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# FAMILY LIMITED PARTNERSHIP FORMATION: DUELING DICTA

MITCHELL M. GANS AND JONATHAN G. BLATTMACHR\*

## INTRODUCTION

In attempting to limit the use of family limited partnerships as a transfer-tax strategy, the Internal Revenue Service (IRS) has advanced several arguments.<sup>1</sup> The courts, however, have not been entirely receptive. For example, the IRS has not had any success with the argument that a partnership formed without a sufficient business purpose must automatically be disregarded for transfer-tax purposes.<sup>2</sup> As a result, partnerships formed for tax-driven reasons remain a viable estate-planning strategy. Nonetheless, the IRS has enjoyed some important successes with two arguments.

The first argument, a gift-tax argument, stems from the indirect gift regulation.<sup>3</sup> Under the regulation, the contribution of an asset to an entity is treated as an indirect gift of the asset to those who own an interest in the

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<sup>1</sup> For example, in *Estate of Strangi v. Commissioner*, 115 T.C. 478 (2000), *aff'd in part, rev'd in part*, 293 F.3d 279 (5th Cir. 2002), the IRS argued that the family limited partnership should be disregarded on the ground that the decedent did not have a business purpose for creating it, *id.* at 484; that the same result should be obtained under I.R.C. section 2703 or section 2036, *id.* at 487; and that a taxable gift occurred in connection with the partnership's formation, *id.* at 489. In *Hackl v. Commissioner*, 335 F.3d 664, 667 (7th Cir. 2003), the IRS successfully denied the annual exclusion for the gift of an interest in a limited liability company (LLC) because of restrictions on transferability. Finally, in *Smith v. United States*, No. 02-264, 2005 WL 3021918, at \*2, \*5 (W.D. Pa. July 22, 2005), the IRS successfully invoked section 2703 to deny an enhanced marketability discount claim for a right of first refusal with respect to the partnership unit that was the subject of a gift.

<sup>2</sup> See *Estate of Strangi*, 115 T.C. at 486-87; see also *Knight v. Comm'r*, 115 T.C. 506, 513-14 (2000). *But see* *Estate of Bongard v. Comm'r*, 124 T.C. 95, 126 n.11 (2005) (noting that the IRS had not argued that the partnership should be disregarded under sections 7701 or 701).

<sup>3</sup> See *Treas. Reg. § 25.2511-1* (2006).

entity.<sup>4</sup> When the regulation applies, the value of the gift is determined on an “undiscounted” basis: the existence of the entity is disregarded for purposes of valuing the gift.<sup>5</sup>

The second argument, an estate-tax argument, derives from I.R.C. section 2036.<sup>6</sup> Under section 2036, if the decedent retains access to or control over the assets contributed to the partnership, the entity may be disregarded for estate tax purposes.<sup>7</sup> This argument, however, is subject to a critical exception: if the estate can demonstrate that the decedent had a sufficient non-tax purpose for forming the entity, then the entity is not disregarded, despite the decedent’s retention of access or control (provided the decedent had received full consideration in contributing the assets to the entity).<sup>8</sup>

Even though taxpayers may be able to defeat both of these arguments with careful planning,<sup>9</sup> the section 2036 argument presents planners with a

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<sup>4</sup> See *id.*

<sup>5</sup> See *Senda v. Comm’r*, 433 F.3d 1044, 1046 (8th Cir. 2006) (“[T]ransfers of property by gift, by whatever means effected [either direct or indirect], are subject to the federal gift tax.” These gifts should be valued at “full undiscounted value.”).

<sup>6</sup> I.R.C. § 2036 (2000).

<sup>7</sup> See *Estate of Strangi v. Comm’r*, 85 T.C.M. (CCH) 1331, 1336, 1344–45 (2003), *aff’d*, 417 F.3d 468 (5th Cir. 2005) (invoking section 2036 to foreclose discount on the ground that the decedent retained an interest in the assets contributed to the partnership); see also Mitchell M. Gans & Jonathan G. Blattmachr, *Strangi: A Critical Analysis and Planning Suggestions*, 100 TAX NOTES 1153, 1154 (2003) (explaining that, in *Strangi*, because the Tax Court found that section 2036 applied, the partnership form was ignored, and no discount based on the existence of the partnership was permitted for estate tax purposes).

<sup>8</sup> See, e.g., *Estate of Rosen v. Comm’r*, 91 T.C.M. (CCH) 1220, 1231–32 (2006); *Estate of Abraham v. Comm’r*, 408 F.3d 26, 37 (1st Cir. 2005), *cert. denied*, 126 S. Ct. 2351 (2006); *Estate of Bigelow v. Comm’r*, 89 T.C.M. (CCH) 954, 960 (2005); *Estate of Bongard v. Comm’r*, 124 T.C. 95, 113–15 (2005); *Estate of Korby v. Comm’r*, 89 T.C.M. (CCH) 1142, 1148 (2005); *Estate of Schutt v. Comm’r*, 89 T.C.M. (CCH) 1353, 1364 (2005); *Estate of Strangi v. Comm’r*, 417 F.3d 468, 478–80 (5th Cir. 2005); *Estate of Thompson v. Comm’r*, 382 F.3d 367, 378 (3d Cir. 2004).

