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Elaine Gagliardi on The Family Limited Partnership in 2018: Powell, Cahill, and Income Tax Basis at Death

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§ 1.01 Introduction

The Tax Court's 2017 holding in *Estate of Powell v. Commissioner*[1] followed by its 2018 decision in *Estate of Cahill v. Commissioner*,[2] signals a need to rethink how best to structure the family limited partnership and the terms of the partnership agreement. In a shift away from its historical approach to analyzing gross estate inclusion of family limited partnership assets, the *Powell* court endorses application of Section 2036(a)(2)[3] to include the value of partnership assets in decedent's gross estate, and in an unprecedented step employs Section 2043 to determine the value of family limited partnership assets includible in the gross estate. Going forward, these decisions impact how best to plan with family limited partnerships for both those clients who will owe estate tax and those who will not. This article discusses the estate planning consequences of these decisions with regard to the family limited partnership and the impact of the *Powell* decision on the determination of income tax basis of partnership assets included in the gross estate.

After *Estate of Powell*, the mere ability of a donor to join in a decision to terminate the partnership, regardless of whether the donor could have controlled the outcome, causes inclusion of assets in donor's gross estate absent showing of a bona fide sale for adequate and full consideration. The court's opinion in *Estate of Powell*, as delivered by Judge Halpern, for the first time determines the value included in the gross estate under Section 2036(a)(2) by applying Section 2043, and consequently includes in the gross estate only that portion of partnership assets equal to the "discount" attributable to the partnership interests received by decedent on formation of the family limited partnership, with any remaining value accounted for under Section 2033 based on the limited partnership interests held by decedent at death. This latter of the two holdings in *Powell* prompted a concurrence by Judge Lauber, and a divided court on the issue of whether to change the manner in which the court has historically determined the value included in the gross estate when Section 2036 causes inclusion of limited partnership assets in decedent's gross estate. Following *Estate of Powell*, the question becomes whether *Powell* signals a seismic shift or no more than a mere ripple on the estate planning landscape in the Tax Court's approach to family limited partnerships.

To eliminate any doubt about the Tax Court's willingness to rely on Section 2036(a)(2) in the context of family limited partnerships and other estate planning techniques, the Tax Court a year later issued its 2018 decision in *Estate of Cahill v. Commissioner*[4] applying a similar analysis in the context of generational split dollar life insurance arrangements. Not surprisingly both cases, *Estate of Powell* and *Estate of Cahill*, rest on facts that some would characterize as egregious. The nature of the underlying facts in these cases leave open the question of whether these holdings will apply in cases where planning is completed well before the anticipated death of the donor and while donor remains in good health. Both make clear formation of a family limited partnership falling within the bona fide sale for adequate and full consideration exception escapes inclusion of its assets in the gross estate.

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[1] 148 TC 392 (2017).

[2] TC Memo 2018–84 (June 18, 2018).

[3] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended.

[4] TC Memo 2018–84 (June 18, 2018).

The article begins with a discussion of the estate planning implications of *Estate of Powell* and *Estate of Cahill* for family limited partnerships. It next moves to a discussion of the income tax basis implications of the *Powell* opinion in light of the Tax Court's 2017 decision, *Hurford Investments No. 2, Ltd. v. Commissioner,*[5] addressing income tax basis of family limited partnership assets. Whether going forward the Tax Court embraces Judge Halpern's analysis or that of Judge Lauber will impact the answers to the issue of income tax basis. Income tax basis at death becomes important for many in light of the current increase in the applicable exclusion amount to $11,180,000 for 2018, and $11,400,000 for 2019.

§ 1.02 Impact of *Powell* and *Cahill* on Family Limited Partnership Planning Techniques

[1] *Estate of Powell v. Commissioner*

The Tax Court in *Estate of Powell v. Commissioner*,[6] a reviewed decision, extends the reach of Section 2036(a)(2) beyond its prior application. In addition, the *Powell* court breaks new, and unexpected ground, in applying Section 2043 to determine the amount included in the decedent's gross estate as a result of Section 2036 inclusion. Judge Halpern wrote for the court, with seven Tax Court judges joining in his opinion and two judges concurring in result only. Judge Lauber wrote a concurring opinion disagreeing with Judge Halpern's Section 2043 analysis, and six judges joined in the opinion of Judge Lauber. What becomes clear, given the opinions of both Judges Halpern and Lauber, is the substantial agreement of the court as to the expanded reach of Section 2036(a)(2). Significant disagreement remains, however, as to the appropriateness of applying a Section 2043 analysis to determine the amount ultimately includible in decedent's gross estate pursuant to Section 2036. Only eight of the 17 judges hearing *Powell* explicitly support application of Section 2043 to determine value included in the gross estate.

[a] Facts of *Estate of Powell*

Decedent Nancy H. Powell through her son, Jeff, who was serving as her attorney-in-fact, formed a family limited partnership (NHP, LP) by transferring cash and securities from decedent's revocable trust to NHP, LP in return for a 99 percent limited partnership interest. The stipulated value of the cash and securities transferred by decedent in exchange for limited partnership interests equaled $10,000,752. Jeff, as general partner, formed the Delaware limited partnership two days prior to decedent's transfer in exchange for the limited partner interests. The limited partnership terms provided the general partner "sole discretion to determine the amount and timing of partnership distributions."[7] Judge Halpern's opinion also highlights the ability to dissolve the partnership with "written consent of all partners."[8]

On the same day as decedent received limited partnership interests, Jeff, also in his capacity as attorney-in-fact, assigned the limited partnership interests to the Nancy H. Powell Foundation, formed as a charitable lead annuity trust or CLAT, with decedent's two sons as remainder beneficiaries. The day prior to the transfers from decedent to NHP, LP and thereafter from decedent to the CLAT, two physicians at decedent's care facility determined she was incapacitated. The power of attorney granted son the power to "[t]o grant, convey, sell, transfer, mortgage, deed in trust, pledge and otherwise deal in all property real and personal, which the principal may own."[9] It also granted son the power to make gifts "to a class composed of the principal's children, any of such children's

[5] Tax Court Docket No. 23017-11 (April 17, 2017), accessed at https://www.ustaxcourt.gov/UstcDockInq/DocumentViewer.aspx?IndexID=7090068.
[6] 148 TC 392 (2017).
[7] Estate of Powell at 395.
[8] *Id.*
[9] *Id.*

issue, or any or all to the full extent of the federal annual gift tax exclusion …”[10] It did not grant the power to make gifts to a charity.

In delivering the opinion of the court, Judge Halpern does not include in the statement of facts whether Jeff made a proportionate contribution for his general partnership interest. Judge Halpern also does not clarify in what capacity Jeff served as general partner, but the opinion implies Jeff held the general partnership interests in his individual capacity. Judge Lauber's concurring opinion specifies the sons contributed unsecured promissory notes in exchange for their respective interests. It is not clear from either opinion what, if any, interest Jeff's brother held in the limited partnership.

Decedent reported a 2008 taxable gift of $1,661,442 to the CLAT, representing the value of the remainder interest of her two sons. An appraisal valued the 99 percent limited partnership interest at $7,516,773, reflective of a 25 percent discount from the reported value of the cash and securities of $10,022,570.[11] The valuations presumed decedent suffered a terminal illness.

[b] *Powell's* Application of Section 2036(a)(2)

Noting the purpose of summary judgment to "expedite" and "avoid unnecessary and expensive trials," the Tax Court focuses its analysis on gross estate inclusion under Section 2036(a)(2) given that no factual questions needed resolution in determining the application of that section.[12] The Code pursuant to Section 2036(a)(2) requires gross estate inclusion of the value of property interests transferred with respect to which decedent retains a "right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom." The Tax Court analyzes two factors and acknowledges that either one alone can cause gross estate inclusion under Section 2036(a)(2). It focuses on the ability of the general partner to control timing and amount of distributions, and on the partners ability to join together to terminate the partnership and thereby control timing of the distribution. Judge Halpern's opinion harkens back to Judge Cohen's memorandum decision in *Strangi v, Commissioner*[13] for precedent with respect to each factor.

[i] Ability of Partners to Dissolve Partnership

First, Judge Halpern's opinion focuses on the right of decedent and her sons under the limited partnership agreement to dissolve the partnership with the written consent of all partners. It reasons "decedent's ability to dissolve NHP with the cooperation of her sons constituted" a prohibited retained right under Section 2036(a)(2).[14] Quoting *Strangi*, the opinion concludes: "The ability to dissolve the partnership carried with it the ability to direct the disposition of its assets."[15] The court determines gross estate inclusion follows under Section 2036(a)(2) whether the transfer to the CLAT is respected or not.[16] The jointly held power to dissolve the entity allowed decedent the right with others to designate possession or enjoyment of the property.[17]

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[10] *Id.*
[11] *Id.* at 396.
[12] *Id.* at 397.
[13] TC Memo 2003–145, *aff'd* 417 F3d 468 (5th Cir 2005).
[14] *Id.* at 401.
[15] Estate of Powell at 401–402 (*quoting* Strangi, TC Memo 2003–145 at 43).
[16] The opinion notes that the gross estate would include the transfers even if the transfer to the CLAT is respected. That conclusion would follow because absent the transfer of the limited partnership interests to the CLAT within three years of death, the interests would have been included in decedent's gross estate based on ability of all partners to join in dissolution via application of Section 2035(a). Later in the opinion, however, the Tax Court holds the transfer to the CLAT either void or revocable on the basis that the attorney-in-fact lacked power to make the gift under the terms of the power of attorney.
[17] *Id.* at 402.

