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Last Gasp Estate Planning: The Formation of Family Limited Liability Entities Shortly Before Death

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LAST-GASP ESTATE PLANNING: THE FORMATION OF FAMILY LIMITED LIABILITY ENTITIES SHORTLY BEFORE DEATH

Walter D. Schwidetzky[*]

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I. INTRODUCTION

Family limited partnerships have been popular gift and estate tax planning vehicles for many years.[1] In recent years, family limited liability companies (LLCs) have also become common, particularly in those states that have updated their statutes to take the check-the-box regulations into account. LLCs with more than one member are usually classified as partnerships for federal income tax purposes.[2] In a typical structure, when there is adequate planning, the donors form a limited partnership or an LLC (jointly, "family limited liability entity" or FLLE), to which they contribute assets expected to appreciate in value.[3] The contribution is typically tax-

[1] For a sampling of the available literature, relatively little of which is in traditional law reviews, see Edward D. Brown, *Maximizing Minority Discounts for Limited Partnerships in an Integrated Estate Plan*, 93 J. TAX'N 306 (2000); Joseph M. Mona, *Use of LLCs in Estate Planning*, 25 EST. PLAN. 167 (1998); Travis L. Bowen & Rick D. Bailey, *Limited Partnerships: Use in Tax, Estate and Business Planning*, 32 IDAHO L. REV. 305 (1996); James R. Repetti, *Minority Discounts: The Alchemy in Estate and Gift Taxation*, 50 TAX L. REV. 415 (1995); Samuel Weiner & Steven D. Leibzig, *Family Limited Partnership Can Leverage the Annual Exclusion and Unified Credit*, 82 J. TAX'N 164 (1995); and Robert G. Kurzman, *A Family Partnership Still May be the Best Entity to Meet Income, Estate Tax Goals*, 17 EST. PLAN. 224 (1990).

[2] The check-the-box regulations, Treas. Reg. § 301.7701-3 (2000), dramatically changed the entity classification landscape. Before their adoption, there was a possibility that a limited partnership or an LLC could be classified as a corporation, though the possibility was quite remote. Under the default rule, how an entity is classified depends on how many owners it has. If the entity has a single owner who is an individual, it is treated as a sole proprietorship for federal income tax purposes. If the single owner is a corporation, it is treated as a division. Alternatively, an entity may elect to be classified as a corporation for federal income tax purposes, but it is a rare entity that would make such an election, given the onus of double taxation for C-corporations. *See* I.R.C. §§ 11, 301(c). In states with updated statutes, limited partnerships and LLCs may be fairly equal alternatives. In states without updated statutes, limited partnerships may be preferable due to the unfavorable dissolution rules often applicable to LLCs in older statutes. *See supra* note 1 and accompanying text. *See also* KATHRYN G. HENKEL, ESTATE PLANNING AND WEALTH PRESERVATION § 17.02[13] (1997). *See generally* MARK SARGENT & WALTER SCHWIDETZKY, LIMITED LIABILITY COMPANY HANDBOOK, chs. 1-3.

[3] Under section 1015, a donee of an FLLE interest generally takes the

free under section 721(b). In the case of a limited partnership, the donors (commonly parents or grandparents) will hold the general partnership interest, likely through a corporation, while in the case of an LLC, they will hold the managerial interest. They will, over time, make gifts of limited partnership interests or membership interests to the donees (commonly children or grandchildren). The availability of minority-interest and lack-of-marketability discounts, discussed in detail below, means that gifts of ownership interests can be made at a value less than the proportionate share of the fair market value of the underlying assets. In making their annual gifts, the donors will take advantage of the section 2503(b) annual exclusion, which may permit the first $10,000 of discounted value gifted by a donor to each donee each year to be excluded from gift taxation.[4] Thus, two parents can gift $20,000 per year per donee without

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same basis in it that the donor had. *See* I.R.C. § 1015. In the case of assets with a basis in excess of fair market value at the time of the gift, a donee generally takes a fair-market-value basis in gifted property for purposes of loss calculation, a carryover basis for gain calculation, and recognizes neither gain nor loss if the property sells for a price in between its fair market value at the time of the gift and its carryover basis. *See* Treas. Reg. § 1.1015-1. Under section 1014, a person who acquires an FLLE interest by bequest, devise, or inheritance from a decedent generally takes a fair-market-value basis. *See* I.R.C. § 1014. Where practical, it is wise to gift high-basis, appreciated property (or interests in FLLEs holding such property) and retain low-basis, appreciated property for eventual transfer after death. This approach maximizes the basis that the recipient takes in the property and reduces the income tax consequence on a later sale of the property. It may still be wise, however, to gift low-basis property if the property is expected to appreciate rapidly. The disadvantage of the low basis to the donee may be more than offset by the increased estate taxes to the donor if the property is included in the donor's estate and substantially appreciates before the donor's death. Further, any gain recognition on a sale of property may be subject to a favorable capital gains rate of taxation, commonly 20% under section 1. *See* I.R.C. § 1(h). The gift and estate tax rate can be as high as 55%, and that rate applies to the full value of the property, not just the gain. *See* I.R.C. § 2001(b). If the property has an inherent loss, the taxpayer is often wise to sell it, recognize the loss, and gift the resulting cash.

[4] Taxpayers are required to disclose gifts of interests in FLLEs in order for the statute of limitations to run. *See* T.D. 8845, 1999-2 C.B. 683 (1999); I.R.C. §§ 6501(c)(9), 2504(c). Section 2503 provides that the first $10,000 per year given by each donor to each donee is not subject to gift taxation, provided that the interest given is a present interest. *See* I.R.C. § 2503(b). This amount is adjusted for inflation for calendar years after 1998, rounded to the next lowest multiple of $1,000. *See* I.R.C. § 2503(b)(2). As this article goes to press, no inflation adjustment has yet been made, and future interests do not qualify for the exclusion. Thus, if the gifted FLLE interest qualifies as a present interest, the first

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$10,000 of (discounted) value per donee will be free of any gift tax or the need to use any portion of the applicable exclusion amount. The Service has ruled that a limited partnership interest can constitute a present interest, *see* Priv. Ltr. Rul. 9415007 (Jan. 12, 1994), and by extension, it is commonly assumed that a membership interest in an LLC constitutes a present interest as well.

However, in a technical advice memorandum (TAM) with unusual facts, Tech. Adv. Mem. 9751003 (Aug. 28, 1997), the Service ruled that a limited partnership interest did not constitute a present interest, casting doubt on the area. In TAM 9751003, the donor/general partner had not only the discretion as to when to distribute partnership funds, but also could retain partnership funds "for any ... reason whatsoever." Further, no limited partner was entitled to a return of capital until 2022, and no limited partner could withdraw from the partnership except on assignment of all of her partnership interest. Assignment was generally not allowed without a super-majority vote of the partners. *See id.*

The Service noted that a gift can be separated into its component parts, any one of which may qualify as a present interest. In this case, the Service considered the right to income and a right to transfer the interest. In the Service's view, the fact that the general partner could withhold the income for any reason whatsoever effectively obviated the fiduciary obligation ordinarily imposed on a general partner, which might otherwise be relied on to insure that income would be appropriately distributed. The uncertainty as to when or whether the limited partners would receive any income prevented the income interest from constituting a present interest. In reaching this conclusion, the Service used some disturbing language. It said that the income component of the limited partnership interests failed to require, at the time of the gifts, that there be a steady and ascertainable flow of income to a donee or limited partner. *See id.* In the past, the Service had not insisted on a steady flow of income for partnership interests to constitute present interests (though that has been the standard in other contexts, *see* Comm'r v. Disston, 325 U.S. 442, 448-49 (1945)), and it was unclear whether the Service might attempt to require this in the future. In the TAM, the Service also said that the partnership agreement's limitations on transfers of the limited partnership interests meant that the limited partnership interests lacked the tangible and immediate economic benefits necessary to constitute a present interest in this regard as well. *See* Tech. Adv. Mem. 9751003, ¶ 26.

Technical Advisory Memorandum 199944003 (July 2, 1999), may have calmed the waters a bit. In this later TAM, the taxpayers formed a limited partnership and acted as the general partners. Gifts of limited partnership interests were made to their children. The partnership agreement permitted net cash flow to be distributed annually to the partners, but did not require it. Limited partners could assign their partnership interests. The assignees were entitled to distributions of net cash flow or other property but could become a substituted limited partner only with the unanimous written consent of the general partners, as decided in their sole and absolute discretion. The Service concluded the limited partnership interests qualified as present interests. *See id.* The Service noted that the applicable law entitled a partner to distributions before withdrawal or dissolution. Limited partners could withdraw at any time. The general partners were under a strict fiduciary duty toward the limited partners and the partnership.

gift tax consequences.[5] If a donor gifts property with a value in excess of $10,000 per donee, the donor must file a gift tax return.[6] An actual gift tax is only due, however, if the total lifetime taxable gifts made by the donor exceed the "applicable exclusion amount." The applicable exclusion amount for 2000 and 2001 is $675,000.[7] Generally, only cumulative lifetime and death transfers in excess of those amounts are actually subject to a gift or estate tax (jointly, "transfer tax").[8]

The available discounts can be significant. If a property directly owned by donors is worth $100,000, it can, through an FLLE, be gifted indirectly over time to donees at a value of perhaps only $65,000.[9] Once properly gifted, the assets are also excluded from the donor's estate when he dies; any subsequent appreciation inures to the benefit of the donees and can stay out of the estate of the donor and therefore out of the hands of the estate tax fisc. This type of planning will be of particular interest to persons who expect their estates to be subject to an estate tax.

A variant of this form with which the Internal Revenue Service (Service) and the courts have struggled of late involves an FLLE formed shortly before a decedent's death. The decedent contributes property to the FLLE and thus no longer holds the property directly.

Given these factors, the Service concluded that the limited partners had the right to the immediate use, possession, and enjoyment of the interest. *See id.*

The moral of the two TAMs is that the donors have to give the limited partners a little "wiggle room." If, as in TAM 9751003, the donor retains total control, the Service likely will conclude that the donees have not received a present interest. If, on the other hand, a more typical limited partnership agreement is used and the limited partners have some independent rights to obtain a current economic benefit (such as by assigning the interest), the promised land of section 2503(b) likely will be reached.

[5] Spouses may split gifts so that a $20,000 gift by one spouse is treated as if each spouse made a $10,000 gift. I.R.C. § 2513.

[6] I.R.C. § 6019.

[7] The applicable exclusion amount increases to $700,000 in 2002 and 2003, $850,000 in 2004, $950,000 in 2005, and $1,000,000 in 2006 and thereafter. *See* I.R.C. §§ 2505, 2010. Given the rate of change of tax laws, and the intentions of the current occupant of the White House, it is unlikely that these amounts would remain unchanged until phase-in has been completed.

