Reg. § 20.2036-1(a).

may apply even if the right is not legally enforceable and even if there are "formal legal structures which prevent de jure retention of benefits of the transferred property."[37] As the Tax Court stated, "[Although] the proverbial 'i's were dotted' and 't's were crossed' . . . [t]hey do not preclude implicit retention by decedent of economic benefit from the transferred property."[38] "To avoid characterization as a retained interest, the decedent must have 'absolutely, unequivocally, irrevocably, and without possible reservations' parted with all of her title, possession, and enjoyment of the transferred assets."[39] This reflects the fundamental idea that "[s]ubstance and not form is made the touchstone of taxability. . . . [T]echnical concepts pertaining to the law of conveyancing cannot be used as a shield against the impact of death taxes when in fact possession or enjoyment of the property by the transferor . . . ceases only with his death."[40]

A lot of the section 2036 litigation focuses on implied agreements under section 2036(a)(1) and the bona fide sale exception. Often, if a court finds that there was an implied agreement that a transferor would retain the possession and enjoyment of property, they will also find against a bona fide sale.[41] Because the factors are similar and overlap, courts occasionally conflate the two inquiries. This overlap makes sense. If a grantor transfers assets out of his estate with the implied agreement that he can access the assets at any time, this should not qualify as a bona fide or good faith transfer. Instead, courts infer that the grantor was trying to defraud the Service (or, more accurately, other federal taxpayers) and find the entire transaction to be a sham.[42]

Implied agreements are often inferred from the facts of a case and are reviewed on appeal only for clear error.[43] "A factual finding is not clearly erroneous if it is plausible in light of the record read as a whole," a fairly low standard of review.[44] When reviewing the case law on this

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[37] *Thompson*, 382 F.3d at 375.

[38] Estate of Strangi v. Comm'r, 85 T.C.M. (CCH) 1331, 1338 (2003) (quoting Estate of Strangi v. Comm'r, 115 T.C. 478, 486 (2000)), *aff'd sub nom.* Strangi v. Comm'r, 417 F.3d 468 (5th Cir. 2005).

[39] Estate of Trombetta v. Comm'r, 106 T.C.M. (CCH) 416, 422 (2013) (quoting Comm'r v. Estate of Church, 335 U.S. 632, 645 (1949)).

[40] Estate of McNichol v. Comm'r, 265 F.2d 667, 673 (3d Cir. 1959).

[41] *See Strangi*, 417 F.3d at 475–82.

[42] *See* Wheeler v. U.S., 116 F.3d 749, 767 (5th Cir. 1997).

[43] *See Strangi*, 417 F.3d at 476–77.

[44] *Id.* at 477.

topic, several themes are immediately apparent. As summarized by the Tax Court:

> In assessing whether a decedent impliedly retained the right to possession or enjoyment of the assets, we previously have considered factors such as the use of the transferred assets to pay the decedent's personal expenses, the decedent's relationship to the assets before and after the transfer, "commingling of funds, a history of disproportionate distributions, testamentary characteristics of the arrangement, the extent to which the decedent transferred nearly all of his or her assets, the unilateral formation of the partnership, the type of assets transferred, and the personal situation of the decedent."[45]

Examples best illustrate these factors.

First, an implied relationship will exist where the grantor ignores whatever structure is set up in order to access the underlying assets and use them for his personal needs.[46] One of the most detailed cases on point is *Strangi v. Commissioner*.[47] In *Strangi*, the decedent executed a power of attorney because his health was deteriorating.[48] His attorney-in-fact then set up an FLP and put 98% of the decedent's wealth into the FLP.[49] Evidence showed that the decedent retained only $762 in cash, a fact that implied to the court that the transfer could not have been intended as legitimate because it left the decedent without sufficient means to support himself.[50] The partnership made cash distributions to the decedent to pay for his personal needs (such as the cost of his in-home nurse).[51] Although the decedent's home had been transferred to the partnership, no rent payments were made for over two years and no action was taken to recover the missing payments.[52] This implied that the

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[45] Estate of Trombetta v. Comm'r, 106 T.C.M. (CCH) 416, 423 (2013) (quoting Estate of Erickson v. Comm'r, 93 T.C.M. (CCH) 1175, 1180 (2007)).

[46] *See Strangi*, 417 F.3d at 478.

[47] 417 F.3d 468 (5th Cir. 2005).

[48] *See id.* at 472.

[49] *See id.* at 473.

[50] *See id.* at 478.

[51] *See* Estate of Strangi v. Comm'r, 85 T.C.M. (CCH) 1331, 1335 (2003), *aff'd sub nom.* Strangi v. Comm'r, 417 F.3d 468 (5th Cir. 2005).

[52] *See Strangi*, 417 F.3d at 474.

legal obligation to pay rent was illusory.[53] Finally, the court noted that the FLP paid the decedent's funeral expenses and the specific bequests in his will despite having no legal obligation to do so.[54] In other words, nothing but the formal title changed concerning the transferor's relationship to his assets: the assets remained available for his personal use even though they had been legally transferred away from his estate.[55] For these reasons, the court had no problem finding that an implied agreement existed that the decedent would still receive the benefits of the property.[56] The fee value of the property was added back to his taxable estate.[57]

The facts of *Estate of Abraham v. Commissioner*[58] are similar. The transferor's assets were put in an FLP and shares of the FLP were sold and gifted to the transferor's children.[59] However, all of the FLP owners shared an understanding—and even testified to that understanding in the Tax Court—that the transferor would be provided for during her lifetime, would "never want for anything," and that FLP income would first be used for her needs.[60] Accordingly, the First Circuit found that there was an implied, perhaps even explicit, agreement that the decedent would retain the right to enjoyment of the transferred property, despite the fact that this understanding was in direct conflict with the legal rights of the parties.[61]

Similarly, in *Estate of Bigelow v. Commissioner*,[62] the decedent transferred her real property into a trust that was then put into an FLP.[63] When she did not have enough income to cover her expenses, she used FLP income to make up the difference.[64] No other partners received

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[53] *See id.* at 477.

[54] *See id.* at 477–78.

[55] *See id.*

[56] *See id.* at 478.

[57] *See id.* at 482.

[58] 408 F.3d 26 (1st Cir. 2005), *amended sub nom.* Estate of Abraham v. Comm'r, 429 F.3d 294 (1st Cir. 2005).

[59] *See id.* at 32.

[60] *Id.* at 29.

[61] *See id.* at 39–40.

[62] 503 F.3d 955 (9th Cir. 2007).

[63] *See id.* at 958–59.

[64] *See id.* at 960–61.

proportionate distributions.[65] The trust's property secured several of the decedent's personal liabilities, which were not transferred to the FLP.[66] Occasionally, the trust made interest payments on those same personal obligations.[67] These payments did not cause any change in the decedent's capital accounts.[68] Taking money at will and using trust income for personal debts showed a disregard for the trust and the partnership as separate legal entities.[69] There was no change in the decedent's beneficial use and enjoyment of the property despite the change in title.[70] Like in *Strangi*, the lack of respect for the legal boundaries of a separate entity was a telling factor, but *Bigelow* also shows the need to be consistent in the treatment of assets and entities. Capital accounts need to be maintained accurately and tax treatment needs to be uniform. Otherwise the Service is likely to see the transaction as a sham and not respect it for the purposes of calculating estate taxes.

This theme of consistency was also illustrated by *Estate of Korby v. Commissioner*.[71] The Korbys transferred assets to an FLP and made gifts of the vast majority of the beneficial interest.[72] Despite only retaining a 2% general partnership interest, Mr. Korby received substantial (and disproportionate) distributions from the FLP that were used for the Korbys' medical expenses, taxes, and other personal needs.[73] The Korbys claimed the payments were management fees.[74] However, Mr. Korby did not keep track of the hours he spent managing the funds, did not report the money as income on his tax return, and received payments whenever he requested them instead of on a set schedule.[75] The Eighth Circuit, affirming the Tax Court, cited these inconsistencies as evidence of retained enjoyment and rejected the taxpayers' framing of the transaction

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[65] *See id.* at 966.
[66] *See id.* at 960.
[67] *See id.* at 960–61.
[68] *See id.*
[69] *See id.* at 965–66.
[70] *See id.* at 965, 967.
[71] 471 F.3d 848 (8th Cir. 2006).
[72] *See id.* at 850.
[73] *See id.*
[74] *See id.* at 851.
[75] *See id.*

as an irrevocable transfer accompanied by payments for management services.[76]

Similarly, in *Guynn v. United States*,[77] the decedent transferred title to her home to her daughter, but "retained all the attributes of ownership except bare legal title. She remained in exclusive possession, paid the taxes, made improvements out of her own funds, and paid no rent."[78] Again, the lack of treatment of the conveyance as a disposition caused the court to find an implied agreement that the transferor would retain possession and enjoyment.[79]

Estate of Maxwell v. Commissioner[80] also concerned the sale of a house to children, but the Maxwells made more of an effort to make the sale look legitimate. Mortgage payments and rent payments were consistently and timely made by both parties, but the two types of payments were always for nearly identical amounts—differing each time by only a few dollars.[81] After the transferor died, the Maxwells failed to demand payments owed on the lease from the estate.[82] No actual change in circumstances occurred as a result of either the sale or the lease back.[83] Consequently, the Second Circuit found an implied agreement that the decedent would retain the continued use and enjoyment of the property and that the lease was only "window dressing," lacking any real substance.[84]

Another big theme in the implied agreement cases is the transferor's impoverishment. Like in *Strangi*, the decedent in *Thompson v. Commissioner*[85] transferred the majority of his assets (95%) into an FLP when he was ninety-five-years-old and had increasing healthcare costs.[86] The FLP made disproportionate distributions to the decedent, and the other partners testified they would not have denied him access to FLP funds.[87]

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[76] *See id.* at 852–53.
[77] 437 F.2d 1148 (4th Cir. 1971).
[78] *Id.* at 1150.
[79] *See id.*
[80] 3 F.3d 591 (2d Cir. 1993).
[81] *See id.* at 592.
[82] *See id.* at 594.
[83] *See id.* at 594–95.
[84] *See id.* at 591–94.
[85] 382 F.3d 367 (3d Cir. 2004).
[86] *See id.* at 370.
[87] *See id.* at 376–77.

The open access implied an agreement, which testimony confirmed.[88] Further, the decedent's age and failing health implied that the transfer was in anticipation of death (testamentary) rather than substantive.[89]

In summation, implied agreements are most likely to be found when the formalities of the entity are not respected, when the transferor's relationship to the transferred assets does not substantially change, when the transferor does not retain sufficient assets to cover his personal expenses, when entity assets are used for the transferor's personal liabilities, and when the tax treatment of certain transactions is not consistent among the gift-tax returns, income-tax returns, the estate-tax return, and internal capital accounts. Although these factors are most commonly seen in the context of retained rights to use and enjoy property, they are equally applicable to the right to income from working assets. Further, many courts cite these same factors as indications that a sale was not bona fide. It is important for practitioners to keep these facts in mind when crafting estate plans for clients. These considerations should be discussed with clients and their representatives to try to prevent them from later undermining a valid estate plan by disregarding formalities of an otherwise legitimate entity or transfer.