Judge Halpern's analysis, however, fails to discuss or distinguish Treasury regulations specifying that similar rights granted to a settlor to join with all beneficiaries to dissolve a trust would not trigger application of Section 2038 provided "the power adds nothing to the rights of the parties under local law."[18] The Treasury regulation reflects the United States Supreme Court holding in *Helvering v. Helmholz,*[19] which addressed a right granted all beneficiaries to terminate a trust and concluded such right does not cause inclusion in a beneficiary's estate on the grounds that the law should recognize the

> essential difference between a power … and a condition which the law imposes. The general rule is that all parties in interest may terminate the trust [citing the Restatement of the Law of Trusts §§ 337, 338]. The clause in question added nothing to the rights which the law conferred. Congress cannot tax as a transfer intended to take effect in possession or enjoyment at the death of the settlor of a trust created in a state whose law permits all the beneficiaries to terminate the trust.

Similar reasoning should apply to powers to affect beneficial enjoyment of transferred property. At the time the Supreme Court decided *Helmholz,* there was no predecessor statute to Section 2036(a)(2) and, as a result, the Court did not address that provision directly. The Uniform Limited Partnership Act (ULPA), similar to that of trust law addressed in *Helmholz,* recognizes the right of all general partners, in conjunction with limited partners holding a majority right to distribution, to join together to dissolve the limited partnership.[20] Under the Tax Court's analysis in *Powell v. Commissioner,* limited partnerships formed in one of the 22 states adopting the ULPA, thus, may be susceptible to gross estate inclusion if the ULPA default rules are not changed by agreement and decedent holds a general partnership interest or sufficient limited partnership interests. Importantly, the court in *Powell* bases its decision on powers specified in the partnership agreement, as opposed to those implied by state law. It may be the court would not have arrived at the same conclusion had the partnership agreement not specifically granted the joint power to dissolve.

The question becomes whether courts will broadly apply *Estate of Powell's* Section 2036(a)(2) holding or limit the holding to facts similar to those of *Strangi* and *Powell* where decedent's attorney-in-fact made transfers at a point where decedent was rapidly failing. Both Judge Halpern's opinion and Judge Lauber's opinion agree Section 2036(a)(2) applies to include property interests transferred to the partnership in Mrs. Powell's gross estate. Recall that from *Strangi* in 2003 to *Powell* in 2017, few other courts have applied Section 2036(a)(2) to include underlying partnership assets in the decedent's gross estate. The court in *Estate of Turner v. Commissioner,*[21] applied Section 2036(a)(2) where decedent retained a power to amend the partnership agreement as general partner. Perhaps, in an effort to signal the Tax Court's intention to apply Section 2036(a)(2) consistently going forward, the Tax Court, shortly after its issuance of *Estate of Powell*, reiterated *Powell's* application of Section 2036(a)(2) in *Estate of Cahill v. Commissioner,*[22] an opinion authored by Judge Thornton, who joined in Judge Halpern's opinion in *Estate of Powell*. Citing *Estate of Powell*, *Estate of Cahill* holds Section 2036(a)(2) applies to a jointly held power to terminate a generational split dollar life insurance arrangement.

[ii] Illusory Fiduciary Duties When Decedent's Attorney-in-Fact Serves as General Partner

Second, the Tax Court in *Estate of Powell* focuses on whether decedent retained a prohibited right to designate possession and enjoyment of the property transferred to the limited partnership by Jeff, in his capacity as decedent's attorney-in-fact. Jeff also acted as general partner in his individual capacity. Although in *Estate of Powell* the decedent never owned any interest in the general partner (instead holding only limited partnership interests), the Tax Court analogizes to *Estate of Strangi* where in that case decedent held an interest in the corporate

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[18]Treas Reg § 20.2038–1(a)(2).
[19]296 US 93, 97 (1935)
[20]Unif Ltd Partnership Act § 801(a)(2) (2001, as amended 2013).
[21]TC Memo 2011–209.
[22]TC Memo 2018–84.

general partner, and, in turn, the corporate general partner appointed decedent's attorney-in-fact to serve as general partner. The Tax Court in *Estate of Powell* explains:

> [W]e concluded in *Estate of Strangi* that the decedent held the right, through his son-in-law, to determine the amount and timing of partnership distributions. The partnership agreement granted that authority to the managing general partner, a corporation owned by the decedent and other family members. The corporate general partner delegated its authority to the decedent's son-in-law in a management agreement. The son-in-law also served as the decedent's attorney-in-fact under a power of attorney. Thus, we concluded, "Decedent's attorney-in-fact thereby stood in a position to make distribution decisions." … In the present cases, NHP's limited partnership agreement gives Mr. Powell, as general partner, sole discretion to determine the amount and timing of partnership distributions. And, as in *Estate of Strangi,* the person with authority to determine distributions also served as decedent's attorney-in-fact.[23]

The Tax Court employed the same reasoning in distinguishing *Estate of Powell* and *Estate of Strangi* from the Supreme Court's holding in *Byrum v. United States*.[24] The Supreme Court came to the opposite conclusion when addressing the interest of a controlling stockholder in a corporation. The Supreme Court in *Byrum* rejected the argument that decedent retained a prohibited right under Section 2036(a)(2) on the basis that, as controlling shareholder, he could vote shares to control the board of directors and "thereby determine the flow of income to the trust."[25] The Court noted that only the trustee of the trust owning the shares could make that determination and not the decedent, Byrum. The Court further reasoned, as controlling shareholder, Byrum owed fiduciary duties to other minority shareholders, some of whom were not family members. The Tax Court in both *Estate of Strangi* and *Estate of Powell* distinguishes *Byrum* on the basis the fiduciary duties owed were illusory because decedent, through decedent's attorney-in-fact, owed fiduciary duties to himself or herself. The *Powell* court essentially imputes the rights and duties of the general partner or manager to the decedent on the basis that the general partner is decedent's attorney-in-fact.

The *Powell* court does not discuss the factual differences between *Strangi* and *Powell*, specifically, that in *Powell* decedent never owned an interest in the general partner. As a result it would have been difficult to argue that she "retained" what the *Byrum* court termed a "legally enforceable" right to make decisions relegated only to the general partner. In *Byrum* the Supreme Court concluded Byrum did not have an "unconstrained de facto power to regulate the flow of dividends to the trust, much less the right to designate who was to enjoy the income from trust property."[26] While Mrs. Powell was owed a fiduciary duty by her son as attorney-in-fact and as general partner, she also did not have an unconstrained right herself to control enjoyment of the limited partnership. Her son owned the general partner interest. An attorney-in-fact owes duties to the principal only with respect to property subject to the power of attorney, although admittedly the attorney-in-fact should not undertake a conflicting interest transaction. The fact the *Powell* court does not address this difference between the two cases, *Strangi* and *Powell*, implies that, if a person owns an interest in the general partner and at the same time serves as the attorney-in-fact for the decedent, the decedent will be deemed to retain prohibited rights to designate enjoyment of income and property under Section 2036(a)(2) if the decedent, as a result, is deemed to stand on both sides of the transaction. If the goal is to avoid gross estate inclusion, going forward the decedent's attorney-in-fact should refrain from serving as general partner of the family limited partnership.

[iii] Lessons from *Powell* on Structuring an FLP

The *Powell* holding makes it exceedingly difficult to avoid Section 2036 if formation of the limited partnership does not meet the bona fide sale for adequate and full consideration exception of Section 2036. The estate in *Powell* did not argue it met the bona fide sale for adequate and full consideration exception.[27] *Estate of*

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[23] Estate of Powell at 402–403 (citing Estate of Strangi, T.C. Memo. 2003-145 at 9).
[24] 408 US 125 (1972).
[25] *Id.*
[26] Byrum at 143.
[27] Estate of Powell at 399.

Powell, as reinforced by the Tax Court's opinions in *Estate of Cahill* and *Estate of Turner*, teaches the donor-decedent should not retain any management rights, veto powers or other jointly held rights to direct assets of the limited partnership. Neither should any person who owes a fiduciary duty to the donor-decedent hold such powers. *Powell* essentially limits those who can serve as general partner to someone other than decedent or decedent's attorney-in-fact if donor-decedent aims to avoid gross estate inclusion. An independent manager subject to fiduciary duties provides the best chance of avoiding the reach of Section 2036(a)(2). Planners have kept this lesson in mind since issuance of the Tax Court's decision in *Estate of Strangi*.

For taxpayers who no longer have concerns about owing federal estate tax because their assets do not exceed the combined applicable exclusion amounts of both spouses, the lessons of *Powell* may be of no concern. For these individuals, the increase in applicable exclusion amount leaves open the possibility of using the family limited partnership as a vehicle to provide management of assets during life and some continued control of assets following client's death. It also may be possible to design the provisions of the FLP to obtain a step-up in basis at death and achieve the primary tax goal of clients whose assets fall within the applicable exclusion amount.