[8] FLLEs can also offer a number of nontax benefits. They permit the smooth transfer of assets from one generation to the next. They provide a practical vehicle in which to hold property for extended families. Management can be readily centralized, and the owners can be protected against vicarious liability.

[9] *See* HENKEL, *supra* note 2, § 16.03[1][c].

Instead, the decedent holds interests in the FLLE that owns the property. The decedent normally holds the bulk of the interests in the FLLE. Other family members usually control the corporate general partner of a limited partnership or are the managing members of an LLC. Notwithstanding the formal structure, however, in many instances the decedent retains actual control. Beyond shifting control, typically only a few, if any, transfers of interests in the FLLE are made to others. This structure may give rise to a form of minority-interest discount. While the courts and commentators use the term minority-interest discount, it is something of a misnomer, since the decedent typically holds most of the interests. A "lack-of-control" discount might be a better term. Further, since it can be harder to sell interests in an FLLE than to sell the underlying property, a lack-of-marketability discount might also be justified. The disputes that have arisen with the Service commonly involve FLLEs that are formed in the name of the decedent shortly before her death by a family member using a power of attorney, sometimes creating, almost literally, a last-minute artifice designed to reduce estate taxes. The Service has hotly disputed this approach, though to date with little success in the courts. Very recently, in *Estate of Strangi v. Commissioner*,[10] the Tax Court had the opportunity to review one such FLLE, and a heavily divided court concluded that it could not ignore the formation of the FLLE for valuation purposes. While the court rejected many of the Service's core arguments, it also expressed concern over the legitimacy of the decedent's actions.[11]

This article will focus on such use of FLLEs as found in the *Strangi* case and offer proposals for reform. It is hardly wise tax policy to permit taxpayers to significantly reduce transfer taxes by dint of a last-minute FLLE of potentially no lasting substance. Further, the line that taxpayers need to cross in order for the structure to fail is decidedly blurry. Accordingly, this article recommends a brighter line. Section 2035 should be amended to provide that the transfer of assets by a decedent to a family-controlled FLLE within three years of her death would be ignored for estate tax purposes. Under this proposed amendment, the transfer of an interest in such an FLLE to members of the decedent's family within three years of her death would also be ignored. As the Internal Revenue Code

[10] 115 T.C. 478 (2000).

[11] *Id.* at 485, 489-90.

(Code) section 2001(b) already provides, credit would be given against the estate tax for any gift tax paid on the lifetime transfers.[12] This approach would stop the most blatant abuses in the use of FLLEs while permitting the use of FLLEs for legitimate estate planning, provided that it is done three years before the death of the decedent.

II. RELATED ISSUES

A. Business Purpose

The Revised Uniform Partnership Act (RUPA) defines a partnership as an association formed to carry on a business for profit.[13] That provision should also apply to limited partnerships.[14] Thus, to be in compliance with typical state law, a limited partnership must have a business purpose. Many state LLC statutes do not impose a business or profit requirement, however, and only require that the LLC be formed for a lawful purpose.[15] Under the check-the-box regulations, a typical multi-member business LLC is classified as a partnership for federal income tax purposes, but an LLC can also elect to be taxed as a corporation.[16] The question is whether a non-business LLC can be given that same classification. The Code defines a partnership for federal income tax purposes as "a syndicate, group, pool, joint venture, or other incorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation."[17] While not free from doubt, the Code here also suggests the need for a business objective. The check-the-box regulations state that they are providing rules for the classification of "business entities," again indicating the need for a business nexus.[18] The courts have required the conduct of some

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[12] *See* I.R.C. § 2001(b).

[13] *See* REVISED UNIF. P'SHIP ACT § 101(6), 6 U.L.A. 37 (Supp. 2001).

[14] *See* REVISED UNIF. LTD. P'SHIP ACT §§ 101(7) (amended 1985), 1106, 6A U.L.A. 61 (1976).

[15] *See, e.g.*, MD. CODE ANN., Corps & Ass'n § 4A-201 (1993).

[16] Treas. Reg. § 301.7701(b). *See also* SARGENT & SCHWIDETZKY, *supra* note 2, ch. 2.

[17] I.R.C. § 7701(a)(2).

[18] Treas. Reg. § 301.7701-3(a).

business activity before finding that a valid tax partnership exits.[19] Finally, the Service often attacks transactions because they lack a business purpose.[20] Strict adherence to the business requirement might forestall the use of LLCs for transferring property with a purely personal character, such as a vacation home used only for personal purposes.[21]

B. Marketable Securities/Investment FLLEs

The question that remains open is whether an FLLE that primarily holds marketable securities or other investment assets has a sufficient business purpose. The Service conceivably could view the general partners or managing members as trustees and the lim-

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[19] *See, e.g.*, Madison Gas & Elec. Co. v. Comm'r, 633 F.2d 512, 514-15 (7th Cir. 1980); Estate of Winkler v. Comm'r, 73 T.C.M. (CCH) 1657, 1663 (1997).

[20] *See, e.g.*, *Strangi*, 115 T.C. at 485-86.

[21] *See* Priv. Ltr. Rul. 200004022 (Jan. 28, 2000). In this ruling, the taxpayers, apparently husband and wife, transferred 98% of their principal residence to a trust that was a grantor trust for federal income tax purposes. Grantor trusts generally are ignored for federal income tax purposes, and the grantor of the trust is deemed to be the owner of the property owned by the trust. The taxpayers (with a remaining 2% direct ownership) and the trust then transferred the residence to a limited partnership. One question was whether this met the state law business purpose test that is common for partnerships. The private letter ruling did not address this issue but did note that the partnership also held "several small rental properties." *Id.* These latter properties may have been contributed to meet a state-law business purpose requirement. The Service did not focus on the rental properties or, apparently, consider their existence to be relevant to its analysis. The taxpayers were the general partner; the trust was the limited partner. Therefore, the taxpayers remained the only persons with any ultimate interest in the underlying property. The partnership ultimately deeded the property back to the taxpayers and the trust. At issue was the application of section 121, which permits $250,000 of gain on the sale of a principal residence to be excluded from gross income if the taxpayers meet certain holding period requirements. *See* I.R.C. § 121. The Service ruled that "in order for a *federal tax law partnership* to exist, the parties must, in good faith *and with a business purpose*, intend to join together in the present conduct of an enterprise and share in the profits or losses of the enterprise." Priv. Ltr. Rul. 200004022 (Jan. 28, 2000) (emphasis added). The Service held that since the residence served no business purpose of the partnership or the taxpayers, the taxpayers were treated as owners of the residence during the time it was held by the partnership. *Id.* The Service went on to conclude that for the purposes of the section 121 holding-period requirement, the taxpayers could count, as part of their holding period, the time the limited partnership held the residence. *See id.*

ited partners or passive members as beneficiaries, and treat the structure as a trust. The passive nature of the enterprise might encourage this approach. Investment partnerships, however, have commonly been upheld, both for state law and federal income tax purposes, despite the fact that no true business is being conducted. Indeed, the Code specifically contemplates investment partnerships that have never engaged in a trade or business and that primarily hold cash, stocks, bonds, notes, etc.[22]

Having the FLLE hold both traditional business assets and marketable securities may make it easier for it to survive judicial scrutiny. *Estate of Church v. United States*,[23] discussed below,[24] involved a limited partnership that held both marketable securities as well as a substantial, working ranch. The court permitted substantial discounts.[25]

Estate of Harper v. Commissioner[26] involved a family limited partnership, the primary assets of which were marketable securities. While the focus of the case was on section 2704(b),[27] it is noteworthy that the Service did not raise, and the court was not disturbed by, the type of assets held by the partnership.[28] Finally, in some districts the Service regularly seems willing to settle cases involving FLLEs holding marketable securities, often for total discounts in the 30% range.[29] While it would be preferable to have unambiguous case law, existing case law and much of the Service's own conduct do not suggest that investment FLLEs are in any great peril for lacking a business purpose.

In order for the formation of an FLLE holding marketable securities to get a tax-free treatment, the FLLE cannot constitute an investment company.[30] There are different ways by which an FLLE is deemed to be an investment company, but the one most relevant

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[22] *See* I.R.C. § 731(c)(3)(C)(i).

[23] 2000-1 U.S.T.C. (CCH) ¶ 60,369 (W.D. Tex. 2000).

[24] *See infra* Part III.D.

[25] *See Church*, 2000-1 U.S.T.C. (CCH) at 84,781.

[26] 79 T.C.M. (CCH) 2232 (2000).

[27] *See infra* Part II(F)(2).

[28] *See Harper*, 79 T.C.M. (CCH) at 2233.

[29] *See* Michael J. Eggers, *Settlement Data and the Effect on Family Limited Partnership Discounts*, 21 EST. PLAN. & CAL. PROB. REP. 137 (Apr. 2000). The Estate Planning and California Probate Reporter is a publication of Continuing Education of the Bar of California.

[30] *See* I.R.C. § 721(b).

in this context is if more than 80% of the FLLE's assets, by value, consist of money, stocks, securities and other comparable assets.[31]

C. Section 704(e)

At one time, the Service argued that donees of partnership interests were not bona fide partners, but section 704(e) now generally overrules that view.[32] A partner who receives her interest by gift will be recognized as a bona fide partner, provided capital is a material income-producing factor for the partnership.[33] It should be noted, however, that section 704(e) also requires that each interest share proportionately in partnership income generated by capital.[34] Thus, the Code does not allow a dilution of the donor's share of income by an inappropriate special allocation[35] of such income to the donee partners. Section 704(e) further requires the donor to be adequately compensated for services rendered to the partnership.[36]

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[31] *See id. See also* Treas. Reg. § 1.351-1(c)(1) (2001) (as modified by Tax Relief Act of 1997 § 1002, amending I.R.C. § 351(e)). There are exceptions for insignificant diversification and where each of several transferors transfers a diversified portfolio.

[32] *See* I.R.C. § 704(e).

[33] I.R.C. § 704(e)(1).

[34] I.R.C. § 704(e)(3).

[35] Section 704 permits special allocations of income and loss to partners, provided that the allocation has substantial economic effect. *See* I.R.C. § 704(b). It is then possible, for example, to allocate 90% of depreciation deductions to someone who is otherwise a 50% partner. In the family context, however, section 704 typically requires proportionate allocation of income to the donor. *See* I.R.C. § 704(e)(3).

[36] Taxpayers should be cautious about naming minor children as partners. The Service has stated that a minor child must be competent to manage her own business affairs in order to be recognized as a member of a partnership; in order to be a partner, a minor must have sufficient maturity and experience to be treated by disinterested persons as competent to enter into business dealings and otherwise to conduct his affairs on a basis of equality with adult persons. *See* Treas. Reg. § 1.704-1(e)(2)(viii). A minor who does not meet this standard, however, can still be a recognized partner as long as another person acts in a fiduciary capacity and exercises control over the partnership interest for the sole benefit of the minor; and accordingly, many practitioners place the partnership interest of a minor, especially younger minors, in trust or appoint a custodian to hold the interest. *See* Treas. Reg. § 1.704-1(e)(2)(vii). Taking advantage of the $10,000 annual exclusion of section 2503(b) may require the use of "Crummey" powers. For a discussion of how these powers work, see HENKEL, *supra* note 2, § 10.03[4].

