Cutting the Strings: How to Create a Family Limited Partnership in Pennsylvania without Being Subject to Section 2036(a) of the Internal Revenue Code

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Sara A. Miller, Cutting the Strings: How to Create a Family Limited Partnership in Pennsylvania without Being Subject to Section 2036(a) of the Internal Revenue Code, 46 Duq. L. Rev. 225 (2008). Available at: https://dsc.duq.edu/dlr/vol46/iss2/5

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Cutting the Strings: How to Create a Family Limited Partnership in Pennsylvania Without Being Subject to Section 2036(a) of the Internal Revenue Code

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I. INTRODUCTION

The family limited partnership (FLP)\(^1\) is a popular estate planning tool used by practitioners to reduce estate taxes.\(^2\) If an FLP

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1. Although a family limited partnership is not a recognized legal entity, every state recognizes limited partnerships as valid legal entities. REV. UNIF. LTD. P’SHIP ACT § 101 (amended 1986). In Pennsylvania, a family limited partnership is formed by executing and filing a certificate of limited partnership with the Pennsylvania Secretary of State. See 15 PA. CONS. STAT. ANN. § 8511 (West Supp. 2008).

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is formed under the right circumstances\(^3\) and composed of the right assets,\(^4\) a taxpayer who holds a significant portion of his assets therein may have his gross estate taxed at a reduced rate due to valuation discounts for lack of control and marketability of his FLP interests.\(^5\) As a result, many wealthy taxpayers have taken up this tax-saving offer and have allowed their family practitioners to incorporate an FLP into their estate plans. The following illustration will show the tax-saving effect of the valuation discounts that the FLP has to offer: Taxpayer A does not hold any of his assets in an FLP. If he dies in 2007 with $4 million in assets, his estate will be required to pay $780,800 in taxes.\(^6\) On the other hand, Taxpayer B transfers an identical $4 million in assets into an FLP in exchange for a limited partnership interest. When Taxpayer B also dies in 2007, his estate will be required to pay substantially less in, or perhaps even be exempted from, estate taxes after receiving discounts for lack of control and marketability of his FLP interests.\(^7\) How is this accomplished? If Taxpayer B claims and the Internal Revenue Service (IRS) grants a fifty percent discount for lack of control and marketability, the value of his estate will be reduced to $2 million. Since an estate valued at


\(^3\) An FLP cannot be formed shortly before the imminent death of the party transferring ownership of assets to the entity. When assets are transferred to an FLP shortly before death or after the owner of the assets is mentally incompetent, the Internal Revenue Service (IRS) will challenge the legitimacy of the FLP. Erickson v. Comm’r, 93 T.C.M. (CCH) 1175 (2007).

\(^4\) An FLP comprised mainly of cash and marketable securities will not withstand the scrutiny of the IRS or the courts. Turner v. Comm’r, 382 F.3d 367 (2004). A decedent will normally need to transfer legitimate business interests to an FLP in order to stand clear of the wrath of the IRS. Turner, 382 F.3d at 383.


\(^6\) Section 2010(c) of the Internal Revenue Code (I.R.C. or Code) applies an “applicable credit amount” of $2 million to persons dying in 2007. I.R.C. § 2010(c) (Supp. V 2005). This means that a person who dies with an estate valued at $2 million dollars or less will not be responsible for paying estate taxes. If an estate is valued at over $2 million, § 2001(c) supplies the rates at which these estates will be taxed. I.R.C. § 2001(c) (Supp. V 2005). An estate valued at $2 million after the application of the “applicable credit amount” is taxed at a marginal rate of forty-five percent.

\(^7\) Normally when a person transfers his or her assets to an FLP, he or she receives both general and limited partnership interests in exchange for the transfer of assets. These interests are normally discounted due to lack of control and marketability because “a willing buyer would pay less for the limited partnership interest than the underlying assets are actually worth.” Short, supra note 5, at 702. See also Bradford Updike, Making Sense of Family Limited Partnership Law After Strangi and Stone: A Better Approach to Planning and Litigation Through the Bona Fide Transaction Exception, 50 S.D. L. REV. 1, 7-8 (2005).
$2 million dollars or less will not be subject to the Federal Estate Tax,\textsuperscript{8} Taxpayer B will not have to pay any estate taxes. The valuation discount available for Taxpayer B is not available for Taxpayer A, whose assets have virtually the same economic value, but does not hold them in an FLP.

The obvious discrepancy that exists between Taxpayer A and Taxpayer B has not gone unnoticed by the IRS. Over the past decade,\textsuperscript{9} the IRS has used a particular section of the Internal Revenue Code (Code) to successfully disallow valuation discounts that have been claimed, not because of the substance of the assets, but because of the form in which the taxpayer holds the assets. This Code section, 2036(a), also referred to as a "string provision,"\textsuperscript{10} is used by the IRS to effectively tax the assets that the estate attempted to avoid through valuation discounts by pulling the value of these assets back into the taxpayer's gross estate.

