Closely Held Business Succession Planning: How a Family Limited Partnership Can Still Work to Your Advantage In Spite of Section 2036

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Family limited partnerships are an effective succession planning tool that can allow business owners to safely pass on their businesses to younger generations. The gross estate will only include a discounted interest in the FLP instead of the full value of the assets transferred. Despite recent scrutiny from the Internal Revenue Service, these partnerships can still be utilized as long as they are structured correctly to withstand a § 2036 attack. In order to retain the most control, the business owner should ensure that any transfers of property into the FLP are bona fide transactions and are for full and adequate consideration. Otherwise, the business owner must give up any retention of possession of or control over the assets in order to keep the assets' full values out of the gross estate.

I. INTRODUCTION

A Family Limited Partnership is "a limited partnership in which members of a family hold all or substantially all of the interests."[1] FLPs can be a useful succession tool for any kind of owner of a family business looking to pass the business on to younger generations; they are useful to wealthy business owners and very small business owners alike as a means of tax savings and business succession planning. The business owner transfers business assets into the FLP in exchange for an interest in the partnership, upon which the business owner can achieve tax savings through valuation discounts. The value of the transferred assets will often

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[1] Katherine D. Black, Stephen T. Black & Michael D. Black, *When a Discount Isn't a Bargain: Debunking the Myths Behind Family Limited Partnerships*, 32 U. MEM. L. REV. 245, 249 (2002). The Uniform Limited Partnership Act defines a limited partnership as a partnership consisting of "one or more general partners and one or more limited partners . . . . " UNIFORM LIMITED PARTNERSHIP ACT § 102-11 (2001). A partnership, under the Uniform Partnership Act, "means an association of two or more persons to carry on as co-owners a business for profit . . . . " UNIFORM PARTNERSHIP ACT § 101-6 (1997).

be higher than the value of the interest, allowing the owner's gross estate to be less than it would have been had he kept the assets until his death.[2]

This use of FLPs, however, has come under scrutiny from the Internal Revenue Service ("IRS"), which has begun utilizing 26 U.S.C. § 2036 to attack these partnerships. Despite this, FLPs can still be utilized in an effective manner that courts will recognize.

In regard to family businesses, "courts have recognized FLPs and other limited liability entities as bona fide arrangements when used to facilitate a smooth transition of management and ownership of an operating business among older and younger family members."[3] In order for an FLP and the subsequent tax savings to be recognized by the IRS, a business owner must be willing to give up some control of the business, treat the younger generation as true partners and co-owners, and allow the younger generation to begin to participate in the management.[4] The key to making an FLP work is that the asset transfer should be a bona fide sale for a business purpose and only proportionate interest in the FLP should be received.

II. BACKGROUND

A. *Traditional Uses of FLPs in Succession Planning*

Upon death, the business owners' assets, including any interest they have in an FLP, will be valued at fair market value and included in their gross estate. The fair market value is defined ordinarily as "the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of relevant facts."[5] The amount agreed upon by a willing buyer and seller for interest in an FLP, however, will be reduced by marketability discounts and control discounts.[6] These discounts can reduce the value of the owner's interest as much as 90%.[7]

The first type of reduction in the fair market value of an FLP interest is the marketability discount. This reduction is based on the quality

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[2] In addition to succession planning, this consequence, obviously, has estate planning benefits as well.

[3] Bradford Updike, *Making Sense of Family Limited Partnership Law After Strangi and Stone: A Better Approach to Planning and Litigation Through the Bona Fide Transaction Exception,* 50 S.D. L. REV. 1, 2 (2005).

[4] *Id.* at 1-2.

[5] Thomas Earl Geu, *Selected Estate Planning Aspects of the Uniform Limited Partnership Act (2001),* 37 SUFFOLK U. L. REV. 735, 761 (2004).

[6] Brett R. Bissonnette, Comment, *Getting It Right: Avoiding the Seven Deadly Sins in the Formation and Management of the Family Limited Partnership*, 30 OHIO N. U. L. REV. 59, 62-63 (2004).

[7] Michael E. Kitces, *Knockout Blow?*, Oct. 1, 2005, http://www.financial-planning.com/pubs/fp/20051001024.html.

of the taxpayer's interest.[8] This discount applies to valuing interest in an FLP because there is "no readily accessible market" for FLP interests.[9] As a result, there is an "increase [in] ownership risks associated with interests in closely held businesses because it is more difficult to liquidate those interests quickly."[10] It is more difficult to liquidate closely held business interests quickly because there are fewer potential purchasers, whereas publicly traded companies have many potential purchasers on the open market.[11]

The second discount is the control discount, which is based on the quantity of interest that the taxpayer owns.[12] This discount is applied to valuing an interest in an FLP because there is a lack of control in the day-to-day operations that accompanies owning a minority interest.[13] In fact, anyone owning less than a majority interest obviously cannot have control over the management of the FLP assets.[14] The IRS has recognized that these discounts are available "even in family owned entities where the minority interest discount is based upon voting control" as long as the entity is formed for a legitimate business purpose and the formation is not temporally proximate to the business owner's death, which would allude to formation for testamentary reasons and tax evasion purposes only.[15]

For a simple example of how this process works, assume the business owner transfers $99,000 worth of business assets into an FLP in exchange for a 99% limited interest. The business owner's son and daughter collectively transfer $1,000 worth of assets into the same FLP in exchange for a 1% general interest. Upon the owner's death, his interest in the FLP is given a 50% discount (25% discount for lack of marketability and 25% discount for lack of control). Included in his gross estate is the interest valued at $49,500 instead of the $99,000 value of the transferred assets.