B. Right to Designate Right to Enjoyment or Income

The Treasury Regulations (Regulations) give some guidance on "the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom."[90] The Regulations explain that this right

> [i]ncludes a reserved power to designate the person or persons to receive the income from the transferred property, or to possess or enjoy nonincome-producing property, during the decedent's life or during any other period described in paragraph (a) of this section. With respect to such a power, it is immaterial (i) whether the power was exercisable alone or only in conjunction with another person or persons, whether or not having an adverse interest; (ii) in what capacity the power was exercisable by the decedent or by another person or persons in conjunction with the decedent; and

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[88] *See id.*
[89] *See id.*
[90] I.R.C. § 2036(a)(2).

> (iii) whether the exercise of the power was subject to a contingency beyond the decedent's control which did not occur before his death (e.g., the death of another person during the decedent's lifetime). The phrase, however, does not include a power over the transferred property itself which does not affect the enjoyment of the income received or earned during the decedent's life. (See, however, section 2038 for the inclusion of property in the gross estate on account of such a power.) Nor does the phrase apply to a power held solely by a person other than the decedent. But, for example, if the decedent reserved the unrestricted power to remove or discharge a trustee at any time and appoint himself as trustee, the decedent is considered as having the powers of the trustee.[91]

The big takeaway from this regulation is that a power will violate section 2036 even if it is exercisable only in conjunction with someone else, regardless of the capacity in which it is used, and even if there is a contingency on the use of the power. This is a broad section.

The United States Supreme Court last addressed this provision in *United States v. Byrum*,[92] which has subsequently been overruled by statute.[93] In *Byrum*, the patriarch of a family created an irrevocable trust for the benefit of his issue and transferred the shares of three closely held corporations into the trust.[94] The grantor gave a corporate trustee the power to manage and control the assets, subject to certain rights that the grantor retained.[95] The grantor kept the powers: (1) to vote the closely held shares of stock; (2) to veto the transfer of trust assets; (3) to approve investments and reinvestments; and (4) to change the corporate trustee. The grantor retained no right to the income or personal enjoyment of the trust assets.[96]

The Service argued that the grantor retained the power to designate enjoyment because he retained the right to vote the majority of the

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[91] Treas. Reg. § 20.2036-1.

[92] 408 U.S. 125 (1972).

[93] *See* I.R.C. § 2036(b) (retaining the power to vote corporate stock will cause 2036 inclusion in some instances).

[94] *See* 408 U.S. at 126–27.

[95] *See id.*

[96] *See id.*

closely held corporations' stock.[97] According to the Service, this allowed the grantor to de facto decide the dividend policy of the company and, consequently, when and if the transferees would receive income.[98] The Supreme Court rejected this argument, stating that section 2036(a)(2) "connotes an ascertainable and legally enforceable power" whereas the power a majority shareholder has over directors is indirect and not legally enforceable.[99] Further, whatever indirect power a shareholder had would be restrained by the fiduciary duties owed by both the directors and any majority shareholder.[100]

Congress overturned *Byrum* when it enacted section 2036(b) as part of the Tax Reform Act of 1976. Section 2036(b) states that the retained power to vote stock does cause inclusion in a gross estate.[101] Despite the enactment of section 2036(b), the Tax Court still treats *Byrum*'s "ascertainable and legally enforceable power" standard as the test for section 2036(a)(2) because 2036(b) does not undermine the basic logic of the *Byrum* opinion.[102] When a "right" to determine distributions is ascertainable and legally enforceable, it will violate section 2036(a)(2).[103] When the power is attenuated or is legally curtailed, the courts tend not to bring assets back into the estate.

For example, the Tax Court recently found the existence of section 2036(a)(2) rights in *Estate of Turner v. Commissioner*.[104] In *Turner*, the decedent and his wife (the "Turners") formed and substantially capitalized a limited liability partnership.[105] The Turners were the sole general partners.[106] The partnership agreement provided that "[t]he balance of the net cash flow, if any, may be distributed to each Limited Partner and

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[97] *See id.* at 131–32.

[98] *See id.*

[99] *Id.* at 136.

[100] *See id.* at 136–37.

[101] *See* I.R.C. § 2036(b).

[102] *See, e.g.*, Estate of Turner v. Comm'r, 102 T.C.M. (CCH) 214, 227 (2011), *supplemented sub nom.* Turner v. Comm'r, 138 T.C. 306 (2012) (holding that the sole general partner who alone had the power to make pro rata distributions and unilaterally amend the partnership agreement had the power to determine who would receive income under *Byrum*); Estate of Schutt v. Comm'r, 89 T.C.M. (CCH) 1353, 1363 (2005) (citing specifically to *Byrum* for the standard).

[103] *See* I.R.C. § 2036(a)(2).

[104] 102 T.C.M. 214 (2011).

[105] *See id.* at 218.

[106] *See id.*

General Partner pro rata at such times and in such amounts as determined by the General Partner in its sole and absolute discretion."[107] The Tax Court held that this discretion was sufficient to activate section 2036(a)(2).[108] For all intents and purposes the decedent was the sole managing partner and, even though his wife was a copartner, the statute applies regardless of whether the right is exercisable alone or in conjunction with another person.[109]

Conversely, serving as the general manager was not found to trigger section 2036(a)(2) in *Estate of Mirowski v. Commissioner*.[110] Even though the LLC in question granted the decedent "full, exclusive, and complete discretion, power, and authority, subject in all cases to the other provisions of this Agreement and the requirements of applicable law, to manage, control, administer, and operate the business and affairs of the Company . . ., and to make all decisions affecting such business and affairs," this broad discretion was limited by other detailed, legally enforceable provisions of the company agreement which specified requirements for distributions, dissolution, and other key events.[111] Accordingly, the Tax Court held that section 2036(a)(2) did not apply because the company agreement, rather than the general manager, controlled when distributions would be made.[112]

The difference in these two cases is crucial. In *Turner*, the transferor had the unfettered and legally enforceable right to determine distributions. In *Mirowski*, the transferor had the power to make distributions, but their amount and timing were essentially dictated by the partnership agreement. This is the crux of the inquiry: there must actually be a right or a power to designate the persons who shall possess or enjoy the property or the income therefrom, not merely an administrative power to make dictated distributions.

Section 2036(a)(2) is relevant for planning techniques besides partnerships. In *Estate of Huford v. Commissioner*,[113] the Tax Court held that the decedent had retained a section 2036(a)(2) right when her execution of a Grantor Retained Annuity Trust (GRAT) was contingent

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[107] *Id.* at 218.
[108] *See id.*
[109] *See id.* at 227.
[110] 95 T.C.M. (CCH) 1277 (2008).
[111] *Id.* at 1299.
[112] *See id.* at 1297.
[113] 96 T.C.M. (CCH) 422 (2008).

on her two children complying with her wishes for the proceeds.[114] Even though this was not a legally enforceable right, her de facto power persuaded the court that section 2036(a)(2) applied.[115]

The right to remove a trustee and designate a successor trustee (either corporate or individual) will not trigger section 2036(a)(2) so long as the new trustee cannot be "related or subordinate to the decedent (within the meaning of section 672(c) of the Code)."[116] Further, management powers (even sweeping ones) do not cause *inter vivos* transfers to be subjected to federal estate taxes unless they are coupled with another right that would trigger section 2036 (such as unfettered discretion to determine income distributions, as discussed above).[117] Finally, any assets transferred in a revocable transaction (for example, transferred to a revocable trust) are includable in the gross estate, as is any income generated by such assets.[118]

While section 2036(a)(2) is less litigated than section 2036(a)(1), it is still important and has formed the basis for successful Service claims of deficiency. It is most likely to be an issue when the client wants to retain as much power over the assets as possible, primarily as a trustee, general partner, or managing member. The safest course is not to let the client accept one of these positions. If, however, the client is insistent on managing the entity, it is crucial to make sure there is a legally enforce-able, ascertainable standard in the governing instrument for all important events such as profit sharing, distributions, liquidation, dissolution, amendments, etc. Further, it is important to remember that regardless of the standards employed, section 2036(b) will bring assets back into the estate when a transferor retains specified rights to vote stock. Section

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[114] *See id.* at 442.

[115] *See id.*

[116] Rev. Rul. 95-58, 1995-2 C.B. 191.

[117] *See, e.g.*, Reinecke v. Northern Tr. Co., 278 U.S. 339 (1929); Old Colony Tr. Co. v. United States, 423 F.2d 601, 602 (1st Cir. 1970); Estate of Schutt v. Comm'r, 89 T.C.M. (CCH) 1353 (2005).

[118] *See* I.R.C. § 2038 (requiring inclusion in the gross estate "[t]o the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the dece-dent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3 year period ending on the date of the decedent's death."); *see also* United States v. O'Malley, 383 U.S. 627 (1966).

2036(b) should be closely examined when setting up closely held, family corporations.

IV. BONA FIDE SALE

If a client retains a right under section 2036(a)(1) or (2), or if the facts are questionable under the abovementioned factors, the transfer may still be upheld if it qualifies under the bona fide sale for adequate and full consideration exception to section 2036.

The Department of the Treasury has issued some guidance on the definition of a "bona fide sale" through its interpretive Regulations. Although Regulation 20.2036-1, which discusses section 2036, does not provide a definition, it directs the reader to Regulation 20.2043-1, "Transfers for Insufficient Consideration."[119] This Regulation states:

> The transfers, trusts, interests, rights or powers enumerated and described in sections 2035 through 2038 and section 2041 are not subject to the Federal estate tax if made, created, exercised, or relinquished in a transaction which constituted a bona fide sale for an adequate and full consideration in money or money's worth. To constitute a bona fide sale for an adequate and full consideration in money or money's worth, *the transfer must have been made in good faith* . . . .[120]

Despite the regulation's guidance, most courts have sought to further clarify the definition and provide more specific parameters for evaluating contested transactions. Although incorporated into the Regulations, many courts are moving away from a "good-faith" test.

A. Current Approaches by the Tax Court

The Tax Court has decided most of the cases dealing with section 2036. Although Tax Court opinions are subject to review by the circuit courts, the opinions (even memorandum opinions) are still informative of broader legal trends and can impact future Tax Court cases. Most litigated cases start in the Tax Court (because it is the only court that allows a taxpayer to contest a deficiency without first paying it) and many end there. The Tax Court's approach to bona fide sales has been

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[119] *See* Treas. Reg. § 20.2036-1(a).

[120] Treas. Reg. § 20.2043-1 (emphasis added).

varied, but there are currently two main approaches to the bona fide sale analysis.