To begin, the Code imposes a graduated tax on "the taxable estate of every decedent who is a citizen or resident of the United States."\textsuperscript{11} A decedent's taxable estate is defined by the Code as "the value of the gross estate" minus deductions.\textsuperscript{12} The gross estate includes "the value of all property to the extent of the interest therein of the decedent at the time of his death."\textsuperscript{13} Property that a decedent is considered to have an "interest therein"\textsuperscript{14} includes any real estate, personal property, life insurance policies, or monetary assets that the decedent owns or has the right to transfer at his death.\textsuperscript{15} The Code also contains "string provisions,"\textsuperscript{16} which are used to pull certain assets a decedent has transferred before death back into his gross estate. "The common theme is a lifetime transfer by the decedent that had a string attached such that the prop-

\textsuperscript{8} I.R.C. § 2001(c) (Supp. V 2005).
\textsuperscript{9} For the first time, in 1997, the IRS was successful in convincing the Tax Court that § 2036(a) of the Code should be used to disallow valuation discounts of the assets sheltered by an FLP. Estate of Schauerhamer v. Comm'r, 73 T.C.M. (CCH) 2855, 2858 (1997). This Code section will be discussed in detail throughout this comment.
\textsuperscript{10} Kleinrock's TaxExpert Analysis and Explanation § 752.8 (2005), available at http://www.lexisnexis.com. Three sections of the I.R.C.—§§ 2036, 2037 and 2038—are considered string provisions. \textit{Id}. If any of these three provisions applies to the decedent's property, then the value of that property will be included in the gross estate and subject to federal estate taxation. \textit{Id}.
\textsuperscript{11} I.R.C. § 2001(a) (2000).
\textsuperscript{12} Id. § 2051.
\textsuperscript{13} Id. § 2033.
\textsuperscript{14} Id.
\textsuperscript{16} See supra note 10.
One of these so-called "string provisions" that has proven to be very beneficial in the IRS's fight against taxpayers claiming valuation discounts for FLP interests is § 2036(a) of the Code. This section states:

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

Section 2036(a) "addresses the concern that inter vivos transfers often function as will substitutes, with the transferor continuing to enjoy the benefits of his property during life, and the beneficiary receiving the property only upon the transferor's death." Consequently, § 2036(a)(1) pulls the value of all of the property transferred during the decedent's life into his gross estate if he "retains possession, enjoyment, or the right to income from the property during his lifetime." In other words, while the form in which the decedent's assets are held is different than if he owned the assets outright, his ability to use the assets is virtually identical.

Section 2036(a) provides an exception for situations where the decedent's transfer of the assets was a "bona fide sale for adequate and full consideration." Under particular circumstances, even if the decedent retains possession, control, or enjoyment of the assets that he transferred during life, the decedent will not have the

19. Turner v. Comm'r, 382 F.3d 367, 375 (3d. Cir. 2004) (citing United States v. Grace, 395 U.S. 316, 320 (1969) ("[T]he general purpose of the statute was to include in a decedent's gross estate transfers that are essentially testamentary.").
20. Turner, 382 F.3d at 375.
value of these assets taxed as part of his gross estate if the IRS, or the appropriate court, finds that the transfer was a "bona fide sale made for adequate and full consideration."\textsuperscript{22} However, this exception has been the center of much confusion due to the fact that many courts have created different requirements for what is considered to be a "bona fide sale for adequate and full consideration."\textsuperscript{23} The remainder of this comment focuses upon the Third Circuit’s definition of a "bona fide sale for adequate and full consideration" and why this definition may be problematic for a practitioner forming an FLP for a taxpayer who is subject to Pennsylvania law.\textsuperscript{24}

**II. ANALYSIS**

**A. Family Limited Partnerships in Pennsylvania**

In Pennsylvania, an FLP is formed when two or more family members file a certificate of limited partnership with the Pennsylvania Department of State Corporation Bureau.\textsuperscript{25} The FLP is comprised of both general partners and limited partners.\textsuperscript{26} The general partners\textsuperscript{27} have all of the control of the FLP, but receive very little economic benefit from their partnership interests.\textsuperscript{28} On the other hand, the limited partners have limited control over the partnership affairs, but usually transfer most of the assets to the partnership and receive most of the economic benefits from the

\begin{itemize}
  \item \textsuperscript{22} Id.
  \item \textsuperscript{23} Id.
  \item \textsuperscript{24} Turner, 382 F.3d at 375.
  \item \textsuperscript{25} 15 PA. CONS. STAT. ANN. § 8511 (West Supp. 2008). While it is not necessary to name the limited partners in the Certificate of Limited Partnership, all of the general partners must be named therein. Id. Pennsylvania also requires other provisions of the limited partnership agreement to be in writing; otherwise the statutory default provisions will apply. Id. These provisions include: (1) rules governing the admission of general partners, id. § 8531; (2) allocation of profits and losses among partners and classes of partners, id. § 8543; (3) distribution of cash or other assets among partners and classes of partners, 15 PA. CONS. STAT. ANN. § 8544 (West 1995); (4) rules governing the voluntary withdrawal of limited partners, id. § 8553; and (5) rules governing distribution in kind from the partnership, id. § 8555.
  \item \textsuperscript{26} Short, supra note 5, at 700.
  \item \textsuperscript{27} Id. at 701. The family that forms the FLP will normally form a corporation that acts as the general partner of the FLP. Id. Members of the family will then hold controlling interests in the corporate general partner so that they are still in control of the actions of the FLP. Id.
  \item \textsuperscript{28} Id. General partners have more rights and responsibilities regarding the control of the corporation and are fully liable for the acts of the partnership. Id.
\end{itemize}
All of the partners in an FLP are either members of the same family or controlled by members of the same family.30