<sup>9</sup> For example, as we have previously suggested, it may be possible to defeat section 2036 by adopting a structure that leaves the transferor with no interest in the partnership. See Gans & Blattmachr, *supra* note 7. To illustrate, assume a husband forms a limited partnership to which he makes an insubstantial contribution for the limited partnership interests; he might own the general partnership interest through an LLC that he owns and the limited partnership units directly. If his wife were to contribute her assets to the partnership as a gift and not receive an interest in the partnership in exchange, then section

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more difficult challenge and, therefore, is the more potent of the two. Indeed, taxpayers aware of the indirect-gift argument may easily defeat it, even though the Eighth Circuit's recent decision in *Senda v. Commissioner* strengthened the argument. Because we have previously written about the section 2036 argument,<sup>10</sup> this Article focuses on the indirect-gift argument—specifically, how *Senda* has reshaped it, and how taxpayers may alter the entity-formation process to defeat it.

Until the Eighth Circuit's recent decision in *Senda*, the IRS had not been very successful in the courts with its gift-tax approach to family limited partnerships.<sup>11</sup> Even though the IRS prevailed in the Eleventh

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2036 would not apply to her estate at her later death because she did not retain access or control with regard to the partnership's assets. *See id.* Nor could section 2036 apply to the husband's estate (except for his insubstantial contribution to the partnership) because he was not the transferor within the meaning of section 2036 with respect to the partnership's assets. In other words, section 2036 cannot apply unless the person making the transfer retains access or control. *See* Mitchell M. Gans, Jonathan G. Blattmachr & Stephanie E. Heilborn, *Some Good News About Grantor Trusts: Rev. Rul. 2004-64*, EST. PLAN., Oct. 2004, at 467, 474; *cf.* *Estate of Gutches v. Comm'r*, 46 T.C. 554, 556–57 (1966) (indicating that section 2036 may not apply where a spouse transfers the home to the other spouse and is allowed to continue residing in it). *But see* *Estate of McCabe v. United States*, 475 F.2d 1142, 1146–47 (Ct. Cl. 1973) (applying section 2036 to the grantor of a trust, even though he was not a beneficiary, where he in fact received distributions with the consent of his wife, the beneficiary). Finally, because of the marital deduction, the wife's gift to the partnership would not result in a taxable gift. *See* Rev. Rul. 71-443, 1971-2 C.B. 338, 338. For further discussion of this arrangement, see Gans & Blattmachr, *supra* note 7, at 1167.

<sup>10</sup> *See* Mitchell M. Gans, *Deference and Family Limited Partnerships: A Case Study*, in 39 ANN. HECKERLING INST. ON EST. PLAN. 5-1, 5-8 to -9, 5-20 to -22 (Tina Portuondo ed., 2005). *See generally* Gans & Blattmachr, *supra* note 7.

<sup>11</sup> *See, e.g.*, *Estate of Strangi v. Comm'r*, 115 T.C. 478, 486–87 (2000), *aff'd in part, rev'd in part*, 293 F.3d 279 (5th Cir. 2002) (rejecting the IRS's gift-on-formation argument); *Knight v. Comm'r*, 115 T.C. 506, 513–14 (2000). This is to be contrasted with the IRS's many successes in applying section 2036 in the family limited partnership context. *See, e.g.*, *Estate of Abraham*, 408 F.3d at 37–39; *Estate of Bongard*, 124 T.C. at 131; *Estate of Strangi*, 417 F.3d at 478; *Estate of Thompson*, 382 F.3d at 376. It is also to be contrasted with the IRS's success in invoking 26 U.S.C. § 2703 to limit the amount of marketability discount claimed in connection with the gift of an interest in a family entity. *See* *Smith v. United States*, No. 02-264, 2005 WL 3021918, at \*2, \*5–6 (W.D. Pa. July 22, 2005). *But cf.* *Hackl v. Comm'r*, 335 F.3d 664, 667–68 (7th Cir. 2003) (denying the annual exclusion for the gift of an interest in an LLC because of restrictions on transferability).

Circuit in *Shepherd v. Commissioner*<sup>12</sup> and in the Tax Court in *Senda*,<sup>13</sup> taxpayers could easily navigate these IRS victories through proper planning.<sup>14</sup> Dicta in the Eighth Circuit's decision in *Senda*, which ironically conflicts with dicta in the Eleventh Circuit's decision in *Shepherd*,<sup>15</sup> has added a new wrinkle that will force taxpayers to rethink the partnership-formation process. The *Senda* dicta may make the formation process somewhat more complicated, but it likely will not make the IRS's gift-tax arguments any more effective against savvy taxpayers.

