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**PRACTICAL PLANNING FOR FAMILY LLCs AND LPs**

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*The PowerPoint presentation used with these materials can be found on the Web at  
[http://www.landerholm.com/Articles/family\\_llc.htm](http://www.landerholm.com/Articles/family_llc.htm).*

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## I. INTRODUCTION

### A. SHIFT OF IRS ATTACK

Since 1997, the principal arguments utilized by the Service to attack the valuation discounts received from family entity (limited partnership or limited liability company) planning have shifted from Chapter 14 (Sections 2703 and 2704(b)) to Section 2036(a).

1. The IRS has been unsuccessful in several attempts to advance its interpretations of Chapter 14. *Church*<sup>1</sup>, *Knight*<sup>2</sup>, *Strangi*<sup>3</sup>

2. However, the IRS has been successful in limiting (or eliminating) valuation discounts in cases where the taxpayer did not effectively implement the gifting plan. *Shepherd*<sup>4</sup>, *Jones*<sup>5</sup>, *Senda*<sup>6</sup> Furthermore, the Eighth Circuit in *Senda* determined that the transactions were integrated and simultaneous and the Court applied the step-transaction doctrine. The dicta in this opinion requires that the funding and gifting transfers be sequenced properly (with documentation) and that the steps be clearly separated.

3. The IRS has successfully challenged the use of the annual gift tax exclusion for a gift of an entity interest where there is not a transfer of a present interest (no right to income and restrictions on the donee's right to transfer the entity interest). *Hackl*<sup>7</sup>

4. In addition, the IRS has successfully asserted that Section 2703(a) applies to the restrictive "buy-sell" provisions of an FLP agreement. *Smith*<sup>8</sup>

5. The IRS has had its greatest success in attacking discounts through the use of Section 2036(a). Taxpayers have been particularly vulnerable where the taxpayer/donor retains economic benefit and implements/operates the entity in a manner that does not qualify for the "adequate and full consideration" exception. *Schauerhamer*,<sup>9</sup> *Reichart*,<sup>10</sup> *Harper*,<sup>11</sup>

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<sup>1</sup> *Church v. United States*, 85 AFTR 2d 2000-804, 2000-USTC par. 60, 369 (W.D. Tex 2000), aff'd without published opinion 268 F. 3rd 1063 (5th cir. 2001).

<sup>2</sup> *Knight v. Comm'r*, 115 T.C. 506 (2000).

<sup>3</sup> *Strangi v. Comm'r*, 115 T.C. 478 (2000), aff'd in part - partnership vitality 293 F. 3rd 279 (5th cir. 2002).

<sup>4</sup> *Shepherd v. Comm'r*, 115 T.C. 376 (2000); aff'd 283 F. 3rd 1358 (11th cir. 2002).

<sup>5</sup> *Jones v. Comm'r*, 116 T.C. 211 (2001).

<sup>6</sup> *Senda v. Comm'r*, TC Memo. 2004-160; 2004 Tax Ct. Memo Lexis 165; aff'd 433 F. 3rd 1044 (8th cir. 2006).

<sup>7</sup> *Hackl*, 118 T.C. 14 (2002); aff'd 355 F. 3rd 664 (7th cir. 2003).

<sup>8</sup> *Sidney E. Smith III, et al. v. United States*, No. 02-264 (W.D. PA. 2004); 2004 U.S. Dist. Lexis 14839. If the safe harbor exception provision of Section 2703(b) does not apply, such restriction will be disregarded in the valuation of the transferred entity interest.

<sup>9</sup> *D.M. Schauerhamer Estate v. Comm'r*, TC Memo. 1997-242.

<sup>10</sup> *C.E. Reichart Estate v. Comm'r*, 114 T.C. 114 (2000).

<sup>11</sup> *M.B. Harper Estate v. Comm'r*, TC Memo. 2002-121; 2002 Tax Ct. Memo Lexis 127. All further cites to this case will be Lexis only.

*Thompson*,<sup>12</sup> *Strangi-II*,<sup>13</sup> *Abraham*,<sup>14</sup> *Hillgren*,<sup>15</sup> *Bongard*,<sup>16</sup> *Bigelow*,<sup>17</sup> *Korby*,<sup>18</sup> *Disbrow*,<sup>19</sup> *Rosen*<sup>20</sup> and *Erickson*.<sup>21</sup>

6. The taxpayer was able to successfully defend against the Section 2036(a) argument in *Stone*,<sup>22</sup> *Kimbell*,<sup>23</sup> *Bongard*<sup>24</sup> and *Schutt*<sup>25</sup> by qualifying for the “adequate and full consideration” exception.

7. The Internal Revenue Service has prepared Appeals Coordinated Issue Settlement Guidelines (hereinafter “Guidelines”) for its internal use, regarding “Discounts for Family Limited Partnerships” (dated October 18, 2006).<sup>26</sup> The Guidelines identify four key issues:

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<sup>12</sup> *T.R. Thompson Estate v. Comm’r*, TC Memo. 2002-246; 2002 Tax Ct. Memo Lexis 254; aff’d *Turner v. Comm’r*, 382 F. 3rd 369 (3<sup>rd</sup> cir. 2004); 2004 U.S. App. Lexis 18473. All further cites to this case will be Lexis only. References to the appeals court opinion will be stated as “*Thompson* (3<sup>rd</sup> cir.)”.

<sup>13</sup> *Strangi v Comm’r*, TC Memo. 2003-145; 2003 Tax Ct. Memo Lexis 144. (hereinafter “*Strangi-II*”); aff’d regarding Section 2036(a)(1) 417 F. 3rd 468 (5<sup>th</sup> cir. 2005); 2005 U.S. App. Lexis 14497 (5<sup>th</sup> cir. 2005). References to the Appeals Court opinion will be stated as *Strangi-III*. All further cites to this case will be Lexis only.

<sup>14</sup> *Ida Abraham Estate v Comm’r*, TC Memo. 2004-39; 2004 Tax Ct. Memo Lexis 41; aff’d 408 F. 3<sup>rd</sup> 26 (1<sup>st</sup> cir. 2005). All further cites to this case will be Lexis only.

<sup>15</sup> *Lea Hillgren Estate v Comm’r*, TC Memo. 2004-46; 2004 Tax Ct. Memo Lexis 48. All further cites to this case will be Lexis only.

<sup>16</sup> *Estate of Bongard*, 124 T.C. 8 (2005); 2005 U.S. Tax Ct. Lexis 8. All further cites to this case will be Lexis only.

<sup>17</sup> *Estate of Bigelow*, TC Memo. 2005-65; 2005 Tax Ct. Memo. Lexis 65. All further cites to this case will be Lexis only.

<sup>18</sup> *Estate of Edna Korby*, TC Memo 2005-102; 2005 Tax Ct. Memo Lexis 103; aff’d Cause No. 06-1201 (8<sup>th</sup> cir. 2006); *Estate of Austin Korby*, TC Memo. 2005-103; 2005 Tax Ct. Memo. Lexis 102; and aff’d Cause No. 06-1203 (8<sup>th</sup> cir. 2006). All further cites to this case will be Lexis only.

<sup>19</sup> *Estate of Lorraine C. Disbrow*, TC Memo 2006-34; 2006 TC Memo Lexis 34. All further cites to this case will be Lexis only.

<sup>20</sup> *Estate of Lillie Rosen*, TC Memo 2006-115; 2006 TC Memo Lexis 116. All further cites to this case will be Lexis only.

<sup>21</sup> *Estate of Hilde E. Erickson*, TC Memo 2007-107, 2007 TC Memo Lexis 108. All further cites to this case will be Lexis only.

<sup>22</sup> *Stone v Comm’r*, TC Memo. 2003-309; 2003 Tax Ct. Memo Lexis 312. All further cites to this case will be Lexis only.

<sup>23</sup> *Kimbell v. United States*, 244 F. Supp. 2d 700; 2003 U.S. dist. Lexis 523 (N.D. Tex 2003), rev’d, No. 03-01529, 2004 U.S. App. Lexis 9911 (5<sup>th</sup> cir. 2004). All further cites to this case will be Lexis only.

<sup>24</sup> *Estate of Bongard*, 124 T.C. 8 (2005); 2005 U.S. Tax Ct. Lexis 8. All further cites to this case will be Lexis only.

<sup>25</sup> *Estate of Schutt*, TC Memo. 2005-126; 2005 TC Memo. Lexis 126. All further cites to this case will be the appeals court opinion in Lexis only.

<sup>26</sup> “Discounts for Family Limited Partnerships,” Appeals Settlement Guidelines, dated October 18, 2006; Internal Revenue Service, UIL 2031.01-00; RIA Checkpoint Estate Planners Alert January 2, 2007, Vol. 32, No. 01 Appeals Settlement Guidelines for FLPs and FLLCs.

