Nebraska Law Review

Volume 59 | Issue 3 Article 6

1980

The Partnership Capital Freeze: An Examination of Control Retention by Donor Partners

Gary N. Clatterbuck
University of Nebraska College of Law, gclatterbuck@bairdholm.com

Comment

The Partnership Capital Freeze: An Examination of Control Retention by Donor Partners

I. INTRODUCTION—ESTATE PLANNING FOR THE FAMILY BUSINESS

Implementing an estate plan for the owner of a closely held family business is one of the most challenging tasks an estate planner will encounter. The estate plan must fulfill the needs of tax reduction, preservation of the family business and satisfaction of the dispositive wishes of the client.[1]

The incentive for transferring the business in a manner which satisfies these sometimes competing objectives is especially strong in situations where the value of the enterprise is primarily attributable to the ownership of capital which is rapidly appreciating. The family farm business best exemplifies the disastrous tax consequences affecting surviving family members when the underlying property of the business appreciates at a rate greatly in excess of the income realized from the operation.[2] Excessive appreciation of the business property may defeat the desired goal of maintenance of family ownership and control of the business after the death of the owner-operator because excessive estate tax liability will require the sale of the business to satisfy those estate taxes.[3]

The primary objective of an estate plan for owners of a family business is to "freeze" the value of the owner-operator's equity in

---

1. Nash, *Family Partnerships: A Viable Planning Alternative*, 13 U. MIAMI EST. PLAN. INST. ¶ 1000 (1979).
2. *See generally* Brugh, *Structuring the Farm and Ranch Operation for Business and Estate Planning*, 54 NEB. L. REV. 262 (1975); Kelley, *The Farm Corporation As an Estate Planning Device*, 54 NEB. L. REV. 217 (1975).
3. Although the burden of the estate tax may be ameliorated through electing the installment methods of payment under sections 6166 or 6166A of the Internal Revenue Code (Code), these elections may be insufficient to prevent the sale of the business where the income generated from operations is considerably disproportionate to the value of the underlying assets of the business. In addition, the transition of management to surviving family members frequently results in a decline in the business during the transition, making available less income for retiring the estate tax liability.

the business and transfer appreciation of the business assets to the family members who are to eventually acquire the business. This freeze is performed by making lifetime gifts through a legal vehicle created to hold title to the assets from which the gifts are to be made.[4]

The legal vehicle primarily utilized by estate planners to accomplish the capital freeze has been the family corporation. The corporate plan is designed to allocate preferred stock with a fixed value to the older generation owners and place common stock with the succeeding generation where all subsequent appreciation is to be channeled. Further value reduction of equity interests may be achieved through buy-sell agreements used alone or in conjuction with a recapitalization.[5]

Recent commentaries have examined the use of family partnerships to achieve the capital freeze now commonly accomplished through a family corporation.[6] Among the reasons advanced in favor of using the partnership vehicle to freeze property for estate tax valuation is that a partnership is a more flexible legal and tax structure. This attribute facilitates blending tax savings with the fulfillment of estate planning objectives ideally suited to the needs of a family-owned business.

Under the unified transfer tax system established by the Tax Reform Act of 1976, one of the few incentives left for making lifetime gifts is avoidance of transfer taxation on subsequently appreciated property.[7] The earlier the owner-operator's estate is frozen, the greater the benefits which accrue from the bypass of appreciation in property values. However, the owner of a business who feels the need for comprehensive estate planning is usually not ready to relinquish total control of the business nor able to transfer substantial amounts of income from the business' operations. The owner-operator will also desire to extend control after his death or retirement to assure that family ownership and control are maintained and to provide a means for conflict resolution between his successors.

4. Kelley, *supra* note 2, at 234.
5. Treas. Reg. § 20.2031-2(h) (1958). For a recent case dealing with the effect of a partnership buy-sell agreement on estate tax valuation, see Estate of Bischoff v. Commissioner, 69 T.C. 32 (1977).
6. Abbin, *Partnership Capital Freeze—An Alternative to Corporate Recapitalization*, 13 U. MIAMI EST. PLAN. INST. ¶ 1800 (1979); Nash, *supra* note 1, ¶ 1000; Schriebman, *Family Partnerships Can Blend Tax Savings with Fulfillment of Estate Planning Objectives*, 3 EST. PLAN. 164 (1975-1976); Schriebman, *Family Partnerships as an Estate Planning Device Must Pass IRS Muster: Some Guidelines*, 4 EST. PLAN. 16 (1976-1977); Comment, *Limited Partnerships: Estate Planning Vehicle for the Family Farm*, 59 NEB. L. REV. 55 (1980).
7. D. KAHN & L. WAGGONER, FEDERAL TAXATION OF GIFTS, TRUSTS & ESTATES 7 (1977).

This paper will discuss and analyze aspects of "control" within a family business which is accomplishing a capital freeze through a family partnership. Although the following discussion will necessarily touch upon areas other than "control", the paper is not intended to be an in-depth analysis of all aspects of partnership capital freezes. In this respect, this article should be read as a corollary to other commentaries containing a broader perspective of the subject matter.[8]

II. IDENTIFYING THE CONTROL OBJECTIVES OF THE OWNER-OPERATOR

All estate plans involve unique considerations of which the practitioner must take account. Generalizations can be made, however, for the typical family business situation. The estate plan must: (1) promote family estate creation; (2) provide day-to-day management by senior family members and supervised participation therein by family members of the younger generation; (3) take advantage of multiple taxpayer and gift programs to reduce the family's total income tax burden now and death tax burden later; (4) contain a management contingency plan that becomes operative in the event of disability or death of a managing member of the family; (5) create estate liquidity through tax planning; and, (6) provide an estate management and distribution plan following the death of senior family members responding to the commitment that the business remain owned by the family for use by future generations and which also contemplates the probable split of children into active and inactive groups.[9]

The mission of the estate planner is to structure a family partnership which will both attain these control objectives and preserve the beneficial tax consequences associated with the partnership entity.[10] The advantages of using a partnership for such an estate plan are apparent when one examines the partnership provisions under state law[11] and subchapter K of the Internal

---

8. *See* note 6 *supra*.
9. *See* Fiore, *Analyzing and Planning the Finances and Estate of the Family Engaged in Agricultural Business*, 1 EST. PLAN. 96, 97 (1973-1974).
10. Although the primary objective of the partnership capital freeze is to reduce future estate tax liability, the income-splitting effect of a family partnership must not be overlooked. If the estate planner can structure a completed transfer for purposes of the estate tax laws and also comply with the income tax laws which provide for the tax recognition of family partnerships, a double benefit will accrue to the client. *See* § IV of text *infra*.
11. The Uniform Partnership Act, [hereinafter cited as UPA] has been enacted in 48 states and the District of Columbia. In Nebraska, it is codified at NEB. REV. STAT. §§ 67-301 to -343 (Reissue 1976). The Uniform Limited Partnership Act (1916) [hereinafter cited as ULPA] has has been enacted in 49 states and the

Revenue Code (Code).[12] Together, these laws operate to achieve a maximum amount of flexibility and simplicity in the formation and operation of the family business.

III. CONSIDERATIONS OF THE CONTROL PLAN

A. Formation of the Partnership[13]

The existence of a limited partnership commences when there are partners, a written partnership agreement, and a filed certificate of limited partnership complying with the provisions of section 2 of the Uniform Limited Partnership Act (ULPA).[14] Section 721 of the Code aids the ease of formation by providing that no gain or loss will be recognized to the partnership or any of its partners upon the contribution of property in exchange for an interest in the partnership.[15]

Control over partnership operations may be unrelated to the percentage of equity ownership in that business. Under the ULPA, control is vested in the general partners with certain qualifications,[16] and among general partners a managing partner may be selected. Furthermore, a person may be a general partner and a limited partner of the same partnership.[17] This division between ownership and control enhances the flexibility needed to accomplish an immediate freeze on the business' valuation while retaining managerial control in the senior-operator. For example, the owner-operator could hold a nominal general partnership interest which would give him control over business operations[18] and si-

---

District of Columbia. In Nebraska, it is codified at NEB. REV. STAT. §§ 67-201 to -232 (Reissue 1976 & Cum. Supp. 1978).

