Strangi -
An Analysis of Commentaries Made at the
2003 Annual Southern California Tax & Estate Planning Forum

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The 2003 annual Southern California Tax & Estate Planning Forum this October, attracted the nations foremost estate planning attorneys to San Diego, CA. The debate over how tax planners must address the much criticized Tax Court decision in the *Estate of Strangi* included thought provoking analyses by attorneys Jonathan G. Blattmachr, John W. Porter, Jeffrey N. Pennell and others, and offered solid ideas, but no clear direction, as even these prominent attorneys disagreed with each other.

***UPDATE November 14, 2003 ***

Estate of Eugene E. Stone, III, et al. v. Commissioner, TC Memo 2003-309, Code Sec(s) 2036; 2044 - The Tax Court earlier this month issued its ruling in the Estate of Stone distinguishing the facts in that case from the *Estate of Strangi*. John W. Porter was representing the Estate. While the Tax Court did not address all of the issues generated by the *Estate of Strangi*, it offered sound reasoning and theory to limit *Strangi, Harper, Thompson* and *Kimbell* to their abusive facts. This holding may mitigate the most serious issues raised by *Strangi, Harper, Thompson* and *Kimbell*, and presumably will offer both the Tax Court and Federal District Courts and appellate courts, a rationale and basis to narrow the legal precedents that were feared by these cases.

In a very lengthy opinion the Court stated:

> "Because no donative transfer occurred when the Partnerships were formed § 2036(a) does not apply." In *Harper*, the Court's finding of no bona fide sale for adequate and full consideration was based upon the conclusion that the creation of the partnerships was not "motivated primarily by legitimate business concerns," and constituted only "unilateral" value recycling. In [Estate of] Thompson [v. Commissioner, T.C. Memo. 2002-46], the Court's finding was based on its conclusion that "the transactions were not motivated by the type of legitimate business "
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> ". . .we have found on the record in the instant cases that the respective transfers of assets by Mr. Stone and Ms. Stone to each of the Five Partnerships, as well as the respective transfers of assets by the other partners to each such partnership,[footnote omitted] were bona fide, arm's-length transfers."
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> "Each member of the Stone family was represented by his or her own

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independent counsel and had input into the decision-making as to how each of the Five Partnerships was to be structured and operated and what property was to be transferred to each such partnership."

". . . they [Mr. and Mrs. Stone] did not intend to, and did not, transfer all their respective assets to such partnerships. Instead, they retained sufficient assets to enable them to maintain their respective accustomed standards of living."

"the record shows that those transfers were motivated primarily by investment and business concerns relating to the management of certain of the respective assets of Mr. Stone and Ms. Stone during their lives 74 and thereafter and the resolution of the litigation among the children."

"the Five Partnerships had economic substance and operated as joint enterprises for profit through which the children actively participated in the management and development of the respective assets of such partnerships during their parents' lives (and thereafter)."

END UPDATE NOTICE

Impact and Status of Strangi

The *Strangi* decision expanded prior and potentially inaccurate legal theories in a "bad facts" type of case, where the *Strangi* taxpayer attempted to manipulate favorable legal precedents in order to achieve an estate and gift tax savings. Bound by prior Tax Court precedents the Tax Court in *Strangi* on the one hand affirmed the legal viability of various estate and gift planning techniques used in limited partnership planning[1], while on the other hand the Tax Court applied an overly broad and inconsistent rationale, to create new law to recognize "gifts" under the estate tax rules that could not be recognized under gift tax rules, by expanding and redefining Internal Revenue Code ("IRC") sections 2036(a)(1) and 2036(a)(2). *Strangi* is on appeal, however speakers at the Forum expressed their concern that the Federal District Court may find support for some of the strained and unprecedented *Strangi* theories from prior and controversial Tax Court decisions in *Harper*[2], *Thompson*[3] and *Kimbell*[4], some of which are pending appeal.

The common thread between *Strangi, Harper, Thompson* and *Kimbell* is that the taxpayers had transferred substantially all of their assets and means of financial and economic support, care and maintenance, to a family limited partnership leaving themselves no other source for income and sustenance. The taxpayers either continued to use and/or reside in the limited partnership property to care for themselves. The legal adage that bad facts make bad law is fully applicable here.