- a. Whether the fair market value of closely held entity interests is properly discounted;
- b. Whether Section 2036 or Section 2038 cause inclusion in the gross estate of the transferor;
- c. Whether there is an indirect gift of underlying assets (instead of entity interests) due to funding and transfer in a single integrated transaction; and
- d. Whether the accuracy related penalty under Section 6662 is applicable to any portion of a deficiency.

The Guidelines also include detailed analysis of each issue and settlement guidelines for Appeals Officers. The settlement guidelines section has limited usefulness because major portions of such section were redacted by the Internal Revenue Service prior to releasing the document to the public.

#### B. NEGATIVE FACTORS IN RECENT SECTION 2036(a) CASES

1. Upon reviewing the recent Section 2036(a) cases that were won by the IRS, it is clear that certain common “negative factors” are present.
2. The factors set forth in the “Negative Factor Matrix” (see Exhibit 1) were considered by the Tax Court in finding an “implied agreement” that decedent will retain possession or enjoyment of property or rights to income from property under Section 2036(a)(1).
3. Many of these negative factors could have been avoided if appropriate legal/accounting guidance had been given and followed in a timely manner.

#### C. FOCUS OF MATERIALS

This paper reviews selected issues involving client communication, the design of the entity plan and the implementation/ operation of the entity for the purpose of eliminating negative factors and avoiding IRS attacks. Special emphasis is given to examples of practical guidance. (See sample memoranda, checklists, forms and diagrams that are attached as exhibits to the outline.)

## II. CLIENT COMMUNICATION - IS ENTITY PLANNING THE RIGHT APPROACH FOR MY CLIENT?

#### A. ENTITY PLANNING EXPLANATION AND REALITY CHECK

The increased scrutiny of form and substance by the Tax Court (as demonstrated in recent Section 2036(a) cases) calls for a high level of communication with the client in making a decision whether to utilize entity planning as part of the overall estate plan. See Exhibit 2.

1. Not only is it important that the attorney convey information regarding the benefits and risks of family entity planning, but it is also imperative to help the client understand

that his/her mind set must change when a family entity is established. Family entity planning will most likely be successful if the client views it as a business (with unrelated third parties as partners) and that his/her benefit and control will be consistent with the rights granted by the governing instrument of the entity.

a. The benefit and control received from the entity will be different from the rights held when the assets were personally owned.

b. Moreover, if the entity formalities and new set of rights are not respected, there is significant risk that any estate tax benefit derived from establishing the entity will be lost.

2. If the family entity plan is motivated primarily by non-tax objectives (as well as tax objectives) then the client is more likely to accept the change of benefit and control that is required. Other “positive factors” include:

a. Good working relationship with children.

b. Children (at least one) having business/investment background and basic business judgment.

c. Intent to provide substantial benefit to children.

d. Transfer of particular assets to the entity that will accomplish the economic and family benefit objectives and retention of other assets that enable the client to preserve his/her financial security.

3. Unless the client has a current, specific non-tax purpose, is willing to manage the entity in a business-like manner and is willing to implement the guidance of professionals, it is best to advise that a different approach be utilized to accomplish the client’s tax-planning objectives.

4. In order to aid client understanding, a memorandum regarding benefits, requirements, risks, formation and governing instrument provisions should be provided at the initial meeting. See Exhibit 3. In addition, it is helpful to provide the client with written confirmation of the issues discussed at the initial meeting regarding the client’s tax and non-tax objectives, material risks of entity planning, reasonable alternatives and his/her decision regarding the family entity plan. A written outline of the steps regarding formation and implementation should also be given to the client.

## B. ENTITY PLANNING COMMUNICATION AND ETHICS RULES

1. The legal ethics rules adopted by the particular state in which a lawyer is practicing will determine the lawyer’s duty to communicate with a client regarding the estate planning strategies that are utilized.

2. It is essential for the lawyer to be aware of the applicable legal standard for ethics purposes in communicating with the client regarding family business entity issues.

However, it is also prudent for the lawyer to take steps that are appropriate in the particular situation to educate the client regarding the potential benefits, material risks and alternatives. Ultimately, the client must make an informed decision whether entity planning is the best approach.<sup>27</sup>

3. Prepare engagement letter.
  - a. Basic provisions include a description of the project, client representation, waiver of conflicts, and fees.
  - b. Scope of project.
    - (1) Extent of implementation to be done (or supervised) by attorney.
    - (2) Attorney participation (if any) in conducting review prior to the end of the first tax year and on an annual basis.
  - c. Waiver of conflicts - if the attorney has previously represented other parties to the entity.
    - (1) If the representation in the planning of the family entity does not adversely affect other client relationships and if the planning representation is not materially limited by responsibilities to another client and if each client consents (in writing).
    - (2) There may not initially be a conflict that causes a problem and all parties may be amicable. However, it is best to identify a particular party(ies) that the lawyer is representing, e.g., primary transferor of assets to the entity and the entity.
    - (3) The ACTEC Commentaries<sup>28</sup> provide guidance in the situation where it is in the best interest of the client for the lawyer to represent multiple clients who are interest holders in the entity and also represent the entity.
    - (4) An excellent discussion of background issues in preparing engagement letters for representation of multiple generations of the same family is found in “Engagement Letters: A Guide for Practitioners.”<sup>29</sup>
4. Inform clients of material risks and possible “tax tradeoffs” associated with family entity planning.
  - a. Reduction or elimination of discount.

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<sup>27</sup> Generally, J. Price, *Price on Contemporary Estate Planning*, Section 1.6.4 (2nd Ed. 2000, 2003 Supp.); ACTEC Commentaries on the Model Rules of Professional Conduct (ACTEC Foundation 4th ed., 2006) (hereinafter “Commentaries”).

<sup>28</sup> Commentaries, pp. 91-95.

<sup>29</sup> *Engagement Letters: A Guide for Practitioners* (ACTEC Foundation 1999), pp. 13-25.

applies.

- b. Inclusion of all entity assets in the donor's estate if Section 2036(a)

- c. Undervaluation negligence penalty Section 6662(a) - if taxpayer does not act reasonably and in good faith by relying on competent tax professionals and appraisers.

- d. Substantial professional fees to defend against any IRS challenge.

- e. In certain circumstances, income tax on capital gains upon the transfer of assets to the entity or out of the entity.

- f. Other tax benefits may be reduced or eliminated based upon the particular circumstances.

- (1) Section 121 capital gain exclusion for personal residence (if residence is contributed to the entity).

- (2) Section 1014 "step up" in income tax basis (gifts of entity interests made during lifetime).

- (3) Current use (state) real property tax classification.

5. The lawyer and client should discuss the particular opportunities and planning steps in the client's situation that will enable the client to retain the desired benefit and management control while minimizing the risk that Section 2036(a)(1) or (a)(2) will apply. Furthermore, the lawyer should also inform the client regarding the level of risk associated with the client's particular circumstances (e.g., advanced age and poor health) and the entity design that will be used to achieve client objectives and tax benefits.

6. Discuss alternatives to entity planning to obtain discounts, including an explanation of the material risks of the alternatives.

- a. Holding undivided interests in assets outright (or in trust) as tenants in common.

- b. Segregating ownership (after the death of one spouse) between a QTIP trust and the surviving spouse.<sup>30</sup>

- c. Retained interest trusts under Section 2702 (GRAT and/or QPRT).

- d. Charitable split-interest planning (Charitable Lead Trust and/or Charitable Remainder Trust).

- e. Installment sale to an Irrevocable Defective Grantor Trust.

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*Mellinger*, 112 T.C. 2G (1999) A.O.D. 1999-006; *Nowell*, TC Memo 1999-15.

- f. Wait for the federal applicable exclusion amount to increase.
- g. ILIT to purchase life insurance.<sup>31</sup>

7. Consider particular issues (opportunities, risks and planning steps) to discuss based upon the donor's specific circumstances.

a. Minimizing Section 2036(a)(1) risk. If the donor wants to maintain primary benefit from the assets in the entity, planning steps should be taken to avoid application of Section 2036(a)(1) (see discussion at III below).

b. Minimizing Section 2036(a)(2) risk. If the donor wants managerial control of the entity, planning steps may be taken to avoid the application of Section 2036(a)(2), even if *Strangi-II* is controlling (see discussion at IV below).

### III. RETENTION OF BENEFIT BY DONOR

#### A. APPLICATION OF SECTION 2036(a)(1)

Section 2036(a)(1) will apply if the donor makes a transfer and retains benefits (substantial present economic benefit)<sup>32</sup> in accordance with the provisions of the governing instrument or based upon the finding of an implied agreement between the donor and the other partners that the donor will continue to receive economic benefit notwithstanding the provisions of the agreement. See Matrix of Negative Factors (Exhibit 1).