1. The Arm's Length Transaction Analysis

The first, and older, method of analysis equates a bona fide sale with an "arm's-length business transaction between a willing buyer and a willing seller" (the "Arm's Length Transaction Test").[121] Commentators note that this may be an especially high standard for intra-family transactions because they do not involve the type of self-interested negotiations associated with normal arm's length transactions amongst business partners.[122]

Estate of Harper v. Commissioner[123] is typically cited as the main case for the Tax Court's Arm's Length Transaction Test.[124] The court looked at old precedent that defined a bona fide sale (under an older version of the code) as "an exchange resulting from a bargain," held

> [T]he exemption from tax is limited to those transfers of property where the transferor or donor has received benefit in full consideration in a *genuine arm's length transaction*; and the exemption is not to be allowed in a case where there is only contractual consideration but not "adequate and full consideration in money or money's worth."[125]

The *Harper* panel divided this test into two distinct parts: (1) A bona fide sale, meaning an arm's-length transaction, and (2) adequate and full consideration.[126] The Arm's Length Transaction Test emphasizes the relationship between the parties and how the transaction compares to those conducted by unrelated parties.

[121] Estate of Reichardt v. Comm'r, 114 T.C. 144, 155 (2000) (finding no bona fide sale where the decedent's children did not contribute anything to the partnership and the decedent did not sell the property to the FLP); *see also* Estate of Hillgren v. Comm'r, 87 T.C.M. (CCH) 1008, 1014 (2004).

[122] *See* Steve R. Akers, *Update of Planning Issues for Family Limited Partnerships* (ALIABA Course of Study, July 13–15, 2005), WLSL002 A.L.I.-A.B.A. 763, 803 (2005).

[123] 83 T.C.M. (CCH) 1641 (2004).

[124] *See id.* at 1653.

[125] *Id.* (emphasis added) (citing Estate of Goetchius v. Comm'r, 17 T.C. 495, 503 (1951)).

[126] *See id.*

Harper concerned transfers to the Harper Family Limited Partnership (HFLP). Finding the transfers were not made at arm's length, the court explained:

> On the facts before us, HFLP's formation at a minimum falls short of meeting the bona fide sale requirement. Decedent, independently of any other anticipated interest-holder, determined how HFLP was to be structured and operated, decided what property would be contributed to capitalize the entity, and declared what interest the Trust would receive therein. He essentially stood on both sides of the transaction and conducted the partnership's formation in absence of any bargaining or negotiating whatsoever. It would be an oxymoron to say that one can engage in an arm's-length transaction with oneself, and we simply are unable to find any other independent party involved in the creation of HFLP.[127]

However, the *Harper* court rejected the Service's argument that consideration was necessarily inadequate when valuation discounts were applied to a family partnership.[128] The court stated:

> [I]t is not unreasonable to assume that a genuine pooling for business purposes injects something different into the adequate and full consideration calculus than does mere, unilateral value "recycling."
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> . . . In the former situation, there is at least the potential that intangibles stemming from a pooling for joint enterprise might support a ruling of adequate and full consideration.[129]

This dicta about the transferor's motivations and the court's acceptance of the legitimacy of valuation discounts became important in the move away from the Arm's Length Transaction Test and towards the Tax Court's other approach, which this Article refers to as the "Nontax Reason Test."

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[127] *Id.*

[128] *See id.* at 1654.

[129] *Id.*

As will be discussed below, the Arm's Length Transaction Test is only used in a minority of cases and jurisdictions. However, it is still relevant. Often, the parties' bargaining positions are considered in determining if a sale was bona fide under the Nontax Reason Test, and this factor is occasionally still treated as dispositive.[130]

2. The Nontax Reason Test

The Nontax Reason Test was first clearly espoused in *Bongard v. Commissioner*,[131] but older Tax Court memorandum opinions considered the transferor's motivation as a non-dispositive factor.[132] In *Bongard*, the decedent created a limited liability company (LLC) to serve as a holding company for all of the family's stock in Empak, the family's operating company.[133] This was done on the advice of the company's board of directors and the family's financial planners, who stated that consolidated control would help with a corporate liquidity event deemed necessary to stay competitive.[134] At the same time, the decedent created an FLP.[135] He then transferred his non-voting interest in the LLC to the FLP.[136] Two years later, the decedent died unexpectedly.[137]

The Service challenged the exclusion of both the Empak shares and the non-voting LLC interest from the decedent's estate.[138] The Tax Court held that the transfer of the stock to the LLC was a bona fide sale for full and adequate consideration but that the transfer of the LLC interest to the FLP was not.[139] Strangely, the court used different reasoning for each transaction.

First, the *Bongard* court summarized many of the recent section 2036 decisions from the different circuits. It then stated:

> In the context of family limited partnerships, the bona fide sale for adequate and full consideration

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[130] *See* Estate of Reichardt v. Comm'r, 114 T.C. 144, 155 ("A bona fide sale is an arm's-length business transaction between a willing buyer and a willing seller.").

[131] 124 T.C. 95 (2005).

[132] *See, e.g.*, Estate of Hillgren v. Comm'r, 87 T.C.M. (CCH) 1008, 1015 (2004).

[133] *See Bongard*, 124 T.C. at 95.

[134] *See id.*

[135] *See id.*

[136] *See id.*

[137] *See id.* at 98.

[138] *See id.*

[139] *See id.*

> exception is met where the record establishes the existence of a legitimate and significant nontax reason for creating the family limited partnership, and the transferors received partnership interests proportionate to the value of the property transferred . . . . The objective evidence must indicate that the nontax reason was a significant factor that motivated the partnership's creation . . . . A significant purpose must be an actual motivation, not a theoretical justification. By contrast, the bona fide sale exception is not applicable where the facts fail to establish that the transaction was motivated by a legitimate and significant nontax purpose.[140]

The court clarified that tax motivations would not necessarily cause inclusion in the gross estate. It stated, "[W]e must separate the true nontax reasons for the entity's formation from those that merely clothe transfer tax savings motives. Legitimate nontax purposes are often inextricably interwoven with testamentary objectives."[141] While this sounds like the Tax Court is fully adopting a Nontax Reason Test, the court then analyzed the first transaction by asking if unrelated people would have agreed to the same terms and conditions.[142] The court concluded that the transfer to the LLC was a bona fide sale because they could not "hold that the terms of the transaction differed from those of two unrelated parties negotiating at arm's length."[143] This sounds more akin to the Arm's Length Transaction Test than the Nontax Reason Test.

However, the court returned to the Nontax Reason Test when discussing the second transaction. Throughout the entirety of their discussion of the transfer of the LLC membership interest to the FLP, the court never once discussed the relationship of the parties or whether the discussions were arm's length. In fact, the court almost completely ignored the estate's argument that all parties were "adequately and independently represented in negotiating the terms" of the transaction.[144] Instead, the court looked at the decedent's motivation in creating the FLP. The court noted that "estate tax savings did play an important role in motivating the transfer to [the FLP]. The record does not support that

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[140] *Id.* at 118 (internal citations omitted).
[141] *Id.* at 121.
[142] *See id.* at 123.
[143] *Id.*
[144] *Id.* at 126.

the nontax reasons for [the FLP's] existence were significant motivating factors."[145] The court added, "such intent is not sufficient to establish that the transfer of membership units to [the FLP] was motivated by a significant nontax reason."[146]

The court then discussed all of the alleged nontax reasons for the FLP and rejected each one as insignificant. It concluded, "[U]nder these facts, decedent's transfer of [the LLC] class B membership units to [the FLP] did not satisfy the bona fide sale exception."[147] It is unclear whether the *Bongard* court was applying different tests for different types of transactions (see *infra*) or if its analysis was muddled.

3. The Tax Court: Going Forward

The Tax Court's reason for having two different standards is not clear. In many cases, like *Bongard*, the Tax Court conflates the Nontax Reason and Arm's Length Transaction Tests. In *Estate of Schutt v. Commissioner*,[148] the Tax Court stated:

> The approach of the Court of Appeals for the Third Circuit correlates with this Court's requirement of a legitimate and significant nontax purpose for the entity. This Court has expressed this requirement using the alternate phraseology of an arm's-length transaction, in the sense of "the standard for testing whether the resulting terms and conditions of a transaction were the same as if unrelated parties had engaged in the same transaction."[149]

In *Liljestrand v. Commissioner*,[150] the Tax Court made some effort to reconcile the two theories and explain how they were interrelated:

> Section 2036(a) excepts from its application any transfer of property otherwise subject to that section which is a "bona fide sale for an adequate and full consideration in money or money's worth." The exception is limited to a transfer of property where the

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[145] *Id.* at 127.
[146] *Id.*
[147] *Id.* at 129.
[148] 89 T.C.M. (CCH) 1353 (2005).
[149] *Id.* at 1364.
[150] 102 T.C.M. (CCH) 440 (2011).

> transferor "has received benefit in full consideration in a genuine arm's length transaction." The exception is satisfied in the context of a family limited partnership "where the record establishes the existence of a legitimate and significant nontax reason for creating the family limited partnership, and the transferors received partnership interests proportionate to the value of the property transferred. . . ."[151]

As will be seen, it may be significant that the court isolates "family limited partnerships" in its analysis. At least in *Liljestrand*, the Tax Court seemed to treat the Nontax Reason Test as a subset of the Arm's Length Transaction Test. The court seemed to assume that if there is a significant and legitimate nontax reason for the FLP, the terms must be acceptable under an Arm's Length Transaction Test.

One of the Tax Court's most recent opinions, *Estate of Trombetta v. Commissioner*,[152] goes in a completely different direction and separates the two tests based on the context. *Trombetta* concerned a Grantor Retained Annuity Trust (GRAT). The court held for the Service under the Arm's Length Transaction Test, explaining that the transferor had prepared the GRAT agreement without any bargaining or negotiating.[153] The court stated:

> [The decedent's attorney] and decedent determined how the entire estate plan would be structured and operated and what property would be contributed to which vehicle. Decedent, as the sole beneficiary and the sole transferor, formed the transaction, fully funded the annuity trust, and essentially stood on both sides of the transaction.[154]

The executor in *Trombetta* tried to use the Nontax Reason Test as a defense. The executor argued that the decedent created the annuity for an assured income stream and because she did not want to manage properties.[155] The Tax Court rejected the applicability of the Nontax Reason Test, stating:

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151 *Id.* at 444.
152 106 T.C.M. (CCH) 416 (2013).
153 *See id.* at 421–22.
154 *Id.* at 421.
155 *See id.* at 421–22.

> Although a number of other cases have applied the "legitimate and significant nontax reasons" standard to determine whether a bona fide sale exception was satisfied, all of the cases applied the standard in the context of a transfer to a family limited partnership. . . . Decedent transferred the Tierra Plaza and Black Walnut Square properties to a grantor trust, not a family limited partnership. Decedent's transfers are not comparable to a transfer to a family limited partnership, particularly given that no other individual received a present interest in the annuity trust. We are not persuaded and are unable to find that decedent's transfers to the annuity trust are sufficiently similar to a transfer to a family limited partnership to apply the "legitimate and significant nontax reasons" standard.[156]

The Court then stated that, even if the Nontax Reason Test did apply, the evidence did not support the executor's asserted justifications. The *Trombetta* Court ignored cases like *Schutt* and *Liljestrand*, which sought to consolidate the different precedents, instead seeking to distinguish different fact patterns for the different entities.

The most recent Tax Court case, *Estate of Perdue v. Commissioner*,[157] exclusively relied on the Nontax Reason Test.[158] Although the Service argued that the transaction should be invalid because the transferor stood on both sides of the transaction, the court stated:

> Where a taxpayer stands on both sides of a transaction, we have concluded that there is no arm's-length bargaining and thus the bona fide transfer exception does not apply. However, we have also stated that an arm's-length transaction occurs when mutual legitimate and significant nontax reasons exist for the transaction and the transaction is carried out in a way in which unrelated parties to a business transaction would deal with each other.