D. Minority-Interest Discount

A decedent's interest in an FLLE may be given a minority-interest discount. Notwithstanding the common use of this term, a lack-of-control discount might be a better term in the context of this article. The decedent typically will own the bulk of the interests in the FLLE. Others will control the general partner of a limited partnership or be the managers of an LLC. The discount arises because the decedent cannot control current management decisions and consequently the entity's future. It also reflects a lack of control over the quality of the investment represented by the interest. For example, whether or not distributions will be made is in the hands of others.[37] The Tax Court has ruled that family attribution rules are not applied to limit the availability of minority-interest discounts.[38] A decedent's family can therefore own the majority (or all) of the interests in an FLLE, and a minority-interest discount can still be available.[39]

E. Lack-of-Marketability Discount

The lack-of-marketability discount arises from the decedent's inability (or reduced ability) to readily dispose of the interest in the FLLE.[40] An interest could lack marketability even though the

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[37] *See* Ward v. Comm'r, 87 T.C. 78, 103-109 (1986). *See also* LeFrak v. Comm'r, 66 T.C.M.(CCH) 1297, 1307-1309 (1993); Estate of Trenchard v. Comm'r, 69 T.C.M.(CCH) 2164, 2172-74 (1995). Of course, there can be no minority-interest discount if the taxpayer owns all of the interests in the entity.

[38] *See* Estate of Andrews v. Comm'r, 79 T.C. 938 (1982) (involving corporate stock). If family attribution rules were applied, children, for example, could be considered to own the interests owned by their parents for purposes of determining whether a minority interest was held. *See* I.R.C. § 318(a)(1).

[39] In an attempt to counter this across-the-board discount, the Service has argued that the value of a minority interest is enhanced if it represents a swing vote. The court in *Winkler*, 57 T.C.M. at 381, determined that a minority-held block of common stock that constituted the swing vote in a company controlled by two separate families should be increased in value by at least 10%. This increase effectively eliminated the minority-interest discount the family had originally claimed. *See id.* For a similar example, see *Estate of Simplot v. Commissioner*, 112 T.C. 130 (1999), in which the Service successfully argued that where the estate held voting stock in a corporation with an unusual capital structure of voting and nonvoting stock, a premium for voting privileges was appropriate. *See* 112 T.C. at 172-73.

[40] *Andrews*, 79 T.C. at 953.

owner holds a majority of the total interests. The Tax Court has given such a discount to a decedent who owned 61% of the stock in a corporation.[41] The court reasoned that a lack-of-marketability discount was warranted because there was no established market for the corporation's stock, which was unlisted and closely held.[42] No lack-of-marketability discount, however, should be available if the decedent owns 100% of the relevant FLLE, since then the taxpayer would have total control, and could sell all of the ownership interests or cause the entity to sell all of its assets.[43] A buyer in such an instance should pay full value, since she could buy all there is to acquire.

Many states provide that a limited partner may have his individual interest liquidated for fair value on six months' notice unless the partnership agreement provides to the contrary.[44] An increasing number of states, in response to prompting from the estate planning practitioners, are eliminating this right.[45] If the state allows for such a withdrawal, the amount of any lack-of-marketability discount would be reduced, since it would be easier to liquidate the interest. The discount should not be reduced to zero, however, since what constitutes a fair value is uncertain. Further, the limited partner would have to wait six months, during which time the fair value could change. These limitations should allow for a meaningful lack-of-marketability discount. Most states with withdrawal rights permit the partnership agreement to override it; however, due to the application of section 2704(b), discussed below, such a provision will not improve the discount.[46]

Both limited partnerships and LLCs can "dissolve." A dissolution is not a liquidation of the FLLE. From the outside world's per-

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[41] *See Trenchard*, 69 T.C.M. (CCH) at 2172-73. The court determined that in this case a control premium existed. *See id.; see also* Estate of Newhouse v. Comm'r, 94 T.C. 193, 249-52 (1990).

[42] *See Trenchard*, 69 T.C.M. (CCH) at 2173.

[43] Indeed, the entity would have to be an LLC.

[44] *See, e.g.*, N.Y. P'SHIP LAW § 121-602 (McKinney 2001); S. Stacy Eastland, *Family Limited Partnerships: Transfer Tax Benefits*, 7 PROB. & PROP. 59, 61 (1993).

[45] *See, e.g.*, MD. CODE ANN., CORPS. & ASS'NS § 10-603(a) (1999). This section was amended in 1998 to eliminate the six-month withdrawal right and provide that unless the partnership agreement provides to the contrary, a limited partner may not withdraw before the dissolution and winding up of the limited partnership. *See id.*

[46] *See infra* Part II.F.2.

spective, nothing may appear to have happened, but there can have been a technical termination of the FLLE, typically immediately followed by its reformation.[47] A withdrawal of a general partner of a limited partnership or a member of an LLC can cause a dissolution. It may take a vote of the majority of the owners to continue an FLLE once it has been dissolved. This in turn makes it more likely that the FLLE will liquidate, giving the owners value for their interests. The more likely the prospect of a dissolution, the lower the lack-of-marketability discount should be. The withdrawal of a limited partner typically does not cause the dissolution of a limited partnership.[48] However, the withdrawal of a member of an LLC historically did cause it to dissolve. This used to make a limited partnership preferable to an LLC for family estate planning, since there was less chance of a dissolution and, therefore, a greater lack-of-marketability discount. However, as states amend their LLC statutes to take into account the check-the-box regulations, state statutes increasingly provide that the withdrawal of a member of an LLC does not cause a dissolution of the LLC.[49]

F. Section 2704

1. In General

Congress enacted section 2704 to curtail the use of restrictions and lapsing rights as estate planning tools. Previously, for example, a restriction on liquidation rights might have been placed on a family partnership interest prior to its transfer to another family member, possibly reducing its value considerably. In many instances, after the transfer, the partners agreed to remove the restriction, or else the restriction automatically lapsed. The donor's controlling interests often were designed to lapse upon her death. As a result, there may have been no interest to value in the donor's estate. Now, however, section 2704 places constraints on both of these planning areas.[50] The part of section 2704 that is most relevant in the context of this article is section 2704(b).

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[47] *See* ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG & RIBSTEIN ON PARTNERSHIP § 7.01 (2001); LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES § 11.01 (2001).

[48] *See* BROMBERG & RIBSTEIN, *supra* note 46, §§ 17.01(f), 17.05.

[49] *See* RIBSTEIN & KEATINGE, *supra* note 46, § 11.01.

[50] *See generally* HENKEL, *supra* note 2, §§ 16.03[3][d]-[e].

2. Section 2704(b) and the Applicable Restriction

Section 2704(b) provides that if there is a transfer of an interest in a partnership to a member of the donor's family,[51] any "applicable restriction" is ignored in determining the value of the interest.[52] An applicable restriction is any restriction that limits the ability of the partnership to liquidate, provided either that the restriction by its terms can lapse or that the transferor or any member of the transferor's family, either alone or collectively, has the right to remove the restriction.[53] Thus, a provision in a family limited partnership agreement stating that the consent of 100% of the partners is required for liquidation, when state law only requires 70% consent, would be an applicable restriction, since the family as a group could have the provision removed from the agreement.[54]

A limited partner normally will not have a statutory power to cause a liquidation of a limited partnership.[55] Many states, however,

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[51] Defined as the transferor's spouse, the transferor's or her spouse's ancestors and lineal descendants, and the brother or a sister of the transferor. Also included are spouses of the covered ancestor, lineal descendants, brothers, and sisters. *See* I.R.C. § 2704(c)(2).

[52] I.R.C. § 2704(b).

[53] *See id.* Section 2704 excludes from the definition of an applicable restriction any restriction imposed by federal or state law. *See* I.R.C. § 2704(b)(3)(B). Also excluded is any commercially reasonable restriction which arises as part of any financing by the corporation or partnership with a person who is not related to the transferor or transferee, or a member of the family of either. *See* I.R.C. § 2704(b)(3)(A). The regulations provide somewhat liberally that an applicable restriction is a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the state law generally applicable to the entity in the absence of the restriction. *See* Treas. Reg. § 25.2704-2(b). In *Kerr v. Commissioner*, 113 T.C. 449 (1999), the Tax Court held that a provision in a partnership agreement that a partnership would liquidate as of a certain date or when agreed to by the partners did not involve an applicable restriction because state law provided that a limited partnership would dissolve upon the occurrence of events specified in the partnership agreement or by the written consent of all of the partners. *See* 113 T.C. at 472. *Accord* Estate of Jones v. Comm'r, 116 T.C. 121, 132-33 (2001); Knight v. Comm'r, 115 T.C. 506, 513-14 (2000); *Harper*, 79 T.C.M. (CCH) at 2234.

[54] Treas. Reg. § 25.2704-2(d), ex. 1. The Treasury Regulations provide that an option, the right to use property, or an agreement that is subject to section 2703 does not constitute an applicable restriction. *See* Treas. Reg. § 25.2704-2(b).

[55] REVISED UNIF. P'SHIP ACT § 801, 6 U.L.A. 108 (Supp. 2001).

provide that a limited partner may withdraw on six-months' notice and be paid fair value for her interest unless the partnership agreement provides to the contrary.[56] If there is such a provision to the contrary in the partnership agreement, some have thought section 2704(b) would treat it as an applicable restriction and require that it be ignored for the purpose of computing the discounts.[57] Indeed, many states have removed the right of a limited partner to withdraw on six months' notice, so as to improve the availability of discounts, and to address the fear that if the partnership agreement removed the right it would trigger the section 2704(b) applicable restriction rules.[58] Recently, however, in *Kerr v. Commissioner*,[59] the Tax Court held that section 2704(b) did not apply to limited partner withdrawal provisions, rejecting the argument to the contrary by the Service.[60] The court premised its holding on the fact that the applicable restriction rules of section 2704(b) only speak to limitations on the liquidation of a partnership as a whole, and do not address limited-partner withdrawal.[61]

A comparable issue exists for LLCs. Only a minority of states permits members of an LLC to voluntarily withdraw; a right to payment is then uncommon, and dissolution is generally not triggered.[62] To the extent withdrawal and payment rights do exist, under *Kerr* it would appear they could be removed by the operating agreement without concern for section 2704(b), assuming dissolution would not be triggered. Many states, however, provide that an LLC will dissolve on an event of involuntary disassociation such as the death, bankruptcy, or expulsion of a member unless the operating agreement provides to the contrary.[63] If a provision in the operating agreement does provide to the contrary, even under *Kerr* the provision could constitute an applicable restriction according to section 2704(b), since, unlike a withdrawal, it limits the ability of the LLC to liquidate. The LLC statutes contain such dissolution provisions in order to avoid the characteristic of continuity of life,

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[56] UNIF. LTD. P'SHIP ACT § 603 (amended 1985), 6A U.L.A. 217 (1976).

