Family Limited Partnership Update: Strangi Decision Affirmed by Fifth Circuit

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On July 15, 2005, in a much-anticipated decision, the Fifth Circuit delivered a victory to the Internal Revenue Service ("IRS") in the family limited partnership ("FLP") area by affirming the U.S. Tax Court's decision in favor of the IRS in Estate of Strangi v. Comm'r.[1] While the decision is not surprising given that the facts of the case were very negative from the perspective of the taxpayer and serve as guidelines on what not to do when planning with a FLP, it was disappointing in that it did not address a key issue that legal practitioners were hoping it would address (this will be discussed further below).

To review the facts of the case, Albert Strangi, through his agent acting under a power of attorney, formed a FLP and a corporation to serve as the 1% general partner of the FLP. Mr. Strangi contributed property with a fair market value of approximately $10 million to the FLP in exchange for a 99% limited partnership interest. The property contributed by Mr. Strangi represented approximately **98%** of his wealth and included his personal residence and other real estate, cash, securities, accrued interest and dividends, insurance policies, an annuity, and partnership interests. He purchased 47% of the corporation and his four children purchased the other 53% of the corporation (the children later collectively gave a 1% interest in the corporation to a charity). The partnership agreement provided that, as general partner, the corporation had sole authority to manage the FLP's affairs and make distributions. Mr. Strangi died two months after the FLP was funded. Various distributions of a personal nature were made from the FLP after its formation, including payments for back surgery for Mr. Strangi's housekeeper, Mr. Strangi's funeral expenses, estate administration expenses, debts of Mr. Strangi such as nursing services, satisfaction of a specific bequest by Mr. Strangi to his sister, and payment of federal estate taxes and state inheritance taxes. The FLP accrued rent on the residence occupied by Mr. Strangi but the FLP did not collect the rent until more than two years after Mr. Strangi's death. On the estate tax return, the estate valued Mr. Strangi's limited partnership interest, with discounts, at approximately $6.5 million, although the total value of the underlying assets was approximately $11 million as of the date of death.

The Fifth Circuit affirmed the Tax Court's decision that the **full, undiscounted** value of the assets transferred to the FLP should be included in Mr. Strangi's estate under Internal Revenue Code ("Code") Section 2036(a)(1), which essentially provides that if a person transfers property and retains for himself the possession or enjoyment of the property or the right to income from the property, then these "strings" over the property cause it to be included in the transferor's estate upon his death. The facts that were fatal to Mr. Strangi's estate on this issue were that various payments were made from the FLP, both before and after Mr. Strangi's death (the court importantly explained that post-death payments are counted also), to meet Mr. Strangi's needs and expenses, Mr. Strangi continued to reside in his house after it was transferred to the FLP, his payment of rent to the FLP was deferred, and he failed to retain sufficient assets outside the FLP to meet his living expenses for his remaining life expectancy.

The Fifth Circuit also affirmed the Tax Court's conclusion that the exception to Code Section 2036, which provides that the transferred assets will not be included in the transferor's estate if the assets were transferred in a "bona fide sale for an adequate and full consideration," was not satisfied. The court explained that the "adequate and full consideration" component of this exception is met where transferred property is replaced with property that is commensurate in value, and that in the case of a transfer to a partnership, this means the transferor must receive a proportionate interest in the partnership and observe partnership formalities. The IRS conceded, and the court found, that this component was satisfied in the Strangi case.

However, the court found that the "bona fide sale" component of the exception was not satisfied. Unfortunately, in describing the proper test to apply in determining whether the "bona fide sale" requirement is met, the court was less than precise, at one point saying that there must be a "substantial business or other non-tax purpose" for the FLP (with this phrase the court incorrectly quoted a prior case which stated there must be a "substantial business and non-tax purpose"), at another point saying there must be a "substantial non-tax purpose," and at yet another point saying there must be "non-tax business purposes."