12. I.R.C. §§ 701-61.
13. The author has assumed that most partnership capital freezes will be accomplished through limited partnerships since the freeze will ordinarily parallel the corporate recapitalization. Accordingly, reference to state partnership law will be primarily to the ULPA rather than general partnership law.
14. NEB. REV. STAT. § 67-202 (Cum. Supp. 1978).
15. The general nonrecognition rule of section 721 does not apply to contributions of property in which the liabilities assumed by the partnership in the transfer are in excess of the contributor's basis in the property contributed. Section 721 also applies only to transfers of property; ordinarily income will be realized by the transferor if an interest in the partnership is exchanged for a contribution of services.
16. ULPA § 9; NEB. REV. STAT. § 67-209 (Cum. Supp. 1978).
17. ULPA § 12; NEB. REV. STAT. § 67-212(1) (Reissue 1976).
18. UPA § 18(e); NEB. REV. STAT. § 67-318(e) (Reissue 1976) provides that all partners have equal rights in the management and conduct of the partnership business. The ULPA adopts this provision by reference under section 9(1) (NEB. REV. STAT. § 67-209(1) (Cum. Supp. 1978)), and grants management rights upon all general partners of the limited partnership.

multaneously hold a limited partnership interest, representing almost all of his equity interest in the business, which has been frozen. When the senior owner decides to retire from active participation this general partnership interest may be liquidated, sold or gifted to other partners, or exchanged for a limited partnership interest.[19] Provisions for disposition should be provided in the initial partnership agreement.

B. The Partnership Agreement

The bulk of the estate plan will be embodied in the partnership agreement. The Code and uniform partnership acts give great deference to the agreement for determining the legal consequences arising from the business structure.

For income tax purposes, the partners' distributive share of income, loss, deduction, and credit is determined solely by the partnership agreement, provided the allocations have economic effect.[20] More stringent distribution restrictions are placed upon family partnership allocations under section 704(e) of the Code. Compensation for services rendered to the business must be paid to the donor before the distributive shares to the donee partners are determined.[21] In addition, the proportionate share of income and loss attributable to donated capital may not be greater than the proportionate share attributable to the donor's capital interest.[22] Also controlled by the partnership agreement are the tax consequences associated with payments to a retired or deceased partner in liquidation of his interest.[23]

The uniform partnership laws rely heavily on the partnership agreement for defining the legal relationships between the entity and its partners. The limited partners may agree to establish differing rates of return and priority of distributions on their respective interests.[24] In other words, differing classes of partnership

19. Section 1031 of the Code which provides for nonrecognition of gain for exchanges of like-kind property has been held inapplicable to exchanges of a general partnership interest for a limited partnership interest. Estate of Meyer v. Commissioner, 58 T.C. 311 (1972), *aff'd per curiam*, 503 F.2d 556 (9th Cir. 1974).

20. I.R.C. § 704(a), (b)(2). Generally, an allocation will be found to have substantial economic effect if the allocation affects the amount of the partner's share of the total partnership income or loss independently of tax consequences. 1 W. McKEE, W. NELSON & R. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS 10-12 (1977) [hereinafter cited as McKEE].

21. I.R.C. § 704(e)(2).

22. *Id.*

23. *Id.* § 736.

24. ULPA § 14; NEB. REV. STAT. § 67-214 (Reissue 1976). The statute requires that differing rates of return be stated in the partnership certificate. In the absence of differing classes of partnership interests, the limited partners "shall

interests may be created. This right is essential to the success of a partnership capital freeze. The senior owner-operator is allowed to have a prior fixed rate of return on his frozen interest which is independent of the business' annual income. Younger family members' share of profit or gain may be made dependent upon the economic success of the business. In this manner, all appreciation of business property will be channeled to those partnership interests whose value is dependent upon the continued success of the business and increased valuation of business assets. The distinction between profits from operations and gains from the sale of business assets must be clearly delineated in the partnership agreement. A frozen profits interest will be meaningless unless distributive shares of gain from the sale of business property is likewise frozen.

Conceptually, the structure of a typical family partnership may be analogized to a corporation having three classes of equity interests. The classes of partnership interests would be held as follows: (1) *senior owner*: nonvoting preferred stock having a fixed annual rate of return and a liquidation value equal to par; (2) *passive owner*: nonvoting preferred stock having a rate of return determined with relation to earnings and a liquidation value being par value plus a proportionate share of the increase in property value which is shared equally with the common stock; and (3) *successor-operators*: voting common stock.

In many families there will be children who have no desire to carry on the business but whom the senior owner will nevertheless wish to include in his bequests. This will necessarily divide the owners of the business into active and inactive groups. A primary objective of the estate plan will require restrictions upon the ability of those inactive members to threaten the existence or viability of the business to the detriment of those family members who are active in the business. State partnership law provides alternatives for the estate planner in dealing with this problem.

The ULPA allows restrictions to be placed on the right of a limited partner to withdraw from the partnership. Section 16[25] of the Act provides that consent of all partners is needed before a limited partner may withdraw and receive return of his contribution, unless otherwise provided by the agreement. Absent unanimous consent, withdrawal may occur only after six months notice has been given to all other partners. Section 16(3)[26] also provides that

---

stand upon equal footing." *Id.* Apparently the statute would require that the limited partner's distributive share be computed on the basis of his or her proportionate contribution in the absence of a contrary agreement.

25. NEB. REV. STAT. § 67-216 (Reissue 1976).

26. *Id.* § 67-216(3).

a withdrawing partner has only the right to receive cash in return for the surrendered interest. Thus, owner-operators who gift limited partnership interests to absentee members can ensure through the partnership agreement that successor-operators will have at least six months to raise financing for such withdrawal. They may also be assured that an absentee partner will not be able to cause severance of the business property by demanding distribution of business property on withdrawal.

A limited partner's right to force dissolution is also restricted under the ULPA.[27] Generally, the grounds upon which such a dissolution is based are limited to situations of abuse, inability of the partnership to function, or other equitable grounds making it not practicable to continue the business. One exception is the failure of a partnership to return a limited partner's contribution after a rightful demand for return of his contribution has been made.[28] Absent extraordinary situations and if a return of capital is given to a withdrawing partner after a rightful demand for the return of his contribution, the limited partner's right to dissolution can be severely restricted by providing in the partnership agreement that grounds for dissolution are limited to those enumerated by statute. Of course, more substantial withdrawal restrictions can be imposed through buy-sell agreements between the partners and the

27. The limited partner has the right to have dissolution and winding up by *decree of court.* ULPA § 10(1)(c); Neb. Rev. Stat. § 67-210(1)(c) (Cum. Supp. 1978). The statute, by granting the same right to limited partner's as that available to general partners, would appear to access section 32 of the UPA (NEB. REV. STAT. § 67-332 (Reissue 1976)), which sets forth grounds for dissolution by decree. Generally these grounds are limited to situations which make it not practicable to carry on the business.

28. ULPA § 16(4)(a); NEB. REV. STAT. § 67-216(4)(a) (Reissue 1976): "A limited partner may have the partnership dissolved and its affairs wound up when (a) He rightfully but unsuccessfully demands the return of his contribution . . . ."

This section must, however, be read in conjunction with section 67-216(2) which specifies when a limited partner may "rightfully" demand return of his contribution. A rightful demand may be made only on dissolution or on the date specified in the certificate. NEB. REV. STAT. § 67-216(2)(a) & (b) (Reissue 1976). Absent a provision in the certificate, a limited partner has the right to return of his contribution after giving six months notice to all other partners. NEB. REV. STAT. § 67-216(2)(c) (Reissue 1976).

This ability to restrict a limited partner's right to withdraw from the partnership can be a useful tool for the estate planner. The most obvious area in which a withdrawal restriction should be used is in resolving the conflict between active and passive owners. Active owners can be assured continued control of the business without fear of having to finance withdrawals by passive owners in the future. However, substantial restrictions upon the right of a limited partner to withdraw from the partnership and receive his proportionate contribution may cause adverse tax consequences. *See* § IV-A of text *infra.*

partnership. Such agreements would supersede the remedies conferred under the uniform partnership laws.

