QUIT TAXING ME, I’M DEAD

I. INTRODUCTION

The use of pass-through entities, such as the family limited partnership (FLP) and the limited liability company (LLC), to obtain transfer tax valuation adjustments, or discounts, has focused the Internal Revenue Service’s (IRS) efforts in challenging such tax-friendly estate planning measures. The use of the FLP and other entities has become common practice in reducing estate taxes. Essentially, a decedent will transfer a portion of her assets into an FLP in exchange for a limited partnership interest, with control of the assets vested in the general partner. The estate then discounts the value of its assets in the FLP for lack of control and/or lack of marketability, thereby reducing the amount of taxable estate.

For example, in *Kimbell v. United States*, the decedent transferred approximately 2.5 million dollars in assets from the decedent’s trust into an FLP for a ninety-nine percent limited partnership interest. The LLC, which was formed by the decedent’s trust and the decedent’s son and daughter-in-law, contributed an additional twenty-five thousand dollars in exchange for a one percent general partnership interest in the FLP. Under the partnership agreement, the son, as general partner, held the exclusive authority to make distributions from partnership assets. Further, the decedent, as a limited partner, could not withdraw from the partnership, but could only remove the general partner by a seventy percent vote. Upon the decedent’s death, the partnership was valued at approximately 2.4 million dollars. However, the estate claimed a forty-nine percent discount on its estate tax return, which the court ultimately upheld, because the ninety-nine percent limited partnership interest obtained in exchange for the 2.5 million dollar transfer to the partnership was valued at only 1.2 million dollars. The value of the limited partnership was discounted to 1.2 million dollars because the interest lacked marketability due to the limited partner’s inability to withdraw from the partnership, and because the interest lacked management control over the partnership. *Kimbell* succeeded in securing a discount for the estate through the FLP, but many cases dealing with pass-through entities have not survived judicial scrutiny.

The IRS’s principal weapon of attack in including estate transfers is Internal Revenue Code section 2036 (Section 2036). Section 2036 seeks to include estate transfers in which the decedent retains either the possession or enjoyment of the transferred property, or the right to designate persons who shall possess or enjoy the transferred property. Under Section 2036, the taxpayer must show either that the transfer was a bona fide sale for full and adequate consideration, or that the taxpayer did not retain an interest in the transferred property. The premise of Section 2036 is that the taxpayer must not retain enjoyment of the assets she transfers, and, once transferred, the taxpayer can no longer designate who will receive those assets. In other words, the decedent must give up control. By transferring assets into an

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2. *Id.*
4. *Id.* at 260.
5. *Id.*
6. *Id.*
7. *Id.*
8. *Id.*
9. *Id.*
10. See e.g. *Est. of Thompson v. Commr.*, 382 F.3d 367, 383 (3d Cir. 2004) (holding that the transferred assets were includable in the decedent’s gross estate).
13. *See Kimbell*, 371 F.3d at 267, 261, 269 (holding the transfer was a bona fide sale for full and adequate consideration).
FLP or other pass-through entity, the decedent effectively gives up his control of those assets by vesting control of the assets in the general partner, who is usually the decedent’s child or other family member.

The use of pass-through entities has aggravated the IRS for years, and the IRS responded accordingly in the mid-1990s with its national compliance program. The program endeavored to eliminate estate tax discounts by attacking the validity of the entities used to create them. The issue of valuation of the transfer for the purposes of the discount has become only a secondary concern. Through a discussion of the scope of Section 2036 and its application by the IRS, its judicial interpretation, and its application to pass-through entities by various circuits and the Tax Court, this article will address what factual circumstances are necessary to withstand a Section 2036 attack.

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15. Id. at OGF-20.