1. In determining whether there was an implied agreement, the court examines both objective and subjective factors (the form and the substance) of the entity design, implementation and operation.

a. Failure to: (i) respect the formalities of the entity implementation or operation (e.g., late or inadequate funding of the entity); (ii) use a separate entity bank account; and (iii) administrate the entity in a businesslike manner and keep financial records in the name of the entity has been evaluated in a strongly negative manner.<sup>33</sup>

b. The Tax Court treated the delay in hiring a CPA until after the decedent's death as "strengthening the inference that the partners had little concern for establishing any precise demarcation between partnership and other funds during decedent's life."<sup>34</sup>

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<sup>31</sup> See Fiore and Ramsbacher, "Protecting the Reality in Entity Based Transfer Tax Valuation Adjustments," 60 N.Y.U. Inst. On Fed. Tax Ch. 30 (2002).

<sup>32</sup> *Strangi-III*, ¶ 14, quoting *U.S. v. Byrum*, 408 U.S. 125, 145 (1972).

<sup>33</sup> *Harper*, ¶37; *Hillgren*, ¶¶35-37.

<sup>34</sup> *Harper*, ¶39.

2. In *Harper*,<sup>35</sup> *Thompson*,<sup>36</sup> *Strangi-II*,<sup>37</sup> and *Korby*,<sup>38</sup> *Disbrow*<sup>39</sup> and *Rosen*<sup>40</sup> the court used “the testamentary characteristics of the arrangement” to support its conclusion that an implied agreement existed. Factors that indicate “testamentary characteristics” include actions that are “far more consistent with an estate plan than with any sort of arm’s length joint enterprise between partners.”<sup>41</sup> Such factors may include:

a. Transfer of a majority of decedent’s assets to the entity (so that the decedent can no longer support himself from assets outside the entity and the decedent’s estate has insufficient assets to pay debts, expenses and specific bequests).<sup>42</sup>

b. Disproportionate distributions to decedent based upon the decedent’s living expenses.<sup>43</sup>

c. Passive investment management by general partners.<sup>44</sup>

d. Minimal change in the economic benefit of the assets from prior to the entity, contrary to the provisions of the partnership agreement.<sup>45</sup>

e. Donor was advanced in age and suffering from serious health conditions.<sup>46</sup>

f. Donor continued to enjoy her transferred asset.<sup>47</sup>

g. Lack of documentation and enforcement of entity rights undermine taxpayer assertions that the arrangement was a lease or loan rather than a testamentary device.<sup>48</sup>

3. In *Strangi*, the donor retained nearly all of the equity interests in the entity (99.47%) and the Tax Court found that Section 2036(a) applied, even though no “gift” transfer was made. This expansive interpretation of the “transfer” requirement of the statute in the

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<sup>35</sup> Id., ¶30, ¶36.

<sup>36</sup> *Thompson*, ¶51.

<sup>37</sup> *Strangi-II*, ¶¶32-33.

<sup>38</sup> *Korby* ¶27.

<sup>39</sup> *Disbrow* ¶¶35-36.

<sup>40</sup> *Rosen* ¶72.

<sup>41</sup> *Strangi-II* ¶32.

<sup>42</sup> *Thompson*, ¶¶48-49; *Bigelow*, ¶29; *Strangi-III*, ¶¶15-18; *Rosen* ¶62.

<sup>43</sup> *Harper*, ¶¶43; *Hillgren*, ¶¶38-40; *Bigelow*, ¶¶25-26; *Korby*, ¶18; *Rosen* ¶¶62-63.

<sup>44</sup> *Harper*, ¶49; *Bongard*, ¶¶65; *Rosen* ¶62.

<sup>45</sup> *Thompson*, ¶50; *Bigelow* ¶26; *Korby*, ¶20.

<sup>46</sup> *Strangi-II*, ¶33; *Rosen* ¶64.

<sup>47</sup> *Disbrow* ¶33.

<sup>48</sup> *Disbrow* ¶35; *Rosen* ¶72.

*Strangi* case has been criticized by commentators.<sup>49</sup> However, subsequent cases have broadly interpreted the term. Furthermore, the Fifth Circuit in *Strangi-III* did not address this issue. As a practical matter, the “transfer” requirement has not been a key issue because either the exception to 2036(a) has applied or the court has not interpreted the term in a manner that affects the application of Section 2036(a) if an implied agreement is found. See Exhibit 4.

a. The facts of recent cases (*Strangi, Abraham, Hillgren, Bigelow, Korby, Disbrow and Rosen*) have involved “testamentary” characteristics and an “implied agreement” was found in each case. However, it is not clear that the expansive interpretation of “transfer” would be applied by a court in order to cause application of 2036(a)(1) if there is no implied agreement “taint” in the particular situation.

b. In cases where the exception to Section 2036(a) (*Stone, Kimbell, Bongard, and Schutt*) applied, the courts also interpreted the transfer of assets to the entity as a transfer for purposes of Section 2036(a). However, the holding was a prerequisite in determining that the exception to Section 2036(a) applied.

4. In *Bongard*, the Tax Court found that the decedent had “practical control” of the FLP by implied agreement under Section 2036(a)(1)<sup>50</sup> even though such statutory provision relates to retained benefit rather than retained control. Furthermore, such conclusion was reached without any analysis of Section 2036(a)(2) or the *Byrum* Case.<sup>51</sup>

5. If Section 2036(a)(1) applies based upon an expressed provision of the governing instrument, and if the distributions are made in accordance with the agreement, only the pro rata portion of the entity assets (that correspond to the entity interests held) should be included in the donor’s estate.<sup>52</sup> Whereas, if Section 2036(a)(1) applies because of an implied agreement, then all assets of the entity (that were originally contributed by the donor) may be includable for estate tax purposes.

## B. SATISFY THE EXCEPTION TO SECTION 2036(a)

Section 2036(a) provides an exception “...in case of a bona fide sale for an adequate and full consideration...” and in recent years, the determination whether the decedent qualified for such exception has been the focus of each case involving Section 2036(a). However, there are significant differences in how various courts have recently interpreted and applied the statute. The Tax Court in *Harper, Thompson, Strangi-II* and *Stone* set forth two (2) requirements in order to satisfy this test: (1) a bona fide sale, meaning an arm’s length transaction; and (2) adequate and full consideration. Commentators have criticized this formulation, observing that prior cases

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<sup>49</sup> Michael D. Mulligan, “*Courts Err in Applying Section 2036(a) to Limited Partnerships*” Estate Planning, p. 486, 490-2, October 2003; S. Stacy Eastland, “*What Do McCord and Strangi-II Mean for the Structuring of Family Limited Partnerships?*” 29 ACTEC Journal 69, p. 87-88, Fall 2003.

<sup>50</sup> *Bongard*, ¶¶71-72

<sup>51</sup> Hatcher and Maniquault, *The Tax Court’s “Practical Control” Test on Bongard: More than FLPs are in the Balance*,” Journal of Taxation, May 2005 pp 267-8.

<sup>52</sup> Gans and Blattmachr, “*Strangi: A Critical Analysis and Planning Suggestions*,” Tax Notes, September 1, 2003, pp. 1153, 1155.

did not require a separate inquiry to determine whether the transaction was “bona fide” (including arm’s length transaction) in order to satisfy the exception.<sup>53</sup> The Fifth Circuit in *Kimbell* rejected the “arm’s length transaction” requirement and adopted a primarily objective approach for satisfying the two requirements that many family entities will find practical to utilize. Such approach was particularly influenced by the *Wheeler*,<sup>54</sup> *Church*<sup>55</sup> and *Stone* cases. The Third Circuit in *Thompson* also rejected the “arm’s length transaction” requirement. The court adopted an approach that focuses on the non-tax purposes and business operations of the entity in the particular case.<sup>56</sup> In *Bongard*, the Tax Court stated that the exception is satisfied when a legitimate and significant non-tax reason for creating the entity is established (“by objective evidence”) and entity interests proportionate to the value of the property transferred were received.<sup>57</sup> In addition, other Tax Court opinions have notably followed this approach.<sup>58</sup> The *Bongard* opinion also cites four factors that will negate a finding that the transaction was motivated by a legitimate and significant non-tax purpose.<sup>59</sup> The Fifth Circuit in *Strangi-III* basically followed the approach it used in *Kimbell*, even though the *Strangi* estate did not prevail.<sup>60</sup>

1. Satisfaction of the “bona fide sale” requirement.

a. The Tax Court in *Harper*<sup>61</sup> cited *Harrison*<sup>62</sup> and *Church* as examples where the “bona fide sale” test was met in the family entity context and stated that there must be an arms-length transaction in order to meet such test. Furthermore, the Eighth Circuit in *Korby* found that this “bona fide sale” test was not satisfied after focusing on the lack of negotiation and input from the limited partners in the design and implementation of the FLP (taxpayer stood on both sides of the transaction) and the lack of a non-tax purpose. The emphasis on the lack of negotiation may indicate that the Eighth Circuit requires an “arm’s length transaction” for the sale to be “bona fide.”<sup>63</sup>

b. In *Stone*, the Tax Court found that there was a substantial business purpose (business and investment issues relating to the management of certain assets for parents

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<sup>53</sup> Gans and Blattmachr, pp. 1161-1163; Mulligan, pp. 492-494.

