ANALYSIS: WHY SECTION 2036 DOES NOT WORK EFFECTIVELY IN MANY FAMILY LIMITED PARTNERSHIP AUDITS AND WHAT CAN BE DONE ABOUT IT

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I. INTRODUCTION

With the unified credit amount set "permanently" at $5 million (adjusted for inflation), discount planning is less beneficial for small and moderate estates.[1] However, many planners still use the same discounting techniques of the recent past for larger estates.[2]

This article will focus on one particular discounting technique, the family limited partnership (FLP), and will describe how the authors have seen the Internal Revenue Service (IRS) apply section 2036 of the Internal Revenue Code (section 2036) in an audit to effectively negotiate, mitigate, or possibly eliminate the applicable discount.[3] In summary, in the typical FLP audit, the IRS applies section 2036 (as to the FLP) in a haphazard manner, and some audits involve extended document requests, which require time consuming and expensive responses.[4] In the authors' opinion, there are no substantially fair ground rules involved with a section 2036 audit. As a result, the FLP audit process is often costly and does not work effectively. This article will suggest several possible improvements to the estate tax audit process in cases involving FLPs.[5] Additionally, this article will point out the inherent dichotomy between sections 2036 and 2001(f) in many FLP cases, and will encourage practitioners to fight against 2001(f) transgressions.[6]

II. THE FLP AUDIT PROBLEM

The main problem with cases involving a section 2036 assertion (in connection with an FLP audit) is well known.[7] There is simply no legislative or regulatory "road map" (or safe harbor) giving practitioners, or the IRS, guidance as to how FLPs can be set up and operated in a way that will guaranty a valuation discount.[8] Instead, case law has merely hobbled together a list of factors that have resulted in either a reduction or disallowance of the discount (described by practitioners as a "minefield" of

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1. I.R.C. § 2010(c)(3), (4) (2012). The credit amount is $5,430,000 for 2015. Rev. Proc. 2014-61, 2014-47 I.R.B. 860.

2. *See generally Effective Estate Reduction Techniques*, PREEO, SILVERMAN, GREEN & EGLE, P.C., www.preeosilverman.com/CM/Articles/Articles27.asp (last visited Feb. 1, 2015) (describing various techniques to reduce tax burdens).

3. *See infra* Parts III–VII.

4. *See* John W. Porter, 30,000 Foot View from the Trenches: A Potpourri of Issues on IRS's Radar Screen, Presented at the 49th Annual Heckerling Institute on Estate Planning (Jan. 13, 2015), *available at* http://www.law.miami.edu/heckerling/pdf/2015/Current%20Audit%20and%20Litigation%20Issues.pdf.

5. *See infra* Part V.

6. *See infra* Parts VII–VIII.

7. *See* I.R.C. § 2036 (2012).

8. *See id.* To paraphrase section 2036 terminology, there are no specific "safe harbor rules" to establish how an FLP can be set up and operated in a way so that the decedent does *not* retain an "interest" in the possession or enjoyment of the assets or the income therefrom. *Id.* In essence, the IRC sets the stage so that a taxpayer must prove a "negative" in audit, meaning the taxpayer must show the IRS that the taxpayer at no point, during or after the formation of the FLP, retained a problematic interest. *Id.*

factors).[9] With these cases, practitioners and the IRS have now gained insight as to what factors courts find important in applying section 2036 to a particular case and what other factors might apply so that the decedent's FLP interest retains much or all of its discount.[10]

While practitioners can certainly try to set up and help their clients operate FLPs in a way that avoids the "known" mines, there is, in practical terms, no legal or economic downside for the IRS to simply invoke section 2036 in every case involving a discounted FLP interest.[11] The result often leads to lengthy and expensive audits, and arguments over the exact value of the discounted FLP interest.[12]

For example, the authors' firm, working with other professionals, recently represented three separate, substantial estates that included discounted FLP interests. In each case, our office had previously formed the FLP in question during the taxpayer's lifetime. We then structured annual gifting programs (and in one case structured a sale) of discounted FLP interests to an intentionally defective grantor trust (DGT) for the benefit of the taxpayer's children over a period spanning several years preceding the death of the decedent. Each discounted gift (or sale) was "adequately disclosed" on a timely filed Form 709 (gift tax return).[13]

However, in each case, the decedent's estate return audit process in connection with the FLP was very difficult and began with the IRS asserting section 2036.[14] Our nonscientific, self-survey concluded that one audit (as to the discounted FLP interest) resolved favorably for the taxpayer;[15] the second audit resulted in a negotiated settlement with the auditor;[16] and the third case resulted in a substantial disagreement with the IRS agent and ended up in tax

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9. *See, e.g.*, Estate of Thompson v. Comm'r, 382 F.3d 367 (3d Cir. 2004) (noting the various factors that apply to section 2036).

10. *See id.* The following is by no means a comprehensive list, but important factors include: (1) whether the FLP owned the transferor's personal residence and the transferor continued to use it; (2) whether the transferor transferred most of his or her assets to the FLP, essentially so that the transferor would have to live off of the FLP's assets; and (3) whether the FLP was formed when the transferor was elderly or terminally ill. Estate of Disbrow v. Comm'r, 91 T.C.M. (CCH) 794 (2006); Estate of Rosen v. Comm'r, 91 T.C.M. (CCH) 1220 (2006); Strangi v. Comm'r, 417 F.3d 468 (5th Cir. 2005); Estate of Thompson v. Comm'r, 382 F.3d 367 (3d Cir. 2004); Estate of Bigelow v. Comm'r, 503 F.3d 955 (9th Cir. 2007). *But see* Keller v. United States, 697 F.3d 238 (5th Cir. 2012) (noting that the FLP was formed after the death of the decedent).

11. *See infra* Part V.B.

12. *See infra* Parts III, VII.

13. In each case, a qualified appraiser was retained to prepare the appraisal attached to each gift tax return, and their appraisal report was attached to the return. *See* I.R.C. § 6501(c)(9) (2012); Treas. Reg. § 301.6501(c)-1(f)(2) (as amended in 2015); Form 709, United States Gift and Generation-Skipping Transfer Tax Return, *available at* http://www.irs.gov/pub/irs-pdf/f709.pdf.

14. I.R.C. § 2036 (2012).

15. Specifically, the audit resulted in no change from the discounted value position taken on the decedent's Form 706.

16. The return position of a 35% discount was effectively lowered to 28% by settlement.

court.[17] Two of the three estates incurred tens of thousands of dollars in professional fees during the FLP audit; the third estate spent hundreds of thousands of dollars.

It is long past time for Congress, the IRS, or possibly the courts to set out some ground rules to clarify situations where invoking section 2036 would be appropriate, and where it would not be. Such guidance should be possible now that courts have decided dozens of FLP cases.[18]

This article will focus on three conceptual remedies to streamline discounted FLP audits. First, Congress should take action to clarify the application of section 2036 rules.[19] Second, the IRS should provide better guidance.[20] Finally, practitioners should consider following the guidelines set forth in this article to bring their client's situation under section 2001(f), and, when appropriate, ask for attorney's fees when the IRS ignores the application of this section.[21]

III. FAMILY LIMITED PARTNERSHIP PLANNING[22]

FLPs are set up for many reasons. First, the tax benefits of FLP planning are numerous and well-documented.[23] From a transfer tax perspective, the taxpayer's family will often achieve a substantial valuation discount, both for a lack of marketability and a lack of control.[24] Other tax benefits of FLP planning include: (1) "freezing" the value of the transferred interest at the date of the transfer, so future appreciation accrues outside of the estate; (2) setting up a system whereby cash flow from the partnership's assets is also removed from the estate; (3) taking advantage of "timing" the lifetime gift or sale, so that the taxpayer can try to transfer the asset while its value is low (for an appreciating asset); (4) transferring an FLP partnership interest that permits a transfer of assets at a discount for transfer tax purposes; and (5) using the FLP to fund other tax-advantaged techniques, such as purchasing life insurance.[25]

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17. Estate of Jack Williams v. Comm'r, No. 29735-13 (T.C. filed Dec. 19, 2013). The taxpayer took a 40% discount on Form 706; the IRS agent offered a 15% discount. The case was settled before going to trial; the terms of the settlement are not disclosed.