[57] *See* Tech. Adv. Mem. 9725002 (Mar. 3, 1997).

[58] *See* BROMBERG & RIBSTEIN, *supra* note 46, § 17.01(c).

[59] 113 T.C. 449.

[60] *See* 113 T.C. at 463-64. *See also Jones*, 116 T.C. at 132-33; *Knight*, 115 T.C. at 513-14; *Harper*, T.C.M. (CCH) at 2234.

[61] *See Kerr*, 113 T.C. at 473.

[62] *See* RIBSTEIN & KEATINGE, *supra* note 46, app. 11-1.

[63] *Id.* § 11.02.

an important consideration under the pre-check-the-box regulations but now just so much excess baggage.[64] Statutory dissolution provisions can reduce the availability of the lack-of-marketability discount, since it makes it more likely that the LLC will liquidate and the owners receive value for their interests. Consequently, the trend is for state statutes to provide that LLCs have perpetual life, eliminating this issue altogether.[65]

III. THE SHAM-TAMS

A. The Basics

In a series of Technical Advice Memoranda, the Service ignored the creation of FLLEs, instead valuing a decedent's estate as if it held the assets of the FLLE directly.[66] The TAMs had similar facts. Typically, children of a dying parent created an FLLE on behalf of the parent, using either a power of attorney granted them by the parent or their powers as trustees of a trust created for the benefit of the parent. The children controlled the FLLE and the parent held the bulk of the beneficial interests in it. In one case, a limited partnership was created within two days after the parent's death--after the parent had been removed from life support.[67] By having the parent shift from direct ownership to indirect ownership through an FLLE controlled by the children, the children hoped that the parent's estate would obtain minority-interest and lack-of-marketability discounts on the FLLE interests retained by the parent. In the TAMs, the parent's estate took discounts ranging from 30% to 55%.[68]

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[64] *See id.* §§ 11.01, 16.20. Prior to the check-the-box regulations, an unincorporated entity could be classified as a corporation in the highly unlikely event that it had a majority of the following characteristics: continuity of life, centralized management, limited liability, and free transferability of interest. *See* SARGENT & SCHWIDETZKY, *supra* note 2, ch. 2.

[65] *See* RIBSTEIN & KEATINGE, *supra* note 46, § 11.01. *See also* MD. CODE ANN., CORPS. & ASS'NS § 4A-203(1).

[66] *See* Tech. Adv. Mem. 9719006 (Jan. 14, 1997); Tech. Adv. Mem. 9723009 (Feb. 24, 1997); Tech. Adv. Mem. 9725002 (Mar. 3, 1997); Tech. Adv. Mem. 9730004 (Apr. 3, 1997); Tech. Adv. Mem. 9735003 (May 8, 1997); Tech. Adv. Mem. 9736004 (June 6, 1997).

[67] *See, e.g.*, Tech. Adv. Mem. 9719006 (Jan. 14, 1997).

[68] *Compare* Tech. Adv. Mem. 9725002 (Mar. 3, 1997) (38%) *with* Tech. Adv. Mem. 9735004 (Apr. 21, 1997) (55%).

The Service made several arguments for its holdings. One of the arguments, in essence, was that given the proximity of the death and the lack of direct involvement by the decedent, the FLLEs were shams.[69] The Service cited *Estate of Murphy v. Commissioner*[70] as authority for its position.[71] In *Murphy*, eighteen days before the decedent died, she had transferred to her two children less than a 2% stock interest in a family-run, closely-held corporation.[72] The transfer reduced the decedent's ownership interest in the corporation to just below 50%. The estate claimed a minority-interest discount for the remaining stock. The Tax Court denied the discount, stating that a minority-interest discount should not be applied if the explicit purpose and effect of fragmenting the control block of stock was solely to reduce federal tax.[73] However, the court did allow a discount for lack of marketability.[74]

Murphy should be contrasted with *Estate of Frank v. Commissioner*.[75] In *Frank*, the son of the decedent held the decedent's power of attorney. Two days before the decedent's death, pursuant to the power of attorney, the son transferred stock owned by the decedent to the decedent's wife. The transfer reduced the decedent's ownership interest in the family corporation from over 50% to 32%.[76] The court held that the transfer was valid and allowed a 20% minority-interest discount and a 30% lack-of-marketability discount on the remaining stock included in the estate.[77] The Service argued that the court should apply the substance-over-form doctrine and ignore the transfer.[78] The court refused to do so, noting that if tax avoidance were the sole motive, a substantially smaller number of shares could have been transferred.[79] As I will discuss in

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[69] *See* Tech. Adv. Mem. 9725002 (Mar. 3, 1997); Tech. Adv. Mem. 9719006 (Jan. 14, 1997); Tech. Adv. Mem. 9723009 (Feb. 24, 1997); Tech. Adv. Mem. 9730004 (Apr. 21, 1997); Tech. Adv. Mem. 9736004 (June 6, 1997).

[70] 60 T.C.M. (CCH) 645 (1990).

[71] *See* Tech. Adv. Mem. 9725002 (Mar. 3, 1997); Tech. Adv. Mem. 9736004 (Apr. 21, 1997); Tech. Adv. Mem. 9730004 (Apr. 21, 1997); Tech. Adv. Mem. 9723009 (Feb. 24, 1997); Tech. Adv. Mem. 9719006 (Jan. 14, 1997).

[72] 60 T.C.M. (CCH) at 645.

[73] *See id.* at 658.

[74] *See id.* at 657.

[75] 69 T.C.M. (CCH) 2255 (1995).

[76] *See id.* at 2256-57.

[77] *See id.* at 2259, 2263.

[78] *See id.* at 2259.

[79] *See id.*

more detail below,[80] the extent to which a decedent transfers interests in FLLEs shortly before death should not be a basis for a differing tax treatment. If the formation of an FLLE shortly before death is a problem, it should be a problem whether or not the decedent transfers interests. Otherwise, decedents will be able to avoid attack by the simple expedient of making the necessary transfers, elevating form over substance.[81]

B. Section 2703

In the TAMs, the Service made an apparently unprecedented argument, stating that section 2703(a)(2) applied, which provides that the value of property is determined without regard to "any restriction on the right to sell or use such property."[82] In the Service's view, the "partnership or LLC wrapper" covering the decedent's assets was a restriction within the meaning of section 2703(a)(2) and, therefore, should be ignored.[83] Without the FLLE wrapper, the decedent could still be considered to own the bulk of the relevant property, which, to that extent, eliminates the discounts.

Section 2703(b) provides an exception to the application of section 2703(a)(2) if the following three tests are met: (1) the arrangement is a bona fide business transaction, (2) the transaction is not a device to transfer property to members of the family of the decedent for less than full consideration, and (3) the transaction has terms that are comparable to similar transactions entered into by persons dealing at arm's length.[84] In the TAMs, the Service concluded that section 2703(b) did not apply.[85] It would be a rare FLLE that could meet the requirements of this section, since typically the whole point of the transfer is to provide a device to transfer prop-

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[80] *See infra* Part VI.

[81] Most likely, there would be no transfer tax savings beyond any availability of the discounts, since gift taxes paid within three years of death are brought back into the estate under section 2035, and property is unlikely to change in value between the time of a death-bed gift and the time of death. *See* I.R.C. § 2035.

[82] I.R.C. § 2703(a)(2). *See, e.g.*, Tech. Adv. Mem. 9725002 (Mar. 3, 1997); Tech. Adv. Mem. 9730004 (Apr. 3, 1997).

[83] *See* Tech. Adv. Mem. 9725002 (Mar. 3, 1997); Tech. Adv. Mem. 9723009 (Feb. 24, 1997); Tech. Adv. Mem. 9719006 (Jan. 14, 1997).

[84] *See* I.R.C. § 2703(b).

[85] *See, e.g.*, Tech. Adv. Mem. 9725002 (Mar. 3, 1997); Tech. Adv. Mem. 9735003 (May 8, 1997).

erty to members of the family of the decedent for less than full consideration, contrary to part two of the exception.[86]

However, the legislative history to section 2703(a)(2) does not seem to contemplate the manner in which the Service is applying its provisions. The section appears to have been intended to prevent buy-sell agreements among family members from reducing the value of the interests the family members hold, rather than to provide an opportunity to ignore the formation of an FLLE altogether.[87] Further, the Service's approach would mostly render moot section 2704(b), which Congress presumably would not have intended.[88] There would be little need to have "applicable restrictions" in the operating agreement be ignored under such a rule. The Service's use of section 2703(a)(2) is aggressive and, in fact, has not met with success in the courts.

C. The Courts

In a number of recent cases, the Service has used a variety of arguments to attack FLLEs.[89] Somewhat surprisingly in some cases, the Service has had little success. Still, one detects genuine skepticism toward FLLEs formed near death, and the final judicial chapter on the matter likely has not been written.

1. The *Church* Case

In *Estate of Church v. Commissioner*,[90] Mrs. Church and her two children owned a combined 57% interest in a large ranch, which they leased for grazing and oil and gas drilling.[91] Distant relatives owned the balance of the ranch, which was managed by

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86 *But see Church*, 2000-1 U.S.T.C. (CCH) ¶ 60,369.

87 *See* HENKEL, *supra* note 2, § 16.03[3][c].

88 *See supra* notes 50-64 and accompanying text.

89 In Field Service Advice Memorandum 200049003, the Service gives a variety of bases for attacking FLLEs, which are in fact generally used in the cases discussed below. Field Serv. Adv. Mem. 200049003 (Sept. 1, 2000).

90 2000-1 U.S.T.C. (CCH) ¶ 60,369. For a discussion of *Church*, as well as of *Estate of Reichardt v. Commissioner*, 114 T.C. 144 (2000), discussed *infra* notes 168-178 and accompanying text, see Jerald August and Adi Rappoport, *Recent Decisions Frustrate Service's Efforts to Challenge FLPs*, 27 EST. PLAN. 19 (2000).

91 *See Church*, 2000-1 U.S.T.C. (CCH) at 84,777.