<sup>54</sup> *Wheeler v. United States*, 116 F. 3rd 749 (5th cir. 1997).

<sup>55</sup> *Church v. United States*, 85 AFTR 2d par. 2000-804, 2000-USTC par. 60, 369 (W.D. Tex 2000), aff’d without published opinion 268 F. 3rd 1063 (5th cir. 2001).

<sup>56</sup> See extensive analysis by Steve Akers in Steve Leimberg’s Estate Planning Newsletter #723 at <http://www.leimbergservices.com>.

<sup>57</sup> *Bongard*, ¶49.

<sup>58</sup> *Korby*, ¶23; *Schutt*, ¶76.

<sup>59</sup> See Exhibit 5-Giii Bongard “Negative Factors Test. Such “negative factors” are commonly used to show “implied agreement.”

<sup>60</sup> See analysis of the Fifth Circuit opinion in *Strangi-III* by Milford B. Hatcher, Jr., in Steve Leimberg’s *Estate Planning Newsletter* #853 at <http://www.leimbergservices.com> (hereinafter *Estate Planning Newsletter*) and by Steve R. Akers, in Steve Leimberg’s *Estate Planning Newsletter* #859 at <http://www.leimbergservices.com>.

<sup>61</sup> *Harper*, ¶¶59-60.

<sup>62</sup> *Harrison v. Commr.*, TC Memo 1987-8.

<sup>63</sup> See analysis of the Eighth Circuit opinion in *Korby* by Steve R. Akers in *Estate Planning Newsletter* #1067.

and the resolution of litigation between the children) and arm's length negotiations that involved all parties.<sup>64</sup>

c. However, in *Kimbell*, the court determined that (quoting *Wheeler*) “the absence of negotiations between family members over price or terms is not a compelling factor in the determination as to whether a sale is bona fide, particularly where the exchange value is set by objective factors.”<sup>65</sup> The court did require that the transfer of assets in exchange for an interest in the entity actually occur.<sup>66</sup> Furthermore, the court applied heightened scrutiny to determine whether the intrafamily transaction was bona fide, including objective evidence of substantial business and other non-tax reasons. In the bona fide sale analysis the court also considered various issues that typically are considered in the “implied agreement” analysis of Section 2036(a)(1) (e.g., sufficient non-entity assets held by Mrs. Kimbell for her support, no commingling and proper attention to entity formalities and funding of assets).<sup>67</sup>

d. The Third Circuit in *Thompson* stated that the “bona fide sale” requirement is satisfied by “good faith,” evidenced by a non-tax purpose. The operation of a legitimate business in a specific situation may satisfy the “good faith” standard. In *Thompson*, the good faith requirement was not satisfied.<sup>68</sup> The “good faith” analysis was also used by the Tax Court in *Bigelow*.<sup>69</sup>

e. The Tax Court in *Bongard* used the “arms length transaction” standard and interpreted it as measuring the way that ordinary parties to a business transaction should deal with each other. In addition, the *Bongard* court held that the “heightened scrutiny” standard was satisfied (due to the legitimate and non-tax reason for creating the entity) and there was a true pooling of assets (due to various factors – see Exhibit 5-Gi).<sup>70</sup>

f. In *Schutt*, the Tax Court used an analysis of the four negative factors from *Bongard* in finding that a bona fide sale had occurred.<sup>71</sup>

g. In *Strangi-III*, the Fifth Circuit found that the “bona fide sale” requirement was not satisfied after analyzing whether “the transfer in question was objectively likely to serve a substantial non-tax purpose.”<sup>72</sup> The court evaluated the non-tax purposes submitted by the estate in light of the factual determinations made by the Tax Court. The Fifth Circuit held that the Tax Court did not clearly err in finding that *Strangi's* transfer of assets to the

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<sup>64</sup> *Stone*, ¶¶151-154.

<sup>65</sup> *Kimbell*, ¶15.

<sup>66</sup> *Kimbell*, ¶¶20-21.

<sup>67</sup> *Id.*, ¶¶26-27.

<sup>68</sup> *Thompson* (3rd cir.), ¶45.

<sup>69</sup> *Bigelow*, ¶¶27-33.

<sup>70</sup> *Bongard*, ¶¶58-60.

<sup>71</sup> *Schutt*, ¶¶78-80.

<sup>72</sup> *Strangi-III*, ¶25

FLP lacked a substantial non-tax purpose.<sup>73</sup> The Fifth Circuit opinion in *Strangi-III* (as contrasted with *Kimbell*) highlights the importance of factual determinations by the Tax Court or by stipulation with the IRS.

2. Satisfaction of the transfer for “adequate and full consideration” requirement.

a. In *Harper*, the Tax Court determined that contribution of more than a de minimis amount of assets by minority partners and pooling of assets by the partners (e.g., undivided interests in real property) is needed in order to provide adequate and full consideration.<sup>74</sup>

b. The Service has publicly ruled in a related context that 11% is more than de minimis.<sup>75</sup> However, we do not have definite guidance regarding the amount of contribution needed in order to satisfy this test.<sup>76</sup>

c. In *Thompson*,<sup>77</sup> the children contributed a significant amount of assets but did not “pool” the assets with the assets contributed by the donor. The Third Circuit emphasized that there was no transfer for consideration because there were no “legitimate business operations that might provide a substantive non-tax benefit for transferring assets to the Thompson partnership.” Furthermore, the form of the assets (principally marketable securities) and the non-businesslike operation of the entity overshadowed the economic/business activities in the Thompson-Turner partnerships.<sup>78</sup> The court focused on the non-tax purposes for the entity and the legitimate business operations based upon the particular facts. The court did not establish any “safe harbor” threshold for the extent of business operations. Various factors, including the non-tax purpose and the businesslike operation of the entity appear to have an impact on the extent of business operations that are needed to satisfy the “transfer for consideration” requirement of the exception to Section 2036(a).

d. If a family member purchases entity interests, there must be credible evidence (e.g., appraisal) that adequate and full consideration was received by the decedent (particularly if discounts are utilized).<sup>79</sup>

e. In *Stone*, the court emphasized the active participation and the services rendered by each child. The contribution of assets made by each child was for a 49.9% general partner interest (1% of the total equity of the entity owned by parents and the particular

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<sup>73</sup> Id., ¶32

<sup>74</sup> *Harper*, ¶59.

<sup>75</sup> Rev. Rul. 87-9, 1987-1, C.B. 133 (extent of diversification needed in the investment company context in order to “trigger” income tax upon the formation of a partnership).

<sup>76</sup> Joseph Korpics, “Practical Guidance After Strangi-II - A Detailed Examination.” *Journal of Taxation*, pp. 270, 274-275, November 2003.

<sup>77</sup> *Thompson* (3rd cir.), ¶¶6-8.

<sup>78</sup> Id., ¶¶32-34.

<sup>79</sup> *Abraham*, ¶31.

child). However, the asset contributions were properly credited to capital accounts and each party received a pro rata share of the entity interests and had a pro rata right to receive distributions upon dissolution of the entity.<sup>80</sup> Furthermore, the court distinguished this situation from *Harper* and *Strangi-II* and concluded that there was a joint enterprise for profit and a genuine pooling of property and services.<sup>81</sup>

f. The court in *Kimbell* did not require that the contribution of a minority partner exceed the de minimis threshold: “so long as the transaction is bona fide, partnership law does not require a minority partner to own a minimum percentage”.<sup>82</sup> Moreover, the court determined that Mrs. Kimbell did receive a pro rata partnership interest in exchange for her contribution of assets and that such contribution was properly credited to her capital account.<sup>83</sup>

g. In *Bongard*, the Tax Court determined that the adequate and full consideration test was satisfied because the transferors to the entity received interests that were proportionate to the contributions, there was proper crediting and debiting of capital accounts and there was a legitimate and significant non-tax business reason for engaging the transaction. Furthermore, the decedent did not need to receive a control premium for his contribution of 86.31% of the assets to the LLC because he had the right to remove the manager and appoint himself to such role.<sup>84</sup> Following *Bongard*, the Tax Court in *Schutt* applied essentially the same analysis in finding that adequate and full consideration was received. In addition, the court focused on the legitimate non-tax purpose and the major contribution by the DuPont Trusts in rejecting the claim by the Service that recycling of value had occurred.<sup>85</sup>

h. It is possible that gift on formation may be a concern in the “pooling” context. However, the risk is minimized if the capital accounts of the contributing parties are credited with the contribution.<sup>86</sup> The court in *Church* rejected the gift on formation argument because the entity interests were distributed in proportion to the contributions made and the entity had a business purpose.<sup>87</sup>

i. The courts in *Stone* and *Kimbell* stated that even if the value of interests received from the entity (due to discounts) is less than the value of the assets contributed, adequate and full consideration is still received.<sup>88</sup> The Third Circuit in *Thompson* observed that such approach is appropriate when a joint enterprise is present (as in *Stone*).