### IRS'S GIFT-TAX ARGUMENTS

The IRS's gift-tax approach with respect to family limited partnerships has had two strands: a gift-on-formation argument and an indirect-gift argument. Under the gift-on-formation theory, the IRS claims that when a contribution of assets is made to a limited partnership in exchange for a limited unit, the person making the contribution depletes his estate by an amount equal to the discount inherent in the limited partnership unit received in the exchange; the taxable gift is equal to the amount of the depletion.<sup>16</sup> To illustrate, if a taxpayer contributes \$10,000,000 to a partnership and, in return, receives a limited partnership interest having a lesser value of, say, \$7,000,000 because of lack of control, lack of marketability, or other discounts, a taxable gift of \$3,000,000 is deemed to occur under the gift-on-formation theory.<sup>17</sup>

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<sup>12</sup> See 115 T.C. 376, 389 (2000), *aff'd*, 283 F.3d 1258 (11th Cir. 2002).

<sup>13</sup> See 88 T.C.M. (CCH) 8, 11–12, *aff'd*, 433 F.3d 1044 (8th Cir. 2006).

<sup>14</sup> See, e.g., Wendy C. Gerzog, *Return to Senda: Order Determinative for FLP Discounts*, 110 TAX NOTES 791 (2006).

<sup>15</sup> See *Shepherd v. Comm'r*, 283 F.3d 1258, 1261 (11th Cir. 2002).

<sup>16</sup> For a discussion of the origin of I.R.S. Tec. Adv. Mem. 98-42-003 (July 2, 1998), where the IRS first articulated this theory, see Leo L. Schmolka, *FLPs and GRATs: What To Do?*, 86 TAX NOTES 1473 (2000). See also Laura E. Cunningham, *Remember the Alamo: The IRS Needs Ammunition in its Fight Against the FLP*, 86 TAX NOTES 1461, 1468–69 (2000). The theory could also apply to the formation of a limited liability company. *Id.* at 1468.

<sup>17</sup> See Cunningham, *supra* note 16, at 1469.

Originally conceived in the corporate context,<sup>18</sup> the gift-on-formation theory has not fared well in the partnership setting. The Tax Court,<sup>19</sup> the Fifth Circuit,<sup>20</sup> and the Third Circuit<sup>21</sup> (in dicta) have rejected it. On the rationale that a shift in wealth does not occur where a taxpayer makes a contribution to a partnership that is credited to her own capital account, the courts have thus far uniformly refused to apply the theory in the case of a partnership.<sup>22</sup> Aware of this developing consensus in the courts, many

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<sup>18</sup> Courts have held that where a contribution is made to a corporation in exchange for preferred stock or non-voting common stock, a taxable gift is made to the extent the value of the stock received is less than the value of the asset contributed. *E.g.*, *Kincaid v. United States*, 682 F.2d 1220, 1224 (5th Cir. 1982); *Estate of Bosca v. Comm'r*, 76 T.C.M. (CCH) 62, 69 (1998); *Estate of Trenchard v. Comm'r*, 69 T.C.M. (CCH) 2732, 2733 (1995); *Lewis G. Hutchens Non-Marital Trust v. Comm'r*, 66 T.C.M. (CCH) 1599, 1611 (1993).

<sup>19</sup> *See Estate of Jones v. Comm'r*, 116 T.C. 121, 128 (2001); *Estate of Strangi v. Comm'r*, 115 T.C. 478, 489–90 (2000), *aff'd in part, rev'd in part*, 293 F.3d 279 (5th Cir. 2002); *Knight v. Comm'r*, 115 T.C. 506, 514 (2000).

<sup>20</sup> *See Estate of Strangi v. Comm'r*, 293 F.3d 279, 282 (5th Cir. 2002).

<sup>21</sup> *See Estate of Thompson v. Comm'r*, 382 F.3d 367, 385 (3d Cir. 2004) (intimating in a two-judge concurring opinion that no taxable gift occurs on account of such depletion).

<sup>22</sup> In the corporate context, a contribution to the corporation in exchange for voting common stock appears not to trigger a taxable gift merely because the value of the stock received in the exchange is, by reason of marketability or minority discount, less than the value of the contributed asset. In *Kincaid*, 682 F.2d 1220, the government tacitly conceded this point—it chose not to assert a gift tax deficiency on account of the discount inherent in the common stock. In *Shepherd v. Commissioner*, the Tax Court, citing its earlier decision in *Gross v. Commissioner*, 7 T.C. 837 (1946), suggested that in the case of a general partnership a contribution should not result in a taxable gift if it is credited to the capital account of the person making the contribution. 155 T.C. 376, 389 (2000). This is somewhat similar to the government's approach in *Kincaid*: no gift on a contribution in exchange for an interest in an entity carrying a reduced value by reason of discount. 682 F.2d at 1226. In *Strangi*, the court extended this approach to limited partnerships. 115 T.C. at 490. Thus, under *Strangi*, a taxpayer who makes a contribution of an asset to a limited partnership in exchange for a limited unit is not treated as having made a taxable gift, because the discounted value of the unit is worth less than the value of the contributed asset, as long as the contribution is credited to the taxpayer's capital account and it does not enhance the interest of any other partner. *See id.* Although the *Strangi* court also emphasized the fact that the taxpayer had owned (directly or indirectly) approximately 95.5% of the partnership units and that there was therefore no meaningful donee, *id.* at 486, the Tax Court has invoked *Strangi* to reject a gift-on-formation argument even where others held a meaningful interest in the partnership. *See Estate of Jones*, 116 T.C. at 128. It is noteworthy, however, that in *Jones* the parent had the ability to force liquidation of the partnership immediately after its formation. *Id.* at 135. Although the court did not allude to