It will be necessary to prevent termination of the partnership upon the death, retirement or insanity of the general partner. This continuity may be provided by granting the remaining general partners the right to carry on the business;[29] this right must be enumerated in the partnership agreement and acknowledged in the certificate of limited partnership.[30] The mechanics of management succession should be expressly stated. One technique calls for the partnership agreement to provide that upon the death or insanity of a general partner his interest as a general partner automatically converts into a limited partnership interest.[31] This facilitates a smooth transition of management to remaining general partners in a manner which precludes involvement by the estate or guardianship of the former general partner. One aspect of the plan which should not be overlooked is what options should be implemented if, in succeeding generations, there remain no family members willing to take an active management role. A contingent right to dissolution in the event of this circumstance should be given to the partners in the agreement.

C. Distributive Shares of Profits and Gains

A senior owner-operator will often desire a business structure which will allow him to retire from active management duties yet permit him to retain a steady source of income from the business. This is the typical function of the partnership capital freeze. However, the owner of the frozen partnership interest must be aware of the competing income and estate tax consequences associated with current distributions from the partnership. Improper planning could cause the freeze to fail in reducing estate tax valuations or cause large amounts of current income to be attributed to him from the donated interests.

The distributive share of income and gain allocated to the frozen partnership interest must be delineated in the partnership agreement in accordance with the client's needs. This allocation will be upheld under the income tax laws if it has substantial economic effect[32] and the donee partners' proportionate share of partnership distributions is not proportionately greater than the

---

29. ULPA § 20(a); NEB. REV. STAT. § 67-220(a) (Reissue 1976).
30. ULPA § 2(1)(a)(XIII); NEB. REV. STAT. § 67-202(1)(a)(xiii) (Cum. Supp. 1978).
31. Christensen, *Family Limited Partnerships—Their Role in Estate Planning*, 117 TR. & EST. 585, 585 (1978).
32. I.R.C. § 704(a), (b).

distributive share allocated to the donor's capital interest.[33]

The estate planner should be aware that a difference does exist between ownership of a profits interest and a capital interest. It is crucial to the success of the freeze that the partnership agreement distinguish the donor's profit interest from his capital interest.[34] Because the income tax laws do not prevent a larger share of income from being allocated to the donor-partner's interest in comparison with the donated interests, the agreement can provide for a large amount of income to go to the donor partner during life and still accomplish a freeze upon the donor's capital interest for estate tax valuation purposes.[35] Alternatively, the donor's lifetime income needs may be provided through a system of guaranteed payments for use of the donor's capital.[36] Such payments should constitute a section 707(c) payment and be deductible by the partnership under the Code.[37]

33. *Id.* § 704(e)(2). The regulations promulgated under section 704(e) provide that if the partnership agreement fails to allocate income in accordance with section 704(e)(2), income for the taxable year shall be reallocated in accordance with the partners' respective interests in partnership capital. Treas. Reg. § 1.704-1(e)(3)(i)(*b*) (1956). *See* Woodbury v. Commissioner, 49 T.C. 180 (1967). The profits of a partnership in a ranching operation in which profits were distributed equally were reallocated to the donor partner when it was found that, under Montana law, the gift of real property was not completed. The donee's capital interest did not include the value of the ranch land and therefore, the donee's distributive share of profits was proportionately greater than his capital interest in the partnership, contravening section 704(e)(2) of the Code.

34. Ordinarily, the profits interest will be stated as either an amount annually applicable to, or a percentage of, the total frozen capital interest. Abbin, *supra* note 6, ¶ 1802.1.

35. However, disproportionate allocations could conceivable constitute a retained income interest within the meaning of section 2036(a)(1) if the allocation has no economic reality under a profits interest analysis.

One commentator has noted that, "conceivably, the gift of a partnership interest which has been specifically allocated capital and § 1231 gain to the exclusion of other income may constitute a transfer with retained life estate under I.R.C. § 2036 since the donor has retaied the income from the property." Kelley, Estate Planning for the Farmer and Rancher, *in* 1979 Great Plains Tax Institute: Program Materials.

36. If a section 707(c) guaranteed payment is made to the frozen partnership interest it would seem that the income tax laws would also require a distributive share of income to be made to that interest in addition to the guaranteed payment. A collective reading of sections 704(e)(1), 704(e)(2) and 707(a) indicates that a guaranteed payment is not equivalent to a "distributive share" under the family partnership distribution rules of section 704(e)(2). Thus, in determining whether donor's distributive share of partnership income meets the section 704(e)(2) requirement of not being proportionately less than the distributive share attributable to donated capital, guaranteed payments to the donor are disregarded.

37. Payments made to partners for their services to the partnership will be deductible as a section 707(c) guaranteed payment if the amount of the pay-

In contrast to income tax laws, the value of the frozen partnership interest for purposes of estate tax should be based on the amount established in the partnership agreement upon termination or withdrawal from the partnership.[38] Agreements such as buy-sell and rights of first refusal which establish the value of the interests for estate taxes have been given effect by the courts.[39] Therefore, it is imperative that the partnership agreement establish the independence of the capital interest from the income interest. In other words, it must be made clear that a partnership interest has a value in liquidation wholly unrelated to its value in partnership profits. If successful, the estate planner can provide his client with the best of both worlds, an adequate and guaranteed level of income during life and a low estate tax valuation after death.[40]

D. The Ability to Transact with the Partnership

Section 13 of the ULPA[41] permits a limited partner to transact with the partnership or loan it money. This right is complementary to section 707 of the income tax laws and increases the estate planner's options with respect to retained controls.

The ability to treat a partner as a third party for services rendered or capital loaned to the partnership may be particularly beneficial to a family business which is in the midst of a capital freeze. A senior member holding a limited partnership interest might be hired by the firm as consultant or in some other similar capacity and receive a salary which would be deductible by the partnership as a section 707(c) payment. This would also avoid many of the difficulties associated with special allocations and differing profit and capital interests which were implemented for the purpose of providing the senior-owner with a retirement income.[42]

Viewing a partner as a potential third party greatly increases the planning options available for the business. For example, sug-

ment is determined without regard to partnership income. If a formula is used to compute the compensation for services, it must be based on variables which are not associated with the partnership's annual income. Variables which are too closely associated with partnership income may fail to meet the section 707(c) requirement. In Pratt v. Commissioner, 64 T.C. 203 (1975) management fees paid to partners which were based on a percentage of rental income were held to be income distributions and not guaranteed payments.

38. Abbin, *supra* note 6, ¶ 1802.3.
39. *See* e.g., Estate of Bishoff v. Commissioner 69 T.C. 32 (1977); Fiorito v. Commissioner, 33 T.C. 440 (1959), *acq.*, 1960-1 C.B. 4.
40. For a discussion of the factors involved in structuring the income rights of a frozen partnership interest, see Abbin, *supra* note 6, ¶ 1802.2.
41. NEB. REV. STAT. § 67-213 (Reissue 1976).
42. *See* § III-C of text *supra*.

gested estate plans for a family farm have called for the holding of the farm land in a family partnership with the donor retaining the operating assets of the farm for lease to the partnership. Under ULPA section 13[43] the donor might retain a frozen limited interest in the land holding partnership and still be able to transact with the partnership as lessor of the operating assets.

E. Conflict Between Active and Inactive Ownership Interests

Invariably, the senior owner-operator, having no other properties but the business, will be faced with the dilemma of providing for children or other family members who have no desire to carry on the family business. A method of control must be implemented which will allow active owners to operate the business free from interference from passive absentee owners. This objective may be best achieved through creation of a limited partnership with differing classes of limited partnership interests for the passive owners and vest control in active owners through the holding of general partnership interests.