B. Disallowance of Valuation Discounts Based upon § 2036(a) of the Code

The creation of an FLP normally involves a senior generation taxpayer transferring a substantial amount of his assets to the FLP in exchange for limited partnership and general partnership interests.31 The following example will illustrate the formation of a typical FLP and the way in which the IRS disallows valuation discounts with the use of § 2036(a) of the Code.32 Taxpayer transfers $3 million, approximately ninety-five percent of his total assets, to an FLP in exchange for a ninety-five percent limited partnership interest. During his lifetime, distributions of cash are made to Taxpayer from the FLP. Taxpayer also gives gifts of partnership interests to his children, which are recorded as reductions in Taxpayer's FLP partnership capital account.

When Taxpayer dies, the FLP contains a total of $2.5 million as a result of the distributions and gifts made during his lifetime. However, in filing Taxpayer's Federal Estate Tax Return, his executor values his ninety-five percent partnership interest at a mere $1.25 million. The executor claims the value of Taxpayer's interest in the FLP should be given this fifty percent discount because Taxpayer only holds a ninety-five percent limited partnership interest, which causes his interest to lack control33 and marketability.34

The IRS counters with the argument that this discount should be disallowed. Since Taxpayer received income from and main-

29. Id.
31. Updike, supra note 7, at 7.
32. This illustration is a simplified version of the facts in Turner v. Comm'r, 382 F.3d 367, 375 (2004).
33. Because the limited partner has essentially no control over the management of the FLP, the IRS allows a twenty to forty percent discount for such nominal interests. Bishow, supra note 30, at 1191 n.56 ("[A] lack of control over management results in a lack of control over the asset contributed to the FLP which includes an inability to influence decisions related to the asset's disposition." (citing DAVID T. LEWIS & ANDREA C. CHOMAKOS, THE FAMILY LIMITED PARTNERSHIP DESKBOOK: FORMING AND FUNDING FLPS AND OTHER CLOSELY HELD BUSINESS ENTITIES 11 (2004))).
34. An FLP interest is discounted for its lack of marketability because it is normally difficult to find a third party willing to purchase an interest in a closely-held family partnership. Bishow, supra note 30, at 1190.
tained control over the FLP by giving gifts to his children, § 2036(a) of the Code includes the entire $3 million that Taxpayer originally transferred to the FLP in the gross estate. Consequently, instead of being exempt from estate taxation because the value of his interest in the FLP is less than $2 million dollars, Taxpayer’s estate will be taxed at a rate over forty percent. Under these circumstances the IRS will prevail, and Taxpayer’s estate plan employing the FLP to shelter his assets will be defeated.

The above result, however, could have been avoided if Taxpayer’s FLP had been set up to avoid the traps the IRS has set for creative, yet imperfect, estate plans. Turner v. Commissioner is the key case that a practitioner must use to determine how to safely structure a Pennsylvania taxpayer’s FLP in order to avoid its inclusion in the gross estate. The most important aspect of the Turner decision is the Third Circuit’s interpretation of what type of transaction will be considered a “bona fide sale for adequate and full consideration.” If a decedent transfers his assets to an FLP as part of a bona fide sale for adequate and full consideration then, even if he “retain[s] . . . possession or enjoyment of, or the right to the income from, the property, or the right . . . to designate the persons who shall possess or enjoy the property or the income therefrom,” the decedent will not have the value of his interest in the FLP included in his gross estate.

C. Third Circuit Interpretation: Turner v. Commissioner

In Turner, when Theodore R. Thompson died in 1995 he had approximately $89,000 in liquid assets, a majority interest in two limited partnerships (Thompson Partnership and Turner Partnership), and shares in the two corporations that served as the general partners of the two limited partnerships. The decedent’s taxable estate, as calculated by his executors, was valued at $1,761,219. This value was derived after the estate applied a forty percent discount to the value of the FLP interests due to lack of control and marketability.
The IRS rejected the estate’s valuation discount and adjusted the value of the decedent’s taxable estate to $3,203,506. The underlying the IRS’s adjustment of the value of the taxable estate was the argument that “the full fair market value of the assets transferred by the decedent to the Turner and Thompson Partnerships should be returned to the decedent’s gross estate under § 2036(a) of the [Code] because [Thompson] retained control and enjoyment over the transferred assets during his lifetime.” The Tax Court sustained this argument and held that § 2036(a) of the Code applied and returned the assets that Thompson transferred to the two FLPs back to his gross estate. The Third Circuit affirmed the Tax Court’s decision, concluding that Thompson retained lifetime control and enjoyment of the assets and that his transfer of the assets to the two FLPs did not fit within the “bona fide sale for adequate and full consideration” exception.