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practitioners have concluded that there is little, if any, need for continuing concern about the gift-on-formation theory in connection with partnership formation.<sup>23</sup>

### A. Indirect-Gift Argument

Courts, however, have been receptive to the indirect-gift theory.<sup>24</sup> In *Shepherd*, the parent contributed assets to the family partnership.<sup>25</sup> Half of the contribution was credited to the children's capital accounts.<sup>26</sup> Invoking Treasury Regulation section 25.2511-1(h)(1) (the indirect gift regulation),<sup>27</sup> the IRS maintained that the parent made an indirect gift in the amount credited to the children's capital accounts.<sup>28</sup> In other words, based on the regulation, the parent is treated as if he made the gift directly to the children, effectively ignoring the existence of the partnership for gift tax purposes.<sup>29</sup> The Tax Court embraced the argument,<sup>30</sup> and the Eleventh Circuit affirmed.<sup>31</sup> Ominously for the IRS, both the Tax Court and the Eleventh Circuit suggested in dicta that the result would have been different (i.e., a partnership-level discount would have been allowed) had the contribution been credited to the parent's capital account before the gift of the partnership interest to the children was made.<sup>32</sup> The dissenting opinion also endorsed this notion.<sup>33</sup>

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this fact in rejecting the IRS's gift-on-formation argument, *see id.* at 128, *Jones* could arguably be distinguished if the parent failed to retain such a liquidation right. Thus, a conservative taxpayer might want to adopt an arrangement that permits him to force liquidation immediately after formation.

<sup>23</sup> *See Gans, supra* note 10, at 5–9 (“[W]ell advised taxpayers ought to be able to avoid the IRS's gift-on-formation argument through the simple expedient of proper maintenance of the capital accounts.”).

<sup>24</sup> *See, e.g., Shepherd*, 115 T.C. at 389.

<sup>25</sup> *Id.* at 381.

<sup>26</sup> *See id.* at 380.

<sup>27</sup> *Id.* at 388.

<sup>28</sup> *Id.* at 384.

<sup>29</sup> Treasury Regulation section 25.2511-1(h)(1) (2006) provides that in the case of a contribution to a corporation, the contribution is treated as a gift made to the other shareholders, and thus the existence of the corporation is ignored for gift tax purposes. In *Shepherd*, this pierce-the-entity's-veil concept was applied to a partnership. *See Shepherd*, 115 T.C. at 388; *see also Shepherd*, 283 F.3d 1258 (2002).

<sup>30</sup> *See Shepherd*, 115 T.C. at 389.

<sup>31</sup> *Shepherd*, 283 F.3d at 1264.

<sup>32</sup> *See Shepherd*, 115 T.C. at 385; *Shepherd*, 283 F.3d at 1261.

<sup>33</sup> *Shepherd*, 283 F.3d at 1266 (Ryskamp, J., dissenting).

The *Shepherd* dicta threatened to undermine significantly the value of the court's holding to the IRS. If, for example, the documentation established that the contribution to the partnership occurred days or perhaps hours before the gift of limited units, then discount would presumably be permitted, according to the dicta.<sup>34</sup> As a result, *Shepherd* quickly came to be seen as a somewhat aberrational case in which a planning failure resulted in the taxpayer's defeat. Had the contribution to the partnership occurred immediately before the gift of the limited units, instead of immediately after the gift, the taxpayer would have prevailed.<sup>35</sup> *Shepherd* was thus perceived as nothing more than a cautionary tale about the need to sequence and document the contribution and gift properly.

This perception of *Shepherd* was borne out in *Estate of Jones v. Commissioner*.<sup>36</sup> In *Jones*, the father made a contribution to a limited partnership in exchange for limited partnership units.<sup>37</sup> Even though he made a gift of his limited units to his children immediately after contributing to the partnership,<sup>38</sup> the court upheld the discount and rejected the IRS's indirect-gift argument as well as its gift-on-formation argument.<sup>39</sup> The court distinguished *Shepherd*, emphasizing that, unlike *Shepherd*, the contribution had been credited to the father's capital account.<sup>40</sup> *Jones* in effect expanded the *Shepherd* dicta into a holding: proper sequencing (even if the parent makes the gift of the partnership interest immediately after the contribution to the partnership) precludes the IRS from invoking the indirect-gift argument as long as the partnership first credits the contribution to the contributing partner's capital account.<sup>41</sup>

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<sup>34</sup> See *id.* at 1261 (majority opinion).