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[156] *Id.* at 422.
[157] 110 T.C.M. (CCH) 627 (2015).
[158] *See id.*

> We have already found the existence of a legitimate nontax motive for the transaction . . . . Accordingly, this factor does not weigh against the estate.[159]

This quote nearly nullifies the Nontax Reason Test. Repeatedly throughout *Perdue*, the Tax Court dismissed the Service's claims that the estate planning motive discredited the estate's positions.

There may be many reasons why the Tax Court has been inconsistent in its analysis. The confusion could be a byproduct of the Tax Court's strange jurisdiction. The Tax Court is an independent court of record established by section 7441 of the Code.[160] The Tax Court, along with the federal district courts, has jurisdiction to re-determine deficiencies assessed by the Service.[161] Appeals from the Tax Court are taken to the circuit court of appeals with jurisdiction where the taxpayer lives.[162] When there is case law on point, the Tax Court has stated that it will follow precedent from the circuit to which an appeal would follow.[163] Consequently, the Tax Court is bound by different circuits' precedents for different cases. These precedents may conflict and make the result of a case dependent on where the complaining taxpayer resides. In an attempt to make its decisions more uniform, the Tax Court could be attempting to unify the different standards so that its analysis can be less jurisdiction dependent.

Regardless of which "test" the Tax Court relies on, it tends to rely on the same factual considerations. These will be discussed further, but for now it is worth noting that the informative factors do not vary with the different tests. For this reason, the factual considerations may be more beneficial to a practitioner in terms of framing transactions and later arguments.

B. The Circuit Courts

1. The Fifth Circuit Cases

The Fifth Circuit has the most developed analysis of any federal circuit and seems to be taking the lead in developing precedent. Its cases are almost always cited, even in other jurisdictions, and cannot be

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159 *Id.* at 632 (internal citations omitted).

160 *See* I.R.C. 7441.

161 *See* Ellis v. Comm'r, 14 T.C. 484, 487 (1950).

162 *See* I.R.C. § 7482(a)(1), (b)(1)(A).

163 *See* Golsen v. Comm'r, 54 T.C. 742, 757 (1970), *aff'd on other grounds*, 445 F.2d 985 (10th Cir. 1971); *see also* I.R.C. § 7482(a)(1).

ignored. The main case is *Kimbell v. United States*,[164] but *Kimbell* drew heavily on a previous Fifth Circuit case, *Wheeler v. United States*.[165]

Wheeler informed the Fifth Circuit's bona fide sale analysis, although it really focused on the adequate and full consideration prong of section 2036.[166] In *Wheeler*, the decedent retained a life estate and sold the remainder interest in his ranch to his sons for its actuarial value as determined under the Regulations.[167] Although all parties agreed the value would have been accurate in the gift-tax context, the Service sought a different interpretation for a "bona fide sale."[168] The Service filed a notice of deficiency claiming the full fair market value of the ranch, less any consideration received from the sons, should have been included in the gross estate.[169]

The Fifth Circuit found for the taxpayer on the basis of Supreme Court precedent holding that terms used in both estate and gift tax statutes should be construed consistently because the two systems were designed to complement each other.[170] The Fifth Circuit quoted the Supreme Court's reasoning:

> Correlation of the gift tax and the estate tax still requires legislative intervention. . . . But to interpret the same phrases in the two taxes concerning the same subject matter in different ways where obvious reasons do not compel divergent treatment is to introduce another and needless complexity into this already irksome situation.[171]

The Fifth Circuit concluded its inquiry after a detailed analysis of why the actuarial value of the remainder is adequate and full consideration. It said that the bona fide sale requirement simply means the sale is not a sham or illusory.[172] The Fifth Circuit stated that the government was asking too much by moving away from established principles of gift

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[164] 371 F.3d 257 (5th Cir. 2004).
[165] 116 F.3d 749 (5th Cir. 1997).
[166] *See id.* at 751.
[167] *See id.* at 751–52.
[168] *See id.* at 755.
[169] *See id.* at 753.
[170] *See id.* at 761–63.
[171] *Id.* at 761 (quoting Merrill v. Fahs, 324 U.S. 308, 313 (1945)).
[172] *See id.* at 763.

tax that should be the same in the estate tax context.[173] The Fifth Circuit concluded that so long as "the transferor actually parted with the remainder interest and the transferee actually parted with the requisite adequate and full consideration," the transfer would be upheld.[174] The court found that the remainder sale was not a sham transaction.[175] The note used to purchase the remainder was fully secured and assignable, and the two sons used their annual bonuses to pay down the note.[176] The court explicitly rejected the argument that the transaction was a sham because there was no evidence of negotiations, unlike an Arm's Length Transaction Test analysis.[177]

Kimbell expanded on the definition of a "bona fide sale" from *Wheeler*. In *Kimbell*, a decedent had transferred securities and mineral interests into a grantor trust and then into an LLC.[178] On her death, the estate discounted the values by almost fifty percent for lack of control and marketability.[179] The Service audited the estate and alleged that all the assets should be taxable at their market value under section 2036.[180] The Fifth Circuit cited *Wheeler* for the proposition that full and adequate consideration did not have to be fair market value and that a bona fide sale could exist between related parties, but the sale would be subject to heightened scrutiny.[181] The court reiterated that aside from adequate consideration, the only requirement was that the sale be legitimate.[182]

Although it could have stopped there, the Fifth Circuit continued. Quoting *Black's Law Dictionary*, the Fifth Circuit stated that something was bona fide if it was "'in or with good faith; honestly, openly, and sincerely; without deceit or fraud' and '[r]eal, actual, genuine, and not feigned.'"[183] The court added that a transaction that was solely for tax avoidance and without a business or corporate motivation was not in

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[173] *See id.* at 761.
[174] *Id.* at 764.
[175] *See id.* at 768.
[176] *See id.*
[177] *See id.*
[178] *See* Kimbell v. United States, 371 F.3d 257, 259 (5th Cir. 2004).
[179] *See id.* at 260.
[180] *See id.*
[181] *See id.* at 263.
[182] *See id.* at 262–63.
[183] *Id.* at 263 (quoting BLACK'S LAW DICTIONARY (5th ed. 1979)).

good faith and should be disregarded for tax purposes.[184] The court was quick to add that some tax motivations in addition to a business purpose would not invalidate an otherwise valid transfer.[185] It upheld the disputed transaction, despite the fact that the decedent had contributed 99% of the partnership assets and that management of the assets had not changed after the "sale" of her assets to the family owned entity.[186] Mrs. Kimbell had received a partnership interest proportionate to her contribution and the Service had not disputed her non-tax reasons for the transaction, which the court characterized as credible.[187]

The *Kimbell* Court rejected the Arm's Length Transaction Test, reasoning:

> [J]ust because a transaction takes place between family members does not impose an additional requirement not set forth in the statute to establish that it is bona fide. A transaction that is a bona fide sale between strangers must also be bona fide between members of the same family. In addition, the absence of negotiations between family members over price or terms is not a compelling factor in the determination . . . particularly when the exchange value is set by objective factors.[188]

This implies that intrafamily sales should not fail under section 2036 for lack of negotiations or a party "standing on both sides," especially when objective criteria—such as an impartial appraisal combined with the Service tables—are used.[189]

Kimbell is one of the most tax-payer friendly precedents. The Fifth Circuit explicitly rejected the Arm's Length Transaction Test that had been previously employed by the Tax Court and did so in the context of an LLC rather than an FLP.[190] Instead, it asked simply if "proportionate" consideration was received and if the transaction was not a sham.[191] Proportionate does not have to be the fair market value of the assets sold

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[184] *See id.* at 266.
[185] *See id.* at 264.
[186] *See id.* at 265.
[187] *See id.* at 266–69.
[188] *Id.* at 263.
[189] *See id.*
[190] *See id.* at 270.
[191] *See id.* at 265.

because the court believed nontax reasons could justify stark discounts.[192]

After *Kimbell*, the Fifth Circuit seemed to regret its sweeping statements and attempted to somewhat reign in its holdings. In *Strangi v. Commissioner*,[193] the Fifth Circuit rejected the executor's characterization of *Kimbell* as solely requiring full and adequate consideration,[194] despite *Wheeler*'s clear statement that "the *only* possible grounds for challenging the legitimacy of the transaction are whether the transferor actually parted with the remainder interest and the transferee actually parted with the requisite adequate and full consideration."[195] The court explained that it had not yet defined the proper inquiry and shifted its focus to language from *Kimbell* requiring a substantial business or other nontax purpose for the transfer.[196] The Fifth Circuit stated:

> Congress has foreclosed the possibility of determining the purpose of a given transaction based on findings as to the subjective motive of the transferor. Instead, the proper inquiry is whether the transfer in question was objectively likely to serve a substantial non-tax purpose. Thus, the finder of fact is charged with making an objective determination as to what, if any, non-tax business purposes the transfer was reasonably likely to serve at its inception. We review such a determination only for clear error.[197]

The Fifth Circuit affirmed the Tax Court's rejection of the executor's five proffered nontax motivations: asset protection, preventing a will contest, preventing a corporate executor from serving, creating a joint investment vehicle, and allowing for centralized management.[198]

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[192] *See id.* at 267.

[193] 417 F.3d 468 (5th Cir. 2005).

[194] *See id.* at 479.

[195] Wheeler v. United States, 116 F.3d 749, 764 (5th Cir. 1997) (emphasis added). The Fifth Circuit distinguished this case by stating, "Although adequate consideration may suffice to show the absence of fraud or deceit where a real property interest is, in fact, transferred from one party to another, such is not the case where, as here, the purported transfer arguably deprives the transferor of literally nothing." *Strangi*, 417 F.3d at n.9.

[196] *See id.* at 479.

[197] *Id.* at 479–80.

[198] *See id.* at 480.

