Strangi: A Critical Analysis And Planning Suggestions

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In Strangi, the Tax Court eliminated all estate tax discounts for a family partnership. The authors note it held, as it had in several prior cases, that section 2036(a)(1) required this result. The court then went on to reach the alternative holding that section 2036(a)(2) likewise precluded the estate from claiming a discount. Gans and Blattmachr believe that while many have taken steps to address the threat that section 2036(a)(1) poses to these partnerships, few, if any, anticipated the court's alternative holding and the potentially critical threat it poses if sustained. They argue that the alternative holding is based on a misreading of the Supreme Court’s decision in Byrum and is inconsistent with the Service's own published guidance. They go on to suggest various planning strategies for existing and new partnerships. The authors also wish to acknowledge Paula Prudenti, whose dedicated assistance was invaluable.

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Introduction

The Strangi family limited partnership has thus far generated two Tax Court decisions and one Fifth Circuit decision. It remains to be seen whether there will be further appellate litigation. The latest Tax Court decision establishes a new, controversial framework, under which many family limited partnerships will fail to achieve the desired tax outcome. While prior Tax

Footnote 2 continued on next page.
Court decisions had also threatened the tax-saving potential that these partnerships offer, the latest decision in Strangi poses a much more critical threat. Nevertheless, if properly addressed, the threat can be neutralized, both for new and existing partnerships.3

I. The Basic Facts

Two months before Mr. Strangi’s death, his son-in-law, who was his attorney and agent, had created a limited partnership. Acting on Mr. Strangi’s behalf as his agent, the son-in-law transferred substantially all of Mr. Strangi’s wealth, including personal-use assets, to the partnership.4 In exchange, Mr. Strangi received a 99 percent limited partnership interest. He also received 47 percent of the stock in the corporate general partner, which held a 1 percent interest in the partnership. His children received 53 percent of the stock in exchange for consideration they had supplied, but then gave a 1 percent interest to a charity shortly after the partnership’s formation (leaving the children with a 52 percent interest).

II. The Arguments and the Court’s Response

In the initial round in the Tax Court, the government had argued that the partnership should be ignored and that, as a result, no discount based on the existence of the partnership should be permitted for estate tax purposes. In essence, the government had asserted three different estate tax theories: (1) the partnership was an estate-planning vehicle that was tax-driven and lacking in economic substance; (2) the partnership agreement itself constituted a restriction within the meaning of section 2703; thus requiring that it be disregarded; and (3) the partnership’s assets themselves (rather than the decedent’s interest in the partnership) should be included in the gross estate under section 2036 without any discount. As an alternative to its estate tax argument, the government had also made the so-called gift-on-formation argument: that, upon formation of the partnership, Mr. Strangi had received partnership interests that were worth less than the value of the assets he contributed to it and that he therefore made a taxable gift to that extent.

The court rejected the gift-on-formation argument on the merits. It similarly rejected the government’s estate tax arguments on the merits with the exception of the section 2036 argument, which it refused to consider on the procedural ground that it was not timely asserted. Having thus rejected all of the government’s arguments, the court went on to reach a factual judgment as to the appropriate level of minority and marketability discount. On appeal, the Fifth Circuit reversed and remanded solely on the section 2036 issue, finding that the Tax Court had abused its discretion in refusing to consider the merits of the government’s argument under that section.

On remand, the Tax Court accepted the government’s section 2036 argument. It first held that full inclusion of the partnership’s assets without any discount was required under section 2036(a)(1). If then reached its alternative holding; that the same result was appropriate under section 2036(a)(2).5

III. A Critical Analysis of the Alternative Holding

A. An Overview of the Analysis

The court’s section 2036(a)(1) holding was not unexpected given its prior decisions disallowing a discount where it found an implied understanding that the partnership’s assets would remain available to the

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3All section references are to the Internal Revenue Code of 1986, as amended.

4The court held that the entire 99 percent limited partnership interest and the decedent’s 47 percent interest in the corporate general partner should be included in the gross estate under section 2036 without any discount (the partnership assets attributable to the contribution made by the children in exchange for their 54 percent interest in the general partner not being includible). However, because the Service had not previously asserted its section 2036 theory, the deficiency was limited by the valuation increase contained in the notice of deficiency.
decedent. In contrast, the court’s alternative holding took many in the estate-planning community by surprise. After all, it was based on a reading of the Supreme Court’s decision in Byrum that even the Service had previously rejected. Indeed, as will be argued, it misreads the decision.

The court’s alternative holding took many in the estate-planning community by surprise. After all, it was based on a reading of the decision in Byrum that even the Service had previously rejected. The alternative holding was, in essence, based on the decedent’s ability to control two different aspects of the partnership. First, acting together with others, he could cause a liquidation of the partnership. Under the partnership agreement, if all of the limited partners and the general partner agreed, a liquidation would occur. And, under the shareholder agreement, the general partner could consent to a partnership liquidation if all shareholders voted in favor of it. Second, acting together with his co-shareholders in the general partner, he could control partnership distributions. Because decisions regarding partnership liquidation or distributions necessarily affect the timing of partners’ receipt of partnership assets and because the decedent was viewed as having retained any right that could be exercised in conjunction with others for purposes of section 2036(a)(2), the court held that all of the partnership’s assets were includible in the decedent’s gross estate without any discount.

Whereas it would seem that under section 2036(a)(1) only the pro rata portion of the partnership’s assets corresponding to the decedent’s limited partnership interest should be included in the gross estate, full inclusion of all partnership assets is required if section 2036(a)(2) is applicable. For section 2036(a)(2) purposes, the decedent’s right to control the beneficiary’s enjoyment is sufficient to bring all transferred assets back into the gross estate even though the decedent did not herself retain any beneficial or ownership interest. Thus, Strangi’s alternative holding not only expands the universe of partnerships that will fail to achieve an estate tax discount, it also creates the rather draconian consequence of full inclusion in the gross estate.

