THE CONTINUING ASSAULT ON FAMILY LIMITED PARTNERSHIPS: THE IMPLICATIONS OF *S TRANGI* AND *THOMPSON*

Steven J. Arsenault William R. Koprowski

Use of a family limited partnership as an estate-planning technique can provide substantial estate- and gift-tax savings, as well as significant non-tax benefits, including more efficient asset management and protection of assets against claims of creditors. Although the family limited partnership has been in use as an estate-planning technique for a number of years, until very recently, the Internal Revenue Service ("IRS") has had little success in challenging the tax savings these techniques provided. However, several recent cases based on Internal Revenue Code ("I.R.C.") §2036 have raised questions about the viability of family limited partnership transactions as an effective estate-planning strategy. This paper focuses on two of the most recent of these cases, *Estate of Thompson* v. *Commissioner*[1] and *Strangi* v. *Commissioner.*[2]

Section I of this article provides an overview of a typical transaction involving a family limited partnership and Section II reviews IRS challenges to family limited partnership planning techniques, with a focus on the application of

I. R.C. §2036.[3] Section III examines *Strangi* v. *Commissioner,* focusing on the most recent decision in the case from the Fifth Circuit Court of Appeals. Section IV of the article considers *Estate of Thompson* v. *Commissioner,* with particular emphasis on the continuing assault by the IRS on the use of family limited partnership planning strategies. Section V considers the estate-planning lessons to be drawn from *Strangi, Estate of Thompson,* and other recent cases.

I. OVERVIEW OF A TYPICAL FAMILY LIMITED PARTNERSHIP TRANSACTION

In concept, a family limited partnership transaction is relatively simple. In the ordinary family limited partnership transaction, the client contributes property (often including cash, privately-held or publicly-traded securities, real estate, or other assets) to a limited partnership in exchange for general and limited partnership interests.[4] As general partner, the client maintains management and investment

* Associate Professor of Accounting and Legal Studies, School of Business & Economics, College of Charleston.
** Associate Professor of Accounting and Legal Studies, School of Business & Economics, College of Charleston.

[1] Estate of Thompson v. Commissioner, 382 F.3d 367, (3d Cir. 2004).
[2] Strangi v. Commissioner, _____F.3d ___ , 96 A.F.T.R.2d 2005-5230,2005 WL 1660817 (5th Cir. 2005).
[3] Sections I, II and III of this article are derived in part from a previous work by the authors: Steven J. Arsenault & William R. Koprowski, *Strangi, Kimbell and Stone: Is Time Limited for the Family Limited Partnership?,* 14 S.L.J. 55 (2004).

[4] Alan Halperin, *Family Limited Partnerships Offer Best of Both* Worlds, N.Y.L.J., Jan. 28, 1994, Outside Counsel, at 1; Sidney Kess, *Family Limited Partnerships*, N.Y.L.J., Jan. 8, 2001, Tax Tips, at 3; Mark L.

control over the partnership assets.[5] The client then makes one or more gifts of limited partnership interests to family members, either directly or through trusts for their benefit.[6] The gifts may be made immediately (typically using the client's $1,500,000 unified credit exemption[7] to shelter some[8] or all of the transfer from gift tax) or they may be made over time (using the client's $11,000 annual gift-tax exclusion[9] to avoid gift-tax liability.)

The transfer-tax savings for this type of transaction can be significant. Both the current value of the limited partnership interests transferred to family members and the value of all appreciation after the date of transfer are excluded from the client's estate for estate-tax purposes. Moreover, in valuing the limited partnership interests, discounts are generally available, because of the lack of marketability and the minority interests involved; depending upon the assets involved and the exact terms of the limited partnership agreement, discounts in the 25%-40% range are not uncommon.[10] Thus, the value of the limited partnership interests for gift-tax purposes may be significantly less than the proportional value of the underlying partnership assets.[11] Using these discounts, clients who wish to transfer wealth to their heirs can leverage their $1,500,000 unified credit exemptions, transferring between $2 million and $2.5 million of underlying assets (depending upon the discount) with no transfer tax liability. Likewise, clients could transfer additional amounts beyond the $1,500,000 unified credit exemption at a discounted rate, resulting in significant gift- tax savings.

II. IRS Challenges and I.R.C. §2036

The IRS has challenged the discounts offered by family limited partnership transactions, using a number of different strategies not related to I.R.C. §2036. For example, the IRS has argued that family limited partnership transactions are sham transactions with no economic substance,[12] that the discounts emphasize form over

Silow, *The Tax Court and Family Limited Partnerships,* 229 THE LEGAL INTELLIGENCER 5, Sept. 30, 2003.