[c] Powell's Application of Section 2043(a)

Judge Halpern's opinion for the court in *Estate of Powell* and Judge Lauber's concurring opinion part ways on the appropriateness of applying Section 2043 to determine the value included in the gross estate of decedent under Section 2036. Writing for the court, Judge Halpern acknowledges the Tax Court has not previously applied Section 2043 to family limited partnerships includible in the gross estate under Section 2036. The opinion sets out to resolve what it unilaterally terms "the illogic" of current law noting:

> [T]he Commissioner customarily includes in the value of her gross estate the value of the assets transferred inter vivos to the partnership in lieu of the value of the partnership interest that the decedent actually owned at death (which would otherwise be includible in the value of her gross estate under section 2033). The illogic of including in the value of a decedent's gross estate both the assets transferred to a family limited partnership and the partnership interest received in return seems to have been widely recognized, but the precise legal grounds that prevent such illogical "double taxation" have gone unarticulated.[28]

Judge Halpern resolves the illogic by including limited partnership interests in the gross estate under Section 2033, and only the value of the discount under Section 2036(a). Judge Lauber's concurring opinion disagrees with this approach: "By adopting an untried new theory without first hearing from the parties, we risk creating problems that we do not yet know about. The more prudent (and conservative) approach in my view would be to adhere to the letter and spirit of our precedent, leaving the law in the relatively stable position it appears to occupy now."[29] Judge Lauber's concurring opinion indicates, for example, the acknowledged possibility that application of Section 2043 can yield a "duplicative reduction" or "increase" in transfer tax.[30]

[i] Application of Section 2043(a) in *Powell*

Judge Halpern's opinion forges a new path by applying Section 2043(a) to determine the appropriate amount included in the gross estate under Section 2036. Application of Section 2043(a) includes in the gross estate "only the excess of fair market value at the time of death of the property otherwise to be included [in this case under Section 2036] on account of such transaction" less "the value of consideration received therefor by the decedent."[31] The Code section applies if the transfer "is made … for a consideration in money or money's worth, but is not a bona fide sale for an adequate and full consideration in money or money's worth."[32] In *Estate of Powell*, Judge Halpern explains: "In the present cases, because of the limitation provided by section 2043(a), section 2036(a)(2),

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[28] *Id.* at 409–410.
[29] *Id.* at 424.
[30] *Id.*
[31] IRC § 2043(a).
[32] *Id.*

if applicable, would include in the value of decedent's gross estate only the excess of the fair market value at the time of her death of the cash and securities transferred to NHP over the value of the 99% limited partner interest in NHP issued in exchange for those assets."[33] In other words, the gross estate per Section 2036(a)(2) includes only the discount allowable based on date of death value, referred to by the court as "the doughnut hole," with the partnership interests referred to as the "doughnut" includible under Section 2033 or if transferred during life accounted for at death as an adjusted taxable gift.[34] Accordingly, Judge Halpern determines the purpose underlying Section 2043(a) is to limit "the reach of the inclusionary rules to transactions that deplete a decedent's estate" is fulfilled.[35] It notes: "To the extent that the value of assets transferred to a family limited partnership does not exceed the value of the partnership interest received in return, the exchange does not deplete the transferor's estate or allow for the avoidance of transfer taxes."[36]

[ii] Reasoning of Concurring Opinion

The concurring opinion of Judge Lauber begins by noting Judge Halpern's acknowledgment that Section 2036 "does not require 'the inclusion in the value of decedent's gross estate of the full date-of-death value of the cash and securities,' while admitting that the statute, 'read in isolation, would require that result.' "[37] Judge Lauber explains that in fact current law does not result in the double inclusion issue claimed by the Tax Court's opinion. The concurring opinion reasons: "The partnership was an empty box into which the $10 million was notionally placed. Once that $10 million is included in [decedent's] gross estate under section 2036(a)(2), it seems perfectly reasonable to regard the partnership interest as having no distinct value because it was an alter ego for the $10 million of cash and securities."[38] The court notes: "This is the approach that we have previously taken to this problem."[39]

[iii] Troublesome Aspects of Applying Section 2043(a)

The Tax Court, prior to Judge Halpern's opinion in *Estate of Powell*, has consistently rejected the notion that I.RC. Section 2043 should apply to inclusion of limited partnership assets under Section 2036. The court acknowledges as much when it notes its prior opinion in *Estate of Harper v. Commissioner*[40] declined to apply Section 2043. The court in *Estate of Harper* stated:

> We therefore hold that where a transaction involves only the genre of value "recycling" described above and does not appear to be motivated primarily by legitimate business concerns, no transfer for consideration within the meaning of section 2036(a) has taken place. Hence, the exception provided in that statute is inapplicable. Furthermore, although section 2043 can entitle taxpayers to an offset for partial consideration in cases where a transfer is otherwise subject to section 2036, this section, too, is inapplicable where, as here, there has been only a recycling of value and not a transfer for consideration.[41]

The *Harper* court did not see fit to apply Section 2043 where the transaction was not "bona fide." Only once, in a later case, *Estate of Abraham v. Commissioner,*[42] did the court acknowledge without disagreement a reduction allowed by the Service to the value included in the gross estate based on cash consideration received by

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[33]Estate of Powell at 407.
[34]*Id.* at 408–409.
[35]*Id.* at 406.
[36] *Id.* at 408–409.
[37]*Id.* at 422.
[38]*Id.* at 423.
[39] *Id.*
[40]TC Memo 2002–121
[41] *Id.*
[42]TC Memo 2004–39, *aff'd* 408 F.3d 26 (1st Cir 2005).

decedent from a beneficiary. In that case the consideration came from the beneficiary, not as a result of a recognition of a contribution to the partnership by decedent herself.

Courts have applied Section 2043 in other contexts where the beneficiary transferred consideration to the donor, but not where what is received is part of the formalities of a transaction that is not deemed bona fide. The Second Circuit, in addressing a sale of a personal residence for a note and mortgage where decedent's rental payments to live in the residence equaled the mortgage payments, held Section 2043 inapplicable on the basis the transaction was not bona fide finding the transfer was without any consideration.[43] In contrast to the Second Circuit's decision, which did not count the mortgage as consideration received, Judge Halpern's opinion in *Estate of Powell* counts the limited partnership interests as consideration despite the fact no consideration was paid by a third party and the partnership interests do no more than represent the proportion of the assets contributed to the partnership. In this respect Judge Halpern's analysis departs from prior law on Section 2043.

Yet another analogy would be to formation of a trust. For example, where a grantor retains an income interest in a trust to which grantor has made a transfer, the income interest retained is not deemed to be adequate consideration for the transfer when determining gross estate inclusion under Section 2036. Similarly, it does not make sense to treat receipt of partnership interests as consideration when applying Section 2043 in the context of Section 2036 inclusion as they are nothing more than the retained interest of the donor on formation. Judge Lauber's concurring opinion notes this concern when it cites cases indicating a retained interest does not constitute consideration under Section 2043.[44] Consideration to meet the Section 2036 exception in the trust context must come from a third party to the decedent.[45] It would seem the same should be true in the limited partnership context where the property is simply received in return for decedent's formation contribution. This is yet another example of the incongruence with which Section 2036 has been applied by the courts to family limited partnerships.[46]

In delivering the court's decision in *Estate of Powell*, Judge Halpern spends considerable time discussing the meaning of Section 2043's reference: "but is not a bona fide sale for an adequate and full consideration in money or money's worth. …"[47] As explained, other courts interpret this phrase to focus on whether the consideration was "full and adequate." Judge Halpern's opinion instead focuses on both prongs — whether the sale is bona fide, and whether it is for adequate and full consideration. It essentially modifies the prior understanding of the "adequate and full consideration" prong. In a footnote, the opinion indicates the former "proportionality" test for adequate consideration as applied in *Bongard v. Commissioner*[48] now applies only to those cases where there is a legitimate and significant nontax reason for the partnership.[49] Judge Halpern's opinion concludes that, when the "bona fide sale exception" does not apply, "if the decedent receives *some* consideration, section 2043(a) limits the required inclusion to the amount by which the transfer depletes the decedent's estate."[50] Earlier courts held the "adequate and full consideration" prong satisfied if the donor received in return a proportional interest in the entity. Under *Estate of Powell*, essentially any time the "bona fide" prong remains unsatisfied, proportional receipt of interests fails the "adequate and full consideration" prong when a discount is included in valuation of limited partner interests. This analysis is difficult to understand. It makes sense that proportionality does not run afoul of "the full and

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[43]Estate of Maxwell v Commissioner, 3 F3d 591 (2nd Cir 1993) *aff'g* 98 TC 594 (1992).

[44]Estate of Powell at 423 (the court cites: "*Estate of Gregory v Commissioner*, 29 T.C. 1012, 1020 (1963) (holding that a decedent's retained interest in her own property cannot constitute consideration under section 2043(a))."

[45] *See* Treas Reg § 20.2043–1(b) (discussing types of consideration from spouse that would be considered per Section 2043); *Wheeler v United States*, 116 F3d 749 (5th Cir 1997) (consideration from children paid to donor for remainder interest deemed full and adequate consideration).

[46] For further discussion of the difficulty in applying Section 2036 to family limited partnerships, *see* Mitchell M. Gans & Jonathan G. Blattmachr, Family Limited Partnerships and Section 2036: Not Such a Good Fit, 42 ACTEC L.J. 253, 269 (2017).

[47] Estate of Powell at 411–412; IRC § 2043(a).

[48]124 TC 95 (2005).

[49]Estate of Powell at 406, n. 6.

[50] *Id.* at 406.

adequate consideration" because the person contributing to the partnership changes only the form of what is owned, but when the contributor gets more or less than the contributor's proportionate share a partner is getting either more or less and should be deemed then to be receiving or giving consideration from or to another. Consistency would urge respecting the reality that partnership interests represent proportional value of property contributed regardless of whether the bona fide sale exception is met. The limited partnership interests represent the property contributed. Judge Halpern's opinion is troublesome in this respect.

[iv] Questions Remaining After *Powell*

The concurring opinion leaves a ring of truth when it warns: "By adopting an untried new theory without first hearing from the parties, we risk creating problems that we do not yet know about."[51] Among the questions left unanswered by the differing opinions in *Powell* are: If decedent successfully transfers partnership interests prior to death, will the limited partnership interests escape taxation with only those assets equal to the discount allowed on formation included in decedent's gross estate? How will the opinions in *Powell* impact application of Section 1014? Should the "discount" Judge Halpern's opinion includes in the gross estate under Section 2036(a)(2) be added to the basis of the partnership assets included in the gross estate?