Paramount to the Third Circuit’s conclusion was the court’s unique interpretation of the “bona fide sale” exception and what must be exchanged in order for a transfer to be “for adequate and full consideration.” A discussion of the details surrounding the creation and operation of Thompson’s two FLPs is necessary to understand the court’s decision to include the full value of the assets transferred to the FLPs in Thompson’s gross estate and why the Third Circuit’s interpretation of the “bona fide sale for adequate and full consideration” was crucial to this decision.

1. Creation and Operation of the Turner and Thompson FLPs

Thompson created the two limited partnerships on April 21, 1993; the Turner Partnership was formed with his daughter, and the Thompson Partnership was formed with his son. Thompson transferred $1,286,000 in marketable securities and real estate to the Turner Partnership in exchange for a 95.4% limited partner-
ship interest.\textsuperscript{49} Similarly, Thompson contributed $1,118,500 in securities and $293,000 in notes receivable in exchange for a 62.27\% limited partnership interest in the Thompson Partnership.\textsuperscript{50}

While the Turner Partnership participated in several small business transactions, none of these transactions resulted in any profit for the partnership. Low interest loans were also made to members of the Turner family. However, the interest payments were frequently late or never paid, and the Turner Partnership never enforced the terms of these loan agreements.\textsuperscript{51} The sole business transaction entered into by the Thompson Partnership did not result in any economic gain for the members of the partnership. This transaction was the operation of a Colorado ranch, for which the Thompson Partnership actually claimed losses on its tax returns for the years 1993 through 1996.\textsuperscript{52}

2. \textit{The Third Circuit's Application of § 2036(a) to the Thompson and Turner Partnerships}

The Third Circuit, after scrutinizing the formation and operation of the Turner and Thompson Partnerships, held that the entire value of the assets that Thompson transferred to the two FLPs in 1993 should be taxed as a part of his gross estate under § 2036(a) of the Code. Consequently, the value of Thompson's gross estate was increased from $1,761,219—the value with the estate's discounts for lack of control and marketability—to $2,939,863.\textsuperscript{53} The court held that § 2036(a) applied to return the value of the lifetime transfer made to the two FLPs to Thompson's gross estate because "there was an . . . implied agreement that . . . [he would] retain lifetime possession or enjoyment of, or right to income from, the transferred property."\textsuperscript{54} Furthermore, the Third Circuit held that the two FLPs did not qualify for the exception to § 2036(a) "because neither the Thompson Partnership nor Turner Partner-
ship conducted any legitimate business operations, nor provided decedent with any potential non-tax benefit from the transfers."

Fundamental to the Third Circuit’s examination of the Turner and Thompson Partnerships was the finding that there was an implied agreement between the partners that Thompson, the transferor of the assets funding the two FLPs, would maintain control over the two partnerships throughout his life. This finding was especially important because §2036(a) pulls assets back into a decedent’s gross estate only if the decedent made an *inter vivos* transfer of the assets but retained either “possession or enjoyment of, or the right to the income from, the property, or the right . . . to designate who shall possess or enjoy the property or the income therefrom.” The facts that Thompson transferred ninety-five percent of his assets to the two FLPs, did not retain sufficient assets to support his annual living expenses of $57,202, and was permitted to withdraw assets from the partnerships whenever he desired, led the court to conclude that there was sufficient evidence to support the application of §2036(a) to the assets transferred to the Turner and Thompson Partnerships.

3. *The Third Circuit’s Definition of the “Bona Fide Sale for Full and Adequate Consideration” Exception and Why that Exception Could Not Apply to Thompson’s FLPs*

The application of §2036(a) to the Thompson and Turner Partnerships was not the end of the Third Circuit’s analysis of the issue. Assets that are transferred by a decedent during life will *not* be “returned to the gross estate if the transfer constitutes a ‘bona fide sale for adequate and full consideration.’” Consequently, the Third Circuit was obligated to flesh out exactly what constitutes a “bona fide sale” and what will be considered “adequate and full consideration” in such a sale. The Third Circuit’s final interpretation of the exception ultimately led the court to hold that Thompson’s transfer of almost $3 million in marketable securities to the

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55. Id. at 383.
56. *See* Treas. Reg. § 20.2036-1(a) (1960) (“An interest or right is treated as having been retained or reserved if at the time of transfer there was an understanding, express or implied, that the interest or right would later be conferred.”).
59. Id. at 378 (citing I.R.C. § 2036(a) (2000)) (emphasis added).
two FLPs was not saved from gross estate inclusion by the exception.  