It is important to reiterate that the donor has the ability to restrict the limited partners' right to freely withdraw from the partnership or cause its dissolution.[44] The minimum six month waiting period on limited partner withdrawals which is imposed by statute in the absence of any withdrawal restriction[45] should be adequate to protect the successor-operators from rash or retributive actions taken by the withdrawing partner. During that period a reconciliation could be made or, if the limited partner remains adamant, sufficient time is given to raise the financing necessary to return the contribution. Additionally, transfer restrictions such as buy-sell, rights of first refusal, or lease commitments in favor of active owners may be employed to guarantee that the land remain within the control of active family owners.[46]

The partnership agreement should provide a means for future dispute resolution between the active and inactive owners. To illustrate, standards may be established under which a general or managing partner must make decisions regarding retention of income for business needs, expansion of the business, investment decisions, and other management decisions which would many times conflict with the limited partners' desire for cash distributions. Remedies would be available under the ULPA if such stan-

---

43. NEB. REV. STAT. § 67-213 (Reissue 1976).
44. *See* notes 27-28 & accompanying text *supra*.
45. ULPA § 16(2)(c); NEB. REV. STAT. § 67-216(2)(c) (Reissue 1976).
46. However, withdrawal restrictions upon donated interests could cause adverse income tax consequeces. *See* § IV-A of text *infra*.

dards were violated.[47] The compensation given managing partners for their services may be established by formula in the agreement and amendable only by ratification from the limited partners.[48]

There are, however, tax risks associated with many commonly used control devices. A trade-off between retained control and tax benefits often times exists in the income and estate tax laws. The next two sections are devoted to this conflict between donor retained controls and the tax consequences desired by the donor.

IV. INCOME TAX CONSEQUENCES

In view of the fact that most clients would also benefit from the income splitting effect associated with family partnership operations, the relationship of control techniques with partnership income tax consequences must be considered by the estate planner.

The regulations under section 704(e) of the Code set forth basic tests of ownership to be administered in determining whether a donee partner who has been given a capital interest in the partnership possesses the real incidents of ownership, or whether the donor has retained actual dominion and control over the interest.[49] If ownership is found to be vested in the donor partner, income attributable to the donated interests will be reallocated to the donor for income tax recognition. Unfortunately, these family partnership rules will often directly conflict with desirable control devices for family businesses.

A. Transfer Restrictions

Treasury Regulation § 1.704(e)(2)(ii)(b) states that a limitation on the right of the donee to liquidate or sell his interest in the partnership at his discretion and without financial detriment will be considered a significant retained control by the donor. Transfer re-

47. *See* ULPA § 9(1)(a); NEB. REV. STAT. § 67-209(1)(a) (Cum. Supp. 1978) which forbids the general partner to do any act in contravention of the certificate. This provision would invoke equitable jurisdiction for wronged partners.

A more severe remedy provided by partnership statutes is dissolution by judicial decree for willful or persistent breaches of the partnership agreement. UPA § 32(1)(d); NEB. REV. STAT. § 67-332(1)(d) (Reissue 1976). Although it is unclear as to whether the grounds for dissolution under the ULPA are the same as those enumerated in section 32 of the UPA, it is probable that a court would adopt the grounds set forth by the UPA.

48. In Rev. Rul. 79-106, 1979-1 C.B. 448, the Service ruled that limited partners' right or lack of the right to vote on the removal and election of a general partner is not a factor of critical importance in determining whether a partnership is taxable as a corporation. Similarly, the right by the limited partners to amend the general partner's salary should not threaten association status for income taxation.

49. Treas. Reg. § 1.704-1(e) (1)-(2) (1956).

strictions placed upon limited partners are particularly susceptible to attack because other indicia of retained control are irrelevant in the limited partnership context. The regulations sustain this distinction, providing that retained managerial control will be ignored in assessing ownership, provided the donee limited partners have the right to transfer or liquidate their interests without substantial restrictions.[50] Expressly designated as an adverse retained control is a requirement that the interest be maintained in the business for a long period of time.[51]

These regulations directly affect the drafting of the buy-sell and liquidation provisions of the partnership agreement. One leading commentator advises that, as a safeguard to income tax recognition, the partnership agreement provide that any partner may demand liquidation of his interest within a reasonable time after demand at a value which is not materially less than the value of the interest.[52]

Despite this admonishment, the committee report to the forerunner of section 704(e)[53] of the Code indicates that not every restriction upon donated interests will be indicative of sham; that restrictions of "the character incident to the normal relationships among partners"[54] may be bona fide and not inconsistent with donee ownership. A persuasive argument could be forwarded that transfer restrictions necessary to the success of the donor's estate plan, *e.g.*, retention of the business within the family, is a control incident to a normal relationship among the partners.[55] Furthermore, section 704(e) is not the sole test for determining the bona fides of a family partnership. A taxpayer may establish that there exists a valid partnership under the test prescribed in *Commissioner v. Culbertson*:[56] that there existed a good faith intent to

50. *Id.* § 1.704-1(e)(2)(ix) (1956).
51. *Id.* This position has also been adopted by case law. In holding that the donors of family partnership interests were the true owners of the donated interests for income tax purposes, the court in Krause v. Commissioner, 57 T.C. 890 (1972), *aff'd*, 497 F.2d 1109 (6th Cir. 1974) listed as a factor in its decision that "[t]he partnership agreement prevented the trustees [who held the interests] from assigning or disposing of the trusts' interest in the partnership without . . . [the donors'] consent. It was uncertain if the contributions of the limited partners would ever be returned." *Id.* at 898.
52. 2 A. WILLIS, PARTNERSHIP TAXATION § 52.06 (2d ed. 1976).
53. H.R. REP. NO. 586, 82d Cong., 1st Sess., at 32-34, *reprinted in* [1951] U.S. CODE CONG. & AD. NEWS 1781, 1813-15, *reprinted in* 1951-2 C.B. 357, 380-81 (1951) [hereinafter cited as H.R. Rep. No. 586].
54. *Id.* at 33, [1951] U.S. CODE CONG. & AD. NEWS 1781, 1815, 1951-2 C.B. at 381.
55. *See* Estate of Bischoff v. Commissioner, 69 T.C. 32 (1977) where the tax court held that restrictive buy-sell agreements which are implemented to preserve family control and continuity of management in the family business have a legitimate business purpose.
56. 337 U.S. 733, 742 (1949).

conduct affairs as partners.

Relevant to the imposition of transfer restrictions upon donated interests is the committee report's statement that "[i]n weighing the effect of a retention of any power upon the bona fides of a purported gift or sale, a power exercisable for the benefit of others must be distinguished from a power vested in the transferor for his own benefit."[57] The primary purpose of placing transfer restrictions on partnership interests in the typical capital freeze plan is to maintain family ownership and to accommodate the competing interests of absentee and active owners. In many plans, the donor will retain no managerial controls and will hold passive limited partnership interests subject to the same transfer restrictions imposed on other donee interests. Transfer restrictions implemented under such circumstances are arguably not relevant to the test of ownership under the rationale postulated in the legislative history of section 704(e) since such restrictions are not imposed for the transferor's own benefit. Furthermore, overriding business purposes, such as keeping the family business intact should override the prohibitions in the regulations.[58] In deciding whether to impose severe transfer restrictions the estate planner must realize that the factors set forth in the regulations are illustrative, not exhaustive, and that the issue of control is ultimately a factual question turning on all of the circumstances.[59]

B.. Retention of Essential Assets

A solution which is often used in estate planning for family businesses is separating the operating portion of the unit from the land holding portion of the unit and gifting or selling the units accordingly.[60] Interfering with the free utilization of such plans are the regulations to section 704(e) of the Code which classify a donor's retention of control of assets essential to the business as a factor indicating that a bona fida partnership does not exist for income tax purposes.[61] Specifically listed as an example is a retention of assets which are leased to the partnership. Plans calling for a division of the business between the family partnership and donor with a leaseback arrangement could cause the donor of the partnership interests to be attributed all partnership income. For example, if in the family farm situation the donor-parents create

