Advanced Underwriting Service
Current Comment 05-24
July, 2005

Is the Music Over for Family Limited Partnerships?

On July 15, 2005, the Court of Appeals for the Fifth Circuit issued an opinion in Strangi v. Commissioner, No. 03-60992. What sort of estate planning case is so momentous that it merits 800 words of coverage in the New York Times (see Story, Appeals Court Clarifies Rules on Family Limited Partnerships, The New York Times, July 20, 2005)? A case that had been anticipated by much of the financial planning community for two years, waiting for the other shoe to drop; a case that had yo-yoed between the Tax Court and the Fifth Circuit for five years against the background of an increasingly pitched battle between taxpayers and the IRS over the validity of family limited partnerships (FLPs); a case awaiting decision by a court whose precedents were so all over the map that its rationale could have been almost anything.

Not that the outcome, per se, was ever really in doubt. The facts in Strangi were among the worst for the taxpayer in a reported FLP decision (though see Turner v. Comm'r, No. 03-3173 (3d Cir., Sept. 1, 2004), aff'g Estate of Thompson v. Comm`r, 84 T.C.M. (CCH) 374 (2002)); as one commentator noted, "The Strangi facts are so bad that if the government can't ultimately prevail in this case, it can't win any family limited partnership cases." Sheppard, News Analysis; Economic Substance Comes to Estate Planning, Tax Analysts, May 31, 2004. The widely held belief among planners that the Fifth Circuit might reverse the IRS's victory in the Tax Court was wishful thinking. The real issue is how the appeals court would rationalize its decision in light of what it had said in Kimbell v. United States, 371 F.3d 257 (5th Cir. 2004). Would it defer to Kimbell, cementing the split between the Fifth and Third Circuits (in light of Turner)? Would it repudiate Kimbell, creating an internal split and throwing the analysis of FLPs into chaos? Or would it do something completely different?

In the end, the Strangi court took the simplest course; citing Kimbell where appropriate but avoiding conflict by deciding the case on its egregious facts. Meltdown has been averted for the moment, but there is still no definitive guidance for practitioners on how to use FLPs for their clients—if, indeed, they should even consider doing so at all. This Current Comment takes Strangi as the jumping-off point for a survey of the FLP landscape now that the new monument has been hoisted into place.

Background I: What Are FLPs?

Throughout the 1990s and beyond, the use of FLPs as planning tools to reduce both income and transfer taxes grew dramatically. The idea is that a taxpayer establishes a limited partnership and transfers assets to it in exchange for a substantial limited partnership interest (often as high as 99 percent). Thereafter, the taxpayer makes gifts (lifetime or at death) of the limited partnership interests to family members or others who would otherwise inherit the underlying assets if they had not been transferred to the partnership. Because these interests in the underlying assets are received by the donees in the form of limited partnership interests, which lack control over the underlying assets and are typically not freely transferable, the gifts are valued, for transfer tax purposes, at discounts up to 40 percent or more from the market value of the underlying assets, and the gross estate is reduced by that value.

To illustrate with a typical example, assume that an individual owns an office building worth $1.5 million, which produces annual net cash flow of $150,000, and he wants to give a 20% interest to each of his four children. He and the four children form a limited partnership in which the father is general partner with a 20% interest, and the four children each own a 20% interest as limited partners. The father then transfers the building to the limited partnership for no consideration. This represents a gift to the children, who hold 80% of the beneficial ownership in the partnership. But what is the value of the gift for gift tax purposes? Even though the children will be enjoying 80% of the future cash flow from the building, the value of what they have received is not 80% of the value of the building at the time of the transfer. This is because they are only limited partners, and as such, they have no voice in management of the building and they cannot, even acting jointly, force a sale of the property, without the concurrence of the general partner. Thus, the 20% interest transferred to each child will be subject to a valuation discount for gift tax purposes. To put it in simple terms, a 20% interest, as a limited partner, in a $1.5 million asset is not worth as much as outright ownership of a $300,000 asset. (Actually, in view of the result in Shepherd v. Comm'r., 115 T.C. 376 (2000), aff`d 283 F.3d. 1258 (1th Cir. 2002), the father should set up the limited partnership first, giving each child a de minimis interest, transfer the building to the limited partnership, and then transfer interests totaling 20% to each child.).

Background II: Deathbed Planning

As the example illustrates, it was thought that the assets need not necessarily be from an operating business; they were frequently passive-investment portfolio securities and even real and personal property used by the taxpayer. That assumption turned out to be one of the critical battlegrounds in Strangi and similar cases of "deathbed planning."

