NOTES

IMPORTING A TRADE OR BUSINESS LIMITATION INTO § 2036: TOWARD A REGULATORY SOLUTION TO FLP-DRIVEN TRANSFER TAX AVOIDANCE*

INTRODUCTION

The federal gift and estate taxes serve important policy goals, among them raising revenue,[1] increasing the overall progressivity of federal taxation,[2] and counteracting the increasing concentration of wealth in the hands of the few.[3] In recent decades, however, many wealthy U.S. taxpayers have managed to avoid the gift and estate taxes by transferring their assets to family limited partnerships (FLPs) in exchange for ownership interests, thereby availing themselves of the valuation discounts the federal transfer tax system has traditionally accorded to equity in closely held businesses.[4] The resulting revenue loss has been significant.[5]

Despite myriad proposals for legislative solutions to FLP abuse, Congress has consistently failed to act.[6] However, this congressional inertia has not prevented the Internal Revenue Service from aggressively challenging FLP transactions in the courts, leaving a litigation trail that spans several decades. In *Estate of Strangi v. Commissioner*,[7] the Service appeared to win a significant victory, convincing the Tax Court to disregard an FLP transaction under an ostensibly broad reading of Internal Revenue Code § 2036.[8] Unfortunately, the victory

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[1] CONG. BUDGET OFFICE, ECONOMIC AND BUDGET ISSUE BRIEF: FEDERAL ESTATE AND GIFT TAXES 4 (2009) (projecting estate and gift tax revenues of $420 billion — or 1.2% of total federal revenues — in the 2010–19 period).

[2] James R. Repetti, *The Case for the Estate and Gift Tax*, 86 TAX NOTES 1493, 1500 (2000).

[3] *Id.* at 1498–99. As President Franklin D. Roosevelt observed in justifying the federal transfer taxes: "Great accumulations of wealth cannot be justified on the basis of personal and family security. In the last analysis such accumulations amount to the perpetuation of great and undesirable concentration of control in a relatively few individuals over the employment and welfare of many, many others." JESSE DUKEMINIER, ROBERT H. SITKOFF & JAMES LINDGREN, WILLS, TRUSTS, AND ESTATES 931–32 (8th ed. 2009) (quoting H.R. REP. NO. 74-1681, at 2 (1935)).

[4] *See* Laura E. Cunningham, *FLP Fix Must Be a Part of Transfer Tax Reform*, 112 TAX NOTES 937, 937–38 (2006) [hereinafter Cunningham, *FLP Fix*].

[5] *See id.* at 939–40.

[6] Laura E. Cunningham, *FLPs, the Transfer Taxes, and the Income Tax*, 127 TAX NOTES 806, 806–07 (2010) [hereinafter Cunningham, *FLPs*].

[7] 85 T.C.M. (CCH) 1331 (2003).

[8] *See id.* at 1337–45.

was short lived, as the Tax Court subsequently clarified that it will respect FLPs under § 2036 so long as they serve a "legitimate and significant nontax purpose."[9] In practice, this "nontax purpose" test permits all but the most poorly planned FLP transactions to pass muster.

This Note argues that the Department of the Treasury has the authority to curb FLP abuse by imposing a "trade or business" limitation on valuation discounts for business interests — a limitation modeled on the "trade or business" eligibility requirement for I.R.C. § 6166 estate tax deferral on business interests. Specifically, this Note proposes that Treasury amend its regulations under § 2036 to replace the Tax Court's "nontax purpose" motive inquiry with an objective economic test: a person who transfers property to a business entity may only discount the value of transferred assets that the entity actually "use[s] in carrying on a trade or business."[10]

The Note proceeds in five Parts. Part I briefly summarizes the mechanics of the gift and estate taxes and explains how FLPs permit wealthy taxpayers to avoid those taxes. Part II describes the evolution of the "nontax purpose" test that the Tax Court currently applies to scrutinize FLP transactions. Part III explains why § 6166's "trade or business" limitation provides the basis for an elegant and administrable solution to FLP abuse, a solution Treasury has authority to implement under § 2036. Part IV addresses possible concerns with this Note's reform proposal, and Part V concludes.

I. TURNING GOLD INTO STRAW: THE REVERSE ALCHEMY OF FLP TRANSACTIONS

To grasp the mechanics of FLP-driven transfer tax avoidance, it is first necessary to have a cursory understanding of the federal gift and estate taxes. The goal of those taxes (collectively, transfer taxes) is to tax the value of all gratuitous transfers made by the taxpayer, dur-

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[9] Estate of Bongard v. Comm'r, 124 T.C. 95, 118 (2005).

[10] I.R.C. § 6166(b)(9)(A), (B)(i) (2006). This Note is not the first to suggest that FLP abuse could be addressed by limiting discounts to entities actually engaged in business. In 1999, the Clinton Administration proposed that Congress limit valuation discounts to entities engaged in an "active business." *See* DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S REVENUE PROPOSALS 167 (1999). However, at less than a page in length, the Clinton Administration's proposal provided little guidance on what constitutes an "active business," or on how the "active business" test would apply in practice. *See id.*; *see also* Laura E. Cunningham, *Remember the Alamo: The IRS Needs Ammunition in Its Fight Against the FLP*, 86 TAX NOTES 1461, 1469 (2000) [hereinafter Cunningham, *Remember the Alamo*] ("[The Clinton proposal leaves] unanswered . . . the question of how 'active business' is to be defined."). Moreover, the Clinton Administration's proposal was directed at Congress, whereas this Note argues that Treasury could unilaterally impose a "trade or business" limitation under existing provisions in the Internal Revenue Code.

ing her life or at her death,[11] at the applicable tax rate (currently 40%).[12] The transfer taxes accomplish this goal in two steps: First, the gift tax applies to any value the taxpayer transfers out of her estate during her life,[13] less applicable deductions and exclusions.[14] (However, if the lifetime transfer is a *sale*, only the gratuitous portion of the transfer — that is, the excess of the value of the transferred property over the value of the sale proceeds — is subject to gift taxation.[15]) Second, the estate tax applies to the value of the taxpayer's gross estate upon her death,[16] less applicable deductions and exclusions.[17] Notably, under the current unified lifetime exemption, a taxpayer can gratuitously transfer up to $5,250,000 either during her life or at death without incurring any gift or estate tax.[18] In light of the lifetime exemption, only a small fraction of Americans ends up owing transfer taxes.[19]

The operation of the gift and estate taxes is best understood by way of example. Suppose that Taxpayer *A* and Taxpayer *B* each own a mix of cash and marketable securities valued at $8,050,000 and $8,583,333, respectively. For the sake of simplicity, assume that neither taxpayer owns any other assets. Each taxpayer has four children, and each taxpayer wishes to make a net gratuitous transfer of $7,250,000 to those children in equal shares. Taxpayer *A* accomplishes her objective by gifting $7,250,000 of her assets to her children during her life. Because Taxpayer *A*'s gifts exceed the $5,250,000 lifetime exemption by $2,000,000, her remaining assets are just sufficient to satisfy her $800,000 gift tax liability.[20] Taxpayer *A* dies a pauper, incurring

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[11] *See* RAY D. MADOFF ET AL., PRACTICAL GUIDE TO ESTATE PLANNING § 5.02[A], at 5-4 to 5-5 (2009 ed. 2008).

[12] American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, § 101(c) (2013) (to be codified at I.R.C. § 2001).

[13] *See* I.R.C. §§ 2503, 2512.

[14] *See, e.g.*, *id.* §§ 2503(b) (annual exclusion), 2503(e) (tuition and medical expense exclusion), 2522 (charitable deduction), 2523 (marital deduction).

[15] *See id.* §§ 2503, 2512.

[16] The value of a decedent's gross estate is determined under the inclusion rules set forth in I.R.C. §§ 2031 through 2042. *See generally* DUKEMINIER, SITKOFF & LINDGREN, *supra* note 3, at 950–72 (surveying the statutory provisions pertaining to the calculation of the gross estate).

[17] *See* I.R.C. §§ 2001, 2010, 2031–42, 2053–58 (2006 & Supp. V 2011). Though the calculation of a decedent's estate tax liability is complicated, *see* DUKEMINIER, SITKOFF & LINDGREN, *supra* note 3, at 948–49, it is sufficient for purposes of this Note to understand that a decedent's estate tax liability correlates positively with the value of her gross estate.

