

Brief Overview Analysis of
Kimbell v. U.S., No. 03-10529 (5th Cir. May 20, 2004)

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A. Basic Facts

1. The decedent formed an FLP, retaining 99% limited partnership interest. The 1% general partner was an LLC, owned 50% by the decedent (her son and daughter-in-law each owned 25%). The son was manager of the LLC.
2. About 13% of the assets transferred to the partnership consisted of working oil and gas interests, which required active management.
3. The district court emphasized that the partnership agreement provided that 70% of the limited partners could remove the general partner. The general partner did not owe a fiduciary duty, but a duty of care and loyalty. Those particular facts were not important to the 5th Circuit's analysis.

B. Holdings

1. The court reversed the district court's decision that "(1) family members cannot enter into a bona fide transaction, and (2) a transfer of assets in return for a pro rata partnership interest is not a transfer for full and adequate consideration."
2. The district court erred in denying taxpayer's motion for summary judgment on the issue of whether the transfer of assets to the partnership "was a bona fide sale for full and adequate consideration so as to remove the transaction from the application of §2036."
3. Because the bona fide sale for full and adequate exception applies for transfers to the partnership, the court did not need to address whether the decedent retained an interest to which §2036(a)(1) [retained possession, enjoyment or rights to the transferred property] or (a)(2) [retained right to designate the persons who would possess or enjoy the transferred property] would apply for transfers to the partnership.

However, the court did not address whether the bona fide sale for full and adequate consideration exception applies to transfers to the LLC. Instead, the court held that even if the exception does not apply, the decedent did not retain sufficient control of the assets transferred to the LLC to make her transfer subject to §2036(a), because she was only held a 50% interest in the LLC and her son had sole management powers over the LLC.

4. The court remanded to the District Court the issue of whether the Decedent's interest in the partnership was an assignee interest or a limited partner interest for purposes of valuing her interest.

C. Court's Analysis

1. Purpose of §2036. The purpose of §2036 is to prevent the circumvention of federal estate tax by the use of inter vivos transactions that do not remove the lifetime enjoyment of property purportedly transferred by a decedent.
2. Standard for "Bona Fide Sale" Requirement in §2036 Exception
 - a. The court rejected the district court's conclusion that "bona fide" means arm's length and that intrafamily transactions cannot meet the bona fide sale requirement.
 - b. The court looked for guidance to Wheeler v. U.S., 116 F.3d 749 (5th Cir. 1997), which is the only Fifth Circuit case (and the only circuit level case cited to the court) addressing the bona fide sale for full and adequate consideration exception to §2036.
 - Basic requirement: "whether the transferor actually parted with the ... interest and the transferee actually parted with the requisite adequate and full consideration."
 - The requirement receives "heightened scrutiny" in intrafamily transfers. However, just because transfers occur between family members does not impose an additional requirement that is not set forth in the statute to be "bona fide."
 - The absence of negotiations is not a compelling factor, particularly when the exchange value is set by objective factors.
 - In summary, the issue under Wheeler is whether "the sale ... was, in fact, a bona fide sale or was instead a disguised gift or a sham transaction."
 - c. Under the regulations, a transaction is a bona fide sale if it is made in good faith. Reg. §20.2036-1(a), 20.2043-1(a).
 - d. The decedent's subjective intent and the presence of tax planning motives do not prevent a sale from being bona fide if it is otherwise real, actual, or genuine. However, "[a] transaction motivated solely by tax planning with no business or corporate purpose is nothing more than a contrivance without substance that is rightly ignored for purposes of the tax computation."
 - e. Business purpose—Two FLP cases that concluded that the bona fide sale exception applied (Church and Stone) both involved fact situations where the partnership was created for genuine business purposes.