Obviously, there is a continuum of situations in which a taxpayer might use an FLP. At one end stands the sole proprietor of an operating business who desires to give his children minority interests in the business during his lifetime. An FLP is an appropriate vehicle for doing this: the proprietor forms a limited partnership through which the business is to be conducted in the future, and gives the children limited partnership interests. In such a situation, the fact that the partnership was an operating business would probably eliminate any potential challenge to its legitimacy in connection with discounting of gift tax valuations. It might even be that the discounting is the taxpayer's secondary motive, the primary motive being to ensure the continuation of the business.

Contrast this, however, with a case in which an elderly widow, who holds a large portfolio of marketable securities, or an office building investment, contributes this property to a limited partnership in which she is the general partner and principal limited partner, followed by a series of gifts of limited partnership interests to children and grandchildren at discounted valuations. The question naturally arises: What purpose could she possibly have other than to avoid, if not evade, transfer taxes? How can it be shown that the FLP is not merely a testamentary transfer in disguise? And depending on how the FLP is drafted a second question may also be inevitable: Did she retain enough control over the partnership assets that they should be included in her gross estate?

These are the endpoints of the continuum. At one extreme is the FLP used as a device to transfer business interests—obviously okay. At the other is the FLP used as a testamentary device to transfer wealth—obviously not okay. The latter is known as deathbed planning, but of course the transferor need not die right after establishing the FLP; that's just how it usually works out. (Nor is the FLP invalidated just because the transferor dies immediately after establishing it.) The moniker merely indicates that it is a testamentary device in sheep's clothing. As such, the question it raises is: Exactly what is wrong with it? What must planners avoid, and how much room do they have for legitimate planning with FLPs?

The IRS experimented with a number of answers to these questions. Because they mostly failed, they are of academic interest—all except I.R.C. §2036(a), which brings us to Strangi.

Strangi in the Tax Court (Strangi I and Strangi II)

Procedural History—Keeping the Names Straight

There are two Strangi v. Commissioner cases in the Tax Court—"Strangi I," 115 T.C. 478 (2000), rev'd, 293 F.3d 279 (5th Cir. 2002), and "Strangi II," T.C. Memo 2003-145 (2003), the case just affirmed by the Fifth Circuit.

Strangi I: The Facts

The Strangi saga can be said to begin in 1994. That summer, Albert Strangi, a self-made millionaire aged 81, was ill with cancer and supranuclear palsy, a brain disorder, and his son-in-law Michael Guilg, an estate attorney, was his attorney in fact. In August 1994 Gulig attended a seminar held by the Fortress Financial Group, whose enterprise was characterized in Strangi I as follows:

> Fortress trains and educates professionals on the use of family limited partnerships as a tool to (1) reduce income tax, (2) reduce the reported value of property in an estate, (3) preserve assets, and (4) facilitate charitable giving. The Fortress Plan recommends contributing assets to a family limited partnership with a corporate general partner being created for control purposes. The Fortress Plan also suggests that shares of stock of the corporate general partner or an interest in the family limited partnership be donated to a

> charity. To facilitate the plan, Fortress licenses the use of copyrighted limited partnership agreements and shareholders' agreements.

In other words, Fortress sold proprietary FLP kits. Gulig bought one, and so the Strangi FLP (SFLP) was formed. Albert Strangi transferred 98 percent of his assets, mostly investments, but including his personal residence, having a total fair market value of nearly $9.9 million. In return, he received a 99 percent limited partnership interest. The general partner of SFLP was a newly-formed corporation, in which Strangi purchased a 47 percent interest, and other family members purchased 53 percent. The corporation entered into a management agreement with Gulig, who was authorized to manage the day-to-day business of the corporation and of SFLP.

Two months later, Albert Strangi died. The SFLP assets had a fair market value of $11.1 million, but on Strangi's estate tax return his 99 percent share in SFLP was valued at some $6.56 million. The IRS challenged this discounted valuation, initially basing its argument primarily upon I.R.C. §2703, which, subject to exceptions, prohibits discounting based upon restrictions on the sale or use of the transferred property. It lost this argument, as it has usually done, but it appealed on the ground that the Tax Court denied it leave to amend its pleadings to add a §2036 argument (even though the Tax Court stated that "The actual control exercised by Mr. Gulig, combined with the 99-percent limited partnership interest in SFLP and the 47-percent interest in Stranco [the corporate general partner], suggest the possibility of including the property transferred to the partnership in decedent's estate under section 2036.") The Fifth Circuit reversed and remanded for consideration of the §2036 claim. The result: Strangi II.