18. Steve R. Akers, *Estate Planning Current Developments and Hot Topics*, BESSEMER TRUST 97 (Dec. 2012), http://www.bessemertrust.com/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/Advisor/Presentation/Print%20PDFs/Hot%20Topics%20Current%20Developments%20_FINAL.pdf.

19. *See infra* Part V.A.

20. *See infra* Part V.B.

21. *See infra* Parts V.C.

22. Although this article references partnerships, similar concepts apply to limited liability companies and closely held corporations.

23. Louis A. Mezzullo, *Family Limited Partnerships and Limited Liability Companies*, in 812 BNA BLOOMBERG ESTATES, GIFTS, AND TRUSTS, at A-11 (Apr. 21, 2014).

24. *Id.*

25. *See id.* at A-5 to A-7.

There are also many nontax benefits to FLP planning, including: (1) centralizing or controlling the management of assets; (2) creditor protection; and (3) other business reasons.[26] The authors recommend that, as part of any FLP plan, the nontax reasons for establishing the FLP be well-documented by counsel in a memo.

A typical FLP plan involves three steps. First, the client forms the FLP and transfers assets into the FLP.[27] At that time, the client normally takes back all the partnership interests, both general and limited.[28] Second, the client then gives or sells partnership interests to his heirs or children (or to a trust set up for the transferee's benefit) at a substantial discount.[29] Finally, the FLP is operated until the death of the taxpayer.

A. Family Limited Partnership Planning Examples

This article will now explore three separate examples of FLP planning and then will examine ways to improve section 2036 compliance in each case.[30] In each example, assume the gift or sale occurred in 2005, and the decedent died in 2014.

1. Example 1: Straight Lifetime Gift of FLP Interest

Assume Mr. and Mrs. Smith own a $20 million building, and they would like to start transferring this property to their three children. They start this process by contributing the building to the Smith Family Limited Partnership (Smith FLP). They decide that they would like to give a 50% interest in the FLP to their children and obtain an appraisal of the building, which confirms the $20 million value of the property. Then, they obtain an appraisal on the

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26. See *id.* at A-7, for a helpful summary of a number of the nontax benefits of FLP planning, including: (1) allowing older family members to retain control over the management of the assets transferred to the entity, to restrict subsequent transfers of interests in the entity, and to undo the entity without unfavorable income tax consequences if circumstances change; (2) reducing expenses and facilitating transfers of interests, particularly in real estate, and avoiding ancillary administration of the decedent's estate when real property is located somewhere other than the state of the decedent's residence; (3) depending on the type of entity used, protecting owners from the possible liability surrounding potentially hazardous assets; (4) shielding the assets themselves from the owners' creditors; (5) providing an effective way of educating younger members about handling the family's financial affairs and protecting the older family members from potential liability for decisions that may not satisfy standards applicable to a trustee; and (6) providing a means to compel arbitration of family disagreements, with the losing party required to pay costs and legal fees.

27. *Id.*

28. *Id.*

29. *Id.* In California, for property tax reasons, counsel might structure FLPs involving real estate differently; the parent will transfer real estate to the child, then the FLP is set up. *See* R. Zebulon Law, *What Every Planner Should Know About Real Estate FLP Planning in California*, 34 BNA'S TAX MGMT. EST., GIFTS, AND TR. J., no. 4, 2009, at 167–77.

30. *See infra* Part V.A.1–3.

particular 50% partner position that they wish to give.[31] The limited partnership interest appraisal will generally factor in both a discount for lack of control (i.e. a minority interest discount) and a separate discount for lack of marketability; when combined, these produce a discount range from one-third to over one-half of the value of the underlying assets.[32] Assuming a 35% discount applies, the $10 million value for the 50% interest in the building would be reduced to $6.5 million for gift tax purposes. The Smiths timely file a Form 709 reporting this gift and all applicable partnership returns.

The benefits of this particular FLP plan include the following: (1) the transfer removes 50% of the future appreciation of the building from the Smiths' estate (assuming the building appreciates during their lifetimes); (2) the transfer removes 50% of the building's future cash flows from their estate; (3) the transfer removes $10 million in value from the estate at a reduced/discounted value of $6.5 million, resulting in a $1.4 million gift/estate tax savings;[33] and (4) the grantor can use the cash flow attributable to this 50% position removed from the estate in other tax-advantaged ways, such as purchasing life insurance. [34]

2. Example 2: Sale to DGT of FLP Interest[35]

Assume Mr. and Mrs. Smith want to keep most or all of the cash flow from the building, but they would like to transfer its possible future appreciation to their children. In such instances, it is not uncommon for a planner to suggest that the Smiths sell, rather than give, the 50% partnership interest to a DGT for the benefit of their children. Some planners refer to this

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31. This article will describe gifts of partner interests. General partner interests are often valued in a manner that is different from the manner used to value limited partnership interests. *See* Mezzullo, *supra* note 23. It is understood that the general partner position will normally be given to the children, to avoid having the parents retain a section 2036 interest/control over the FLP's assets. *See id.*

32. The rationale behind a minority interest discount is that the value of the minority interest is less than its proportionate share of the value of the asset. Treasury Regulation section 20.2031-1(b) states that the fair market value is established in the market in which the item is most commonly sold to the public. *See* Treas. Reg. § 20.2031-1(b) (as amended in 1965). If the market is limited to a small group (e.g. the transferor's family members), then the value of the asset will be less than if there were no such restriction. *See id.* These transfer restrictions are now governed by sections 2703 and 2704 of the Internal Revenue Code. *See* I.R.C. §§ 2703, 2704 (2012).

33. It should be noted that, in this case, the retained 50% interest is also discounted, resulting in a total effective discount of $7 million for transfer tax purposes.

34. This example assumes a 40% estate tax rate, and represents a $3.5 million discount multiplied by the 40% rate, which equals $1.4 million. The tax savings will increase if the property appreciates in value, and because the estate retains only a 50% partnership position, similar discounts may apply to the estate—resulting in a total of $2.8 million in gift and estate tax savings. However, practitioners should note that reduced values for estate tax purposes will result in increased capital gains taxes to heirs.

35. Please note there have been some recent challenges to this "sale to DGT" transaction. *See, e.g.*, Estate of Donald Woelbing v. Comm'r, No. 30261-13 (T.C. filed Dec. 26, 2013); Estate of Marion Woelbing v. Comm'r, No. 30260-13 (T.C. filed Dec. 26, 2013).

as an "estate freeze" technique because the value of the sold interest freezes at the value of the note, plus interest.

Using the same facts as above, the 50% interest in the FLP might sell to the DGT in exchange for $6.5 million. Because the DGT is a "grantor" trust for income tax purposes, no gain or loss is recognized on the sale of the partnership interest.[36]

Often the FLP interest is sold to the DGT in exchange for a promissory note.[37] If the note is properly structured, the note payments will be less than (or will closely reflect) the distributions from the partnership that the family would have otherwise received.[38] For example, assume the property generates $1.5 million per year in net cash flow. Normally, the FLP would then distribute around $750,000 per year to the 50% FLP interest.[39] It might be possible to structure a sale transaction whereby the promissory note payments would be similar to the $750,000, so Mr. and Mrs. Smith would continue to get much of the $1.5 million cash flow from the property after the sale.[40] This example also assumes Mr. and Mrs. Smith file a Form 709, showing no gift, but adequately disclose that a sale occurred and the discounted values used for the sale.