- f. Business purpose—Prior Tax Court cases, which held that the bona fide sale exception did not apply, recognized that the exception would apply if the transfer were not a sham or a disguised gift. Harper (“not appear to be motivated primarily by legitimate business concerns”); Thompson (no active business, business enterprise or trade or business); Strangi (no “functioning business enterprise”). *[However, the court’s analysis did not require the existence of active business operations to meet the bona fide requirement. The court was just observing that even cases that held for the IRS would have held differently if active businesses issues or concerns had existed.]*
- g. Summary of Bona Fide Sale Standard: “...a sale in which the decedent/transferor actually parted with her interest in the assets transferred and the partnership/transferee actually parted with the partnership interest issued in exchange.... In addition, when the transaction is between family members, it is subject to heightened scrutiny to insure that the sale is not a sham transaction or disguised gift. The scrutiny is limited to the examination of objective facts that would confirm or deny the taxpayer’s assertion that the transaction is bona fide or genuine.” *[Observe, this statement of the standard does not directly refer to business purpose at all.]*
3. Application of Bona Fide Sale Requirement
- a. The district court ignored evidence that the transaction was entered into for “substantial business and other non-tax reasons.”
- b. Objective facts included:
- Decedent retained assets for her support
 - No commingling of partnership and personal assets
 - Formalities were satisfied
 - Assets were actually assigned to the partnership
 - Assets contributed (including working interests) required active management
 - The partnership satisfied business strategies that could not be satisfied by merely holding assets in a revocable trust
 - Legal protection from creditors, especially important because decedent owned oil and gas working interests
 - Decedent wanted to continue oil and gas operations beyond her lifetime, and partnership allowed keeping pool of capital together in one entity
 - Reduced administrative costs by keeping all accounting functions together
 - Avoid costs of recording transfers of oil and gas properties in passing them from generation to generation
 - Preserve property as separate property for her descendants

- Provide for succession of management should something happen to her son
- All disputes could be resolved through mediation or arbitration
- The recitation of purposes in the partnership agreement is confirmed by objective facts

[Observe that many of those purposes could have been provided by a long-term trust arrangement. The court did not deem that important enough to even mention.]

- c. The fact that only de minimis contributions were made by others does not justify treating the partnership as a sham. There is no principle of partnership law requiring that a minority partner own a certain minimum percentage for the entity to be legitimate and its transfers bona fide.
 - d. The fact that the decedent's son managed the assets both before and after the partnership was created does not matter. What is important is that he contributed his management expertise after the partnership was formed.
 - e. Summary of court's application of the bona fide standard: "[T]here is no contention that the transfer did not actually take place. The assets were formally assigned to the Partnership and Mrs. Kimbell was actually credited with a pro rata interest. There is no evidence that partnership formalities were ignored or that Mrs. Kimbell used Partnership assets for personal expenses. Finally, applying the heightened scrutiny applicable to transactions between family members, we are satisfied that the taxpayer has established through objective evidence recited above that the transaction was not a disguised gift or sham transaction. The ... taxpayer's... substantial business reasons ... were strongly supported by the nature of the business assets (divided working interests in oil and gas properties) conveyed ..."
4. Standard for Full Consideration Exception
- a. Wheeler "requires only that the sale not deplete the gross estate." "In other words, the asset the estate receives must be roughly equivalent to the asset it gave up."
 - b. The adequate and full consideration test is an objective inquiry, not related to perceived testamentary or tax savings motives.
 - c. Summary of the standard: "In order for the sale to be for adequate and full consideration, the exchange of assets for partnership interests must be roughly equivalent so the transfer does not deplete the estate. In addition, when the transaction is between family members, it is subject to heightened scrutiny to insure that the sale is not a sham transaction or disguised gift. The scrutiny is limited to the examination of objective facts ..."

5. Application of Full Consideration Requirement

- a. The government's inconsistency argument (that it is inconsistent for the estate to argue that the partnership interest is worth only 50% of the assets transferred to the partnership but claim that the partnership interest received in exchange for assets transferred was adequate and full consideration) is rejected. The court observed that the Tax Court in Stone, T.C. Memo 2003-309 rejected that argument. The court gave a common sense practical answer:

“We would only add to the Tax Court’s rejection of the government’s inconsistency argument that it is a classic mixing of apples and oranges: The government is attempting to equate the venerable “willing-buyer-willing seller” test of fair market value (which applies when calculating gift or estate tax) with the proper test for adequate and full consideration under §2036(a). This conflation misses the mark: 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 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.”

- b. Close scrutiny must be applied in an intrafamily situation, but that does not mean “automatic proscription or impossibility vel non.”
- c. In the context of transfers to a partnership: “The proper focus therefore on whether a transfer to a partnership is for adequate and full consideration is: (1) whether the interests credited to each of the partners was proportionate to the fair market value of the assets each partner contributed to the partnership, (2) whether the assets contributed by each partner to the partnership were properly credited to the respective capital accounts of the partnership, and (3) whether upon termination or dissolution of the partnership the partners were entitled to distributions from the partnership in amounts equal to their respective capital accounts. [Stone] at 580. The answer to each of these questions in this case is yes. Mrs. Kimbell received a partnership interest that was proportionate to the assets she contributed to the Partnership. There is no question raised as to whether her partnership account was properly credited with the assets she contributed. Also, on termination and liquidation of the Partnership, the Partnership Agreement requires distribution to the Partners according to their capital account balances.”