B. *IRS Subjecting Traditional Use for FLPs to Stricter Scrutiny*

It is important to note that because FLPs involve intra-family transactions, they will be subject to heightened scrutiny by the IRS and the courts.[16] There is a presumption that transactions among family members are not arm's length transactions, so the burden is on the taxpayer to prove

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[8] Bissonnette, *supra* note 6, at 63.
[9] Geu, *supra* note 5, at 790.
[10] *Id.*
[11] Russell Stanaland, Note, *Valuation Discounts After Estate of Nowell v. Commissioner: A Clear Formula for Reducing Estate Taxes*, 30 GOLDEN GATE U. L. REV. 679, 688 (2000).
[12] Bissonnette, *supra* note 6, at 63.
[13] Black et al., *supra* note 1, at 256.
[14] Stanaland, *supra* note 11, at 687.
[15] Black et al., *supra* note 1, at 257.
[16] *Id.* at 267.

that there has been an arm's length transaction should the IRS challenge it.[17] FLPs have come under attack recently by the IRS because of this presumption, and § 2036 is one way that the IRS has successfully disallowed tax savings from FLPs to occur.[18] Briefly, this statute will include the actual value of the assets that have been transferred into an FLP in the decedent's gross estate instead of the value of the decedent's interest in the FLP.[19] This can result in a difference of millions of dollars, depending upon the size of the estate. Unless the transfer of the assets into the FLP was a bona fide transaction for full and adequate consideration, the value of the assets in the FLP will be included when the decedent has retained possession, enjoyment, and control of the transferred assets.[20]

A recent example of a case where the IRS has attacked an FLP via § 2036 is *Estate of Strangi v. Commissioner*.[21] Throughout this note, this case will be used to demonstrate the courts' and the IRS's analysis of the different sections of § 2036 and how it can be used to bring previously transferred assets back into the gross estate of a decedent, essentially disregarding the FLP.

It will be helpful to outline a brief background of the facts of this case. In *Strangi*, the decedent formed Stranco, Inc. (Stranco) and the Strangi Family Limited Partnership (SFLP) under the guidance and counsel of his attorney in fact and son-in-law, Mr. Gulig.[22] The decedent owned

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[17] *Id.*

[18] 26 U.S.C. § 2036 (2000). Although the focus of this article is § 2036, there are other sections of the Internal Revenue Code that can be used by the IRS to attack the validity of FLPs, such as §§ 2701 – 2704, which "operate to disregard the value of certain interests for transfers between family members." Geu, *supra* note 5, at 774-75. For example, § 2703 will not allow any discount attributable to a restriction unless said restriction meets all three of the following conditions: (1) "[i]t is a bona fide business arrangement"; (2) "[i]t is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth"; and (3) "[i]ts terms are comparable to similar arrangements entered into by persons in an arms' length transaction." 26 U.S.C. § 2703 (2000); Geu, *supra* note 5, at 771.

[19] 26 U.S.C. § 2036 (2000). Under § 2033, "[t]he value of the gross estate shall include the value of all property *to the extent of the interest therein* of the decedent at the time of his death." 26 U.S.C. § 2033 (2000) (emphasis added). This allows the decedent to only have to include the value of his interest in an FLP in his gross estate unless the transfer of his property into the FLP falls within § 2036.

[20] 26 U.S.C. §2036 (2000).

[21] Estate of Strangi v. Comm'r, 115 T.C. 478 (2000) [hereinafter *Strangi I*]; Estate of Strangi v. Comm'r, 85 T.C.M. (CCH) 1331 (2003) [hereinafter *Strangi II*]; Estate of Strangi v. Comm'r, 417 F.3d 468 (5th Cir. 2005) [hereinafter *Strangi III*]. The tax court originally held that the IRS could not amend its complaint to include a § 2036 assertion. This decision was overruled and remanded back to the tax court for a decision on whether § 2036 applied to this situation. Upon remand, the tax court found that § 2036 does apply and the FLP is not recognized. This decision was then affirmed by the appellate court.

[22] *Strangi I*, 115 T.C. at 480-81.

47% of Stranco and a 99% limited partnership interest in SFLP.[23] Stranco owned a 1% general partnership interest in SFLP and had the sole authority to run the affairs of SFLP.[24] Decedent's children purchased the remaining 53% interest in Stranco.[25] Mr. Gulig, decedent's attorney in fact, was employed to manage the daily operations of Stranco and SFLP.[26] Therefore, the corporation of which the decedent owned 47% held the only general partnership interest in the FLP. In *Strangi*, the court held that the FLP could not be recognized because of § 2036.