[18] *See* American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, § 101(c) (2013) (to be codified at I.R.C. § 2001); *see also* Paul Sullivan, *The End of a Decade of Uncertainty over Gift and Estate Taxes*, N.Y. TIMES, Jan. 5, 2013, at B5.

[19] *See* CONG. BUDGET OFFICE, *supra* note 1, at 4. In 2007, 17,400 decedents reported estate tax liability, representing roughly 0.7% of adult deaths in the prior year. *Id.* at 1.

[20] *See* I.R.C. §§ 2502, 2503, 2512. $2,000,000 multiplied by the applicable 40% rate equals $800,000. This calculation ignores the annual gift tax exclusion available under I.R.C. § 2503(b).

no estate tax liability. Now consider Taxpayer *B*. Unlike Taxpayer *A*, Taxpayer *B* retains his cash and marketable securities until death, at which point they pass gratuitously to his four children under his will. Because Taxpayer *B*'s gross estate exceeds the $5,250,000 lifetime exemption by $3,333,333, Taxpayer *B*'s death results in an estate tax liability of roughly $1,333,333, which leaves approximately $7,250,000 for *B*'s children.[21] When the dust settles, Taxpayers *A* and *B* have made the same net transfers to their children, though Taxpayer *B* ends up with a higher transfer tax liability because the gift tax is calculated on a tax-exclusive basis whereas the estate tax is tax inclusive.

An FLP reduces a taxpayer's gift and estate tax liability by artificially reducing the tax value of her assets.[22] That is, the taxpayer transfers property into the FLP and receives an interest in the FLP that — for tax-valuation purposes — is worth significantly less than the property she transferred into the FLP.[23] Consider again Taxpayer *B* from the example above. Had Taxpayer *B* transferred his cash and marketable securities to a properly structured FLP during his life, he could have completely eliminated his estate tax liability by claiming a discounted value for the partnership interest he holds at death. To bring his $8,583,333 estate below the $5,250,000 lifetime exemption, Taxpayer *B* would have had to claim a valuation discount of slightly below 39%,[24] which is readily attainable under current law.[25] Now consider Taxpayer *A*. Had Taxpayer *A* transferred her assets to a properly structured FLP and then gifted equal partnership interests to her four children, she could have eliminated her gift tax liability by claiming a 28% discount on each gifted interest,[26] which is also easily defensible under current law.[27]

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[21] *See id.* §§ 2001, 2010. $3,333,333 multiplied by the applicable 40% rate equals approximately $1,333,333.

[22] Cunningham, *FLP Fix*, *supra* note 4, at 940 ("Interposing [an FLP] between the donor or decedent and the assets held in entity solution depresses [the assets'] transfer tax value.").

[23] *Id.* at 937–38.

[24] $8,583,333 multiplied by 61% (100% less the 39% discount) equals $5,235,833, which falls below the $5,250,000 lifetime exemption.

[25] *See* Martha Britton Eller, *Which Estates Are Affected by the Federal Estate Tax?: An Examination of the Filing Population for Year-of-Death 2001*, *in* 2 INTERNAL REVENUE SERV., COMPENDIUM OF FEDERAL ESTATE TAX AND PERSONAL WEALTH STUDIES 192, 202 (2005) ("[R]ecent discounts of FLP interests range between 30 percent and 60 percent."); *see also* Estate of Miller v. Comm'r, 97 T.C.M. (CCH) 1602, 1608–09 (2009) (permitting 35% discount); Estate of Schutt v. Comm'r, 89 T.C.M. (CCH) 1353, 1362, 1368 (2005) (permitting 46.4% aggregate discount).

[26] $7,250,000 multiplied by 72% (100% less the 28% discount) equals $5,220,000, which falls below the $5,250,000 lifetime exemption.

[27] *See, e.g.*, Perracchio v. Comm'r, 86 T.C.M. (CCH) 412, 419 (2003) (upholding aggregate valuation discount of 30% on gifted FLP interests).

The preceding scenario naturally raises the question of *why* the federal transfer tax system permits taxpayers to discount their FLP interests. Essentially, FLPs take advantage of the fact that the Service and the courts determine an asset's tax value on the basis of all the facts and circumstances,[28] including the asset's relative liquidity or illiquidity.[29] In the typical FLP transaction, a taxpayer transfers his investment assets to a limited partnership in exchange for a 99% limited (nonvoting) interest in the partnership's assets and profits, parceling out the remaining 1% general (voting) interest among himself and his family members so that no one person holds a controlling stake.[30] The taxpayer has thereby turned his liquid investment assets into a limited partnership interest that is — at least in the eyes of our tax system — illiquid.[31] First, the taxpayer's limited interest is not publicly traded and is usually subject to transfer restrictions, entitling the taxpayer to a "lack of marketability" discount.[32] Second, the limited interest is nonvoting, entitling the taxpayer to a "minority" discount to account for the fact that he formally lacks the ability to force a liquidation, demand dividends or salary, or otherwise reach the FLP's assets.[33] The underlying premise behind both discounts is the same: because the taxpayer cannot readily cash out his equity interest in the FLP, he should be able to reduce the value of that interest below its propor-

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[28] *See, e.g.*, Rev. Rul. 59-60, 1959-1 C.B. 237 ("A determination of fair market value . . . will depend upon the circumstances in each case . . . based upon all relevant facts . . . .").

[29] *Cf., e.g.*, Treas. Reg. § 20.2031-2(e) (as amended in 2006) ("If the executor can show that the block of stock to be valued is so large in relation to the actual sales on the existing market that it could not be liquidated in a reasonable time without depressing the market, the price at which the block could be sold as such outside the usual market, as through an underwriter, may be a more accurate indication of value than market quotations.").

[30] *See, e.g.*, Strangi v. Comm'r, 417 F.3d 468, 473–74 (5th Cir. 2005).

[31] *See* Estate of Thompson v. Comm'r, 382 F.3d 367, 381 (3d Cir. 2004) (noting that FLPs function by "converting liquid, marketable assets into illiquid partnership interests"); Wendy C. Gerzog, *Valuation Discounting Techniques: Terms Gone Awry*, 61 TAX LAW. 775, 779 (2008) (noting that FLPs function by allowing the taxpayer to "convert liquid assets into illiquid ones to reduce the value of his gifts or of his estate"); Louis S. Harrison & John M. Janiga, *The Interplay of Behavioral Economics and Portfolio Management with the Current Examination of Family Partnerships by the Courts*, 40 REAL PROP. PROB. & TR. J. 117, 120 (2005) ("The investment FLP is designed to reduce the value of the decedent's immediate interest in the FLP to less than the value the decedent would receive on liquidation of the FLP. The investment FLP does so by making certain interests in the FLP illiquid and therefore entitled to a discount.").

[32] *See* Cunningham, *Remember the Alamo*, *supra* note 10, at 1464 ("Discounts for lack of marketability . . . reflect the fact that no ready market exists for closely held business interests. A seller does not have access to a public market for his interest, but instead must incur expenses in locating a buyer, including syndication, legal, and accounting fees.").

[33] *See id.* ("Minority discounts [for business interests] are premised on the theory that the owner of a noncontrolling interest is to some extent at the mercy of the controlling owners. . . . Control carries with it the ability to dictate the amount and timing of distributions to owners, to hire oneself (and one's family) as employees, and to sell or liquidate the entity's assets.").

tionate share of the value of the FLP's assets.[34] Of course, this premise ignores the reality that the FLP is owned and controlled by family members, who will inevitably cause the entity to liquidate once it has served its tax valuation purpose.[35]

One obvious cure to FLP-driven transfer tax avoidance is to eliminate valuation discounts altogether.[36] While the simplicity of such a measure is appealing, it could work injustice on small business owners. The justifications for valuation discounts may ring hollow as applied to FLPs, which are specifically designed to obtain discounts while avoiding any actual diminution in the economic value held by the taxpayer and her family. However, those justifications make eminent sense as applied to legitimate closely held commercial enterprises.[37] Consider the extreme case of a minority owner who has been "frozen out" of the business by her antagonistic co-owners. Because the minority owner is cut off from salary and dividends and cannot liquidate the business's assets or sell her ownership interest, the value of her interest approaches zero.[38] In such circumstances, it would hardly be fair to tax the minority owner as if her interest were worth a proportionate share of the overall value of the enterprise.[39] Hence, the solution to FLP abuse is not to eliminate valuation discounts altogether, but to come up with a better method for discriminating between legitimate business enterprises and sham structures set up solely to manufacture valuation discounts.