Mrs. Church's children.[92] Mrs. Church intended to transfer $1,000,000 in marketable securities and her interest in the ranch to a newly formed family limited partnership.[93] Her two children also intended to transfer their interests in the family ranch to the partnership.[94] There was apparently no intent on the part of Mrs. Church to transfer the partnership interests she was to receive to others. The general partner was supposed to be a corporation controlled by the two children.[95] Two days after attempting to form the relevant entities, Mrs. Church died of a heart attack.[96] While she had been ill with cancer, her death was unexpected.[97] At the time of her death, the certificate of limited partnership had not been filed, and the corporation had not yet been incorporated.[98] The account that held the marketable securities remained in Mrs. Church's name.[99] The government argued that the transactions had no substance and that this was merely a device to remove assets from Mrs. Church's estate.[100] The district court found that under Texas law a valid limited partnership was formed notwithstanding the procedural irregularities, and that the limited partnership held the relevant assets.[101]

The *Church* case was distinguishable from more abusive cases by the significant business and nontax motivations that were involved. The court held that the primary purpose of the partners in forming the partnership was a desire to preserve the family ranching enterprise for themselves and their descendants.[102] Bringing organization to the ranch would remove it from the control of one or more fractional, undivided-interest owners who could use the property at will, interfere with operations, and ultimately force a partition or sale of the ranch.[103] Mrs. Church and her children had already experienced the consequences of an undivided ownership in a real-estate-based business enterprise.[104] Prior to formation of the

[92] *See id.*
[93] *See id.*
[94] *See id.*
[95] *See id.*
[96] *See id.* at 84,778.
[97] *See id.*
[98] *See id.* at 84,777-78.
[99] *See id.* at 84,778.
[100] *See id.* at 84,779.
[101] *See id.* at 84,780.
[102] *See id.* at 84,778.
[103] *See id.*
[104] *See id.*

partnership, Mrs. Church's nephew had exercised his rights as an undivided owner by moving onto the ranch, interfering with operations, threatening legal action, and almost driving off the grazing lessee who was the major source of the ranch's income.[105] Mrs. Church, her two children, and their cousin had to solve this threat by borrowing money to purchase the nephew's interest.[106] Moreover, they knew this nephew would likely inherit an additional interest in the ranch through his father and have to be bought out again.[107] This did in fact occur after formation of the partnership.[108] The securities contributed to the partnership by Mrs. Church provided the $ 200,000 in capital necessary for this second buy-out.[109] The court also noted that the partnership was formed with an eye toward the possibility of actively engaging in raising cattle.[110] Although the ranch was in the midst of a prolonged and continuing drought, and the grazing lease expired in 1994 without the certainty that it would be renewed, the partnership was prepared, if necessary, to replace this lost income through active operations.[111] Working capital over and above income from the ranch would have been necessary to engage in this activity.[112]

The court also rejected the Service's arguments that section 2703(a)(2) permitted it to ignore the partnership wrapper.[113] The court noted that there was no legislative, regulatory, or case law support for this position.[114] Given that the children, like Mrs. Church, contributed their own interests in the ranch in exchange for partnership interests, the court held that the transfer was not a device to transfer property to members of her family for less than full consideration and that the terms were comparable to those entered into by persons dealing at arm's length.[115] These holdings, along with the court's holding that the transfers involved a bona fide

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[105] *See id.*

[106] *See id.*

[107] *See id.*

[108] *See id.* at 84,778-79.

[109] *See id.*

[110] *See id.* at 84,779.

[111] *See id.*

[112] *See id.*

[113] *See id.* at 84,779, 84,781. *See also supra* notes 83-88 and accompanying text.

[114] *See Church*, 2000-1 U.S.T.C. (CCH) at 84,781.

[115] *See id.* at 84,779.

business arrangement, brought the transfers within the exception contained in section 2703(b).[116] Thus, only the limited partnership interests were included in Mrs. Church's estate. Although Mrs. Church transferred about $1.5 million worth of assets to the limited partnership, the court held that after the minority-interest and lack-of-marketability discounts, the value of the limited partnership interests in her estate was about $600,000.[117]

Church is most noteworthy for being atypical of the FLLEs under discussion in this article. The children made substantial contributions to the partnership, and there were reasons beyond estate planning for its formation. Mrs. Church's death was unexpected, and the court was clear on the bona fide business nature of the transaction. None of these factors will be present for a typical last-minute FLLE. Consequently, the case provides little in the way of general guidance. It also does not provide much in the way of specific guidance on section 2703 for the Service or the taxpayer, since the court held that the transaction came within the section 2703(b) exception, which commonly would not be the case.[118] It does perhaps suggest that the courts will be inclined to uphold bona fide transactions that follow from good planning, but that is not exactly surprising.

2. The Strange *Strangi* Case[119]

Albert Strangi, a self-made millionaire, lived and died in Waco, Texas.[120] He married, divorced, and remarried, with children from the first marriage and stepchildren from the second.[121] Strangi survived his second wife.[122] A son-in-law, a lawyer, prepared many of the estate planning documents and held the decedent's general power of attorney.[123] In August 1994, fresh from an estate planning seminar, the son-in-law formed a Texas limited partnership, SLFP,

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[116] *See id.* at 84,779, 84,781. *See also supra* notes 53-56 and accompanying text.

[117] *See Church*, 2000-1 U.S.T.C. (CCH) at 84,780.

[118] *See id.* at 84,779-81.

[119] *Strangi*, 115 T.C. 478.

[120] *See id.* at 478-79.

[121] *See id.* at 479.

[122] *See id.* at 480.

[123] *See id.* at 479.

and its Texas corporate general partner, Stranco, Inc.[124] At the time Strangi was suffering from terminal cancer. The son-in-law handled all of the details of the formation and executed the documents as Strangi's attorney-in-fact.[125] Stranco had the sole authority to conduct the business affairs of SFLP without the concurrence of any limited partner.[126] The son-in-law assigned to SFLP Strangi's interest in certain real estate, securities, accrued interest and dividends, insurance policies, and annuities with a combined fair market value of $9,876,929.[127] Seventy-five percent of the value was attributable to cash and securities.[128] Strangi purchased a 47% interest in Stranco for $49,350, and his four children purchased the remaining 53% for $55,650.[129] Stranco contributed $100,333 to the limited partnership in exchange for a 1% partnership interest.[130] Since the children had control of Stranco, they technically also had control of the limited partnership.[131] All these transactions were completed by August 1994.[132] In October of that year, Strangi died.[133]

In 1995, SFLP distributed several million dollars to Strangi's estate to pay, or otherwise address, state and federal estate and inheritance taxes.[134] SFLP also extended lines of credit to three of the children.[135] In 1995 and 1996, SFLP distributed $563,000 to each of the Strangi children, characterizing them as distributions from the estate.[136] In May 1996, SFLP divided its primary Merrill Lynch account into four separate accounts in each of the Strangi children's names, giving them control over a proportionate share of the partnership assets.[137] By 1998, SFLP had distributed around $2.5 million to each of the Strangi children.[138]

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[124] *See id.* at 480-81.

[125] *See id.* at 480-82.

[126] *See id.*

[127] *See id.* at 481.

[128] *See id.*

[129] Three of the children borrowed the funds for their shares from the fourth child, giving unsecured promissory notes in turn. *See id.*

[130] *See id.* at 481.

[131] *See id.* at 481-82.

[132] *See id.* at 482.

[133] *See id.*

[134] *See id.* at 482-83.

[135] *See id.*

[136] *See id.* at 483.

[137] *See id.*

[138] *See id.*

When filing the estate tax return, Strangi's estate took minority-interest and lack-of-marketability discounts on the value of the SFLP interests it held.[139] At trial, the Service argued that the existence of SFLP should be disregarded for lack of a business purpose and economic substance.[140] The estate countered with two main arguments. First, it claimed that SFLP helped insulate Strangi from an anticipated tort claim by a caregiver, and the estate from a will contest by disinherited stepchildren, through the creation of another layer with which creditors would have to contend.[141] Second, the estate maintained that SFLP provided a joint investment vehicle for managing Strangi's assets.[142] The court largely rejected the estate's arguments, stating that there was no realistic prospect of either a tort claim or a will contest.[143] Since Strangi ended up with 99.47% of the SFLP, directly or indirectly, and three of the four Strangi children were not meaningfully involved in the affairs of SLFP prior to the fragmentation of the Merrill Lynch account, the court concluded that a joint-investment motive was not apparent either.[144] Further, SFLP conducted no active business.[145] Actual control was exercised by the son-in-law, via the power of attorney, meaning that technically Strangi retained control.[146] Interestingly, the court noted that the Service might have had a claim that the assets of SFLP could have been included in Strangi's estate under section 2036.[147] Luckily for the estate, however, the court did not address the section 2036 issue, because the Service had failed to assert that argument in a timely manner.[148] This is an important issue, and will be discussed in detail below.[149]

The court concluded that despite the questionable motivations, SFLP was in fact a validly created entity.[150] The existence of the partnership in fact changed the relationships between Strangi and

[139] *See id.*
[140] *See id.* at 484.
[141] *See id.* at 485.
[142] *See id.*
[143] *See id.*
[144] *See id.* at 485-86.
[145] *See id.* at 486.
[146] *See id.*
[147] *See id.*
[148] *See id.*
[149] *See infra* Part IV.
[150] *See Strangi*, 115 T.C. at 486-87.

his heirs, and the court concluded that the partnership could not be ignored for federal income tax purposes.[151] Although the majority did not state so explicitly, an inference can be drawn from the majority's rejection of any legitimate nontax motivations for the formation of the limited partnership that, barring the application of section 2036, a legally formed state law entity cannot be ignored for valuation purposes.[152] As will be discussed below,[153] the dissenting judges took issue with this perspective, which is indeed a surprising one. If section 2036 can be avoided, which should readily be possible,[154] then a decedent can reduce the valuation of her estate by simply putting her assets into an FLLE before her death, notwithstanding the fact that the FLLE was formed primarily for tax-avoidance purposes.[155] It hardly seems sensible to allow significant amounts of estate taxes to be so easily avoided. The proposal set forth below would largely eliminate such tax avoidance.

In *Strangi*, the Service argued, as it had in the TAMs,[156] that section 2703 provided a basis for ignoring the "partnership wrapper."[157] The court rejected the argument, noting that neither section 2703's statutory nor its regulatory language supports such an interpretation.[158] Chapter 14, which includes sections 2701 through 2704, was intended to target transfer tax valuation abuses in the intra-family context, while relieving taxpayers of the broad sweep of section 2036(c) as previously enacted.[159] Congress wanted to value property interests more accurately when they were transferred instead of including previously transferred property in the trans-

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[151] *See id.*

[152] *See id.*

[153] *See infra* notes 133-53 and accompanying text.

[154] *See infra* notes 180-82 and accompanying text.

[155] *See Strangi*, 115 T.C. at 498 (Ruwe, J., dissenting).

[156] *See supra* notes 81-82 and accompanying text.

[157] *See Strangi*, 115 T.C. at 487-88. *See also supra* notes 83-88 and accompanying text.

[158] *See Strangi*, 115 T.C. at 488.