If sustained, the alternative holding could eliminate entirely discounts for partnerships where the decedent retains any limited partnership interest or even a minority interest in the corporate general partner. Equally important, the retention of such an interest could result in the inclusion of all of the partnership’s assets in the decedent’s estate even if limited partnership interests had been transferred many years prior to death. While in Strangi the decedent had retained distributions made other than to the decedent were “de minimis.” Thus, had the decedent owned, say, a 1 percent limited partnership interest and had distributions been properly made to the decedent and the other partners, presumably the court would have included only 1 percent of the value of the partnership’s assets in the gross estate under section 2036(a)(1). To make the point in more familiar section 2036 terms, if a grantor creates a trust and retains the right to receive 1 percent of the trust’s income, only 1 percent of the trust corpus is included in the gross estate under section 2036(a)(1). See Treas. reg. section 20.2036-1(a). It is, however, true that if the court were to find as a matter of fact that there was an implied understanding that the decedent would continue to have access to all contributed assets, section 2036(a)(1) would require full inclusion. In Estate of Harper v. Commissioner, T.C. Memo. 2002-121, for example, the court held that the section mandated full inclusion. Significantly, however, the decedent had received non-pro-rata distributions, enabling the court to infer that there was an implied agreement to retain access to all contributed assets (though the court does not explicitly connect the distribution pattern to its analysis of the amount required to be included). Had distributions in Harper been made instead on a pro rata basis, the court presumably would have required inclusion under section 2036(a)(1) of only that portion of the partnership’s assets allocable to the decedent’s limited partnership interest.

Assuming the gift (after 1996) of the limited partnership interests had been reported on a gift tax return containing adequate disclosure with regard to the gift, the estate might argue that the Service should be precluded from invoking section 2036(a)(2) once the gift tax statute of limitations has expired. Treas. reg. section 301.6501(c)-1(f)(5) provides that, where an adequately disclosed gift is reported as complete, the running of the gift tax statute of limitations will bar not only future gift tax deficiencies but also any estate tax inclusion argument with respect to the gift. In response, however, the Service would presumably argue that the regulation was not intended to apply in these circumstances. That is, the gift completion rules (Treas. reg. section 25.2511-2) are not congruent with section 2036(a)(2) (or section 2038), and

(footnote 11 continued in next column.)

(footnote 13 continued on next page.)
very substantial ownership as a limited partner and as a shareholder in the general partner, the court’s reasoning would presumably apply even if the decedent had retained nothing more than a 1 percent limited partnership interest. Such a limited partner would (absent an atypical partnership agreement) be able to join together with the other limited partners and the general partner to cause a liquidation. Similarly, a decedent owning a 1 percent interest in the general partner, and no other interest in the partnership, would fall within the scope of Strangi’s reasoning because of the retained control over liquidation and distribution decisions (through joint action).

Inasmuch as, under the structure of many (if not all) family limited partnerships, the decedent does not divest herself prior to death of all partnership interests, the validity of the alternative holding is of critical practical significance. Although many practitioners have taken remedial steps to address the section 2036(a)(1) threat, presumably few, if any, had appreciated the threat posed by Strangi’s construction of section 2036(a)(2). The article will first critique Strangi’s section 2036(a)(2) analysis, and in particular its reading of Byrum. Strangi’s analytical weaknesses aside, however, practitioners may well be inclined to assume its validity in terms of planning for new and existing partnerships. The article will conclude with a discussion of how new partnerships should be structured and how existing partnerships should be restructured in light of Strangi.

B. Section 2036: A Basic Review

Section 2036(a)(1) applies where the decedent has retained either: (i) the possession or enjoyment of the transferred property; or (ii) the right to the income from the transferred property. Given the statute’s disjunctive structure, the courts (although the Supreme Court has not yet spoken to the question) have understandably made clear that the retained ability to enjoy or possess the property need not be legally enforceable. Thus, if the possession or enjoyment of the transferred property is retained under an implied understanding or agreement that the decedent would not have been able to enforce under state law, inclusion is nevertheless required.

In contrast, section 2036(a)(2) applies only where the decedent has retained the right (either alone or in conjunction with others) to control the beneficial enjoyment of the transferred property. An important question arising under this provision is whether the decedent’s retained practical control is sufficient to trigger it where state law imposes certain constraints that narrow the scope of the decedent’s power. It was precisely this question that the Supreme Court addressed in 1972 in Byrum. Many, including the Service itself, have read Byrum as establishing the proposition that the provision is applicable only where the decedent retained a legally enforceable right. And, under this reading, if the decedent’s ability to control is circumscribed by a fiduciary duty owed to an unrelated or related minority interest, the decedent cannot be viewed as having retained a legally enforceable right. Byrum can also be read as strongly implying that the retained ability to cause the liquidation of an entity is too speculative to serve as a predicate for estate tax inclusion. Yet, in Strangi, the Tax Court, as part of its alternative holding, concluded that the fiduciary duty that the decedent had owed to family members should be disregarded and that his ability to cause a liquidation was sufficient to trigger section 2036(a)(2). Since the Supreme Court has not reexamined these questions in the last 30 years, Strangi’s reading of section 2036(a)(2) must be measured against Byrum’s benchmark.

C. Does Strangi Misread Byrum?

An examination of Byrum must begin with the Court’s earlier, foundational decision in O’Malley. In O’Malley, the grantor expressly reserved the right in the trust instrument to make distribution decisions. Under the instrument, the grantor was a trustee and, together with his two cotrustees, had “sole discretion” regarding distributions. The grant of discretion was not limited by a standard, much less an ascertainable one. Nevertheless, under state law, the trustees remained subject to a fiduciary duty. The lower courts had held it would be inappropriate to apply the regulation in a manner that would render them congruent. Where, for example, the donor retains continuing control over the timing of the beneficiary’s enjoyment, the gift is complete but the gifted asset must nevertheless be included in the gross estate. It would be surprising, indeed, if the statute of limitations regulation were interpreted as foreclosing the Service from invoking section 2036(a)(2) or section 2038 merely because the completed gift had been adequately disclosed on a gift tax return. Moreover, the Service would likely argue that it is not attempting to include in the gross estate the asset reported as a completed gift (i.e., a limited partnership unit), but rather the underlying partnership assets (which had not been reported as a gift).

It could similarly apply if the decedent were to retain nothing more than a 1 percent partnership interest in a general partner. The Strangi reasoning might even apply where the decedent had retained a 1 percent stock interest in a conventional business corporation.

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16See, e.g., McNichol’s Estate v. Commissioner, 265 F.2d 667 (3rd Cir. 1959); Estate of Linderme v. Commissioner, 52 T.C. 305 (1969). Indeed, Strangi itself applies this principle in the course of its section 2036(a)(1) analysis.

17Even where the decedent could exercise the right only in conjunction with a person having an adverse interest, the section nevertheless applies. See Treas. reg. section 20.2036-1(b)(3).

18See, e.g., LTR 9150007; LTR 9150009; and TAM 9130006.

19See id.

20See id. at 630 n.3.