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36. Rev. Rul. 85-13, 1985-7 I.R.B. 28 (explaining that no gain or loss is recognized in any transaction between a grantor and his or her grantor trust).

37. In order to avoid a "form-over-substance" or a "sham transaction" argument by the IRS in an attempt to undo the transaction for tax purposes, some conservative planners believe that the DGT should first be funded independently with "seed money" by the grantor (or another) to support the integrity of the installment note sale—to give it some credibility as a credit purchaser. *See* HOWARD ZARITSKY, TAX PLANNING FOR FAMILY WEALTH TRANSFERS ¶12.07 (2013). In lieu of seed money, other practitioners will employ a guarantor for the note. *Id.* ¶ 12.07[3][d][iv]. It is often recommended that the seeded amount be 10% of the anticipated value of the asset to be sold (in this case, $650,000), but there appears to be no authority requiring this. *Id.* ¶ 12.07[3][d][ii] ("There is really no case or ruling that declares that a specific amount of seed money is sufficient."). This 10% rule of thumb is based upon an informal conversation that Byrle Abbin had with the IRS. *See* Byrle M. Abbin, *[S]he Loves Me, [S]he Loves Me Not—Responding to Succession Planning Needs Through a Three-Dimensional Analysis of Considerations to be Applied in Selecting from the Cafeteria of Techniques*, 31 U. MIAMI INST. ON EST. PLAN. 13, 13-9 (1997) ("Informally, IRS has indicated that the trust should have assets equal to 10% of the purchase price to provide adequate security for payment of the acquisition obligation"); *see also* I.R.S. Priv. Ltr. Rul. 95-30-26 (May 1, 1995) (issued to Byrle Abbin as a result of that meeting). In one of the authors' three recent audits, the agent asked whether any seed funds were given to the DGT.

38. Care must taken to avoid having the note be treated as a sham/annuity under the principles of *Ray v. United States*. *See* Ray v. United States, 762 F.2d 1361, 1363 (9th Cir. 1985). In *Ray*, the court found that the decedent had made a transfer to a trust with a retained income interest and not a sale of property in consideration for an annuity because there was a "'tie' between the amount of the payments [under the promissory note] and the trust income, [which] is the most important characteristic which distinguishe[ed] [the] transaction from an annuity purchase." *Id.* at 1363.

39. *See supra* Part III.

40. *See Estate Freezing Techniques*, MONTELLO WEALTH (2014), http://www.Montellowealth.com/estate_freezing_techniques.html (providing examples of estate freezing techniques). This is generally referred to as an estate freezing technique because the value of the estate is frozen at the value of the promissory note plus interest at the applicable federal rate. *Id.*

3. Example 3: Sale of FLP Interest, Followed by Note Forgiveness

The third example is the same FLP interest sale as the second example. However, the note is forgiven over a period of years. Assume a gift tax return is filed in the year the sale occurs.

B. Reporting of FLP Transactions

As noted in the examples above, whether FLP planning involves a substantial gift or sale, the authors recommend filing a gift tax return for each and every year in which a discounted gift or sale is made.[41] Disclosing transactions on a gift tax return became more important after October 2006, at which point Form 706 added the question: "did the decedent at any time during his or her lifetime transfer or sell an interest in a partnership, limited liability company, or closely held corporation to a trust described in lines 13a or 13b?"[42] Proper filing begins the application of the statutes of limitations under sections 6501(a) and 2001(f)(1).[43]

IV. SECTION 2036

In the past few years, it appears the IRS has stepped up its application of section 2036 to FLP situations.[44] Section 2036(a) provides as follows:

> (a) General rule — 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 case of a bona fide sale for an 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 -
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> (1) the possession or enjoyment of, or the right to the income from, the property, or
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> (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.[45]

In other words, if a taxpayer/decedent owned a property (such as a building or a limited partnership interest), and then transferred that property to another family member and "retained" an interest equating to possession

41. *See supra* Part III.

42. *See* Form 706, United States Gift and Generation-Skipping Transfer Tax Return, *available at* http://www.irs.gov/pub/irs-pdf/f706.pdf.

43. *See* I.R.C. §§ 6501(a), 2001(f) (2012).

44. *See id.* § 2036.

45. *Id.* § 2036(a)(1)–(2).

or enjoyment of the income, retained the ability to designate who can enjoy the property (principal or income), or both, the value of the property is included in his estate.[46]

A. Estate of Strangi v. Commissioner

After several different attempts to articulate arguments against the discounts inherent in FLP planning, the IRS finally succeeded in using section 2036 in *Strangi v. Commissioner*.[47] *Strangi* effectively confirmed that section 2036 could be used to eliminate discounts.[48]

Strangi involved a number of "bad facts" for the taxpayer.[49] The incapa-citated taxpayer's son-in-law, acting as agent under a power of attorney, set up a family limited partnership.[50] The son-in-law then proceeded to contri-bute 98% of the taxpayer's personal and investment assets (valued at nearly $10 million) to the FLP.[51] Approximately 75% of that value was attributable to cash and marketable securities.[52] The entity was then managed by the son-in-law under a power of attorney.[53] The taxpayer ended up retaining a 99% limited partnership interest in the FLP, and purchased a 47% interest in the corporate general partner.[54] The IRS successfully applied section 2036 by arguing that the taxpayer effectively retained a section 2036(a)(1) interest in the FLP's property.[55]

After *Strangi*, several court cases have confirmed that the value of the underlying assets held in an FLP can be drawn back into a decedent's estate under section 2036.[56]

B. Section 2036 Audits

Although section 2036 presents an effective tool to prevent "abusive" FLP situations where the decedent retained effective control over the entity or its assets, the IRS's application of this section has itself now become subject to perceived abuse.[57] It can be (and is) asserted in cases where the

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46. *See id.*
47. *See* Strangi v. Comm'r, 417 F.3d 468 (5th Cir. 2005).
48. *See id.*
49. *See id.* at 473–74.
50. *See id.*
51. *See id.*
52. *See id.*
53. *See id.*
54. *See id.*
55. *See id.* at 478.
56. Akers, *supra*, note 18. As the summary notes, section 2036 has successfully brought assets back into an estate in at least twenty-one cases. *Id.*
57. *The IRC* § 2036 *Trap in Planning with FLPs & Grantor Trusts*, L. OFFICES DAVID L. SILVERMAN (Mar. 15, 2010), http://nytaxattorney.com/2010/03/15/the-irc-§-2036-trap-in-planning-with-flps-grantor-trusts/. Please note that the authors wish to clarify that although the word "abuse" may imply

FLP was set up and operated in a "technically perfect" manner. The time and expense involved to rebut an IRS assertion is very high in most cases. For example, the cost to rebut its assertion can often be the same in nonapplicable cases as well as egregious situations. Unfortunately, there appears to be very little (if any) practical economic or legal "downside" to keep the IRS from asserting section 2036 in every case involving an FLP.[58] This is the case whether the decedent adequately disclosed the discounted values involved in original FLP interest gifts on a previous Form 709 (as referenced in each of the examples above) or not.[59]

Section 2036's assertion is truly an anathema to estate planning counsel. By invoking section 2036, the IRS is implicitly arguing that the lifetime discount planning was "invalid" (which in turn suggests estate planning counsel committed malpractice).[60] If the IRS successfully challenges an FLP discount and brings all of the FLP's assets back into a decedent's estate for transfer tax purposes (especially where the challenge is due to the failure to meet the formalities of forming or operating the FLP), counsel would have concern because the court might find counsel liable for the loss of all of the tax benefits described above.[61]

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some intentional effort by the IRS to misuse section 2036, that is not the intended use of the word for this article. Instead, there is an increased *perception* that section 2036 is either being haphazardly asserted, or is being asserted in cases where it is not applicable, because none of the "bad" factors developed under the case law apply. Because the cost to fight any section 2036 dispute is high, any ongoing misapplication can be perceived as abusive. The authors commend IRS agents who properly raise section 2036 concerns during an audit.