Judge Halpern's opinion leaves a larger unanswered question regarding application of Section 2043 to limited partnerships. Is that opinion precedential as regards to its analysis and application of Section 2043(a) to limited partnership assets includible under Section 2036? Including Judge Halpern, only eight of seventeen judges explicitly agree with the portion of the opinion of the court addressing application of Section 2043 to determine inclusion of family limited partnership assets under Section 2036. Including Judge Lauber, seven judges agree with the concurring opinion rejecting application of Section 2043 on the facts of *Powell*, which is referenced as an opinion "concurring in the result only." Two other judges "concur in the result only," but do not join in either opinion and there is no explanation as to why the two judges chose not to join in agreement with Judge Halpern's opinion or the concurring opinion. Thus, while all judges either join or concur in the court's opinion, only eight judges have signified agreement with application of Section 2043 to determine value included in the gross estate. There is no clear majority supporting application of Section 2043 in determining the value to be included per Section 2036(a)(2). Nonetheless, the court's holding is clear that decedent's gross estate in *Powell* includes an amount equal to the full value of the partnership assets: Sections 2033 and 2036, in conjunction with 2043(a), per Judge Halpern would include in the gross estate value equal to that of the partnership assets, while Section 2036(a)(2) would include the value of the partnership assets per Judge Lauber. Perhaps this lack of any difference in actual monetary result given the unique facts of *Estate of Powell* is the reason two of the judges entered their concurrence in result only. We will likely not know unless Judges Foley and Paris take the opportunity to address this issue in a later opinion.

[v] What Results Based on the Differing Analyses

The analytical approaches of Judge Halpern and Judge Lauber differ significantly. The core difference rests in the treatment of whether both the partnership and partnership interests should be deemed illusory for purposes of determining inclusion in the gross estate.

Judge Halpern finds it "illogical" to ignore the existence of the partnership interests that should be included under Section 2033. In doing so, Judge Halpern's analysis inconsistently recognizes the existence and includability of the partnership interests despite acknowledging appropriateness of the "recycling" of value theory that has caused the court to ignore existence of the partnership, itself, in favor of including the partnership assets. In discussing the recycling theory which treats the partnership as illusory when there is an absence of pooling of assets, Judge Halpern reasons:

> Therefore, the degree of pooling is relevant to the question of the nontax bona fides of the transaction. But we see no reason why the degree of pooling should affect the extent to which a partnership interest received

[51]*Id.* at 424.

> in exchange for transferred assets should be treated as consideration received for those assets in applying section 2036(a) or section 2043(a).[52]

The opinion ignores the partnership for purposes of applying I.R.C. Section 2036 and yet conflictingly recognizes existence of partnership interests held by decedent in an "illusory" partnership for purposes of applying Sections 2043 and 2033.

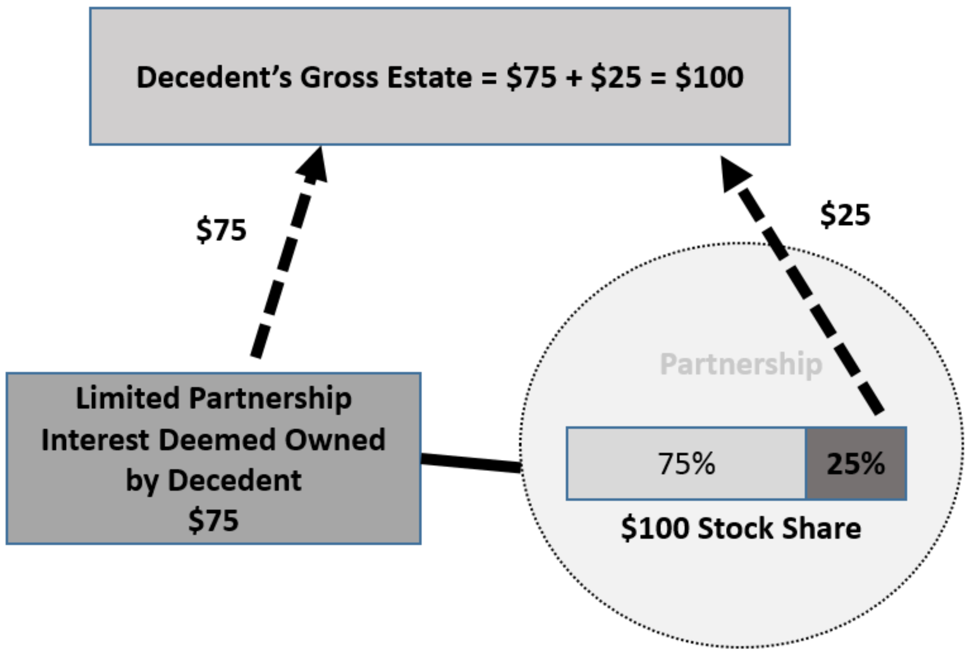
By contrast, Judge Lauber's opinion ignores both the existence of the partnership and the partnership interests in light of underpinnings of the recycling theory. Judge Lauber, consistent with Tax Court precedent, would include the full value of the partnership assets in decedent's gross estate and ignore existence of both the partnership and partnership interests for purposes of the estate tax analysis. Judge Lauber's opinion would not recognize the partnership interest as having value recognizable for purposes of either 2043 or 2033.

Applying either opinion, the gross estate includes the same ultimate value. Use of a simplified hypothetical is helpful in understanding the differing analyses of Judges Halpern and Lauber. The hypothetical highlights the manner in which the opinions differ in their treatment of the partnership and the partnership interests as illusory, or not. It demonstrates that, despite these differences, decedent's gross estate includes the same total value. Later, the hypothetical will be used to demonstrate that the differing analyses result in significantly different treatment with regard to income tax basis on a decedent's death.

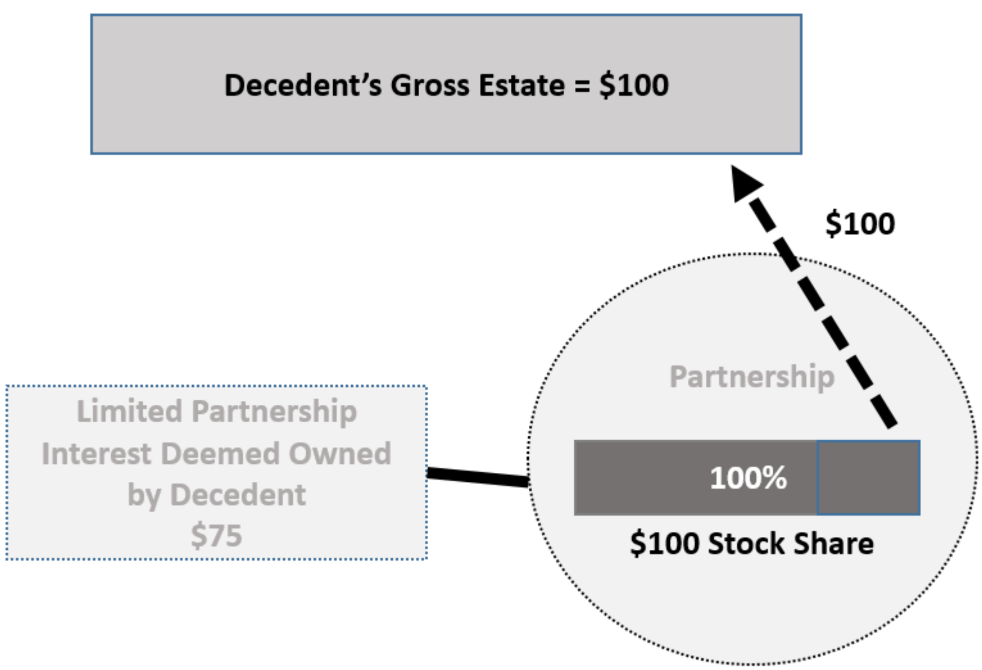
> **Hypothetical**: For illustration purposes, assume decedent forms a limited partnership with one share of stock valued at $100, and assume limited partnership interests received in return take a fair market value of $75 after application of a 25% discount. Assume further that decedent's basis in the share of stock at the time of its contribution to the partnership is $40. Further assume decedent owns the limited partnership interests at death and did not make any transfers of interests prior to death. Under either Judge Halpern's analysis or Judge Lauber's analysis, the gross estate includes $100 of total value. Per Judge Halpern the estate would include 25% of the share value representing the discount and $75 representing the value of the limited partnership interests owned by decedent, for a total of $100. Judge Lauber would include the value of the share of stock at $100.

[52] *Id.* at 412.

Gross Estate Inclusion Per Judge Halpern's Analysis



Gross Estate Inclusion Per Judge Lauber's Analysis



[2] *Estate of Cahill v. Commissioner*

The next published Tax Court opinion to address inclusion under Section 2036(a)(2) reinforces the holding of *Estate of Powell* and applies a similar rational to inclusion of decedent's rights in three generational split dollar arrangements. Judge Thornton, who joined in the opinion of the court in *Estate of Powell*, delivered the memorandum opinion in *Estate of Cahill v. Commissioner*.[53]

[a] Facts of *Estate of Cahill*

Decedent's son, Patrick Cahill, entered into split dollar agreements on behalf of his father, Richard Cahill, at a time when Richard was 90 years old and lacked capacity to manage his own affairs. Richard died on December 12, 2011. Patrick served as Richard's attorney-in-fact and as trustee of Richard's "Survivor" trust. The parties stipulate that Richard's gross estate includes the assets of the Survivor Trust.[54] In 2010, as attorney-in-fact, Patrick created the irrevocable "Morris Brown Trust," termed the MB Trust, naming his cousin and business partner William as trustee, and himself and his descendants as beneficiaries. The MB Trust owns three whole life insurance policies, two on the life of Patrick's spouse with a policy amount of $39.8 million, and one on Patrick's life with a policy amount of $40 million, with each policy guaranteeing a 3-percent return. Each policy is the subject of a split dollar agreement with the Survivor Trust agreeing to pay the premium as an advance to the MB Trust.[55] The Survivor Trust obtained a five-year loan at 1.5 percent interest, guaranteed by Richard and Patrick, for the purpose of making the premium payment. The split dollar agreements further provided: "Survivor Trust will receive a portion of the death benefit equal to the greatest of: any remaining balance on the loan as relates to the relevant policy, the total premiums paid by Survivor Trust with respect to that policy, or the cash surrender value of the policy immediately before the insured's death."[56] The MB Trust receives the excess. Under the agreements "MB Trust is not permitted to sell, assign, transfer, borrow against, surrender, or cancel the related policy without the consent of Survivor Trust."[57]

In exchange for $10 million in premium payments, Richard retained termination rights. Richard, in conjunction with MB Trust, could terminate the split dollar agreements and either (1) MB Trust then could retain the policy and pay Richard the greater of premium payment or cash surrender value of the policy; or, (2) MB Trust could decline to retain the policy and pay over the policy to the bank in satisfaction of the five-year loan.[58] Because it would not make economic sense for MB Trust to allow exercise of the termination rights, the estate took the position the termination rights had no value. The estate also took the position that Richard's right to the death benefits was worth little because the insureds were expected to outlive Richard. On Richard's death the combined cash surrender value of the policies totaled $9,611,624.[59] The estate tax return for Richard's estate reported the total value as $183,700, and Richard had previously reported a gift under the economic benefit regime of $7,578.[60]

Although *Cahill* specifically addresses split dollar arrangements and not family limited partnership interests as addressed in *Powell*, it does signal the Tax Court's willingness to apply the Section 2036(a)(2) analysis of *Estate of Powell* in a situation where decedent's attorney-in-fact orchestrated the estate planning transfers. In addition, it reaffirms in dicta the Tax Court's earlier position on the application of Section 2703 to partnership formation and the partnership agreement itself. It hints, however, at broader application of that provision. It also addresses the economic benefit regime as applicable specifically to split dollar arrangements, and that discussion is not reviewed as part of this article.