Strangi II: The Terrible Facts

Section 2036

I.R.C. §2036 provides as follows:

> TRANSFERS WITH RETAINED LIFE ESTATE.
>
> (a) General Rule.--The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death--
>
> > (1) the possession or enjoyment of, or the right to the income from, the property, or
> >
> > (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

The courts have interpreted the statute as embodying Congress's intent to include transfers that are testamentary in nature—that only take effect upon the transferor's death—in the gross estate. As applied in the FLP context, the IRS's argument is that the transfer to the limited partnership involves the retention of §2036 rights by the transferor with respect to the property. Therefore, all of the assets transferred are themselves includable in the gross estate, rather than just the limited partnership interest received.

The §2036(a)(1) Issue—A No-Brainer

The estate thus had to argue that either Albert Strangi did not retain possession or enjoyment, or the right to designate the person who has the right of possession or enjoyment, of the property he transferred to the FLP (i.e. that §2036 does not apply at all), or that the transfer was a bona fide sale for adequate and full consideration (i.e. that the parenthetical §2036 exception applies, saving the transfer). It had a tough—in fact, impossible—row to hoe to make the first argument. Witness the parade of activities that flout the claim that Albert had relinquished possession or enjoyment, in just the two short months the FLP existed before his death:

- The FLP was managed by Gulig (under contract from the general partner), the same individual who had a durable general power of attorney to act on behalf of the property transferor, Strangi. Thus, Strangi's agent was in a position to control distributions of partnership income to him.

- Because Strangi transferred virtually all of his assets to SFLP, and most of his remaining assets were not liquidated for cash, there must have been an implicit understanding among all parties that his foreseeable living expenses would be paid by distributions from the partnership.

- Strangi continued to occupy his personal residence even after transfer to SFLP. (Even though there was a rental agreement, and rent was accrued by SFLP, this rent was not actually paid by the estate until 1997, several years after Strangi's death.)

- SFLP distributed funds to Strangi or his estate on several occasions to meet particular needs. Because these distributions were in response to specific needs of the party from whom the partnership's assets had been transferred, and not to any independent distribution policy decision by the partnership, through its corporate general partner, the Court viewed this pattern as indicative of a §2036 continuing interest in the underlying assets that Strangi had transferred.

- The court considered the motivation for the formation of SFLP and the transfer to it of Strangi's assets as bearing a "greater resemblance to one man's estate plan than to any sort of arm's length enterprise. . . . [V]irtually nothing beyond formal title changed in decedent's relationship to his assets."

Under these facts it is really rather hard to imagine any court finding for the estate under §2036(a)(1). The Tax Court certainly did not.

The §2036(a)(2) Issue—Controversial Dicta

The §2036(a)(1) discussion was enough to keep the case moving. The Tax Court would have done well to proceed to a discussion of whether the "bona fide sale" exception applied.

However, it also considered the alternative argument that the transfer to the FLP was invalid under §2036(a)(2). It sided with the IRS, causing consternation in the estate planning community, but it did not need to do this to decide the case. Generally, courts do not opine on any questions other than those that are necessary to decide the case. Their discussion of these issues is called a “holding,” and is binding on any lower courts. When they go further and address questions that are not necessary to decide the questions presented to them, the discussion is called “dictum.” Thus, to say that something is dictum means that it is not binding on other courts, whereas a holding is.

No doubt for this reason, the Fifth Circuit did not even mention the Tax Court’s §2036(a)(2) discussion, and rightly so. This Current Comment does so only to record the fact that the discussion was controversial and that the controversy is largely beside the point.

The Bona Fide Sale Exception

Even more controversial, through no fault of the Tax Court’s, was its discussion of the §2036 exception. It followed existing cases in holding, first, that there was no bona fide sale because there were not really two parties to the transaction: Michael Gulig “essentially stood on both sides”; and second, there was no full and adequate consideration because there was a mere “recycling of value”; in Harper v. Comm’r, T.C. Memo. 2002-121, the Tax Court had held that a transaction that merely changed the form in which the decedent held a beneficial interest in the property, in which there was no change whatever in the underlying pool of assets, was not an instance of full and adequate consideration. It now held that Strangi’s was not such an instance.