- d. The “recycling of value” position of the Tax Court was totally dismissed. The court said that issue is better addressed under the bona fide sale prong of the analysis (i.e., as to whether the transaction was a sham transaction).
6. LLC Analysis: Not Analyze Applicability of Bona Fide Sale Exception But Insufficient Control to Constitute Right to Designate Who Can Enjoy LLC Property.
- a. The district court had included the assets transferred to both the partnership and the LLC were included in the estate under §2036(a). There was no specific discussion of the LLC transfers in the district court’s opinion. The government’s brief clarifies that the government’s motion for summary judgment and the district court opinion did not address the assets transferred to the LLC. It stated that the parties had agreed for the district court to amend its opinion to include the LLC interest.
 - b. The Fifth Circuit opinion approaches the LLC transfers differently than the transfers to the partnership. *[Why the analysis is different is not explained.]* The court does not explain why the bona fide sale for full and adequate exception does not apply to transfers to the LLC. Instead, the court says that even if the bona fide sale for full and adequate consideration does not apply, the decedent did not retain “sufficient control” of assets transferred to the LLC to cause §2036(a) to apply. The court’s reasons: The decedent only had a 50% interest in the LLC and her son was the manager. *[Apparently, the court believed that it was such an easy straightforward conclusion that the decedent did not have sufficient control to cause her to have a “right” to designate who can possess or enjoy the LLC assets, that there was no necessity to apply its analysis of the bona fide sale exception.]*
7. Observations.
- a. The opinion is a major blow to the IRS’s §2036 attack on FLPs and LLCs. It applies the bona fide sale for full and adequate consideration exception to the creation of the FLP. Section 2036 is about the only attack that has led to any success for the IRS. Most well-planned FLPS would appear to meet the exception announced in Kimbell. Undoubtedly, the IRS will try to put a “spin” on the Kimbell decision—but it is a MAJOR taxpayer victory at the circuit court of appeals level.
 - b. Observe that the full consideration exception would not apply to a subsequent *gift* of partnership interests. (In that case, the issue would be whether the partnership *interests* [with appropriate discounts] would be brought back in the estate under §2036 (if the donor retained the power to use the property or designate who can possess or enjoy the property), or whether the partnership assets [without a discount] would be brought back into the estate by tying the

transfer of assets to the partnership and the subsequent transfer of an interest in the partnership as a single integrated transaction.

- c. The court clearly rejects the IRS's argument that it is being improperly whipsawed—that the transfer of assets to the partnership is treated as a transfer for full consideration even though it is included in the estate only after applying a steep discount. The court's rejection of this argument is a very practical analysis that makes sense in real-life. The opinion recognizes that investors routinely make investments that cannot be liquidated the next day for the full amount invested. Thus, it is not surprising to say that the transfer was for full consideration even though, at the time of the decedent's death, the decedent does not have the right to retrieve the full value contributed.
- d. **Business Purpose Discussion.** A major caveat to the court's analysis is that the bona fide sale requirement is satisfied if there is at least some degree of non-tax purpose. The gist of the concern would appear to be the following statement that appears in the opinion: "A transaction motivated solely by tax planning with no business or corporate purpose is nothing more than a contrivance without substance that is rightly ignored for purposes of the tax computation. See Gregory v. Helvering, 293 U.S. 564, 469 (1935)."
 - The Wheeler case did not apply a business purpose test to the meaning of "bona fide." The Wheeler court said the modifier "bona fide" does not mean that a different "adequate and full consideration" test would be applied in intrafamily situations. Instead, it said that the "bona fide" qualifier" requires that neither transfers nor the adequate and full consideration for them be "illusory or sham." The Wheeler court concluded: "Certainly an intrafamily transfer—like any other—must be a "bona fide sale" for the purposes of section 2036(a). But assuming, as we must here, that a family member purports to pay the appropriate value of the remainder interest, 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."
 - It is interesting that the initial summary statement of the "bona fide sale" *standard* is merely that "the decedent/transferor actually parted with her interest in the assets transferred and the partnership/transferee actually parted with the partnership interest issued in exchange." (This is the same standard announced in Wheeler, which also stated that the transfers must not be "illusory or sham.") The initial summary statement goes on to add that in intrafamily situations, there is "heightened scrutiny to insure that the sale is not a sham transaction or disguised gift. The scrutiny is limited to the examination of objective facts that would confirm or deny the taxpayer's assertion that the transaction is bona fide or genuine." Accordingly, apparently the determination of whether the requisite

“business purpose” exists is in determining that the transfer is not a “sham transaction” or “disguised gift” and that the transaction is “genuine.”