<sup>35</sup> See *id.* Even the IRS agreed that discount would have been appropriate had the gift of the partnership interest followed the contribution of assets to the partnership. See *id.* at 1266 (Ryskamp, J., dissenting) (“*The parties agree* that if Mr. Shepherd . . . conveyed the property to the partnership . . . , and then gave his partnership interest to his sons . . . , the sons would receive gifts . . . , the valuation of which would take into account the . . . partnership.” (emphasis added)).

<sup>36</sup> See 116 T.C. 121, 128 (2001).

<sup>37</sup> *Id.* at 124.

<sup>38</sup> *Id.*

<sup>39</sup> See *id.* at 128. The Court did not consider the IRS's gift-on-formation argument. *Id.*

<sup>40</sup> *Id.* The court did not elaborate as to the circumstances in which such an enhancement in value might be deemed to occur. See *id.* Presumably, if a contribution were reflected in the parent's capital account but the income it generated were to be reflected in the children's capital accounts, the court would find a gift-taxable enhancement.

<sup>41</sup> See *id.*

*B. The Indirect-Gift Argument and the Eighth Circuit's Dicta in Senda*

In *Senda*, the Tax Court left intact this understanding of the *Shepherd* dicta and the decision in *Jones*.<sup>42</sup> In *Senda*, as in *Jones*, the contribution of assets to the partnership and the gift of limited units to the children occurred at approximately the same time.<sup>43</sup> The taxpayer relied on *Jones*, claiming that the contribution was properly reflected in his capital account, and therefore, the gift of the limited units should qualify for a discount.<sup>44</sup> The Tax Court, however, distinguished *Jones* and applied *Shepherd*,<sup>45</sup> denying a discount in computing the value of the gifted limited units.<sup>46</sup> According to the court, unlike *Jones*, *Senda* involved a sequencing failure: the taxpayer failed to prove that the contribution had been made to the partnership before the gift of the limited units.<sup>47</sup> In such circumstances, the gift and contribution “were integrated . . . and, in effect, simultaneous.”<sup>48</sup> The taxpayer, in other words, could not establish, as the *Shepherd* dicta required, that the contribution had preceded the gift.

The court also found that the taxpayer failed to prove that his contribution was properly credited to his capital account.<sup>49</sup> The implication is that, had the taxpayer carried his burden of proof on this factual issue, the court would have permitted a discount, despite the sequencing failure.<sup>50</sup> The implication is consistent with the notion in *Shepherd* that a contribution of assets that is credited to the contributing partner’s capital account cannot be viewed as a gift of those assets.

On the taxpayer’s appeal in *Senda*, the IRS sought to undo the *Shepherd* dicta, the *Jones* holding, and the *Senda* implication.<sup>51</sup> In its Eighth Circuit brief, the IRS made two critical arguments. First, it argued that the *Shepherd* dicta was just that—dicta—and should not be followed.<sup>52</sup> Second, it argued that the step-transaction doctrine was neither raised nor

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<sup>42</sup> See 88 T.C.M. (CCH) 8, 11 (2004), *aff’d*, 433 F.3d 1044 (8th Cir. 2006).

<sup>43</sup> *Id.*

<sup>44</sup> *See id.*

<sup>45</sup> *Id.*

<sup>46</sup> *See id.* at 12.

<sup>47</sup> *See id.* at 11.

<sup>48</sup> *Id.*

<sup>49</sup> *Id.*

<sup>50</sup> *See id.*

<sup>51</sup> *See infra* notes 52–54 and accompanying text.

<sup>52</sup> *See* Brief for the Appellee 28–29, *Senda v. Comm’r*, 433 F.3d 1044 (8th Cir. 2006) (No. 05-1118), *available at* [http://www.ca8.uscourts.gov/briefs/05/05/appellee/051118\\_1br.pdf?A1=View+Brief](http://www.ca8.uscourts.gov/briefs/05/05/appellee/051118_1br.pdf?A1=View+Brief).

considered by the court in *Jones*.<sup>53</sup> Focusing on the word “integrated” in the Tax Court opinion in *Senda*, the IRS argued that, unlike the decision in *Jones*, the *Senda* decision had applied the step-transaction doctrine.<sup>54</sup> In short, the IRS did not merely seek an affirmance in the Eighth Circuit on the narrow, factual ground that the taxpayer failed to establish the sequencing necessary to invoke the *Shepherd* dicta. It rather sought to negate the *Shepherd* dicta through application of the step-transaction doctrine.<sup>55</sup>

