



Estate & Succession

Planning Corner



By Louis S. Harrison

Raddling the Myths and Realities of Partnership Planning in a *Strangi II* World

In the second Tax Court review of the *Strangi* case, *A. Strangi Est.* ("*Strangi II*"),¹ Judge Mary Ann Cohen accepted both prongs of Code Sec. 2036 (either one of which, by itself, would have been successful) to include decedent's *pro rata* value of the partnership's assets (essentially all of the partnership), without discounts, in the decedent's gross estate.² Judge Cohen invoked the first prong by concluding the decedent, directly and indirectly (*via* the decedent's agent acting for him), as a shareholder in the corporate general partner, had the right to distribute income to the partners, and therefore, even as a limited partner, the decedent had retained the right to the income (directly) or enjoyment (indirectly) from the property.³ She implicated the second prong by concluding that having any say with regard to the right to liquidate or distribute partnership assets, either as a controlling general partner, or as a limited partner acting in conjunction with the other limited and general partners, was tantamount to the "right to designate."⁴ The decision has generated quite a bit of mythology on how to proceed with partnership planning.

Myth 1

The Strangi II decision is wrong on the law, and therefore, we can ignore it.

Judge Cohen's decision in *Strangi II* corroborates the aphorism: "Bad facts make bad law." And the *Strangi* facts are really bad. Judge Cohen's holding in the case, correct on equitable principles, may nevertheless misapply the principles of Code Sec. 2036. Accordingly, implicit in much current advice on partnerships is an undercurrent that the *Strangi II* decision can be ignored because it is not correct. And although it is true that the holding is questionable, that does not mean the holding should be ignored.

First, the case has not been overturned despite the Tax Court having the opportunity to do so in *Stone*.⁵ In that case, the court held that the *bona fide* full and adequate consideration exception applied, and that Code Sec. 2036 was therefore inapplicable to the partnership in question. But that case has substantially different facts than *Strangi II*, and the Tax Court in that decision did *not* overturn the *Strangi II* holding; it merely differentiated the holding based on the facts. Further, it did not eliminate the *bona fide* requirement applied by *Strangi II*, a requirement that is questionable.⁶

Second, ignoring *Strangi* is dangerous in practice because the IRS will not ignore the decision. The IRS is now using *Strangi* aggressively in denying discounts and in negotiating reductions in discounts. And the practitioner needs to focus on the increased audit risk and difficulties that *Strangi* presents. Further, a client's temperament for the IRS's entrenchment in its position because of *Strangi*, and the client's understanding that the planning may be unsuccessful, needs to be measured. One of *Strangi's* dictates is that a practitioner needs to be more careful in shifting risk of unsuccessful partnership planning to the client. And merely shrugging off the holding as incorrect may lessen the practitioner's desire to do this.

Third, as practitioners, we tend to have a bias as to the application of the law. Although *Strangi's* holding appears to misapply the law, we are looking at the law through our own beliefs. There is bad law out there, and *Strangi* has not been repudiated by the Tax Court or overturned (yet?) by the Fifth Circuit. It is possible that the Fifth Circuit in *Kimbell*⁷ will not affirm certain of the reasoning found in the *Strangi* decision that is clearly wrong to the practitioner world. The

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good news here is that on May 20, the Fifth Circuit overturned the District Court in *Kimbell*.

Fourth, until it is overturned, *Strangi* is at least the Tax Court's interpretation of the law, and the Tax Court, through Judge Cohen, has indicated that Code Sec. 2036 could rear its extremely ugly application to cause the taxpayer great problems, not only in disallowing discounts, but also in inclusion of partnership interests not even owned by the taxpayer at the taxpayer's passing. Careful planning needs to be undertaken in an attempt to avoid the application of the *Strangi* holding.

Myth 2

A different set of facts than the egregious ones in Strangi II will avoid the Code Sec. 2036 problems of Strangi II. Better facts will allow the taxpayer to avoid Code Sec. 2036 even if the decedent, as general partner, retains voting power, or the decedent receives distributions from the partnership.

Strangi II indicates that retained voting power is but one of the problems under Code Sec. 2036. If the decedent retains the right and expectancy (maybe, more importantly, the "expectancy") of distributions from the partnership, *Strangi II* indicates that this could be a problem. Any receipt of payments from a partnership could, under the court's reasoning, evidence retained enjoyment, creating a problem under Code Sec. 2036(a)(1). Further, even if the facts demonstrate a valid partnership for business reasons, the concept in *Strangi II* is that any ability to control distributions or liquidation, either alone or in conjunction with another, is a retained right to "designate" creating a problem under Code Sec. 2036(a)(2):

Pursuant to the SFLP agreement, the partnership would be dissolved and terminated upon a unanimous vote of the limited partners and the unanimous consent of the general partner. Accordingly, decedent [as a limited partner] can act together with other Stranco shareholders essentially to revoke the SFLP arrangement and thereby to bring about or accelerate present enjoyment of partnership assets. Furthermore, it is noteworthy that such action would likely revert in decedent himself, as the 99-percent limited partner, the majority of the contributed property.