III. SECTION 2036: TRANSFERS WITH RETAINED LIFE ESTATE

Section 2036 is designed to include in a decedent's gross estate inter vivos transfers that are testamentary in nature.[27] The Code section provides, in part, the following:

> (a) 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-
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> (1) the possession or enjoyment of, or the right to the income from, the property, or
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> (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.[28]

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[23] *Id.* at 481.
[24] *Id.*
[25] *Id.*
[26] *Id.* at 482.
[27] Estate of Thompson v. Comm'r, 382 F.3d 367, 375 (3d Cir. 2004). *See also* United States v. Grace, 395 U.S. 316, 320 (1969) ("The general purpose of the statute was to include in a decedent's gross estate transfers that are essentially testamentary."); Estate of D'Ambrosio v. Comm'r, 101 F.3d 309, 312 (3d Cir. 1996) ("Section 2036(a) effectively discourages manipulative transfers of remainder interests which are really testamentary in character by 'pulling back' the full, fee simple value of the transferred property into the gross estate . . . .").
[28] 26 U.S.C. § 2036 (2000).

A. *Section 2036(a)(1)*

Section 2036(a)(1) forces an estate to include, in the gross estate, transfers made within the decedent's lifetime where the decedent retained "the possession or enjoyment of, or the right to the income from, the property . . . ."[29] This possession, enjoyment, or right can be an express or an implied agreement at the time of transfer between the transferor and the transferee.[30]

1. Retained Possession or Enjoyment

"[A] transferor retains the enjoyment of property if there is an express or implied agreement at the time of the transfer that the transferor will retain the present economic benefits of the property, even if the retained right is not legally enforceable."[31] Possession or enjoyment is said to be retained if the decedent retains "substantial present economic benefit."[32] When considering whether there is an implied agreement that the transferor will retain possession or enjoyment of the transferred property, the court will consider the following factors: (1) whether the transfer included the majority of the decedent's assets; (2) the continued occupation (such as of a house) of transferred property; (3) whether there was a commingling of personal and entity assets; (4) whether there were disproportionate distributions issued by the FLP; (5) whether FLP funds were used for personal expenses; and (6) whether the transaction had testamentary characteristics.[33] This implied agreement must be contemporaneous with the transfer of property.[34]

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[29] *Id.*

[30] *Thompson,* 382 F.3d at 375. *See also Strangi II,* 85 T.C.M. (CCH) at 1336 ("An interest or right is treated as having been retained or reserved if at the time of the transfer there was an understanding, express, or implied, that the interest or right would later be conferred.") (quoting Estate Tax Reg. § 20.2036-1(a)); Estate of McNichol v. Comm'r, 265 F.2d 667, 671 (3d Cir. 1959); Black et al., *supra* note 1, at 279 ("For purposes of section 2036(a), a transferor retains the enjoyment of property if there is an express or implied agreement at the time of the transfer that the transferor will retain the present economic benefits of the property, even if the retained right is not legally enforceable . . . . ").

[31] Estate of Reichardt v. Comm'r, 114 T.C. 144, 151 (2000).

[32] *Strangi III,* 417 F.3d at 476 (quoting United States v. Byrum, 408 U.S. 125, 145, 150 (1972)).

[33] *Strangi II,* 85 T.C.M. (CCH) at 1383.*See also* Guynn v. United States, 437 F.2d 1148, 1149 (1971) (finding that a house that was conveyed by mother to daughter was included in mother's gross estate because mother lived alone in the house until her death with an implied understanding that this would occur until mother's death); Estate of Harper v. Comm'r, 83 T.C.M. (CCH) 1641, 1648-52 (2002) (finding that assets were includable in gross estate where the decedent commingled personal and partnership funds, there was a history of disproportionate distributions to the decedent, and the transaction had testamentary characteristics); Estate of Trotter v. Comm'r, 82 T.C.M.

In *Strangi*, the Court concluded that the decedent met many of these factors that are indicative that possession or enjoyment of the transferred property was retained. The decedent transferred 98% of all of his property to Stanco and SFLP.[35] The Court explained that this showed an implied agreement that decedent would rely on Stranco and SFLP to meet his standard of living.[36] The decedent also continued to live in his residence even though he had transferred it to the SFLP.[37] Although he was required to pay rent, the rent owed was allowed to accrue for more than two years,[38] indicating retained possession or enjoyment, and the court noted that mere accounting adjustments "are of small moment in belying the existence of an agreement for retained possession and enjoyment."[39] The *Strangi* Court also noted that the SFLP paid for decedent's nurse's medical bills when she hurt herself, paid for decedent's nursing bills, and paid for decedent's funeral expenses, showing that FLP funds were used for personal expenses and that disproportionate distributions were made.[40] Regarding the testamentary characteristic factor, the Court noted facts such as the decedent's old age when the FLP was formed; whether the decedent was suffering from serious health conditions during formation; the level of little input from other family members regarding formation; and whether the purpose of the formation was not for business purposes.[41]

In *Thompson*, the decedent used the same structure as was used in *Strangi*. Two corporations were formed to be general partners of two FLPs that were formed at the same time.[42] The court held that the FLPs were invalid and that the transferred assets where includable in decedent's gross

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(CCH) 633, 636-637 (2001) (finding that a condo that decedent had transferred into an irrevocable trust was includable in her gross estate because decedent and her husband lived in the condo rent-free until her death); *Reichardt,* 114 T.C. at 152 (finding that assets were includable in decedent's gross estate where the only thing that changed was legal title and the decedent commingled personal and partnership funds); Estate of Schauerhamer v. Comm'r, 73 T.C.M. (CCH) 2855, 2857 (1997) (finding that assets were includable in decedent's estate where decedent commingled personal and partnership funds by directly depositing income generated by transferred property into her personal bank account, instead of the partnership bank account and the management of the assets was the same after the transfer as it was before).