[5] Revised Uniform Limited Partnership Act §403(a) (1985) (general partner has the rights and powers of a partner in a partnership that does not have limited partners); Revised Uniform Partnership Act §301 (1997) (each partner is an agent for the partnership for the purpose of partnership business).

[6] Kess, *supra* note 4.

[7] *See* I.R.C. §2010. The unified credit amount is currently $1.5 million and is scheduled to increase in various increments to $3.5 million in 2009. I.R.C. §2010(c).

[8] Even where the transfer exceeds the client's available unified credit and triggers a gift tax, there can be a significant tax benefit to the client. The gift tax is tax exclusive, meaning that the dollars used to pay the gift tax are never subject to transfer tax. The estate tax, in contrast, is tax inclusive, meaning that the dollars used to pay the estate tax come from the assets that make up the estate-tax base. For a good discussion of these issues, *see* Kess, *supra* note 4.

[9] I.R.C. §2503(b)(l).

[10] Cecily P. Maguire & John M. Oliveri, *Look Again at Family Limited Partnerships*, N.Y.L.J., Sept. 10, 2001, Trusts & Estates, at 11; Kess, *supra* note 4.

[11] Silow, *supra* note 4; Maguire, *supra* note 10.

[12] Maguire, *supra* note 10. For an extensive discussion of prior IRS litigation in challenging family limited partnership transactions, *see* Field Service Advice 200049003 (Sept. 1, 2000).

substance and should therefore be disregarded,[13] and that family limited partnerships lack any business purpose other than the reduction of transfer taxes and should therefore be disregarded as legal entities.[14] None of these arguments have produced substantial and continuing success for the IRS. The Tax Court has generally taken the view that, if the partnership is valid under state law, then the partners have rights and obligations under state law and the transaction should be recognized for federal tax purposes.[15]

More recently, however, the IRS has successfully attacked family limited partnerships using an I.R.C. §2036[16] analysis, claiming that the client who transfers assets to a family limited partnership has retained the enjoyment of those assets.[17]

I. R.C. §2036 requires the inclusion of property transferred by a decedent where the decedent retains (1) the right to possession or enjoyment of, or the right to income from, the property transferred, or (2) the right to designate the persons who shall possess or enjoy the property of the income from the property transferred.[18] An exception to §2036(a) inclusion exists where the transfer involves "a bona fide sale for an adequate and full consideration in money or money's worth.[19] I.R.C. §2036(a) reflects the legislative policy to include in the gross estate transfers that are testamentary in nature, where the decedent makes a transfer that leaves the transferor with a significant interest in or control over the property transferred.[20]

III. ESTATE OF STRANGI

The *Strangi* case has generated much attention in the estate-planning world since the Tax Court's initial opinion in 2000. In *Strangi,* after a series of serious medical problems involving his wife, Mr. Strangi executed a power of attorney appointing his son-in-law, Michael Gulig, as his attorney-in-fact.[21] Several years later, Gulig entered into a family limited partnership transaction on behalf of Mr. Strangi, after attending a seminar on the subject.[22] The seminar explained the

[13] Maguire, *supra* note 10.

[14] *Id.*

[15] *Id., citing* Knight v. Commissioner, 115 T.C. 36 (2000).

[16] I.R.C. §2036(a) provides:

> GENERAL RULE. --The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death -
> (1) the possession or enjoyment of, or the right to the income from, the property, or
> (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

[17] *See, e.g.,* Strangi v. Commissioner, T.C.M. (RIA) 2003-145.

[18] I.R.C. §2036(a)(l) and (2).

[19] I.R.C. §2036 (parenthetical language).

[20] Craig Stephanson and Jeff Bae, *Family Limited Partnerships Must Jump the Section 2036 Hurdle,* 70 PRAC. TAX. STRATEGIES 260,261 (2003).

[21] *Strangi,* 2005 WL 1660817, at *1.

[22] *Id.* at *2.

"Fortress Plan," an estate-planning strategy created by the Fortress Financial Group, which used a family limited partnership transaction to reduce the taxable value of a client's estate for estate-tax purposes.[23] In the transaction, Mr. Strangi transferred 98% of his wealth to the Strangi Family Limited Partnership ("SFLP") in exchange for a 99% limited partnership interest and also transferred $49,350 to a newly formed corporation, Stranco, in exchange for a 47% ownership interest.[24] Mr. Strangi's children invested $55,650 in Stranco in exchange for the remaining 53% ownership interest.[25] Stranco then purchased a 1% general partnership interest in SFLP.[26] The shareholders of Stranco entered into a management agreement with Gulig that authorized Gulig to manage the day-to-day business of Stranco.[27]