Therefore, even a differentiation under the facts is not enough to ensure that the problem set forth in *Strangi II* can be avoided if the decedent retains

general partnership control or receives partnership distributions. In that instance, if this becomes a problem, the decedent would have to rely on the *bona fide* for full and adequate consideration exception to the Code Sec. 2036, discussed below.

Alternatively, a better course is to avoid the possible application of *Strangi II* by avoiding retention of any control over the partnership and by avoiding retention of the need or expectation of distributions from the partnership (even if, in fact, distributions are made after the partnership is established). As set forth by Judge Cohen:

Fundamentally, the preponderance of the evidence shows that decedent as a practical matter retained the same relationship to his assets that he had before formation of SFLP and Stranco found probative of an implicitly retained interest ...include transfer of the majority of the decedent's assets, continued occupation of transferred property, commingling of personal and entity assets, disproportionate distributions, use of entity funds for personal expenses, and testamentary characteristics of the arrangement.

Myth 3

Obtaining back partnership interests equal in value to what was contributed to the partnership will remove one from the Code Sec. 2036 argument enunciated in Strangi II.

This myth has two geneses. Fallacious underpinning number one: The requirement to fall outside of Code Sec. 2036 merely requires that the transferor receive "an adequate and full consideration in money or money's worth."⁸ Fallacious underpinning number two: The *Stone* case⁹ recognized that partnerships will not run afoul of Code Sec. 2036 except in the most egregious of situations.

The statute requires a "*bona fide* sale" for an adequate and full consideration. Although one school of thought would interpret the quoted phrase as redundant and not adding an additional requirement to the adequate and full consideration standard, the evolving Tax Court attitude is that "*bona fide*" is a separate requirement.¹⁰ Further, Judge Cohen in *Strangi* found not only that the *bona fide* requirement was not satisfied, but also that receiving back consideration equal to what was put in did not satisfy the "full and adequate consideration" prong of that exception. Quoting Judge Cohen:

[F]ull and adequate consideration does not exist where, as here, there has been merely a ‘recycling’ of value through partnership or corporate solution.

In *Stone*, the Tax Court impliedly accepted the *bona fide* test as a separate one. Because the court in that case felt that the partnership structure was for a valid purpose (other than to reduce value), it held that the recycling theory was inapplicable, and that the *bona fide* and full and adequate consideration test had been satisfied.¹¹

In accepting that the Tax Court will really look for a valid partnership reason to justify the now required *bona fide* standard to the Code Sec. 2036 full and adequate consideration exception, consider the evolving attitude since *Strangi I*. *Strangi I* had a divided Tax Court indicating that the partnership at question was nonsense and set up for no reason other than to save taxes. A close read of the first case indicates an attitude of irritation by the Court that it had to hold in the taxpayer’s favor. But no valid statutory reason was propounded to the Tax Court to invalidate it. Hence, it hinted that Code Sec. 2036 would have been an interesting argument, had it been made. Lo and behold, when the Code Sec. 2036 argument resurfaces in *Strangi II*, the Court finds that the *bona fide* adequate and full consideration exception is not applicable. And in the few Tax Court cases discussed after *Strangi II*, such as *Stone*, the court applies the principle that if the partnership is valid, there are no Code Sec. 2036 issues; if set up merely for discounting, then there are such problems.

To fall within the exception to Code Sec. 2036, that is, to take a partnership out of the Code Sec. 2036 argument, the partnership itself should now be structured for a legitimate reason other than merely tax savings. Greater capital contributions by the other partners, valid investment reasons, creditor protection justifications (the parents are both doctors, for example), or consolidation of investment opportunities, all offer a *bona fide* rationale and, therefore, possible escape from the Code Sec. 2036 conundrum.¹² The Fifth Circuit in *Kimbell* has held that an objectively defensible reason other than tax planning for establishing the partnership will be sufficient to take the partnership out of the Code Sec. 2038 realm.

Myth 4

In establishing a partnership to avoid Strangi II, the decedent must, if a substantial contributor,

retain a pro rata portion (either directly or through a business entity) of the general partnership interest or, otherwise, risk a finding that there is a deemed gift on formation.

Though this argument has plausible underpinnings, it suffers on many fronts. For example, first there is the actual structural problem. Assume a million dollar partnership with the 99-percent contributor retaining a 99-percent limited partnership interest. The one-percent contributor retains a general partnership interest. How much is the one-percent interest worth? \$10,000 is the *pro rata* number. A control premium of 20 percent gets it up to \$12,000. So, what is the gift—\$2,000? No other transfer of value exists. (*Simplot* would have applied a much greater control premium, but the case was overruled on appeal.¹³) Also, has there really been a transfer of value? The 99-percent limited partnership interest will get all equity and cash distributions at a 99-percent clip. Isn’t this what it put in? Interestingly, would not a client wish to risk the gift on formation issues, with the attendant 20-percent control premium argument, versus a *Strangi II* no-discount-at-death result?¹⁴ In *Stone*, the Tax Court accepted that if the following three requirements are satisfied, there is not an explicit need to retain control in order to satisfy the full and adequate consideration exception (and therefore implicitly to avoid the gift on formation issue):

1. All partners have respective interests proportionate to the fair market value of the assets that such partners respectively transfer to the partnership.
2. The respective assets that the partners transfer are properly credited to the respective capital accounts of such partners.
3. Upon the termination or dissolution of the partnership, the partners are entitled to distributions from the partnership in amounts equal to their respective capital accounts.