First, the court discussed what it means to transfer assets for consideration and why the formation and operation of the Turner and Thompson Partnerships did not fit that definition. One of the most significant factors in determining that there was no transfer for consideration in this case was the fact that the two FLPs did not engage in any "valid, functioning business enterprise." What Thompson truly sought to achieve by transferring ninety-five percent of his assets to the FLPs was to change the form in which he held title to the assets. The failure of Thompson to change the "underlying pool of assets or prospect for profit" resulted in a mere "recycling of value" of his assets, which the Tax Court has held not to be a transfer for purposes of § 2036(a).

Moreover, the fact that Thompson made numerous loans to his daughter and his grandchildren from the FLP assets (loans which were never repaid) also supported the finding that the purpose of the FLP was merely to hold title to his property in a more tax-efficient form. The court stated that these lending activities "lacked any semblance of business transactions" and were "testimonial in nature" because Thompson was using his FLP assets "as a source of financing for the needs of individual family members, not for business purposes."

Also significant to the finding that there was no transfer for purposes of § 2036(a) was the fact that the Turner Partnership agreement directed that all income, "including any appreciation realized in the sale of such assets," derived from the partnership's real estate assets shall be paid to the partner contributing those assets. This aspect of the agreement "denied [Thompson] any non-tax benefit potentially derived from the assets collected in the partnership."

Finally, the amount of real estate held by the two partnerships was miniscule. While the estate might have had a better chance supporting its argument that the FLPs were involved in legitimate business operations if there were more real estate transactions involved, the fact that the two FLPs were comprised mainly of

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60. Id. at 383.
61. Id. at 379.
63. Turner, 382 F.3d at 380 (quoting Estate of Thompson v. Comm'r, 84 T.C.M. (CCH) 374, 388 (2002)).
64. Id.
65. Id.
marketable securities obliterated this argument. The Third Circuit noted that “[o]ther than favorable estate tax treatment resulting from the change in form, it is difficult to see what benefit could be derived from holding an untraded portfolio of securities in this [FLP] with no ongoing business operations.”

As to the question of whether the transfer was for “adequate and full consideration,” the Third Circuit noted that “[i]n one sense, claiming an estate tax discount on assets received in exchange for an inter vivos transfer should defeat the section 2036(a) exception outright.” In order to claim a discount for lack of control and marketability, one necessarily must argue that the interest that he possesses is worth less than the actual economic value of the interest. However, in the case of an FLP, the party arguing that the fair market value of his interest is less than its actual economic value due to lack of control and marketability is the party who originally transferred the assets into the FLP. This essentially defeats any argument that the transfer could have been for full and adequate consideration because the assets are willingly transferred in exchange for other assets of lesser value and, in doing so, “the decedent has not replenished the estate with other assets of equal value.”

While the Third Circuit refused to hold that any transfer of marketable securities to an FLP would automatically disqualify that interest from application of the § 2036(a) exception, the majority did state that such a massive dissipation of a decedent’s gross estate requires “heightened scrutiny into the actual substance of the transaction.” FLPs, such as the Thompson and Turner Partnerships, that do not operate any legitimate business and appear merely to be freezing liquid assets by forcing them into a limited partnership will not withstand this heightened scrutiny.

Next on the Third Circuit’s agenda was to declare yet another reason why the Thompson and Turner Partnerships could not qualify for the exception to § 2036(a). Along with the requirement that the inter vivos transferor must receive “full and adequate consideration” in exchange for his assets is the condition that this

66. Id.
67. Id. at 381.
68. Turner, 382 F.3d at 381 (“[U]nless a transfer that depletes the transferor’s estate is joined with a transfer that augments the estate by a commensurate (monetary) amount, there is no ‘adequate and full consideration’ for the purposes of either the estate or gift tax.” (quoting Wheeler v. United States, 116 F.3d 749, 762 (5th Cir. 1997))).
69. Id.
transfer be a “bona fide sale.” While the Tax Court concluded that Thompson's inter vivos transfers were not “bona fide sales” because of the absence of an “arm's length transaction,” the Third Circuit found Thompson's transfers inadequate for another reason. According to the court, a “bona fide sale” only requires a sale in which the decedent/transferor actually parted with her interest in the assets transferred and the partnership/transferee actually parted with the partnership interest issued in exchange. While evidence of an “arm's length transaction” would be most persuasive to a finding of a “bona fide sale,” the fact that Thompson stood on one side of the transaction as the transferor of assets and on the other side of the transaction as a limited partner was not enough for the Third Circuit to find the absence of a “bona fide sale.”

What is more important in the determination of whether a transaction constitutes a “bona fide sale” is whether the transfer is made in “good faith.” This good faith requirement stands for the notion that a transfer to an FLP must “provide the transferor some potential for benefit other than the potential estate tax advantages that might result from holding assets in partnership form.” Because neither the Turner nor the Thompson Partnership provided Thompson with any discernable non-tax benefits, the Third Circuit found that Thompson's transfer of assets to the two FLPs was not made in “good faith” and thereby was not a candidate for the “bona fide sale” exception to § 2036(a) of the Code.