23See, e.g., Restatement (Second) of Trusts section 187, comment i.
that this duty was not sufficiently rigorous to defeat the section.25 When the case reached the Supreme Court, the parties did not dispute this aspect of the lower courts’ reasoning. Thus, the Court accepted as a premise in the course of deciding a different issue (i.e., whether income accumulated in the trust should be viewed as having been transferred by the grantor) the notion that a grantor does not avoid the section26 by undertaking such a relaxed fiduciary duty.27 It did, however, intimate that it agreed with the lower courts, stating that the grantor’s power was of “sufficient substance to be deemed the power to ‘designate’ within the meaning of” the section.28

In Byrum, O’Malley served as the baseline for both the majority and dissenting opinions. The decedent in Byrum had transferred closely held stock to a trust but reserved the right to vote the shares.29 The IRS took the position that, because the decedent had the ability to vote a majority of the shares, he could affect the flow of income to the trust and that the trust corpus should therefore be included in his estate under section 2036(a)(2).30 The majority started its analysis by observing that O’Malley was a straightforward case that clearly fell within the scope of the statute.31 In thus describing O’Malley, the majority appears to endorse not only its holding but also the premise that a trustee’s general fiduciary duty cannot take a reserved discretionary power out of the statute. The majority then goes on to limit and distinguish O’Malley, emphasizing that the decedent in O’Malley had expressly reserved the right to make discretionary distributions in the trust instrument.32 In Byrum, in contrast, the decedent had not reserved any discretionary authority.33 Instead, he merely retained the right to vote the stock.

Although the majority failed to make entirely clear the difference between the right reserved by O’Malley and the one reserved by Byrum, it would seem that the differing nature of the constraints imposed by fiduciary duty principles under state law accounts for the different outcomes. Where, as in O’Malley, the trustee is given “sole discretion” with regard to distributions and the instrument does not contain a guiding standard (such as support), the trustee is not subject to a conventional fiduciary duty analysis but, rather, to a more relaxed one. Under the relaxed standard, a trustee has extensive discretion.34 As long as the trustee does not have a dishonest or improper motive, courts are not permitted to interfere with the trustee’s decision-making.35 Thus, the trustee/grantor in O’Malley would have been permitted to take into account, in exercising his discretion, his personal values and sensibilities, as well as his views concerning the members of his family who were beneficiaries. In contrast, in Byrum, as the Court indicated, the decedent’s right to vote the stock was circumscribed by a corporate fiduciary duty that was not relaxed. Because, as a result, any use of the decedent’s right to vote the stock to achieve his personal or family-related objectives would have been actionable,36 he did not have the requisite legally enforceable right.37

It is true that, in Byrum, in the course of discussing the constraining nature of the fiduciary duty imposed on the grantor and the corporate directors he could select, the Court did allude to the fact that there were minority shareholders unrelated to the decedent.38 This raises the question whether the presence of these shareholders was critical to the Court’s holding. The structure of the decision, as well as the backdrop of a well-accepted exception grounded in fiduciary duty principles, suggests it was not.

First, in terms of the structure, the Court did not intend to adopt a facts-and-circumstances approach but rather to create a bright-line test turning on whether the grantor retained a legally enforceable right.39 Concerned about the ability of taxpayers to rely on clear rules in drafting their estate planning documents,40 the Court opted for the bright-line construction over the dissent’s more amorphous standard. The Court’s ensuing discussion of the variety of constraints that typically narrow the scope of a majority shareholder’s ability to control the flow of dividends was an explication of the rationale for its bright-line test, not a listing of elements that must be present in every

26In O’Malley, the Court construed the predecessor to section 2036(a)(2). There is no relevant difference in the language between the current version of the section and the earlier one.
27See O’Malley at 383 U.S. at 630-31.
28See id. See also Treas. reg. section 20.2036-1 (indicating that a grantor’s retained discretion is sufficient to trigger the section even though it is held as trustee).
29See 408 U.S. at 126-27.
30See id. at 130.
31See id. at 136.
32See id. at 136-37.
33See id.
case if the section is to be rendered inoperative. In referring to the unrelated minority shareholders, the Court was simply illustrating its point that the decedent and the directors could not violate their fiduciary duties with impunity. Indeed, obviously anticipating the possibility that in other cases there might not be any unrelated shareholders, the Court also pointed to the ability of the related shareholders to hold the decedent, as well as the directors, accountable for any breach of fiduciary duty: The trustees, acting on behalf of the decedent’s family members, would themselves have had a duty, according to the Court, to seek redress if the grantor or the directors had acted improperly.

Thus, the structure of the decision suggests that estate tax inclusion is appropriate under section 2036(a)(2) only where the grantor retains a right that is legally enforceable— that is, it can be exercised without thereby creating a claim in a family or nonfamily member. Put differently, the decision would be internally inconsistent if read as establishing: (i) that the grantor’s retained right must be legally enforceable for the provision to apply; and (ii) at the same time, that the provision nonetheless applies even where a family member would acquire a breach-of-fiduciary-duty claim against the grantor upon the exercise of the putative right.

Second, in terms of the backdrop against which Byrum was decided, a consensus had developed in the lower courts that section 2036(a)(2) (as well as section 2038) contained an implicit exception, under which estate tax inclusion was not required where the grantor’s retained discretion was limited by a so-called ascertainable standard. In other words, if the grantor’s control over trust assets was subject to a standard sufficiently ascertainable so that a state court would enforce it under fiduciary duty principles, the exception would apply. For example, if the grantor, in his capacity as trustee, had the discretion to make income distributions to different family members based on their health, support, or education needs, the exception would preclude estate tax inclusion. The consensus had so solidified that the Court in Byrum did not question its validity, with the minority explicitly alluding to it and the majority implicitly accepting the underlying logic that a fiduciary duty can be so constraining that it eviscerates what would otherwise be considered a right.

Shortly after Byrum was decided, the Service issued Rev. Rul. 73-143, where, alluding to the consensus, it embraced the exception without reservation. In the ruling, the Service hypothesized a trust where the grantor, as trustee, could invoke principal for the benefit of his daughter if he deemed advisable for her support and education; the remainder was to pass upon the daughter’s death to his grandchildren. The Service concluded that the support-and-education standard so narrowed the scope of the grantor’s discretion that section 2038 could not apply. In the words of the Service, where the instrument contains an ascertainable standard, the grantor’s power is a “nondiscretionary” one and therefore not subject to tax. The rationale, the courts have explained, is that the trust beneficiaries could seek redress against the grantor in state court if distributions were made or withheld in violation of the standard. Thus, in the ruling, had the grantor made excessive distributions to his daughter, his grandchildren would have been entitled to damages for his breach of duty—and, conversely, had the grantor failed to make distributions to his daughter required under the standard, she similarly would have been able to hold him accountable.

Neither the ruling nor the cases on which it is based suggest that the grantor’s fiduciary duty emanating from the standard should be disregarded on the ground that it could only be enforced by members of the grantor’s family. To the contrary, the Service, as well as the courts, reached the conclusion that the ability of the family to hold the grantor accountable for a violation of the standard was sufficient to negate estate tax inclusion. This treatment of intrafamily transactions for transfer tax purposes is, moreover, not aberrational.