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[34] *See, e.g.*, Estate of Newhouse v. Comm'r, 94 T.C. 193, 249 (1990) ("[T]he [minority discount] reflects the minority shareholders' inability to compel liquidation and inability to realize a pro rata share of the corporation's net asset value. . . . [T]he lack of marketability discount reflects that there is no ready market for the shares of a closely held corporation." (citations omitted)); Cunningham, *Remember the Alamo*, *supra* note 10, at 1471 ("The controlling owner of a partnership or limited liability company should not be entitled to a lack of marketability discount if assets held by the entity would not otherwise qualify for the discount. This is because the controlling owner has the ability to liquidate the entity and re-convert the assets to marketable form.").

[35] *See* Samuel A. Donaldson, *Liquidation of the Family Partnership: The Taming of the Shrewd*, PRAC. TAX LAW., Winter 2006, at 47, 47–48. FLP liquidation presents a host of complex tax issues for estate planners. *See generally id.* (discussing the possible income tax ramifications of FLP liquidation); Eugene Pollingue & Pauline W. Markey, *Family Partnership Liquidation Presents Tax Issues*, EST. PLAN., May 2011, at 25, 25 (same); Gary V. Post, Navigating the Mines and Potholes in Unwinding a Family Limited Partnership (Dec. 10, 2010) (unpublished manuscript), *available at* http://www.utcle.org/eLibrary/preview.php?asset_file_id=27964 (same).

[36] Cunningham, *FLP Fix*, *supra* note 4, at 940.

[37] *See* Douglas K. Moll, *Shareholder Oppression and "Fair Value": Of Discounts, Dates, and Dastardly Deeds in the Close Corporation*, 54 DUKE L.J. 293, 315–18 (2004).

[38] *E.g.*, Brown v. Allied Corrugated Box Co., 154 Cal. Rptr. 170, 176 (Ct. App. 1979).

[39] Admittedly, the gift and estate taxes affect only a small fraction of small business owners. CONG. BUDGET OFFICE, *supra* note 1, at 6 (noting that only about "2.4 percent of small-business owners (8,291) who died in 2005 had to file estate tax returns"). However, this low figure is attributable in part to the availability of valuation discounts. *See, e.g.*, CONG. BUDGET OFFICE, EFFECTS OF THE FEDERAL ESTATE TAX ON FARMS AND SMALL BUSINESSES 11 (2005), *available at* http://www.cbo.gov/publication/16897.

II. FROM *STRANGI* TO *MILLER*: THE SERVICE'S EFFORTS TO CHALLENGE FLPS UNDER § 2036

The Service has sought to challenge FLP transactions for decades, with little success.[40] Its fortunes appeared to change in *Estate of Strangi v. Commissioner*, in which the Tax Court accepted the Service's argument that I.R.C. § 2036 required the taxpayer to include the full, undiscounted value of property he transferred to an FLP in his gross estate.[41] At the time, commentators viewed *Strangi* as a watershed in the Service's war against FLPs.[42] However, subsequent Tax Court decisions have turned *Strangi* into a mere tax trap for the unwary. Abusive FLP transactions continue unabated.[43]

To appreciate the Tax Court's opinion in *Strangi*, it is first necessary to understand the mechanics of § 2036, the Code section under which the Service challenged the FLP structure at issue in that case. Prior to the passage of § 2036, taxpayers could avoid the estate tax by transferring assets out of their estates during their lives while still retaining use or possession of, or ownership-equivalent control over, the assets.[44] Section 2036 was designed to close off this loophole: First, under § 2036(a)(1), a taxpayer who transfers property but expressly or impliedly retains the right to use or receive income from the property must include the property's full value in her gross estate.[45] Second, under § 2036(a)(2), a taxpayer who transfers property but retains, "alone or in conjunction with any person," the power to "designate the persons who shall possess or enjoy the property or the income there-

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[40] *See, e.g.*, Church v. United States, No. SA-97-CA-0774-OG, 2000 WL 206374 (W.D. Tex. Jan. 18, 2000), *aff'd*, 268 F.3d 1063 (5th Cir. 2001) (upholding an FLP against the Service's challenges under I.R.C. §§ 2501, 2036, 2038, and 2703); Estate of Harrison v. Comm'r, 52 T.C.M. (CCH) 1306 (1987) (upholding an FLP against the Service's challenges under I.R.C. §§ 2033, 2035, 2036, 2037, 2038, and 2041, reasoning that taxpayer created FLP for "business purpose" of centralized asset management).

[41] Estate of Strangi v. Comm'r, 85 T.C.M. (CCH) 1331, 1337–45 (2003).

[42] *See, e.g.*, Bradford Updike, *Making Sense of Family Limited Partnership Law After* Strangi *and* Stone*: A Better Approach to Planning and Litigation Through the Bona Fide Transaction Exception*, 50 S.D. L. REV. 1, 3 (2005) ("It goes without saying that the Service's recent victory in *Estate of Strangi v. Commissioner* . . . has thrown the estate-planning bar into a state of panic and in search of a new security blanket.").

[43] *See* Paul Sullivan, *In an Unusual Tax Year, the Wealthy Turn to Partnerships*, N.Y. TIMES, July 7, 2012, at B5.

[44] Though lifetime transfers are subject to the gift tax, there are a number of reasons why lifetime giving is tax-advantageous, including the fact that the gift tax is calculated on a tax-exclusive basis. *See* DUKEMINIER, SITKOFF & LINDGREN, *supra* note 3, at 949–50.

[45] I.R.C. § 2036(a)(1) (2006); Treas. Reg. § 20.2036-1(c) (as amended in 2011). For example, suppose that a taxpayer gifts her primary residence to her children but continues to live in the residence until death. Under § 2036(a)(1), the taxpayer must include the full value of the residence in her gross estate, despite the formal transfer. *See* Estate of Maxwell v. Comm'r, 3 F.3d 591, 594–95 (2d Cir. 1993).

from" must include the property's full value in her gross estate.[46] Treasury Regulation § 20.2036-1(b)(3) emphasizes the broad reach of § 2036(a)(2), clarifying that the provision is triggered irrespective of "[how] the power [is] exercisable by the decedent or by another person . . . in conjunction with the decedent."[47]

However, both § 2036(a)(1) and (2) are subject to a critical exception. If a taxpayer transfers property to another in a "bona fide sale for an adequate and full consideration in money or money's worth," the transferred property is *not* included in the transferor's gross estate, even if the transferor retains an otherwise impermissible § 2036(a)(1) or (2) interest in the property.[48] This exception is merely an application of the logical principle that transactions that do not diminish the value of the taxpayer's estate should not trigger any gift or estate tax consequences, as the full value of the estate is preserved so that it can be taxed upon the taxpayer's death.

In *Strangi*, the Tax Court held that the taxpayer's transfers to an FLP triggered both § 2036(a)(1) and (2), requiring the taxpayer to include the full, undiscounted value of the transferred property in his gross estate.[49] The court began by determining that the transfer to the FLP triggered § 2036(a)(1), finding a tacit agreement between the taxpayer and the other family members with voting rights to have the FLP make distributions of income to the taxpayer as necessary to meet his expenses.[50] More significantly, the court held that the transfers to the FLP triggered § 2036(a)(2),[51] reasoning that the taxpayer had retained a minority voting interest in the FLP's corporate general partner, and that he could — in conjunction with other voting family members — exercise his voting right to have the FLP make distributions or liquidate.[52]

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[46] I.R.C. § 2036(a)(2). For example, suppose that a taxpayer transfers property to an irrevocable trust, naming herself as trustee. Suppose further that as trustee, the taxpayer retains the power to accumulate trust income for the benefit of remainder beneficiaries, or to distribute it immediately for the benefit of income beneficiaries. Under these circumstances, the transfer into trust triggers § 2036(a)(2), as the taxpayer has effectively reserved the power to determine which beneficiaries will enjoy the trust property. *See* United States v. O'Malley, 383 U.S. 627, 634 (1966). Consequently, the taxpayer must include the entire value of the trust property in her gross estate at death. *See id.*

[47] Treas. Reg. § 20.2036-1(b)(3).