[159] *See id.* The pre-1991 version of section 2036 provided that if a person held a substantial interest in an enterprise and transferred property having a disproportionately large share of the potential appreciation in her interest in the enterprise while retaining interest in its income, she was considered to have retained the enjoyment of the transferred property. *See* I.R.C. § 2036(c) (1990). That would have triggered section 2036(a), requiring inclusion of the transferred property in the estate at death. The court was obviously not amiss in characterizing the pre-1991 version of section 2036(c) as having a broad sweep.

feror's gross estate.[160] The court accurately noted that treating the partnership assets rather than the decedent's interest in the partnership as the "property" to which section 2703 applied, would raise anew the difficulties Congress sought to avoid by enacting Chapter 14.[161] Accordingly, the court concluded that Congress did not intend through the enactment of section 2703 for the Service to be able to look through the partnership wrapper and treat the decedent as owning the assets transferred to the partnership rather than owning the partnership interest.[162] Indeed, the Service's arguments under section 2703 were a stretch and, as the court rightly indicated, clearly beyond what Congress intended when enacting section 2703.[163] Therefore, it was quite appropriate that the arguments failed.

The Service also argued that Strangi made a gift when he transferred property to the partnership and received in return a limited partnership interest of lesser value.[164] Since Strangi gave up property worth $10 million and received back a limited partnership interest arguably worth around $6.5 million, the Service maintained that the difference was a gift.[165] The court noted, however, that since Strangi's interest in SFLP exceeded 99%, and his contribution was allocated to his own capital account, the transfer of property could not be considered a gift.[166] Since essentially nothing Strangi put in went anywhere but to his own account, there was no one to whom a gift could have been made.

While this part of the argument provides a reasonable basis for not finding a gift on formation, the court also stated that the decedent had not given up "control over the assets," notwithstanding the fact that he only had a minority interest in the general partner.[167] It is not entirely clear what the court meant by this cryptic statement. Perhaps the statement is no more than casual dicta, since the court grounded its holding on the fact that nothing of real signifi-

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[160] *See Strangi*, 115 T.C. at 488.

[161] *See id.*

[162] *See id.* at 488-89.

[163] *See id.* at 488.

[164] *See id.* at 489.

[165] *See id.*

[166] *See id.* at 489-90. The Tax Court reaffirmed this view in *Jones*, 116 T.C. at 128.

[167] *Strangi*, 115 T.C. at 490.

cance was given to others.[168] However, if the court really believed Strangi kept control, it is hard to understand the discount it ultimately allowed.

While the court did not accept the Service's legal arguments, it also did not accept the estate's valuation.[169] Rather than the 43.75% discount claimed by the estate, the court permitted a 31% discount for the partnership interest.[170] The latter amount was based on the Service's experts, and the court indicated that even this discount could be overly generous.[171] SLFP was not in a risky business or one in which the continuing value of the assets depended on continuing operations, and there was no real issue as to liquidity.[172]

A total of seven judges joined in the majority opinion. There were two concurring and four dissenting opinions.[173] The number of dissents and concurrences indicates that the Tax Court judges are far from uniform in their views and that similar cases in the future may generate different outcomes. The appellate courts also have generally not yet addressed this issue.

Judge Wells, in the only written concurrence, believed that the majority misapplied the "economic substance argument."[174] Since the majority rejected the alleged business purposes underlying the formation of the partnership, a proper application of the economic substance doctrine would ignore the partnership, assuming the doctrine's applicability.[175] In Judge Wells' view, the court should have concluded that the economic substance doctrine did not operate to disregard a validly formed entity where the issue is the value for federal gift and estate tax purposes of the interest trans-

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[168] *See id.*

[169] *See id.* at 490-91.

[170] *See id.* at 491-92.

[171] *See id.* at 492-93.

[172] *See id.* at 491-92.

[173] *See id.* at 493, 494, 496, 500.

[174] *See id.* at 493. The nomenclature Judge Wells used is not one that is commonly employed. The "substance over form" doctrine is probably the more common term. Judge Wells' usage is nonetheless consistent with *Gregory v. Helvering*, 293 U.S. 465 (1935), cited by the majority, in which the Supreme Court stated that a genuine multiple-party transaction with *economic substance* and not shaped solely by tax avoidance features should be respected for tax purposes. 293 U.S. at 469-70. Judge Foley agreed with Judge Wells' concurrence. *See Strangi*, 115 T.C. at 494. Judge Laro concurred without expressing an opinion. *See id.* at 493.

[175] *See id.* at 493-94.

ferred in the entity.[176] This concurrence is at least slightly curious in that it is not at all clear that the majority in fact applied the economic substance doctrine. Nevertheless, while not free from doubt, the majority did seem to reject the notion that there was any economic substance to the formation of SLFP, and in effect appeared to agree with Judge Wells that the doctrine did not apply in this context.[177] Perhaps what troubled Judge Wells and triggered his concurrence was the ambiguity of the majority's discussion. Certainly, Judge Wells' opinion is far crisper in rejecting the economic substance doctrine than is the majority's opinion. Indeed, the courts have often been more reluctant to apply the economic substance doctrine to federal transfer tax cases than to income tax cases,[178] even though that reluctance has hardly been absolute.[179] It is never been apparent why this is so. The policies underlying the doctrine — that structures and transactions should have an economic reality, rather than just being tax gambits — would seem as applicable to the federal transfer tax regime as to the income tax regime. The dissents seemed to share this view.[180]

Judge Parr wrote a dissenting opinion, in which Judges Beghe and Marvel joined.[181] In the opinion, she complained that the facts clearly demonstrated that the written partnership agreement had no relationship to the reality of Strangi's ownership and control of the assets contributed to the partnership.[182] Judge Parr disagreed with the majority's valuation, which assumed that the restrictions written in the partnership agreement were actually binding on the partners.[183] Even assuming that the partnership must be recognized for federal estate tax purposes, Judge Parr would have valued the interest under the agreement that actually existed, which she felt permitted funds to be withdrawn at will rather than under the written part-

[176] *See id.*

[177] *See id.* at 485.

[178] *See, e.g.*, Kohlsaat v. Comm'r, 73 T.C.M. (CCH) 2732 (1997); Estate of Cristofani v. Comm'r, 97 T.C. 74 (1991), *acq. in result*, 1992-1 C.B. 1 (Mar. 23, 1992).

[179] *See* Heyen v. United States, 945 F.2d 359, 363 (10th Cir. 1991) (applying the substance over form doctrine in the transfer tax context); Griffin v. United States, 42 F. Supp. 2d 700, 703-704 (W.D. Tex. 1998) (same).

[180] *See Strangi*, 115 T.C. at 495 (Parr, J.), 499-500 (Ruwe, J.), 504-505 (Beghe, J.).

[181] *See id.* at 494, 496.

[182] *See id.* at 494.

[183] *See id.* at 494-95.

nership agreement.[184] She argued, rather persuasively, that a minority-interest discount is premised on the fact that limited partners cannot force the partnership to make distributions.[185] Yet Strangi and his estate in fact caused the partnership to do so. A lack-of-marketability discount is allowed because the third party would pay less for the partnership interest than for the assets.[186] In Judge Parr's view, however, under the actual facts, Strangi could have distributed all the assets to himself and sold them directly to the buyer, making the lack-of-marketability discount inappropriate.[187] Because the actual partnership arrangement provided for distributions at will, Judge Parr would have valued the partnership interest at the value of the partnership assets without any discount.[188]

In his dissent, Judge Ruwe accepted the Service's gift argument.[189] If the partnership interest Strangi received is worth, as the majority held, 31% less than the value of the property that the decedent transferred, and was not transferred for a bona fide business reason, then the difference should be a gift.[190] A literal reading of the Code and regulations might support this view.[191] A stumbling block for this position, however, is that, as the majority suggested, nothing was really given away: Strangi retained almost all of the partnership interests.[192] Judge Ruwe responded that it is not necessary to know who the donees are for the gift tax to apply.[193] That is true under the treasury regulations,[194] but historically, this rule has been applied in cases such as *Robinette v. Helvering*,[195] where a remainder interest was given and the putative remaindermen, unborn children of the grantor, did not yet exist.[196] The difficulty with

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[184] *See id.*

[185] *See id.* at 496.

[186] *See id.*

[187] *See id.*

[188] *See id.*

[189] *See id.* at 497.

[190] *See id.* at 497 n.1.

[191] *See* I.R.C. §§ 2501, 2512(b). Section 2512 states, "[W]here property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift." I.R.C. § 2512(b).

[192] *See Strangi*, 115 T.C. at 490, 497 n.1.

[193] *See id.* at 499.

[194] *See* Treas. Reg. § 25.2511-2.

[195] 318 U.S. 184 (1943).

[196] *See id.* at 185-86.

applying that principle to the facts of *Strangi* is that in *Strangi* the donees were known.[197] Further, on formation of the partnership, the children received virtually nothing, since Strangi retained almost all of the interests.[198] To say there is a gift where the donor retains virtually all of the beneficial interests in the underlying property defies common sense. Nevertheless, Judges Parr, Beghe, Gale and Marvel joined this dissenting opinion in *Strangi* and would have recognized a gift in such a situation.[199]

Judge Beghe, in addition to joining the dissents of others, wrote a separate dissent.[200] He noted, no doubt correctly, that the only reason for the formation of SFLP was to reduce the federal transfer taxes by depressing the value of Strangi's assets.[201] The transactions did nothing to affect Strangi's or his children's interests in the underlying assets; the control exercised by Strangi and his children over the assets did not change.[202] For example, shortly after Strangi's death, SFLP made substantial distributions to the children, and the Merrill Lynch account was divided into four separate accounts to allow each child to control his or her proportionate share of the SFLP assets.[203] Since the apparent intent was to transfer assets to the children, with SFLP only hopefully proving itself a federal transfer-tax-reducing way-station, Judge Beghe would have applied the step transaction doctrine to collapse the steps and treat the transfer as going from Strangi directly to his children, eliminating any SFLP-related valuation discounts.[204] Judge Beghe's reasoning seems cogent. However, it would be fairly easy to plan around this simply by leaving assets in FLLE solution for longer periods of time and limiting the control exercised by the transferor. The proposal discussed below would apply more widely and uniformly, while avoiding the abuse Judge Beghe correctly identified.[205]

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[197] *See Strangi*, 115 T.C. at 482-83.
[198] *See id.* at 481, 490.
[199] *See id.* at 500.
[200] *See id.*
[201] *See id.* at 502.
[202] *See id.*
[203] *See id.*
[204] *See id.* at 503, 505-506.
[205] *See infra* Part V.