58. *Id.* The authors are not aware of any precedent where the IRS lost attorneys' fees (and expert valuation opinion fees) as a result of an improper assertion of section 2036.

59. *See infra* Part X.

60. By way of clarification, in the authors' opinion, it is very difficult to commit malpractice in this area of law. This is due, in part, to the fact that there is no standard of care that is normal in this area. We do suggest, though, using a wonderful checklist for FLP formation and use by Byrle Abbin. *See* Byrle Abbin, *Comprehensive Quality Control FLP Checklist*, NAEPC (June 4, 2009), https://www.naepc.org/journal/issue06n.pdf. We mention this issue because a section 2036 assertion will sometimes have the effect of encouraging the client to question whether the attorney who performed the FLP planning did the work correctly. In one of the actual audits described in this article, the IRS agent asserted that the partnership agreement (which was drafted by our office) established retained rights to the taxpayer in a way that violated section 2036. Specifically, the partnership agreement gave the limited partners certain narrow veto rights (for example, before the sale of the partnership) that were set forth in California's, then existing, Revised Uniform Limited Partnership Act (the law provided that these limited veto rights were nonwaiveable, however, they could be narrowed under the terms of a written agreement). In other words, *every* California limited partnership would have been invalid (according to the agent's reasoning) because every California limited partnership granted the same narrow veto rights whether the partnership agreement included the rights not. The agent asserted that, under section 2036(a)(2), the decedent (a limited partner), in conjunction with his son, retained control over the partnership due to the narrow retained statutory veto rights. The client (the son) was left wondering whether we had properly drafted the partnership agreement. This also creates a very difficult situation in any case where a taxpayer has to change counsel—subsequent counsel must understand that, due to a prior discounted gift or sale, they need to make sure the FLP is operating in a "hypothetically" perfect manner (and avoid amending the partnership agreement), or risk bringing the FLP's assets back into the taxpayer's estate.

61. *See id.*

A section 2036 audit creates an inherent documentary and evidentiary nightmare for certain estates.[62] As previously mentioned, the estate's representative must essentially prove a negative—that the decedent, alone or in conjunction with others, did not retain a disqualifying interest in the FLP's property.[63] This creates an extreme burden on the estate's representative.[64] Because certain evidence is more difficult to obtain once the decedent has died, the IRS can simply wait until the decedent has died, ask for every document that anyone ever created in connection with the FLP, and look to see if any document (or lack of documentation), after the fact, has violated one of the factors considered by a court to result in FLP asset inclusion in the estate (i.e., see if the taxpayer "stepped on a mine").[65]

C. Potentially Abusive Section 2036 Application to Discounted FLP Interest Audits

In the authors' opinion, there are times where a section 2036 assertion can be perceived to be abusive. Assume the facts of the first example above.[66] In that case, an FLP was set up in 2005.[67] Assume the general partner and certain limited partner interests were then given to the children (using the parents' lifetime exclusion), and the gifts were adequately disclosed on a gift tax return. Also, assume that none of the "bad facts" brought out in recent cases apply.[68] For example, the decedent retained substantial assets out of the estate, did not retain managerial control over the FLP, the FLP maintained proper accounting books and records over the years, etc. Also, assume all of the applicable partnership returns were properly filed, showing the correct ownership, correct capital accounts, profits accounts, K-1 distributions, etc.[69]

Now assume the decedent dies while retaining a 50% limited partner position in the FLP. The property has appreciated in value to $40 million by the time of the decedent's death, and the decedent's estate obtains a qualified appraisal reflecting a 40% discount on the value of the retained interest.[70]

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62. *See generally* Richard A. Behrendt, *FLP Planning Is Still Viable*, BAIRD, http://www.rwbaird.com/bolimages/media/pdf/whitepapers/flp-planning-still-viable.pdf (last visited Feb. 2, 2015) (describing the numerous documents the service auditor may request).

63. *See* I.R.C. § 2036 (2012).

64. *See id.*

65. *See generally* Behrendt, *supra* note 62 (discussing the steps the IRS takes when auditing an estate tax return).

66. *See supra* Part III.A.

67. *See supra* Part III.A.

68. *See, e.g.*, Strangi v. Comm'r, 417 F.3d 468 (5th Cir. 2005).

69. This was essentially the fact pattern in one of the actual audits described herein (the one that "settled" with a 28% valuation discount). At no time during that audit did the IRS auditor in that case question the accounting, the operations, or formation of the FLP.

70. *See generally* Abbin, *supra* note 60 (discussing rules to establishing a FLP). In summary, these facts would lead to substantial estate tax savings. If the $40 million property had been in Mr. and Mrs. Smith's estate, then assuming a 40% estate tax rate, the tax would have been around $12 million ($40 million property, reduced by a little over $10 million credit amount, equals $30 million times 40%). By

In summary, the taxpayer/decedent has fully played by all the rules.[71] The taxpayer/decedent established and operated the hypothetically "perfect" FLP, fully disclosed its operation to the IRS on timely filed gift and partnership tax returns, and fully disclosed the discounted gifts made initially (and over the years) on timely filed (and adequately disclosed) gift tax returns.[72] Simply put, the taxpayer has done everything possible to behave, report, and act properly.[73] In such case, the authors question whether the IRS should be able to assert section 2036. If the IRS asserts section 2036, it will ask, in its information and document request, to see copies of every document generated in connection with the FLP, as well as all of its income tax returns and accounting records since 2005.[74]

In short, the IRS's position is "yes," and, it seems, in most cases, it would assert this position.[75] If the IRS does assert section 2036, the decedent's estate (which, keep in mind, has already incurred substantial professional fees since 2005 to make sure it has fully complied with the tax laws in the planning and operation of the FLP) will, nonetheless, still have to gather up all of the requested documents to satisfy the request.[76] In other words, the estate of the decedent who had a "fully compliant" FLP will incur the same fees and expenses complying with a document request as the most egregious FLP. The estate would have to provide the original deed transferring the property to the FLP, and will have to review and turn over all of the partnership's bank statements, deposits, contributions, and withdrawals.[77] The estate would have to turn over all records of partner meetings and all decisions relating to property repairs, improvements, major tenant approvals, etc.[78] Essentially, the IRS can create a situation where the hypothetically perfect FLP's estate representative feels coerced into settling on a reduced discount, simply to avoid the extensive accounting and attorney's fees involved in satisfying such an audit request.[79]

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entering into the plan, the estate only pays $4.8 million in estate taxes ($20 million, representing the gross value of the retained partnership interest, reduced by the 40% discount, equals $12 million, times the 40% estate tax return (this assumes the credit amount was used up in the lifetime gift)). Note, however, that the basis of the FLP interests for income tax purposes would only be $12 million, plus any original basis on the 50% that was given to the children.

71. *Id.*
72. *See id.*
73. *See id.*
74. Our firm actually received this type of request in one of our recent audits.
75. *See, e.g.*, Strangi v. Comm'r, 417 F.3d 468 (5th Cir. 2005).
76. *See* Behrendt, *supra* note 62.
77. *See id.* The IRS will also want to see the partnership's general ledger.
78. *See id.*
79. Section 2036 cases typically involve a series of audit requests over many months.