[34] *Strangi II,* 85 T.C.M. (CCH) at 1339. "The taxpayer 'bears the burden (which is especially onerous for transactions involving family members) of proving that an implied agreement or understanding between decedent and his children did not exist when he transferred the property at issue to the . . . partnership.'" Black et al., *supra* note 1, at 280 (quoting *Reichardt,* 114 T.C. at 151-52).

[35] *Strangi II,* 85 T.C.M. (CCH) at 1338.

[36] *Id.*

[37] *Id.*

[38] *Id.*

[39] *Id.* (citing *Reichardt,* 114 T.C. at 154-55).

[40] *Strangi II,* 85 T.C.M. (CCH) at 1338-39.

[41] *Id.* at 1339.

[42] *Thompson,* 382 F.3d at 370-71.

estate because decedent transferred 95% of his assets to the FLPs, decedent received disproportionate distributions from the FLPs to pay for his living expenses, and the transaction was of testamentary character because decedent was ninety-five when the FLPs were formed and the FLPs were not engaged in business activities outside of family members.[43]

It is important to consider the circumstances uniquely surrounding each case.[44] The aforementioned factors are those that courts have pointed out as particularly probative of a testamentary transfer being disguised as an inter vivos transfer.

2. Right to Income

Section 2036(a)(1) also includes inter vivos transfers made by a decedent in the gross estate where decedent retains the right to income generated by the property.[45] "The section does not require that the transferor pull the 'string' or even intend to pull the string on the transferred property; it only requires that the string exist."[46] As long as a decedent had some way to control the income from the transferred property, a string will exist.

In *Strangi*, the decedent's attorney in fact operated the daily affairs of Stranco and of the SFLP and had sole discretion when it came to distributions.[47] There was no restriction in the partnership agreements that would have disallowed the decedent, acting through his attorney in fact, to distribute income to himself.[48] Therefore, although the decedent did not actually sign distribution checks that were issued to him, he had a "string" on the transferred property via his attorney in fact.

3. Implications

In order to withstand attack from the IRS under § 2036(a)(1), taxpayers will need to plan ahead and conduct analysis before formation of the FLP. When transferring property into the FLP, taxpayers should not transfer all or almost all of their assets.[49] Taxpayers should have enough

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[43] *Id.* at 376-77.
[44] *See Thompson,* 382 F.3d at 376-77; *Guynn,* 437 F.2d at 1150; *Reichardt,* 114 T.C. at 151; Estate Tax Reg. § 20.2036-1.
[45] 26 U.S.C. § 2036.
[46] *Strangi II,* 85 T.C.M. (CCH) at 1337 (quoting Estate of Pardee v. Comm'r, 49 T.C. 140, 148 (1967)). *See also McNichol,* 265 F.2d at 671 (finding that even if the decedent does not actually receive the income, as long as he is entitled to receive it, it is included in his gross estate).
[47] *Strangi II,* 85 T.C.M. (CCH) at 1337.
[48] *Id.*
[49] Kitces, *supra* note 7; *Blueprint for an FLP that Can Withstand IRS Attack*, INSIGHT ON ESTATE PLANNING (Mallah Furman), Aug. Sept. 2005, http://mallahfurman.com/downloads/204086IEPas05.pdf [hereinafter *Blueprint*];

personal assets left to maintain their standard of living, and they should not have to commingle business and personal expenses.[50] In addition, it is helpful if more than one family member is contributing property to the FLP, indicating a true pooling of assets.[51] Formalities should also be respected if taxpayers are to persuade the IRS and courts that the FLP is legitimate and not purely testamentary in nature.[52]

In conjunction with the respect of formalities, it is also important, once the FLP has been formed, to actually operate it as a business and actively manage it.[53] All partners should actively participate in the management and operations of the entity.[54] Distributions should not be irregular to the taxpayer that would indicate any kind of implied agreement that taxpayer would still retain enjoyment and use of the assets.[55]

B. *Section 2036(a)(2)*

1. Legally Enforceable Right

Section 2036 also provides that assets must be brought back into a gross estate if the transferor retained "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."[56] The Supreme Court construed this "right" to "connote[] an ascertainable and legally enforceable power."[57] The Supreme Court also noted that a "power to terminate . . . and thereby designate the beneficiaries at a time selected by the settler" invokes § 2036(a)(2).[58]

As applied by the court in *Strangi*, the decedent retained this right because he, along with the other partners of SFLP, had the power to terminate SFLP; he, along with other directors of Stranco, had the power to liquidate SFLP by revoking the existing SFLP liquidation agreement; and

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Michael D. Larobina, *Limited Liability Companies and Estate Planning*, THE CPA JOURNAL ONLINE, March 2005, http://www.nysscpa.org/cpajournal/2005/305/essentials/p50.htm; Susan Kimsey Smith, *Bulletproofing Family Limited Partnerships and Limited Liability Companies*, 10 ALI-ABA EST. PLAN. J. 45, 51 (2003), *available at* https://www.ali-aba.org/aliaba/EPCMJ0412-SMITH.pdf.