IV. THE POSSIBLE APPLICATION OF SECTION 2036

Section 2036 provides that the estate of a decedent includes transferred property if the decedent retained possession or enjoyment of the property or the right to the income from the property, excluding transfers for adequate consideration.[206] Further, section 2036 provides that the estate includes all assets that the decedent has transferred while retaining the right to designate who shall possess or enjoy the associated property or income.[207] Given the control Strangi effectively retained, both of these provisions of section 2036 could have applied in the case, had the Service asserted them in a timely manner.[208] Both *Estate of Schauerhamer v. Commissioner*[209] and *Estate of Reichardt v. Commissioner*[210] shed light on this issue.[211]

Schauerhamer involved a widow who took control of a family building-material business after her husband's death.[212] In November 1990 she was diagnosed with colon cancer. She then retained an attorney to assist with her estate planning.[213] Three limited partnerships were formed, one for each of her three children.[214] She and an alternate child were the general partners of each limited partnership.[215] Mrs. Schauerhamer was also the sole initial limited partner of each partnership as well as the managing partner of each partnership with full power to manage and conduct the respective partnership's affairs, and she did in fact manage each partnership.[216] In 1990 and 1991, Mrs. Schauerhamer transferred her business assets in undivided one-third shares to the partnerships.[217] In 1990, and again in 1991, she assigned 33 limited partnership interests, each

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[206] *See* I.R.C. § 2036(a)(1). The classic example: a decedent, while alive, transfers her home to her children, but retains the right to live in it.

[207] *See* I.R.C. § 2036(a)(2).

[208] *See Strangi*, 115 T.C. at 486-87.

[209] 73 T.C.M. (CCH) 2855 (1997).

[210] 114 T.C. 144.

[211] *See generally* Howard M. Zaritsky, *Back to Basics for the Family Limited Partnership*, 27 EST. PLAN. 240 (2000).

[212] *See Schauerhamer*, 73 T.C.M. (CCH) at 2856.

[213] *See id.* at 2855-56.

[214] *See id.* at 2856.

[215] *See id.*

[216] *See id.*

[217] *See id.*

purportedly worth $10,000, to family members.[218] Mrs. Schauerhamer deposited all partnership income into an account that she held with a daughter-in-law and that she used as her personal checking account.[219] She did not maintain any records to account separately for partnership and nonpartnership funds.[220]

The court noted that the term "enjoyment" in section 2036[221] is not a term of art but is synonymous with substantial present economic benefit.[222] Retained enjoyment may exist where there is an express or implied understanding at the time of the transfer that the transferor will retain the economic benefits of the property.[223] The court concluded that there was such an implied agreement among the partners.[224] Notwithstanding that each partnership agreement required each partnership to maintain a separate bank account and that partnership income be deposited in it, the partnership income was deposited in an account Mrs. Schauerhamer used as a personal checking account, where it was commingled with funds from other sources.[225] Further, her relationship to the assets did not change before or after the transfer.[226] As a consequence, the court held that section 2036(a)(1) required inclusion of the partnership assets in her estate.[227]

Reichardt involved the estate of Charles Reichardt, who had inherited from his wife a life interest in her separate property along with the power, on terms he deemed advisable, to sell, lease, or otherwise dispose of any of that property without requiring him to account for or replace any of it.[228] In 1993, Reichardt was diagnosed

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[218] *See id.* at 2856-57. These transfers, if correctly valued, would be exempt from gift tax under the $10,000 annual exclusion contained in section 2503. *See* I.R.C. § 2503(b).

[219] *See Schauerhamer*, 73 T.C.M. (CCH) at 2857.

[220] *See id.*

[221] *See* I.R.C. § 2036(a)(1).

[222] *See Schauerhamer*, 73 T.C.M. (CCH) at 2857.

[223] *See id.*

[224] *See id.*

[225] *See id.* at 2857-58.

[226] *See id.* at 2858.

[227] *See id.* at 2857-58.

[228] *See* 114 T.C. at 145-47. He would lose the life estate if he remarried. His wife was apparently upset about an extramarital affair that he had been having, and this provision was apparently an effort from the grave to control his behavior, or failing that, his marital status. *See id.* at 146.

with terminal cancer.[229] In June of that year, on the advice of his son and a CPA, Reichardt signed a will and durable power of attorney, and formed a revocable living trust and a family limited partnership.[230] The trust was the general partner of the limited partnership, Reichardt and his children were trustees of the trust, and each was authorized to act on behalf of the trust.[231] Reichardt was entitled to the net income of the trust and could use the corpus of the trust for his support, maintenance, health, and general welfare.[232] Reichardt placed almost all of his property in the partnership, including his home.[233] He transferred a 30.4% interest in the partnership to each of his two children, claiming a gift tax value of $310,000.[234] The court noted that Reichardt controlled and managed, or allowed the co-owners to control and manage, the partnership assets in the same manner both before and after his transfer of them to the partnership.[235]

The court stated that for purposes of section 2036, 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 present economic benefits of the property, even if the retained right is not legally enforceable.[236] The court held that Reichardt did not curtail his enjoyment of the transferred property after he formed the partnership.[237] Nothing changed except legal title: he managed the trust, which managed the partnership; he commingled partnership and personal funds.[238] The court also concluded that there was an implied agreement between Reichardt and his children that he could retain the right to make income from the transferred property.[239] The court held that since Reichardt's relationship to the assets remained the same before and after the transfer, section

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[229] *See id.* at 147.
[230] *See id.* at 147-48.
[231] *See id.* at 147.
[232] *See id.* at 147-48.
[233] *See id.* at 148.
[234] *See id.* at 148-50.
[235] *See id.* at 149.
[236] *See id.* at 151.
[237] *See id.* at 152.
[238] *See id.*
[239] *See id.* at 153, 155, 158-59. Reichardt did not retain the right to earn income from the home, but since he continued to live in it, he retained possession and enjoyment of it, which is one of the standards for triggering section 2036(a)(1). *See id.* at 152.

2036(a)(1) required the assets to be included in his estate.[240] The estate claimed that Reichardt formed the partnership to prevent him from treating the transferred property imprudently.[241] The court rejected this argument since he stayed in effective control.[242] The estate also contended that Reichardt's fiduciary duties as a general partner and trustee precluded him from retaining enjoyment of the assets.[243] The court also rejected this argument given the effective control Reichardt in fact maintained and the implied agreement that the court found to exist between him and his children.[244]

What the *Reichardt* and *Schauerhamer* cases demonstrate, and the *Strangi* case might have demonstrated but for the Service's failure to raise the section 2036 issue in a timely manner, is that sloppy procedures invite trouble. Donors cannot commingle funds and maintain precontribution use of the property and then expect supposed transfers to keep the property out of their estates. This makes it obviously unwise to put purely personal-use assets such as the family home into an FLLE. The decedent's use of FLLE assets for personal purposes might not only trigger section 2036, but also might raise questions as to whether there is an adequate business purpose for the transfer.[245]

Nevertheless, avoiding section 2036 should not be difficult for FLLEs formed shortly before death. Personal-use assets should not be included, and proper procedures should be followed. Obviously, partnership and personal funds should not be commingled. In *Schauerhamer* and *Reichardt*, the courts stated that section 2036 could be applied if there were an express or implied agreement that the decedent retain the economic benefits from the contributed property.[246] A decedent could avoid this problem simply by giving up much of the benefits associated with the contributed property. He could contribute the property to the FLLE and give a significant portion of the FLLE interests to family members. To avoid a *Reichardt* situation, the decedent should not disproportionately benefit from the FLLE assets. The transfers would be subject to a gift tax,

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240 *See id.* at 152-53.

241 *See id.* at 153.

242 *See id.*

243 *See id.* at 154.

244 *See id.* at 153-55.

245 *See supra* Part II.A.

246 *See Schauerhamer*, 73 T.C.M. (CCH) at 2857; *Reichardt*, 114 T.C. at 151.

even though the application of the annual exclusion and the applicable exclusion amounts could limit the amount of taxes that actually has to be paid.[247] Further, since gift taxes paid within three years of death are brought back to the estate, these near-death transfers would not be "gift-tax exclusive."[248] These results will often be small prices to pay, however, for significant valuation discounts on the property contributed to the FLLE, should the reasoning of *Strangi* hold true. Further, with the decedent near death, paying gift taxes currently may not pose a large time-value-of-money concern, since an estate tax liability presumably would have applied regardless to the gifted property in the short run.

While it would reduce the likelihood of the Service's attack if the decedent does not control the FLLE in her capacity as a general partner or managing member, the decedent can retain such control as long as she also retains typical state-law fiduciary duties to the other owners. The application of those fiduciary duties will prevent the general partner from disproportionately benefiting from the FLLE assets. The Service has frequently ruled that the fiduciary duties to which a general partner is subject will prevent section 2036 from applying to business property contributed by the general partner to a limited partnership.[249] Of course, the fiduciary duties have to be real: a private agreement obviating otherwise applicable state-law fiduciary duties would run afoul of *Reichardt*.

Additionally, gifting away interests in the FLLE to other family members may pose psychological problems. Many resist yielding absolute control until they breathe their last breath. Many also fear giving up the assets they might need to endure the final stages of life. For those of moderate wealth, this latter point may be more than just a psychological concern and, indeed, may be a valid reason to minimize transfers. Taxpayers with substantial wealth, however, can transfer substantial assets without this concern. They will typically have assets for which they have no direct need and that

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[247] *See* I.R.C. § 2503(b). *See supra* notes 6-8 and accompanying text.

[248] *See* I.R.C. § 2035(b). Gift taxes paid more than three years before death are "gift-tax exclusive," meaning that the gift taxes are paid from other assets of the donor, further reducing the size of the donor's estate. Estate taxes are never "exclusive," since the estate taxes are paid from the assets of the taxable estate. *See* I.R.C. § 2001(a).

[249] *See, e.g.*, Priv. Ltr. Rul. 9546007 (Nov. 17, 1995); Priv. Ltr. Rul. 9546006 (Nov. 17, 1995); HENKEL, *supra* note 2, § 16.03[4]. *Accord* United States v. Byrumf, 408 U.S. 125, 137-38 (1972).

can be contributed to the FLLE. If they are willing to put aside any psychological limitations and either give up control or retain relevant fiduciary duties, section 2036 should not pose a problem, and substantial assets can be transferred close to the time of death at reduced gift tax cost after the application of valuation discounts as seemingly sanctioned by *Strangi*.

While the court's interpretation of section 2036 in *Reichardt* is admittedly reasonable, the policy support is questionable. Effectively, the court's holding imposes a limitation on those of moderate wealth who have legitimate concerns about retaining enough assets to get through the final stages of life. Those with more substantial wealth can readily fund the partnership with appropriate assets and follow appropriate procedures. It is not apparent why the latter group should be preferred to the former. Finally, section 2036 in this context is an invitation to litigation, since it forces one to ask difficult questions. Did the decedent really give up control or, as was likely in *Strangi*, did he merely give up the appearance of control while maintaining control in fact, thereby triggering section 2036? Have state-law fiduciary duties been subverted by a private agreement by the parties to favor the decedent? My proposal, discussed below, would both apply more neutrally and provide an unambiguous standard that would not invite undue litigation.