In the minority discount context, for example, as a general matter, family members are treated as if they were unrelated.

In sum, given this backdrop, it would be difficult to read Byrum as implying that, for purposes of section 2036(a)(2), the grantor’s fiduciary duty is irrelevant where owed to a family member. Indeed, were Byrum so understood, the ascertainable-standard exception would not be tenable. For, as a practical matter, the exception is in almost all cases applied, as in the ruling, on the basis of a fiduciary duty that the grantor owes to family members. Because the majority, as well as the dissent, appeared to accept the exception, the decision is better understood as contemplating that a fiduciary duty, whether owed to a family member or otherwise,
is sufficient to negate estate tax inclusion. This reading is consistent with Rev. Rul. 73-143, which explicitly adopts the principle that a fiduciary duty owed to a family member can so circumscribe the grantor’s retained discretion so as to preclude it from being characterized as a right. Given the Service’s obligation to respect its rulings, it should not be permitted to argue that this principle is inconsistent with Byrum without first revoking the ruling.50

Apparently not recognizing the full scope of the principle it had adopted in the ruling, the Service argued in Gilman51 only a few years after having issued it that the presence of unrelated minority shareholders in Byrum lent substance to the decedent’s fiduciary duty that was critical to the outcome. The Service argued in Gilman that because the minority shareholders were members of the decedent’s family, his sisters and brothers-in-law, Byrum was distinguishable. The Tax Court, without citing the ruling, rejected this argument on three grounds. First, the court indicated that the decedent’s ability to vote the stock held in a trust he had created was sufficiently constrained by his duties as trustee so as to make estate tax inclusion inappropriate under section 2036(a)(1). In other words, the decedent’s fiduciary duty was a meaningful constraint even though owed to family members. Second, the court went on to support its conclusion by adding the observation that the factual context suggested that the interests of the decedent’s sisters and brothers-in-law were adverse to his. Third, the court further supported its conclusion by pointing out that the remaindermen under the trust, the decedent’s grandchildren, also had an interest adverse to his — presumably in the sense that, as beneficiaries, they could seek redress against the decedent were he to breach his duty as trustee.

When the court turned to section 2036(a)(2), it rejected the Service’s position as inconsistent with Byrum’s legally enforceable right language. It did so without even a passing reference to the Service’s minority shareholder argument that it had dismissed in making its section 2036(a)(1) analysis. While the decision might be read as standing for the narrow proposition that the factual context indicated that the family members had an interest adverse to the decedent’s, it is more easily read as standing for the broader proposition that a fiduciary duty is no less constraining simply because it is owed to a family member. Indeed, the Service itself has embraced this reading of Byrum. In TAM 9131006,52 for example, the Service concluded that section 2036(a)(2) did not apply to a family limited partnership even though the decedent, as general partner, had the ability to control partnership distributions to the limited partner donees and even though all of the partners were related to the decedent. It predicated its conclusion on the decedent’s fiduciary duty. In doing so, it simply cited Gilman, as well as Byrum, and did not even discuss or make reference to the fact that the decedent’s fiduciary duty was owed exclusively to family members.53 Most critical, the Service appears to have endorsed this reading of Byrum in a published ruling as well. In Rev. Rul. 81-1554 invoking Byrum’s fiduciary-duty analysis, the Service concluded that section 2036(a)(2) did not apply in the case of corporate stock where the decedent had retained voting rights even though the only shareholders were apparently the decedent and a family trust created by the decedent. Oddly, in Strangi, while the court made reference to the TAM and dismissed it on the ground that it was not entitled to any weight as a precedent, it then failed to mention the revenue ruling, even though as suggested the Service is obligated to respect its published rulings in Tax Court litigation.55

**D. Enforceable Rights and Joint Action**

Two aspects of section 2036(a)(2) are in tension. On one hand, the section applies only where the decedent had a “right” to control beneficial enjoyment. And, as the Supreme Court in Byrum interpreted the section, only rights that are legally enforceable are within its scope. On the other hand, the section itself provides that it will apply where the right is exercisable either by the grantor alone or with the consent of another person (even if the grantor’s exercise of the right would adversely affect the other person’s interest).56 Thus, even though the right of a grantor may be circumscribed by the requirement of third-party consent, the section nevertheless contemplates that it may be viewed as legally enforceable. In O’Malley, as indicated, the grantor had created a trust, explicitly giving the trustees discretion over income distributions. The grantor being one of three trustees, he could not exercise control over distributions without the consent of at least one other trustee. The Court held that the section applied without discussing the necessity for the consent of another trustee. The result makes sense. After all, the statute itself provides that it will apply even where the grantor can only exercise the right with the consent of another. This aspect of the statute obviously reflects the reality that, were the rule otherwise, it would be too easy for taxpayers to escape estate tax while maintaining control through the simple expedient of a trust provision precluding the grantor from exercising discretion without the consent of an accommodating cotrustee (that is, a friendly cotrustee who would be sensitive to the fact that trust assets had

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52TAM 9131006.

53See also LTR 9415007; LTR 9310039.

541981-1 C.B. 457.

55See note 50 supra.

56See Treas. reg. section 20.2036-1(b)(3).
or originally belonged to the grantor and who would therefore be disinclined to disappoint the grantor).

In focusing on whether or not the grantor retains the ability to participate in the decisionmaking process, however, the statute draws a somewhat arbitrary line. Where the grantor is authorized to participate, the section applies. But where the grantor instead designates an accommodating trustee and does not retain the ability to participate directly as a cotrustee (or otherwise), the section does not apply. Thus, it remains possible for well-counseled grantors to avoid estate tax inclusion even where they designate an accommodating trustee and thereby retain practical control, as long as they themselves do not have the right to participate directly in the trustee’s decisionmaking.57

To illustrate the expansive nature of the statute, assume the trust instrument designates, as trustees, the grantor and nine others who are hostile to the grantor and that they are given extensive discretion (with no standard imposed in the instrument that would guide the discretion) regarding income distributions. The statute clearly calls for inclusion in this case, even though the other trustees will likely vote in a way that frustrates the grantor’s desires. The question becomes whether there is any limiting concept that would render the statute less expansive in this regard. What if, for example, an agreement is executed that contemplates that it will continue for the indefinite future but which can be terminated if all parties consent? Is the ability to terminate the agreement too speculative to be considered a right within the meaning of the statute? After all, each party has nothing more than the ability to persuade the others that the agreement should be discontinued.

