Vedder Price

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IRS ESTATE TAX VICTORIES REQUIRE ACTION BY FAMILY LIMITED PARTNERSHIPS, LLCs AND CORPORATIONS

Business, investment and real estate activities long have been conducted in the form of a partnership, limited liability company (LLC) or corporation. These entities offer many business, financial and personal advantages. In the case of a closely held entity, one advantage is the ability to transfer equity at a significant valuation discount for estate and gift tax purposes. For as long as we have had the federal estate and gift taxes, the IRS has challenged these discounts. In recent times, the IRS' primary focus has been on family limited partnerships, LLCs and corporations that hold and manage investment assets. The IRS believes that such entities inherently are abusive and that no valuation discount should be allowed for transfers of interests in such entities.

After suffering a number of defeats under various lines of attack, the IRS recently has won complete victories in a series of Tax Court cases involving family investment entities. The most significant IRS victory was *Strangi v. Commissioner*, which will be discussed in detail in this Bulletin. The result in all of these cases was that the estate tax valuation discount was disallowed and all lifetime gifts of equity interests were treated as if they had not occurred. In other words, the amount subject to estate tax was the same as the amount that would have been taxed had the entity not been created and no gifts been made — a disastrous estate tax result.

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Because the tax consequences in these cases were so devastating, taxpayers who have created family limited partnerships, LLCs and corporations that are engaged primarily in investment activities (as opposed to an operating business) are urged to immediately consult their estate planning advisors to assess the impact of these cases on their particular situations and to formulate appropriate strategies for dealing with the attacks used by the IRS in these cases.

IRS Attacks

The IRS' primary attacks against investment limited partnerships, LLCs and corporations have been under section 2036 of the Internal Revenue Code. This section has two prongs. First, section 2036(a)(1) provides that if a person makes a transfer of property during lifetime and retains until death "the possession or enjoyment of, or the right to the income from, the [transferred] property," such property will be subject to estate tax. For example, if P transfers property to a trust that pays the income to P for life, the transferred property will be subject to estate tax upon P's death. Most of the IRS' recent victories have come under this section.

Second, section 2036(a)(2) provides that if a person makes a transfer of property during lifetime and retains

until death "the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the [transferred] property or the income therefrom," such property will be subject to estate tax. For example, if P transfers property to a trust and as trustee retains the right to distribute income and principal to P's descendants for their best interests, the transferred property will be subject to estate tax upon P's death. To date, the IRS has won two cases involving family investment entities under this subsection, *Strangi* being the most significant.

Ever since the United States Supreme Court's decision in 1972 in *United States v. Byrum*, it has been widely believed that section 2036(a) would not apply to limited partnerships, LLCs and corporations simply because the transferor has retained voting interests or management powers as a general partner, manager or director. In that case, the Supreme Court reasoned that the powers of a voting shareholder and director do not amount to "rights" under section 2036(a)(2) because they are limited by a fiduciary duty owed to other equity shareholders.

SECTION 2036(a)(1)

Under section 2036(a)(1), the IRS has used a novel line of attack that has been successful in a series of Tax Court cases, including *Strangi*. Specifically, the IRS has argued that the contribution of property to an entity constitutes a transfer and, if the entity has "bad facts," the transferor will be deemed to have retained the enjoyment of the transferred property and/or the income therefrom. The following example illustrates how a properly formed limited partnership can run into trouble under this approach.

> **Example**: P transfers $990,000 of marketable securities to a limited partnership in exchange for 99 general partner units (GPUs) and 9,801 limited partner units (LPUs). P's child, C, transfers $10,000 cash to the partnership in exchange for 1 GPU and 99 LPUs. In other words, the equity is owned 99% by P and 1% by C. The vote of all the GPUs is required to dissolve the partnership and the vote of more than 50% of the GPUs is required for distributions of cash flow. Over the years, P transfers 5,000 LPUs to C by means of annual exclusion gifts and gifts that use part of P's $1,000,000 lifetime gift tax exemption. P and C are sloppy in managing the partnership. They do not maintain partnership records, distributions occasionally are made to P to pay P's personal expenses and on several occasions distributions are made to P without making a pro rata distribution to C. P dies when the assets of the partnership are worth $5,000,000.