[50] Kitces, *supra* note 7; *Blueprint*, *supra* note 49, at 3.

[51] Kitces, *supra* note 7; Larobina, *supra* note 49.

[52] Kitces, *supra* note 7; Larobina, *supra* note 49; Smith, *supra* note 49, at 46-47.

[53] *Blueprint*, *supra* note 49, at 3; Simon Butler, *Court Ruling Threatens Use of Family Limited Partnerships*, OWS MAGAZINE, Sept. 1, 2005, http://www.onwallstreet.com/article.cfm?articleid=3063; Smith, *supra* note 49, at 46-47.

[54] Updike, *supra* note 3, at 4.

[55] Kitces, *supra* note 7.

[56] 26 U.S.C. § 2036(a)(2).

[57] United States v. Byrum, 408 U.S. 125, 136 (1972).

[58] *Strangi II*, 85 T.C.M. (CCH) at 1341 (quoting *Byrum*, 408 U.S. at 143 n.23).

he, along with the other directors of Stranco, had the power to declare dividends.[59]

The Estate Tax Regulations further explain how this gives the decedent in *Strangi* the power to designate:

> With respect to such a power, *it is immaterial (i) whether the power was exercisable alone or only in conjunction with another person or persons*, whether or not having an adverse interest; (ii) in what capacity the power was exercisable by the decedent or by another person or persons in conjunction with the decedent; and (iii) whether the exercise of the power was subject to a contingency beyond the decedent's control which did not occur before his death.[60]

As a result, even though Strangi did not have exclusive control to terminate, liquidate, and declare dividends, he did have the power in conjunction with his fellow partners and directors. Therefore, he possessed a legally enforceable right.[61]

The *Byrum* Court also recognized that there are factors that can severely impede the right to exercise these powers including: the existence of a layer of independence, the way economic and business realities of a small company would control decedent's power, and the presence of fiduciary duties.[62] For these reasons, the Supreme Court in *Byrum* found that shares of stock that were transferred into an irrevocable trust, with an independent bank appointed as sole trustee, were not includible in decedent's gross estate.[63]

2. Implications

The *Strangi* decisions allude to the fact that the key to winning a § 2036(a)(2) attack is to give up control. The taxpayer and major transferor should not be a general partner in the FLP, rather he should be a limited partner.[64] In addition, the taxpayer should not have the power to terminate the FLP or have much control over voting rights.[65] This will end any legally enforceable right to designate who shall enjoy the property.

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[59] *Id.* at 1341-42.
[60] 26 C.F.R. § 20.2036-1(b)(3) (2005) (emphasis added).
[61] *Strangi II,* 85 T.C.M. (CCH) at 1341.
[62] *Byrum,* 408 U.S. at 137-51.
[63] *Id.* at 126-51.
[64] Kitces, *supra* note 7.
[65] *Id.*; Larobina, *supra* note 49.

C. *Bona Fide Sale Exception*

Contained in a parenthetical in § 2036 is an exception that if the inter vivos transfer was a "bona fide sale for an adequate and full consideration," then even if the transfer would otherwise be includable under § 2036, it no longer will be included in the gross estate.[66] "To constitute a bona fide sale for an adequate and full consideration in money or money's worth, the transfer must have been in good faith, and the price must have been an adequate and full equivalent reducible to a money value."[67] In order for this exception to apply, there must be a bona fide sale *and* the sale must have been for adequate and full consideration.[68]

1. Bona Fide Sale

There must be a "'substantial business [or] other non-tax' purpose" for a transfer to qualify as a bona fide sale.[69] This prong is met when the "record establishes the existence of a legitimate and significant nontax reason for creating the FLP . . . ."[70] This nontax reason must be an actual motivation for the formation of the FLP.[71] The Tax Court has also listed some factors it will consider in determining if there has been a bona fide sale: (1) whether the taxpayer was on both sides of the transaction; (2) whether the taxpayer was financially dependent upon the FLP distributions; (3) did personal and partnership funds commingle; and (4) did the taxpayer actually transfer property to the FLP.[72]

In *Strangi*, the estate listed three nontax motivations for forming the FLP; however, these motivations were rejected by the Tax Court.[73] The estate argued that the FLP was formed to reduce attorneys' fees due at decedent's death, but the Court denied this factor as "mere window dressing to conceal tax motives."[74] The estate also claimed that a motivating factor for FLP formation was to insulate the estate from any tort claim that may arise from the injury of decedent's nurse, but the Court denied this claim