Mr. Strangi died two months after the partnership transaction was completed.[28] SFLP distributed $3,187,800 to Mr. Strangi's estate to provide funds to pay state and federal estate taxes, along with a proportionate amount (presumably $32,200) to Stranco.[29] Strangi's estate-tax return valued his 99% limited partnership interest at $6,560,730.[30] At the time of Strangi's death, the assets in the SFLP were valued at approximately $11,000,000, so the estate-tax valuation represented approximately a 40% discount from the fair market value of the underlying assets transferred.[31] The IRS issued a notice of deficiency of $2,545,826, and the Strangi estate petitioned the Tax Court for a redetermination.[32]

The Tax Court initially ruled in favor of the Strangi estate, rejecting the IRS assertion that inclusion of the full fair market value of the partnership's underlying assets was required.[33] After an appeal to the Fifth Circuit Court of Appeals and remand of the case on procedural grounds[34], the Tax Court allowed the IRS to amend its answer to include a claim under I.R.C. §2036.[35]

On remand, the Tax Court held that Mr. Strangi's gross estate should include the full value of each asset contributed to the SFLP.[36] In the most recent decision in the case, the Fifth Circuit Court of Appeals affirmed the Tax Court's holding and provided additional insight into the retained interest under I.R.C §2036 and the application of the bona fide sale exception.[37] Each of these issues is discussed separately below.

23 *id.*
24.*Id.*
25. *Id.*
26 *Id.*
27.*Id.*
28 *Id.* at *1.
29 *Id.* at *3.
30 *Id.*
31 *Id.*
32 *Id.*
33 Strangi v. Commissioner, 115 T.C. 478 (2000) ("Strangi I").
34 *Strangi,* 2005 WL 1660817, at *1.
35Strangi v. Commissioner, T.C. Memo 2003-145,2003 WL 21166046 (2003) ("Strangi II").
36.Id., 2003 WL 21166046, at *17.
37 *Strangi,* 2005 WL 1660817, at *11.

A. *The Retained Interest Under I.R.C. §2036*

The Fifth Circuit Court of Appeals agreed with the Tax Court's determination that Strangi retained the right to possess and to enjoy the transferred assets and the right to the income from the transferred assets, in violation of I.R.C. §2036(a)(l).[38] The Tax Court found an implied agreement between Strangi and Mr. Gulig that the transferred assets and related income would be available to Strangi if he needed them.[39] Such an implied agreement is considered to be the retention of the right to possession of or income from the property or both, leading to estate-tax inclusion under I.R.C. §2036(a)(l).[40] The Tax Court indicated that it was unlikely that an individual in poor health would transfer 98% of his assets without such an implied agreement.[41] In making this determination, the court looked at a number of factors, noting that Strangi's relationship to his assets remained essentially unchanged after the transfer, he remained in his residence rent-free after it was transferred to the partnership, and significant assets were transferred from the partnership for Strangi's benefit, including significant distributions for Strangi's home health care costs, funeral and estate administration expenses, and estate taxes.[42] Strangi's lack of liquid assets following the transfer to SFLP also supported such an argument, given that he retained barely sufficient assets to meet his living expenses for the lowest estimate of his remaining life expectancy, not including costs for rent, payment of personal debts, funeral expenses or taxes.[43] Given these findings, the Fifth Circuit held that the Tax Court did not err in finding an implied agreement between Strangi and his children, and, therefore, that Strangi retained possession or enjoyment of the transferred assets within the meaning of Code §2036(a)(l).[44]

Although the Fifth Circuit decided the *Strangi* case under I.R.C. §2036(a)(l) and therefore did not consider the possible application of I.R.C. §2036(a)(2),[45] the Tax Court's analysis of the I.R.C. §2036(a)(2) issue is equally important from a planning perspective. The Tax Court concluded that Strangi had retained the right to designate the person who would possess or enjoy the transferred assets and the income from the assets, leading to inclusion under I.R.C. §2036(a)(2).[46] This conclusion was surprising, because of the Tax Court's interpretation of the application of a U.S. Supreme Court case, *U.S. v. Byrum.*[47]

In *Byrum,* the U.S. Supreme Court held that I.R.C. §2036(a)(2) did not require inclusion of closely held stock that had been transferred to a family trust, despite the fact that the transferor retained the right to vote the stock and elect the

[38] *Id.* at *6.
[39] *Strangi*, 2003 WL 21166046, at *10.
[40] Treas. Reg. §20.2036-1 (a).
[41] *Strangi,* 2003 WL 21166046, at *10.
42. Id. at 10-11.
[43] *Strangi,* 2005 WL 1660817, at *6.
[44] *Id.*
[45] The Fifth Circuit held that, because it had determined that Code §2036(a)(l) applied, there was no need to consider the Commissioner's alternative argument under Code §2036(a)(2). *Id.* at *6, lh. 7.
[46] *Strangi,* 2003 WL 21166046, at *16.
[47] U.S. v. Byrum, 408 U.S. 125 (1972).