The IRS found a receptive audience in the Eighth Circuit. After affirming on the failure-of-proof ground, finding no clear error after evaluating the evidence on the sequencing issue, the court went on to read the Tax Court as adopting a view that is inconsistent with the *Shepherd* dicta and the *Jones* holding.<sup>56</sup> In a critical sentence, the Eighth Circuit stated: “The tax court recognizes that even if the *Sendas*’ contribution would have first been credited to their accounts, this formal extra step does not matter.”<sup>57</sup> Thus, as the Eighth Circuit appears to read the Tax Court decision, even if the contribution and the gift had been properly sequenced, the indirect-gift doctrine would still produce a taxable gift if the timing of the contribution and gift were such that they could be integrated under the step-transaction doctrine.<sup>58</sup> Surprisingly, the court did not acknowledge the contrary dicta in *Shepherd* or the holding in *Jones*.<sup>59</sup>

What is even more interesting is that the court posits a counterfactual hypothetical—contribution followed by gift—not discussed in the Tax Court opinion, and then wrongly reads the opinion as having addressed it.<sup>60</sup> The Tax Court in *Senda* was at pains to emphasize the difference between *Senda* and *Jones*: whereas in *Jones* the taxpayer proved that the contribution had occurred prior to the gift and that it had been properly

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<sup>53</sup> *Id.* at 29.

<sup>54</sup> *Id.* at 29–30.

<sup>55</sup> *Id.* at 30. In *Knight v. Commissioner*, 115 T.C. 506 (2000), on facts somewhat similar to those in *Jones*, the court explicitly indicated that the IRS had not made the indirect-gift argument. *Id.* at 513 n.3. Although *Jones* does not include a similar indication and does not cite *Knight*, see *Estate of Jones v. Comm’r*, 116 T.C. 121 (2001), one might infer that the Tax Court did not want to foreclose the IRS from using the step-transaction doctrine to make an indirect-gift argument.

<sup>56</sup> *Senda v. Comm’r*, 433 F.3d 1044, 1048 (8th Cir. 2006).

<sup>57</sup> *Id.*

<sup>58</sup> See *id.*

<sup>59</sup> See *id.*

<sup>60</sup> See *id.*

credited to his capital account, the taxpayer's evidence in *Senda* established either that the contribution and gift had occurred simultaneously or that the contribution was made after the gift; it also failed to establish that the contribution had been credited to the taxpayer's capital account.<sup>61</sup> In thus distinguishing *Jones*, the Tax Court in *Senda* did not find that the contribution followed the gift and therefore did not consider the consequences of such sequencing.<sup>62</sup>

Given the fact that the opinions in *Senda* and *Jones* were written by the same Tax Court judge (Judge Cohen)<sup>63</sup> and given the way in which the decision in *Senda* is narrowly tailored so as not to call into question the holding in *Jones* or the *Shepherd* dicta,<sup>64</sup> it seems implausible that the author of the *Senda* opinion in the Tax Court was prepared to embrace the resolution proffered by the Eighth Circuit for the counterfactual it posits. Most ironically, the Eighth Circuit's implicit rejection of the *Shepherd* dicta is itself dicta,<sup>65</sup> thus creating a conflict in dicta between the circuits (as well as a conflict between the Eighth Circuit's dicta and the holding in *Jones*).<sup>66</sup>

This is not to suggest that the Eighth Circuit's dicta should be rejected in favor of the *Shepherd* dicta. Indeed, resulting from an IRS concession, the *Shepherd* dicta failed to distinguish between two very different cases: where the gift of the partnership interest is made long after the donor's contribution to the partnership, on the one hand, and where the gift is made immediately following the contribution, on the other.<sup>67</sup> Whereas in the former case the no-indirect-gift conclusion under the dicta does make sense, there is little justification for extending the same treatment to the latter case. The step-transaction doctrine should, in other words, be available to the IRS where the contribution and the gift can be viewed as constituting part of the same transaction. Nonetheless, the Eighth Circuit erred in attributing its dicta to the Tax Court. It also seemingly fails to appreciate the tension it has created between the *Shepherd* dicta and the *Jones* holding.

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<sup>61</sup> See *Senda v. Comm'r*, 88 T.C.M. (CCH) 8, 11 (2004), *aff'd*, 433 F.3d 1044 (8th Cir. 2006).

<sup>62</sup> See *id.* at 11–12.

<sup>63</sup> *Id.* at 8; *Estate of Jones*, 116 T.C. at 122.

<sup>64</sup> See *Senda*, 88 T.C.M. (CCH) at 11.

<sup>65</sup> See *Senda v. Comm'r*, 433 F.3d 1044, 1048 (8th Cir. 2006).

<sup>66</sup> See *Estate of Jones*, 116 T.C. at 128.