70. I.R.C. § 2036(a) (2000).
71. Turner, 382 F.3d at 381. The fact that Thompson stood on both sides of the transaction—as the transferor of assets and as a limited partner of the two FLPs—eliminated any chances of the transaction being at “arm's length.” See Estate of Thompson v. Comm'r, 84 T.C.M. (CCH) 374 (2002).
72. The Third Circuit noted that neither the IRC nor the governing Treasury Regulations define “bona fide sale” to include an “arm's length transaction.” Treasury Regulation 20.2036-1(a) defines “bona fide sale for an adequate and full consideration” as a transfer made “in good faith” and for a price that is “[an] adequate and full equivalent reducible to a money value.” Id. at 382 (citing Treas. Reg. § 20.2036-1(a) (1960) and quoting Treas. Reg. § 20.2043-1(a) (1958)).
73. Id. (quoting Kimbell v. United States, 371 F.3d 257, 265 (5th Cir. 2004)).
75. Turner, 382 F.3d at 383.
D. How to Avoid the Application of Turner to your FLP

While the Third Circuit's decision in Turner does not eliminate the possibility of using an FLP to achieve a tax-saving estate plan, there are certain precautions that must be used to properly create and maintain an FLP in order to avoid the heavy hand of the Third Circuit. The most important consideration for structuring an FLP is the fact that courts are no longer recognizing FLPs supported solely by an argument of form over substance. A mere "recycling" of assets through an exchange of personal assets for limited and general partnership interest in the same assets, without any true investment scheme or any change in the use and enjoyment of the assets, will not pass muster in the Third Circuit. What a taxpayer truly needs in order to take full advantage of the valuation discounts offered to FLPs are non-taxation motives. This eliminates the practitioner's ability to mindlessly transfer a client's assets into an FLP in order to achieve instant estate tax benefits.

Although the decision in Turner has proven that "the good-old days of using FLPs to save on taxes and also to retain total control

76. "Despite its more suitable purposes, many unwary legal and financial practitioners have applauded the FLP as a strategy that allows older generation taxpayers to keep total control over their assets and to achieve multi-million dollar estate tax savings." Updike, supra note 7, at 1.

77. The IRS shudders at the very thought of a triumph of form over substance. See Elaine Hightower Gagliardi, Economic Substance in the Context of Federal Estate and Gift Tax: The Internal Revenue Service Has It Wrong, 64 MONT. L. REV. 389, 389-90 (2003). In order for a transfer to be considered legitimate for the purpose of federal taxation, there must be some economic substance to the transaction other than the fact that the transfer will effectuate tax savings. Id. at 390.

78. The Turner court held that when an FLP is not "engaged in any valid, functioning business enterprise" and it is clear that the transfer of assets to an FLP was only a "recycling of value" of the assets, there will be "no transfer for consideration within the meaning of § 2036(a)." Turner, 382 F.3d at 378-79.

79. The Third Circuit is not the only court that has upheld the IRS's argument that § 2036(a) applies to return the assets transferred to an FLP back into the estate of the transferor. See Strangi v. Comm'r, 417 F.3d 468 (5th Cir. 2005); Estate of Abraham v. Comm'r, 408 F.3d 26 (1st Cir. 2005); Estate of Schauerhamer v. Comm'r, 73 T.C.M. (CCH) 2855 (1997) (all favorable to the IRS).

80. Turner repeatedly emphasized the fact that in order to have a transfer of assets during life that will fit perfectly into the mold of § 2036(a)'s exception, the decedent must have transferred his assets in "good faith." Turner, 382 F.3d at 383.

A "good faith" transfer to a family limited partnership must provide the transferor some potential estate tax advantages that might result from holding assets in partnership form. Even when all the "i's are dotted and t's are crossed," a transaction motivated solely by tax planning and with "no business or corporate purpose...is nothing more than a contrivance." Id. (quoting Gregory v. Helvering, 293 U.S. 465, 469 (1935)).
over family assets are gone forever,” there are still ways to make beneficial use of an FLP. Imperative to the estate practitioner’s decision of whether to present an FLP to a client as an estate planning vehicle will be a consideration of the following factors: the type of assets held by the client, the value of the assets the client wishes to protect from taxation, the amount of control the client wishes to relinquish, and the underlying business and investment schemes that the client’s assets may be used to achieve.