directors who would authorize dividends.[48] The right to require distributions was not legally enforceable because, as a majority shareholder, Byrum had a fiduciary duty not to misuse his power by promoting his personal interests at the expense of corporate interests.[49] Further, the customary changes in the business cycle, including years of declining earnings, new competition and litigation, created a level of unpredictability with regard to earnings that further eroded the argument that Byrum had a right to control distributions.[50]

The Tax Court distinguished the situation in *Strangi* from that in *Byrum.* First, the court determined that, unlike the situation in *Byrum,* Strangi had an absolute right to determine who would enjoy the income from the transferred assets because Gulig, his attorney-in-fact, was authorized under the management agreement to declare distributions for SFLP and (with the other directors) dividends from Stranco.[51] Further, Strangi, again acting through Mr. Gulig, could terminate SFLP and cause a distribution of the partnership assets to the partners.[52] While this power could not be exercised by Strangi alone, §2036(a)(2) specifically applies whether the power is exercisable alone or in conjunction with others.[53]

The Tax Court also noted that *Strangi* is different from *Byrum,* because the things that prevented the transferor in *Byrum* from exercising his power to compel dividends were not present in the *Strangi* case.[54] In *Strangi,* there was no active business enterprise involved, so the normal variations in earnings argument would not apply.[55] Further, neither distributions from SFLP or dividends from Stranco were subject to the approval of an independent party (such as the independent trustee of the family trust in *Byrum).*[56] Finally, the Tax Court noted that Mr. Strangi was not subject to the fiduciary duty limitations, because of the related nature of the parties involved; unlike *Byrum,* which involved a number of unrelated shareholders and trust beneficiaries, in *Strangi,* all of the participants were Strangi's close relatives.[57] In such a case, the Tax Court found that the likelihood of the shareholder-children enforcing their rights under the fiduciary duty provisions was very small.[58]

B. *The Bona Fide Sale Exception*

The Fifth Circuit also agreed with the Tax Court, finding that the bona fide sale exception was inapplicable.[59] Under this exception, a transaction in which a prohibited interest is retained does not result in estate-tax inclusion if the transaction

[48] *Byrum*, 408 U.S. at 126-127.
[49] *Id.* at 143-144.
[50] *Id.* at 149.
[51] *Strangi,* 2003 WL 21166046, at *14.
[52] M.
[53] 1.R.C. §2036(aX2).
[54] *Strangi,* 2003 WL 21166046, at *14.
[55] /rf. at 15.
[56] *Id.*
[57] *Id.*
[58] *Id.*
[59] *Strangi,* 2005 WL 1660817, at *7.

was "a bona fide sale for an adequate and full consideration in money or money's worth."[60] This exception requires two elements: (1) a bona fide sale, and (2) adequate and full consideration.[61] These two elements are discussed in reverse order below.

1. Adequate and Full Consideration

The adequate and full consideration element is considered met where assets are transferred into a partnership in exchange for a proportional interest in the partnership, as long as the formalities of the partnership are respected.[62] As the Fifth Circuit noted in *Kimbell,* the adequate and full consideration analysis should focus on three concerns: (1) whether the interests credited to each of the partners was proportionate to the fair market value of the assets each partner contributed to the partnership; (2) whether the assets contributed by each partner were properly credited to their respective partnership capital accounts; and (3) whether on termination or dissolution of the partnership, the partners were entitled to distributions equal to their respective capital accounts.[63] These formalities were followed in *Kimbell,* leading to the conclusion that the transfer was for adequate and full consideration.[64]

In *Strangi,* the IRS conceded that the formalities were properly followed.[65] Therefore, the question becomes whether the transaction was a "bona fide sale."[66]

2. Bona Fide Sale

The Tax Court found that the Strangi transaction was not a bona fide sale, because it was not an arm's-length transaction.[67] Specifically, the Tax Court found that there was no meaningful negotiation or bargaining with other interest holders.[68] Strangi, through Mr. Gulig, determined how the entities would be structured, how they would be operated, what property would be contributed, and what interests the various parties would have; the transaction was one in which, for all practical purposes, Strangi was on both sides of the transaction.[69]

The Fifth Circuit took a different approach, based largely on its decision in the *Kimbell* case, in which the court held that a sale is bona fide if it objectively

[60] I.R.C. §2036 (parenthetical).
[61] Estate of Harper v. Commissioner, T.C. Memo 2002-121.
[62] *Strangi,* 2005 WL 1660817, at *7; Kimbell v. United States, 371 F.3d 257,266 (5th Cir. 2004).
[63] *Kimbell,* 371 F.3dat266.
[64] *Id.* at 266-267.
[65] Strangi, 2005 WL 1660817, at *7.
[66] *Id.*
[67] *Strangi,* 2003 WL 21166046, at 16.
[68] *Id. Cf.* Estate of Stone, T.C.M. (RIA) 2003-309, at 10, in which the other partners in the family limited partnership (the decedent's children) were actively involved in the negotiation of the structure of the partnership.