Under *Strangi* and the other Tax Court cases, 99% of $5,000,000 will be subject to estate tax at P's death, with no valuation discounts. This will be the case even though at P's death P owns only 49% of the partnership (99 GPUs and 4,801 LPUs). In other words, the significant lifetime gifts to C will be disregarded for estate tax purposes. Even worse, the approximately $2,500,000 of value represented by the LPUs held by C will not qualify for the estate tax marital deduction if P is married and instead will use P's estate tax exemption and, if such tax exemption is exceeded, will result in estate tax.

This result will come as a shock to P's family, which had thought that only P's remaining 4,900 units would be subject to estate tax upon P's death and, even then, at a discount of perhaps as high as 40%. Instead, the result will be the tax disaster discussed above.

Generally, it appears that the IRS' section 2036(a)(1) argument will not apply unless there are "bad facts." Examples of bad facts include:

- Commingling entity and personal assets;
- Depositing entity income in the accounts of the equity holders instead of into an entity account;
- Transferring personal use property (such as a residence or automobile) to an entity;

- Using or purchasing entity assets at less than fair market value;

- Not having a purpose for creating the entity beyond mere tax savings;

- The lack of any significant business or investment activity;

- Transferring all or substantially all of an individual's assets to an entity;

- Ignoring business formalities;

- Not keeping adequate entity records and resolutions;

- Paying personal expenses from the entity;

- Failing to pay equity holders for significant services rendered to the entity;

- Making distributions to equity holders based on their personal needs rather than the needs of the entity's business;

- Having an express or implied understanding with the other equity holders that they will manage the entity as senior family members may request;

- Failing to continue the entity after the death of a senior family member.

The same bad facts and disastrous estate tax result can arise in connection with an LLC and a corporation. Unfortunately, it is unclear how many bad facts an entity can have before section 2036(a)(1) will apply. Conceivably, one bad fact may be enough.

Although at first glance the "bad facts" cases appear to be reasonable, upon closer examination, the rationale of these cases is dubious. Nearly all these bad facts constitute violations of duties established by state law and/or provisions of the documents governing formation and management of entities. These duties can be enforced by other equity holders and managers. Thus far, the Tax Court has dismissed this argument rather cavalierly, but it is difficult to see how it can do so in light of the *Byrum* decision.

> ***" . . .unless and until these cases are reversed on appeal, they must be taken seriously. . . ."***

In addition, the Tax Court's conclusion in these cases that the contribution of property to an entity constitutes a transfer under section 2036(a)(1) ignores the holding in a number of cases that such a contribution does not constitute a transfer for federal gift tax purposes. If the contribution is not a transfer for purposes of a gift tax statute, how can it be a transfer for purposes of an estate tax statute? To date, the Tax Court has not addressed this anomaly. Although the reasoning of the bad facts cases is questionable, unless and until these cases are reversed on appeal, they must be taken seriously.

SECTION 2036(a)(2)

Although the IRS' section 2036(a)(1) attack probably can be avoided through proper formation and management of a partnership, LLC or corporation, the IRS' section 2036(a)(2) attack, which was successful in *Strangi*, may be more difficult to deal with.

The facts in *Strangi* were as follows. On August 12, 1994, at a time when Mr. Strangi was in failing health, his son-in-law, Mr. Gulig, who also was Mr. Strangi's agent under a power of attorney, formed a limited partnership (SFLP) and its corporate general partner (Stranco). Mr. Gulig transferred approximately 98% of Mr. Strangi's assets to SFLP. Approximately 75% of the assets were cash and securities and the balance consisted of real estate, including Mr. Strangi's residence, insurance policies, an annuity, receivables and partnership interests. Mr. Strangi owned the 99% limited partner interest in SFLP and Stranco owned the 1% general partner interest. Stranco was owned 47% by Mr. Strangi and 53% by his children. Subsequently, 1% of the stock of Stranco was transferred to a charity.

Mr. Strangi was one of the five directors of Stranco and Mr. Gulig was employed as the manager of the Stranco with authority to manage the day to day business of SFLP, including distribution decisions. SFLP could be dissolved by the unanimous vote of the limited partners and the unanimous consent of the general partner, Stranco, but only with the affirmative vote of all the Stranco shareholders. SFLP also had some of the "bad facts" listed above. Mr. Strangi died on October 14, 1994.