[48] I.R.C. § 2036(a). For example, suppose that a taxpayer sells her primary residence to her children for fair market value but continues to live in the residence until death. Though the taxpayer has retained a § 2036(a)(1) interest in the residence, it will not be included in her gross estate. *See Maxwell*, 3 F.3d at 595–97. However, the sale proceeds *will* be included to the extent that the taxpayer has not consumed them before death. *See* I.R.C. § 2033.

[49] Estate of Strangi v. Comm'r, 85 T.C.M. (CCH) 1331, 1337–45 (2003).

[50] *Id.* at 1337–40.

[51] *Id.* at 1340–43.

[52] *Id.* at 1341–43.

In light of the sweeping language of § 2036(a)(2) and Treasury Regulation § 20.2036-1(b)(3),[53] the *Strangi* court's extension of § 2036(a)(2) to retained FLP voting rights seems uncontroversial. Nonetheless, the taxpayer in *Strangi* argued that the Supreme Court's decision in *United States v. Byrum*[54] required a different result. *Byrum* held that where a taxpayer's power to vote on corporate distributions or liquidation is constrained by fiduciary duties to other unrelated minority owners, the power does not trigger § 2036(a)(2).[55] The *Strangi* court rejected the taxpayer's assertion that his FLP voting rights were constrained by analogous duties, noting that the other owners of the taxpayer's FLP were *not* unrelated parties, but his family members.[56]

The *Strangi* court also rejected the taxpayer's claim that his transaction was excepted from § 2036 as a bona fide sale.[57] The court reasoned that the taxpayer's estate planner had structured virtually every aspect of the transaction.[58] It also noted that the transferee partnership "fail[ed] to qualify as [a] functioning business enterprise."[59] Consequently, it concluded that the taxpayer's exchange of his assets for an equity interest in the transferee partnership was a mere "circuitous 'recycling' of value" that, if upheld as a bona fide sale, would "open section 2036 to a myriad of abuses engendered by unilateral paper transformations."[60]

The *Strangi* decision alarmed the estate planning community, as its interpretation of § 2036(a)(2) subjected virtually every conceivable FLP transaction to the full-inclusion rule of § 2036.[61] After *Strangi*, estate planners feared, a taxpayer would have to give up *all* legal control over the assets he contributed to an FLP in order to avoid § 2036(a)(2) — at least three years prior to his death.[62] So long as the

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[53] *See supra* notes 46–47 and accompanying text.

[54] 408 U.S. 125 (1972).

[55] *Id.* at 137–38, 141–42. Commentators have criticized *Byrum*'s logic. *See, e.g.*, JOSEPH M. DODGE, WENDY C. GERZOG & BRIDGET J. CRAWFORD, FEDERAL TAXES ON GRATUITOUS TRANSFERS 474–75 (2011).

[56] *Strangi*, 85 T.C.M. (CCH) at 1340–43.

[57] *Id.* at 1343–44.

[58] *Id.*

[59] *Id.* at 1344.

[60] *Id.* (quoting Estate of Harper v. Comm'r, 83 T.C.M. (CCH) 1641, 1653 (2002)).

[61] Carter G. Bishop, *The Ebb and Flow of the Federal Tax Role of Fiduciary Duties in Family Limited Partnerships: From* Byrum *to* Bongard, 35 CAP. U. L. REV. 61, 61 (2006) ("[*Strangi*] sent shock waves throughout the estate planning community when it became the first case to reject the family limited partnership estate planning technique by expanding the reach of . . . section 2036.").

[62] *See, e.g.*, Mitchell M. Gans & Jonathan G. Blattmachr, Strangi*: A Critical Analysis and Planning Suggestions*, 100 TAX NOTES 1153, 1155–56, 1164, 1166 (2003) (noting that under I.R.C. § 2035 and *Strangi*'s interpretation of *Byrum*, FLP transactions trigger § 2036(a)(2) unless the transferor taxpayer gives up all rights to vote on FLP distributions or liquidation at least three years prior to death); *see also* I.R.C. § 2035(a) (2006).

taxpayer retained *any* voting rights in the FLP, either directly or through a corporate general partner, the taxpayer could — in conjunction with the other family members who held voting rights — vote to have the FLP make distributions or liquidate.[63] Because taxpayers whose deaths are not yet imminent typically do not want to cede all legal control over their assets to other family members, *Strangi* created uncertainty as to whether any viable FLP structure remained immune from attack under § 2036(a)(2).[64]

However, the estate planning bar's initial consternation over *Strangi* turned out to be unfounded. Post-*Strangi* Tax Court decisions have virtually eliminated *Strangi*'s value as a tool to challenge abusive FLP transactions by giving an extraordinarily broad reading to the bona fide sale exception to § 2036(a)(1) and (2).[65] The broadening of the exception began in *Estate of Bongard v. Commissioner*,[66] in which the Tax Court held that a taxpayer's exchange of his assets for an FLP interest qualifies as a bona fide sale so long as there exists a "legitimate and significant nontax purpose" for creating the FLP.[67] *Bongard* observed that such a nontax purpose might exist as long as the FLP engaged in a modicum of active asset management,[68] and also emphasized that "[l]egitimate nontax purposes are often inextricably interwoven with testamentary objectives."[69]

A few months after deciding *Bongard*, the Tax Court further expanded the bona fide sale exception in *Estate of Schutt v. Commis-*

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[63] *See* Gans & Blattmachr, *supra* note 62, at 1154–55.

[64] *See id.* at 1156 ("Inasmuch as, under the structure of many (if not all) family limited partnerships, the decedent does not divest herself prior to death of all [rights to vote on FLP distributions or liquidation], the validity of [*Strangi*'s § 2036(a)(2)] holding is of critical practical significance."); Christopher P. Bray, *Was* Strangi II *a Setup?*, PLANNED GIVING DESIGN CENTER (Sept. 16, 2012), http://www.pgdc.com/pgdc/was-strangi-ii-setup ("Based on [*Strangi*'s] section 2036(a)(2) analysis, the entire universe of FLP planning . . . was at risk of producing a result never contemplated or intended . . . . [*Strangi*] was a monumental surprise to the estate planning community.").

[65] *See, e.g.*, J. Joseph Korpics, *Qualifying New FLPs for the Bona Fide Sale Exception: Managing* Thompson*,* Kimbell*,* Harper *and* Stone, 102 J. TAX'N 111, 111–12 (2005) ("Not surprisingly, [*Strangi*'s broad interpretation of § 2036(a)(2)] brought renewed focus and attention to the Section 2036(a) bona fide sale exception. . . . [T]he bona fide sale exception is a powerful weapon for the taxpayer who desires to form a new FLP."); Updike, *supra* note 42, at 3–4 ("[*Strangi*'s] analysis of the bona fide transfer exception is conclusory to say the least. . . . [P]ractitioners can take some comfort in knowing that FLPs can be recognized as legitimate planning tools under the § 2036(a) bona fide transfer exception."); Steve R. Akers, *Estate Planning Current Developments and Hot Topics* (ALI-ABA Continuing Professional Education, July 18–20, 2012), WL CU005 ALI-ABA 435, 517 (noting that virtually "[*a*]*ll* of the [many recent] FLP cases resulting in taxpayer successes against a § 2036 attack . . . have relied on the bona fide sale exception to § 2036").

[66] 124 T.C. 95 (2005).

[67] *Id.* at 118.

[68] *See id.* at 128–29.

[69] *Id.* at 121.

sioner.[70] The assets of the FLPs in *Schutt* consisted entirely of readily marketable blue-chip stocks.[71] Nevertheless, the Tax Court affirmed an aggressive 46.4% valuation discount on the taxpayer's FLP interests,[72] accepting the taxpayer's claim that he had established his FLPs for the nontax purpose of carrying out his "buy and hold" investment philosophy.[73] By accepting this purported nontax purpose, the *Schutt* court effectively held that an FLP need not even engage in active asset management to satisfy the *Bongard* test.[74] Perhaps realizing that the taxpayer's asserted purpose was a feeble ground on which to rest its opinion, the *Schutt* court emphasized that the "bona fides" of the sale were enhanced by the fact that the taxpayer had scrupulously observed formalities, keeping FLP assets separate from his personal assets and retaining sufficient assets outside of the FLP to sustain himself until his death.[75]

The Tax Court recently reaffirmed *Schutt* in its decision in *Estate of Miller v. Commissioner*.[76] The *Miller* court expressly rejected the government's argument that a partnership's activities must amount to a functioning business for interests in the partnership to be entitled to valuation discounts.[77] As in *Schutt*, the assets of the FLP in *Miller* consisted entirely of cash and liquid securities.[78] Nevertheless, the *Miller* court upheld a 35% "lack of marketability" discount on the taxpayer's FLP interest, accepting the taxpayer's claim that the FLP served the nontax purposes of "asset protection, succession of management, centralized management, and continuation of the family's investment strategy."[79] As in *Schutt*, the court buttressed its decision by noting that the taxpayer had scrupulously followed formalities.[80]

Together, *Schutt* and *Miller* make clear that taxpayers can continue to use FLP transactions to avoid the federal transfer taxes so long as they retain competent estate planners.[81] As Professor Laura Cunning-

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[70] 89 T.C.M. (CCH) 1353 (2005).