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<sup>80</sup> *Stone*, ¶¶158-159.

<sup>81</sup> *Id.*, ¶160.

<sup>82</sup> *Kimbell*, ¶¶30-31.

<sup>83</sup> *Id.*, ¶32.

<sup>84</sup> *Bongard*, ¶¶60-62.

<sup>85</sup> *Schutt*, ¶¶80-84.

<sup>86</sup> *Jones v. Comm’r*, 116 T.C. 121, 127-128 (2001).

<sup>87</sup> *Church v. United States*, 85 AFTR 2d par. 2000-804, 2000-USTC par. 60, 369 (W.D. Tex 2000), aff’d without published opinion 268 F. 3rd 1063 (5th cir. 2001).

<sup>88</sup> *Stone*, ¶160; *Kimbell*, ¶¶22-23.

However, the court applied a stricter standard (the “equilibrium” approach) to the *Thompson* case.<sup>89</sup> The Tax Court in *Bongard* cited *Thompson* and stated that such dissipation of value triggers heightened scrutiny and whether there was a true business purpose.<sup>90</sup> Based upon the use of the references in *Bongard* and *Strangi-III* to “non-tax reason,” “non-tax business reason” and “business purpose,” it appears that each has the same meaning – the substance of the transaction (other than tax reasons) will be evaluated.

j. The Court in *Harper* summarized its analysis by stating: “. . . where a transaction involves only the genre of value “recycling” described above and does not appear to be motivated primarily by legitimate business concerns, no transfer for consideration within the meaning of Section 2036(a) has taken place.”<sup>91</sup> The Third Circuit in *Thompson* reached the same conclusion for “essentially the same reasons”.<sup>92</sup> However, if there is a substantial business/non-tax motive and the entity is appropriately planned and executed, *Stone*, *Kimbell*, *Bongard* and *Schutt* show that a family entity can successfully utilize the exception to Section 2036(a). See Exhibits 5A-5G.

### C. DESIGN GUIDELINES

In order to minimize the risk of the application of Section 2036(a)(1), the following guidelines should be considered:

1. State the specific current business purposes or legitimate and significant non-tax reasons for the entity.
2. Negotiate the decisions regarding design, implementation and operation of entity between the donor and the other partners.
3. Develop a business plan and pool the property and services from each of the partners and document the steps taken to implement the business plan.
4. Transfer to the entity only those assets that are appropriate to achieve the economic objectives and to satisfy other non-tax goals. The donor should keep sufficient assets to comfortably provide for his/her personal needs and desires (including gifting) and the obligations of his estate (expenses, debts, specific bequests and taxes).
5. Confirm adequate and full consideration (by appraisal) for any transaction involving the entity and a family member.
6. Implement and operate the entity in a business-like manner as a joint enterprise for profit.
7. Make pro rata distributions.

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<sup>89</sup> *Thompson* (3rd cir.), ¶¶38-39.

<sup>90</sup> *Bongard*, ¶62.

<sup>91</sup> *Harper*, ¶¶60-61.

<sup>92</sup> *Thompson* (3rd cir.), ¶32.

8. Take a proactive approach to accomplish the economic objectives of the entity.
9. Make significant changes in the benefit to be received from assets and in the control/management of assets (“before entity” compared with “after entity”).
10. Continue to operate the entity after the death of the donor and invest assets according to economic objectives (rather than making a disproportionate distribution to pay estate taxes and other estate obligations or liquidating the entity).

#### IV. RETENTION OF CONTROL BY DONOR

##### A. APPLICATION OF SECTION 2036(a)(2)

Section 2036(a)(2) will apply if the donor retains control including “...the right...to designate the persons who shall possess or enjoy the property or the income therefrom” (hereinafter “the right to designate”). Although Section 2036(a)(2) has not been a primary weapon in the IRS arsenal in the past, recent developments indicate it is important to protect against this risk.

1. The Federal District Court in *Kimbell* found that Section 2036(a)(2) applied in the family entity context where the extraordinary powers of the general partner were imputed to the donor/decedent.<sup>93</sup> However, as referenced above, the *Kimbell* case was reversed by the Fifth Circuit Court of Appeals because the court found that the exception to Section 2036(a) applied to the partnership. Therefore, the court did not analyze the Section 2036(a)(2) issue with respect to the partnership. Furthermore, the court concluded (without significant analysis) that Section 2036(a)(1) and (a)(2) did not apply to the assets of the LLC (general partner) because Mrs. Kimbell did not retain sufficient control (Mrs. Kimbell had only a 50% interest in the LLC).

2. The Tax Court in *Strangi-II* primarily utilized the rationale of *Harper* and *Thompson* and held that 99.47% of the assets of the Strangi Family Limited Partnership (SFLP) and Stranco (another family entity) were includable in the estate of Albert Strangi under Section 2036(a)(1) without any discounts. In addition, the court provided an alternative holding with the same tax result under Section 2036(a)(2). In reaching its conclusion on the application of Section 2036(a)(2), the court found that:

a. Mr. Strangi had legally enforceable rights based on the governing instruments of the entities to designate who shall enjoy property and income from SFLP and Stranco within the meaning of Section 2036(a)(2).<sup>94</sup> Although Mr. Strangi only owned a 47% interest in the corporate general partner, the court determined that he could join together with the other shareholders of Stranco to distribute income and liquidate the entities (“joint action”). The court interpreted Treasury Regulation 20.2036-1(b)(3) broadly because:

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<sup>93</sup> *Kimbell*, ¶35.

<sup>94</sup> *Strangi-II*, ¶42.

(1) there was no independent trustee who had the sole authority to determine distributions (as in *Byrum*);

(2) the other shareholders were family members who did not have a meaningful economic stake in the property; and

(3) Mr. Gulig (son-in-law) had dual (conflicting) fiduciary obligations to Mr. Strangi (as the attorney-in-fact for Mr. Strangi) and to all shareholders of Stranco (as the president of Stranco).<sup>95</sup>

b. Mr. Strangi's authority "to designate" was not subject to legal and economic constraints comparable to the constraints in *Byrum*.<sup>96</sup> In *Byrum*, there was a "realistic possibility for enforcement (of fiduciary duty) and an objective business environment against which to judge potential dereliction."<sup>97</sup> The court distinguished the fiduciary duty in *Strangi-II* from *Byrum* by contrasting:

(1) In *Byrum*, an independent trustee had sole authority ultimately to pay or withhold income from the trust. The funds were generated by businesses subject to economic realities and the corporate shareholders and directors of the businesses had fiduciary duties to act in the best interests of the entity that could be enforced by unrelated shareholders.

(2) In *Strangi-II*, Mr. Gulig (subject to his dual roles) made all decisions. SFLP and Stranco only held monetary or investment assets, and the shareholders were family members with de minimis interests.<sup>98</sup> In *Strangi-II*, the court concluded that "the facts of this case belie the existence of any genuine fiduciary impediments to Mr. Strangi's rights."<sup>99</sup> Furthermore, "*Byrum* simply does not require blind application of its holding (fiduciary duty limitations on legal rights to designate) to scenarios where the fiduciary duties have no comparable substance."<sup>100</sup>

## B. CRITICISM OF THE STRANGI-II RATIONALE

A number of commentators have criticized the rationale of the alternative holding in *Strangi-II* under Section 2036(a)(2).<sup>101</sup> The criticisms include the following:

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<sup>95</sup> *Strangi-II*, ¶¶43-45.

<sup>96</sup> *Id.*, ¶47, *United States v. Byrum*, 408 U.S. 125 (1972); 1972 U.S. Lexis 168.

<sup>97</sup> *Id.*, ¶48.

<sup>98</sup> *Id.*, ¶¶47-48.

<sup>99</sup> *Strangi-II*, ¶¶52-53.

<sup>100</sup> *Id.*, ¶49.

<sup>101</sup> S. Stacy Eastland, "What Do *McCord* and *Strangi-II* Mean for the Structuring of Family Limited Partnerships?" 29 *ACTEC Journal* 69, p. 87-88, Fall 2003.