V. PROPOSAL FOR REFORM

It is hardly good tax policy to allow taxpayers in the last hours of life to place their assets in an essentially artificial structure and thereby significantly reduce federal transfer taxes. In longer-standing FLLEs, taxpayers typically make gifts of FLLE interests to the next generation and argue for minority-interest and lack-of-marketability discounts on those gifts. Here the Service has also resisted taxpayers' arguments.[250] While a full discussion of whether taxpayers should ever be allowed to use FLLEs to reduce federal transfer taxes is beyond the scope of this article, I would note that the argument for discounts for such longer-standing FLLEs is at least stronger. One cannot always assume, for example, that donee-siblings will have amicable relations and act jointly. As a result of the gifts to the next generation, the interests in the FLLE may be

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[250] *See, e.g.*, *Jones*, 116 T.C. 121; *Knight*, 115 T.C. 506; *Harper*, 79 T.C.M. (CCH) 2232; *Kerr*, 113 T.C. 449.

spread out among a number of members of the family. After the gifts are made, someone who wants to buy all the FLLE assets may have to negotiate with a number of underlying owners.[251] One family member's FLLE interest may indeed be worth far less than the proportional share of the fair market value of the underlying assets. But in an FLLE formed shortly before death, the situation is very different.

In these near-death transactions, beneficial ownership typically stays primarily with the decedent, so the diversity of interests that can justify discounts usually is lacking. Of course, significant beneficial ownership in the FLLE could be transferred to others. Given the proximity of death, there would likely be no federal transfer tax benefit beyond the discounts. Gift taxes paid within three years of death are included in the estate.[252] Values of the property are unlikely to change between the time of the contribution and the time of death, and the unified gift and estate tax system adds gifts made during life and after death together to compute the transfer tax.[253] Transferring interests to others proved effective in *Frank*.[254] Such transfers of FLLE interests to others, however, would not seem to provide an intelligent basis for differing tax treatment. All that is likely involved is a last-minute artifice without any genuine economic substance. Even estranged family members probably will find a way to get along, considering the desire to obtain the discounts and the short period of time until the decedent dies upon which the FLLE is possibly dissolved and its assets distributed.

One avenue of attack is section 2036, but, as noted above,[255] its application would not be difficult to avoid for wealthier decedents who have assets for which they have no financial need. To avoid section 2036, they simply need to avoid transferring personal-use assets to the FLLE, gift away meaningful amounts of the FLLE interests, and exercise whatever control they retain through the FLLE in a fiduciary capacity. Section 2036 does not always provide a reliable bright line test, and accordingly, factual disputes could arise

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[251] The Uniform LLC Act requires the consent of all members to a sale of all or substantially all of the assets of an LLC. *See* UNIF. LTD. LIABILITY COMPANY ACT § 404(c)(12), 6A U.L.A. 458 (1995).

[252] *See* I.R.C. § 2035(b).

[253] *See* I.R.C. § 2001(b).

[254] *See* 69 T.C.M. (CCH) at 2256-57, 2259, 2263.

[255] *See supra* Part IV.

as to whether the decedent is adhering to his fiduciary duties and/or receiving a disproportionate benefit.

Another option would be to apply some form of family-attribution rules and ignore the FLLE wrapper when the FLLE is controlled by family members. While this approach would be effective in stopping many abuses, it would be much broader than needed to address the abuse of last-minute FLLEs. For longer-standing FLLEs, one cannot assume family members will have amicable relations or readily come to agreement on when and whether to sell the underlying assets. Thus, in this context minority-interest and lack-of-marketability discounts for the diversely held interests of family members often are justifiable and represent economic reality. That fact would make it politically difficult to craft a rule that always ignores the FLLE wrapper for family-controlled FLLEs. The Clinton Administration's unsuccessful efforts to make a frontal assault on FLLEs are instructive in this regard.[256]

A more focused approach, and one that would be easy to administer, would be to bring transfers of property to FLLEs within the scope of section 2035.[257] Under this approach, any contributions made to a family-controlled FLLE by a decedent within three years of death would be a nonevent for Federal estate tax purposes.[258] The property transferred, and not the associated FLLE interests, would be included in the decedent's estate. Another concern is that a decedent could operate an FLLE as the primary owner for a prolonged period. Then, in an attempt to obtain increased valuation discounts, the decedent could transfer control of the FLLE at the

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[256] The Clinton administration had on several occasions proposed that transfers of interests in FLLEs be subject to a valuation discount only if the entity is engaged in an active trade or business. The Clinton Administration had no success with its proposals. *See, e.g.*, Cong. Budget Office, 106th Cong., *Analysis of the President's Budgetary Proposals for FY2001*, 93218 (Comm. Print 2000); H.R. Rep. No. 106-658, *Providing for the Consideration of H.R. 8, The Death Tax Elimination Act of 2000*, at 8-10 (Comm. Print 1998); Cong. Budget Office, 105th Cong., *Analysis of the President's Budgetary Proposals for FY99*, 93212 (Comm. Print 1998).

[257] Currently, section 2035 requires inclusion in the decedent's estate gift taxes paid within three years of death and transfers made within three years of death which, if they had not been made, would have resulted in the transferred property being included in the estate under sections 2036 through 2038, or 2042. *See* I.R.C. § 2035.

[258] This rule, of course, would not apply to the extent the decedent is paid fair value (in other than FLLE interests) for the property transferred.

end of her life. To counter this strategy, under this proposal any transfers of FLLE interests in a family-controlled FLLE made within three years of death would also be ignored, and the transferred interests would be included in the decedent's estate. This latter part of the rule would effectively codify *Murphy*[259] and overrule *Frank*.[260] As section 2001 already provides, credit will be given against the estate tax for any gift tax paid on the lifetime transfers.[261] Under these rules, if a decedent contributes property to a family-controlled FLLE within three years of death, and also transfers FLLE interests within that time period, the following would occur: the property transfers would be ignored, and the property would be included in the decedent's estate; the FLLE interests would also be included in the decedent's estate, but they would be valued as if the FLLE did not hold the property that was pulled back into the decedent's estate.

An FLLE for these purposes would include a limited partnership, LLC, or S-corporation. An S-corporation is an unlikely vehicle for this type of planning, because the gain is recognized when an S-corporation distributes appreciated property to a shareholder.[262] Nevertheless, like limited partnerships and LLCs, S-corporations typically impose a single level of taxation on income at the owner level and could conceivably be used in a manner comparable to limited partnerships and LLCs. S-corporations are included in the proposal to make sure the door to this type of abuse is fully shut. The double-tax burden of C-corporations would make them an inappropriate vehicle for such last-minute planning,[263]and thus they would not be included in the definition of an FLLE.

For section 2035 to apply under this proposal, the beneficial ownership of the transferred assets or FLLE interests must stay with

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[259] *Murphy*, 60 T.C.M. (CCH) 645.

[260] *Frank*, 69 T.C.M. (CCH) 2255. *See supra* notes 68-78 and accompanying text.

[261] *See* I.R.C. § 2001(b).

[262] *See* I.R.C. § 311(b).

[263] C-corporations are subject to two levels of taxation, one at the corporate level and another at the shareholder level, when corporate income is distributed to shareholders as dividends. *See* I.R.C. §§ 11, 301, 316. Further, distributions of appreciated property by a C-corporation cause gain to be recognized by the corporation, and the shareholder receiving the property as a dividend has ordinary income to the extent of the fair market value of the property. *See* I.R.C. §§ 301, 311(b).

the decedent or within the decedent's family and the decedent's family needs to control the FLLE. Since section 2701 provides rules often relevant for valuing FLLEs, it would seem an appropriate place to look for a definition of "family" for these purposes. Section 2701 defines "family" to include the transferor; the transferor's spouse; a lineal descendant of the transferor or the transferor's spouse, and the spouse of any such descendant; the definition also includes an ancestor of the transferor or the transferor's spouse, and the spouse of any such ancestor.[264] This excludes collaterals such as uncles and nephews; but such persons are less likely to be involved, and a definition of family already in use in a related area is more likely to find acceptance than would a more expanded definition. Similarly, for purposes of determining whether the family controls the FLLE, the definition of control contained in section 2701 could be used.[265] That section defines control for partnerships (including LLCs taxed as partnerships) as the holding of at least 50% of the capital or profit interests in the partnership.[266] In the case of a limited partnership, control is defined as the holding of any general partnership interest by a family member.[267] For corporations, control means the holding of at least 50% by vote or value of the stock of the corporation.[268]

While even those transfers made more than three years before death may involve the hopes of eventual estate tax savings, the structure is far more likely to bear the markings of legitimacy. Typically, the transferor after the formation of the FLLE will transfer interests to others, providing legitimate dispersion of interests. Section 2036 would still be available to attack transactions where the transferor keeps undue control and benefit. Further, the passage of three years at least suggests that the structure has some significant economic reality.

One potential, although inferior, option would be to apply, in addition to the three-year provision, a rule actually requiring a decedent to transfer to others some minimum amount of interest in the FLLE for the FLLE wrapper to be respected. For example, perhaps a minimum of 20% of the interests would need to be transferred to

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[264] *See* I.R.C. § 2701(e)(1), (2).
[265] *See* I.R.C. § 2701(b)(2).
[266] *See id.*
[267] *See* I.R.C. § 2701(b)(2)(B)(ii).
[268] I.R.C. § 2701(b)(2)(A).

others more than three years before death, or all of the interests held by the decedent would be valued without the FLLE wrapper. This approach would not be indefensible, and would help insure that there is substance to the FLLE, rather than simply approximating an alter ego of the decedent. Such a rule, however, would break a fundamental, and too often violated, principle of tax legislation: the tax system should only address problems that are, or are likely to be, reasonably widespread. Given the need to transfer assets to the FLLE three years before death and the risk of the applications of section 2036 in any event, the vast majority of taxpayers will in fact make appropriate transfers of FLLE interests to others. Therefore, there is little need to craft a rule for situations in which this does not occur, and our already Byzantine tax code does not need more provisions of only limited application.

VI. CONCLUSION

It is not difficult to understand the frustration of the Service and most of the judges in the *Strangi* case.[269] The creation of FLLEs near the time of the death of the decedent usually involves no more than a naked artifice designed to reduce transfer taxes. Normally, these FLLEs have little economic substance or nontax business purpose. Yet the current tax code does not provide a ready touchstone from which to address the problem. Amending section 2035 to apply a three-year rule to FLLEs formed near the time of death would provide a straightforward solution to the problem, and would also make the rule easier to administer without unduly infringing upon the legitimate use of FLLEs.

[269] *See supra* notes 102-151 and accompanying text.