After *Strangi*, the safest interpretation of the Fifth Circuit's precedent is that a transaction will be upheld as a bona fide sale if the asset and the consideration are actually parted with and there is at least one legitimate nontax reason for the transaction.[199] Importantly, it is still safe to assume that the Fifth Circuit will not disqualify a transaction solely because of estate planning motivations or merely because the consideration is not equal to the fair market value of the asset transferred.[200]

2. The Third Circuit

In *Estate of Thompson v. Commissioner*,[201] the decedent transferred securities and other assets to two FLPs.[202] The decedent's two children also added assets (worth significantly less).[203] In exchange, the decedent and the children received partnership interests proportionate to their contributions.[204] The executors included the decedent's partnership interest in the decedent's estate, but applied a forty percent discount for lack of control and marketability to the underlying value.[205] The Service claimed a deficiency and sought to have the entire date of death value of the FLP assets returned to the estate.[206]

Affirming a memorandum decision by the Tax Court, the Third Circuit held that the decedent had an implied agreement to maintain the beneficial enjoyment of the assets and that the transactions were not bona fide sales.[207] The court rejected case law holding that a bona fide sale must be "an arm's length transaction" but stated that intrafamily transactions would be subject to higher standards of review.[208] While noting that a bargained-for exchange and an arm's length transaction could be informative, the court found no statutory or regulatory authority for making that the dispositive inquiry.[209] Instead, the Third Circuit relied on

[199] *See* Kimbell v. United States, 371 F.3d 257, 265–67 (5th Cir. 2004).
[200] *See id.* at 264–65.
[201] 382 F.3d 367 (3d Cir. 2004).
[202] *See id.* at 370.
[203] *See id.*
[204] *See id.*
[205] *See id.* at 372.
[206] *See id.*
[207] *See id.* at 381–82.
[208] *See id.* at 382.
[209] *See id.*

the Regulations to define a bona fide sale as one made in good faith. It then went on to define a transaction made in good faith as one that could "provide the transferor some potential for benefit other than the potential estate tax advantages that might result from holding assets in the partnership form," regardless of whether the partnership formalities were followed.[210] Finding that there was no reason for the transfer besides avoiding estate taxes, the Third Circuit affirmed the Tax Court's opinion.[211]

The Third Circuit's combination of a good faith examination and the Nontax Reason Test mirrors recent Tax Court opinions trying to reconcile the varying precedents.

3. The Ninth Circuit

The Ninth Circuit's controlling opinion is *Estate of Bigelow v. Commissioner*,[212] in which it upheld a Tax Court opinion bringing residential property that had been transferred into a FLP and discounted by 37% back into the decedent's gross estate.[213]

First, the Ninth Circuit rejected the Service's argument that discounts taken because of the partnership structure necessitated a finding that there was not adequate and full consideration in money or money's worth.[214] In so finding, the Court cited to the Tax Court in *Harper*, the Third Circuit in *Thompson*, and the Fifth Circuit in *Kimbell*.[215] The Ninth Circuit stated that, while discounts would not necessitate that value be brought back into the estate under section 2036, the estate must prove genuine pooling and the potential for benefits from such an arrangement that explained the desire to devalue the assets.[216] Like the Third Circuit, the Ninth Circuit linked validity of the transfer and the discount with the existence of a significant and legitimate nontax reason for the transfer.[217] The Ninth Circuit went on to uphold the Tax Court's decision, stating that the significant and legitimate nontax reason was the crux of the bona

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[210] *Id.* at 383.
[211] *See id.*
[212] 503 F.3d 955 (9th Cir. 2007).
[213] *See id.* at 973.
[214] *See id.* at 969.
[215] *See id.* at 968–69.
[216] *See id.* at 969.
[217] *See id.*

fide sale issue and no such reason was present.[218] This was a shift from a case eight years earlier which primarily dealt with the adequacy of consideration.[219] In that case, the Ninth Circuit used the terms "bona fide sale" and "arm's length transaction" almost interchangeably.[220]

The Ninth Circuit affirmed its analysis in one of the most recent section 2036 opinions, *Estate of Jorgenson v. Commissioner*,[221] which upheld a Tax Court decision bringing a decedent's interest in two FLPs back into her estate under section 2036. The Ninth Circuit found no clear error in the Tax Court's rejection of the estate's proposed nontax reasons (for example, the FLPs could not be justified as a tool for educating the children on investment decisions when the children did not participate in the management and the securities did not require any active management).[222]

4. *The Eighth Circuit*

The Eighth Circuit's case on point is *Estate of Korby v. Commissioner*.[223] Although *Korby* does not add any new law or analysis, it (much like *Thompson*) integrates all of the prior law and leaves the practitioner with a clear statement of the rule. The Eighth Circuit stated:

> A transfer is typically not considered a bona fide sale when the taxpayer stands on both sides of the transaction. The transaction must "be made in good faith" which requires an examination as to whether there was "some potential for benefit other than the potential estate tax advantages that might result from holding assets in the partnership form." "[I]f there is no discernible purpose or benefit for the transfer other than estate tax savings, the sale is not 'bona fide' within the meaning of § 2036."[224]

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[218] *See id.* at 973.

[219] *See* Estate of Magnin v. Comm'r, 184 F.3d 1074 (9th Cir. 1999).

[220] *See id.*

[221] 431 Fed. App'x 544 (9th Cir. 2011).

[222] *See id.*

[223] 471 F.3d 848 (8th Cir. 2006).

[224] *Id.* at 853–54 (internal citations omitted).

Although the internal citations were omitted above, the Eighth Circuit is citing to and integrating major cases from the Tax Court (*Bongard*), the Third Circuit (*Thompson*), and the Fifth Circuit (*Strangi* and *Kimbell*).[225]

This is the way the case law is evolving. It uses the "good faith" language from the Regulations to justify the Nontax Reason Test. If the sole reason for the transfer was tax avoidance or defrauding the Service, the transaction was not in good faith. This rule has logical appeal and is consistent with the trends of allowing valuation discounts, assuming they can be justified beyond avoiding estate tax liability. Although the Tax Court's law is still inconsistent, it seems to be moving this way as well.

C. Major Factual Considerations

Many of the factual considerations that courts find dispositive are consistent across jurisdictions and across different rules. For that reason, they are worth examining.

1. Not Respecting Formalities and Comingling Assets

The factors discussed in Part III.A, above (formalities of the entity are not respected, the transferor's relationship to the transferred assets does not substantially change, the grantor does not retain sufficient assets to cover their personal expenses, entity assets are used for personal liabilities, and the tax treatment of certain transactions is not consistent) are informative for both an implied agreement to maintain use or enjoyment of property and the lack of a bona fide sale. For example, the Tax Court in *Liljestrand v. Commissioner*[226] cited not respecting partnership formalities as evidence of a lack of bona fide sale when the partnership failed to open its own bank account for its first two years of existence, only held one partnership meeting, paid off the transferor's personal liabilities, and failed to make proportionate partnership distributions.[227] Although this overlap means that the analysis of different factors is often conflated, it makes sense. Comingling and using entity assets for personal purposes indicates that a transaction is testamentary and intended to avoid estate tax rather than one where interests are actually severed and the sale is in good faith.

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[225] *See id.*

[226] 102 T.C.M. (CCH) 440 (2011).

[227] *See id.* at 446.

The Second Circuit explained this overlap in the context of a mortgage note that no one ever intended to repay. It quoted the Supreme Court, which said,

> [T]he family relationship often makes it possible for one to shift tax incidence by surface changes of ownership without disturbing in the least his dominion and control over the subject of the gift or the purposes for which the income from the property is used . . . [T]here can be no doubt that intent is a relevant inquiry in determining whether a transaction is "bona fide."[228]

When the family does not intend a transaction to be real or to be respected (has an implied agreement that the grantor will retain enjoyment), the courts should not consider such a transaction bona fide.

2. Grantor on Both Sides of Transaction

The idea behind considering if the grantor is on both sides of the transaction is analogous to the Arm's Length Transaction Test. If one structures a transaction as a "sale" or a "pooling" of assets there needs to be more than one party involved. *Harper* is an example of the grantor standing on both sides of the transaction.[229] Although the *Harper* Court predominantly focused on the fact that no consideration was given by the grantor's children for the sale, they also mentioned that no one else in the family was involved in structuring the FLP or determining the terms and conditions under which it would be run.[230]

The Eighth Circuit similarly considered this factor, stating, "Austin [the decedent] formed [the partnership] with the help of his estate lawyer and without the involvement of his sons, who testified they were unfamiliar with the terms of the [partnership] agreement. Austin alone decided which assets would be included in funding the partnership."[231] As a side note, this quote also shows the court considering the use of an estate planning attorney, despite the fact that estate tax avoidance should not, without more, disqualify a transaction from being bona fide sale.

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[228] Estate of Maxwell v. Comm'r, 3 F.3d at 595–96 (2d Cir. 1993).
[229] *See* Harper v. Comm'r, 83 T.C.M. (CCH) 1641 (2002).
[230] *See id.* at 1653.
[231] Estate of Korby v. Comm'r, 471 F.3d 848, 854 (8th Cir. 2006).

Estate of Stone v. Commissioner[232] is a good contrast. In *Stone*, the decedent spouses had created several successful closely held businesses.[233] Subsequently, they established five FLPs to hold various business interests and sold interests in those different FLPs to their children.[234] The Stone family had already experienced substantial intra-family disputes and litigation.[235] Further, the children were all interested in managing and running different entities.[236] Absent some overarching plan, future litigation seemed likely. Accordingly, all family members retained independent legal counsel and a comprehensive family plan was reached.[237] They negotiated which assets would go into which partnerships and which children would have management powers over them.[238] Although the children contributed less value, they put in sweat equity which was dutifully tracked in the companies' capital accounts.[239] Further, despite taking valuation discounts, all assets were appraised before being transferred and the values were accurately reported to the Service.[240]

3. Nontax Reasons

Even courts that purport to follow the Arm's Length Transaction Test find nontax reasons for a transaction informative. While the following nontax reasons are in no way exclusive of those which will be respected by the courts, they are some that are examined repeatedly.

Preventing potential litigation is a common justification for transferring assets into partnerships. Typically, courts will only take this as a credible reason when something in the record supports the idea that litigation is likely. For instance, the Tax Court rejected preventing litigation as a justification when nothing in the record showed family strife or a litigious state atmosphere.[241] This was contrasted with a case where the family attorney credibly testified that he repeatedly advised his

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232 86 T.C.M. (CCH) 551 (2003).
233 *See id.* at 552.
234 *See id.*
235 *See id.* at 553.
236 *See id.* at 555.
237 *See id.*
238 *See id.*
239 *See id.* at 571.
240 *See id.* at 575.
241 *See* Liljestrand v. Comm'r, 102 T.C.M. (CCH) 440, 446 (2011).

clients "about the use of limited partnerships to protect family assets from the risks imposed by Mississippi's litigious atmosphere."[242] Similarly, litigation protection was a legitimate nontax reason in a case where the grantors' children had already been involved in litigation over family business interests.[243]

The Tax Court upheld succession planning as a legitimate nontax reason for transfers when the record reflected it was a real need.[244] *Stone* concerned an intricate estate plan.[245] The decedents owned several successful businesses and had abnormally litigious children.[246] Prior to the creation of the estate plan, disputes over family assets had already resulted in litigation.[247] Without a binding family agreement, (which had been agreed to by all parties with legal independent representation) future litigation was probable. The decedents transferred different assets to five different partnerships in exchange for proportional interests in those partnerships in accordance with the agreement.[248] Each partnership contained different business assets and the children received different ownership interests.[249] Given the peculiar circumstances and the likeliness of litigation, the Tax Court upheld the transfers.[250]

Another legitimate reason is the need for active and centralized management of the underlying assets. Where the grantor is unable to manage the assets alone or where there are joint owners who could benefit from unified management, courts are more sympathetic to the idea that the transfer is legitimate. For instance, in *Church v. United States*,[251] the family consolidated undivided ownership interests and administration of a family ranching business, and the court found this to be a legitimate reason for the transfer.[252] The ranch's administration was much easier when there was one manager and the interests were not