V. WHAT SHOULD BE DONE ABOUT THIS

The authors propose three different sets of ideas to help provide more certainty to this area of planning and prevent potential (or perceived) abuse: (1) legislative clarification; (2) administrative relief; and (3) potential judicial relief through stronger interpretation of section 2001(f) of the IRC.[80]

A. Legislative Clarification

Admittedly, it is difficult for Congress to specifically legislate in this area. However, ideally, the authors would like to see some momentum for some simple legislative changes to section 2036.[81] The changes would provide further guidance as to specific "interests" that an estate would need to retain for an asset to be brought back into a taxpayer's estate.[82] For example, legislators might revise section 2036 to provide some "bright line" examples of "abusive" retained interests.[83] For instance, if taxpayers transfer more than X% of their net worth and render themselves unable to pay debts when due, and where the discounted interest would lead to estate tax savings; the latter requirement giving a nod to the fact that where the overall estate is under the total unified credit amount, there is simply no estate tax motivation for implementing an FLP.[84] Such abusive interests might result in higher penalties.[85] Alternatively, Congress could amend section 2036 to provide some kind of safe harbors as to FLP situations.[86] Any changes to section 2036 could take into account the many cases in this area.

Other legislative ideas include amending section 2001(f) to provide some kind of penalty if the IRS takes the "second cut" at the value of an adequately disclosed gift.[87] Additionally, Congress could amend section 7430 of the IRC to provide that the administrative remedies are deemed exhausted if section 2001(f) applies (or perhaps if the IRS performs an "abusive" section 2036 audit), and the IRS would be required to pay the attorneys' fees incurred in putting together the document request.[88] Finally, Congress could amend section 7491 of the IRC so that the burden of proof is shifted to the Secretary in cases where section 2001(f) applies.[89] In other words, the Secretary would have to overcome at least some level of burden

80. *See infra* Part V.A–C.
81. *See* I.R.C. § 2036 (2012).
82. *See id.*
83. *See id.*
84. *See id.*
85. *See id.*
86. *See id.*
87. *See id.*
88. *See id.* § 2001(f).
89. *See id.* § 7491.

of proof in order to try to assert some value other than the value that was adequately disclosed on the applicable gift tax return.[90]

B. Administrative Ideas

The administrative process is an area where the IRS could easily give better guidance. This article simply points out that the IRS has no economic motivation to do so. There is probably no effective process to obtain "pre-approval" of an FLP.[91] However, with some simple revisions to the gift tax or partnership returns, the IRS should be able to identify most abusive situations, which would greatly ease compliance.

For example, simply adding questions to Form 709 may help identify many potentially abusive FLP situations.[92] For instance, the IRS could add boxes for whether gifts or sales of an entity occurred, and, if so, request that the taxpayer attach a copy of the applicable partnership agreement to the gift return.[93] The IRS could review the partnership agreement (hopefully while the taxpayer/parent is still alive) to determine if the taxpayer retained any kind of express control over the partnership.[94] Any potentially abusive partnership could lead to increased compliance for all years it remained in existence.[95]

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90. *See id.* § 2036. There could be variations on this, including that the preponderance of the evidence burden of proof is simply not available in cases where section 2001(f) applies. Another idea is that the taxpayer will be deemed to have "fully cooperated" with the IRS where they have adequately disclosed the gift.

91. *See Family Limited Partnerships*, INC., http://www.inc.com/encyclopedia/family-limited-partnership.html (last visited Feb. 2, 2015). The taxpayer may not possibly obtain a private letter ruling as to every aspect of an FLP. Among other reasons, even if the taxpayer obtained a letter ruling request on the initial gift/sale transaction, subsequent events could occur to bring section 2036 back into question.

92. *See* Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return (2014), *available at* http://www.irs.gov/pub/irs-pdf/f709.pdf.

93. *See id.*

94. *See generally* I.R.C. § 2036 (2012) (discussing transfers with retained life estates). Indeed, such a change might have prevented one of the hotly contested items in one of our FLP audits. In our audit, the partnership agreement contained language that was part of California's RULPA, which gave limited partners very narrow veto rights in certain situations. Such rights were available under California law (at the time), whether they were included in the partnership agreement or not. In fact, the partners could not waive such rights by the partners (the partnership agreement could provide veto parameters, like requiring 90% of the limited partners to implement a veto, rather than 50%). The IRS's position was that such rights amounted to a section 2036(a)(2) retained interest—the decedent (who was a limited partner) "in conjunction with" the other partners (an intentionally defective grantor trust) could control the enjoyment of the FLP's property. Of course, the partnership agreement by this time had been in existence for many years. The law can better resolve concerns involving the management of the FLP by requiring the partnership to submit the agreement with a Form 709 while the decedent is still alive.

95. *See generally* Michael V. Bourland et al., *The Family Limited Partnership*, PLANNED GIVING DESIGN CENTER, http://pgdc.com/family-limited-partnership (May 18, 2011) (discussing the possible challenges to FLPs).

Similarly, extra questions could be added to a Form 1065 partnership tax return.[96] The idea would be to flag partnership interests that might be subject to a discount on an estate return, in order for the IRS to closely examine for potential abuse.[97] For example, K-1s might be revised to ask whether the "type of entity" is a family limited partnership (with instructions defining this as an entity where one owner has taken, or is reasonably expected to take, a discount in transferring the interest to another family member).[98] If the "family limited partnership" box were checked, other questions could follow to identify potentially abusive situations—like whether the partnership owns the personal residence of a partner, or whether the partnership owns more than X% of the partner's assets.[99] These follow-up questions could be developed from existing case law.[100]

Another idea would be to require taxpayers to fill out an additional form every year the FLP is in existence, until the death of the decedent, to identify potential abuses while the taxpayer is still alive (for example, disproportionate draws and the like).[101] One useful aspect of such a system is that if the IRS were to identify, through its audits, additional systemic types of FLP abuse (for example, presenters giving seminars about how owners can borrow abusively from the FLP), the questions on a partnership return or K-1 could be revised year after year.[102] While not as effective from the taxpayer's perspective as receiving pre-approval of an FLP, such a system would have two primary benefits: (1) it would encourage compliance, which would be useful for the IRS; and (2) it would raise questions involving the FLP more or less contemporaneously (i.e., resulting in greatly reduced audit expenses for the taxpayer).[103]

Finally, the IRS could amend Form 706 (estate tax return) to include questions about prior, adequately disclosed gifts.[104] For example, Form 706 could ask for the taxpayer's position about whether anything disclosed on

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96. *See* Form 1065, United States Return of Partnership Income (2014), *available at* http://www.irs.gov/pub/irs-pdf/f1065.pdf.

97. *See* Bourland, *supra* note 95.

98. *See* Schedule K-1 (Form 1065), Partner's Share of Income, Deductions, Credits, etc. (2014), *available at* http://www.irs.gov/pub/irs-pdf/f1065sk1.pdf.

99. *See* Bourland, *supra* note 95.

100. *See* Kenneth L. Wenzel, *Pitfalls in Administration of Family Limited Partnerships*, BOURLAND, WALL & WENZEL, P.C. 7–21 (Feb. 4, 2004), http://www.burlaw.com/resources-seminars/resources-seminars-archives/.

101. *See generally* Steve R. Akers, *Valuation Issues, Including Planning Considerations for Family Limited Partnerships, Return Preparer Penalties, Defined Value Transfers, and Hot Topics with IRS Estate and Gift Tax Agents*, A.B.A., http://www.americanbar.org/context/dam/aba/events/real_property_trust_estate/symposia/2008/.te3akers.authcheckdamn.pdf (last visited Feb. 2, 2015) (explaining the issues that affect FLPs and LLCs).