- The Kimbell decision is similar to the Stone opinion in looking to business purposes in determining that the “bona fide” requirement is met.
- The opinion makes very clear that the court can only look to objective factors (p. 10).
- What is not clear is HOW MUCH “business or corporate purpose” is required.
- The court was able to recite a wide number of business purposes satisfied by the partnership. The opinion mentioned various times that the partnership included some active business interests requiring management (i.e., the 13% of the assets in oil and gas working interests) but the opinion nowhere suggests that only FLPs with some active business interests could qualify as “bona fide.” Also, the opinion never suggests that a partnership must satisfy a long list of business purposes to qualify as passing the “sham transaction/disguised gift/genuine” test.
- Many of the “objective facts” listed to show the existence of “substantial business and other non-tax reasons” would be present in most FLP situations. See the list in Item C.3.b. above. (The one factor that may not ordinarily be present, at least with investment partnerships, is the reference to assets requiring active management.)
- Many of the “non-tax business reasons” that the court said were satisfied by the partnership but that could not be satisfied by Mrs. Kimbell’s revocable trust *could* have been satisfied by an appropriately drafted long-term trust arrangement (except the factor of providing creditor protection). That apparently was not important to the court.
- John Porter’s summary of the “business purpose” discussion: “We should be careful when saying that the 5th Circuit required a “business purpose.” I don’t think the opinion goes that far, at least the narrow way the IRS traditionally speaks of business purpose. It does appear to require some non-tax purpose (see the language on page 16 which talks about ‘business and non-tax reasons’), but I don’t see that being much different from the definition of a partnership under 7701(a). Those non-tax reasons are present in almost every case. The interesting thing is the non-tax purposes can include post-death management (which we have always thought was a substantial non-tax reason (See Bishoff)), such as ease in generational transfer of assets (as the court found with respect to the oil and gas interests).”
- The requirement of non-tax reasons may be amorphous. A wide variety of estate planning transactions are entered into only because of tax reasons. For example, special provisions inserted into many trusts are included ONLY for tax reasons (provisions to qualify as GRAT, QPRT, QDOT, QSST, NIMCRUT, CLAT, Crummey powers, bypass trusts, etc.).
- The opinion’s discussion of the bona fide requirement is somewhat similar to the analysis suggested by the ACTEC amicus curiae brief in suggesting that a “sham transaction” standard be applied in determining if a transfer

has actually been made, thus satisfying the “bona fide” test. However, the ACTEC brief did not suggest applying a business purpose test, but that the sham transaction standard would weed out abusive situations in which the parties ignore the partnership, especially if the partnership is disregarded by the decedent after creation. Indeed, the ACTEC brief took the position that the “adequate and full consideration” test should be applied objectively, and “subjective criteria such as testamentary intent or the absence of a primary business purpose should not be relevant.”

- Reports from the oral argument are the Judge Davis asked a number of questions about business purpose. Perhaps the judges were concerned about business purpose, and saw the “bona fide” requirement as the only place to address business purpose, particularly in light of the Fifth Circuit’s first opinion in Strangi [293 F.3d 279 (2002)] affirming the Tax Court’s ruling in the taxpayer’s favor in its first opinion regarding the IRS’s lack of business purpose attack.

e. Full Consideration Requirement Means “Roughly Equivalent”.

- The court’s opinion is similar to the Stone case, which held that transfers to a partnership in return for pro rata interests and capital accounts in the partnership would be treated as meeting the full consideration requirement.
- The test regarding contributions to partnerships (quoted in Item 5.c. above) would be satisfied in most FLP situations.
- The court makes clear that an objective test is applied: “... taxpayer’s testamentary or tax-saving motive for a transfer alone does not trigger §2036 recapture if objective facts demonstrate that the transfer was made for a full and adequate consideration.” (p.9).
- The court does not specifically address the tension between two possible approaches to the full consideration requirement: (1) an “in pari materia” test, which would focus on whether the consideration received is sufficient to avoid a gift for gift tax purposes; and (2) an “equilibrium test,” which focuses on not depleting the gross estate. Arguably, an “equilibrium test” would not be satisfied by the contribution of assets to a partnership, because the gross estate would be lower if the contributor to the partnership were to die the next day. In Wheeler, the court was able to demonstrate that the sale of remainder interest situation satisfied both tests. In Kimbell, the court recited some of its discussion from Wheeler, hinting that an equilibrium test might be applied (“requires only that the sale not deplete the gross estate”), but then interpreted the inquiry as follows: “In other words, the assets the estate receives must be roughly equivalent to the asset it gave up.” The opinion’s statement of a “test” for adequate consideration regarding partnership contributions is that the “exchange of assets for partnership interests must be roughly equivalent so that the transfer does not deplete the estate.”