The court upheld the Tax Court's rejection of the five non-tax reasons advocated by Mr. Strangi's estate. The first of these reasons was to deter potential tort litigation by Mr. Strangi's former housekeeper for injuries sustained on the job. The court noted that Mr. Strangi paid all of the medical expenses from this injury and continued to pay her salary during her absence from work, the housekeeper and Mr. Strangi were very close and the housekeeper never threatened to take action. The second reason was to deter a potential will contest by Mr. Strangi's stepchildren. The court noted that the claims of the stepchildren were stale when the partnership was formed and never materialized, and that although the stepchildren retained a lawyer, neither the stepchildren nor the lawyer contacted Mr. Strangi's agent in regard to the will and no claim was ever made against the estate. The third reason was to persuade the corporate executor under Mr. Strangi's will to decline to serve so that executor's fees would not be incurred. The court noted the Tax Court's skepticism that this could be a business purpose, and that the reason why the corporate executor ultimately declined to serve was not reflected in the record. The fourth reason was to create a joint investment vehicle for the partners. The court noted that Mr. Strangi's children only contributed a total of $55,650 to the FLP, which was minimal and properly ignored, and that even if these contributions were not ignored, the court stated that the FLP never made any investments or conducted any active business after it was formed. The fifth reason was to permit centralized, active management of Mr. Strangi's "working assets" such as real estate and partnership interests. The court noted that the overwhelming majority of the assets transferred to the FLP did not require active management (approximately 75% of the assets consisted of brokerage accounts).

What disappoints us the most about the Fifth Circuit's decision is that the court declined to address certain statements made by the Tax Court regarding Code Section 2036(a)(2). This section essentially provides that if a person transfers property and retains the right to designate who will possess or enjoy the property or the income from it, then these are also "strings" over the property that cause it to be included in the transferor's estate upon his death. The Tax Court suggested that if the transferor can, whether alone or together with the other partners, control distribution decisions or liquidate the entity, then this is sufficient to cause the transferred assets to be included in the transferor's estate under Code Section 2036(a)(2). This implies that if the transferor owns <u>any</u> interest (not just a controlling interest) in the entity at the time of death, the assets will be included in his estate. The Tax Court also suggested that the fiduciary obligations that the transferor owes to other partners would not change this result because in the family context these obligations are illusory and unlikely to be enforced. Many legal practitioners believed these conclusions to be incorrect. Unfortunately, because the Fifth Circuit concluded that the assets in Mr. Strangi's FLP were included in his estate under Code Section 2036(a)(1), it stated that it did not need to address Code Section 2036(a)(2).

Observations and Conclusions:

The Fifth Circuit's decision with respect to Code Section 2036(a)(1) is not surprising given that Mr. Strangi (and after his death, his estate) essentially used the FLP as his personal pocketbook to satisfy his needs and expenses. In our March 2003 and March 2004 Updates, we set forth some of the guidelines that should be followed in creating and maintaining a FLP to produce the best factual scenario in the event of IRS attack (i.e., not commingling FLP and personal assets, not putting personal use assets such as a home into a FLP, following FLP formalities, maintaining sufficient assets outside the FLP to meet living expenses and to cover post-death expenses such as estate taxes, etc.). This advice remains the same after the Fifth Circuit's recent decision. If the FLP is created for appropriate reasons and properly maintained, we continue to believe that it should be able to withstand a Code Section 2036(a)(1) attack by the IRS.

Since the Fifth Circuit did not address the Tax Court's Code Section 2036(a)(2) analysis, it might be advisable, as discussed in our March 2004 Update, for the transferor to gift or sell his/her entire interest in the FLP more than three years prior to death (transfers made within three years of death will nonetheless be included in the estate). This could result in gift tax or accelerated use of the gift tax exemption, however, and also defeats the control that many clients expected when setting up a FLP. In addition, as indicated in our March 2004 *Update*, many existing FLPs have the transferor as the sole general partner, or have another entity in which the transferor owns an interest as the general partner, which may no longer be advisable. It may therefore be advisable to change the general partner, or in the case where an entity in which the transferor owns an interest is the general partner, the transferor might consider gifting or selling not only his/her interest in the FLP, but also his/her interest in the entity that is the general partner.

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1. No. 03-60992 (5th Cir. 7/15/05)

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