<sup>67</sup> See *id.*

Given the IRS's Eighth Circuit brief in *Senda*,<sup>68</sup> the IRS will likely argue that the *Senda* dicta does not create such a conflict. The IRS will presumably maintain that the *Shepherd* dicta and the *Jones* holding remain intact, but they will now be subject to an exception when the IRS can successfully assert the step-transaction doctrine. Thus, whenever the contribution and gift occur within a narrow time frame, the IRS will presumably claim that the two steps should be integrated in order to trigger the indirect-gift doctrine. And, most significantly, given the *Senda* dicta, the IRS will undoubtedly take this position even if the evidence establishes that the contribution preceded the gift.<sup>69</sup>

It should be conceded that it is possible to read the *Senda* dicta differently. It may be read as speaking not at all to the question of sequencing. It may instead be read as contemplating a taxpayer who: (1) first makes a gift of the limited units to the children; (2) then makes an additional contribution that is first credited to the taxpayer's capital account; and (3) then immediately causes the contribution to be re-credited to the children's capital account as a gift.<sup>70</sup> In other words, perhaps the sentence was intended to do no more than permit the IRS to treat such a taxpayer as if the contribution had been directly credited to the children's capital account in the first instance. Indeed, this would be consistent with the approach the IRS took in a 2001 Technical Advice Memorandum: discount should not be allowed in the context of similar facts based on an application of the step-transaction doctrine.<sup>71</sup> But such a reading also raises questions, because the Tax Court decision cannot be read as applying the step-transaction doctrine in this fashion.<sup>72</sup> To the contrary, the Tax Court found that the taxpayer failed to prove that the contribution had been credited to his capital account, implying that the taxpayer would have come within the *Jones* holding and thus prevailed had he carried his burden of proof on the issue.<sup>73</sup>

### C. Planning in Light of *Senda*

In terms of planning, it is no longer prudent for taxpayers to rely on the holding in *Jones* and the *Shepherd* dicta. The *Senda* dicta suggests the

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<sup>68</sup> See Brief for the Appellee, *supra* note 52, at 29–30.

<sup>69</sup> See *Senda*, 433 F.3d at 1048.

<sup>70</sup> See *id.*

<sup>71</sup> See I.R.S. Tech. Adv. Mem. 02-12-006 (Nov. 20, 2001).

<sup>72</sup> See *Senda v. Comm'r*, 88 T.C.M. (CCH) 8, 11 (2002), *aff'd*, 433 F.3d 1044 (8th Cir. 2006).

<sup>73</sup> See *Senda*, 433 F.3d at 1048.

need to rethink the formation process. Whereas under *Jones* a parent could make a contribution in exchange for limited units and then, immediately afterward, make a gift of the limited units without falling under the indirect-gift doctrine,<sup>74</sup> this may no longer be true under the *Senda dicta*. Thus, taxpayers using the *Jones* template may need to allow sufficient time to elapse between the contribution and the later gift in order to minimize the threat of the step-transaction doctrine.

Other strategies may also be effective. For example, if the parent's contribution is credited to her capital account and she retains all of the partnership units that she receives in exchange, the indirect-gift argument cannot be made.<sup>75</sup> It can only apply if the contribution is credited to the children's capital accounts<sup>76</sup> or if the IRS can invoke the *Senda dicta* by integrating the contribution and the gift.<sup>77</sup> In other words, if the contribution is credited to the parent's capital account and no gift of partnership units is made, the indirect-gift argument cannot be applied, despite the *Senda dicta*.<sup>78</sup> Thus, the formation of the partnership would not result in a taxable gift, even though discount would be available for estate tax purposes at the parent's later death with respect to all retained partnership units (assuming section 2036 does not apply).

Alternatively, the parent's gift of, say, a one percent general partnership interest shortly after formation should limit the parent's exposure to the indirect-gift argument.<sup>79</sup> And, assuming again that section 2036 does not apply, estate-tax discount should be available for the retained units (though such a gift could possibly trigger estate-tax inclusion under section 2035(b) if death were to occur within three years<sup>80</sup> and if the section 2036(a)(2) argument endorsed by the Tax Court in *Strangi v.*

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<sup>74</sup> See *Estate of Jones v. Comm'r*, 116 T.C. 121, 124, 128 (2001).

<sup>75</sup> See *id.* at 128.

<sup>76</sup> See *Shepherd v. Comm'r*, 155 T.C. 376, 389 (2000), *aff'd*, 283 F.3d 1258 (11th Cir. 2002).

<sup>77</sup> See *Senda*, 433 F.3d at 1048.

<sup>78</sup> See *supra* notes 75–77 and accompanying text.

<sup>79</sup> The amount of the taxable gift would be equal to the undiscounted value of one percent of the partnership's assets. See *Senda*, 433 F.3d at 1046. Thus, as long as the post-formation gift is not substantial, *Senda* does not pose a very serious threat as a practical matter.

<sup>80</sup> See I.R.C. § 2035(b) (2000).

*Commissioner* were followed).<sup>81</sup> In short, given the *Senda dicta*, careful taxpayers will likely no longer use the *Jones* template.