The IRS audited Mr. Strangi's estate tax return and argued that sections 2036(a)(1) and (2) both applied. The Tax Court agreed with the IRS on both counts.

With regard to section 2036(a)(2), the Tax Court concluded that Mr. Strangi retained the right, either alone or with others, to designate the persons who would enjoy the property transferred to SFLP or the income therefrom. Mr. Gulig's power to direct SFLP distributions was attributed to Mr. Strangi because of the power of attorney. In addition, the court concluded that Mr. Strangi, together with the other Stranco shareholders, could dissolve SFLP, thereby bringing about or accelerating the present enjoyment of its assets. Finally, the court also applied section 2036(a)(2) to Stranco, because Mr. Strangi, together with the other shareholders, could cause the payment of dividends.

At first glance, all of the powers retained by Mr. Strangi appear to be similar to the powers of a director and voting shareholder, which, as previously noted, were found by the Supreme Court in *Byrum* not to be retained "rights" under section 2036(a)(2). The Tax Court recognized this and attempted to distinguish *Byrum* on two principal grounds. First, it attached great weight to the fact that *Byrum* involved an operating business and not mere investment activity. Presumably, the point is that if there is an operating business, decisions will be made based on business considerations rather than for personal reasons. Not only is this presumption faulty, but it also ignores the fact that nothing in *Byrum* or in section 2036 suggests that the same statutory language should be interpreted or applied differently from case to case based on the type of activity in which an entity is involved. To the contrary, the Supreme Court in *Byrum* recognized that a corporation could be engaged in a wide variety of activities, including the holding of "static assets for prolonged periods."

Second, the Tax Court stressed that in *Byrum* the directors and majority shareholder owed a fiduciary duty to unrelated parties who had significant interests in connection with an operating business. By contrast, Mr. Strangi owned the 99% limited partner interest of SFLP (an investment partnership) and 47% of the shares of Stranco, his children owed 52% of the shares of Stranco and a charity owed 1% of such shares. The Tax Court reasoned that as any fiduciary duty owed to Mr. Strangi's children and the charity was unlikely to be enforced, Mr. Strangi essentially owed a duty only to himself. Accordingly, the court concluded that no real duty existed. Although *Strangi* admittedly involved extreme facts, the court's analysis leaves much to be desired. Under state law, the same fiduciary duty exists regardless of the relationship of the parties, the size of the equity holdings of the parties and the type of activity conducted by the entity. Moreover, the question under *Byrum* is not whether a fiduciary duty will be enforced, but rather whether an enforceable fiduciary duty exists. If such a duty exists, then the power to make distributions legally is restrained and does not amount to a "right" under section 2036(a)(2).

SIGNIFICANCE OF *STRANGI*

Strangi appears to be a classic example of the old legal adage that "bad facts make bad law." The problem with this type of case is that it is difficult to determine whether the precedent is limited to the extreme facts of the particular case and cases involving similarly extreme facts or whether it will be applied more broadly. The scope of *Strangi* is made more uncertain by the fact that the opinion was that of only one judge and not the entire Tax Court, thereby leaving the door open for a different opinion by another judge in another case, even one with roughly similar facts. Further confusion is created by the possibility that *Strangi* may be reversed on appeal, although one should not count on this given the bad facts in the case.

Many estate planners believe that the strained reasoning in *Strangi* should be limited to cases involving similarly extreme facts. Most family investment entities are not created by a senior family member on his death bed with the transfer of substantially all of his assets to the entity, but instead involve significant investment or business activity and have other equity holders with significant interests. These types of entities should be less vulnerable, but not necessarily immune, to the type of attack that was successful in *Strangi*. Accordingly, even in these cases, the entity should be structured and managed with *Strangi* in mind.