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[53]TC Memo 2018–84 (June 18, 2018).
[54]*Id.* at 3.
[55]*Id.* at 4.
[56]*Id.* at 5–6.
[57]*Id.* at 6.
[58]*Id.* at 7–8.
[59]*Id.* at 8–9.
[60]*Id.* at 5–6.

[b] *Cahill's* Application of Section 2036(a)(2)

With reference to *Estate of Powell*, the Tax Court determines Sections 2036(a)(2) and 2038(a)(1) apply to include in decedent's gross estate his interest in the cash surrender value of the insurance policies under the split dollar arrangements. The *Cahill* court rejected the estate's assertion that because the irrevocable MB trust could prevent termination of the split dollar arrangement, the decedent had not retained any rights to the cash surrender value of the policy. In response, the court cited the ability of decedent, through the revocable trust, to terminate the split dollar arrangement in conjunction with the irrevocable trustee, asserting "the words 'in conjunction with any person' in section 2036(a)(2), and 'in conjunction with any other person' in section 2038(a)(1)" must be given meaning."[61] Analyzing the facts it concluded: "the rights to terminate and recover at least the cash surrender value were clearly rights, held in conjunction with another person (MB Trust), both to designate the persons who would possess or enjoy the transferred property under section 2036(a)(2) and to alter, amend, revoke, or terminate the transfer under section 2038(a)(1)."[62] It did not matter that the decedent could not unilaterally force termination.

In applying the bona fide sale for adequate and full consideration exception, the court addressed both prongs – whether the transaction was bona fide, and whether there was adequate and full consideration received by Richard. In determining whether the transaction was bona fide, the court queried: "Whether a transfer was a bona fide sale is a question of business purpose; i.e., did decedent have a legitimate and significant nontax reason, established by the record, for transferring the $10 million?"[63] Unresolved facts precluded the court from determining the bona fide nature of the transaction. The manner in which the court stated the question may indicate a shift in focus to whether the transaction makes economic sense from the perspective of the transferor. As to the second prong of the exception, the court determined the transaction lacked adequate and full consideration. The court applied the following test: "Whether a transfer was for adequate and full consideration is a question of value; i.e., did what decedent transferred roughly equal the value of what he received in return?"[64] Focusing on the estate's application of a 98 percent discount, and noting that the basis for the discount applied from the inception of the transaction, the court determined there was a failure to meet the adequate and full consideration prong of the exception. On this basis the court denied the estate's request for summary judgement that Section 2036(a)(2) and 2038(a)(1) do not apply. Should a discount indicate a lack of adequate and full consideration?

Notably the court did not address Section 2043 although it could have chosen to do so in a manner analogous to the court's application of that provision in *Estate of Powell*. The court could have viewed the value of the rights in the split dollar arrangements provided the decedent consideration for the premium payments on the life insurance policies similarly to the court's analysis in *Estate of Powell* where it viewed receipt of partnership interests as consideration for assets transferred pursuant to the partnership agreement. The fact the *Cahill* court chose not to address Section 2043 in contrast to Judge Halpern's analysis in *Estate of Powell*, where there was similarly a lack of briefing on the application of Section 2043, may signal the court's reluctance to apply that section in contexts outside of the limited partnership scenario.

[c] *Cahill's* Application of Section 2703

In dicta, the *Cahill* court addressed application of Section 2703 to family limited partnerships and, in doing so, distinguished treatment of family limited partnership interests under Section 2703 from that of split dollar arrangements. The court rejected the estate's argument that split dollar arrangements are like partnerships. It reaffirmed its prior holdings addressing how Section 2703 applies to family limited partnerships:

> In *Estate of Strangi v. Commissioner*, [citation omitted], we held that "Congress did not intend, by the enactment of section 2703, to treat partnership assets as if they were assets of the estate where the legal interest owned by the decedent at the time of death was a limited partnership or corporate interest." In other

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[61] *Id.* at 15.
[62] *Id.*
[63] *Id.* at 17.
[64] *Id.* at 18.

> words, section 2703 generally does not function as a look-through rule for entities which are valid under State law. No State law entity is involved in this case. *Estate of Strangi* is therefore inapplicable. Moreover, whereas in *Estate of Strangi* the Commissioner "did not argue separately that the … shareholders' agreement should be disregarded … under section 2703(a)", [citation omitted], in this case respondent is specifically arguing that MB Trust's ability to prevent termination functions, with respect to decedent's termination rights, in much the same way a restrictive agreement functions with respect to corporate or partnership interests.[65]

The *Cahill* court draws the distinction between application of Section 2703 to formation of a partnership and application to the restrictions included in a partnership agreement. It notes that restrictions in a partnership agreement are subject to analysis under Section 2703 and gives as an example its holding in *Holman v. Commissioner*.[66] In *Holman,* the family limited partnership consisted entirely of publicly traded stock interests and on that basis, where there was no closely held business necessitating the restrictions on sale, Section 2703 would apply. Viewed critically, this affirmance of the court's application of Section 2703 may provide little comfort given the court's application of that provision to the contract rights under the split dollar arrangement unless the court's reference is properly interpreted to apply only to those restrictions in the partnership agreement that vary state law default rules as to what comprises a partnership.

Notably, the *Cahill* court begins its Section 2703 analysis with the view that "the relevant property interests for purposes of section 2703(a) are the rights held under the split dollar agreements, and [] the estate has not disputed that decedent did, in fact, own the termination rights and decedent's death benefit rights."[67] The court holds the split dollar arrangement is subject to the requirements of Section 2703:

> On the basis of the undisputed facts, we conclude that under section 2703(a)(1) the split dollar agreements, and specifically the provisions that prevent decedent from immediately withdrawing his investment, are agreements to acquire or use property at a price less than fair market value.
>
> ***
>
> Next, it is clear that under section 2703(a)(2) the split dollar agreements, and specifically MB Trust's ability to prevent termination, also significantly restrict the decedent's right to use the termination rights.[68]

With regard to application of Section 2703(a)(1) the court notes the MB Trust provided no consideration for its rights under the agreement. And, as to Section 2703(a)(2), the court assumes, absent the agreement, decedent would have the right to terminate the agreements and withdraw from the investment. Might this imply that if both parties provided consideration Section 2703 would not apply? Of note, the court also distinguishes a promissory note on the basis that parties bargain and consideration passes both ways under the note.[69]

Of great concern, the court brushes aside policy implications of a literal reading of its holding: "if section 2703(a) applies in this case, it would also apply to all sorts of other options, agreements, rights, and restrictions. For example, the estate argues that 'almost every two-party agreement has a restriction that one party cannot just unilaterally terminate the agreement.' "[70] The court impliedly acknowledges this broader reading by replying Congress provided an exception under Section 2703(b), specifically subsection (b)(3), which compares the terms of the agreement to "similar arrangements entered into by persons in an arms' length transaction."[71]

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[65] *Id.* at 25-26.
[66] *Id.*, citing Holman v Commissioner, 130 TC 170, 195 (2008).
[67] Cahill at 20–21.
[68] *Id.* at 23–24.
[69] *Id.* at 24.
[70] *Id.* at 27.
[71] *Id.*

Circling back to family limited partnerships, might a court applying *Estate of Cahill* view the partnership agreement as incorporating state law and thereby conclude terms restricting unilateral dissolution should be ignored under Section 2703? Or, would it acknowledge the choice to form a family limited partnership carries with it the choice to apply default rules of the statute and that only variations from the statutory terms should be scrutinized under Section 2703? This latter reading appears to be implicit in the prior holdings of the Tax Court as initially recited rejecting application of Section 2703 to the family limited partnership itself.

For those taxpayers intending to use the family limited partnership to obtain a tax benefit, the planner should refrain from modifying restrictions applicable pursuant to state law if those restrictions will preclude the agreement from meeting the requirements of the exception to application of Section 2703.[72] For those taxpayers who are unconcerned with possible estate or gift tax implications of such restrictions, the application of Section 2703 will cause partnership interests to be valued as if any restrictions on transfer of use of partnership interests do not apply. The higher valuation required by Section 2703 may prove important to obtaining a higher income tax basis on decedent's death.