#### *D. Gift-Tax Arguments: Practical Significance*

What, then, is the practical significance of *Senda* and, more generally, of the IRS's gift-tax arguments? In terms of the gift-on-formation argument, as suggested, the courts have been unreceptive.<sup>82</sup> But, even assuming they were to take a different view of the argument, it would nonetheless be rather ineffective. Planners would likely recommend that the parent own all units in the partnership immediately following the contribution (for example, the parent might own the general partner units through a single-member LLC and might directly own all of the limited units). Under this structure, even assuming the courts were willing to apply the gift-on-formation theory, no gift could occur in connection with the formation because the parent is the only partner and there is therefore no donee.<sup>83</sup> And if, after waiting a significant period of time, the parent were to make a gift of partnership units, discount would be available in valuing the gift—at least under present law.<sup>84</sup> Thus, absent a change in the

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<sup>81</sup> See *Estate of Strangi v. Comm'r*, 85 T.C.M. (CCH) 1331, 1341–42 (2003), *aff'd on other grounds*, 417 F.3d 468 (5th Cir. 2005) (stating that if the parent retains a general partnership interest, then a right to vote concerning liquidation of the partnership that is inherent in the interest could trigger estate-tax inclusion, even assuming the parent does not have sufficient voting power to trigger liquidation unilaterally). For a further discussion of the section 2036(a)(2) analysis made by the court in *Strangi*, see generally Gans & Blattmachr, *supra* note 7. For suggestions on how to structure a partnership so that a parent who owns a general partnership interest does not have any voting rights (to avoid falling under section 2035 via section 2036(a)(2)), see *id.* at 1164–69 (suggesting that the parent own the general partnership interest through an LLC with someone other than the parent-manager having all of the voting rights).

<sup>82</sup> See *supra* notes 19–22 and accompanying text.

<sup>83</sup> See *Cunningham*, *supra* note 16, at 1469 (“[T]he argument could be avoided altogether if taxpayers form single-member LLCs, because of the impossibility of making a gift to oneself. The Service would need to rely on some other theory to deny discounts on subsequent transfers of interests in the entity.”); *cf.* *Estate of Strangi v. Comm'r*, 115 T.C. 478, 490 (2000), *aff'd in part, rev'd in part*, 293 F.3d 279 (5th Cir. 2002) (indicating that the parent owned practically all of the interests in the partnership, implying there was no meaningful donee).

<sup>84</sup> If, for example, the parent made a later gift of the general partnership interest, it would be valued under conventional principles: based on the price that a third party would pay for the interest without taking into account the fact that the parent's retained limited units would have a lesser value once no longer held in conjunction with the general

regulations or the Code,<sup>85</sup> planners could easily defeat the gift-on-formation argument, even if it were accepted by the courts, by adjusting the steps in the partnership-formation process.

Finally, as indicated, unlike the gift-on-formation argument, the indirect-gift argument has produced success for the IRS—in *Shepherd*<sup>86</sup> and *Senda*.<sup>87</sup> But, most importantly, it can only be effective if the taxpayer, as in *Shepherd* or *Senda*, fails to structure the formation process properly.<sup>88</sup> For taxpayers, however, who follow one of the suggested approaches,<sup>89</sup> the argument will be entirely ineffective. In sum, the indirect-gift argument, even in its more robust *Senda*-dicta version, is nothing more than a trap for the unwary.

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partnership interest. See *Cunningham*, *supra* note 16, at 1469; Rev. Rul. 93-12, 1993-1 C.B. 202, 203. If, however, under state law or under the agreement, the donee became an assignee, rather than a full partner, section 2704(a) could apply and could treat the diminution in value of the retained limited units as a taxable gift. See *Cunningham*, *supra* note 16, at 1468. Thus, careful planners would make certain that full-partner status was conferred on the donee. See *Estate of Jones v. Comm'r*, 116 T.C. 121, 132 (2001) (concluding that, by reason of the structure of the gift, the donee became a full partner rather than an assignee); *Kerr v. Comm'r*, 113 T.C. 449, 464 (1999). *But see* *McCord v. Comm'r*, 120 T.C. 358, 370–73 (2003). For further discussion of this problematic aspect of section 2704 and how it might be cured, see *Schmolka*, *supra* note 16, at 1487–89.

<sup>85</sup> See *Gans*, *supra* note 10, at 5-14 to -22 (suggesting regulations that would address these issues).

<sup>86</sup> See 115 T.C. 376, 389 (2000), *aff'd*, 283 F.3d 1258 (11th Cir. 2002).

<sup>87</sup> See 88 T.C.M. (CCH) 8, 11–12, *aff'd*, 433 F.3d 1044 (6th Cir. 2006).

<sup>88</sup> See *Shepherd*, 283 F.3d at 1261; *Senda*, 433 F.3d at 1048.

<sup>89</sup> See *supra* notes 72–81 and accompanying text.