57. H.R. REP. No. 586, *supra* note 50, at 33, [1951] U.S. CODE CONG. & AD. NEWS 1781, 1815, 1951-2 C.B. at 381.
58. Schriebman, *supra* note 6. *See* note 55 & accompanying text *supra*.
59. *See, e.g.*, Ketter v. Commissioner, 70 T.C. 637, 648 (1978).
60. Kelley, *Planning the Estate of the Farm and Ranch owner: Solutions to Recurring Prolems*, 43 J. TAX. 350, 351 (1975).
61. Treas. Reg. § 1.704-1(e)(2)(ii)(*c*) (1956).

and gift a family partnership in the farm land but retain all the farm machinery and equipment for leaseback to the partnership, the Service might argue the dominion and control of the land has not been vested in the donee partners.[62]

The regulations, however, are directed toward controls retained by donors and do not concern control vested in donees. Therefore, control of essential assets by donee partners for lease-back to the partnership would not contravene the ownership test of the regulations.[63] Thus, any leasing arrangements between the partnership and the successor operators entered into for the purpose of assuring that active donees maintain control over the business should not cause imputation of ownership to the donor. One control technique which is compatible with this analysis would call for the donor to gift limited partnership interest in the land to absentee owners and the operating assets and inventory to the successor-operator. The successor-operator would then enter into a long-term lease with the partnership with a possible option to buy out the passive partners. In this manner, the passive owners may be assured a continuing income flow from their interests and active owners will be free to operate the business without outside interference. Moreover, the donor partner, holding a frozen interest in the land holding partnership, has not retained an incident of ownership over the donee interests which would invite income tax liability. The successor-operator who now owns the business operating assets and inventory may also be a partner in the land-holding partnership.[64]

---

62. This example was taken from United States v. Ramos, 393 F.2d 618 (9th Cir. 1968), *cert. denied*, 393 U.S. 983 (1968), where it was held that retention by donor-parents of all the operating assets of the farm which were leased to a family partnership formed to operate a farming business constituted an anticipatory assignment of income from the property. Although the case would seem distinguishable on grounds that all assets of the farm were retained by the parents, commentators appear unwilling to advise that land holdings operating business assets can be controlled by the donor partners. *But see* Estate of Barlow v. Commissioner, 55 T.C. 666 (1971). *See also* Christensen, *supra* note 31, at 585; Nash, *supra* note 1, ¶ 1009.3 (suggests that a lease which only indirectly effects control over the business should be valid if reasonable and a customary type of transaction).
63. *See* Kelley, *supra* note 60, at 351. The author states that separation of land holding and operating portions of the family farm is an often used solution to provide for the competing interests of active and passive successive generations. The passive land holders will ordinarily serve as landlords for the successor-operators. *Id.*
64. ULPA § 13(1); NEB. REV. STAT. § 67-213(1) (Reissue 1976) expressly allows a limited partner to transact business with the partnership.

C. Operational Controls

The regulations under section 704(e) of the Code enumerate other general retained controls as being inconsistent with donee ownership of partnership capital. The estate planner should be aware that restrictions or control over the distribution of income to the donee interests, other than control over the amounts of income necessary for the reasonable needs of business, will be considered as showing the ownership of donated interests has not vested in the donee partners.[65] It is important in drafting the partnership agreement to specify that all partnership earnings shall be distributed, except for amounts retained, "for the reasonable needs of business."[66]

Retention of management powers by the donor as general partner or through another entity is not significant provided the donee is free to liquidate or sell his interest.[67] Freedom of the donee to transfer or liquidate his interest refers to more than the absence of legal transfer restrictions. The facts and circumstances must show that the donee is independent of the donor and has such maturity and understanding of his rights to withdraw from the partnership.[68] Obviously, this proviso is directed toward minor children of the donor; however, the donor's spouse or mature children who are dependent upon the donor for economic support might be amenable to the donor's will. In cases of doubt, the partnership interest might be held by an independent trustee.[69] In all cases an evidentiary record should be compiled showing participation in management by the partners in their permitted capacity.[70] In this respect it would be wise to provide for some decision-making input by limited partners for various matters. For example, written consent could be required of limited partners for retention of income for business needs above a specified level.[71]

---

65. Treas. Reg. § 1.704-1(e)(2)(ii)(*a*) (1956).
66. 2 A. WILLIS, *supra* note 52, § 52.06. *See* Driscoll v. United States, 24 A.F.T.R.2d 69-5249 (C.D. Cal. 1969).
67. Treas. Reg. § 1.704-1(e)(2)(ii)(*b*), (*d*) (1956).
68. *Id.* § 1.704-1(e)(2)(ii)(*d*) (1956).
69. *Id.* § 1.704-1(e)(2)(vii) (1956) for the Service's position with regard to trustees serving as partners.
70. There must also be developed a record showing that donees are actually treated as partners in the operation of the business. *Id.* § 1.704-1(e)(2)(vi) includes such a showing as a test of ownership for purposes of I.R.C. § 704(e). Among the factors listed by the regulations are: recognition of donee's rights in distributions on partnership property and profits, the existence of written agreements and records establishing the nature of the partnership agreement and the rights of the respective partners, the presentment of the donee to the public as a partner in matters such as insurance policies, leases, and business contracts.
71. However, management powers vested in the limited partners could cause the

The estate planner must realize that the basic tests of ownership are guidelines only, that any one factor listed in the regulations is not in itself determinable on the issue of ownership. Thus, if it is necessary to impose a control considered inconsistent with donee ownership (*e.g.*, transfer restrictions) it would be beneficial to provide added ownership attributes in another area (*e.g.*, greater voice in management).

D. Competing Considerations

If the present owner is in a position where he is willing to transfer management to a successor-operator, the bona fides of the partnership will be much easier to establish under the income tax laws. However, this is often not the case. The owner's children may be too young or unsettled to fully assume full responsibilities of running the business or the owner is simply not ready for semiretirement. This could force the estate planner to take an aggressive stance on income tax issues in order to establish a capital freeze which comports with the client's wishes and needs. In many instances the freeze should receive priority over the income tax consequences.[72] Unfortunately, the spectre of retained controls rears its head in the estate tax context and may operate to defeat estate plans designed to limit the valuation of the donor's gross estate.

V. ESTATE TAX CONSEQUENCES OF RETAINED CONTROLS

The family partnership may be used as an estate planning tool independent of its income tax consequences. The law developed under section 704(e) of the Code regarding tax recognition of family partnerships is not applicable to the estate and gift tax laws. An overlap does exist, however, with case law developed from *Culbertson*[73] in determining the realities of the transfer.

---

loss of their limited liability under the ULPA. "A limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business. . . ." ULPA § 7. Cases in which general liability has been imposed usually involved factual situations in which the exercise of power by limited partners has been clear cut and extensive. For an excellent analysis of section 7 of the ULPA, see Coleman & Weatherbie, *Special Problems in Limited Partnership Planning*, 30 Sw. L.J. 887, 897 (1976).

72. The most apparent situation in which estate tax considerations will prevail over income tax considerations is in the family farm estate plan where real estate appreciation has increased astronomically over the last generation while farm income has increased at relatively moderate levels.

73. Commissioner v. Culbertson, 337 U.S. 733, 742 (1949). *Culbertson* was utilized by a taxpayer in United States v. Neel, 235 F.2d 395 (10th Cir. 1956) to estab-

A partnership not recognized under income tax laws may nevertheless be valid for estate tax purposes. This principle was first advanced by the Service in *Blalock v. Allen*.[74] The case involved the Service's contention that a decedent's interest in a family partnership should be included in his gross estate even though in an earlier action the decedent was found not to be a partner for income tax purposes.[75] The issue was accurately condensed by the court:

> His estate now contends that, if he was not a partner, the value of his interest in the firm belonged to the other three Blalocks and should not be included in his estate. The defendant (IRS) contends that, while not a partner for income tax purposes, he did own a proprietary interest in these firms and estate taxes were due thereon.[76]

The court did not directly rule on this estate tax issue as the question became moot when the court found the decedent a bona fide partner for income tax purposes for the years subsequent to the earlier decision.[77] The distinction between ownership for the purposes of the income tax and ownership for purposes of the estate tax was also addressed in *Aldrich v. United States*[78] where the Fifth Circuit adopted the arguments stated in the government's brief as controlling principles of law.