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[66] 26 U.S.C. § 2036(a).
[67] 26 C.F.R. § 20.2043-1(a)
[68] *See Strangi III,* 417 F.3d at 478; *Harper,* 83 T.C.M. (CCH) at 55. *See generally* David Pratt & Jennifer E. Zakin, *Family Limited Partnerships: To Qualify or Not to Qualify for the Bona Fide Sale for Full and Adequate Consideration Exception under § 2036*, 79 FLA. BAR J. 53 (2005).
[69] *Strangi III,* 417 F.3d at 479 (quoting Kimbell v. United States, 371 F.3d 257, 267 (5th Cir. 2004)).
[70] Pratt & Zakin, *supra* note 68, at 3 (quoting Estate of Bongard v. Comm'r, 124 T.C. 95, 118 (2005)).
[71] *Bongard,* 124 T.C. at 118.
[72] Estate of Korby v. Comm'r, 89 T.C.M. (CCH) 1143, 24 (2005).
[73] *Strangi I,* 115 T.C. at 485.
[74] *Id.* (quoting Estate of Baron v. Comm'r, 83 T.C.542, 555 (1984)).

because the nurse never threatened to sue and the tort claim never materialized.[75]

The final motivating factor argued by the estate was that formation of the FLP was "to provide a "joint investment vehicle" for management of decedent's assets."[76] The court rejected this because of the nature of the assets transferred - they were not operating business assets, 75% of the property was composed of cash and securities, and SFLP never conducted any business.[77]

In *Estate of Stone v. Commissioner*, the Tax Court held that there was a bona fide sale where assets were transferred into five different FLPs.[78] These FLPs were set up to put an end to the litigation between the Stones' five children and as a means of succession planning.[79] Among the factors listed as to why the transfers qualified as bona fide, the Court noted that each family member was represented by different counsel, the sales were negotiated and both sides had input into the terms of the sale, and the FLPs were a vehicle to allow the children to become actively involved in the management of the decedents' assets.[80]

2. Adequate and Full Consideration

The second prong of the bona fide sale exception of § 2036 is that there must be adequate and full consideration.[81] This is "met only where any reduction in the estate's value is 'joined with a transfer that augments the estate by a commensurate . . . amount.'"[82] There are three factors to consider in determining if this test has been met:

> (1) whether the interest 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 to the partnership were properly credited to the respective capital accounts

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[75] *Id.*
[76] *Id.*
[77] *Id.* at 486.
[78] Estate of Stone v. Comm'r, 86 T.C.M. (CCH) 551 (2003). *Cf. Harper,* 83 T.C.M. (CCH) at 55 (finding that there was not a bona fide sale where the decedent independently determined the structure and operations of the FLP, the decedent stood on both sides of the transaction, and there was absolutely no bargaining or negotiating in the formation of the FLP).
[79] *Stone,* 86 T.C.M. (CCH) at 29-30.
[80] *Id.* at 153-54. *See also Thompson,* 382 F.3d at 378 (finding that FLP formation was not motivated by legitimate business concerns where the partners had not pooled their transferred assets with the decedent's transferred assets and the partners had not conducted any business in the partnerships).
[81] 26 U.S.C. § 2036(a).
[82] *Strangi III,* 417 F.3d at 478 (quoting *Kimbell,* 371 F.3d at 262).

> of the partners, and (3) whether on termination or dissolution of the partnership the partners were entitled to distributions from the partnership in amounts equal to their respective capital accounts.[83]

The Tax Court has also held that where there is only effectively a "recycling of value," adequate and full consideration does not exist.[84] This mere recycling occurs when only legal title of the assets changes, but not the form or management or profit potential of the transferred assets.[85] "[T]he transferors [must] receive[] partnership interests proportionate to the value of the property transferred."[86]

In *Estate of Bongard v. Commissioner*, all of the decedent's family's shares of Empak, Inc. were transferred into a holding company so that Empak could raise capital and remain competitive.[87] The Court upheld this transfer as a bona fide sale where decedent received interest in the holding company proportionate to his contributions and the partner's capital account was properly credited based on his contributions.[88] On the other hand, the Court disallowed the transfer in *Estate of Harper v. Commissioner* to come under the bona fide sale exception because there was nothing to suggest adequate and full consideration.[89] In *Harper*, the decedent transferred assets into an FLP and named his son and daughter as general partners. There was no negotiation in the formation of the FLP.[90] The Court noted that there had not been a pooling of assets because the son and daughter had not contributed assets, which indicates a lack of consideration.[91]

3. Implications

The courts have made it clear that there needs to be a legitimate business purpose for forming an FLP.[92] These formation reasons should be documented in external documents, as well as any partnership agreement.[93]

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[83] *Id.* at 479 (quoting *Kimbell,* 371 F.3d at 266).
[84] *Harper,* 83 T.C.M. (CCH) at 56.
[85] *Id.* ("Without any change whatsoever in the underlying pool of assets or prospect for profit, as, for example, where others make contributions of property or services in the interest of true joint ownership or enterprise, there exists nothing by a circuitous 'recycling' of value.").
[86] *Bongard,* 124 T.C. at 118.
[87] *Id.* at 100.
[88] *Id.* at 122-25.
[89] *Harper,* 83 T.C.M. (CCH) at 57-60.
[90] *Id.* at 55.
[91] *Id.* at 56.
[92] Kitces, *supra* note 7; *Blueprint*, *supra* note 49, at 3; Butler, *supra* note 53; Smith, *supra* note 49, at 46-47.
[93] Pratt & Zakin, *supra* note 68, at 58.