[71] *Id.* at 1360–61.

[72] *See id.* at 1362.

[73] *Id.* at 1364–65.

[74] *See id.* at 1362 ("Through at least the time of decedent's death, the trusts had never sold any of the DuPont or Exxon shares used to fund the entities, nor had they acquired any other assets.").

[75] *Id.* at 1362, 1367.

[76] 97 T.C.M. (CCH) 1602 (2009).

[77] *Id.* at 1609 ("[An FLP's] activities need not rise to the level of a 'business' under the Federal income tax laws in order for the ['bona fide sale'] exception under section 2036(a) to apply.").

[78] *See id.* at 1604–06.

[79] *See id.* at 1604, 1608.

[80] *See id.* at 1609–10.

[81] *See* Cunningham, *FLP Fix*, *supra* note 4, at 940 ("*Schutt* is an excellent example of how well-advised, extremely wealthy taxpayers can avoid the risk of a section 2036 attack, and even the amateurs are being coached on how to do so. There is no doubt that the superrich can continue to obtain substantial discounts, and the resulting revenue loss is staggering." (footnote omit-

ham has observed, "FLPs are vulnerable under section 2036 only when poorly planned," such that "only rank amateurs will be deterred."[82] Estate planners have declared victory.[83]

It is not yet entirely clear whether the federal courts will accept the Tax Court's recent expansion of the § 2036 bona fide sale exception. For example, though the Fifth Circuit upheld an FLP under § 2036 in *Kimbell v. United States*,[84] it relied heavily on the fact that approximately 15% of its assets consisted of oil and gas working interests that required "active management."[85] *Kimbell* could be read to suggest that for a transfer to a business entity to satisfy the bona fide sale exception, the entity must engage in some actual business activity.[86]

However, even if the Fifth Circuit's possibly narrower view of § 2036 were to become established law, it would do little to curb FLP-driven transfer tax avoidance. Reading *Kimbell* in the light most unfavorable to taxpayers, a taxpayer would still be able to insulate her entire FLP structure from a § 2036 challenge by ensuring that the entity held a small percentage of assets that require "active management."[87] *Kimbell* itself is illustrative: though some 85% of the FLP's assets in that case consisted of cash and readily marketable securities, the Fifth Circuit upheld a 49% valuation discount on the *entire* value of the FLP.[88]

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ted)); Cunningham, *FLPs*, *supra* note 6, at 808 ("What *Miller* tells us is that the Tax Court is willing to split hairs in making distinctions, guaranteeing that well-advised wealthy taxpayers can drastically reduce the amount of estate taxes due on their death. . . . [T]he court seems bound and determined to keep the FLP alive, even in cases in which it easily could find that section 2036 controls.").

[82] Cunningham, *FLP Fix*, *supra* note 4, at 938–39; *see also* Cunningham, *FLPs*, *supra* note 6, at 807 ("While the Tax Court has been willing to deny discounts in cases in which the taxpayers were sloppy, it shows no sign that it is willing to back away from the established practice of allowing significant discounts to partnerships holding even the most liquid of assets, as long as the transferor dots all her i's and crosses all her t's . . . ."); Wendy C. Gerzog, *FLP in the Black*, 127 TAX NOTES 343, 347 (2010) (suggesting that the Tax Court's FLP jurisprudence has devolved into "a clear example of 'exalting artifice above reality'"); Rebecca B. Hawblitzel, Case Note, *A Change in Planning:* Estate of Strangi v. Commissioner*'s Effect on the Use of Family Limited Partnerships in Estate Planning*, 57 ARK. L. REV. 595, 625 (2004) (noting that by using certain simple planning strategies, "a tax or estate planning practitioner should be able to avoid any problems caused by the Tax Court's interpretation of section 2036(a)").

[83] *See, e.g.*, Thomas E. Rutledge, *Unsuccessful and Successful Attacks on Family Limited Partnerships and Family Limited Liability Companies by the Internal Revenue Service* (ALI-ABA Continuing Legal Education, July 23, 2012), WL VCU0723 ALI-ABA 683, 687 (noting that taxpayers using FLP structures can now avoid the application of section 2036 altogether "through careful planning during entity formation and proper management after formation").

[84] 371 F.3d 257 (5th Cir. 2004).

[85] *Id.* at 267; *see id.* at 259, 267–69.

[86] *See* Estate of Hurford v. Comm'r, 96 T.C.M. (CCH) 422, 443 (2008) (citing *Bongard* and *Kimbell* for the proposition that "a FLP needs to be a functioning business or at least have some meaningful economic activity").

[87] *Kimbell*, 371 F.3d at 267.

[88] *Id.* at 259–60.

III. IMPORTING THE § 6166 "TRADE OR BUSINESS" LIMITATION INTO § 2036: TOWARD A REGULATORY SOLUTION TO FLP-DRIVEN TRANSFER TAX AVOIDANCE

This Note argues that the "trade or business" limitation that I.R.C. § 6166 imposes on estate tax deferral provides the paradigm for an elegant, administrable regulatory solution to FLP-driven transfer tax avoidance. Specifically, this Note recommends that Treasury amend Treasury Regulation § 20.2043-1(a) such that — in the context of transfers to business entities — § 2036's bona fide sale exception is limited to circumstances in which the transferee entity actually "use[s]" the transferred assets "in carrying on a trade or business."[89]

Section III.A explains why the "trade or business" limitation of § 6166 provides the template for a simple and effective solution to FLP abuse. Section III.B discusses the language, structure, and application of the proposed regulatory amendment. Section III.C suggests that the Service should construe the amended regulation in accordance with the guidance it has issued under § 6166, explaining why such an interpretation would appropriately deter abuse of valuation discounts while assuring their availability to legitimate closely held businesses. Finally, section III.D discusses Treasury's statutory authority to make the proposed amendment.

A. *Section 6166's "Trade or Business" Limitation as a Solution to FLP Abuse*

Section 6166 permits qualifying owners of closely held businesses to pay off the estate tax due on their business interests over a period of up to fifteen years,[90] exempting them from the general rule that a taxpayer's entire estate tax liability is due nine months after death.[91] Like valuation discounts, § 6166 deferral endeavors to conform the estate tax to the reality that owners of closely held businesses cannot readily cash out their equity.[92] For estates whose value derives primarily from an illiquid business interest, imposition of the estate tax could trigger a liquidity crisis. Deferral prevents this result by permit-

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[89] *Cf.* I.R.C. § 6166(b)(9)(A), (B)(i) (2006).

[90] *See id.* § 6166(a).

[91] *See id.* § 6075(a).

[92] *See* H.R. REP. NO. 94-1380, at 30 (1976) ("The present [version of § 6166 has] proved inadequate to deal with the liquidity problems experienced by estates in which a substantial portion of the assets consist of a closely held business or other illiquid assets. In many cases, the executor is forced to sell a decedent's interest in a farm or other closely held business in order to pay the estate tax."); S. REP. NO. 94-938, pt. 2, at 18 (1976) (same); *see also* H.R. REP. NO. 105-148, at 356 (1997) ("The Committee believes that [§ 6166] need[s] to be expanded in order to better address the liquidity problems of estates holding farms and closely held businesses.").

ting such estates to pay off their estate tax liability in installments over a period of years.

Though deferral and discounts serve similar objectives, deferral is subject to a logical antiabuse limitation, whereas discounts are not. Under § 6166, a taxpayer can claim deferral only on the value of his business interest attributable to assets the entity actually "use[s] in carrying on a trade or business."[93] That is, § 6166 accommodates illiquidity only to the extent that it arises from the organic development of a commercial enterprise.[94] A taxpayer cannot manufacture deferral-eligible illiquidity merely by lumping together marketable investment assets in a paper entity.[95]

Treasury should address FLP-driven transfer tax avoidance by imposing an analogous "trade or business" restriction on the availability of valuation discounts. Like deferral, valuation discounts are made available to account for the illiquidity of equity in closely held businesses.[96] Like deferral, discounts should be available only to the extent such illiquidity is the natural consequence of business necessity, not the synthetic product of tax planning.