> [A] taxpayer owning a capital interest in a partnership under state law must include that interest in his gross estate whether or not he is taxable on any portion of the income of the partnership. The courts have not developed a rule against estate splitting similar to the income tax rule . . . .[79]

Income tax and estate tax principles were once again distinguished in *Krause v. Commissioner*.[80] In that case the taxpayer

---

lish a partnership between the decedent and his wife which had the effect of removing one-half of the partnership property from decedent's gross estate. The Court of Appeals found the partnership to be valid despite the fact that there existed no partnership agreement and all partnership property was held in decedent's name.

Neel was held to be controlling precedent in Craig v. United States, 451 F. Supp. 378 (D.S.D. 1978). In *Craig*, the court found a partnership to exist between a decedent and spouse in a farming operation under the "intent" test of *Culbertson*. Thus, only one-half the value of personal property used by the farming operation was properly includible in the decedent's gross estate. *But see* Estate of Ethel M. Bullock, 19 T.C.M. (CCH) 1080 (1960).

74. 100 F. Supp. 869 (M.D. Ga. 1951).
75. The income tax case which held the interest owned by decedent invalid for income tax recognition was Blalock v. Allen, 56 F. Supp. 266 (M.D. Ga. 1944), *aff'd per curiam*, 151 F.2d 927 (5th Cir. 1945).
76. Blalock v. Allen, 100 F. Supp. 869, 872 (M.D. Ga. 1951).
77. *Id.* at 874-75. The estate had conceded the estate tax issue as its action was brought in the alternative with the income tax issue. *Id.* at 875.
78. 346 F.2d 37 (5th Cir. 1965) (per curiam).
79. *Id.* at 39 (citing the government's brief).
80. 497 F.2d 1109 (6th Cir. 1974), *aff'ing*, 57 T.C. 890 (1972).

argued that *United States v. Byrum*,[81] an estate tax case arising under section 2036 of the Code, was precedent for challenging tax liability arising under section 704(e) of the income tax laws. In holding that *Byrum* was not controlling, the court reasoned that principles developed under the estate tax laws were not necessarily germane to income tax issues.[82] "The estate tax statute involved in *Byrum*, § 2036(a), is different in language, legislative history, and objectives, from the income tax statute involved in the present case, § 704(e)."[83]

As a result of these decisions, the courts' position would appear to be that for estate tax purposes, the ownership interest in a partnership is determined by reference to state law; assignment of income principles codified under section 704(e) and the regulations thereto do not interrelate with estate tax concepts. Thus, the test of whether the transfer of a partnership interest is complete for purposes of the estate tax is to be determined by reference to sections 2036 and 2038 of the Code.[84]

A. Retained controls by the Donor-Partner

In accomplishing the freeze the extent of permissible retained controls must be determined. Four fact patterns have been identified which might cause the estate plan to contravene the provisions of sections 2036 and 2038 of the estate tax laws: retention of management powers, retention of majority control of partnership interests, failure to distribute income or accumulation of unreasonable amounts of income to donated interests, and restrictions

81. 408 U.S. 125 (1972).
82. Krause v. Commissioner, 497 F.2d 1109, 1111-12 (6th Cir. 1974).
83. *Id.* at 1111.
84. These estate tax provisions require the inclusion in a decedent's gross estate of the value of any property which was transferred by inter vivos gift, if:

> the decedent had retained for his life "the possession or enjoyment of, or the right to the income from, the property, 'I.R.C. § 2036(a)(1); or
>
> the decedent had retained for life "the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom", I.R.C. § 2036(a)(2); or . . . .
>
> the enjoyment of the property transferred was subject to a power held by decedent at his death to alter, amend, revoke or terminate the transferred property interest. I.R.C. § 2038(a)(1).

There exists an overlap of coverage between sections 2036(a)(2) and 2038; the same transfer can, and usually is, includible in the gross estate under either provision. However, section 2036(a)(2) will generally include larger amounts within the gross estate by virtue of the language utilized in the statute. Section 2036(a)(2) also reaches contingent powers not reachable under section 2038.

on transferability of donated interests.[85]

Due to the nature of a family partnership, sections 2036 and 2038 are potential problems anytime a gift is made of a partnership interest, unless the donor relinquishes all vestiges of control over the donated interests.[86] However, this is usually not a viable alternative to the owner of a family business who finds it necessary to remain at the helm. To complicate matters, the partnership area is fraught with uncertainty regarding estate tax consequences and little guidance is available to the planner for determining how much control the donor may retain over income and business operations of the partnerships.

Some clues do exist for the estate planner who seeks answers to the riddle of retained controls in the family partnership context. The Service has revealed its position in a recent letter ruling which was reissued in 1979.[87] Further guidance can be found from the few partnership cases arising under section 2036 and by analogy to the *Byrum* case which addressed corresponding issues in the corporate area. Finally, decisions dealing with valuation of partnership interests under the estate tax have alluded to the possible estate tax implications of donor retained controls.

B. Letter Ruling 7824005

In private letter ruling 7824005 the Service ruled that the value of farm land which was held in a limited partnership with the decedent-donor's family members must be included in the decedent's gross estate under retained life estate principles of section 2036.

Under the facts prompting the letter ruling, the donor contributed farm land to a newly formed limited partnership which consisted of herself as sole general partner and eight family members as limited partners. The family members who received interests were eventual heirs of the decedent-donor. Decedent's capital in-

85. Nash, *supra* note 1, ¶ 1023. Nash contends that the major arguments for includibility center upon sections 2036(a)(2) and 2038. Under section 2036(a)(2) the Service would likely contend that the donor-partner, through his continued management and control of the partnership, in effect, allows him or her to control not only the partnership property but also the stream of income from the property, thereby retaining a right to designate the persons who shall possess or enjoy the property or the income derived therefrom. *Id.* ¶ 1025. The potential arguments under section 2038 are similar, that a donor-partner's control of the partnership through the exercise of administrative and management powers may be considered a power to alter or amend the enjoyment of the partnership property. *Id.* ¶ 1026.

86. If the owner-operator's frozen interest is held as a passive limited partnership interest with active management vested totally within general partners, sections 2036(a)(2) and 2038 should not be applicable.

87. Tech. Adv. Memo. 7824005 (issued Mar. 2, 1970; reissued 1978).

terest consisted of a sixty percent interest as general partner and a twenty percent interest as a limited partner, although the limited interest was later gifted to the other partners. Broad powers were given under the partnership agreement to the general partner along with the right to an annual salary of $12,000 for management services. The decedent was not actively involved in farming operations but rented the farmland for approximately $20,000 per year in the first year of the partnership's existence.

Nearly all of the cash flow was distributed to the decedent during the partnership's existence by reason of her guaranteed payment and sixty percent share of partnership profit. In the two years preceding decedent's death, all of the cash flow went to decedent in year one and eighty-eight percent in year two.

In ruling that the full value of the farm was includible in decedent's gross estate under section 2036, the Service relied heavily on case law which holds that there exists a retained life estate when there is an implied understanding or prearrangement between the donor and donee which allows the donor to enjoy the property for his or her life.[88] The ruling distinguished case law which had held that the receipt of a salary from administering donated property is not a retained income interest on grounds that the salary was not related to the services rendered by the decedent.[89] No management was required because the only income generated was rental income, in fact, any management that was required was actually performed by other members. Other factors relied upon by the Service indicating a retained income interest were: (1) the partnership was created only for estate tax purposes and served no general business purpose; (2) the decedent continued to reside on the farm which was in itself a retention of farm income potential; and (3) the salary, together with the decedent's rights to profits were calculated to ensure that the decedent would receive virtually all income produced from the land.

One commentator has labeled the fact pattern underlying the ruling as "extreme" and as such, the result is essentially correct.[90]

88. The Service cited Estate of McNichol v. Commissioner, 265 F.2d F.2d 667 (3d Cir.), *cert. denied*, 361 U.S. 829 (1959).