Upon formation, it is important for family members to obtain independent counsel and negotiate over the partnership agreement.[94] All of these factors will indicate that this is actually a bona fide sale.

To show that there has been adequate and full consideration, it is imperative that the partners' capital accounts be credited proportionately to the amount of property each partner transferred into the FLP.[95] This will show that there has been a fair exchange of property: assets to an FLP in exchange for a proportionate interest in that FLP. Also, upon dissolution of the partnership, each partner should be entitled to a proportionate percentage of assets based upon capital accounts.[96]

IV. THE FUTURE OF THE FAMILY LIMITED PARTNERSHIP AFTER *STRANGI*

These recent attacks by the IRS and the courts' subsequent interpretation of § 2036 does not mean that the life of FLPs has come to an end. Gone are the days, however, when FLPs were used for purely tax avoidance reasons with the older generation still maintaining complete control over the assets. Today, an FLP will be best suited for a family business owner who is trying to pass the business on to the younger generation in a way that will produce tax savings yet still allow him to completely control the business. This business owner has to understand that by forming an FLP, he will expose himself to enhanced scrutiny by the IRS.

The best way to start an analysis of how to withstand IRS attack under § 2036 is to start with the bona fide sale exception in the statute. If the exception applies, then § 2036(a)(1) and (2) do not apply because the exception will make them inapplicable. Therefore, the most important factor to comply with is ensuring that the transfer of assets into an FLP is a "bona fide sale for an adequate and full consideration."[97]

First and foremost, there must be a legitimate business purpose for forming the FLP and the FLP should be actually treated like a business. Therefore, a taxpayer simply looking to avoid taxes may want to consider other estate planning techniques. By transferring business assets into the FLP for succession purposes, the taxpayer should meet this test.

The partnership agreement should be properly negotiated, with all family members preferably retaining separate counsel. This shows that the family members actually consider this a bona fide transaction. In addition, the taxpayer should retain enough assets to meet his standard of living

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[94] *Id.*; Smith, *supra* note 49, at 51.
[95] Kitces, *supra* note 7; *Blueprint*, *supra* note 49, at 3; Pratt & Zakin, *supra* note 68, at 7.
[96] Pratt & Zakin, *supra* note 68, at 58.
[97] 26 U.S.C. § 2036 (2000).

because if this transaction was with a party with whom the taxpayer had no affiliation, the taxpayer could not and would not expect that the transferred assets would be available for use to pay for his personal expenses. The business entity and personal assets should be kept completely separate with no commingling. Any personal assets, such as the taxpayer's residence, should be held by the taxpayer and not transferred into the FLP. Finally, the taxpayer should actually transfer the property into the FLP and, as a result, not retain possession of and enjoyment from the property.

In addition to the appearance of a bona fide sale, the transaction also needs to have "adequate and full consideration."[98] The taxpayer should receive only an interest in the FLP that is proportional to the value of the assets he contributed. The capital accounts should properly reflect all contributions made. After the capital accounts have been properly recorded, then the taxpayer can gift his FLP interests to family members if he so desires.[99] These capital accounts should continue to be maintained as they would be in any general limited partnership.

If the FLP and taxpayer can meet both prongs of the bona fide sale exception offered in § 2036, the taxpayer will be effectively able to pass on his business to younger generations while producing estate tax savings for himself. If the exception can be met, the taxpayer will also still be able to maintain some control over the business while allowing the younger generation to be actively involved in the management of the business so that it can continue to be successful after the taxpayer's death.

If, after proper analysis, it does not seem likely that the taxpayer will fall within the bona fide sale exception, which would effectively take the transaction out of § 2036, the taxpayer must be willing to give up control of the business so that the transaction will not meet § 2036(a)(1) or (2). For this reason, it is best to make sure that the transaction is a bona fide sale for adequate and full consideration. Then, the taxpayer can still maintain some control and reap the benefits of valuation discounts received because of his interest in an FLP. If meeting the exception is impossible based upon the surrounding circumstances, however, the taxpayer can still receive these coveted discounts.

In order to fall outside of § 2036(a)(1), the taxpayer will truly have to give up the assets. He cannot retain possession, enjoyment, or the right to income from the assets.[100] He must transfer them into the FLP, and they will no longer be his. In order to fulfill this requirement, the taxpayer cannot transfer most of his assets into the FLP.[101] He must retain enough assets to maintain his standard of living. Otherwise, there is the implication that the assets will continue to be used to support the taxpayer. It is best to

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[98] *Id.*
[99] Updike, *supra* note 3, at 35.
[100] 26 U.S.C. § 2036(a)(1).
[101] *Strangi II*, 85 T.C.M. (CCH) at 1338.

work with a financial planner to decide how many assets the taxpayer needs to retain based upon actuarial tables and future expenses and income.

The taxpayer should also not transfer into the FLP a residence in which he plans to continue to reside[102] unless the taxpayer can pay the fair market value of what would be normal rent for said residence in an arms' length transaction. If it is necessary or desired to transfer the residence into the FLP, there should be a written contract. This contract should have a provision for when the lessee goes into default after missed payments. Missed payments should not be allowed to simply accrue with no interest or penalties imposed. Again, this will avoid retention of possession or enjoyment of the transferred property by the taxpayer.