Michael D. Mulligan, "Courts Err in Applying Section 2036(a) to Limited Partnerships" *Estate Planning*, p. 486, 490, October 2003.

1. the legal significance of a donor/general partner's fiduciary duty should not diminish because it is owed to a family member;
2. the interpretation of joint action in Treasury Regulation 20.2036-1(b)(3) was too broad;
3. the interpretation of the right to liquidate the entity as a "right to designate" is too broad;
4. the interpretation of "transfer" for purposes of Section 2036(a) (without any gift being made) was too broad;
5. the interpretation of "bona fide sale for adequate and full consideration ... " was expanded (initially in *Harper*) from one (1) requirement to two (2) requirements without sufficient legal precedent; and
6. the Tax Court did not analyze relevant 5th circuit precedents and a relevant revenue ruling. However, the Fifth Circuit in *Strangi-III* did not address the Section 2036(a)(2) argument or comment on the Tax Court analysis of the applicability of Section 2036(a)(2) in *Strangi II* because it found that the transferred assets were includable under Section 2036(a)(1).

#### C. SUPPORT FOR THE STRANGI-II RATIONALE

Other commentators have expressed views consistent with (or supportive of) *Strangi-II*, that the fiduciary duty "shield" of *Byrum* should be limited to the particular central facts of that case.<sup>102</sup>

#### D. IMPACT OF STRANGI-II AND STRANGI-III

The *Strangi-II* and *Strangi-III* cases make a major impact on family entity planning.

1. The broad interpretation of Section 2036(a)(2) by the Tax Court raises the risk that many typical FLPs/LLCs may become subject to the statute and thereby cause the nondiscounted inclusion of all entity assets (as appreciated) in the donor's estate that were initially contributed by the donor (not just the value of the donor's retained interests). See Exhibits 6-A and B.

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Gans and Blattmachr, "*Strangi: A Critical Analysis and Planning Suggestions*," Tax Notes, September 1, 2003, pp. 1153, 1161-1163.

Louis A. Mezzullo, "*Is Strangi a Strange Result or a Blueprint for Future IRS Success Against FLPs?*," pp. 45-47, Journal of Taxation, July 2003.

<sup>102</sup> Lee A. Sheppard, "*Compensatory Option Sale Shelter Resolved*," Tax Notes, July 14, 2003, p. 143.

Brant J. Hellwig, "*Estate Tax Exposure of Family Limited Partnerships Under Section 2036*," 38 Real Property, Probate and Trust Journal 169-206 Spring 2003.

Wendy C. Gerzog, "*A Different Take on the FLP Valuation Game*," Tax Notes, November 2002, pp. 683-686.

2. In addition, if Section 2036(a)(2) applies, any annual exclusion gifts of entity interests made during lifetime will be wasted and the reporting of gift transfers on a Form 709 in compliance with the adequate disclosure rules will not start the three (3) year statute of limitations (with respect to Section 2036).<sup>103</sup>

3. Since the Fifth Circuit in *Strangi-III* declined to provide any further guidance on the applicability of Section 2036(a)(2),<sup>104</sup> it is important to take into account, for planning and advising purposes, the position of *Strangi-II*. However, as a practical matter, if the facts of a particular situation provide a strong position for satisfying the exception to Section 2036(a), then the special planning issues relating to Section 2036(a)(2) become less significant.

a. The court in *Strangi-II* gave clear statements of its focus on the practical substance of the donor's fiduciary duty and its concern when an entity is used as a testamentary device. Furthermore, the Tax Court demonstrated that it will interpret Section 2036(a)(2) broadly in order to nullify the estate tax planning benefit of family entities that merely comply with technical rules but, by the behavior of the parties, do not evidence an arm's length joint enterprise. The Tax Court opinion by Judge Cohen essentially adopted a facts and circumstances test to determine whether "fiduciary duty" will be an effective shield to the application of Section 2036(a)(2) ("comparable constraints" to *Byrum*).

b. The Tax Court did not give clear guidance whether:

(1) all of the central facts of *Byrum* (independent trustee, unrelated entity interest owners and going business) are necessary in order to meet the "comparable constraint" test; or

(2) the comparable constraints can be achieved through other means to some extent (e.g., distributions made according to an ascertainable standard or elevating general partner accountability through the establishment and monitoring of objectives by the entity) and still avoid the application of Section 2036(a)(2).

c. However, the court in *Strangi-II* did quote *Byrum* and acknowledged that "retention of a right to exercise managerial power over transferred assets or investments does not of itself result in inclusion under Section 2036(a)(2)."<sup>105</sup> Also, the court did not see any problem with "mere control, management or influence."<sup>106</sup> Therefore, it is clear that a donor may serve as general partner or manager so long as there is no "right to designate."

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<sup>103</sup> Mezzullo, p. 52.

<sup>104</sup> *Strangi-III*, ¶20 n7

<sup>105</sup> *Strangi-II*, ¶22.

<sup>106</sup> *Id.*, ¶46.

V. STRATEGIES FOR AVOIDING SECTION 2036(a)(2) WHILE COMPLYING WITH STRANGI-II

A. ASSESSMENT OF RELEVANT FACTS

Before determining the appropriate remedial strategy for a particular existing family entity, the practitioner should take into account all relevant facts, including:

1. non-tax objectives of client regarding management control and retaining benefit;
2. extent of contributions (assets and services) to entity by parties, pooling of contributions, and business or investment purpose;
3. going business or active management changes that are made after the entity is implemented;
4. age and health of client;
5. willingness of client to make gifts and (potentially) pay gift tax;
6. provisions of the governing instrument regarding distributions, liquidation rights and fiduciary duty;
7. businesslike operation of the entity (including distributions, administration and monitoring of investment performance);
8. ownership of entity interests; and
9. risk tolerance of client. See Exhibit 7.

B. SIMPLE STRATEGIES FOR EXISTING ENTITIES MAY (OR MAY NOT) BE ADEQUATE

1. Gift of all entity interests of the donor to or for the benefit of the beneficiaries.
  - a. If most of the equity interests have been transferred to beneficiaries in prior years, and if the donor wants to transfer the remaining interests to them, this approach can be relatively simple and effective.
  - b. However, a gift may also trigger a gift tax and/or require a Form 709 gift tax return, a determination of value (appraisal) and a decision whether to comply with the adequate disclosure rules.<sup>107</sup>

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<sup>107</sup> Treas. Reg. § 301.6501(c)-1(f); 20.2001-1; 28.2504-2.

c. Moreover, a gift (or any transfer) will be subject to the Section 2035 three (3) year rule if Section 2036 would otherwise have applied. Therefore, the donor must understand the risk and alternatives before adopting this approach.

d. Determine whether any generation skipping transfer tax issues need to be addressed.

2. Modification of the operating agreement to eliminate any discretionary distribution authority of the donor and the donor's right to vote on a liquidation of the entity.

a. If the donor already has a minority interest (and does not have discretionary distribution authority), modification of the operating agreement may be a simple and practical approach.

b. However, the lapse of voting rights may result in a gift to family members and the application of Section 2704(a).

c. If the broad (*Strangi-II*) interpretation of "transfer" is utilized, the assets corresponding to any retained interest will be included in the donor's estate under Section 2036(a)(1), notwithstanding the modification to the governing instrument.

d. Furthermore, the Section 2035 three (3) year rule applies to the relinquishment of any power.

3. No changes to the entity or ownership where family members or others already own a meaningful interest.

a. There is a significant basis for concluding that a fiduciary duty owed solely to family members should be recognized even though the *Strangi-II* opinion emphasizes that a fiduciary duty is more likely to be enforced when it is owed to entity interest holders having a meaningful independent interest.<sup>108</sup>

b. Furthermore, substantial arguments can be made that the *Strangi-II* opinion erred in several other respects regarding the application of Section 2036(a). See discussion at IV.B above.

c. However, all relevant circumstances of the client and entity should be evaluated before a decision is made that no action will be taken to avoid Section 2036(a)(1) and (2) and the advisor should make adequate disclosure of risks and alternatives to the client.

## C. STRATEGIES BASED UPON PARTICULAR OBJECTIVES AND CIRCUMSTANCES

Ascertain whether the donor has a priority of deriving ongoing benefits from the entity (e.g., *Strangi-II*) or of retaining management control over the assets of the entity. The objectives of the donor and the circumstances of the entity will determine which strategies are most

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<sup>108</sup> Mezzullo, pp. 48-49; Gans and Blattmachr, pp. 1158-1159.

effective. For example, certain strategies will be appropriate if the donor wants to maximize retained control but does not want to retain benefit. Other strategies will be most effective if the donor's objectives emphasize benefit rather than control.