89. Taxpayer's reliance on Estate of Hofford v. Commissioner, 4 T.C. 542 (1945) was found to be misplaced as in *Hofford*, the court specifically found that the decedent had rendered worthwhile services. The Service instead cited Estate of Holland v. Commissioner, 47 B.T.A. 807 (1942), *result aff'd*, 1 T.C. 564 (1943), a case where corporate stock which was gifted to children of the donor with an agreement that the donor receive a guaranteed salary for life regardless of the donor's health or performance was included in decedent's gross estate. In essence, the salary payments represented a retained income interest. *See* Bixby v. Commissioner, 58 T.C. 757, 790-91 (1972) for a discussion of the *Hofford* and *Holland* cases.

90. Abbin, *supra* note 6, ¶ 1806.1.

It is urged that a retained interest in the form of a frozen partnership interest should escape the clutches of section 2036 as there exists substantial economic policy reasons to justify its existence for estate tax purposes.[91] In the typical situation, the holder of the frozen interest is not retaining an interest in the total income of the partnership, but is rather foregoing a right to potential appreciation in income and property values in return for a present right to a fixed income and capital interest.

If the estate plan formulated for the client requires the donor-partner to remain as general partner or managing partner of the business, the letter ruling provides the following rudimentary guidelines for avoiding retained life estate problems. If the donor-manager is to receive guaranteed payments for services, the services must actually be performed by the donor and the compensation paid be reasonable for that type of service.[92] In addition, the services must be essential to the business; the ruling shows that the Service will scrutinize the type of business activity being conducted by the partnership in determining whether the services performed by the donor-partner are bona fide. Should the amount paid to the donor as guaranteed payments constitute substantially all of the revenue generated by the business, there is a danger that the Service will assert that an income interest has been retained by the donor-partner. If the donor is to continue to dwell on the partnership property, the dwellings should either be excluded from the initial contribution to the partnership or be distributed back to the donor so that the residence is individually owned by the donor-partner.[93]

In instances where the guaranteed payment to the donor constitutes nearly the entire gross income of the partnership, the estate planner should bolster the economic realities of the plan so as to provide an effective counter-attack against section 2036 applicability. One method would be to give the limited partners the right to remove the managing donor-partner from control should income available for distribution to limited partners fail to meet certain specified levels for a certain number of years. Such a provision in the partnership agreement would tend to show that the donor is not merely retaining an income interest for life, that he is being paid for the purpose of producing an income flow to the partners and is subject to sanction from the other partners should his serv-

91. *Id.*
92. *See* Estate of Hofford v. Commissioner, 4 T.C. 542 (1945).
93. This distribution by the partnership would be tax-free although the distributee must reduce the adjusted basis in his partnership interest. I.R.C. § 733. There will be no "hot asset" problems involved as distributions of property which the distributee contributed to the partnership are exempt from the "hot asset" provision. *Id.* § 751(b)(2)(A).

ices fail to produce the specified levels of income.[94]

C. *United States v. Byrum*[95]

In the landmark decision of *United States v. Byrum*, the Supreme Court held that the power to control a corporation through retention of majority voting rights in transferred stock, exercised through control over dividends or business policy, does not constitute a legal right to control beneficial enjoyment of an interest in the corporation for purposes of section 2036 of the Code. The principles of retained managerial controls developed by this case should apply with equal force to the partnership context.[96]

In *Byrum*, the decedent created an irrevocable trust to which he transferred shares of stock in three closely held corporations. He maintained a seventy-one percent control over each corporation. The trusts, which were administered by an independent trustee, were subject to four essential rights which were reserved by the decedent over the transferred stock: (1) the right to vote the shares of stock which were transferred to the trust; (2) to disapprove the sale or transfer of the shares; (3) to approve investments and reinvestments; and (4) to remove the trustee and designate a new corporate trustee as a successor.[97] The Service assessed a deficiency against the decedent's estate, contending that decedent's right to vote the transferred shares and to veto any sale thereof granted him the power to determine the flow of income to the trust—equivalent to a power to designate the persons who shall enjoy the income from the property.[98] In addition, it was urged that the retained controls constituted a retention of the income and enjoyment of the property.[99]

1. *The Section 2036(a)(2) Argument*

The government's argument that decedent's de facto power to control the flow of dividends amounted to a retention of the right to designate the persons who should possess the income from the property was rejected for two basic reasons. First, Byrum had not retained the legally enforceable right specified by the statute.

94. *See* Estate of Hofford v. Commissioner, 4 T.C. 542 (1945). A bona fide employment agreement with an entity previously transferred will not constitute a retained life estate. *See also* Estate of Barlow v. Commissioner 55 T.C. 666 (1971), *acq.*, 1972-2 C.B. at 1. Gifts of undivided interests in family farm with leaseback to donor-parents withstood the Service's contentions that the scheme constituted a retained life estate.

95. 408 U.S. 125 (1972).

96. Nash, *supra* note 1, ¶ 1020.

97. 408 U.S. at 127.

98. I.R.C. § 2036(a)(2).

99. *Id.* § 2036(a)(1).

"[T]he right ascribed to Byrum was the power to use his majority position and influence over the corporate directors to 'regulate the flow of dividends' to the trust. That 'right' was neither ascertainable nor legally enforceable and hence was not a right in any normal sense of that term."[100] Secondly, it was emphasized that mere voting control did not confer an absolute right to the grantor to control dividend policies or guarantee his continued employment. Byrum had a fiduciary duty as majority stockholder, as well as the corporation's directors, which could not be abused for Byrum's personal or family gain. Other variables such as economic demands of business, were referred to by the Court as working against the Service's concept of control. Beyond mere rejection of the Service's arguments, the Court severely chastized their "control" rationale as being "so vague and amorphous as to be impossible of ascertainment in many instances."[101]

2. The Section 2036(a)(1) Argument

The Service reasoned that Byrum, through reserving the right to voting control, had retained possession and enjoyment of the property in that he could guarantee himself continued employment and renumeration from the corporations, as well as the right to determine or control merger and liquidation.[102] The Court countered this argument by holding that Byrum had not retained "possession and enjoyment" of the stock through a retention of an income or possessory interest as required by section 2036.[103] Moreover, no present economic benefit had been retained as Byrum's exercise of control was subject to fiduciary restraints under state corporation law.[104]

3. Application to Partnership Estate Planning

The *Byrum* decision should provide some security to the estate planner who is contemplating the use of a family partnership to accomplish a capital freeze. The four types of retained control at issue in *Byrum* all have counterparts in the family partnership whose donor-partner serves as managing partner.[105] Absent an open retention of possession or enjoyment as found under letter

100. United States v. Byrum, 408 U.S. 125, 136-37 (1972) (footnote omitted).
101. *Id.* at 137 n.10.
102. *Id.* at 145.
103. Estate of Holland v. Commissioner, 47 B.T.A. 807, (1942), *result aff'd*, 1 T.C. 564 (1943) was distinguished on grounds that the settlor in *Holland* retained a considerably greater interest than Byrum had retained. 408 U.S. at 148.
104. United States v. Byrum, 408 U.S. 125, 150 (1972).
105. Under the ULPA, control over partnership operations is vested in the managing or general partner. ULPA § 9; NEB. REV. STAT. § 67-209 (Cum. Supp. 1978). Often there will exist transfer restrictions on the partnership interests. To-

ruling 7824005, a donor's power to control or manage a partnership through bona fide business relationships should not result in the inclusion of a transferred partnership interest in the donor's estate under section 2036.[106] In any event, it is probable that the managing partner's powers will be curtailed in the partnership agreement to avoid income tax pitfalls, for example, in the area of control over partnership distribution.[107] Such constraints will operate to strengthen arguments against estate taxation of donated interests under the control rationale advanced by the Service in *Byrum*.

Central to the Court's holding was the presence of fiduciary constraints upon the exercise of Byrum's de facto powers. Similarly, a partner is bound by a fiduciary duty, albeit more exacting, to the partnership and his other partners.[108] Whatever the amount of control exercisable by the donor-partner may be, his powers are always exercisable within the constraints of state fiduciary law. Thus, a donor who wishes to remain at the head of a family business should be able to do so without fear that his continued managerial control over the donee interests will cause the transfer to be deemed incomplete for estate tax purposes. As stated by the *Byrum* Court, "[T]his Court has never held that trust property must be included in a settlor's gross estate solely because the settlor retained the power to manage trust assets."[109] This principle should apply equally to donors of family partnerships.