I have always referred these situations as "*personal piggy bank*

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abuses"("PPBAs"). Notwithstanding the legal viability of an entity, which could be a spendthrift trust, or a qualified retirement plan and trust that is otherwise available to lawfully protect assets from creditors, or the limited partnerships illustrated in these tax court cases that can effectively serve to remove assets from the taxpayer's taxable estate, the finding that *personal piggy bank abuses* occurred will grant to the Courts the discretion to disregard the entity. The fear over *Strangi* is that case may stand for a legal principal that does not require the finding of abuse.

In *Strangi, Harper, Thompson* and *Kimbell* the Tax Court properly concluded that an essential element of IRC § 2036(a) was satisfied because at the time of the transfers to capitalize their limited partnership, the taxpayers retained possession or enjoyment, or the right to the income from the property they transferred. The concerns raised by *Strangi* are that the Tax Court when rejecting the IRC § 2036(a) exception for transfers made pursuant to a "*bona fide sale for an adequate and full consideration*", to hold that the retention of these rights of enjoyment required the inclusion of the transferred assets into the estate of the taxpayer, did not clearly cite the legal standards to reject the exception. The fear expressed by speakers at the Forum was that the "*bona fide sale for an adequate and full consideration*" exception that is well recognized under gift tax rules and principles is being rejected under estate tax rules; specifically, at the time the *Strangi* partnership was organized, the Tax Court held that there was no gift for gift tax purposes because sufficient consideration was exchanged, however for estate tax purposes there was no similar finding of a "*bona fide sale for an adequate and full consideration*." Either the Tax Court did not view a transfer of property in exchange for a 100% partnership ownership interest as a "bona fide sale", or the Tax Court rejected the "*bona fide sale for an adequate and full consideration*" exception because of the taxpayer abuses.

The concern is that the Court in *Strangi* rejected the IRC § 2036(a) exception by applying a different standard and new law under the estate tax provision of IRC § 2036, and thereby disregarded the established body of law for determinations and valuations of gift taxes. Other commentators, including Howard M. Zaritsky have suggested that, "Many of the problems raised by Section 2036(a)(1) and 2036(a)(2) can be overcome if the estate planning attorney oversees the operations of each family limited partnership." Zaritsky Newsletter, WG&L Publishers (pending publication).

Taxpayer Arguments That Have Defeated Service Positions to Disregard Partnerships; Gifts on Formation and 2703, Under Gift Tax Rules.

The Internal Revenue Service ("Service") has prior to *Strangi, Thompson, Harper* and *Kimbell* been generally unable to demonstrate that a transfer of property to organize and capitalize a wholly owned company (partnership or limited liability company) was a gift at inception. The Courts have refused to hold that a gift can be created upon the organization and capitalization of a limited partnership and/or limited liability company, which are expressly governed under the provisions of IRC §

2701 et seq.

The dilemma facing the Service is that Treasury must work within the framework of the law, including their own public regulations and rulings (Revenue Ruling 93-12), that permit valuation discounts against the value of a gift to a donee/beneficiary for lack control and marketability of the fractional and typically minority interest when recognized by a qualified appraisal. The law therefore permits a taxpayer to engage in the sale or gift of a minority fractional interest in property that is subject to a valuation discount. Even the interest that is retained by the taxpayer at death, if any, if a minority interest, is subject to a valuation discount at death. As a result, under the IRC and existing rules, regulations and case law, a $2.3 million asset could be "diced and sliced" into interests that individually can be valued at 65% of the value of the whole, or as little as $1.495 million, which can fall within the 2004 Unified Credit and therefore be rendered fully exempt from estate taxes. The Service has unsuccessfully been trying to levy a tax on the $805,000 in valuation discounts that the law authorizes, in order to generate an estate tax of more than $350,000, plus interest.

Strangi as an Exception to Gift Tax Rules

The nature of the *Strangi* decision gives the Service the legal authority to say that at the time of transfer and capitalization of the limited partnership or limited liability company, even when the taxpayer received equal consideration for gift tax purposes by receiving a 100% ownership interest and a properly valued capital account, the transfer for estate tax purposes was not a ***"bona fide sale for an adequate and full consideration"*** under IRC § 2036(a). The broader[5] and still contradictory analysis by the Tax Court in *Strangi* has stymied the tax community, as they try to reconcile why a lifetime transfer for equal consideration that does not qualify as a gift for gift tax purposes can be fail as being a transfer for adequate and full consideration for estate tax purposes.