The court in *Stone* specifically rejected that the fair market value received in exchange for a contribution to a partnership must equal the fair market value of what was contributed:

We reject such an argument [that there is a transfer for less than adequate and full consideration because what decedent put into the partnership was greater than what the decedent received in value in terms of the limited partnership interests] by respondent that reads out of section 2036 (a) the exception that Congress expressly prescribed when it enacted that statute.

Myth 5

Avoiding the “retained right to designate,” the problem that causes Code Sec. 2036(a)(2) to apply, can be achieved by defining the amount of net cash flow that the general partner can distribute to the partners.

One goal post-*Strangi II* is to limit the decedent's control over partnership distributions. If the decedent is a general partner, the decedent has the right, albeit in a fiduciary capacity, to determine the timing and amount of distributions. In a trust context, the retained right of a trustee to determine whether a beneficiary receives distributions of income or principal pursuant to a broad, unascertainable standard (such as one relating to “best interests”) has been held to be a retained right to designate causing gross estate inclusion under Code Sec. 2036(a)(2). A line of private letter rulings holds that a general partner's determination of when and how much of partnership cash flow to distribute, because it is limited by a general fiduciary obligation, is not subject to the Code Sec. 2036(a)(2) problem. But *Strangi II*'s holding goes against these rulings and indicates that this retained right to determine amount and timing, in the partnership setting, could be a retained right to designate under Code Sec. 2036(a)(2).

It has been suggested that to avoid this problem, the partnership agreement should dictate the amount of cash flow that can be distributed each year and remove general partner discretion in this regard. However, from a practical standpoint, this may not be so easy. Should a distribution of partnership

“income” be mandated each year? What is the right percentage? And who determines income? Further, isn't the general partner's right to invest in certain assets the ability to determine this “income” leading to the same problem?

Mandatory distributions of cash flow also could lead to greater valuation by reducing the uncertainty of cash flow, thereby lowering the discounts.

But, the most substantial problem with this arrangement is that a mandatory distribution of cash flow, at any level, could invoke the other prong of Code Sec. 2036, the retained right to income or enjoyment under Code Sec. 2036(a)(1), itself a problem. Accordingly, solving one problem exacerbates another.

A more advantageous structure is to remove all control, direct and indirect, from the decedent. It is conservative and not desired by certain clients. But query, as to those clients that must retain control, is a family limited partnership really the best structure?

Myth 6

The holding of Strangi II eliminates the effectiveness of partnership planning in all cases.

Strangi II is an estate tax discount case; it does not involve the propriety of discounts in lifetime transfers of partnership interests. Accordingly, the negative results from the holding of *Strangi II* have to be considered in the context in which the case developed—the estate tax setting. One way to avoid *Strangi II* is to use partnership planning for lifetime transfers (which invokes other concerns, such as a step-transaction argument).¹⁵

ENDNOTES

¹ *A. Strangi Est.*, 85 TCM 1331, Dec. 55,160(M), TC Memo. 2003-145. The IRS appealed the decision of the Tax Court in *R. Gulig, CA-5*, 2002-2 USTC ¶60,441, 293 F2d 279 (Gulig was the independent executrix acting on behalf of the estate). There, in addition to the arguments it raised in *Strangi I*, the IRS sought to have the Circuit Court reverse the Tax Court's denial of leave to amend to add a claim that under Code Sec. 2036 that the estate should include the undiscounted value of the limited partnership assets transferred from the decedent. Concluding that the Tax Court's denial was an abuse of discretion, the Fifth Circuit reversed and remanded for consideration of the Code Sec. 2036 claim. The Fifth Circuit affirmed all other conclusions made by the Tax Court, but with the proviso that the Tax Court may revisit its valuation ruling after considering the Code Sec. 2036 claim.

² Code Sec. 2036 provides:

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—

i. The possession or enjoyment of, or the right to the income from, the property, or

ii. The right, either alone in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

³ *Strangi II, supra* note 1. The Judge looked at other factors in reaching this conclusion, including the substantial proportion of decedent's assets contributed to the partnership and use of partnership disbursements by the decedent for his ordinary living expenses.

⁴ *Id.*

⁵ *E.E. Stone III Est.*, 86 TCM 551, Dec. 55,341(M), TC Memo. 2003-309. Even with the favorable *Kimbell* decision, *infra*, it is uncertain whether *Strangi* will be reversed.

⁶ *Cf. C.I. Magnin Est.*, CA-9, 99-2 USTC ¶60,347, 184 F3d 1074 (the theory of the court's holding is loosely premised on the concept that if “full and adequate consideration” exists, there is no need to look at the *bona fide* part of the transaction because this is subsumed in the fact that the consideration is adequate).

continued on page 46