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## Tax Valuation E-Flash

### Kimbell v. United States, U.S. Court of Appeals for the Fifth Circuit, May 20, 2004

The Fifth Circuit has vacated and remanded a Texas district court decision that the value of assets Decedent transferred to a limited partnership was includible in her gross estate under I.R.C. §2036 because the transfer was not a bona fide sale for full and adequate consideration.

#### History

Decedent died in March 1998 at the age of 96. In January of 1998, her living trust and her son and daughter-in-law formed a limited liability company. Decedent's trust contributed \$20,000 to the LLC for a 50% interest while her son and his wife each contributed \$10,000 for two 25% interests.

Later in January 1998, her trust and the LLC formed a limited partnership. The trust contributed some \$2.5 million in cash, oil and gas working interests and royalty interests, securities, notes and other assets for a 99% pro-rata limited partner interest. The LLC contributed

Not all of Mrs. Kimbell's assets were conveyed to the LLC and the Partnership. She retained over \$450,000 in assets outside of the LLC and the Partnership for her personal expenses.

approximately \$25,000 in cash for a 1% pro-rata general partner interest. Decedent's son managed her business interest before and after the creation of the LLC and the Partnership.

Not all of Decedent's assets were conveyed to the LLC and the Partnership. She retained over \$450,000 in assets outside of the LLC and the Partnership for her personal expenses.

Under the Partnership agreement, the trust, as limited partner, had no right to withdraw from the Partnership or receive a return of contributions until the Partnership was terminated, which could occur only by unanimous consent of the partners. The Partnership Agreement provided that a vote of 70% of the limited partners could remove the general partner. A

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majority in interest of the limited partners had the right to elect a new general partner.

At the time of Decedent's death, the value of the Partnership assets was approximately \$2.4 million. On the estate tax return, the estate claimed a 49% discount for lack of control and lack of marketability.

### Bona Fide Sale Test

In the district court trial, the IRS successfully argued that the value of assets Decedent transferred to a limited partnership was includible in her gross estate under I.R.C. § 2036 because the transfer was not a bona fide sale for full and adequate consideration. The district court found that because family members were present on both sides of the transfer, the transfers were not at arm's length and therefore there was not a "bona fide sale."

The Fifth Circuit relied on *Wheeler v. United States*, 116 F.3d 749 (5th Cir. 1997). In *Wheeler*, the IRS argued that the requirement that a sale be "bona fide" takes on heightened significance in intrafamily transfers and the Court agreed. The Court also concluded that a court should

The Fifth Circuit also noted that the "willing buyer-willing seller" test of fair market value is different from the adequate and full consideration under § 2036(a).

inquire beyond the form of a transaction between family members to determine whether the substance justified the claimed tax treatment, but did make it clear that there is not an additional requirement not set forth in the statute to establish that it is bona fide just because a transaction takes place between family members .

The Fifth Circuit also noted that the "willing buyer-willing seller" test of fair market value is different from the adequate and full consideration under § 2036(a), noting:

*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*

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*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 [is] a classic informed trade-off.*

The Fifth Circuit also concluded that the taxpayers established the following facts that were uncontroverted by the IRS and which supported the existence of a bona fide sale:

- (1) Decedent retained sufficient assets outside the Partnership for her own support and there was no commingling of Partnership and her personal assets,
- (2) Partnership formalities were satisfied and the assets contributed to the Partnership were actually assigned to the Partnership,
- (3) The assets contributed to the Partnership included working interests in oil and gas properties which do require active management, and
- (4) The estate's witnesses advanced several credible and unchallenged non-tax business reasons for the formation of the Partnership that could not be accomplished via Decedent's trust.

**Retained Interest Test**

Because the Fifth Circuit concluded the bona fide sale test was met, it did not directly address the retained interest test in §2036. The court did note, however, "*Even if the transfer did not constitute a bona fide sale for full and adequate consideration, Mrs. Kimbell did not retain*

*Partnership formalities were satisfied and the assets contributed to the Partnership were actually assigned to the Partnership.*

*sufficient control of the assets transferred to the LLC to make her transfer subject to §2036(a). Mrs. Kimbell's interest in the LLC was only a 50% interest, and her son had sole management powers over the LLC. Thus, Mrs. Kimbell did not retain the right to enjoy or designate who would enjoy the LLC property." [Editor's note - this was despite the fact that the Partnership Agreement provided that 70% in interest of the limited partners had the right to remove the general partner and Mrs.*

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- Estate and Gift Tax

*Kimbell owned a 99.5% limited partner interest.]*

### Conclusion

While this Fifth Circuit decision was clearly a taxpayer victory, care should be taken in expanding it beyond the fact set to which it applied. Briefs are due next month in the *Strangi* §2036 appeal to the Fifth Circuit and we can only hope that when that decision is rendered, it gives clearer guidance for the application of §2036.