102. *See* Bourland, *supra* note 95.

103. *See id.*

104. *See* Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return (2014), *available at* http://www.irs.gov/pub/irs-pdf/f706.pdf.

Form 706 cannot be revalued due to a prior, adequately disclosed gift.[105] This would set the stage for a reasonable dialogue between the IRS and the estate's representative as to the scope of the estate tax audit.[106]

C. Judicial Action

As previously mentioned, there appears to be no economic disincentive for the IRS to simply continue its audits in the same way.[107] As such, it is very possible that none of the legislative or administrative remedies above will be undertaken any time soon.[108] Maybe it is time for practitioners to consider planning on a previously unused (or underutilized) argument: courts should interpret section 2001(f) in a way to prevent the IRS from applying section 2036 in certain estate tax FLP audits.[109]

More precisely, the authors' position is that courts should preclude the IRS from asserting section 2036 in an estate audit to challenge the value of previously disclosed gifts or sales after the applicable three-year statutory period expires.[110] This assumes the prior gift or sales transactions were adequately disclosed (within the meaning of section 6501(c)(9) of the IRC and Treasury Regulation section 301.6501(c)-1(f)(2)) to the IRS on Form 709.[111] Certain exceptions to our position are noted below.[112]

The foundation for this argument rests on the conjunction of a few statutes: sections 2036(a), 6501(c), and 2001(f).[113]

VI. GIFT TAX STATUTE OF LIMITATIONS

Since the enactment of sections 2001(f) and 2504(c), the gift tax statute of limitations will run if the transaction in question has been adequately disclosed "in a manner adequate to apprise the Secretary of the nature of [the] item."[114] As explained below, adequate disclosure requires compliance with

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105. *Id.*

106. *See id.*

107. *See supra* Part II.

108. *See supra* Part V.A–B.

109. The authors are not aware of any court confirming this position. Our informal discussions with the IRS representatives indicate that their position is that section 2001(f) does not prevent raising section 2036. We welcome counsel to contact us if they have raised the section 2001(f) argument in any court briefs.

110. *See generally* I.R.C. § 2036 (2012).

111. *See id.* § 6501(c)(9); Treas. Reg. § 301.6501(c)-1(f)(2) (as amended in 2015); *see also* Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return (2014), *available at* http://www.irs.gov/pub/irs-pdf/f709.pdf (providing necessary information required by the IRS concerning gift tax returns). In certain cases involving intra-family transactions occurring in the "ordinary course of business" the disclosure requirement is satisfied if each party reports the transaction on his income tax return. *See* Treas. Reg. § 301.6501(c)-1(f)(4).

112. *See infra* Part VIII.

113. *See* I.R.C. §§ 2036(a), 6501(c), 2001(f) (2012).

114. *Id.* § 2001(f).

certain formalities.[115] All told, sections 2001(f) and 2504(c) work together to prevent the IRS from taking a "second cut" at revaluing an adequately disclosed transaction, as was the IRS's policy before adding these statutes in 1997.[116]

Note that these statutes were enacted to prevent two things from occurring in the case of an adequately disclosed gift: (1) any additional transfer tax liability after the statute of limitations has run; and (2) any revaluation of the adequately disclosed gift.[117]

The Treasury regulations confirm that the inability to revalue an asset subsumes all legal positions that the IRS would extend to revalue the gift.[118] The regulations expressly prevent the IRS from making adjustments with respect to "all issues relat[ed] to the gift"—including valuation issues and legal issues.[119] This must inherently include valuation issues under section 2036.[120]

The Treasury determined that allowing these adjustments to the legal issues was "contrary to Congressional intent in enacting section 2001(f) and amending section 2504(c) to provide a greater degree of finality with respect to the gift and estate tax statutory scheme."[121] Therefore, the "final regulations preclude adjustments with respect to *all issues* related to a gift once the gift tax statute of limitations expires with respect to that gift."[122] Accordingly, the initial proposed regulations disallowed "adjustments involving all issues relating to the gift, including valuation issues and *legal issues involving the interpretation of the gift tax law*."[123]

The authors' argument is quite straightforward: there is no logical way for the IRS to bring FLP assets back into an estate without effectively revaluing a previously (and adequately) disclosed gift in express violation of

115. *See id.* §§ 2001(f), 2504(c).

116. *See* Treas. Reg. §§ 20.2001-1 (as amended in 1999), 25.2504-2 (as amended in 1999); *see also* T.D. 8845, 1999-51 I.R.B. 683.

117. *See* T.D. 8845.

118. *See* Treas. Reg. §§ 20.2001-1, 25.2504-2. Care must be taken so that the "perceived abuse" doesn't simply shift to a battle over whether or not adequate disclosure has taken place. *See, e.g.*, Estate of Hazel Hicks Sanders v. Comm'r, 107 T.C.M. (CCH) 1493 (2014). In that case, the taxpayer made a series of disclosed gifts over several years. The IRS asserted section 2036. Judge Kroupa, unfortunately, denied summary judgment in favor of the taxpayer as to whether the disclosed discounted gifts were adequately disclosed, because the IRS asserted that a subsidiary was not disclosed (as required under the adequate disclosure regulations). The subsidiary in question did not have any material revenues.

119. *See* Treas. Reg. § 25.2504-2(b).

120. *See* I.R.C. § 2036(a) (2012).

121. T.D. 8845.

122. *Id.* (emphasis added). To accomplish this, the Treasury added the sentence: "The rule of this paragraph (b) applies to adjustments involving all issues relating to the gift, including valuation issues and legal issues involving the interpretation of the gift tax law." *Id.*

123. *Id.* (emphasis added).

section 2001(f).[124] This is exactly the kind of perceived abuse Congress was trying to prevent in 1987.[125]

Certain exceptions to the authors' contention are noted below.

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124. *See* I.R.C. § 2001(f) (2012). The is because of the parenthetical language in section 2036, which provides that it applies "except in cases of a bona fide sale for an adequate and full consideration in money or money's worth." *Id.* § 2036. Please note that the authors do not intend to prevent the IRS from auditing FLPs. We simply contend that (in the case of a discounted FLP gift or sale transaction that was adequately disclosed on a gift tax return) the audit should occur generally within three years from the date of the applicable gift tax return, rather than what could be many years later on an estate return.

125. Even before section 2001(f) was added to the IRC, case law addressed whether the IRS could revalue a gift for purposes of determining estate tax liability once the gift tax statute of limitations had run. Admittedly, such case law was mixed. One of the first cases to address the issue was *Boatman's First National Bank v. United States*, which held that the Commissioner was not permitted to revalue the gifts when computing the estate tax because section 2504(c) implicitly precluded it. *See* Boatmen's First Nat'l Bank of Kan. City v. United States, 705 F. Supp. 1407, 1413 (W.D. Mo. 1988). The court reasoned:

> For instance, plaintiff argues, if Internal Revenue can increase the gift value on line 4, it necessarily must increase the line 7 gift tax on that value. However, under Section 2504(c), the gift tax cannot be recomputed after the limitations period expires. If the tax cannot be recomputed (that is, raised) to reflect the higher value on line 4, then the previously paid gift tax amount is entered. That amount, when subtracted from the tentative tax, would leave a higher estate tax due than if the gift value had not been increased. The effect would be to tax the estate on the amount by which the gift allegedly was undervalued.
>
> By this means, Internal Revenue effectively would have taxed the gifts (actually, the amount of higher gift value which had not already been taxed) again. Thus, even though Internal Revenue is not permitted to revalue and assess a gift tax after three years expires, it would have done so in figuring the estate tax. Internal Revenue would have done indirectly what it could not do directly. This approach, in practice, would extend the statutory limitations period on gift valuation indefinitely, limited only by how long the donor survived after giving a gift. Congress could not have intended this, in light of its clearly established three-year limitation.