D. Section 2038 Obstacles

Retained management and administrative controls by the donor-partner might be construed as a power to alter, amend, revoke or terminate over donated partnership interests causing inclusion of those interests in the donor's gross estate under section 2038. Controls over income distributions are arguably identical to powers over the timing or manner of enjoyment which have been taxed pursuant to the case law under section 2038.[110] However, if the donor-partner's powers are limited by a definite ascertainable stan-

---

gether, this is equivalent to the de facto powers ascribed to Byrum under the trust instrument.

106. *See* Stukenberg, *Gifts of Partnership Interests with Strings Attached: Problems and Possibilities*, 51 J. TAX. 258, 258 (1979).

107. *See* § IV of text *supra*.

108. *See* UPA § 21; NEB. REV. STAT. § 67-321 (Reissue 1976); ULPA § 9; NEB. REV. STAT. § 67-209 (Cum. Supp. 1978). "A partnership is fiduciary in character with each partner owning the others the highest degree of fidelity, loyalty and fairness in their mutual dealings." *In re* Lester, 87 Misc. 2d 717, 721, 386 N.Y.S.2d 509, 512 (1976).

109. United States v. Byrum, 408 U.S. at 132-33.

110. *See* Lober v. United States, 346 U.S. 335 (1953).

dard, such as being pursuant to the reasonable needs of business, section 2038 can be circumvented under the authority of case law which holds that powers so limited do not cause the transfer to be deemed incomplete under the estate tax.[111] Furthermore, if the donee-partners are free to withdraw from the partnership and receive a return of their capital contribution, section 2038 should not apply as ultimate control over the time and manner of enjoyment of the property rests with each partner.[112] As added protection, powers affecting partnership distributions could be made exercisable only with the consent of all partners.[113]

E. Partnership Case Law

There are few partnership cases under section 2036 dealing with the issue of donor-partner retained controls. *Estate of Roddenberry v. Commissioner*[114] represents the most direct confrontation of the partnership problem. Decedent had formed partnerships to operate family owned businesses and had, over a period of thirteen years, gifted partnership interests to his sons. The partnership agreements vested control to the majority partner in all matters, including the distribution of profits. The partners could not sell or encumber their interests without unanimous consent from the other partners and the partnership was to dissolve only upon the consent of seventy-five percent of the interest invested. The Service included certain donated interests in the decedent's gross estate under the forerunner[115] to section 2036 on grounds that at no time did the donees have dominion and control over the partnership interests for reason of the conditions and restrictions imposed by the partnership agreement.

The Tax Court dismissed the arguments, reasoning that if the Commissioner's position prevailed then partnership interests could never be the subject of valid gifts should the donor retain an interest in the partnership. Crucial to the court's decision was the fact that the donor had added no restrictions upon the donated interests that did not also apply to his capital interest. In other words, the extent of his property interest was defined by the partnership agreement and he merely transferred all title he had in the

111. *See* Leopold v. United States, 510 F.2d 617 (9th Cir. 1975); Old Colony Trust Co. v. United States 423 F.2d 601 (1st Cir. 1970).
112. Nash, *supra* note 1, ¶ 1026.
113. Treas. Reg. § 20.2038-1(a)(1958). "However, section 2038 does not apply . . . [i]f the decedent's power could be exercised only with the consent of all parties having an interest . . . in the transferred property . . . ." *Id.* § 20.2038-1(a)(2).
114. 8 T.C.M. (CCH) 781 (1949). *See also* Estate of Louis Bendet, 5 T.C.M. (CCH) 302 (1946); Britt's Estate v. United States, 190 F.2d 946 (5th Cir. 1951).
115. Int. Rev. Code of 1939, § 811(c).

partnership interests "as free from restrictions as said interests were held by him."[116]

The principle of this decision is that partnership interests subject to the conditions and restrictions set forth in an existing partnership agreement can be validly gifted as complete transfers under the estate tax laws. The decision could, however, be distinguished from the situation in which a partnership has been forced for the purpose of serving as a gift vehicle for an estate plan. The facts of *Roddenberry* were favorable to the taxpayer in that the partnerships were in existence for a number of years before the gifts in issue were made. For this reason, estate planners should be hesitant to rely totally on this case when the gifting of partnership interests coincides with the formation of the partnership. As noted by one commentator, controls which are commensurate with the donor's ownership interest will escape taxation under section 2036; "[h]owever, if the 'controls' are not those commonly found in business relationships, and appear to be specifically entered into by the donor to allow him to retain control over the partnership in excess of his ownership interest, the transferred interest likely will be includable under Section 2036."[117]

Case law addressing the valuation of partnership interests for estate tax purposes has generally been favorable to taxpayers who have implemented control techniques such as the buy-sell agreement. Although the valuation cases cannot serve as precedent for section 2036 issues of gross estate inclusion, the case law does indicate that courts are sympathetic to the needs of an owner of a family business who wishes to preserve the business for succeeding generations.

The most recent valuation case, *Estate of Bischoff v. Commissioner*,[118] held that the estate tax value of a partner's interest which was subject to a mandatory buy-sell agreement upon his death is the amount provided for in the agreement. The court had followed earlier precedent which had recognized mandatory buy-sell agreements at book value for establishing the value of decedent partners' interests.[119] The Service argued that the buy-sell provisions should be disregarded because they lacked a bona fide business purpose and merely served as a substitute for a testamentary disposition.[120] It was found, however, that the transfer re-

116. 8 T.C.M. (CCH) at 785.
117. Stukenberg, *supra* note 98, at 261 (footnote omitted).
118. 69 T.C. 32 (1977).
119. Brodrick v. Gore, 224 F.2d 892 (10th Cir. 1955); Estate of Weil v. Commissioner, 22 T.C. 1267 (1954).
120. The Service's argument embodied the test set forth in Treas. Reg. § 20.2031-2(h) (1958) for determining the estate tax value of securities which are subject to an option or contract price.

strictions in this family partnership had a business purpose, that the restrictions on transferability were intended to maintain ownership within the family and to assure continuity of management. These objectives were held to constitute a legitimate business purpose as a matter of law. Rejected was the argument that maintenance of continuity of management is not a valid business purpose in the context of a limited partnership.[121] Thus, restrictive buy-sell agreements may be placed on passive owners who are relegated to limited partnership interests even though there would otherwise be no direct disruption of business management.

The *Bischoff* case stands as an important taxpayer victory and establishes the buy-sell agreement as a most important tool of partnership estate planning. The restrictive buy-sell agreement will most certainly be integrated in most partnership capital freezes. In this respect, the estate planner can, under the case authority culminating with *Bischoff*, operate on firm ground if the principle motives behind the freeze include maintenance of family ownership or continuity of management.

VI. CONCLUSION

The estate planner who finds it necessary to vest substantial controls in the donor-partner is given little guidance from established legal authority as to the estate tax consequences of the proposed plan. In addition, many desirable control techniques will run afoul of the family partnership income tax rules. This comment attempted to identify those areas which present the greatest threat to the estate plan's viability and to offer possible measures which may be taken to alleviate those dangers. It must be emphasized that until there is established legal authority, a capital freeze accomplished through a family partnership will be fraught with uncertainty. The ultimate task of the estate planner is to assess possible challenges to the proposed partnership capital freeze and circumvent those dangers through effective planning.

Gary N. Clatterbuck '80

> [S]uch [option or contract] price will be disregarded in determining the value of the securities unless it is determined under the circumstances of the particular case that the agreement represents a bona fide business arrangement and not a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth.

Id.

121. 69 T.C. at 40. "We are convinced that the members of . . . [the partnerships] entered into the respective partnership agreements in order to assure their continuing ability to carry on their . . . business without outside interference, including that of a dissident limited partner." *Id.*