[69] *Strangi,* 2003 WL 21166046, at 17.

serves a substantial business or other non-tax purpose.[70] The Strangi estate offered five non-tax reasons to support Strangi's transfer of assets to SFLP, including protecting against potential tort litigation by a former housekeeper, deterring a possible will contest, creating a joint investment vehicle for the partners, and permitting centralized management of working assets Strangi owned.[71] The Tax Court reviewed each of the estate's claims and found them either unlikely (in the case of the first two), de minimis (in the case of the investment by the other partners in the joint investment vehicle), and not supported by the facts (in the case of the management of working assets).[72] The Fifth Circuit found that the Tax Court's determinations were not clearly erroneous.[73] More important from a planning perspective, the Fifth Circuit reiterated that the question of whether a particular rationale serves a substantial business or non-tax purpose is made on an objective basis rather than a subjective basis.[74] The Tax Court's approach in *Strangi* would seem to indicate a more discerning examination of these non-business purposes than prior cases would suggest.

IV. THOMPSON V. COMMISSIONER

Three years after its first opinion in *Strangi,* the Tax Court considered the case of *Thompson* v. *Commissioner. Thompson* involved the estate tax due on the estate of Theodore Thompson.[75] In 1993, Mr. Thompson set up two family limited partnership transactions with his son and daughter.[76] In late April, Mr. Thompson formed the Turner Partnership with his daughter and son-in-law.[77] In exchange for assets contributed, Mr. Thompson received a 95.4% limited partnership interest in the Turner Partnership.[78] His daughter and son-in-law received a 3.54% limited partnership interest, primarily in exchange for real property they contributed.[79] The parties also formed Turner Corporation, which owned a 1.06% general partnership interest.[80] Turner Corporation was owned 49% by Mr. Thompson, 24.5% by his daughter, 24.5% by his son-in-law, and 2% by an unrelated not-for-profit entity.[81]

Nine days later, Mr. Thompson entered into a similar transaction with his son, forming the Thompson Partnership.[82] In this transaction, Mr. Thompson and his son received 62.27% and 36.72% limited partnership interests, respectively, and a

[70] *Strangi,* 2005 WL 1660817, at *7, citing *Kimbell*, 371 F.3d at 267.

[71] *Strangi,* 2005 WL 1660817, at *8.

[72] *Id.* at *8-*9.

[73] *Id.* at *8-*9

[74] *Id.* at *7; *Kimbell,* 371 F.3d at 267.

[75] *Estate of Thompson,* 382 F.3d at 369.

[76] *Id.* These transactions were created under an estate plan offered by the Fortress Financial Group, the same estate_planning strategy that was the basis of the family limited partnership transaction at issue in the *Strangi* case. *See Strangi,* 2003 WL 21166046, at *17.

[77] *Thompson,* 382 F.3d at 370.

[78] *Id.*

[79] *Id.*

[80] Id.

[81] Id.

[82] Id.

1.01% general partnership interest was owned by Thompson Corporation, which in turn was owned 49% by Mr. Thompson, 49% by his son, and 2% by an unrelated third party.[83]

In these two transactions, Mr. Thompson transferred a total of $2,800,000, including $2,500,000 in marketable securities, retaining only $153,000 in personal assets, despite having only $14,000 in annual income from annuities and Social Security and annual expenses of more than $57,000.[84] At the time, he was 95 years old, with a life expectancy of 4.1 years.[85]

Approximately two years later, Mr. Thompson died at age 97.[86] In filing his estate-tax return, the estate included a 40% discount for lack of control and marketability, valuing his interest in the Thompson Partnership at $875,811, his interest in the Thompson Partnership at $837,691, and his interest in the shares of Thompson Corporation and Thompson Corporation at $5,190 and $7,888, respectively.[87]

In early 1999, the IRS issued a Notice of Deficiency of $707,054, based primarily on disallowance of the discount on the partnership interests, under a I.R.C. §2036(a) theory.[88] Specifically, the Service claimed that Mr. Thompson retained control and enjoyment over the transferred assets, based on an implied agreement that Mr. Thompson would have the economic benefit of the assets after transfer.[89]