It has been recognized and believed that 2036(a) was enacted to prevent the transfer of property to a family member, coupled with the retention of certain rights to ***enjoy*** (IRC § 2036(a)(1)) or ***control*** (IRC § 2036(a)(2)) that same property by the transferor. It was never anticipated that IRC § 2036(a) would be used to deny the successful and tax free transfer of property to a wholly owned corporation, partnership or limited liability company free of gift tax, but can thereafter impose taxes and penalties upon the same transfer of interests at the death of the taxpayer.

Effect of Strangi

Without further judicial clarification that *Strangi, Harper, Thompson* and *Kimbell* are expressly limited to their abusive facts that must exist in order to deny the *"bona fide sale for an adequate and full consideration"* exception, *Strangi* can completely disrupt commerce and the traditional uses of wholly owned or subsidiary

entities and the taxpayers ability to engage in "risk free" transfers of property interests to family members.

The entire concern over *Strangi* may be overblown if its legal principles are limited to abusive cases. The Court in each of these cases did make specific findings that the decedent after organizing the partnership had no remaining assets to provide for his or her support and sustenance, and concluded that the partnership form was an alternate means to achieve estate planning, referring the planning as "value recycling". However, while this may be the desired result, there is concern in the tax community and those in attendance at the Forum that the effect of *Strangi* can and will be broader.

I personally have one situation where the gift tax return for gifts of two (2) separate 1/3 minority interests in a family limited liability company made by a mother to her children was audited and the Service entered into a settlement to accept a modest additional gift tax, agreeing that there was no taxable event or gift at the formation and capitalization of the limited liability company. However, the mother's retention of a 1/3 interest at her death under *Strangi* could allow the Service to argue that the previously gifted 2/3rds interest should be included in the mother's estate at her death, because *Strangi* will allow the Service to deny that the transfers to capitalize a limited liability company in exchange for 100% of its interests, can be "a bona fide sale for an adequate and full consideration" (a position which is contrary to the Service settlement and agreements reached for gift tax purposes).

A second noteworthy situation involved the formation by a father of a limited liability company to hold real estate and other limited liability positions. Valuation discounts were applied to the shares of the newly formed limited liability company and sales to each of the father's six (6) son's were made totaling sales of 80% of the LLC, or 13.3% to each son, at the established and discounted fair market values. Under *Strangi* the retention by the father of a 20% interest, which was required by his lending banks, could result in the previously sold interests being included in his estate because at the time he organized the limited liability company, the transfer was not "a bona fide sale for an adequate and full consideration" for estate tax purposes.

Both of the foregoing situations were neither aggressive nor abusive and were pursued to achieve business transition planning and at the same time minimize estate taxes. In the case of the sale by the father to the sons, the father reported capital gains on the sale, and lives off the interest income and payments generated by the sale installment notes.

Because of the harsh and punitive impact that could come about because of the *Strangi* decision, Jonathan Blattmachr is advocating that no parent/organizer of a family limited partnership or limited liability company be allowed to die while retaining any ***income interest*** in the entity, or any ***control*** or other right to vote on

matters that authorize the distributions of income, property or liquidation of the entity. Other speakers at the Forum, such as Professor Pennell and litigation attorney John Porter were a little more restrained. Professor Pennell argued that a wait and see approach may be indicated and more appropriate for most clients who are not interested in spending significant monies and make significant decisions now to solve "uncertain" problems that may never exist in the future. He resisted concluding that *Strangi* would apply to the family corporation and transition planning. Attorney John Porter expressed his philosophy that the time to create a good record is well before the deadline when events and facts cannot be changed. While it may be sheer speculation as to how and what should be done, it may still be advisable to engage in some actions to avoid a client's situations from giving rise to the most abusive facts that gave the Tax Court reason to find that the IRC was being manipulated.

Defenses Against Strangi Arguments

The *Strangi* decision, which appears to respond to Service's desire to eliminate the inherent estate and gift tax savings that results from recognized valuation and fractional discounts, relies on two (2) serious judicial, common sense and/or technical errors or flaws.

The first serious flaw is that the standard for determining and valuing a gift for gift tax purposes, and the body of rules and regulations that deny the existence of a gift at the time of formation of a partnership can be completely disregarded under IRC § 2036 (a), even though at the time of the transfer adequate and full consideration was exchanged. On appeal, one can only hope and speculate that if this proposition is upheld in any way, the Court will force a clarification of the legal significance of the case, specifically that the ability to completely disregard or minimize the ***"adequate and full consideration"*** exception must be supported with factual findings of abuse, specifically the personal piggy bank abuses ("PPBAs"). In the case of *Strangi*, PPBAs would be evidenced by the findings that the conveyance by the taxpayer of substantially all of his property including personal use property, with no identifiable rationale or purpose other than tax motivation, was made subject to implied and retained rights that were not mentioned in the four corners of the organizational agreement, specifically the right to retain income and enjoyment to the property, when and as needed. In order for this type of judicial clarification to be of value to taxpayers, such a finding would have to be fully supported by facts of abuse: (i) lack of purpose to the transaction and (ii) that the transfer rendered the taxpayer almost insolvent and unable to survive without an implied agreement that authorized invasion or access to the partnership property, and not merely because the transaction gives the taxpayer the ability to claim valuation discounts.