B. *The Proposed Amendment to Treasury Regulation § 20.2043-1(a)*

To understand the regulatory amendment this Note proposes, it is useful to first briefly revisit the mechanics of § 2036. As discussed above, § 2036 claws back transfers into the transferor's gross estate if (1) the transferor retains an ownership-equivalent right to use or control the transferred assets, and (2) the transfer is not a bona fide sale.[97] Under *Strangi*'s interpretation of § 2036(a)(2), a taxpayer who transfers assets to an FLP retains an impermissible interest in the property unless he relinquishes all rights to vote on FLP distributions or liquida-

[93] I.R.C. § 6166(b)(9)(B)(i); *see id.* § 6166(b)(9)(A); *see also* Rev. Rul. 2006-34, 2006-1 C.B. 1172 ("Under section 6166(b)(9)(A), for purposes of section 6166(a)(1) and determining the closely held business amount, the value of an interest in a business does not include the value of that portion of the interest that is attributable to passive assets held by the business. The term 'passive asset' is defined in section 6166(b)(9)(B)(i) as any asset other than an asset used in carrying on a trade or business.").

[94] *See* Rev. Rul. 75-367, 1975-2 C.B. 472 ("[S]ection [6166] was not intended to protect continued management of income producing properties or to permit deferral of the tax merely because the payment of the tax might make necessary the sale of income-producing assets, except where they formed a part of an active enterprise producing business income rather than income solely from the ownership of property.").

[95] Rev. Rul. 75-365, 1975-2 C.B. 471 ("What amounts to a 'trade or business carried on' within the meaning of the statutory language of section 6166(c)(1) . . . should be found in keeping with the intent of the legislature in enacting section 6166. . . . It follows that the mere grouping together of income-producing assets from which a decedent obtained income only through ownership of the property rather than from the conduct of a business, in and of itself, does not amount to an interest in a closely held business within the intent of the statute.").

[96] *See supra* pp. 1330–31.

[97] I.R.C. § 2036(a); *see also supra* pp. 1332–33.

tion more than three years prior to death.[98] Since taxpayers are usually unwilling to cede such legal control over their assets,[99] the application of § 2036 to FLP transactions hinges on the scope of the bona fide sale exception to the section's full-inclusion rule.[100]

This Note proposes that Treasury narrow the bona fide sale exception by amending Treasury Regulation § 20.2043-1(a), which currently provides that a sale is "bona fide" for purposes of § 2036 if the transfer is made "in good faith."[101] The amended regulation would provide that:

> If a taxpayer transfers money or property to another taxpayer who is not a natural person, the transfer will only qualify as bona fide to the extent that immediately after the transfer, the transferee uses the transferred money or property in carrying on a trade or business.[102]

The mechanics of the proposed amendment (hereinafter "Amended Regulation § 20.2043-1(a)") are best understood by way of an example. Suppose that on the first day of Tax Year 1, the taxpayer, owner of an automotive parts wholesale business, charters an FLP structure to which he transfers $5,000,000 worth of land, buildings, equipment, and goodwill; $200,000 in cash; and $3,000,000 worth of marketable securities. The taxpayer divides up FLP ownership and voting rights as in *Strangi*, receiving a 99% limited interest in partnership assets and profits. Immediately after the transfer, the FLP uses the land, buildings, equipment, goodwill, and cash (but *not* the marketable securities) in carrying on an auto parts wholesale business. Under Amended Regulation § 20.2043-1(a), the transfer of the $5,200,000 worth of business assets would qualify as a § 2036 bona fide sale, but the transfer of the $3,000,000 worth of marketable securities would not qualify.

Now suppose that in Tax Year 5, the taxpayer dies, still holding his 99% limited partnership interest. On the date of the taxpayer's death, the land, buildings, equipment, and goodwill have fallen in value to

[98] *Supra* pp. 1333–35.

[99] *Supra* p. 1335.

[100] *Supra* p. 1335.

[101] Treas. Reg. § 20.2043-1(a) (as amended in 2011).

[102] The definition of "bona fide sale" set forth in Treasury Regulation § 20.2043-1 currently applies not only for purposes of § 2036, but also for purposes of §§ 2035, 2037, 2038, and 2041. *See* Treas. Reg. § 20.2043-1. It is beyond the scope of this Note to address whether the proposed "trade or business" limitation should also apply in the context of the latter four Code sections. However, consistency probably requires such a result. *Cf.* Rose v. United States, 511 F.2d 259, 261–62 (5th Cir. 1975) (reading §§ 2036, 2037, 2038, and 2041 *in pari materia*). All five sections are part of an interrelated antiavoidance regime that prevents taxpayers from skirting the estate tax by making lifetime transfers that, in economic reality, do not take effect until the taxpayer's death. Rev. Rul. 74-556, 1974-2 C.B. 300. Failing to apply the proposed "trade or business" limitation uniformly under all five sections might — aside from generating needless complexity — leave open opportunities for FLP-driven tax avoidance. *Cf.* I.R.C. §§ 2035, 2041.

$4,000,000, the securities have appreciated in value to $5,000,000, and the business has increased its cash reserves to $300,000 through retained earnings. Under Amended Regulation § 20.2043-1(a) and § 2036, the taxpayer's estate would be entitled to discount the $4,300,000 portion of the value of taxpayer's limited partnership interest attributable to the land, buildings, equipment, goodwill, and cash reserves but would have to include the full $5,000,000 value of the marketable securities in the taxpayer's gross estate.[103]

Notably, the taxpayer cannot avoid the reach of Amended Regulation § 20.2043-1(a) by gifting away discounted limited partnership interests during his life. While Amended Regulation § 20.2043-1(a) would not directly affect gift tax valuation rules, under which valuation discounts would presumably still be available,[104] the application of § 2036 depends only on the *initial* transfer of assets to the business entity.[105] Thus, so long as the taxpayer retains any right to vote on FLP distributions or liquidation within three years prior to death, § 2036 requires full inclusion of *all* transferred assets that did not originally fall within the bona fide sale exception.[106] (Incidentally, the taxpayer is not subjected to double transfer taxation, as she will receive an estate tax credit for gift taxes paid.[107])

C. The Service Should Look to Its Rulings Under § 6166 when Applying Amended Regulation § 20.2043-1(a)

In determining whether assets are "used" in a "trade or business" for purposes of Amended Regulation § 20.2043-1(a), the Service should look to its rulings under § 6166 for guidance. These rulings, which the Service has issued and refined over the span of several decades, establish a pragmatic and effective set of rules for distinguishing between those business interests whose illiquidity is tax planning artifice and those whose illiquidity is the natural consequence of the development of an underlying commercial enterprise.

Essentially, the Service's rulings under § 6166 operate by rendering the costs of manufacturing tax-cognizable illiquidity too great to entice the estate planning bar. Most importantly, the Service has held that the definition of "trade or business" as used in § 6166 is limited to

[103] *See* Estate of D'Ambrosio v. Comm'r, 101 F.3d 309, 316 (3d Cir. 1996) ("[I]f the full, fee simple value of the property at the time of death is pulled back into the gross estate under § 2036(a), . . . then the post-sale appreciation of the transferred asset will be taxed at death.").

[104] *See, e.g.*, Perracchio v. Comm'r, 86 T.C.M. (CCH) 412, 419 (2003) (upholding aggregate valuation discount of over 30% on gifted FLP interests).

[105] *See* I.R.C. § 2036(a); Treas. Reg. § 20.2036-1.

[106] *See* Gans & Blattmachr, *supra* note 62, at 1164; *see also* I.R.C. §§ 2035, 2036(a); Treas. Reg. § 20.2036-1.

[107] *See* I.R.C. § 2001(b)(2).