As they did in *Strangi,* the Tax Court held in *Thompson* that I.R.C. §2036(a)(l) applied under the implied agreement theory.[90] The Tax Court found that an implied agreement existed for several reasons. First, in investigating the transaction, Mr. Thompson's children sought assurances that he would be able to withdraw funds in order to make gifts, and the partnerships did in fact make such distributions.[91] Second, Mr. Thompson transferred almost all of his wealth in the transaction, and such a transfer could be explained only if an implied agreement existed.[92] Finally, the Tax Court noted that nothing but legal title changed in Mr. Thompson's relationship with his assets, and the partnerships were more in the nature of an estate plan than any type of arm's length joint enterprise between partners.[93] The Tax Court also determined that the transfer was not a "bona fide sale for adequate and full consideration," which would have exempted it from the application of I.R.C. §2036(a), based on its finding that the partnerships were a vehicle for changing the form in which the decedent held his property—what the Tax

[83] *Id.*
[84] *Id.*
[85] *Id.*
[86] *Id.* at 372.
[87] *Id.*
[88] *Id.* at 372-373.
[89] *Id.* at 373.
[90] *Id.*
[91] *Id.*
[92] *Id.*
[93] *Id.*

Court called a "mere 'recycling of value'" that is insufficient to constitute full and adequate consideration.[94]

On appeal, the Third Circuit Court of Appeals considered both the applicability of I.R.C. §2036(a)(l) and the bona fide sale exception.

A. *The Applicability of I.R.C. §2036*

First, the Third Circuit examined the Tax Court's finding that I.R.C. §2036(a)(l) applied to the transactions. In doing so, the Third Circuit found that there was no clear error in the Tax Court's finding of an implied agreement.[95] The court found support for this finding in the facts that Mr. Thompson transferred 95% of his assets when he was 95 years old, that he did not retain sufficient assets to support himself, and that his children anticipated and prepared for his likely need to receive distributions from the partnerships in order to support himself.[96]

In response, the Thompson estate argued that, because the distributions complied with the formalities of partnership operations, an inference that he retained control over the assets transferred was not supported.[97] The Third Circuit noted that the practical effect of the change in form of ownership was minimal; while the structure required that he follow certain formalities in receiving distributions, it was clear from the operation of the partnerships and from the testimony of his children that he would not have been denied a distribution.[98] Again, the court noted, nothing beyond formal title changed in Mr. Thompson's relationship with his assets.[99]

Finally, the court found that the testamentary nature of the transaction supports an inference of an implied agreement.[100] The partnerships did not operate like a business; with one exception, they did not engage in business or loan transactions with anyone outside the Thompson family.[101] Thus, the Third Circuit found, their operation was more consistent with an estate plan than with an investment in a business.[102]

B. *The Bona Fide Sale Exception*

The Third Circuit also considered the applicability of the bona fide sale exception. According to the Third Circuit, this exception requires both a "transfer for consideration" and that the transfer constitute a "bona fide sale."[103]

The Third Circuit agreed with the Tax Court that the transaction did not involve a transfer for consideration, because the partnerships were not engaged in

[94] *Id.* at 373-374.
[95] *Id.* at 376, *citing* Thompson v. Commissioner, 84 T.C.M. (CCH) 374, 387 (2002).
[96] *Estate of Thompson,* 382 F.3d at 366.
[97] *Id at* 366-367.
[98] *Id.*
[99] *Id.*
[100] *Id.*
[101] *Id.*
[102] *Id.*
[103] *Estate of Thompson,* 382 F.3d at 378,381.

legitimate business operations to any significant extent[104], but rather were merely vehicles for changing the form of ownership.[105] The Third Circuit was also concerned that the assets transferred consisted primarily of marketable securities.[106] As the court noted, there is little benefit to be derived from holding an untraded portfolio of securities in partnership form other than the favorable estate-tax treatment resulting from the formation of the partnerships.[107]

The Third Circuit also noted that the transaction was not a "bona fide sale."[108] While the court refused to categorically require an "arm's length transaction" in order to be a bona fide sale,[109] it did require that the transaction be made in "good faith."[110] Such a transaction must provide some potential benefit for the transferor, besides just the estate-tax savings from holding assets in partnership form.[111] Because neither partnership provided Mr. Thompson with any such benefit, the Third Circuit agreed with the Tax Court that the transaction did not involve a bona fide sale.[112]

V. ESTATE PLANNING LESSONS FROM STRANGI AND THOMPSON

The lessons to be drawn from these cases fall into two categories: (1) the factual similarities between the cases and their planning implications, and (2) the application of the bona fide sale exception under I.R.C. §2036(a).