Although Byrum did not explicitly address this issue, it did so by implication. The IRS has argued that, by virtue of Byrum’s retained ability to vote the stock, he could cause a liquidation of the corporation and that therefore the stock he had conveyed to the trust should be included in his estate under section 2036(a)(1). The Court, however, rejected this argument. It concluded that, even if he had conveyed a majority interest in the corporation to the trust, the ability to cause a liquidation through the retained right to vote the transferred stock would have been too speculative and contingent to be viewed as either a right or the kind of possession or enjoyment that this provision contemplates.58 Section 2036(a)(1) casts a much wider net than section 2036(a)(2): As Byrum indicates, inclusion is required under the latter provision only where the decedent has a legally enforceable right, whereas it is required under the former provision where the grantor merely retains the possession or enjoyment of the transferred property under an implied understanding or agreement that is not legally enforceable.59 It would therefore appear that if the ability to terminate an entity by liquidation is too speculative for section 2036(a)(1) purposes, it must likewise be too speculative for section 2036(a)(2) purposes as well.

Byrum’s implication that the right to terminate an ongoing arrangement might be too speculative to trigger section 2036(a)(2) solidified only two years later in Estate of Tully.60 In Tully, the decedent and his co-sharer each owned half of the stock in a corporation that employed them. The two shareholders, together with the corporation, had entered into an agreement providing for a death benefit to be paid to the widow in the event either were to die. The Service argued that the death benefit should be included in the employee-shareholder’s gross estate under section 2038 on the theory that he could have, in conjunction with his co-shareholder,61 modified the death-benefit agreement to alter the identity of the beneficiary. The court rejected this argument, saying that in the in-conjunction-with-any-person language in section 2038 has its limitations: It does not result in estate tax inclusion merely because the decedent had the ability to persuade another to modify an agreement.

Without referencing the Court’s indication in Byrum that the decedent’s retained enjoyment may be too speculative to warrant inclusion under section 2036(a)(1), the Tully court obviously reached its conclusion through similar reasoning. In other words, unlike the grantor/trustee who, as a practical matter, will often be able to persuade a cotrustee (especially an accommodating cotrustee designated by the grantor) concerning the administration of the trust, a person entering into a contract contemplating its continuation cannot be as confident about the prospects of persuading the other party to agree to bilateral modification. Concededly, the court adopted this limitation in the context of rejecting the government’s section 2038 argument. The same analysis ought to control, however, in the context of section 2036(a)(2) given that it contains the identical language regarding joint action.62 Indeed, the Service itself in 1978, citing Byrum and Tully as well as other lower court decisions, recognized that the same analysis applies for purposes of both provisions and that, under this analysis, the power to persuade others to modify an agreement is too speculative to be considered a right (under section 2036(a)(2)) or a power (under section 2038).63

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57See, e.g., Estate of Wall v. Commissioner, 101 T.C. 300, 313 (1993) (holding that section 2036 did not apply where the grantor of the trust had retained the right to remove the trustee and replace it with a successor other than the grantor); Rev. Rul. 95-58, 1995-2 C.B. 191.
58See 408 U.S. at 150.
60Estate of Tully v. U.S., 528 F.2d 1401 (Cl. Ct. 1976).
61See id. at 1404-05.
62See id. at 1405.
63See, e.g., Estate of Wall v. Commissioner, 101 T.C. 300, 313-14 (1993) (applying the same analysis in the context of section 2038 as the Supreme Court applied in Byrum in the context of section 2036).
64See GCM 37422 (February 23, 1978). While ordinarily private letter rulings are not entitled to any precedential weight, it is possible that a court would give a general counsel memorandum some deference. See Morganbesser v. U.S., 984 F.2d 560, Doc 93-1268, 93 TNT 20-15 (2nd Cir. 1993).
Some months after the Service had conceded that it would be inappropriate to apply section 2036(a)(2) or 2038 simply because the decedent had the ability to persuade others to modify an agreement, Congress focused its attention on section 2036. Earlier (in 1976), it had amended the section to overrule a narrow aspect of the Court’s holding in Byrum. And, in 1978, shortly after the Service’s concession, it altered the approach it had adopted in 1976. Most significantly, these amendments do not disturb the Court’s holding that section 2036(a)(2) applies only where the decedent has retained a legally enforceable right. Nor do they reject — or even suggest disapproval of — the Service’s concession. Given the implication in Byrum that certain kinds of retained control may be too speculative to fall within section 2036(a)(2), the explicit holding in Tully, and the Service’s recognition of its validity, there is a rather compelling inference that Congress intended to ratify this understanding of the section.

If sustained, Strangi will pose a threat only to those partnerships where appropriate advice is not secured.

In Strangi, the court concluded that the decedent’s ability to vote with others to cause a liquidation constituted sufficient control to invoke section 2036(a)(2). It also concluded that the fiduciary duty the decedent had owed to his family members did not adequately constrain his retained right to vote on liquidation or distributions and should, therefore, be disregarded. However understandable the court’s impulse to establish a framework that would end abusive family partnerships, neither of these conclusions can be sustained given Byrum, Rev. Rul. 73-143, Rev. Rul. 81-15, Tully, and Congress’s ratification of Byrum’s perceived understanding. Equally important, as will be shown in the section on planning, well-advised families will in many cases be able to structure new partnerships — and restructure existing partnerships — without violating the Strangi framework. Thus, if sustained, Strangi will pose a threat only to those partnerships where appropriate advice is not secured.

E. The Bona Fide Sale Exception and Recycling Strangi is problematic on yet another ground. In invoking section 2036 in the partnership setting, the Tax Court has refused to permit taxpayers to qualify for the section’s bona fide sale exception. It has done so on the basis of its so-called “recycling” theory, first fashioned in the context of section 2036(a)(1) and now extended in Strangi to section 2036(a)(2). Although the court refuses to acknowledge it, the theory is inconsistent with the traditional treatment of the exception. It also has somewhat limited application: The theory will tend to be available to the Service in the case of families who either are not well advised or who have more moderate resources. Before turning to the theory directly, the exception must first be considered.

Section 2036, as do sections 2035, 2037, and 2038, contains an exception in the case of a “bona fide sale for an adequate and full consideration.” Thus, a transferor who retains the kind of control or access to the transferred property that would ordinarily trigger section 2036 right to the income from the property transferred or the right to designate the person who will enjoy the income is not required to include the transferred property in her gross estate if the exception applies. The courts appear to be in disagreement about the scope of this exception. In a series of cases involving family limited partnerships, the Tax Court has taken the view that an estate must satisfy two conditions to invoke the exception: (1) the transfer was a “bona fide” one, in the sense that it was at arm’s length; and (2) the decedent received full consideration in exchange for the transfer. On the other hand, there is a consensus in the circuit courts reflecting the traditional view that, if the latter condition is satisfied, the exception applies and there is no need to inquire whether the transaction was bona fide.