§ 1.03 Minimizing Estate Taxes in the Wake of *Powell* and *Cahill*

Some may conclude the Tax Court's holding in *Estate of Powell*, as reinforced in *Estate of Cahill*, requires review and rethinking how to structure and use family limited liability entities to minimize federal estate and gift taxes. The breadth of *Powell's* impact, however, depends on how one views the facts and their impact on the court's holding. In *Powell,* the decedent was unable to manage her affairs, her attorney-in-fact engaged in the formation of the partnership, the attorney-in-fact choreographed the transaction and stood to benefit, as did the decedent according to the court, and decedent died shortly after the transaction. Facts similar to these in a number of cases have led the court to determine the transaction was not "bona fide."[73]

The *Powell* court confirmed a bona fide sale for adequate and full consideration avoids application of Section 2036, and for that matter avoids Sections 2038 as well. Although the court did not directly address whether the transaction in *Estate of Powell* was bona fide, relying instead on the estate's concession, the facts nevertheless likely impacted the court's view of the transaction. A family limited partnership complying with the bona fide sale for adequate and full consideration exception will continue to yield valuation discounts and achieve the goal to minimize estate tax.

[1] Reliance on *Bona Fide* Sale for Adequate and Full Consideration Exception

The question becomes: Did the *Powell* court modify the test for whether the formation of the partnership and subsequent transfer of partnership interests meets the bona fide sale for adequate and full consideration exception? The term has come to require a showing of (1) a "legitimate and significant nontax reason" for the transaction and facts directly supporting the nontax reason, and (2) receipt of partnership interests in proportion to the partner's contribution.[74]

[a] Meaning of Bona Fide Sale

In discussing the meaning of "bona fide" in relation to Section 2043, as opposed to Section 2036, the *Powell* court focuses on whether a "genuine pooling" of assets occurs on formation. In doing so it cites cases prior to the announcement of the "legitimate and significant nontax reason" requirement formulated by the Tax Court in *Estate of Bongard v. Commissioner*.[75] The court focuses in *Powell* on the importance of an arm's length transaction and a genuine pooling of assets. This analysis raises questions regarding what must be shown to prove the bona

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[72] *See* IRC § 2703.

[73] *See* Estate of Hurford v Commissioner, TC Memo 2008-278; Estate of Erickson v Commissioner, TC Memo 2007-107; Estate of Rosen v Commissioner, TC Memo 2006-115; Estate of Strangi v Commissioner, TC Memo 2003-145.

[74] *Id.* at 25.

[75] 124 TC 95 (2005).

fide sale for full and adequate consideration exception applies. The Tax Court in *Estate of Cahill* provides assurance that in fact the *Bongard* court's "legitimate and significant nontax reason test" remains the correct analysis for determining whether the I.RC. Section 2036 exception applies, citing a later case, *Estate of Hurford v. Commissioner*.[76]

Over the course of many cases, the meaning of "legitimate and significant nontax reason" has become clearer. The court looks for a significant motive other than for the purposes of minimizing estate tax. Most importantly the facts specific to the family circumstances must support the stated nontax reason. Among nontax reasons supported by the specific facts and found to be legitimate and significant include pursuit of a unique investment strategy,[77] change in management,[78] and fear a closely-held business would fall to owners other than family members.[79]

[b] Meaning of Adequate and Full Consideration

The meaning of adequate and full consideration has come to be understood in the context of a family limited partnership as requiring an increase in the capital account proportionate to the assets contributed. The Eleventh Circuit in affirming the Tax Court in *Shepherd v. Commissioner*[80] applied this analysis in determining whether a gift was made to other partners on contribution of assets to the partnership. The *Powell* court acknowledges that in *Bongard v. Commissioner*[81] the court determined the "adequate and full consideration" prong of the exception to Section 2036 met by satisfaction of the "proportionality" test.[82] Interestingly, the latest versions of the Uniform Partnership Act, the Uniform Limited Partnership Act, and the Uniform Limited Liability Company Act do not so much as mention capital accounts. The default rule under these acts is to specify distributions; for example, in the Uniform Limited Partnership Act distributions are proportionate to the value of contributions.[83] In explanation, the comments to the Uniform Limited Partnership Act suggest information necessary for tax capital accounts can be obtained from the Act's distribution requirements.[84] So long as a significant and legitimate nontax reason for forming the partnership exists, the *Powell* court acknowledges the proportionality test will meet the bona fide sale for adequate and full consideration exception. In light of this affirmance of the proportionality test, assuming a bona fide sale, it may be important to take the cautionary step of providing for capital accounts in those states adopting the most current version of the Uniform Limited Partnership Act.

[2] Avoid Decedent or Decedent's Fiduciary Acting as General Partner

Only if no legitimate and significant nontax reason for formation exists need the planner worry about the reach of Section 2036. The question now becomes whether the reach of Section 2036 can be avoided if for some reason the court determines the family limited partnership does not meet the bona fide sale for adequate consideration exception. For a number of years, since the Tax Court's 2003 decision in *Estate of Strangi v. Commissioner,*[85] planners have been careful not to place the decedent-donor in the position of being able to participate in management decisions through an ownership interest in the general partner. Read literally, *Estate of Powell* simply expands that requirement to necessitate that neither the decedent nor decedent's attorney-in-fact hold any interest in the general partner. Read more broadly, it suggests that any person owing fiduciary duties to

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[76]TC Memo 2018–48 at 17–18 (citing Estate of Hurford v Commissioner, TC Memo 2008-278).
[77] Estate of Shutt v Commissioner, TC Memo 2005–126.
[78]Estate of Stone v Commissioner, TC Memo 2012–48.
[79]Estate of Black, 133 TC 340 (2009).
[80]283 F3d 1258 (2002), *aff'g* 115 TC 376 (2000).
[81]124 TC 95 (2002).
[82] Estate of Powell at 24, n6.
[83]*See* Uniform Limited Partnership Act § 503(a).
[84] *See* Uniform Limited Partnership Act § 503, comment.
[85] Supra at n. 13.

decedent-donor should not hold an interest in the general partner. Fiduciary duties owed by a general partner to limited partners will not protect the donor who acts as general partner from Section 2036 inclusion.

The question becomes whether, if decedent's estate can show the family limited partnership meets the bona fide sale rule, does it even matter whether the decedent or the decedent's attorney-in-fact held say as a general partner. The technical answer would be "no." But in determining whether the "bona fide sale" prong of the exception is satisfied facts indicating continued control of the assets by the decedent or decedent's attorney-in-fact may sway the court to find lack of a bona fide sale. Practically speaking, the better planning decision would be to avoid giving the decedent or, per *Powell*, decedent's attorney-in-fact a general partner interest. The ability for a family to maintain some control over the general partner and at the same time minimize gift and estate tax liability, thus, becomes harder to accomplish following *Estate of Powell.*

[3] Avoid Granting Decedent a Voice as to When the Partnership Dissolves

Absent a determination the partnership complies with the bona fide sale for adequate consideration exception, Section 2036(a)(2) kicks in to include in the gross estate the value of the partnership assets if the decedent "in conjunction with any person" can (per the holding in *Powell*) terminate the partnership. The partnership agreement in *Powell* specifically included a provision allowing the partners to unanimously dissolve the partnership. The court relied on this provision, and not a provision implied by the default rules of state law. In the wake of *Powell*, partnership agreements should avoid including provisions that would give the decedent a right to dissolve the partnership. It may be that future courts would limit *Powell's* holding to a review of the terms of the partnership given the analysis of the United States Supreme Court in *Helvering v. Helmholz,*[86] refusing to apply Section 2038 to reach powers granted under state law. If the *Powell* holding is not so limited it would be extremely difficult to structure the family limited partnership in a manner to avoid the reach of Section 2036(a)(2). Unfortunately, while the regulations under Section 2038 limit application of that section if the retained power adds nothing to rights granted under local law, the Section 2036 regulations do not. Until the courts specifically address application of Section 2036(a)(2) to the limited partnership default rules imposed by state law, it becomes even more important to plan in a manner the courts will recognize as being a bona fide sale for adequate and full consideration.

In an effort to avoid the reach of Section 2036(a)(2), commentators have explored a number of planning strategies, at the same time acknowledging those strategies may come up short.[87] One alternative is to include a provision prohibiting decedent from participating in any decision to dissolve the partnership. Query whether this type of restriction would be caught by Section 2703, as suggested by the *Cahill* court? Another alternative suggested is the partnership be formed by the trustees of irrevocable trusts. Query, whether funding the trust would cause a gift tax based on the actual value of transferred assets? Query, also, whether, if the transfer to the trust were structured as an incomplete gift, the power retained to cause the transfer to be treated as an incomplete gift would require inclusion of the value of the transferred assets under Section 2036(a)(2)? It may be that the best avenue is for decedent to transfer all partnership interests retained to others at least three years prior to death and insure the general partner is not decedent's attorney-in-fact. This should allow for transfer of limited partnership assets at a discounted value and preclude estate tax inclusion under Sections 2035, 2036 and 2038. Query, however, whether the analysis of the *Cahill* court would cause Section 2703 to value the transferred interests at fair market value of the underlying partnership assets? Alternatively, for those partnerships formed and where limited partnership interests have been transferred to intended beneficiaries, consider dissolving the partnership and distributing assets to the limited partners preferably three years prior to decedent's death. Query, however, would the *Cahill* court's analysis of Section 2703 again cause Section 2703 to apply?

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[86] 296 US 93, 97 (1935), discussed supra at n. 18.

[87] For a more detailed discussion of these alternatives, *see* Mitchell Gans and Jonathan Blattmachr, Family Limited Partnerships and Section 2036: Not Such a Good Fit, Vol. 42, No 3 ACTEC Law Journal, 253, 275–278 (Winter 2017); Steve Akers, Estate of Powell v Commissioner, 148 TC No 18 (May 18, 2017).

§1.04 Basis Implications of the Opinions of Judges Halpern and Lauber in *Powell*

While the courts have developed and revised intricate rules for gross estate inclusion of family limited partnership assets and interests, they have not similarly addressed the impact of those estate tax rules on income tax basis under Section 1014. Because application of the Section 1014 basis rules depends in part on whether there is gross estate inclusion under Section 2036, decisions addressing Section 2036 inclusion of limited partnership assets provide an important beginning point for understanding income tax basis for property acquired from a decedent. The dearth of case law directly addressing determination of basis for family limited partnerships leaves some uncertainty. As planning begins to focus more on obtaining a stepped-up income tax basis at death and as implementation of the basis consistency rules require a more careful analysis by the executor, answers will likely be forthcoming.