A. *Factual Similarities and Their Planning Implications*

The first lessons can be drawn from the factual similarities between *Thompson* and *Strangi.* Both cases involved a family limited partnership established by a very elderly individual who died within a relatively short period of time after the transaction. Likewise, in both cases, the taxpayer transferred almost all of his wealth, consisting primarily of marketable securities, to the family limited partnership, retaining very little wealth for his ongoing living expenses, and in both cases the partnerships made distributions to the taxpayer to fund those living expenses. Further, in both cases, the partnerships did not engage in any significant business activities, providing no benefits to the taxpayer beyond the potential estate- tax savings the transactions provided. Thus, in both cases, the primary motivation for

[104] As the court noted, while the partnership did conduct some economic activity, including entering into a lease of a ranch in Colorado and making loans to family members, these transactions did not "rise to the level of legitimate business operations." *Id.* at 379.

[105] *Id.* at 378-379, *citing* Estate of Harper v. Commissioner, T.C. Memo 2002-121 (2002) and Strangi, 85 T.C.M. (CCH) 1331 (2003).

[106] Estate of Thompson, 382 F.3d at 379.

[107] *Id. at* 379-381.

[108] *Id.* at 381.

[109] Some prior cases had suggested such a requirement. *See, e.g.,* Estate of Harper, T.C. Memo 2002-121 (2002).

[110] *Estate of Thompson,* 382 F.3d at 385.

[111] *Id.*

[112] Id.

the family limited partnership transaction was tax savings. Each of these similarities contributed significantly to the findings by the Fifth Circuit in *Strangi* and the Third Circuit in *Thompson* that I.R.C. §2036(a)(l) applied to the transaction.[113]

For planning purposes, establishing an objective non-estate-tax reason for the transaction is critical. Moreover, both *Strangi* and *Thompson* suggest that the courts will examine such purported reasons more closely and with greater skepticism than in the past. It is also very important to give serious consideration to the assets to be contributed; where the assets consist primarily of marketable securities, it will be more difficult to establish a non-tax reason for the transaction, and, at the very least, the courts will scrutinize such transactions more carefully. Finally, the amount of wealth transferred is very important. Clients should not transfer such a large percentage of their wealth that they do not retain sufficient assets on which to live; such a transfer clearly invites an argument that there is an implied agreement that the transferred assets will be available for the taxpayer's future needs.

B. *Application of the Bona Fide Sale Exception*

The second lesson that can drawn from *Thompson* and *Strangi* involves the application of the bona fide sale exemption under I.R.C. §2036(a). Taken together, these cases demonstrate that the bona fide sale exemption has two distinct parts. First, it requires that the transaction involve a transfer for fair and adequate consideration. This requirement, in turn, involves two different aspects: a transfer for consideration and "fair and adequate" consideration. The exemption also requires that the sale be "bona fide." Each of these three aspects of the exemption is discussed further below.

1. Transfer for Consideration

The first requirement is that the transaction involve a transfer for consideration. This requires that the transaction be motivated by legitimate business concerns.[114] Where the family limited partnership does not reflect legitimate business concerns and fails to involve business activities outside the family and the partners, the Tax Court has found that such partnerships serve as a "vehicle for changing the form in which the decedent held his property—a mere recycling of value."[11] Where the transaction involves the transfer of a functioning business, there are additional "intangibles" that would make the transaction more than just a recycling of value.[116]

[113] In contrast, the facts in *Stone* were significantly different. In *Stone,* the family limited partnership transaction was motivated not by tax savings, but rather by an attempt to settle intra-family disputes; the decedents retained significant assets to maintain their standard of living; and the assets they contributed to the partnership consisted primarily of ongoing business assets, rather than marketable securities. Thus, the partnership structure provided a way to resolve the family disputes and, at the same time, provided a succession plan for the family business. *See* Stone, T.C. Memo 2003-309. These differences clearly played a significant role in the different results obtained by the taxpayers in the *Stone* case.

[114] *Estate of Thompson,* 74 T.C.M. (CCH) at 388.

[115] *Id.* This recycling of value concept first appeared in Estate of Harper, T.C. Memo 2002-121.

[116] *Strangi,* 85 T.C.M. at 1344.

Such intangibles are not present where there is a lack of legitimate business activities.[117] This concept of "intangibles" also factors into the second requirement, that the consideration received in the transaction be "fair and adequate."