"business such as a manufacturing, mercantile, or service enterprise, as distinguished from management of investment assets," at least where "the [taxpayer's] relationship to the [assets is] merely that of an owner managing [the] assets to obtain the rents ordinarily expected from them."[108] That is, the taxpayer cannot turn her otherwise liquid investment assets into deferral-eligible business assets merely by transferring them to a paper entity, but must furnish proof that her entity manufactures widgets,[109] produces agricultural products or natural resources,[110] or otherwise provides goods or services to unrelated clients.[111]

Moreover, the Service has held that assets are "used" in "carrying on" a § 6166 "trade or business" only if the assets are — in economic reality and considering all the circumstances — necessary to carrying on that trade or business.[112] Thus, even if a taxpayer *does* carry on a legitimate "trade or business," she cannot turn her otherwise liquid investment assets into deferral-eligible business assets merely by parking them in the business. Instead, she must demonstrate that the assets are integral to the business, which, in the case of cash or marketable securities, generally requires proof that the assets reflect working capital or reasonable reserves.[113]

Assuming that the Service utilizes its § 6166 guidance in interpreting and applying Amended Regulation § 20.2043-1(a), § 2036 would become a potent weapon against FLP-driven transfer tax avoidance. Many FLPs would fail the threshold requirement of "carrying on a trade or business." Consider, for example, the FLPs at issue in *Schutt* and *Miller*.[114] The Tax Court upheld both FLPs on the ground that they facilitated the taxpayers' investment schemes, but neither FLP

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[108] Rev. Rul. 75-367, 1975-2 C.B. 472.

[109] *See id.* (ruling that manufacturing qualifies as a "trade or business").

[110] *See, e.g.*, Rev. Rul. 61-55, 1961-1 C.B. 713 (ruling that oil and gas exploration, development, and production qualifies as a "trade or business"); I.R.S. Tech. Adv. Mem. 84-19-002 (Dec. 21, 1983) (same); I.R.S. Tech. Adv. Mem. 96-35-004 (May 15, 1996) (ruling that cattle ranching qualifies as a "trade or business"); I.R.S. Tech. Adv. Mem. 86-01-005 (Sept. 24, 1985) (same); I.R.S. Tech. Adv. Mem. 85-15-010 (Jan. 8, 1985) (ruling that timber production qualifies as a "trade or business"); I.R.S. Tech. Adv. Mem. 84-32-007 (Apr. 9, 1984) (ruling that farming qualifies as a "trade or business"); I.R.S. Tech. Adv. Mem. 83-14-003 (Dec. 9, 1982) (same).

[111] *See, e.g.*, Rev. Rul. 2006-34, 2006-1 C.B. 1172 (ruling that real estate management qualifies as a "trade or business" if the taxpayer furnishes significant services to tenants); I.R.S. Priv. Ltr. Rul. 1999-29-025 (July 23, 1999) (same); I.R.S. Priv. Ltr. Rul. 2000-06-034 (Feb. 11, 2000) (ruling that operation of a wholesale automotive parts store qualifies as a "trade or business"); I.R.S. Priv. Ltr. Rul. 93-09-015 (Dec. 1, 1992) (ruling that operation of a hotel qualifies as a "trade or business"); I.R.S. Priv. Ltr. Rul. 90-15-009 (Jan. 5, 1990) (same); I.R.S. Priv. Ltr. Rul. 83-17-110 (Jan. 28, 1983) (ruling that operation of a commercial campground qualifies as a "trade or business").

[112] *See* I.R.S. Priv. Ltr. Rul. 2001-14-005 (Apr. 6, 2001) (citing S. REP. NO. 98-169, vol. 2, at 711, 714 (1984)).

[113] *See id.*

[114] *See supra* pp. 1335–36.

undertook any activities beyond the management of its own investment assets. Consequently, neither FLP carried on a "trade or business" within the meaning of Amended Regulation § 20.2043-1(a), and § 2036 would require full inclusion.

As for FLP structures that actually incorporate legitimate businesses, Amended Regulation § 20.2043-1(a) would limit valuation discounts to that portion of the FLPs' value attributable to assets actually "used" in a business immediately after the transfer. Take the *Kimbell* FLP as an example.[115] While the *Kimbell* FLP's management of oil and gas working interests would likely qualify as a "trade or business,"[116] some 85% of the FLP's value derived from cash and liquid securities unconnected to the oil and gas interests.[117] Under Amended Regulation § 20.2043-1(a), § 2036 would require the *Kimbell* taxpayer to include the cash and liquid securities in her gross estate at full value.

By adopting its § 6166 guidance when interpreting and applying Amended Regulation § 20.2043-1(a), the Service would also preserve valuation discounts for small business owners who genuinely lack the ability to realize the full value of their business equity. First, taxpayers generally qualify as carrying on a § 6166 "trade or business" as long as their activity level meets a minimum threshold that is easily satisfied in the context of commercial enterprises with business motives apart from reducing their owners' estate tax liability. Thus, the owners of small businesses ranging from cattle ranches and farms, to hotels and commercial campgrounds, to real estate management companies would all be entitled to discount the value of assets used in their respective businesses, as long as they, their agents, or their employees are active in the day-to-day management and operation of the business.[118]

Second, the Service's substance-over-form approach to whether assets are "used" in "carrying on a trade or business" would ensure that small, unsophisticated business owners could obtain valuation discounts even if they fail to observe legal formalities. For example, the owner of a construction business would be entitled to discount the value of a bank account that holds working capital of the business even if the account is formally registered in the taxpayer's own name.[119] Similarly, the owner of an automotive supply wholesale business would be entitled to discount the value of the land and build-

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115 *See supra* p. 1337.

116 *See* Rev. Rul. 61-55, 1961-1 C.B. 713 (ruling that the exploration, development, and operation of oil and gas properties is a § 6166 "trade or business"); I.R.S. Tech. Adv. Mem. 84-19-002 (Dec. 21, 1983) (same).

117 *See* Kimbell v. United States, 371 F.3d 257, 259 (5th Cir. 2004).

118 *See* sources cited *supra* notes 110–111.

119 *See* I.R.S. Priv. Ltr. Rul. 2001-14-005 (Apr. 6, 2001).

ing he uses in the business, even if both are formally held in the name of the owner and not of the business.[120]

D. Treasury's Statutory Authority to Issue Amended Regulation § 20.2043-1(a)

Section 7805 gives Treasury the general authority to pass "all needful rules and regulations for the enforcement of" the Internal Revenue Code.[121] Although courts have long disputed the appropriate standard of judicial review for regulations issued under § 7805, the Supreme Court recently clarified that *Chevron* deference[122] applies with "full force" to such regulations.[123] Hence, the question of whether Treasury has the authority to pass the proposed "trade or business" limitation as an interpretation of the bona fide sale exception to § 2036 turns on whether the statutory text is ambiguous and, if so, whether such an interpretation is reasonable.[124]

The proposed regulation should not have difficulty passing muster under the *Chevron* standard. Section 2036's bona fide sale language is not defined by statute and is sufficiently indeterminate to give Trea sury substantial interpretive leeway.[125] Treasury has often implemented similarly vague statutory language through the adoption of detailed, mechanical rules, and its interpretations in this regard have generally been upheld by the courts. Perhaps the most dramatic recent example is the check-the-box regulations under § 7701, which interpret the statutory term "associations" to mandate a complex set of mandatory and default entity classification rules that span at least a dozen pages in the Code of Federal Regulations.[126] Both the Second and

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[120] *See* I.R.S. Priv. Ltr. Rul. 2000-06-034 (Feb. 11, 2000).

[121] *See* I.R.C. § 7805(a) (2006).

[122] *See* Chevron U.S.A. Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 842–43 (1984).

[123] Mayo Found. for Med. Educ. & Research v. United States, 131 S. Ct. 704, 713 (2011); *see also* Charles J. Cooper & Vincent Colatriano, *The Regulatory Authority of the Treasury Department to Index Capital Gains for Inflation: A Sequel*, 35 HARV. J.L. & PUB. POL'Y 487, 498–99 (2012).

[124] *See Chevron*, 467 U.S. at 842–43.

[125] *Cf., e.g.*, Matul-Hernandez v. Holder, 685 F.3d 707, 712 (8th Cir. 2012) ("The phrase 'particular social group' is not defined in the INA. 'As a result, we give *Chevron* deference to the BIA's reasonable interpretation of the phrase, and will not overturn the BIA's conclusion unless it is arbitrary, capricious, or manifestly contrary to the statute.'" (quoting Ngengwe v. Mukasey, 543 F.3d 1029, 1033 (8th Cir. 2008); Gaitan v. Holder, 671 F.3d 678, 680 (8th Cir. 2012))); Wheatland Tube Co. v. United States, 495 F.3d 1355, 1359–60 (Fed. Cir. 2007) ("Congress has not defined or explained the meaning or scope of 'United States import duties' as set forth in 19 U.S.C. § 1677a(c)(2)(A). . . . Thus, . . . this court finds that the statute is ambiguous . . . .").