- The application of the “rule” to partnership contributions clearly points out that transfers for pro rata interests in a partnership based on capital accounts will satisfy the full consideration test.
- The court’s statement of the rules is very similar to the position taken in the ACTEC amicus curiae brief. It concluded that a transfer for interests in an entity that are proportionate in all material economic respects to the capital contributions should be “full consideration.” It rejected a strict equilibrium test (i.e., no depletion of the gross estate), because such a test would almost never be satisfied whenever property is transferred to an entity as a capital contribution, irrespective of whether the transferor is a family member.
- The court summarily the “mere recycling” argument that has been adopted by the Tax Court, by saying that a concern that a contribution of assets to an FLP is a “mere paper transaction resulting in a ‘recycling of value’ is better addressed under the ‘bona fide sale’ prong of this exception.”

f. Inadequate “Control” for Application of §2036 to LLC.

- The U.S. Supreme Court in Byrum rejected the government’s position that a right to designate should be construed as mere “control.” The Supreme court said: The ‘control’ rationale, urged by the Government and adopted by the dissenting opinion, would create a standard—not specified in the statute—so vague and amorphous as to be impossible of ascertainment in many instances.”
- A strict control test makes no sense, because many courts have blessed transfers to trusts, with the grantor as trustee with complete control over trust distributions, as long as distributions may be made only under a determinable standard.
- The opinion concludes that §2036 does not apply to the LLC because the decedent “did not retain sufficient control” to trigger §2036(a) where the decedent was a 50% member where her son had sole management powers. If the Fifth Circuit was suggesting that a pure control test should be used to gauge whether a decedent has retained a right to designate who can possess or enjoy property, that approach is most suspect. However, perhaps the court was just saying that the decedent had no ability at all to designate who could possess or enjoy property where she was only a 50% member and not the sole manager). Therefore, there was no need to address whether any power at all to designate would rise to the level of a “right to designate,” taking into consideration any fiduciary or other limitations on the exercise of that power.
- The discussion ameliorates some of the concern that has been raised about Judge Cohen’s extremely broad application of the “in conjunction with” language in §2036 in her opinion in Strangi. Her analysis, if pushed to its limits, would suggest that retaining even a 1% limited partnership interest could risk inclusion of the entire partnership contribution because that 1% limited partner, in conjunction with all other partners, could dissolve and

liquidate the partnership at any time. The Kimbell decision debunks that theory, indicating that even a 50% member interest in an LLC, where the decedent was not the sole manager, would not cause inclusion under §2036(a)(2).

g. De Minimis Transfers.

- The court rejected the government’s argument that one factor suggesting that the transfer was not bona fide was because of the de minimis contributions made to the partnership by other partners. “This argument amounts to a restatement of the government’s recycling of value argument and does not justify treating the transaction as a sham. We know of no principle of partnership law that would require the minority partner to own a minimum percentage interest in the partnership for the entity to be legitimate and its transfers bona fide.”
- Another reason suggested for having significant transfers by other partners is to avoid a “mere recycling” argument where the decedent had an interest in the same pool of assets both before and after the transfer. The Kimbell court totally dismisses the “mere recycling” argument, so that would not be a valid reason to insist on having substantial contributions by other partners if Kimbell is followed.
- There is a separate argument by the government to disregard fiduciary limitations on the exercise of a power, to determine whether it rises to the level of a “right to designate,” if there are only de minimis other partners to whom a fiduciary duty would be owed. The Kimbell opinion does not address that issue and thus is not a complete repudiation of a possible advantage of having significant contributions by other partners.

D. Status of Strangi and Thompson Appeals

1. The Strangi appeal had been stayed by the Fifth Circuit pending resolution of Kimbell. Norm Lofgren reports that the Fifth Circuit lifted the stay on May 21, 2004, and the estate’s opening brief is due by June 30, 2004.
2. The Thompson oral arguments to the Third Circuit were in April. The Third Circuit has requested the parties to advise it of any developments in the Kimbell case, leading some to believe that the court planned to wait to rule until the Kimbell decision was announced.