[1] Section 1014 General Overview

The Code provides specific rules to determine basis of "property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent …"[88] Generally property transferred at death takes a date of death fair market value basis.[89] This value, however, is adjusted if the estate tax return elects alternate valuation, special use valuation, or the conservation easement exclusion.[90] Excluded from taking a date of death fair market value basis is any property characterized as income in respect of a decedent.[91] Special rules apply for DISC stock,[92] and appreciated property that decedent acquired by gift within one year of death.[93]

The Code specifically lists the property considered as "acquired from" or having "passed from the decedent." The list includes "property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent."[94] It also includes "property acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), if by reason thereof the property is required to be included in determining the value of the decedent's gross estate under [the estate tax code]. …"[95] This latter assumes transfer of property by decedent prior to death that is then pulled back into the gross estate. As a result, depreciation deductions and the like taken prior to decedent's death in the hands of the transferee continue to be deemed taken in determining date of death basis.[96] The Second Circuit in explaining the policy underlying this section stated: "The legislative history surrounding § 1014 indicates that, in part, Congress enacted that section in an attempt to minimize the tax consequences of decisions made by executors and trustees concerning when to distribute trust property."[97] These two alternatives for deeming property to have been "acquired from" or having "passed from the decedent" are key to understanding the impact of Section 1014 on family limited partnership interests. Both are implicated when the gross estate includes assets transferred to a family limited partnership pursuant to Section 2036, and when limited partnership interests owned by decedent transfer at death.

[2] Section 1014 Basis with 2036 Inclusion

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[88]IRC § 1014(a).
[89]IRC § 1014(a)(1).
[90]IRC § 1014(a)(2)–(4).
[91]IRC § 1014(c), citing IRC § 691.
[92]IRC § 1014(d).
[93]IRC § 1014(e).
[94] IRC § 1014(b)(1).
[95]IRC § 1014(b)(9).
[96]*Id.*
[97]Connecticut National Bank v United States, 937 F2d 90, 94 (2nd Cir 1991) (citing, e.g., S Rep No 1622, 83rd Cong, 2nd Sess, 423-24, reprinted in 1954 Code Cong & Admin News 4629, 4740-41).

As acknowledged in Judge Lauber's concurring opinion in *Estate of Powell*, in the absence of a bona fide sale for adequate and full consideration, the Tax Court has long included under Section 2036 the underlying value of the family limited partnership assets in decedent's gross estate under Section 2036. Inclusion of the value of the underlying assets makes sense. On the same basis that partnership assets have been included, partnership interests held by decedent have been disregarded in an effort to avoid double estate taxation. When analyzing the basis implications of including the full value of the underlying family limited partnership assets as long recognized under Section 2036 in comparison to application of Section 2043, the long-standing rule yields a result in line with the date of death fair market value basis contemplated by Section 1014.

[a] Stepped-up Basis for Assets Included Per Section 2036

The Tax Court recently addressed application of Section 1014 when the family limited partnership is disregarded and assets are included in the gross estate under Section 2036. It did so by way of an order in *Hurford Investments No. 2, Ltd. v. Commissioner*[98] issued by Judge Holmes subsequent to his initial decision in *Estate of Hurford v. Commissioner.*[99] In *Hurford Investments*, the Tax Court addressed the basis of phantom stock earlier included in decedent's gross estate when the court disregarded the family limited partnership which owned the phantom stock. The order states:

> But HI-2 has a final tax-minimizing argument. It says it's entitled to a step up in basis to [$]59,639,588, which was the phantom stock's value at the time of Thelma's death. This might seem an argument too far. The Code section that creates the step up in basis generally limits that benefit to property acquired "from a decedent." I.R.C. §1014(a). Thelma was not yet a "decedent" at the time she contributed the phantom stock to HI-2. Yet section 1014(b)(9) tells us to consider property "to have been acquired from or to have passed from the decedent … if by reason thereof the property is required to be included in determining the value of the decedent's gross estate." That's what happened here — in the estate-tax case we included the value of the phantom stock in Thelma's gross estate. See Estate of Hurford, 96 T.C.M. (CCH) at 442; see also Connecticut National Bank v. United States, 937 F.2d 90, 92 (2d Cir. 1991); Schrader v. Commissioner, 420 F.2d 443, 445 (6th Cir. 1970) (retention of life estate drew value of property into estate but gives stepped-up basis); H.R. Rept. No. 94-1380, at 36 (1976), 1936-3 C.B. (Vol. 3) 770 ("For the purposes of determining what property is given a stepped-up basis, the test is generally whether the property was included in the gross estate of the decedent").[100]

The order specifically indicates the underlying partnership assets included per Section 2036 obtain a basis step up pursuant to Section 1014(b)(9). Treasury regulations make clear neither a filed estate tax return nor estate tax payment is required to obtain the basis step up under Section 1014(b)(9).[101]

[b] Likely Stepped-up Basis for Disregarded Partnership Interest

The order in *Hurford Investments*, however, does not address the basis of partnership interests retained by decedent as of date of death. For estate tax purposes those interests are ignored. Judge Lauber's concurring opinion in *Estate of Powell* references the limited partnership interests as having "no distinct value" and as "an alter ego" for the contributed assets.[102] The fact the partnership is ignored for estate tax purposes does not mean it is ignored for income tax purposes. The characterization of partnership interests as having "no distinct value" for estate tax purposes does not reflect the reality that the partnership is recognized as a tax reporting entity for income tax

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[98] Tax Court Docket No 23017-11 (April 17, 2017), accessed at
<https://www.ustaxcourt.gov/UstcDockInq/DocumentViewer.aspx?IndexID=7090068> .
[99]TC Memo 2008–278.
[100]Hurford Investments at 12.
[101]Treas Reg § 1.1014–2(a)(2).
[102] Estate of Powell at 47.

purposes and that state law recognizes the partnership, and transfer of partnership interests, for property law purposes.

The limited partnership interests ignored for estate tax inclusion purposes, nevertheless, prove to be interests acquired from the decedent for state law purposes. If owned by decedent at death, the partnership interests arguably would obtain a Section 1014 basis as "[p]roperty acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent."[103] If the partnership interests were owned by a revocable trust, they arguably would obtain a Section 1014 basis as "[p]roperty transferred by the decedent during … lifetime in trust …with the right reserved to the decedent … to revoke the trust…"[104] Neither sub-section quoted specifically requires that property be included in the decedent's gross estate in order to obtain a date of death fair market value basis. In fact, the Service took this position in Revenue Ruling 84-139,[105] and General Counsel Memorandum 39320,[106] with reference to foreign property not included in the gross estate. In both pronouncements the Service ruled the plain language of Section 1014(b)(1) does not require inclusion in decedent's gross estate for its terms to apply. Specifically, the Service states: "In reaching this conclusion, we have considered the possibility of interpreting section 1014 to say that only property includable in the decedent's gross estate can qualify for a basis step-up. However, both the language of section 1014 and its legislative history negate such an interpretation."[107] If a court were to apply the plain wording of Section 1014, the limited partnership interests in the hands of the executor or beneficiary of decedent's estate would take a date of death fair market value basis regardless of whether includible in the decedent's gross estate. Assuming Section 1014 applies to determine basis of limited partnership interests, fair market value would likely take into account lack of marketability and minority interest discounts attributable to those interests.

Only if decedent held the limited partnership interests at death would Section 1014 provide a fair market value date of death basis for the partnership interests. If decedent had gifted limited partnership interests after formation, the beneficiaries in receipt would hold the partnership interests with a Section 1015 transferred basis. The basis of the partnership interests transferred prior to death to beneficiaries would not change on decedent's death.

A contrary argument could be made. Treasury regulations indicate: "The purpose of section 1014, is in general, to provide a basis for property acquired from a decedent that is equal to the value placed upon such property for purposes of the federal estate tax."[108] In accord with this stated purpose, a court, if it were so inclined, could interpret the definition of "acquired" or "passing" from decedent to require the property be includible in the gross estate despite the contrary legislative history mentioned in the General Counsel Memorandum. If that were the case, the limited partnership interests would not be subject to Section 1014. Such an interpretation would not yield a zero basis for non-inclusion. Instead, the limited partnership interests would retain the basis as in place prior to decedent's death, unaffected by Section 1014. It is curious that Treasury has announced it will not issue private letter rulings addressing whether assets of a grantor trust not includible in the gross estate can obtain a Section 1014 basis.[109] Perhaps this signals an intent by the Service to reverse its earlier position as indicated in Revenue Ruling 84-139 and General Counsel Memorandum 39320.