A more pessimistic view of *Strangi* is that the Tax Court intends to limit *Byrum* to cases involving an operating business or an entity that has unrelated equity holders with significant equity interests. If so, the court's test leaves many unanswered questions. What is an operating business? Presumably, the answer is some activity other than the management and holding of investments. What about rental real estate, farm land and real estate held for development? Traditionally, such activities have been conducted by both related and unrelated parties in the form of a partnership, LLC or corporation, and it would seem unreasonable to construe *Strangi* to mean that related parties can use such entities only at the risk of adverse estate tax consequences. As for the interests of other equity holders, how significant must such interests be? Also, must there be unrelated equity holders? As previously noted, the same fiduciary duty exists regardless of the relationship of the equity holders and the size of their equity holdings. Thus, notwithstanding any suggestion in *Strangi* to the contrary, significant equity holdings by other family members should be sufficient to prevent the application of section 2036(a)(2). To conclude otherwise not only would treat related parties differently than unrelated parties but also would be contrary to *Byrum*, where the court noted that one of the persons to whom Mr. Byrum owed a fiduciary duty was a trust that he had created for his children, clearly a related party.

Unfortunately, definite answers to questions regarding the scope and meaning of *Strangi* will have to await an appeal of that case and/or clarifying decisions in other cases.

Summary

Unless and until *Strangi* and other cases in which the IRS has been victorious are reversed on appeal and/or the law is clarified by other court decisions, it must be assumed that these cases represent the current state of the law. New investment partnerships, LLCs and corporations should be structured with *Strangi* and the other cases in mind. For existing investment limited partnerships, LLCs and corporations, the planning strategies discussed above should be considered.

"New investment partnerships, LLCs and corporations should be structured with Strangi and the other cases in mind."

If you have an existing entity that is engaged primarily in investment activity (as opposed to an operating business), you should contact your estate planning advisor immediately to assess the impact of *Strangi* and the other cases won by the IRS on your particular situation and to formulate an appropriate strategy for dealing with the possible IRS attacks.

Avoiding IRS Attacks

If you have a limited partnership, LLC or corporation that is engaged primarily in investment activity (as opposed to an operating business), you should consider a number of planning strategies to avoid the IRS' attacks under sections 2036(a)(1) and (2).

With regard to the section 2036(a)(1) argument, care must be taken to avoid any bad facts in connection with the formation or management of an entity. If an entity already has bad facts, it should be cleaned up. This can be done by making certain that, going forward, the entity is managed in accordance with all formalities, in the same manner it would be managed if it had significant unrelated equity holders. Unfortunately, the IRS may argue that once an entity has bad facts, it always has bad facts. Accordingly, in order to purge an entity of bad facts, it may be necessary to dissolve the entity and start over with a new entity, preferably one with different equity holders, assets and purposes. Also, in the case of a senior family member who is older or in poor health and has made significant transfers of equity interest to junior family members during his or her lifetime, dissolving the entity without creating a new entity may be the only way to ensure that all prior equity transfers are not disregarded for estate tax purposes. However, even if an entity is dissolved (whether or not a new entity is created), the IRS may argue that the section 2036(a)(1) taint will not be purged unless the senior family member lives more than three years after dissolution.

With respect to the section 2036(a)(2) argument, the planning alternatives are less clear. One strategy is to wait and see if *Strangi* is reversed on appeal and/or the law is clarified by other cases. This may be an appropriate short-term strategy for senior family members who are younger and in good health. A more cautious strategy is to make certain that no senior family member has any interest as a general partner in a limited partnership and no voting or management interest in an LLC or corporation. For example, a senior family member who has created a corporation funded with marketable securities could divest himself of voting shares (preferably by sale) and resign as a director (and perhaps as an officer). However, if a senior family member gives up management and voting power and dies within three years, *Strangi* still may apply. Another cautious strategy is to structure the entity so that other equity holders have significant interests. Unfortunately, *Strangi* gives no guidance as to how significant such interests must be and suggests that such interests may have to be held by unrelated parties, which will be impractical in most cases. If significant gifts or other transfers of equity interests in an entity have been made to family members and you wish to avoid any risk that such gifts may be disregarded for estate tax purposes, consideration should be given to dissolving the entity to purge it of its section 2036(a)(2) taint. However, as noted above, the purge may not be complete until more than three years after dissolution. Finally, the entity should pursue an operating business or, if this is not feasible, it should pursue a broad range of investments and those investments should be actively managed.

For questions about using an annuity trust or unitrust, please contact any member of the estate planning group.

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