However, many courts after 1988, but before the enactment of section 2001(f) in 1997, disagreed with the *Boatman* holding. *See, e.g.*, Evanson v. United States, 30 F.3d 960, 963 (8th Cir. 1994); Stalcup v. United States, 792 F. Supp. 714, 717–18 (W.D. Okla. 1991); Estate of Prince v. Comm'r, 61 T.C.M. (CCH) 2594, *aff'd sub nom.*, Levin v. Comm'r, 986 F.2d 91, 93 (4th Cir. 1993); Estate of Smith v. Comm'r, 94 T.C. 872, 878 (1990). These cases were decided before Congress expressed a desire in the 1997 legislative history to prevent gifts from being revalued during the estate tax calculation. H.R. REP. NO. 105-220 at 408 (1997) ("The House bill provides that a gift for which the limitations period has passed cannot be revalued for purposes of determining the applicable estate tax bracket and available unified credit"); S. REP. NO. 105-174 at 160 (1998) ("The valuation of a gift becomes final for gift tax purposes after the statute of limitations on any gift tax assessed or paid has expired. The 1997 Act extended that rule to apply for estate tax purposes. . ."). Treasury Decision 8845 explains that under both the proposed and the final regulations "if a transfer is adequately disclosed on the gift tax return, and the period for assessment of gift tax has expired, then the IRS is foreclosed from adjusting the value of the gift under section 2504(c) (for purposes of determining the current gift tax liability) and under section 2001(f) (for purposes of determining the estate tax liability)." T.D. 8845, 1999-51 I.R.B. 683. Thus, the statutory history and regulatory notes reflected the desire of Congress and the Treasury, respectively, to have the reasoning of *Boatman* (i.e., limiting the ability to revalue disclosed gifts once the statute of limitations has run) apply to post-1997 gifts.

VII. FULL AND ADEQUATE DISCLOSURE RULES

Generally, this article assumed that the applicable gift or sale of an FLP interest (i.e., the FLP interest of a general partner or a limited partner) was adequately disclosed. Accordingly, we must briefly review the requirements of adequate disclosure pursuant to section 6501 of the IRC.[126] The adequate disclosure rules do not apply to the following transactions: (1) the adequate disclosure rules (for this purpose) apply only with respect to taxable gifts made on or after August 6, 1997; and (2) the adequate disclosure rules will not apply in situations involving false returns or in cases where one willfully attempts tax evasion.[127] Therefore, the authors agree that the IRS can raise section 2036 as an issue on an estate tax return in such cases (i.e., even if the gift or sale transaction is otherwise considered adequately disclosed).[128]

The rules to satisfy adequate disclosure of gifts are largely set forth in Treasury Regulation section 301.6501(c)-1(f).[129] A gift is considered adequately disclosed on a gift tax return if the return includes the following information:

1. A description of the property transferred and a description of any consideration received in exchange;
2. The identities of the transferor and the transferee;
3. If the transferor will transfer the property into a trust (like a DGT), the trust's TIN, and a brief description of the trust's terms (or a copy of the trust);
4. A detailed description of the method used to compute the value of the gift (or alternatively, a qualified appraisal); and
5. A statement describing any position taken that is contrary to any Treasury regulations or IRS rulings.[130]

While a detailed analysis of adequate disclosure is beyond the scope of this article, three additional aspects of the adequate disclosure rules are relevant to FLP situations for purposes of this article.[131] First, section 301.6501(c)-1(f)(4) provides that transfers to family in the ordinary course of business are considered adequately disclosed (even if the transfer is not reported on a gift tax return) if all parties properly report the transfer for income tax purposes.[132] Applying this to a typical FLP means that if an FLP

126. *See* I.R.C. § 6501 (2012).

127. Treas. Reg. §§ 20.2001-1(a), (f) (as amended in 1999), 301.6501(c)-1(a)–(b) (as amended in 2015).

128. *See id.* §§ 20.001-1(a), (f), 301.6501(c)-1(a)–(b). This admittedly sets up something of a "catch 22" in that the IRS would want to be able to request, and audit, all documents relating to the FLP in order to see if any fraud was involved; the authors contend that unless there is some other reason to suspect fraud, the scope of an FLP audit once the statute has run for gift tax purposes should be extremely limited.

129. *See id.* § 301.6501(c)-1(f).

130. *Id.* § 301.6501(c)-1(f)(2)(i)–(v).

131. *See id.* § 301.6501(c)-1(f)(4)–(5), (7).

132. *Id.* § 301.6501(c)-(1)(f)(4).

is set up and properly files partnership returns, as long as the proper Forms K-1 were filed, the IRS (attempting to apply section 2036 on an estate return) is prevented from arguing any change in value (or from applying section 2036) after the applicable statute of limitations has run.[133] This is particularly helpful if the parent was receiving any kind of guaranteed payment or other payments from the FLP, as long as the payments were properly reported.[134]

Second, section 301.6501(c)-1(f)(5) provides that the statute will run for reported gifts that are subsequently found to constitute incomplete gifts for gift tax purposes (as long as the transfer is adequately disclosed on a gift tax return).[135] This would prevent the IRS from asserting section 2036 against an estate in which, for example, the IRS argues that the decedent could "designate" the persons who could enjoy the benefits of the FLP, by somehow retaining a right (perhaps along with other partners) of when distributions could be made from the partnership.[136]

Third, section 301.6501(c)-1(f)(7), examples 4 and 5 confirm the finality of value in the case of an adequately disclosed transfer of a discounted FLP interest.[137]

A. Application of Adequate Disclosure Rules to Examples

Section 2001(f) was intended to provide finality in cases in which a gift was made and adequately disclosed to the IRS.[138] In each of the examples discussed above, the gift or sale (at a discount) was adequately described on a gift tax return.[139] However, in each case (as applied to our real life situations), the IRS asserted section 2036, and argued that the IRS should bring the value of the FLP's assets back into the decedent's estate because the decedent retained an interest in the FLP.[140] The IRS argued that section 2036 could both eliminate the discount on the estate's retained 50% interest and could (essentially) reach back to 2005 to bring in the entire value of the 2005 gifted (or sold) 50% interest into the estate.[141]

In the first example, the gift was adequately described in 2005 so the statute of limitations has clearly run.[142] The FLP's property increased in value to $40 million.[143] The IRS, claiming that the decedent (who retained

133. *Id.* This might be the case, for example, where a gift was disclosed, but the actual tax return did not include everything necessary to constitute adequate disclosure—the partnership returns might serve to constitute adequate disclosure in such instance.

134. *See id.*

135. *Id.* § 301.6501(c)-1(f)(5).

136. *See id.*

137. *See id.* § 301.6501(c)-1(f)(7), ex. 4–5.

138. *See id.* § 20.2001-1(f) (as amended in 1999).

139. *See supra* Part III.A.

140. *See supra* Part III.A; I.R.C. § 2036 (2012).

141. *See supra* Part III.A; I.R.C. § 2036.

142. *See supra* Part III.A.1; I.R.C. § 2001(f).

143. *See supra* Part III.A.1.

the same 50% limited partner interest since 2005) retained a section 2036 interest, argued that the $40 million property value should be included in the decedent's estate. The IRS simply disregarded the section 2001(f) argument. However, how is the IRS's position possible without violating the tenant of "non-revaluation" of a previously disclosed gift under section 2001(f)? In the end, to avoid the ongoing, costly dispute, the taxpayer settled in audit.