See also Estate of Harper, T.C. Memo. 2002-121. For cases prior to Strangi, see, e.g., Estate of Harper; Estate of Thompson v. Commissioner, T.C. Memo. 2002-246. See Estate of Magnin v. Commissioner, 184 F.3d 1074, Doc 1999-24332 (17 original pages), 1999 TNT 136-14 (9th Cir. 1999); Wheeler v. U.S., 116 F.3d 749, Doc 97-19675 (49 pages), 97 TNT 129-14 (5th Cir. 1997); Estate of D’Ambrosio v. Commissioner, 101 F.3d 309, Doc 96-31256 (21 pages), 96 TNT 234-10 (3rd Cir. 1996).
The difference between these two views reflects a difference in philosophy. The circuit courts take an objective approach. They start with the proposition that there cannot be a taxable gift if the transaction does not deplete the transferor’s estate.75 Invoking the notion that, at least in this context, the estate tax and gift are in para materia and must therefore be given a parallel reading, they then superimpose on the section 2036 exception the gift tax depletion concept. As long as an objective analysis demonstrates that the transferor received consideration equal to the value of the transferred property as part of the exchange, no depletion occurs, making it inappropriate to apply the gift tax at the time of transfer or the estate tax at the time of death. In contrast, the Tax Court takes a more difficult-to-apply subjective approach. Under the Tax Court’s view, even if an objective analysis indicates that the transferor had received full value, the court will nevertheless reject the exception if its subjective analysis reveals that the transaction was tax-driven (abusive) and therefore not bona fide. As a result, under the Tax Court’s view, an intrafamily transfer implemented without adversarial bargaining could result in estate tax inclusion under section 2036 even though the decedent had in fact received full value for the transferred property.76

At first blush, the Tax Court’s reading of the exception is, perhaps, more defensible linguistically. After all, had Congress intended to make the exception hinge solely on an objective depletion analysis, the adequate consideration language would have sufficed and there would have therefore been no need to insert the phrase “bona fide.” However, the general rule itself strongly implies that the circuit courts’ reading of the exception is a better one. Because the general rule is operative solely on an objective depletion analysis, the adequate consideration language would have sufficed and there would have therefore been no need to insert the phrase “bona fide.”

Conversely, not every transaction that results in depletion produces a taxable gift. Where it can be established that the depletion occurred in an arm’s-length setting on account of a mistake about value, as distinguished from a transaction driven by donative intent, the ordinary-course-of-business exception immunizes the transaction from the gift tax. See Treas. reg. section 25.2512-8.

The Tax Court would presumably avoid a “double inclusion” by permitting the estate to reduce, under section 2043, the amount required to be included under section 2036 by the amount of the consideration received. Without examining the obvious tax-driven motivation for the transfer.77

This is not to suggest that, if the Tax Court reading were rejected, the phrase would be entirely meaningless. If, for example, a facade is erected creating the false impression that the transfer was made in exchange for consideration, the transaction would not be bona fide and the exception therefore would not apply. Put differently, the phrase prevents taxpayers from qualifying for the exception on the basis of a sham or illusory consideration.78 Under the circuit courts’ view, this is precisely the limited function that the phrase is designed to serve.79

Indeed, until its decision in Harper, the Tax Court itself had so construed the phrase. In Harper,80 however, the court, striking down what it perceived to be an abusive family limited partnership, inflated the significance of the phrase. In doing so, it failed to acknowledge that it was altering its approach. Instead, it mischaracterized the authority on which it relied. In Goetchius,81 the only direct authority cited by Harper, the Tax Court rejected the taxpayer’s exception-based argument. But, contrary to Harper’s reading, the court did not invest the phrase with any new significance. It simply held that the decedent had not received consideration for the transfer and that, as a result, depletion occurred.82 The court even intimated that the exception would have applied had the decedent received

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76Treas. reg. section 20.2036-1 indicates that the exception applies where there is “adequate and full consideration.” It does not mention any requirement that the sale also be a bona fide one. It does, however, cross-reference Treas. reg. section 20.2043-1(a), which does appear to contemplate the need to satisfy two conditions for the exception to apply: that the sale be a bona fide one and that the consideration be adequate. Nonetheless, the latter regulation is not inconsistent with the traditional (Wheeler’s) understanding of the exception. Its use of the phrase “bona fide” is obviously designed to do nothing more than make certain that the consideration was actually supplied and not an illusory one. Indeed, the last sentence of the provision confirms this reading. It provides that, if the value at the time of death of the transferred asset to be included under section 2036 (or similar section) exceeds the consideration received by the decedent, only the excess is included in the gross estate. The failure to require that the sale be a bona fide one to qualify for treatment under this last sentence makes it clear that it was intended to embrace the traditional understanding of the exception.

77See, e.g., Wheeler v. U.S., 116 F.3d 749 (5th Cir. 1997).

78See, e.g., Harper v. Commissioner, T.C. Memo. 2002-121.


80Treas. reg. section 20.2036-1(a), which does appear to contemplate the need to satisfy two conditions for the exception to apply: that the sale be a bona fide one and that the consideration be adequate. Nonetheless, the latter regulation is not inconsistent with the traditional (Wheeler’s) understanding of the exception. Its use of the phrase “bona fide” is obviously designed to do nothing more than make certain that the consideration was actually supplied and not an illusory one. Indeed, the last sentence of the provision confirms this reading. It provides that, if the value at the time of death of the transferred asset to be included under section 2036 (or similar section) exceeds the consideration received by the decedent, only the excess is included in the gross estate. The failure to require that the sale be a bona fide one to qualify for treatment under this last sentence makes it clear that it was intended to embrace the traditional understanding of the exception.

82The decedent did not receive any consideration in exchange for the transfer. Instead, under the agreement, the consideration was given to the decedent’s brother. To prevent the tax-free depletion of the transferor’s estate, the court held that the estate did not qualify for the exception.
the consideration in exchange for the transfer.83 Goetchius, therefore, is consistent with the circuit courts’ approach and cannot be properly viewed as modifying the phrase’s traditional, limited role.