Even when all of the aforementioned factors are properly considered, the key element to achieving estate tax benefits through the use of an FLP is the motivation underlying its creation. Turner made it clear that in order to qualify for the “bona fide sale” exception to § 2036(a), a transfer must be made in “good faith.” Remember that this “good faith” requirement does not eliminate the ability to create an FLP with family members as the sole limited and general partners. What it does require, however, is “a sale in which the decedent/transferor actually parted with [his] interest in the assets transferred and the partner-

81. Updike, supra note 7, at 4.
82. When the FLP is comprised predominantly of marketable securities and there is no active management of the portfolio of securities, an estate will be hard-pressed to make the argument that a legitimate business enterprise existed at the creation and during the management of the FLP. Turner, 382 F.3d at 380.
83. The assets that the taxpayer retains after transferring a large portion of his wealth to an FLP are important to creating an FLP that is legitimate in the eyes of the Third Circuit. If a decedent cannot “live comfortably without resorting to the transferred assets,” then the court will see through the transaction as a mere recycling of value. Short, supra note 5, at 730.
84. The court will be more likely to find that there is a legitimate non-tax purpose supporting an FLP if the decedent who transferred a majority of the assets to the FLP gives up control of his assets. In Turner, although the Thompson and Turner Partnership agreements did not contain any provision that Thompson would maintain control over his transferred assets, his “de jure lack of control over the transferred property [did] not defeat the [court’s] inference of an implied agreement in these circumstances.” Turner, 382 F.3d at 376. “The Tax Court recognized that although ‘some change ensued in the formal relationship of [Thompson] to the assets he contributed to the partnership . . . [the] practical effect of these changes during [Thompson’s] life was minimal.’” Id. (quoting Thompson, 84 T.C.M. at 387). There was even testimony from family members that “they would not have refused [Thompson’s] request for . . . [annual] distributions.” Id. at 377.
85. The most important aspect of the Third Circuit’s disqualification of Thompson’s transfers for the exception to § 2036(a) was the fact that neither the Thompson nor the Turner Partnership conducted any legitimate business operation. Turner, 382 F.3d at 383.
86. Id.
87. “[J]ust because a transaction takes place between family members does not impose an additional requirement not set forth in the statute to establish that it is bona fide.” Kimbell, 371 F.3d at 263 (citing Wheeler v. United States, 116 F.3d 748, 764 (5th Cir. 1997)).
ship/transferee actually parted with the partnership interest issued in exchange."

In order to meet this requirement, evidence must be presented that, after the FLP was formed, the partners acted in conformity with corporate formalities, and income distributions from the FLP were made in a manner consistent with the partnership agreement. If it is clear from the operation of the FLP that "the entire family really intended in good faith to pool their assets and services in a common enterprise," then the "good faith" requirement will most likely be met. For example, the fact that Thompson contributed nearly all of the assets held by the Thompson and Turner Partnerships and received substantial limited partnership interests in return was not the fatal factor in the Third Circuit's determination that all of the assets he transferred would be returned to his gross estate. Instead, the court's conclusion was based upon the facts that there was no legitimate pooling of all of the assets of the family member partners, that there was no effort to invest the funds for the benefit of the FLP, and that the partners' relationships to the funds that they contributed to the FLP did not change.

In the absence of any United States Supreme Court decision interpreting § 2036(a) or a Code section explicitly applying special valuation rules to FLPs, estate practitioners must struggle to conform their Pennsylvania client's FLP to the mold set by the Third Circuit in Turner. On the other hand, practitioners could also slyly choose to dodge the stringent test set forth in Turner and successfully receive valuation discounts for lack of control and marketability from the Commissioner of the IRS. However, this does not always mean that the client's gross estate will escape without a scratch, for the Pennsylvania Department of Revenue (Department) has proven itself to be just as stringent in its attack against FLPs.

88. Turner, 382 F.3d at 382 (quoting Kimbell, 371 F.3d at 265).
89. Updike, supra note 7, at 21. Note that in Turner, the family members amended one of the partnership agreements "to allocate all gains and losses from, and distribution of real estate contributed to the partnership, to the individual contributing partner." Turner, 382 F.3d at 380. This type of income distribution is repugnant to the argument that a legitimate business operation exists because the decedent, or anyone else for that matter, has not changed his relationship to the assets he contributed to the FLP. See Updike, supra note 7, at 22.
90. Updike, supra note 7, at 22.
91. Turner, 382 F.3d at 378-80.
III. THE PENNSYLVANIA DEPARTMENT OF REVENUE'S USE OF 
TURNER TO DISALLOW VALUATION DISCOUNTS FOR PURPOSES OF 
THE PENNSYLVANIA INHERITANCE TAX

Even the IRS will sometimes overlook the savvy estate practitioner's formation of an FLP that does not fit within the exception to § 2036(a) and allow generous valuation discounts for a lack of control and marketability.93 This does not, however, free the estate from scrutiny by the Department for determination of the amount of Pennsylvania inheritance taxes owed.94 An example of this exceptionally strict review by the Pennsylvania courts occurred in April 2007.95

In January 1998, Helen H. Berry contributed $6,783,593 in cash and marketable securities to the HJL Family Limited Partnership (HJL) in exchange for a one percent general partnership interest and a ninety-seven percent limited partnership interest.96 Then, in June of the same year, Berry transferred the assets into a revocable trust for her sole benefit with the ability to “withdraw all or any part of the income and principal at any time.”97

Berry’s executor submitted a federal estate tax return to the IRS with a thirty-three percent discount for lack of control and marketability of HJL.98 However, the Department disallowed such a discount, and the Estate appealed to the Department Board of Appeals (Board) and the Venango County Orphans’ Court,99 both of which refused to overturn the Department’s disallowance of the valuation discounts.100 The Board found, and the trial court agreed, “given the nature of the partnership, its members, and its assets, the Estate failed to demonstrate that a partner, not compelled to sell, would have disposed of his interest at a discount.”101 The Estate then appealed to the Commonwealth Court.