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[242] *Id.* (citing Estate of Shurtz v. Comm'r, 99 T.C.M. (CCH) 1096 (2010)).
[243] *See Stone*, 86 T.C.M. (CCH) 551.
[244] *See id.*
[245] *See id.*
[246] *See id.* at 552–53.
[247] *See id.* at 553.
[248] *See id.* at 552.
[249] *See id.*
[250] *See id.*
[251] No. SA-97-CA-0774-OG, 2000 WL 206374 (W.D. Tex. Jan. 18, 2000), *aff'd*, 268 F.3d 1063 (5th Cir. 2001).
[252] *See id.* at *6.

divided amongst family members with potentially divergent ideas.[253] Similarly, in *Kimbell*, working oil and gas interests were transferred to a family partnership to provide, among other things, centralized management, protection from personal liability, and pooling of all of the decedent's various interests to promote increased economic growth.[254] In upholding the transfer, the Fifth Circuit emphasized the fact that the oil and gas interests needed active management.[255]

Estate of Harrison v. Commissioner[256] is another example. There, the Tax Court held that a transfer was not a substitute for a testamentary disposition when the underlying assets needed consolidation and active management.[257] The decedent, whose health had been failing, executed a power of attorney in favor of his son.[258] The son then created an FLP and transferred many of the decedent's assets into it for the purpose of managing and preserving them.[259] Both of the decedent's sons also contributed to the FLP and took proportionate interests.[260] The assets included ranching properties and developed and undeveloped oil and gas interests that required active management, which the grantor was no longer capable of providing because of his health problems.[261] The transfers helped the son facilitate his takeover of his father's responsibilities.[262]

Conversely, both the Tax Court and the Third Circuit refused to recognize management as a legitimate nontax reason for the transfer in *Estate of Thompson v. Commissioner*[263] because most of the assets transferred consisted of securities that were not sold, traded, or even diversified.[264] The *Thompson* assets also included a ranch, but there was no change in its management after the transfer, and the decedent

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[253] *See id.*
[254] *See* Kimbell v. United States, 371 F.3d 257, 267–68 (5th Cir. 2004).
[255] *See id.*
[256] 52 T.C.M. (CCH) 1306 (1987).
[257] *See id.* at 1309.
[258] *See id.* at 1307.
[259] *See id.*
[260] *See id.*
[261] *See id.*
[262] *See id.*
[263] 382 F.3d 367 (3d Cir. 2004).
[264] *See id.* at 379–80.

continued to use it as his primary residence.[265] Although some of the transferee entities made "loans," they were all to family members and were more like testamentary transfers than legitimate business transactions.[266]

The claim that property was put into an FLP to ensure the decedent's son could maintain management control was also rejected in *Liljestrand* because putting the real estate into a partnership in no way changed who could or could not manage the assets.[267] Further, there was a conflict of interest that could have been invoked to invalidate the son's management under state law, and the partnership form did nothing to alleviate this.[268] Accordingly, the Tax Court found the executor's claims illusory since they could not offer the protection claimed.[269]

The Fifth Circuit refused to recognize a "group investment plan" as a valid reason when only one person contributed the vast majority of the assets, most of the assets were cash and securities, and the investment strategy never actually changed.[270]

Asset protection, while recognized as a legitimate nontax reason, is often rejected when unsupported by the record. "Premarital asset protection" has been rejected when there was insufficient evidence of an engagement, the assets were already solely in the decedent's name, and the assets were unreachable by a hypothetical spouse.[271] Asset protection and facilitating a postmarital agreement were also rejected in *Bongard*, because the decedent already received those benefits from other structures and the postmarital agreement would have been successful with or without the entity.[272]

The Tax Court recognized restructuring for purposes of providing liquidity for an anticipated public offering as a legitimate nontax reason. In *Bongard*, the transfers were recommended not by estate planning advisors, but by business planners whose ultimate goal was to keep the underlying business competitive.[273] The decedent's advisor made a

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[265] *See id.*
[266] *See id.* at 380.
[267] *See* Estate of Liljestrand v. Comm'r, 102 T.C.M. (CCH) 440, 445 (2011).
[268] *See id.*
[269] *See id.*
[270] *See* Strangi v. Comm'r, 417 F.3d 468, 481 (5th Cir. 2005).
[271] Estate of Hillgren v. Comm'r, 87 T.C.M. (CCH) 1008, 1015 (2004).
[272] *See* Bongard v. Comm'r, 124 T.C.M. (CCH) 95, 127 (2005).
[273] *See id.* at 122.

checklist of steps for the decedent to follow, and the decedent followed through with most of them.[274]

In summation, asset protection, preventing litigation, providing centralized and consolidated management, and liquidity for anticipated public offerings are some of the most common nontax reasons that courts have upheld. However, the same reasons are rejected when there is no evidence to support the need. In cases where centralized management is the claimed motivation, courts find it informative whether the interests are active or passive and whether management of the assets actually changes. The lesson from these cases is clear: however one seeks to justify a transaction, it must be supported by the record. This means that attorneys may have to be conscious of creating an appellate record, not only before there is an appeal, but before there is a trial, before there is a deficiency, and even before their client has died.

4. Actual Change

It should go without saying that a transfer that is executed on paper should be considered to have occurred. However, courts have repeatedly reviewed cases where the "transferor" retains possession of the assets and nothing changes in the day-to-day activities. Similarly, if the client is justifying the transaction as a way to get extra value from pooling assets, other people must also contribute to the endeavor. The Tax Court described this pooling concept as follows:

> [T]o call what occurred here a transfer for consideration within the meaning of section 2036(a), much less a transfer for an adequate and full consideration, would stretch the exception far beyond its intended scope. In actuality, all decedent did was to change the form in which he held his beneficial interest in the contributed property . . . . Without any change whatsoever in the underlying pool of assets or prospect for profit, as, for example, where others make contributions of property or services in the interest of true joint ownership or enterprise, there exists nothing but a circuitous "recycling" of value. We are satisfied that such instances of pure recycling do not rise to the level of a payment of consideration. To hold otherwise would open section 2036

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[274] *See id.*

> to a myriad of abuses engendered by unilateral paper transformations.[275]

One clear example of this was in *Harper*. In that case, the grantor "sold" both of his children interests in an FLP, but the estate could not identify the assets each child contributed in exchange for their partnership interests.[276] The exact same facts were seen in *Estate of Reichardt v. Commissioner*.[277] This "improper pooling," often referred to as a "circuitous recycling of value," is simply a sale where the consideration is never transferred or the assets are not actually combined with any others. If an estate planner seeks to set up a sale for a client, it is crucial that they not only state in sale documents or assignments that "true and adequate consideration" exists, but also ensure that the same consideration is actually furnished and that such transfer is documented in case of a future audit.

The decedents executed this type of documentation well in *Estate of Stone v. Commissioner*.[278] In that case, although the decedent parents contributed most of the assets to the partnerships, the children bought interests in the entities and contributed management and services.[279] Because each partner actually brought something of value to the transaction (and documented it), all partnerships were found to be genuine pools of assets and services for the joint pursuit of profit.[280] All parties received proportionate shares of income, and capital accounts were properly maintained. All interests were appraised, and, when valuation errors were found, transfers were made to compensate.[281]

For estate planning attorneys, it is important to urge clients (or their financial advisers and managers) to actually make whatever transfer or change is contemplated. This may involve a large amount of hand-holding (and at times hand-wringing), but it is crucial for the successful implication of many estate plans.

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[275] Estate of Harper v. Comm'r, 83 T.C.M. (CCH) 1641, 1653 (2002).
[276] *See id.* at 1649.
[277] 114 T.C. 144 (2000).
[278] 86 T.C.M. (CCH) 551 (2003).
[279] *See id.* at 555.
[280] *See id.* at 581.
[281] *See id.* at 571.

5. *Documented Estate Tax Motivations*

Although there is ample case law explicitly stating that estate tax motivations will not, by themselves, cause a transfer to be brought back into the estate under section 2036, many cases do mention tax savings motivations unfavorably. For instance, in *Thompson*, the Third Circuit said:

> The estate claims decedent's transfer of liquid, marketable securities and other assets to the family limited partnerships reduced the value of those assets by 40% because of the resulting lack of control and marketability. Indeed, as the Tax Court found, decedent's financial advisors presented this reduction in value for estate tax purposes as one of the primary advantages of using the Fortress Plan. *In one sense, claiming an estate tax discount on assets received in exchange for an inter vivos transfer should defeat the § 2036(a) exception outright*. If assets are transferred inter vivos in exchange for other assets of lesser value, it seems reasonable to conclude there is no transfer for "adequate and full consideration" because the decedent has not replenished the estate with other assets of equal value. *See Wheeler v. United States*, 116 F.3d 749, 762 (5th Cir.1997) ("[U]nless a transfer that depletes the transferor's estate is joined with a transfer that augments the estate by a commensurate (monetary) amount, there is no 'adequate and full consideration' for the purposes of either the estate or gift tax.").
>
> That said, the Tax Court has held that the dissipation of value resulting from the transfer of marketable assets to a closely-held entity will not automatically constitute inadequate consideration for purposes of § 2036(a). See *Harper*, 83 T.C.M. at 1654 (noting partnership interests may constitute "adequate and full consideration" if there is also a "potential [for] intangibles stemming from pooling for joint enterprise"); *Stone*, 86 T.C.M. at 581 (concluding the lack of marketability discount applied to limited partnership interests does not, on its own, result in inadequate consideration for purposes of § 2036).

> Nonetheless, we believe this sort of dissipation of value in the estate tax context *should trigger heightened scrutiny* into the actual substance of the transaction. Where, as here, the transferee partnership does not operate a legitimate business, and the record demonstrates the valuation discount provides the sole benefit for converting liquid, marketable assets into illiquid partnership interests, there is no transfer for consideration within the meaning of § 2036(a).[282]

Similarly, the Tax Court noted in *Trombetta* that the GRAT was executed at the age of seventy-two, at the same time as the decedent's will.[283] The court added, "Decedent had significant stated tax reasons for creating the annuity trust. While decedent's creation of the annuity trust accomplished some nontax objectives, we are unable to find that, when viewed in totality, those nontax objectives were significant."[284]

A final example of this theme comes from *Estate of Jorgenson*, in which the Ninth Court affirmed an opinion of the Tax Court.[285] The Tax Court relied heavily on letters from the decedent's attorney advising her to take a 35% discount on interests in FLPs as evidence of no nontax justification.[286] The attorney stated,

> Hopefully, this will allow your estate to qualify for the discount available to ownership of interests in limited partnerships and at the same time, facilitate your being able to make annual gifts to your children and grandchildren. This is important if you wish to reduce the amount of your own estate which will be subject to estate taxes.[287]

While it would be disingenuous to completely deny tax savings motivations, this may imply that practitioners should be careful how much their letters and other documents stress tax savings over nontax

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[282] Estate of Thompson v. Comm'r, 382 F.3d 367, 381 (3d Cir. 2004) (emphasis added).

[283] *See* Estate of Trombetta v. Comm'r, 106 T.C.M. (CCH) 416 (2013).

[284] *Id.* at 422.

[285] *See* Estate of Jorgenson v. Comm'r, 431 Fed. App'x 544 (9th Cir. 2011).