[126] *Compare* Treas. Reg. § 301.7701-1 (as amended in 2009), *and* Treas. Reg. § 301.7701-2 (as amended in 2008), *and* Treas. Reg. § 301.7701-3 (as amended in 2006), *with* I.R.C. § 7701. For other examples in which Treasury has "take[n] on the role of lawmaker in the absence of a specific [c]ongressional mandate," see Mark E. Berg, *Judicial Deference to Tax Regulations: A Reconsider-*

Sixth Circuits have upheld the regulations as an "eminently reasonable" exercise of Treasury's authority to fill statutory gaps.[127]

Moreover, the "trade or business" limitation set forth in Amended Regulation § 20.2043-1(a) is consistent with congressional intent. As the Fifth Circuit has observed, legislative history suggests that Congress intended § 2036's bona fide sale exception to apply to those sale transactions that — based on *objective* indicia — serve a substantial business purpose: "Congress has foreclosed the possibility of determining the purpose of a given transaction based on findings as to the subjective motive of the transferor."[128] While the Tax Court in *Bongard* suggested that its "nontax purpose" test provides the objectivity Congress intended,[129] the Tax Court's recent decisions — which have upheld FLP structures on the basis of little more than the taxpayer's statement of his subjective nontax motive — suggest that *Bongard*'s nontax purpose test is anything but objective.[130] Congress's desire to avoid subjective motive inquiries would be better served by limiting the § 2036 bona fide sale exception to transfers whose business purpose is objectively discernible from the fact that the transferee uses the assets in carrying on a trade or business.

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ation in Light of National Cable*,* Swallows Holding*, and Other Developments*, 61 TAX LAW. 481, 483 & n.12 (2008).

[127] McNamee v. Dep't of Treasury, 488 F.3d 100, 109 (2d Cir. 2007); Littriello v. United States, 484 F.3d 372, 378 (6th Cir. 2007). The reader may object that Congress knows how to implement an active business limitation where it sees fit, as evidenced by § 6166. While this argument is not without merit, Treasury has successfully imposed active business limitations under other Code sections that do not expressly mandate such a requirement. *Compare* Treas. Reg. § 1.269-3(d) (as amended in 1992), *with* I.R.C. § 269; *compare* Treas. Reg. § 1.881-3(b)(3), *with* I.R.C. § 7701(*l*). Active business limitations provide a simple, administrable mechanism to prevent taxpayers from using shell entities to avoid taxes. *See, e.g.*, John P. Simon & Julie M. Bradlow, *Chapter 11 Plan Strategies in the '90s — Federal Income Tax Aspects* (ALI-ABA Course of Study, Apr. 27, 1992), WL C685 ALI-ABA 179, 191 (noting that the "active trade or business" requirement of the § 269 regulations "prevent[s] a favorable result . . . in situations where a debtor corporation sells all its assets and becomes a 'shell' corporation"). It is unlikely that a federal court would strip Treasury of the power to implement a simple, effective antiabuse tool, especially as Congress and the courts have made clear that Treasury's regulatory power is at its broadest where necessary to prevent abuse. *See, e.g.*, I.R.C. § 7805(b)(3); Meserve Drilling Partners v. Comm'r, 152 F.3d 1181, 1183–84 (9th Cir. 1998).

[128] *See* Strangi v. Comm'r, 417 F.3d 468, 479 (5th Cir. 2005).

[129] *See* Estate of Bongard v. Comm'r, 124 T.C. 95, 118–19 (2005) (noting that "[*Kimbell*] set forth an objective inquiry," *id.* at 118, and that "the objective evidence must indicate that the nontax reason was a significant factor that motivated the partnership's creation," *id.* at 119).

[130] *See supra* pp. 1335–37; *see also Bongard*, 124 T.C. at 144 (Halpern, J., concurring in part and dissenting in part) ("[T]he majority['s] [nontax purpose test] makes [the taxpayer's] state of mind critical . . . .").

IV. *STRANGI*, *BYRUM*, AND § 2036(A)(2): ADDRESSING POSSIBLE CONCERNS

At least two criticisms can be leveled against the reform proposal set forth in this Note. Both relate to the fact that Amended Regulation § 20.2043-1(a) addresses only the bona fide sale *exception* to the full-inclusion rule of § 2036(a) and has no application to FLP transactions that do not fall within the scope of § 2036(a)(1) or (2) as an initial matter.

First, Professor Mitchell Gans and Jonathan Blattmachr suggest that *Strangi*'s interpretation of § 2036(a)(2) and *Byrum* can be avoided by using modified FLP structures.[131] However, most of the structures Gans and Blattmachr propose would require the taxpayer to cede her right to vote on FLP distributions or liquidation more than three years prior to death.[132] The remaining structures are either speculative[133] or rely on unique circumstances unlikely to obtain for most taxpayers (such as independently wealthy heirs).[134] It seems improbable that many taxpayers would accept the loss of control entailed by the transactions Gans and Blattmachr propose.

Second, *Strangi*'s interpretation of § 2036(a)(2) and *Byrum* has not been tested in subsequent cases.[135] However, this lack of case law is due in part to the fact that the Tax Court often finds that FLP transactions trigger § 2036(a)(1), obviating the need to reach (a)(2).[136] Moreover, Treasury could address this concern by codifying *Strangi*'s understanding of *Byrum* under Treasury Regulation § 20.2036-1(b)(3).[137] It is beyond the scope of this Note to address whether Treasury has authority to pass such a regulatory amendment. Suffice it to say that *Strangi* itself explains why its construction of § 2036(a)(2) is both reasonable and in keeping with *Byrum*.[138]

V. CONCLUSION

Valuation discounts serve a legitimate role in our system of transfer taxation, assuring fair treatment to small business owners by taking

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[131] *See* Gans & Blattmachr, *supra* note 62, at 1153.
[132] *See id.* at 1166–68, 1170–71.
[133] *See id.* at 1168–69.
[134] *See id.* at 1169–71.
[135] Since *Strangi*, the Tax Court has often upheld FLP transactions under the bona fide sale exception without making meaningful inquiry into § 2036(a)(1) or (2). *See, e.g.*, Estate of Schutt v. Comm'r, 89 T.C.M. (CCH) 1353, 1368 (2005).
[136] *See, e.g.*, Estate of Miller v. Comm'r, 97 T.C.M. (CCH) 1602, 1610 (2009); Estate of Rector v. Comm'r, 94 T.C.M. (CCH) 567, 2007 WL 4355345, at *7–8 (Dec. 13, 2007).
[137] *See supra* pp. 1332–33.
[138] *See* Estate of Strangi v. Comm'r, 85 T.C.M. (CCH) 1331, 1340–43, *aff'd,* 417 F.3d 468 (5th Cir. 2005).

into account the illiquidity of their equity. In recent years, however, aggressive tax planners have managed to untether business interest valuation principles from their economic moorings, with taxpayers routinely claiming (and receiving) eye-popping valuation discounts on passive FLP structures filled entirely with cash and liquid investment assets. Sooner or later, Congress will strike back, perhaps by eliminating valuation discounts altogether.[139] Taxpayers would be wise to embrace a regulatory solution that curbs the worst excesses of the current system while preserving discounts for legitimate family businesses.

[139] *See, e.g.*, Jay A. Soled & Mitchell Gans, *Sales to Grantor Trusts: A Case Study of What the IRS and Congress Can Do to Curb Aggressive Transfer Tax Techniques*, 78 TENN. L. REV. 973, 986 (2011) (assuming that "Congress will at some point eliminate several of the most utilized estate planning techniques, including . . . valuation discounts"); Bernard Eizen, *Understanding the Succession Planning Goals of Family Business Owners*, ASPATORE (Nov. 2012), 2012 WL 4963309 ("Congress and the IRS have expressed criticism at the lack of uniformity of court findings and taxpayer practices in this area, threatening to eliminate valuation discounts through legislation."); *see also* Mitchell M. Gans & Jay A. Soled, *Reforming the Gift Tax and Making it Enforceable*, 87 B.U. L. REV. 759, 784 (2007) ("Congress should eliminate . . . the use of valuation discounts . . . .").