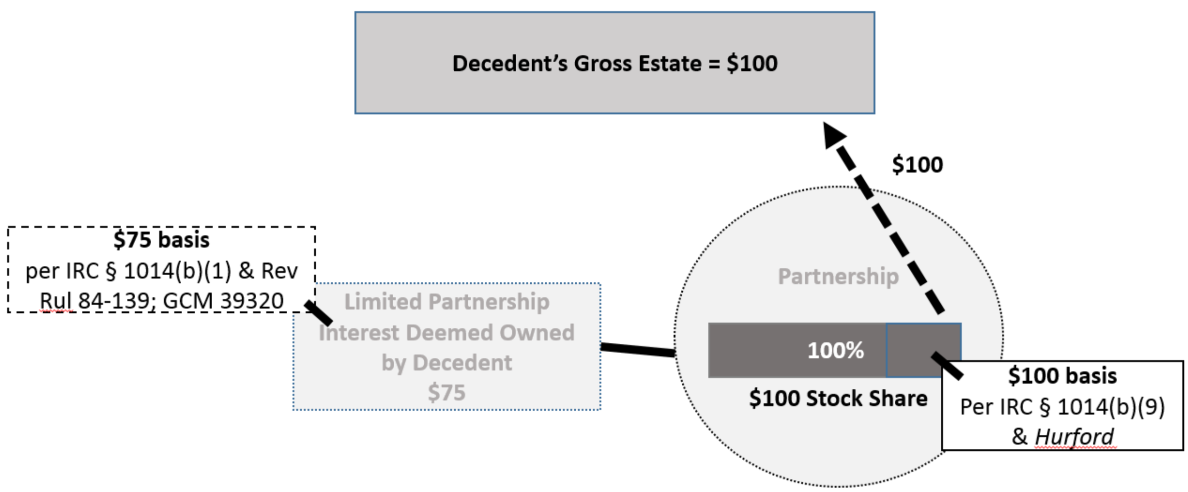
[3] Income Tax Basis Implications of Judge Lauber's Concurring Opinion

The same simplified hypothetical used above for the purpose of explaining the differing analyses of Judges Halpern and Lauber, demonstrates the basis implications of the two opinions. Recall the hypothetical assumes the family limited partnership has only one asset, a share of stock valued at $100 at the time of formation and at the

[103]IRC § 1014(b)(1).
[104]IRC § 1014(b)(2).
[105]1984-2 CB 168.
[106]1985 GCM LEXIS 3.
[107]General Counsel Memorandum 39320.
[108]Treas Reg § 1.1014–1(a).
[109]Rev Proc 2018-3, 2018–1 IRB 130.

same amount as of date of death, with no appreciation or depreciation. It further assumes that, at the time of formation the share had a basis of $40, and the fair market value of the partnership interests received by decedent in return for contribution of the share on formation of the family limited partnership takes into account an aggregate 25 percent discount, yielding a partnership interest fair market value of $75. Applying the analysis of Judge Lauber, the partnership assets would take a Section 1014 basis of $100, the value included in the gross estate pursuant to Section 2036, and, as a result, the basis per Section 1014(b)(9) and *Hurford Investments*. For income tax purposes, the partnership interests would take a fair market value date of death basis of $75, which reflects a 25% discount and assumes no appreciation from time of receipt to date of death, the basis per Section 1014(b)(1) and Revenue Ruling 84-139. In this instance, if there is a choice, a Section 754 election should not be made.

Basis Implications Per Judge Lauber's Analysis



[4] Income Tax Basis Implications of Judge Halpern's Opinion

The opinion of the Tax Court in *Powell* delivered by Judge Halpern, for the first time, applies Section 2043 to determine the net value included in decedent's gross estate when Section 2036 applies to include the underlying partnership assets in the absence of a bona fide sale for adequate and full consideration. The court explains inclusion of partnership interests and assets:

> If, after formation of a family limited partnership, a decedent transfers her interest in the partnership inter vivos by gift, the value of that interest (taking into account any applicable valuation discounts) will be subject to gift tax. If the decedent instead retains her partnership interest until death, section 2033 will include the value of that interest (again, subject to applicable discounts) in the value of her gross estate. In either case, section 2036(a), as limited by section 2043(a), would bring back into the estate the amount of any discounts (that is, the doughnut hole) allowed in valuing the partnership interest.[110]

The court further clarifies in a footnote:

> More precisely, the net inclusion required by applying sec 2036(a) to a transfer to a family limited partnership would equal any discounts applied in valuing the partnership interest the decedent received plus any appreciation (or less any depreciation) in the value of the transferred assets between the date of the transfer and the decedent's date of death. Changes in the value of the transferred assets would affect the required inclusion *because sec. 2036(a) includes in the value of decedent's gross estate the date-of-death*

[110] Estate of Powell at 409.

value of those assets while sec 2043(a) reduces the required inclusion by the value of the partnership interest on the date of the transfer.[111]

Judge Halpern's analysis has implications for both the partner's outside basis in the partnership interest and the inside basis of the partnership assets on a partner's death.

In determining inside basis, Judge Halpern's analysis contemplates gross estate inclusion of a portion of the partnership assets under Section 2036(a)(2), the portion attributable to the "doughnut hole or discount." The remaining portion of the partnership assets would not be included in the gross estate. Thus, to determine income tax basis of partnership assets only the portion includible in the gross estate would take a Section 1014 date of death basis pursuant to Section 1014(b)(9) and *Hurford Investments*. The basis of the remaining portion of the assets not included in the gross estate would remain unchanged at death.[112] The inside basis would be the aggregate of the bases attributable to the two portions.

In determining outside basis, Judge Halpern's analysis includes decedent's partnership interests under Section 2033 at their date of death fair market value, taking into account applicable discounts. The partnership interests take a fair market value basis under Section 1014(b)(1) as those interests pass from decedent at death. The partner's outside basis, thus, would be adjusted to date of death value of the partnership interests.

Applying the assumptions of the hypothetical to reflect Judge Halpern's analysis demonstrates the two opinions lead to different results when determining inside and outside basis. Assume again the partnership has only one asset, a share of stock valued at $100 at both the time of contribution and at date of death. Assume when contributed, the share had a basis of $40. Also assume the fair market value of the partnership interest received in return on formation takes into account a 25 percent discount, yielding a fair market value of $75 for the partnership interests. Per Judge Halpern's opinion, the partnership interests take a date of death basis per Section 1014(b)(1) of $75. The inside basis includes (i) the value of 25 percent of the asset included in decedent's gross estate or $25, per Section 1014(b)(9) and *Hurford Investments*, and (ii) the basis of the remaining 75percent portion of the asset not included in the decedent's gross estate reflecting a proportionate basis of $30 (75% of the original $40 basis). This analysis yields an inside basis for 100 percent of the asset of $55. In this instance, the estate would prefer a Section 754 election.

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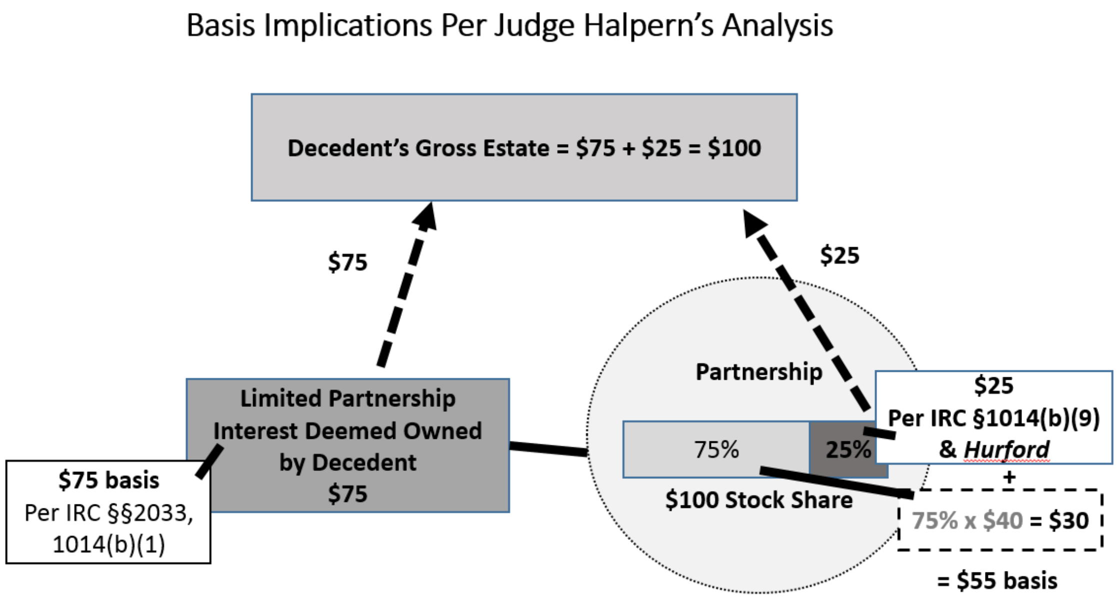
[111] *Id.* at 408, n. 7 (emphasis added).

[112] It would not make sense to ignore the proportionate basis attributable to the portion of assets not deemed included under Judge Halpern's analysis. This results because of the nature of how outside and inside basis in a partnership is determined. Typically, in the absence of a Section 754 election the inside basis of partnership assets remain as before death with respect to that partner. Thus, for the portion not included in the gross estate, the inside basis should remain the same at decedent's death.



[5] Basis Consistency Rules Raise Issue

Regardless of how the Tax Court resolves the apparent disagreement as to the application of Section 2043, the opinions of both Judges Lauber and Halpern raise questions under the basis consistency rules for those estates required to file a federal estate tax return. Basis consistency rules and the accompanying proposed regulations require assets to be reported on the federal estate tax return to avoid application of the punitive "zero basis rule."[113] Application of Judge Lauber's opinion indicates partnership interests retained by decedent are not included in the gross estate. How does the proposed zero basis rule impact basis of disregarded partnership interests? Is the zero-basis rule flawed because it does not recognize that assets may receive a date of death fair market value basis even if not includible in the gross estate? Application of Judge Halpern's opinion would require resolution of how to treat the basis of the portion of partnership assets not included in the gross estate.

§ 1.05 Conclusion

For clients wishing to minimize estate tax, facts surrounding the family limited partnership should support a substantial non–tax motive that would cause the formation to meet the bona fide sale for adequate and full consideration exception from application of I.R.C. Section 2036. The Tax Court decisions in *Estate of Powell* and *Estate of Cahill* otherwise make it more difficult to escape gross estate inclusion under Section 2036(a)(2). For those clients whose focus lies instead on obtaining a Section 1014 basis for the partnership interest (and consequently partnership assets) at the highest value possible, the Section 754 election combined with careful structuring of limited partnership interests to provide partners rights resulting in an increase in the value of the partnership interests will prove important.

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[113] Prop Treas Reg § 1.1014–10(e).