While in my own client situations, described above, provide no facts to support these types of abuses, litigation attorney John W. Porter expressed his concern that under *Strangi* the IRS could raise a "gift on formation" argument to deny

the "*bona fide sale*" exception under IRC § 2036(a). This concern has been raised by the legal community because of the *Strangi* Court's strained analysis and application of IRC § 2036(a)(2), does somehow modify the legal theories proposed in the cases of *Harper, Thompson* and *Kimbell* where the IRC § 2036(a) "*bona fide sale*" exception was clearly rejected because there was an implied retention of enjoyment that is prohibited under IRC § 2036(a)(1). When the *Strangi* Tax Court ruled to include all of Strangi partnership property in Mr. Strangi's estate, the Court was not clear on whether or not IRC § 2036(a)(2) could apply independent of a finding that IRC § 2036(a)(1) did not apply. The loss of the "*bona fide sale*" exception in *Harper, Thompson* and *Kimbell* directly and solely related to the implied retention of enjoyment rights tainted under IRC § 2036(a)(1), and therefore, it should be the case but this is only speculation, that application of IRC § 2036(a)(2) in *Strangi* had to be contingent on findings of abuse that would require IRC § 2036(a)(1) to apply.

The second serious flaw is that the Tax Court in *Strangi* disregarded the authority of the United States Supreme Court when interpreting IRC § 2036(a)(2), the retained **control** element of IRC § 2036(a), when it concluded that any element of control that can be exercised "***either alone or in conjunction with any person, to designate the person who shall possess or enjoy the property or the income therefrom***" would include the rights of the taxpayer to vote their retained minority and pro-rated interest because they could urge others to vote with them. The Supreme Court has previously stated in *Helvering v. Helmholz*, 16 AFTR 979 (56 S. Ct. 68), 11/11/1935, when ruling on the significance of language in the predecessor statute to IRC § 2036, *"either alone or in conjunction with any person"*, in connection with the authority of the decedent to alter amend or revoke a trust in concert with others, and thereby liquidate a corporation:

> "Like every well-drawn instrument it embodies provisions for the termination of the trust. . . . there was nothing out of the ordinary in requiring that the trust terminate upon dissolution of the company and that the proceeds of liquidation be distributed amongst the then beneficiaries. It was not unnatural to direct that the trust should end if the managers of the company should unanimously so decide.
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> "The petitioner, however, pitches upon the only remaining event of termination, [pg. 981] asserting it to be the equivalent of a power to revoke, or to amend, to be exercised by the settlor with others. This is found in the clause providing that the delivery to the trustee of a writing signed by all the then beneficiaries (other than testamentary appointees), declaring such purpose, shall be effective to end the trust. He points out that such a writing might have been executed by Mrs. Helmholz and her cobeneficiaries while she was alive, with the effect of revesting in her the shares which she had delivered into the trust. This argument overlooks the essential difference between a power to revoke, alter, or amend, and a condition which the law imposes. The

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general rule is that all parties in interest may terminate the trust. [Footnote omitted]. The clause in question added nothing to the rights which the law conferred. Congress cannot tax as a transfer intended to take effect in possession or enjoyment at the death of the settlor a trust created in a state whose law permits all the beneficiaries to terminate the trust."

Here again, it seems that it will be difficult for the Service to deny the legitimacy of pro-rata voting rights or offer arguments that are contrary to *Helmholz.* Without any further PPBAs and evidence to prove that it is appropriate to disregard or transcend the pro-rata voting rights in the partnership agreement or operating agreement, these specific rights should not be aggregated or presumed to be exercisable only by the taxpayer.