1. Methods that will maximize the amount of management control that a donor may retain.

Example: Parent (donor) and children established a 1% GP and 99% FLP five (5) years ago. Donor currently owns only the 1% GP because donor made major gifts of FLP interests to each child more than three (3) years ago (each child owns a "meaningful" interest).<sup>109</sup>

a. Each owner of an entity interest (other than the donor) may make a transfer of his/her interest to a trust, having an independent trustee who has discretion to accumulate income or to make distributions.<sup>110</sup> The trust will remain in effect until the entity liquidates. The grantor of the trust may retain the power to remove the independent trustee and appoint a new independent trustee.<sup>111</sup> See Exhibits 8-A and B.

(1) The inclusion of an independent trustee for making distributions and monitoring the general partner's administration of the entity minimizes the risk of Section 2036(a)(2) (*Strangi-II* and *Byrum* emphasized the significance of an independent trustee in not applying "joint action").

(2) No gift is made by donor and no powers are relinquished. Therefore, there is no application of the Section 2035 three (3) year rule or Section 2704(a) lapse of voting rights. As referenced above, Section 2036(a)(1) may apply to the donor's retained 1% interest.

(3) Certain non-tax reasons for the children to establish the trust include:

- (a) protection of separate property assets (from an estranged spouse);
- (b) assistance with investments and restriction on amounts available for spending; and
- (c) advocacy for the interests of the limited partners by the independent trustee.

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<sup>109</sup> In *Strangi-II*, the Court indicates that meaningful independent interests or oversight provide a basis for presuming that fiduciary obligations will be enforced, ¶¶52-53. Possibly, an interest of approximately 11% will be "meaningful" since 11% has been held to be more than de minimis in a related context. See footnote 42. However, a 1% contribution by each child in *Stone* was full and adequate consideration (when the personal services of each child were taken into account). In contrast, the combined interests of the Strangi family members and charity in Stranco were not "meaningful."

<sup>110</sup> Korpics, pp. 275-280 for further analysis and significance of making transfers of entity interests to an irrevocable trust with an independent trustee.

<sup>111</sup> See Rev. Rul. 95-58, 1995-2, C.B. 191; *Wall v. Comm'r*, 101, T.C. 300 (1993).

b. (See facts in the above example.) The owners of entity interests (other than donor) transfer a meaningful interest in the entity to a third party. See Exhibit 8-C.

(1) The inclusion of a meaningful third party entity interest holder strengthens the fiduciary duty shield and “severs” joint action.<sup>112</sup>

(2) No application of Section 2035 or Section 2704(a), Section 2036(a)(1) may apply to donor’s retained interest.

(3) Capital gain on sale or charitable income tax deduction on contribution.

c. Modify the governing instrument to provide for an ascertainable standard for distributions (distribution of all cash flow other than reasonable amounts for reserves).<sup>113</sup> The ascertainable standard approach is effective when used to make distributions to persons “other than a donor who establishes the power.” The result is uncertain when the creator of the power makes distributions to herself subject to the ascertainable standard.

(1) If the donor’s right to vote on liquidation is eliminated, a Section 2704(a) lapse of voting rights may occur.

2. Methods to maximize retained benefit and equity ownership in conjunction with a minimum amount of desired control.

a. Modify the provisions of the governing instrument and make transfers so that the donor relinquishes all rights to participate in making discretionary distributions or to vote on a liquidation. The risk of a taxable gift or application of Section 2704(a) can be minimized (or eliminated) by using the entity restructuring/incomplete gift strategies set forth in the Gans and Blattmachr article.<sup>114</sup>

(1) Amend the governing instrument to provide for the 1% general partner interest to hold the exclusive rights regarding distribution and liquidation. The 99% FLP interests will not hold any of such rights. Donor will make an incomplete gift of the 1% general partner interest to an irrevocable trust and the donor/grantor will retain a special power of appointment to modify the beneficiaries.

(a) The amendment itself should not result in a taxable gift and the transfer to the trust is an incomplete gift.

(b) The assets of such trust (1% general partner interest) will be included in the donor/grantor’s estate for estate tax purposes under Section 2036(a)(2).

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<sup>112</sup> *Strangi-II*, ¶45.

<sup>113</sup> Eastland, pp. 90-91; Rev. Rul. 1973-1, C.B., 407; *Jennings v. Smith* 161 F.2nd 74 (2nd cir. 1947).

<sup>114</sup> Gans and Blattmachr, pp. 1164-1165.

(c) However, since the distribution and liquidation rights are held exclusively by the trustee, the donor will no longer hold a right to designate that triggers Section 2036(a)(2) with respect to the underlying assets of the FLP.

(d) Furthermore, if an independent trustee is utilized, the approach will more effectively address the *Strangi-II* concerns and follow the *Byrum* model. The donor/grantor may also be a co-trustee with powers that are restricted to asset management and administration (no powers to make distributions or vote on liquidation).

(e) The donor may receive benefit from such trust so long as the benefit does not result in the application of Section 2036(a)(1). Receipt of benefit from the retained FLP interest may also trigger the application of Section 2036(a)(1).

(2) Sale of the 1% general partner interest is a practical alternative only if the Section 2035 three (3) year rule is not projected to be a practical problem.

b. The incomplete gift trust strategy will be subject to the Section 2035 three (3) year rule. If a transfer is made or a power is relinquished within three (3) years of death, all assets otherwise subject to Section 2036 will be includable in the donor's estate for estate tax purposes. Section 2035 does not apply if an amount of consideration is paid that is equal to the value of all assets that were initially contributed by the donor and would be otherwise includable in the donor's estate under Section 2036.<sup>115</sup> Therefore, a donor must live for three (3) years following the transfer or relinquishment of a power in order to remove the asset value from the donor's estate.

3. Planning for New Entities (utilizing variations of the planning options set forth above). As a practical matter, until it is clarified whether the broad interpretation of "transfer" for Section 2036(a) purposes will apply generally, all reasonable steps should be taken to qualify a new entity for the exception to Section 2036(a) discussed at III.B above. The analysis set forth below addresses Section 2036(a)(2) issues and assumes that the broad interpretation of "transfer" does not apply.

a. Minimum ownership/maximum control.

(1) Donors (husband and wife) establish a limited liability company (LLC) and receive a 1% manager interest and a 99% member interest in exchange for their contribution of assets. The governing instrument states that a special manager (that would qualify as an independent trustee) has the sole authority to make distributions and has sole authority to liquidate the entity. The donors have the right to remove the special manager so long as another independent party is appointed as a replacement. See Exhibit 9-A.

(a) The donors do not ever have the right to make discretionary distributions or participate in liquidation of the entity. Therefore, no Section 2035 three (3) year rule will apply when gifts of LLC member interests are made and Section 2704(a) lapse of voting rights will not apply.

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<sup>115</sup> Gans and Blattmachr, pp. 1166-1167; and *U.S. v. Allen*, 293 F. 2nd 916 (10th cir. 1960), Cert. Denied, 368 U.S. 944 (1961).

(b) This approach should not trigger a gift on formation because all interests in the entity are includable in the donor's estate upon the formation of the entity.

(c) When any gift transfers are made to or for the benefit of beneficiaries, gift tax rules will apply.

(2) Donors (husband and wife) establish an LLC and receive a 1% manager interest and a 99% member interest in exchange for their contribution of assets. After a reasonable period of time, donors make meaningful gifts of member interests to qualified charities and the remaining member interests are given to a trust for children having an independent trustee. Furthermore, the governing instrument provides that distributions are subject to an ascertainable standard. See Exhibit 9-B.

(a) The Section 2035 three (3) year rule may apply (depending on whether the transfer for Section 2036(a) purposes occurs upon funding of the entity or when gifts are made). However, the facts (including the meaningful gift to charities, the oversight of an independent trustee and an ascertainable standard for distributions) should elevate the fiduciary duty of the donor/manager to a level where it provides an adequate shield from the application of Section 2036(a)(2).

(b) Joint action should not apply because of the meaningful interest owned by an independent party and independent oversight.

(c) There is no gift on formation.

(d) Gift tax rules will apply to the gifts made in trust.

b. If the approach in subparagraphs (1) and (2) above are combined (special manager, transfers to charity and/or trusts for children with an independent trustee), there is substantial protection from the application of Section 2036(a)(2). See Exhibit 9-C.

c. Maximum donor ownership/minimum desired control.

(1) Contribution of donor is made in exchange for a minority interest in the 1% general partner and the 99% nonvoting interest in the FLP. Other family members receive the majority interest in the general partner. The governing instrument provides that the interests received by the donor do not have any voting rights on distributions or liquidation and the donor may not participate in any amendment of the governing instrument.<sup>116</sup>

(a) This approach avoids Section 2036(a)(2) and the Section 2035 three (3) year rule.