In Strangi, given the court’s earlier conclusion in its initial decision that no taxable gift had been made at the formation of the partnership84 — implicitly recognizing that depletion had not occurred — the estate qualified for the exception unless precluded from doing so by the phrase. Under the so-called “recycling” theory the court had created in Harper, however, the phrase renders the exception inapplicable where the decedent contributes assets to a partnership in exchange for all partnership interests without any simultaneous contribution by others.85 That is, a taxpayer who stands on both sides of the transaction, as transferee and as the only meaningful partner in the transferee, cannot claim that it is a bona fide one and is therefore not eligible for the exception — even though it did not produce depletion. Relying on the “recycling” gloss Harper had imposed on the phrase, the court in Strangi concluded the estate could not qualify for the exception.86

The court, however, failed to acknowledge that the Fifth Circuit, the court having appellate jurisdiction, is among the circuit courts explicitly adhering to the traditional view.87 Indeed, the court did not even mention the relevant Fifth Circuit decision.88 And, in distinguishing a district court decision that had been affirmed by the Fifth Circuit (without published opinion),89 the court did not reference the district court’s conclusion, based on the prior Fifth Circuit precedent, that the exception necessarily applies whenever the original transfer did not deplete the transferor’s estate and therefore did not constitute a taxable gift.90 Because the Tax Court follows controlling circuit court authority under its Golsen91 rule, perhaps the court was simply unaware that its rejection of the exception, notwithstanding the decedent’s receipt of full consideration, was inconsistent with the Fifth Circuit’s approach.

In creating its recycling theory, the Tax Court was obviously motivated by its strong distaste for what it views as abusive family limited partnerships. Having previously rejected the Service’s argument that Strangi made a taxable gift at the time of partnership formation,92 as well as the argument that the partnership should be ignored because of the absence of a business purpose,93 the court understandably tried to “smuggle” the tax-driven nature of the transaction back into the calculus. Although the recycling theory does accomplish this objective, it deviates from the traditional understanding of the exception. Moreover, and perhaps even more important, the theory will only present an obstacle for taxpayers who are not well advised or whose children (or other heirs) have insufficient independent resources. To illustrate, consider a well-advised family where the children have independent wealth. If the parent were to form the partnership and her children were simultaneously to contribute assets in exchange for a partnership interest, the theory would have no application and the partnership would withstand the Tax Court’s section 2036 analysis as long as the requisite business purpose was present.94 In short, the section 2036 solution that the Tax Court has devised to close down these partnerships is, to be sure, an imperfect one. If the court’s rejection of the Service’s gift-on-formation and business-purpose arguments is not modified, new legislation replacing the Tax Court’s section 2036 approach with a model more effectively targeting family-partnership abuse would be salutary.

83See id. at 505 (stating that the “receipt of ‘adequate and full consideration’ can intervene to avoid the tax only if the facts show that the transfer of property in question does not cause a depletion of the transferor’s estate.”).

84See Estate of Strangi, 115 T.C. 478, 489-90; see also Jones v. Commissioner, 116 T.C. 121, 127-28, Doc 2001-6611 (34 original pages), 2001 TNT 45-12 (2001) (explaining the holding in the initial Strangi decision that no gift occurs at partnership formation if the taxpayer continues to own an interest in the entity and received appropriate credit in the entity’s capital accounts for the amount contributed).

85But see Estate of Thompson v. Commissioner, T.C. Memo. 2002-246, where the court refused to apply the exception even though the decedent’s children had also contributed assets to the partnership. In effect, the court disregarded their contribution on the ground that, under the partnership agreement, all transactions relating to the assets they had contributed would be allocated to them.

86See Strangi, T.C. Memo. 2003-149.

87See Wheeler, 116 F.3d 749.

88See id.


811See Strangi, 115 T.C. 478 at 489-90.

812See id.

813In explaining its recycling theory in Harper, the court failed to clarify fully its contours. It remains unclear whether a contribution by others would be sufficient to avoid the theory if investment assets, as opposed to business-type assets, were contributed. In Strangi itself, the decedent’s children had contributed their own assets to the corporate general partner in exchange for their 53 percent interest, and the court nonetheless invoked the theory. Whether this was attributable to the fact that personal-use assets had been contributed to the partnership, to the fact that so much of the decedent’s wealth was in the partnership, or to the fact that it was essentially a deathbed transaction remains uncertain. It is also not entirely clear whether the theory would apply where there is only one person who makes the contribution but does so for a nontax purpose (e.g., where the partnership is formed for creditor protection purposes).
IV. Planning: How to Neutralize the Threat

A. Existing Partnerships

Given Strangi’s alternative holding, it is critical for existing partnerships to consider restructuring. Where, under any existing partnership arrangement, a limited partnership interest or an interest in the general partner carrying the right to vote with respect to liquidation or distributions is retained until death, section 2036(a)(2), according to Strangi, requires that all assets that the decedent had contributed to the partnership be included in the gross estate without discount. As indicated, this undiscounted, full-inclusion rule applies under Strangi’s reasoning even if the decedent made extensive gifts of limited partnership interests many years prior to death. To avoid this outcome, it is necessary that the decedent’s right to vote on liquidation and distributions be eliminated prior to death. An inter vivos gift of all interests in the partnership (as well as any interest in the general partner) would be the most straightforward method by which to achieve this, for section 2036(a)(2) can apply only where the right to control the transferred property remains intact at the time of death. And if the limited partnership interest and the interest in the general partner are gifted before death, the decedent would no longer have the voting rights at the time of death. Two practical difficulties, however, will be encountered if the inter vivos gift approach is utilized. First, a gift could produce a gift tax liability, which many taxpayers may find unattractive (especially in light of the possible repeal of the estate tax). Second, any gift occurring within three years of death may be disregarded under section 2035.

In terms of the gift tax, assuming there is an unwillingness to tolerate the potential liability and that the remaining unified credit is not sufficient to offset it, a restructuring of the partnership agreement to create two different classes of limited partnership interests may be an effective strategy. Under this strategy, the partnership agreement would be amended to create two different classes of limited partnership interests: one in which all voting and liquidation rights are concentrated, and the other having no such rights. The amendment itself should not produce a taxable gift because, after the amendment, the taxpayer still owns all limited partnership interests and still possesses all of the preamendment voting rights. If the interest carrying the voting rights were, say, a 1 percent interest, a gift of this interest should not produce any significant gift tax liability given its relatively modest value. Nor should the gift (if made a reasonable period of time after the amendment is adopted) or the amendment cause a lapse to occur under section 2704(a) inasmuch as the voting rights are not eliminated but merely transferred to another. Even assuming Strangi’s alternative holding is valid, section 2036(a)(2) could no longer apply with respect to the partnership’s underlying assets given that the power to affect these assets by voting on liquidation or distributions would cease to be held by the donor once the gift was made.