Concluding Comments:

The question facing my clients, is how can *Strangi* apply and what should be done to protect against it? The "wait and see" approach raised by Professor Pennell may be too risky, but the Blattmachr approach to purge the taint and tainted rights may be too traumatic and not feasible. Porter's advice to avoid abuses frowned upon by the Court seems the most rational. He did try to identify those common threads and facts from *Strangi, Harper* and *Thompson* of abuse, and urging that whenever possible they should be eliminated. Presuming that the Courts will consider the PPBAs approach, the first line of vulnerability and attack will be those facts that give rise to abuse.

In attempting to come up with a middle ground and purge facts that give rise to PPBAs, any rights that are abandoned, may be forever unrecoverable. Further, it is a complete unknown and sheer speculation to try to ascertain whether the Courts will completely overturn and reject *Strangi* or try to find a common ground and distinguish *Strangi, Harper* and *Thompson* on their facts. If the Court of Appeals upholds those most dangerous aspects of *Strangi*, that a different standard can be applied for to determine the adequacy of consideration for a gift and estate, then the matter will have to be revisited and a Blattmachr type purging will have to be adopted, presuming there is time to implement the changes. Another caveat is that the IRC § 2043 will look to any "tainted" interest that was held in anytime in the three (3) years prior to death. The tax cost to holding a "tainted" interest at death or being deemed to have held a "tainted" interest at death, can significantly exceed the gift value of the property conveyed, as the computation eliminates discounts and adds back to the taxable estate all appreciation in value.

There are approaches that can be pursued for new entities, to avoid the *Strangi* fisaso. Specifically, new family limited partnerships or limited liability companies should be organized with contributions made by other family members, which can be accomplished by merging similar entities together, or with cash

contributions made with these family members. However, these matters are beyond the scope of this letter.

Endnotes:

1. The Tax Court in *Strangi* found that the typical Service arguments under Murphy, IRC § 2703 and "gift at formation" were not valid. When evaluating the Murphy argument, the Tax Court found that the partnership was properly and validly formed under Texas law and would not be disregarded by third parties. As a result the Service arguments under the 2703, that the partnership agreement was a restriction on the uses of the partnership property was also held inapplicable. Finally, the Tax Court found that there was no gift at formation because the taxpayer was given a capital account to reflect the value of his contributed property.

2. In Estate of *Harper v. Commissioner* the Court concluded that there were sufficient abuses in the organization and operations of the partnership, that there was "compelling indicia of an implied understanding or agreement that the partnership would not curtail the decedent's ability to enjoy the economic benefits of assets contributed." Mr. Harper had contributed a majority of his wealth to the partnership. The Court found that a history of disproportionate distributions, commingling of funds with Mr. Harper's own personal funds, and delays in contributing assets to the partnership. In holding IRC § 2036(a) applicable and rejecting "the bonafide sale for an adequate and full consideration" exception, the Court referred to the formation of the partnership as a "pure recycling" of interests, and "testamentary" in nature.

3. In *Estate of Thompson v. Commissioner* the Court found that because the Mr. Thompson contributed the majority of his wealth to the partnership, there was an implied understanding and other evidence, that he could access that property for both his support and to make annual gifts to his family. The Court in rejecting "the bonafide sale for an adequate and full consideration" exception called this an alternative vehicle to implement Mr. Thompson's estate plan, with no motivation to address business concerns, but a "pure recycling of value".

4. In *Kimbell v. United States,* Mrs. Kimbell at age 96 organized her limited partnership and contributed the majority of her assets, and died 2 ½ months thereafter. The Court citing *Harper* denied the "the bonafide sale for an adequate and full consideration" exception, due to lack of any evidence that the organization of the partnership and planning was anything other than "value recycling".

5. *Strangi* in finding that transfers not otherwise taxable as gifts could be included in the estate of a taxpayer at their death, also went beyond *Harper, Thompson* and *Kimbell*, because it asserted that not only did Mr. Strangi retain the right to the previously contributed partnership assets, but that the actions of his son-in-law, who was serving in dual capacities, as Mr. Strangi's attorney in fact and as an "independent" general partner, were properly imputed as acts by Mr. Strangi by reason of the fiduciary relationship to Mr. Strangi. Mr. Strangi also contributed substantially all of his property to the partnership, but was not named as the partnership's general partner. The Tax Court also found that because Mr. Strangi could exercise of voting control in conjunction with others, the partnership property was also includable in his estate under 2036(a)(2). However, the Tax Court did not distinguish whether or not this latter finding was dependent upon a finding that a 2036(a)(1) enjoyment right was also retained, which would have clarified whether or not the found "abuses" were themselves the basis to deny application of "the bonafide sale for an adequate and full consideration" exception.

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