[286] *See* Estate of Jorgenson v. Comm'r, 97 T.C.M. (CCH) 1328 (2009).

[287] *Id.*

reasons for the transfers. In the case of an audit, one needs to be able to credibly say that tax savings was not the only reason for the transfers.

V. ADEQUATE AND FULL CONSIDERATION

Regulation section 20.2043-1 states that in order to qualify as "adequate and full consideration in money or money's worth" the price

> must have been an adequate and full equivalent reducible to a money value. If the price was less than such consideration, only the excess of the fair market value of the property (as of the applicable valuation date) over the price received by the decedent is included in ascertaining the value of his gross estate.[288]

As a preliminary matter, it should be stated that all values need to be justifiable. The First Circuit rejected a taxpayer's claim of adequate and full consideration when the taxpayer produced no admissible evidence in support of the property's value at the date of sale or in support of the discounts taken.[289] This seems obvious. If you are going to take a thirty or forty percent discount, it is worth paying for a credible appraisal.

Generally speaking, the Tax Court has identified four factors that support finding "adequate and full" consideration.[290] These are:

> (1) The interests received by the participants in the entity at issue were proportionate to the value of the property each contributed to the entity; (2) the respective assets contributed were properly credited to the capital accounts of the transferors; (3) distributions from the entity required a negative adjustment in the distributee' s capital account; and (4) there existed a legitimate and significant nontax reason for engaging in the transaction.[291]

These factors overlap with other prongs of the section 2036 analysis and were mostly discussed above, but it is worth noting again that ensuring entity ownership and distributions are proportional to capital or services contributed is a highly litigated area. Estate planners should be

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[288] Treas. Reg. § 20.2043-1(a).

[289] *See* Estate of Abraham v. Comm'r, 408 F.3d 26, 38 (1st Cir. 2005).

[290] *See* Estate of Schutt v. Comm'r, 89 T.C.M. 1353, 1368 (2005).

[291] *Id.*

documenting and valuing all contributions and ensuring that capital accounts are properly maintained. Additionally, "consideration" should not be recycled value.[292] For instance, *Estate of Maxwell v. Commissioner*[293] concerned a sale and lease back of a residential home.[294] Since the payments on the lease and mortgage essentially canceled each other out, the Tax Court found that there was no actual consideration.[295] The lease payments had no substance.[296]

There are two current debates associated with the section 2036 consideration prong. The first is the appropriateness of valuation discounts in the context of family entities and the second is how adequate consideration should be measured for remainder interests.

A. Valuation Discounts

Courts have almost uniformly rejected the Service's argument that valuation discounts will necessitate a finding against full and adequate consideration, even in the context of family held entities.[297]

Although restrictions on marketability and control bring down the value of underlying assets, there are intangible benefits from legitimate pooling—the benefit of more capital, specialized management, etc.—that explain why rational actors would still find it economically efficient to engage in such transactions.[298] In *Kimbell* the Fifth Circuit explained the business reasons behind valuation discounts:

> The business decision to exchange cash or other assets for a transfer-restricted, non-managerial interest in a limited partnership involves financial considerations other than the purchaser's ability to turn right around and sell the newly acquired limited partnership interest for 100 cents on the dollar. Investors who acquire such interests do so with the expectation of realizing benefits such as management expertise, security and preservation

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[292] *See id.*

[293] 3 F.3d 591 (2d Cir. 1993).

[294] *See id.*

[295] *See id.*

[296] *See id.* at 597.

[297] *See, e.g.*, Estate of Bigelow v. Comm'r, 503 F.3d 955, 969 (9th Cir. 2010); Estate of Thompson v. Comm'r, 382 F.3d 367, 381 (3d Cir. 2004); Estate of Harper v. Comm'r, 83 T.C.M. (CCH) 1641, 1645 (2002).

[298] *See Harper*, 83 T.C.M. (CCH) at 1645.

> of assets, capital appreciation and avoidance of personal liability. Thus there is nothing inconsistent in acknowledging, on the one hand, that the investor's dollars have acquired a limited partnership interest at arm's length for adequate and full consideration and, on the other hand, that the asset thus acquired has a present fair market value, i.e., immediate sale potential, of substantially less than the dollars just paid—a classic informed trade-off.[299]

In other words, it is entirely possible for the assets to have less than their fair market value and for the transaction to still be beneficial overall. If both of those ideas make sense economically, the transaction should not fail simply because it is done between members of the same family.

Despite a legal consensus upholding the use of valuation discounts, the debate is still politically active. In fact, proposals to limit valuation discounts were included in the Treasury Department's "Greenbooks" (legislative proposals) for 2010, 2011, and 2012. The proposals were eliminated starting in 2013. However, the Service still maintains that it has the regulatory authority to limit discounts without legislation. On May 10, 2015, Cathy Hughes, with the Treasury's Office of Tax Policy, indicated to a section of the American Bar Association that such Regulations were pending and could be released as early as September of 2015.[300] Although September 2015 has come and gone, no such Regulations have been released as of the writing of this Article.

The reason for this debate is twofold. To many people, valuation discounts in the context of family held entities fly in the face of economic realities and undermine the ideas of horizontal and vertical equity in our tax system.[301]

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[299] Kimbell v. United States, 371 F.3d 257, 266 (5th Cir. 2004).

[300] *See* Jonathan G. Blattmachr & Matthew Blattmachr, *Anticipating New Regulations under IRC Section 2704* (June 4, 2015), http://wealthmanagement.com/valuations/anticipating-new-regulations-under-irc-section-2704?page=1; U.S. TRUST, *Tax Alert 2005-3: Possible Limitations on Family Discounts*, http://www.ustrust.com/publish/content/application/pdf/GWMOL/USTp_NWPSTA03_2016-05.pdf.

[301] *See, e.g.*, Karen C. Burke & Grayson M.P. McCouch, *Family Limited Partnerships: Discounts, Options, and Disappearing Value*, 6 FLA. TAX REV. 649 (2004); John F. Coverdale, *Of Red Bags and Family Limited Partnerships: Reforming the Estate and Gift Tax Valuation Rules to Achieve Horizontal Equity*, 51 U. LOUISVILLE L. REV.

As to the first point, commentators argue that no actual value is lost when assets are placed in an entity. In reality, there is no lack of transferability or management because the family (which, it is argued, should be thought of as one economic unit) still controls the entire company. The idea is that if the transactions are entered into solely for tax savings purposes, they can be easily undone when economically beneficial. For example, in the case of restrictions on marketability, most families will not want to sell their interest unless the entire family agrees because the idea was always that the family was in it together. As for lack of transferability, if the partnership agreement requires the approval of Dad as sole general partner, critics do not believe Dad will deny a sale for estate planning purposes (to a trust) or if the child really needs liquidity. If Dad really has the child's best interest at heart, as we imagine he does, restraints on transferability will not actually hurt the minority interests and may be illusory. Finally, should the family interest require the entity or structure be eliminated, there is unlikely to be anyone who stands in the way. Critics argue that for these reasons, the family should really be thought of as one interested party with consolidated control rather than as individuals with disparate interests.

The counter to this argument is that, while families often act in harmony and in the best interest of all, that certainly is not always the case. If it were, there would be less demand for probate and estate planning attorneys. One has only to look to *Estate of Stone v. Commissioner*[302] to see this. In that case, the children began litigating who would control what interests before their parents died.[303] Additional litigation after the parents' deaths was only avoided through extensive negotiations where every member of the family had their own independent legal counsel.[304] In cases like *Stone*, it is clear that the family is not one cohesive economic unit.

The critique based on horizontal inequity of discounts plays off of this idea of illusory restrictions. Horizontal equity is one of the underlying principles of our tax system. It is the idea that people who are similarly situated should pay the same amount of tax. If two people have estates of the same value but one puts their assets into a family entity that qualifies for valuation discounts because of restrictions on marketability

239 (2013); Wendy C. Gerzog, *Valuation Discounting Techniques: Terms Gone Awry*, 61 TAX LAW. 775 (2008).

[302] 86 T.C.M. (CCH) 551 (2003).

[303] *See id.* at 554.

[304] *See id.* at 555.

and transferability, the two could end up paying significantly different amounts in estate taxes solely because of the entity structure. Absent some economic substance to the entity, this result is hard to justify.

Further, discounts lower the amount of revenue that the government is able to raise from its richest citizens. Currently, only the estates of the very rich are taxed; the estate tax only applies to estates with more than $5.45 million for an individual or $10.9 million for a married couple. When the rich pay for estate planning to devalue their assets and avoid estate taxes, they keep money from the government's coffers that could be used for education and social nets for the poor. In this way, the discounts are seen to violate vertical equity—the idea that the rich should pay higher taxes because they can afford to pay and are hurt less by doing so.

Regardless of where one stands on this normative debate, it is crucial that practitioners watch how it unfolds. Should the Department of the Treasury follow through with its proposed Regulations, attorneys need to be ready to react and advise their clients appropriately. This could drastically change the applicability of section 2036 and could force practitioners to abandon many common planning techniques.

B. Consideration for Remainder Interests

Unlike the above debate, the debate over valuing remainder interests is primarily a judicial one. However, it also invokes the policy debates surrounding valuation discounts. The actuarial value of a remainder interest is substantially less than the fair market value of the underlying property. If the decedent owns the fee property until death, the entire fair market value will be taxable in the decedent's estate. If, however, a remainder is sold some time prior to the decedent's death and that actuarial value is considered full and adequate consideration under section 2036, only the actuarial value paid to the decedent, rather than the full value of the fee, is taxable.

For example, imagine that A and B own buildings of identical values. A holds his building until he dies and leaves it to his daughters. B, on the other hand, sells the remainder interest to her daughters for a value based on an impartial appraisal and the Treasury's Regulations for valuing life estates based on the transferor's age at the time of the sale. In both situations, A and B retain the possession and economic enjoyment of their buildings until they die. However, in the first situation, A (if the estate is taxable) is taxed on the entire fee value of the building at a rate of almost forty percent. Conversely, at the time of B's death, the building

is not in her estate, and she is only taxed on the consideration she received for the remainder interest, which may be very low depending on how old B was when she made the transfer. Any of the buildings' appreciation that occurs after the date of the remainder sale is included in A's estate but excluded in B's. Accordingly, two identical estates may be subjected to drastically different taxes solely based on if and when they sold their remainder interest.[305]

Critics of this idea counter that the proceeds from the sale will be invested and by the time the transferor dies (if they live as long as predicted) will have grown at a comparable rate of the remainder. Accordingly, A and B's estates may not substantially vary in value.

Interestingly, no one argues that the actuarial values would not be fair consideration if the sale was to a third party. Again, the question is if the rules should be different for intrafamily transactions, where the primary motivation is likely estate tax savings, as opposed to arm's length transactions.