While there are no Department rules or regulations applicable to FLPs, the Department, as part of its statutorily authorized102

93. Berry, 921 A.2d at 1262.
94. Id. at 1263.
95. Id.
96. Id. at 1262.
97. Id. at 1261.
98. Berry, 921 A.2d at 1262.
100. Berry, 921 A.2d at 1263. The Venango County Orphans’ Court found that the HJL did not operate as a functioning business enterprise. Id.
101. Id.
102. Section 9121 of the Pennsylvania Inheritance and Estate Tax Act (Act) states “t]he value of a life interest shall be determined in accordance with rules and regulations promulgated by the department. Until the promulgation of rules and regulations to the con-
course of action, looked to the provisions of the Code to determine whether the valuation discounts should have been applied to HJL. 103 The Pennsylvania Commonwealth Court, in step with the Board and the trial court, also used federal estate tax considerations in making its determination of whether to affirm the decision below. 104

Central to the court’s determination of whether the “HJL was a legitimate business enterprise, rather than merely a tax-avoidance mechanism,” 105 was an analysis of § 2036(a) of the Code. Because Berry retained “both the possession of, and the right to income from, the assets of the HJL trust,” 106 the court held that the only way in which the entire value of the HJL partnership could escape taxation as part of Berry’s gross estate would be if there was a bona fide sale for adequate and full consideration. 107 The HJL, however, did not meet the exception to § 2036(a). The court held, relying on the Third Circuit’s decision in Turner, that since the partnership “did not engage in ‘any valid, functioning business enterprise’” and because Berry “continued after the transfer of assets to the partnership, ‘to be the principal economic beneficiary of the contributed property,’” the HJL could not fit within the bona fide sale exception to § 2036(a). 108

The Commonwealth Court’s strict application of the Third Circuit’s decision in Turner makes it clear that estate practitioners are going to have to conform their clients’ FLPs to the “legitimate business interest—bona fide sale for adequate and full consideration—good faith” framework in order to properly effectuate their clients’ estate plans. Additionally, the fact that the Pennsylvania Department of Revenue is, in some instances, scrutinizing FLPs even more closely than the IRS should send a clear signal to prac-

103. The fact that the IRS allowed the valuation discount was not dispositive of the value of the estate for purposes of the Pennsylvania inheritance tax. Berry, 921 A.2d at 1263. Section 9137 of the Act states that “[t]he Department shall have supervision over, and make or cause to be made, fair and conscionable appraisements of property.” 72 PA. STAT. ANN. § 9137 (West 2000). Also, “[t]here is no statutory or common-law authority for the proposition that the Department or [a Commonwealth] Court is bound by an assessment of the I.R.S. when considering the correct assessment of Pennsylvania inheritance tax.” Berry, 921 A.2d at 1263.

104. Berry, 921 A.2d at 1263-64.

105. Id. at 1263.

106. Id. at 1264.

107. Id.

108. Id. (quoting Turner, 382 F.3d at 376, 379).
tioners that the days of creating illegitimate FLPs to shelter their clients’ estates from taxes are over.

III. CONCLUSION

The Third Circuit’s decision regarding the proper formation and maintenance of an FLP gives anything but a straightforward guide to a practitioner who wants to be sure that he protects his clients’ assets from excessive federal estate taxation. The fact that the determination of whether a decedent’s estate will be subjected to millions of dollars more in federal estate taxes is based upon an evaluation of the “good faith” of the decedent and his family is quite unnerving. Using a test that is more akin to determining a taxpayer’s mental state can be risky when million-dollar discounts are on the line and the courts are in favor of the IRS’s position. Clearly, the Third Circuit has taken a zero-tolerance approach in its examination of an FLP if there is any evidence of the abuse of valuation discounts.

With this in mind, it is also significant that when the IRS somehow allows valuation discounts for lack of control and marketability that would otherwise violate the Third Circuit’s approach, the Pennsylvania Department of Revenue is quick to disallow those discounts for purposes of determining the Pennsylvania inheritance tax. What this means for the practitioner creating an estate plan for a taxpayer within the jurisdiction of Pennsylvania courts is that he must make it clear, in both his formation and documentation of an FLP, that the taxpayer has a legitimate business purpose and that the FLP comports with the mold set by the Third Circuit in *Turner*. Part of achieving this goal is avoiding the inappropriate commingling of funds between the general and limited partners, as well as working to ensure that the FLP is engaging in an activity that has the possibility of being a profitable enterprise for the holders of the partnership interests. Finally, practitioners must be sure that the “good faith” requirement is met by requiring the transferors to actually part with the assets that they are transferring to the partnership in exchange for a concrete interest in the partnership being created.

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