Looking at this example more closely, the $6.5 million gift was adequately disclosed in 2005, the partnership timely filed partnership tax returns every year, and the 50% limited partnership interest that remained in the estate received the same 35% discount (only by the time of the decedent's death, the value had doubled to $13 million).[144] In this case, by arguing section 2036, the IRS not only wanted the 50% estate position valued at no discount ($20 million), but it also wanted to reach into the FLP and include some or all of the assets relating to the 2005 gifted 50% position in the estate. The authors contend that the IRS should not be able to reach back to the 2005 transfer under section 2001(f), and the authors would like to eventually see case law support this position.[145]

Furthermore, the IRS should not have the authority to conduct an extensive document request going back as far as 2005 in connection with the FLP. Instead, the IRS's audit of the decedent's estate tax return should end with the valuation issues involved with the estate's remaining 50% partnership position.[146] If the estate tax return includes a qualified appraisal, an audit centered on the discount factors present in that appraisal report only would greatly limit audit expenses at that time.[147]

Conceptually, section 2001(f) must operate to prevent section 2036 from being used. Otherwise, the IRS could *always* circumvent section 2001(f) by simply asserting section 2036.[148]

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144. *See supra* Part III.A.1; I.R.C. § 2036.

145. An award of attorneys' fees against the IRS for violating section 2001(f) would certainly bring this argument to the IRS's attention. There are many variations to this argument. One possible argument is that, once the gift is disclosed, the IRS should not argue section 2036 (once the statue runs) even if facts are subsequently changed so that the decedent retains some kind of invalid interest in the partnership. However, this argument seems extreme. The authors strongly feel that if a gift (and FLP) is adequately disclosed, and assuming no intervening "bad" facts or changes, the IRS should be precluded from asserting section 2036 as to an adequately disclosed gift, even if the IRS, for example, determines that provisions in the original partnership agreement would enable the transferor to retain an invalid interest. Basically, the IRS should have three years to question items in the original partnership agreement in such cases. After that, the IRS should not assert section 2036 even as to any retained interest in the estate. Applied to the facts of the first example, if the IRS had received a copy of the partnership agreement as part of the 2005 gift tax return, the IRS should be precluded from asserting section 2036 issues stemming therefrom (even as to the estate's retained 50% position) because the IRS should have raised any section 2036 concerns (as to the partnership agreement) within three years from the 2005 gift tax return.

146. *See* I.R.C. §§ 2036, 2001(f) (2012).

147. *See id.* §§ 2036, 2001(f).

148. *See id.* §§ 2036, 2001(f).

B. Application of Rules to Bona Fide Sale for Full and Adequate Consideration

Section 2036(a) includes an important exception.[149] If property is transferred by way of a bona fide sale for "adequate and full consideration," then section 2036 does not apply.[150]

In the second example, a gift tax return would not have been required because the transfer (assuming the $6.5 million did represent full and adequate consideration) was a *sale*, rather than a *gift*.[151] In such an instance, however, the authors recommend the taxpayer file a gift tax return and disclose the sale transaction. In fact, the author's firm did disclose such a sale, and the IRS nonetheless asserted section 2036 in an attempt to revalue the interest that the firm sold.

Section 2001(f) should apply in the adequately disclosed transaction whether a gift or sale occurred.[152] The logic is the same as above. There is simply no way for the IRS to increase the value of the estate's retained 50% position without revaluing the 2005 sale transaction.

The third example above involves a sale transaction followed by a series of gifts forgiving the related promissory note.[153] In this case, the gift tax return disclosed the original sale as well as each annual note forgiveness.[154] All of the section 2001(f) limits should bind the IRS, and the IRS should not use section 2036 to bring the value of the sold or forgiven items back into the estate.[155]

VIII. EXCEPTIONS WHERE THE SECTION 2001(F) ARGUMENT SHOULD NOT APPLY

The argument set forth in this article—that adequately disclosed FLP gift or sale transactions should preclude IRS examination under section 2036 once the statute has run—should not apply in certain situations.[156] One such case where the protection afforded under section 2001(f) should not apply is in situations where a gift or sale was adequately disclosed, but when actions

149. *See id.* § 2036(a).

150. *Id.*

151. *See supra* Part III.A.2.

152. *See* I.R.C. § 2001(f). The value of an adequately disclosed transaction is solidified once the statute of limitations runs. Accordingly, it must be construed to constitute full and adequate consideration. Any other interpretation would render section 2001(f) useless. The IRS must be precluded from arguing that there was somehow insufficient consideration once the statute runs.

153. *See supra* Part III.A.3.

154. *See supra* Part III.A.3.

155. *See* I.R.C. §§ 2001, 2036.

156. *See id.* § 2036.

are taken by the taxpayer that substantially modify the disclosed gift or sale.[157]

Once a gift of a limited partnership interest is adequately disclosed and the three-year statute of limitations period has run, the value should generally be considered "set in stone" and arranged as a bona fide sale for full and adequate consideration for purposes of section 2036.[158] However, what if the partnership agreement is subsequently amended so that the decedent retains the general partner interest (thereby retaining control over the partnership)? In such cases, it would appear the underlying nature of the gift has changed, so the limitation under section 2001(f) should not apply.[159]

Additional situations include many of the things that the courts view as problematic.[160] For example, if the transferor/decedent subsequently transfers a personal residence to the FLP without paying rent or subsequently transfers a large majority of assets to the FLP, such situations would negate the protection under section 2001(f).[161]

Counsel should report such major changes on a subsequent gift tax return to start a new three-year limit.[162] This is also an area where some simple changes to a partnership return would make administration much easier.[163] Consider asking whether there is any material modification to the partnership agreement that would impact a section 2036 case?[164]

IX. CONCLUSION

Around the country, there are dozens of FLP/section 2036 audits in process.[165] Right now, these audits are likely costing the government and the taxpayer extraordinary costs and fees that, with some simple legislative or regulatory changes, could be eliminated. While this article simply gives suggestions as to how this process can be streamlined, it will be up to the parties involved, the different branches of government, practitioners, and clients to work together to make a better system.

Currently, practitioners have less incentive to adequately disclose FLP transactions because adequate disclosure (in the IRS's mind) does not prevent the IRS from asserting section 2036 on an estate return to effectively unwind

157. *See id.* § 2001(f).
158. *See id.* § 2036(a)–(c).
159. *Id.* § 2001(f).
160. *See id.*; Treas. Reg. § 301.6501(c)-1 (as amended in 2015).
161. *See* I.R.C. § 2001(f); Treas. Reg. § 301.6501(c)-1; Strangi v. Comm'r, 417 F.3d 468 (5th Cir. 2005).
162. *See* I.R.C. § 2001(f); Treas. Reg. § 301.6501(c)-1; *Strangi*, 417 F.3d at 475. The authors suggest that section 2001(f) should preclude all adequately disclosed transactions once the statute of limitations has run. In the case of subsequent changes, each adequately disclosed change would start its own three-year statute.
163. *See* I.R.C. § 2001(f).
164. *See id.* § 2036(a)–(c).
165. *See supra* Part II.

any discount.[166] Congress must not have intended this result when it added section 2001(f).[167] The IRS should review its rules or perhaps issue a general counsel memo to clarify that, in cases where a taxpayer has behaved properly, the IRS should not re-examine a previously reported and adequately disclosed transaction.[168]

In the long term, legislative or regulatory guidance or relief would be very helpful to practitioners.[169] In the meantime, counsel should strongly assert section 2001(f), when possible. Eventually, this argument will gain some traction, which could lead to some favorable cases to prevent potentially abusive future section 2036 audits.

166. *See supra* Part VII.A–B.
167. *See* I.R.C. § 2001(f); *see also supra* Part XI.
168. *See supra* Part V.B.
169. *See supra* Part V.A–B.