(b) Broad interpretation of joint action is a possible concern since there are no nonfamily members involved.

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<sup>116</sup> Gans and Blattmachr, p. 1168.

(c) Gift on formation is a possible concern due to the limitations on voting.

4. Summary of Entity Design Considerations in Order to Satisfy the *Strangi-II* Rationale and Avoid Section 2036(a)(2).

a. Threading the “needles.”

(1) In designing and implementing the entity, the advisors must utilize an appropriate planning approach to qualify for the exception to Section 2036(a) or avoid the application of Section 2036(a)(1) and (2) and avoid the gift on formation argument.

(2) Upon the transfer of interests or modification of voting rights, the Section 2035 three (3) year rule, Section 2704(a) lapse of voting rights, gift tax and generation skipping tax issues must be considered.

(3) The substantive facts must be highlighted and a plan must be developed and documented that anticipates scrutiny of the substance in a future audit by the IRS.

(4) In some situations, the restrictions on the participation of the partners that will be needed in order to “thread the needles” will substantially undermine the objectives of the donor. In such situations, alternative strategies (not an FLP) will be utilized.

b. In structuring the ownership plan and the governing instrument provisions, the following issues must be addressed:

(1) The right to designate must be held by a party other than the transferor or there must be sufficient constraints on the right to designate.

(2) If family members hold the right to designate, there must be a meaningful ownership interest and/or right of entity oversight held by a third party in order to block “joint action.”

(3) Carefully evaluate whether the provisions of the partnership agreement may indirectly provide a right to designate (e.g., the failure to file annual entity reports with the state may result in the eventual dissolution of the entity or the right to remove a decision maker without restrictions on the appointment of a replacement).

(4) The governing instrument should confirm the general partner’s fiduciary duty under state law, set forth the non-tax purposes for the entity and provide specific accountability guidelines for the general partner (objective standards for enforcing fiduciary duty).

## VI. IMPLEMENTATION AND OPERATION

### A. EXECUTE THE DETAILS

In addition to properly forming the entity under state law and executing the governing instrument, careful attention must be paid to the “nuts and bolts” of entity implementation and operation.

1. Transfer assets in a timely manner and only transfer assets that are appropriate to accomplish economic objectives and other non-tax motives. Contemporaneously document all transfers to the entity as contributions to the capital account of the transferor. Obtain insurance coverage in the name of the entity (if applicable).

2. Obtain an employer identification number for the entity and establish a bank account for the entity as soon as it is formed.

3. Arrange a meeting for the donor and key advisors (including the CPA) to review use of entity bank account, operation of the entity assets/business, financial and tax reporting (including confirmation of gift tax preparation), general partner compensation and related issues. See Exhibit 11.

4. After full implementation of entity (including transfer of assets, entry in capital accounts) and an appropriate “cooling off” period that clearly separates the entity funding and gifting transfers, a meeting should be held to finalize gifts, including execution and delivery of instruments. See Exhibit 12.

5. Clarify the lawyer’s role in holding original documents and effecting gifts of entity interests.

a. The lawyer should not hold gifted certificates unless the “completed gift” and donee instructions are clarified in writing.

b. Confirm completed transfers with CPA for client.

6. Arrange for appropriate appraisals and follow up with appraiser to make certain that all pertinent facts are accurate and included in the report and that the safe harbor provisions of the adequate disclosure rules are satisfied.<sup>117</sup>

7. Arrange a follow-up meeting (within a reasonable time, but less than 1 year) to make certain that the initial operation of the entity is being conducted in accordance with the governing instrument and applicable law.

a. Proper use of entity bank accounts.

b. Appropriate distributions.

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<sup>117</sup> Treas. Reg. Section 301.6501(c)-1(f); 20.2001-1; 28.2504-2.

- c. Initial economic objectives established.
- d. Action on repositioning investments (as appropriate) to accomplish economic objectives.

## B. GIFTING GUIDELINES

1. Gift sufficient amount to accomplish non-tax objectives. Client should identify the portion of entity equity that he/she wants to keep.
2. Maximize opportunity to make tax saving gifts while the appraisal is “fresh” (annual exclusion gifts and applicable gift tax exclusion).
3. Balance tax savings, non-tax objectives and the cost/complexity of an ongoing gifting plan of interests in the entity.
4. Provide guidance so that “over gifting” to family members does not occur.
  - a. Over gifting can easily lead to the application of Section 2036(a)(1).
  - b. The donor may want more cash flow to maintain his/her standard of living than what his/her pro rata distributive share and fair market value compensation (as general partner) will provide.
  - c. If over gifting occurs, the donor may want excessive compensation, disproportionate distributions, unenforced loans and uncompensated personal use of entity assets. These approaches demonstrate an implied agreement and can trigger Section 2036(a)(1).
5. Risks associated with gifting:
  - a. Future changes in tax law may reduce or eliminate the tax benefit of making current gifts (particularly if gift tax is paid).
  - b. Shifting future appreciation of assets to donees is very beneficial; however, future depreciation produces a negative result.

## C. KEY ISSUES FOR ANNUAL REVIEW OF THE ENTITY

1. Evaluate economic objectives and active management efforts.
2. Review distributions (confirm that proportionate distributions were made) and the appropriateness of the current distribution policy with regard to future distributions.
3. Review capital contributions (confirm that such transfers are appropriately documented and that capital account entries are made).

4. Review financial procedures (including use of entity bank accounts), records and tax reporting.

5. Confirm that any transaction between the entity and a partner is fully documented, legally enforced and is based upon fair market value. If the transaction results in a substantial restriction that will reduce the price a third party will pay for an interest in the entity (e.g., the business loan agreement in *Hillgren*), an additional discount may be obtained.<sup>118</sup>

a. Any loan to a partner must have adequate interest and security. Furthermore, the loan must be an unconditional obligation and there must be intent on the part of the transferee to repay the loan and an unconditional intent on the part of the transferor to secure repayment (evidence by objective factors).<sup>119</sup>

b. The personal use of any entity asset (e.g., house, automobile) must be documented with a written lease and appraisal to determine lease rate and appropriate term and actual payment must be made.

6. Determine whether any additional assets were contributed to the entity and appropriate entries have been made to capital accounts.

7. Ascertain whether any gifts of entity interests should be made (or whether any gifts were made without the lawyer's guidance).

8. Prepare annual minutes of partnership actions.

9. All parties should have meaningful participation.

#### D. ACCOMPLISH THE TASK OR PROVIDE WRITTEN GUIDANCE

Due to the substantial risk that results from any mishandling of implementation tasks and operation of the entity, the lawyer should either accomplish the tasks as part of the project (implementation) or provide written guidance if tasks are performed by the general partner or another person (operation). See Exhibits 13 and 14.

### VII. SUMMARY

A. The IRS has been successful in utilizing Section 2036(a)(1) and (a)(2) to eliminate the estate tax benefits of family entity planning under certain circumstances. However, *Stone*, *Kimbell*, *Bongard* and *Schutt* provide examples in a variety of factual circumstances of how to qualify for the exception to Section 2036(a). Therefore, if an entity is designed, implemented and operated in accordance with the appropriate substance and form considerations, it can qualify for the exception.

B. It is probable that the interpretation of Section 2036(a) will continue to develop and change as current cases are appealed and new cases are decided.

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<sup>118</sup> *Hillgren*, ¶¶51-52.

<sup>119</sup> *Rosen* ¶¶74-89

C. Finally, even if the *Strangi-II* interpretation of Section 2036(a)(2) becomes controlling authority, family entity planning can still achieve the donor's non-tax and tax objectives under appropriate circumstances if the donor and other partners receive appropriate guidance in structuring the entity and give close attention to the businesslike operation of the entity.

## APPENDIX A

1. What are the primary facts to look for in determining that an entity is an appropriate strategy?
2. Should a written explanation of the entity strategy be given to the client, including benefits, risks and alternatives, and including a statement of the specific non-tax benefits that are achieved?
3. Should special steps be taken during the planning process in preparation for possible litigation?
4. How can the entity/plan be designed so that there is the greatest likelihood of qualifying for the exception to section 2036(a)—bona fide sale for adequate and full consideration?
5. Should the client engage in transactions with the entity (living in the home; borrowing money)? What steps should be taken in documenting such transactions if they are necessary?
6. How can an entity be rehabilitated that has a section 2036(a)(2) “retained control” issue or be designed to avoid section 2036(a)(2)?
7. Can an independent party play a significant role in safeguarding the plan from a Section 2036(a) attack?
8. What is the most common problem in (a) implementing the entity, and (b) operating the entity?
9. What steps can be taken in order to “separate” the funding of the entity and the gifting of entity interests to assure that the “step transaction” doctrine does not apply?
10. What safeguards should be implemented so that the operation of the entity will be effective?