This was another holding that caused consternation among FLP planners, since the structure of the Strangi FLP, as opposed to the egregious misuse the family made of the partnership assets, was typical of marketed FLPs. If this holding of Strangi II was affirmed on appeal, could FLPs survive?

Meanwhile . . . : Kimbell and Turner

So matters stood while the Strangis and the IRS commenced the appeal process. But the rest of the world did not stand still. The Fifth Circuit decided Kimbell, which FLP planners praised as a major victory, and the Third Circuit decided Turner, which they mourned as a major loss. We will only recap the main points of interest here.

Kimbell

The facts of Kimbell, on their face, were very similar to those in Strangi: a very old transferor dying two months after the FLP was established; similar limited partnership shares and general partnership powers held by the transferor. But for present purposes, at least two facts were very different: the Kimbell taxpayers were careful to place evidence in the record that Ruth Kimbell, the transferor, was concerned about her business interests, specifically certain mineral interests that the record alleged required active management, and that Ruth retained sufficient assets for her own support, meaning that she did not need to draw on partnership assets.

Equally important for the disposition of Kimbell, the Fifth Circuit rejected the District Court's holding that the FLP represented a mere recycling of value. There is a bona fide sale, and not a mere recycling, the court held, when there is adequate and full consideration, and this means, according to its previous decision in Wheeler v. United States, 116 F.3d 749 (5th Cir. 1997), that the transfer not deplete the gross estate:

> The following rule emerges: unless a transfer that depletes the transferor's estate is joined with a transfer that augments the estate by a commensurate (monetary) amount, there is no "adequate and full consideration" for the purposes of either the estate or gift tax.

116 F.3d at 762.

Kimbell thus posed two questions for the Strangi appeal. First, does an FLP require a business purpose? The posture here was that of an IRS motion for summary judgment, so the mere allegation of a business purpose by the Kimbell taxpayers was enough to defeat the motion. The apparent lack of such a purpose looked bad for the Strangi taxpayers. Second, even if the Strangi FLP was subject to §2036, does the Kimbell court's rejection of the recycling of value argument, relied on by the Tax Court in Strangi to deny the FLP the bona fide sale exception, mean that the Strangi FLP could get the benefit of that exception?

Turner

As Roseanne Roseannadanna used to say on Saturday Night Live, it's always something. Did you think the facts in Strangi were as bad as they could get? Then take a look at the Turner case. Here again, taxpayers bought a DIY kit from Fortress Financial, but lacking Michael Gulig's estate planning expertise, such as it was, violated the partnership form even more blatantly. The transferor made requests for partnership assets that were liberally granted, such as one for $40,000 in 1993 to pay for holiday gifts; the FLP portfolio consisted largely of minimally traded securities, and the partnership agreement explicitly provided that gains and losses from the FLP's real estate holdings would be directly allocated to the partners; the FLP made loans to family members without even attempting ever to collect either principal or interest; and perhaps most remarkable, (a) a letter from one of the FLP providers to the family stated that "all of the benefits [of the FLP] can be achieved while total control of all assets is retained by the directors of the Corporate General Partner (in which the transferor held a 49 percent interest) and (b) the family's appellate brief actually called the FLP an "estate plan."

Still worse than the facts, for FLP planners, was the legal analysis the Third Circuit applied to them. First, it found that there was a mere recycling of value, adopting that criterion in the face of the Fifth Circuit's rejection in Kimbell. Second, it flirted with the idea that an FLP could never be legitimate, because the discount implies that there was not a bona fide sale for full and adequate consideration. If there's a discount, then by the very meaning of the term there can't have been full consideration. (The Kimbell court rejected this idea by arguing that "full and adequate consideration" can't mean "fair market value," as one would ordinarily think; it must mean that the partnership assets are not depleted. That is where this unintuitive notion comes in.) It did not go all the way, but did suggest that heightened scrutiny is required: "Where, as here, the transferee partnership does not operate a legitimate business, and the record demonstrates the valuation discount provides the sole benefit for converting liquid, marketable assets into illiquid partnership interests, there is no transfer for consideration within the meaning of § 2036(a)." Thus, in addition to the no-brainer holding that this particular FLP should not be entitled to a discount, the Third Circuit at least implied that any FLP could be entitled to a discount only if it "operate[s] a legitmate business." This proposition was driven home in an unusual concurrence joined by two members of the court, and caused much weeping and gnashing of teeth among FLP planners.

