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## IRS Suffers Setback with Fifth Circuit Reversal of *Kimbell v. United States*

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On May 20, 2004, the Fifth Circuit reversed the district court's holding in *Kimbell v. United States*, 244 F. Supp. 2d 700 (N.D. Tex. 2003), eradicating one of the IRS's recent victories with respect to family entity tax planning for family limited partnerships (FLPs) and limited liability companies (LLCs).

In light of some recent successes in the courts, the IRS has focused its attack on such family entities by arguing that, on account of Section 2036 of the Internal Revenue Code, older generation family members have retained such control over the entities that the underlying value of assets that such family member transferred to the FLP or LLC should be reincluded in the transferor's estate at fair market value if such FLP or LLC interests are retained by the transferor at his or her death, without the benefit of any discount for a minority interest or a lack of marketability inherent in a partnership or LLC interest.

In *Kimbell*, the Fifth Circuit held that the underlying assets involved in the transfer were not includable in the transferor's estate at full fair market value because she was deemed to have sold assets to the FLP in a bona fide sale for full and adequate consideration. Therefore, only the value of the FLP interests was includable. Most properly planned FLPs or LLCs would likely meet the bona fide sale rule articulated in the *Kimbell* opinion, thereby nullifying the use of the Section 2036 attack. The IRS may try to distinguish future cases from this most recent Fifth Circuit holding, but the ruling is nevertheless a significant taxpayer victory.

One major qualification to the court's analysis is that the bona fide sale exception applies only if there is some non-tax purpose to the creation of the family entity. The non-tax reasons articulated in the opinion, however, are extensive and varied and would apply to many family entity situations. In addition, the court emphasized that all of the formalities of the partnership were followed and the transferor retained sufficient assets outside of the FLP for her support.

The case holding is only applicable to the situation in which a taxpayer contributes property to an FLP or LLC and dies holding the FLP or LLC interest. The holding does not necessarily protect a taxpayer who subsequently gifts the FLP or LLC interests to a family member but continues to manage or control the FLP or LLC entity. Further guidance is soon expected with respect to the reinclusion of such gifted interests because the Fifth Circuit has now agreed to hear an appeal of

the controversial *Strangi* case, in which the issue was the reinclusion of gifted FLP interests where the transferor retained control over the FLP.

Please click [here](#) for the full decision.