The Court of Appeals for the Federal Circuit went against the general trend when it decided for the government in *Gradow v. United States*.[306] In *Gradow*, the decedent had been given a "widow's election" under her husband's will.[307] She could either keep her one-half of the community property and get none of her husband's share or she could transfer her community property into a trust for their son and receive income for life from both halves of the community. She elected the latter.[308] At issue was how to value the consideration she had given and the interest she received in order to determine if her transfer to the trust was a bona fide sale under section 2036.[309] More specifically, the issue was whether the consideration flowing from the decedent was simply the value of her remainder interest in half of the community property (the estate's position), or the fee value of her half of the community property.[310]

The Federal Circuit, in a brief but sweeping opinion, affirmed the decision of the Court of Claims[311] that the decedent had contributed the

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[305] *See* Martha W. Jordan, *Sales of Remainder Interests: Reconciling* Gradow v. United States *and Section 2702*, 14 VA. TAX REV. 671, 673 (1995).

[306] 897 F.2d 516 (Fed. Cir. 1990).

[307] *See id.* at 517.

[308] *See id.*

[309] *See id.* at 518.

[310] *See id.*

[311] *See* Gradow v. United States, 11 Cl. Ct. 808, 816 (1987), *aff'd*, 897 F.2d 516, 517 (Fed. Cir. 1990).

fee value of one-half of the community rather than the actuarial value of the remainder.[312] Importantly, the Court of Claims stated:

> The fond hope that a surviving spouse would take pains to invest, compound, and preserve inviolate all the life income from half of a trust, knowing that it would thereupon be taxed without his or her having received any lifetime benefit, is a slim basis for putting a different construction on § 2036(a) than the one heretofore consistently adopted.[313]

Gradow is significant because it implies that a bona fide sale will not exist when the fair market value of what is transferred is significantly greater than the value received, a situation analogous with valuation discounts.[314] Further, the above quote has been interpreted to mean the time value of money should not ever factor into the question of whether or not consideration was adequate and full.[315]

Gradow was followed by *Pittman v. United States*,[316] a case out of the Eastern District of North Carolina. There, a husband and wife conveyed remainder interests in three pieces of real property to their daughter for the actuarial value of the remainder, roughly 20% of the fair market value at the time of the transfer.[317] In between the time of the sale and the grantors' deaths, all three properties appreciated significantly.[318] The *Pittman* Court reiterated that consideration is measured at the date of sale but that:

> [T]he meaning of consideration under this section [2036] is not the same as common law contractual consideration. The consideration flowing from the transferor is based on what would otherwise have been included in the estate, not on the interest transferred. In other words, it is the value of the *entire* property which is measured against the

[312] *See* Gradow v. United States, 897 F.2d 516, 517 (Fed. Cir. 1990).
[313] *Gradow*, 11 Cl. Ct. at 816.
[314] *See Gradow*, 897 F.2d at 517.
[315] *See* Wheeler v. United States, 116 F.3d 747, 758 (5th Cir. 1997).
[316] 878 F. Supp. 833 (E.D.N.C. 1994).
[317] *See id.* at 834.
[318] *See id.*

> consideration received. Such valuation is necessary in order to establish an equilibrium for estate tax purposes.[319]

Accordingly, the court found that there was not adequate and full consideration for the sales.[320]

In 1961, the Tenth Circuit decided the issue similarly, stating:

> It does not seem plausible, however, that Congress intended to allow such an easy avoidance of the taxable incidence befalling reserved life estates. This result would allow a taxpayer to reap the benefits of property for his lifetime and, in contemplation of death, sell only the interest entitling him to the income, thereby removing all of the property which he has enjoyed from his gross estate. Giving the statute a reasonable interpretation, we cannot believe this to be its intendment. It seems certain that in a situation like this, Congress meant the estate to include the corpus of the trust or, in its stead, an amount equal in value.[321]

Although still good law, the Tenth Circuit has not returned to the issue or even affirmed its holding in nearly fifty years. *Gradow* and its progeny are still good law for the Federal Circuit. Conversely, the Third Circuit, Fifth Circuit, and Ninth Circuit have all recently decided the issue the other way.[322]

In *Estate of D'Ambrosio*, the Third Circuit overturned a Tax Court decision following *Gradow*.[323] In that case, the decedent sold the remainder interest in preferred stock to a third party in exchange for an annuity worth the remainder's actuarial value.[324] There was no evidence that the transaction was meant to be testamentary or was made in anticipation of death.[325] The Third Circuit disagreed with *Gradow*'s holding that

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[319] *Id.* at 835 (citation omitted).

[320] *See id.*

[321] *United States v. Allen*, 293 F.2d 916, 918 (10th Cir.), *cert. denied*, 368 U.S. 944 (1961).

[322] *See* Magnin v. Comm'r, 184 F.3d 1074, 1078 (9th Cir. 1999); Wheeler v. United States, 116 F.3d 749, 767 (5th Cir. 1997); Estate of D'Ambrosio v. Comm'r, 101 F.3d 309, 311, 317–18 (3d Cir.1996).

[323] *See* Estate of D'Ambrosio, 101 F.3d 309, 311, 318 (3d Cir. 1996).

[324] *See id.* at 311.

[325] *See id.*

property in section 2036 necessarily meant the fee simple value.[326] Instead, it interpreted the phrase "to the extent of any interest therein" to mean that the gross estate shall include the value of the remainder interest, unless it was sold for adequate and fair consideration.[327]

The Court also disagreed with *Gradow*'s policy justifications. The Third Circuit stated, "[W]hen the transfer of the remainder interest is essentially gratuitous and testamentary in character, we focus on substance rather than form and require that the full value of trust property be included in the gross estate."[328] However, *D'Ambrosio* did not concern a gratuitous or testamentary transfer, the court saw no potential for abuse, and the decedent's estate was supplemented by the economic value of what it gave up. *D'Ambrosio* was especially critical of *Gradow* for completely disregarding the time value of money.[329]

The Fifth Circuit's main case on point is *Wheeler*, in which a father sold his sons the remainder interest in his ranch for its fair market value as determined by an appraisal combined with the Treasury Regulations for valuing life expectancies. Citing Tenth Circuit precedent for the proposition that estate and gift taxes aim to prevent the depletion of the taxable estate, the Fifth Circuit held that a bona fide sale was one that augmented the estate to put it in equilibrium with where it was before the transfer.[330] It stated, "[U]nless a transfer that depletes the transferor's estate is joined with a transfer that augments the estate by a commensurate (monetary) amount, there is no 'adequate and full consideration' for the purposes of either the estate or gift tax."[331] Because the Treasury's actuarial tables quantify both the remainder and life estates into monetary values, if the actuarial remainder value is paid, the court determined that there is no problem of estate depletion and no violation of section 2036.[332]

Attacking the logic of *Gradow* and *Pittman*, the Fifth Circuit stated:

> *Pittman* . . . presents a conscientious estate planner with quite a conundrum. If the taxpayer sells a remainder

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[326] *See id.* at 312–13.

[327] *Id.* at 315.

[328] *Id.*

[329] *See id.* at 315–17.

[330] Wheeler v. United States, 116 F.3d 749, 762 (5th Cir. 1997) (citing United States v. Allen, 293 F.2d 916 (10th Cir. 1961), *cert. denied* 368 U.S. 944 (1961)).

[331] *Id.*

[332] *See id.*

> interest for its actuarial value as calculated under the Treasury Regulations, but retains a life estate, the value of the full fee interest in the underlying property will be included in his gross estate and the transferor will incur substantial estate tax liability under section 2036(a). If the taxpayer chooses instead to follow *Gradow*, and is somehow able to find a willing purchaser of his remainder interest for the full fee-simple value of the underlying property, he will in fact avoid estate tax liability; section 2036(a) would not be triggered. The purchaser, however, having paid the fee-simple value for the remainder interest in the estate, will have paid more for the interest than it was worth. As the "adequate and full consideration" for a remainder interest under section 2512(b) is its actuarial value, the purchaser will have made a gift of the amount paid in excess of its actuarial value, thereby incurring gift tax liability. Surely, in the words of Professor Gilmore, this "carr[ies] a good joke too far."[333]

The Fifth Circuit went on to address potential objections to its position. In response to the idea that the holder of the life estate could then squander the property and convey to the purchaser less value than they received, the court noted that the goal of section 2036 is to analyze the consideration *at the time of the transfer*.[334] Consequently, it does not matter if the actuarial value at the date of transfer is significantly higher or lower than the value at the date of death.[335]

Next the court addressed the argument that allowing a remainder sale effectively "freezes" the estate at the time of the transfer and excludes any future appreciation from tax.[336] The Fifth Circuit responded that this is only a problem if the proceeds of the sale are not comparably invested and pointed out that assets sometimes depreciate (as in fact the ranch in *Wheeler* did), making it a nonissue.[337]

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[333] *Id.* at 759.
[334] *See id.* at 763.
[335] *See id.* at 762–63.
[336] *See id.* at 763.
[337] *See id.*

The Ninth Circuit extended this logic to the context of FLPs in *Estate of Magnin v. Commissioner*.[338] The Ninth Circuit favorably cited both *D'Ambrosio* and *Wheeler* and clearly explained how the time value of money fixed *Gradow*'s policy concerns:

> [A] party who is selling his remainder interest in a bona fide arm's length transaction is unlikely to have a life expectancy of one day. On average, persons engaging in these transactions will have a life expectancy comparable to the standard mortality tables, which Congress has mandated be used to value remainder interests and life estates, see 26 U.S.C. § 7520(a)(1); see also 26 C.F.R. § 20.2031-7.2 Thus, if the consideration for the remainder is actuarially accurate at the time of the transfer, by the time the decedent reaches his actuarially predicted date of death, his estate will not be depleted, but will be comparable to what it would have been had the transaction never occurred. The Commissioner would include in the estate the full value of property whose remainder is sold plus the full amount of the invested consideration from the sale of the remainder. The Commissioner's failure to take into account the time value of money would result in the overtaxation of estates, rather than the depletion of them.[339]

Currently, there is a clear circuit split on how the courts measure adequate consideration of remainders. For practitioners in the Third, Fifth, and Ninth Circuits, there is some real potential to sell remainders in assets that are anticipated to appreciate to younger generations in exchange for depreciable assets. This opportunity does not exist in the Tenth or Federal Circuits and could be eliminated if the legislature or Supreme Court weighs in.

VI. CONCLUSION

It is hard to overstate the importance of section 2036 for estate-planning practitioners who work with high-net-worth clients. If one understands the Service's position on what is and what is not a bona fide sale, transfers can be made without fear of a Service audit and the

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[338] 184 F.3d 1074 (9th Cir. 1999).

[339] *Id.* at 1079.

potential ensuing litigation. In the context of FLPs, split-purchase qualified personal residence trusts, or other structures that qualify for discounts for lack of marketability and control, such an understanding allows attorneys to facilitate transfers of wealth to younger generations for less than the fair market value of the underlying assets and to the exclusion of future appreciation. This is especially useful for clients who have used (or will use) their entire exemption amount. However, there are many pitfalls of which the practitioner needs to be aware. First, if you plan to argue that section 2036 does not apply, be very careful with your factual situation. If that argument is not sound or you are conceding a life interest, make sure you can justify the transaction in terms of the different standards of a bona fide sale. Finally, make sure you know the debates and potential changes concerning valuation discounts and the adequacy of consideration for remainder interests. Although the case law is muddied and plentiful, careful study and analysis can lead to substantial estate tax savings.