That, then, is the background against which the Fifth Circuit's decision in Strangi needs to be seen. Does an FLP require a business purpose? And what is "full and adequate consideration"?

The Fifth Circuit's Discussion

Again, the actual holding of this opinion is the easy part. There is no way the FLP was going to prevail on appeal. The point is the analysis.

With regard to the §2036(a)(1) issue, the Fifth Circuit had no problem at all affirming that "the benefits retained by Strangi –- including, for example, periodic payments made prior to Strangi's death, the continued use of the transferred house, and the postdeath payment of various debts and expenses –- were clearly 'substantial' and 'present'" as the statute requires. The only issue was whether the requirement of Treas. Reg. §20.2036-1(a) that there be an express or implied agreement at the time of transfer that the transferor would retain such benefits was fulfilled. It easily found that the disbursements to Strangi, his continued physical possession of one of his houses, and his lack of enough liquid assets for his own support implied such an agreement.

To repeat, the Fifth Circuit did not consider the Tax Court's §2036(a)(2) dictum.

This led finally to the main event: had there been adequate and full consideration, leading to a bona fide sale of the assets to the partnership? The court followed Kimbell on the first point and disposed of it quickly. Still more strikingly, it followed Kimbell on the criterion for a bona fide sale: "We think that the proper approach was set forth in Kimbell, in which we held that a sale is bona fide if, as an objective matter, it serves a 'substantial business [or] other non-tax' purpose. . . . the proper inquiry is whether the transfer in question was objectively likely to serve a substantial non-tax purpose." The Strangi estate had set forth five such purposes, none of which convinced the Tax Court or, on appeal, the Fifth Circuit. Importantly, one of them was "permitting centralized, active management of working interests owned by Strangi"—a recitation of a legitimate business interest that was not factually persuasive.

After the Ball Is Over: Outstanding Questions

Now that the Strangi litigation is finally over (barring a petition for rehearing en banc or an appeal to the United States Supreme Court), what is the state of FLP law? There are at least three major issues:

First, Strangi cements the requirement that an FLP have an objective nontax business purpose. There is basically no getting around this any longer: it is now the law in the Third and Fifth Circuits, and the other federal courts of appeals are likely to follow in any future FLP litigation that comes before them.

Second, it is important to note that the §2036(a)(2) issue was also raised in Kimbell, and the Fifth Circuit did not address it then either. This does not mean that it will never be the dispositive issue in an appropriate case, and a future court might well find the restrictions on transferor control discussed by the District Court in Kimbell to be the law.

Third, to the extent the Strangi court adopts a business purpose requirement, the possibility of a conflict with the Third Circuit that would incite Supreme Court review is lessened, though not extinguished.

Conclusion: Dos and Don'ts Revisited

The practical upshot of Strangi is not so much to break new ground as to underline the need for prudent practices:

- DO make sure that the transfer of assets to the FLP has, and evidences, a legitimate business purpose.
- DO include a statement of business purpose in the partnership agreement.
- DON'T let clients believe or say that the whole purpose of the FLP is to avoid transfer taxes and particularly DON'T make any such representations to them, especially not in writing. It's essential that the non-testamentary purpose of the FLP be explained (and the explanation documented) to the family members.
- DO be sure that the donor retains sufficient assets for his or her needs.
- DO ensure that the partnership is run like a business.
- DO avoid the appearance of "deathbed planning."
- DO ensure that the donor is fairly compensated for his or her capital contribution.
- DO pay special attention to control issues, adhering to conservative principles such as:
- DON'T make the donor the general partner.
- DON'T give the donor power to replace the general partner.
- DON'T give the donor control over distributions.
- DO partner with an experienced attorney. Given the state of the law, the old adage "Don't try this at home" rules. Be sure that you have knowledgeable help in setting up the FLP. DON'T be like Strangi's son-in-law, who got his FLP out of a kit.

What Strangi does for us is underline the seriousness with which an FLP should be undertaken. The business purpose requirement is now close enough to being settled law that planners should be very skeptical of setting up an FLP unless there is an actual business behind the limited partnership interests. The standard list of business-sounding purposes relating to family assets will no longer do. Passive investment portfolios, even though arguably permissible on other grounds, will probably no longer do. FLPs remain inherently legitimate, and even legitimate as a device for tax reduction, but a prudent planner will make sure that tax reduction is not the only, and ideally not even the primary, motive for setting up the FLP.

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