2. Fair and Adequate

One significant motivation for most family limited partnership transactions is the estate-tax benefits that accrue from the transaction. These valuation benefits stem from the valuation discounts that result from exchanging assets for partnership interests that are subject to valuation discounts, because of lack of control and lack of marketability.[118] In many cases, including the Thompson case, such discounts can be as high as 40% of the value of the underlying assets transferred.[119]

The 1RS has argued that these discounts should result in a finding that the transfer was not for fair and adequate consideration. As the Third Circuit recognized, where assets are transferred in exchange for assets of lesser value, it seems reasonable to conclude that there is no transfer for adequate and full consideration, because the estate is not replenished with other assets of equal value.[120] This concept recognizes, and the 1RS has frequently argued, that such an exchange of assets results in a dissipation of value in the estate that should result in a determination of inadequate consideration.[121]

While this argument is logical and holds some appeal, especially where the assets transferred are marketable securities, both the Tax Court and the Fifth Circuit have held that this dissipation of value theory will not automatically constitute inadequate consideration for purposes of I.R.C. §2036(a).[122] In many of these cases, the Tax Court has applied the "intangibles" concept, indicating that the discount in valuation may be made up by the "potential for intangibles stemming from pooling for joint enterprise," and, in such cases, the partnership interests may in fact constitute full and adequate consideration.[123] Further, the Fifth Circuit seems to indicate in *Strangi* that the fair and adequate consideration issue turns on whether the partnership formalities have been followed.[124]

The Third Circuit took the Tax Court's intangibles analysis one step further. While the Third Circuit did not disagree with the Tax Court on the possibility of intangibles entering into the equation, it did indicate that such a dissipation of value should trigger heightened scrutiny into the substance of the transaction and, where the record demonstrates no legitimate business concerns and a valuation discount

[117] *Cf* Stone, T.C. Memo 2003-309, at 32-34.
[118] *See supra* notes 9-10 and accompanying text.
[119] *Estate of Thompson,* 382 F.3d at 381.
[120] *Id.*
[121] *See* Estate of Harper, 83 T.C. Memo 2002-121.
[122] *See Kimbell,* 371 F.3d at 266; Stone, T.C. Memo 2003-309, at 33-34.
[123] Estate of Harper, 83 T.C.Memo 2002-121.
[124] *Strangi, 2005* WL 1660817, at *7; *Kimbell,* 371 F.3d at 266.

that is the only benefit for converting liquid assets into partnership interests, the exception under I.R.C. §2036(a) should not apply.[125]

3. Bona Fide Sale

The final requirement is that the transaction constitute a bona fide sale. In *Thompson,* the IRS argued that the transaction did not constitute a bona fide sale, because the decedent acted on both sides of the transaction and a bona fide sale requires an arm's length bargain.[126] The IRS has made this argument for a requirement of an arm's length transaction in several cases, including *Harper*[127] and *Strangi.*[128]

The Third Circuit recognized, however, that while an arm's length transaction provides good evidence of a "bona fide sale," it is not necessarily required. The court noted that neither the Internal Revenue Code nor the governing Treasury Regulations contain such a requirement.[129] There is also a difference between cases such as *Harper* and *Strangi,* where the decedent was the only party with any significant involvement in the transaction, and cases such as *Thompson*, where both the formation and the funding of the partnerships involved participation by family members and their spouses.[130]

While the bona fide sale requirement does not necessarily require an "arm's length transaction," it does require that it be made in good faith.[131] In order to be made in good faith, a transfer must provide the transferor a potential benefit other than the potential estate-tax advantages.[132] Where there is no business purpose for the partnership, the transfer will not be considered to be made in good faith for purposes of I.R.C. §2036.[133] Again, the business purpose is a critical element for a successful family limited partnership transaction. Taxpayers considering such transactions must carefully consider the non-tax business purposes behind the transaction.

VII. Conclusion

The IRS's assault on family limited partnership transactions is very likely to continue. Its recent successes in cases such as *Thompson* and *Strangi* suggest that the courts are receptive to arguments that I.R.C. §2036 applies in such cases. On the other hand, these cases do not, as some commentators have suggested, suggest the

[125] *Estate of Thompson,* 382 F.3d at 381.
[126] *Id.*
[127] *Estate of Harper,* 83 T.C.M. at 1653 (finding the I.R.C. §2036 exception inapplicable, because there was no arm's length bargain where decedent stood on both sides of the transaction).
[128] *Strangi,* 85 T.C.M. at 1343 (decedent stood on both sides of the transaction), *citing* Bank of New York v. United States, 526 F.2d 1012 (3d Cir. 1975).
[129] *See* Treas. Reg. §20.2036-l(a).
[130] *Estate of Thompson,* 382 F.3d at 382.
[131] *Id.* at 45, *citing* Treas. Reg. §20.2043-1 (a); *Strangi,* 2005 WL 1660817, at *7.
[132] *Estate of Thompson,* 382 F.3d at 382.
[133] *Id;, cf. Kimbell,* 371 F.3d at 267.

demise of family limited partnerships as an estate planning strategy. Rather, these cases provide valuable lessons for practitioners and clients regarding the use of family limited partnerships. These cases suggest that, if properly structured and implemented for the right reasons, family limited partnerships still serve as a viable estate planning strategy.