Another important factor to consider, and for which to plan, is keeping personal and business funds completely separate.[103] Any commingling of these funds will lead to an appearance of retained possession of the transferred assets. Any banking accounts should be kept completely separate, and the accounting for each account should be completely separate. All business-related expenses and deposits should be taken out and put into only the business accounts.

During the continued operation of the FLP, distributions always should be made proportionately to the partners' capital accounts.[104] Thus, the taxpayer cannot expect that he will be receiving distributions to accommodate any financial needs that he may have. Any and all distributions should be made on a regular and proportionate basis to defray any suspicion that the assets are continuing to support the standard of living of the taxpayer.

On a similar point, business funds should not be used to pay the personal expenses of the taxpayer.[105] If, for example, every time a taxpayer needed to pay bills, business funds were used, the taxpayer would clearly still be retaining the enjoyment of the transferred assets. This is why the taxpayer really needs to retain enough assets to adhere to his standard of living. Then, having to use business funds to pay for personal expenses will not be a problem for the taxpayer.

The transfer also cannot be one that is purely testamentary in nature.[106] A factor to consider when attempting to avoid the appearance of a testamentary transfer is the age and health of the taxpayer. If, for example, the formation of the FLP and the subsequent transfer of property into said FLP occurs after the taxpayer finds out he is terminally ill and only has a couple of years to live, there is a strong presumption that the transfer was only made to avoid estate taxes. If, however, the transfer is made as part of a succession plan, which is a legitimate business purpose,

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[102] *Id.*
[103] *Id.* at 1338-39
[104] *Id.* at 1338-40.
[105] *Id.* at 1338-39.
[106] *Id.* at 1339.

and the assets are transferred into the FLP for a proportional interest, then the appearance of purely testamentary motives is avoided. The key to overcoming this factor is to start planning early and enact the succession plan as soon as possible. The courts and the IRS do not want to see and will not recognize a last-ditch effort from a dying taxpayer looking to avoid paying large estate taxes by throwing all of his assets into an FLP at the last minute. A legitimate business purpose behind the formation is necessary.

In addition to these factors that prove that the taxpayer has given up possession and enjoyment of the assets, the taxpayer will also need to plan on giving up the right to income from the transferred property. In this respect, the taxpayer will need to create a separation between him and those that make decisions about disbursements. His attorney-in-fact, for example, should not be making those decisions, as was the case in *Strangi*.[107]

After adhering to all of these standards to pass the test of § 2036(a)(1), the taxpayer still needs to plan for § 2036(a)(2). In this sense, the taxpayer cannot maintain the right to designate who shall enjoy the benefits of the transferred assets.[108] To adhere to this standard, it does not matter whether the taxpayer is the sole decision-maker when it comes to designating these rights.[109] Even if his votes must be in conjunction with others' votes in order for the final decision to be made, the value of the assets can still be brought back into the taxpayer's estate under § 2036(a)(2).[110] Because of this, it is wise if the taxpayer does not own a voting interest. The interests of the FLP could be divided into separate classes: voting and nonvoting. The taxpayer should own the nonvoting class of interest to win under a § 2036(a)(2) attack.

V. CONCLUSION

It is important to keep in mind that as long as the bona fide exception of § 2036 is met, these drastic standards need not be met because the exception will take the transfer out of § 2036. Therefore, if at all possible, the taxpayer should do everything in his power to plan to meet the exception. The key, of course, is planning ahead and not just jumping into the transaction without considering all of the implications. It can be devastating for a family that was under the impression that the value of a decedent's estate was at a much lower value than the IRS and the courts say it is. Often times, there may not be enough liquidity in the estate to make up for the difference, and the family is forced to sell off the family business. However, with the proper planning and knowledge, this doomsday scenario can be avoided.

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[107] *Strangi II*, 85 T.C.M. (CCH) at 1341.
[108] 26 U.S.C. 2036(a)(2).
[109] 26 C.F.R. § 20.2036-1(b)(3).
[110] *Id.*

As a quick recap, the keys to meeting the exception are the following:

1. Only form an FLP if there is a legitimate business purpose for forming it. It cannot be formed for purely testamentary reasons, such as tax avoidance.
2. The partnership agreement should be a negotiated document, with all involved family members partaking in the negotiations and represented by their own counsel.
3. The taxpayer needs to retain enough assets so that he can maintain his standard of living and not rely on the FLP to pay for his personal expenses. With proper planning, this can easily be done.
4. There should be no commingling of personal and business assets. Separate accounts need to be maintained and kept separate at all times.
5. The taxpayer should only receive interest in the FLP that is proportionate to the value of the assets that he contributed. All partnership capital accounts should be properly credited and maintained.

If a transfer of assets can fall into the exception of § 2036, the formation of an FLP can be an extremely useful and cost-effective means of succession planning in a closely-held business. In addition, analyzing the effectiveness of an FLP will, in the very least, force the business owner to think critically about succession planning and allow him to formulate a proper plan.