While this strategy may minimize potential gift tax liability, it doesn’t eliminate it. It could, however, be eliminated under a different strategy: by transferring the interests carrying the problematic voting rights to a trust containing provisions that render the gift incomplete for gift tax purposes. For example, a limited partner or a shareholder in the general partner who has such voting rights could convey the interest(s) to a trust under which she would retain the right to modify the interests of the beneficiaries. The retained modification power would render the gift incomplete and would therefore defeat the gift tax. At the same time, section 2036(a)(2) would be rendered inoperative in terms of the partnership’s underlying assets, for the grantor’s power to affect these assets by voting on liquidation or distributions would cease to exist upon the trust’s creation. Instead, the voting rights would be held by the trustee (the grantor might even be

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96 If made simultaneously with the amendment, the Service might argue that the transfer of the voting rights with respect to the retained portion of the limited partnership is a “naked” transfer. The section 2704 regulations, according to the argument, contemplate that a transfer of an interest will not trigger the section merely because voting rights are inherent in the transferred interest, see note 97 infra, but they don’t go on to provide that the transfer of voting rights without a simultaneous transfer of an equity interest in the entity is similarly beyond the scope of the section.

97 See Treas. reg. section 25.2704-1(f) example 7. See also preamble to Proposed Regulations under section 2704, 56 Fed. Reg. 46245-01 (September 11, 1991) (“The proposed regulations provide generally that a lapse of a right occurs when the right is reduced or ceases to exist. Generally, a transfer of an interest conferring a right is not a lapse of that right because the right is not reduced or eliminated.”). Note, however, that if the interest the transferor retains is a subordinate interest (e.g., common stock is retained while preferred stock is transferred), a taxable lapse might occur. See Treas. reg. section 25.2704-1(c)(1) (last sentence).

98 If the taxpayer held an interest in the general partner in addition to the limited partnership interest, the same result could be achieved if a gift of the interest in the general partner were made after first amending the agreement to concentrate all voting and liquidation rights in the general partner.


100 See id.

101 By a parity of reasoning, the same conclusion regarding section 2036(a)(2) would apply if the interests were instead transferred to a trust in a transaction constituting a completed gift. As Burrow makes clear in the context of a completed gift in trust, provided the trustee is independent, the grantor is not viewed as having a power simply because it is held by the trustee.
named a cotrustee as long as only the nongrantor trustee has the authority to vote on these issues under the trust instrument). To be sure, the interests held in the trust would themselves be included in the gross estate under section 2036(a)(2) because of the modification power. However, these interests would be valued with the appropriate discount taken into account. Thus, in the case of an existing partnership, Strangi’s alternative holding can be easily avoided without incurring any gift tax liability.\footnote{For individuals who are reluctant to relinquish completely all access to partnership assets, one might consider authorizing the trustee to make distributions on a discretionary basis to the grantor. The right of the trustee to vote, the limited partnership interests should not, by virtue of the trustee’s discretion regarding distributions, be attributed to the grantor. As suggested, Byrum indicates that the discretionary authority of an independent trustee is an inappropriate predicate for utilizing section 2036(a)(2). While, under Byrum’s reasoning, section 2036(a)(2) should not apply with respect to the partnership’s assets even if the trust is located in a state that follows the common-law self-settled trust rule allowing the grantor’s creditors to reach trust assets, see Restatement (Second) of Trusts, section 156, it might be advisable as a practical matter to locate the trust in a state that has overruled the common-law rule to prevent the Service from distinguishing Byrum on the ground that, unlike Byrum, the grantor of such a self-settled trust can effect its termination. See Commissioner v. Vander Weele, 254 F.2d 895 (6th Cir. 1958).}

\section*{The more difficult hurdle is section 2035.}

For those who are made uncomfortable by the loss of control resulting from a transfer to the trust of the ownership interest in the general partner, as well as the limited partnership interest, a variation on the suggested incomplete gift trust might be affective. Under this variation, ownership in the general partner would be retained, with only the limited partnership interest conveyed to the trust. Although the retention until death of the ownership interest in the general partner would, if it carried the right to vote on liquidation or other distributions, cause Strangi’s alternative holding to apply, it is arguable that only a portion of the partnership’s assets would thereby become includible in the estate. If, for example, the decedent owned a 47 percent interest in the general partner, the general partner held a 1 percent interest in the partnership and the 99 percent limited partnership interest were held in the trust, Strangi’s alternative holding might only apply with respect to 1 percent of the partnership’s underlying assets.\footnote{For even though the decedent could vote with regard to the interest in the general partner, 99 percent of any distribution or any liquidation proceeds would flow into the trust and become subject to the trustee’s discretion. And, as Byrum suggests, the use of a trust as an intermediary sufficiently blunts the control inherent in the retained voting right to avert application of section 2036(a)(2). In the course of reaching its conclusion, the Court indicated that the decedent’s ability to vote the stock he had transferred to a discretionary trust could not trigger the provision because any distribution he caused the corporation to make would inure to the benefit of the trust beneficiaries chosen by the trustee in the exercise of discretion. Thus, conveying the limited partnership interests to an incomplete gift trust, even though the court from so characterizing the trustee.} For those who are made uncomfortable by the loss of control resulting from a transfer to the trust of the ownership interest in the general partner, as well as the limited partnership interest, a variation on the suggested incomplete gift trust might be affective. Under this variation, ownership in the general partner would be retained, with only the limited partnership interest conveyed to the trust. 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If, in the example in text, the decedent instead owned a controlling interest in the general partner, the Service would presumably deny all discount with respect to the decedent’s limited partnership interest on the ground that the interest in the general partner and the limited partnership interests should be aggregated for valuation purposes even though includible in the gross estate under different sections. See Rev. Rul. 79-7, 1979-1 C.B. 294 (aggregating two items includible in the gross estate under two different sections for valuation purposes); Estate of Fontana v. Commissioner, 118 T.C. 318, Doc 2002-7744 (10 original pages), 2002 TNT 61-11 (2002) (applying the IRS’s aggregation theory in terms of valuing property includible under section 2041 and section 2033). But compare Estate of Mellinger v. Commissioner, 112 T.C. 26, Doc 1999-3887 (34 original pages), 1999 TNT 17-6 (1999) (rejecting the IRS’s aggregation theory in the context of a QTIP trust includible under section 2044). Finally, it should be emphasized that retaining the 47 percent interest, as suggested in text, is not a risk-free strategy. For the Service might argue that Strangi’s alternative holding should be extended to apply in this context, making its reasoning even more attenuated. Borrowing from Strangi, the Service would presumably argue that section 2036(a)(2) should apply on the ground that the right to vote the 47 percent interest with respect to liquidations or distributions, together with the power to modify the interests of the trust beneficiaries, had enabled the decedent in effect to control the beneficial enjoyment of the partnership’s assets. It might therefore be prudent, if this approach is utilized, to eliminate the right to vote on these issues inherent in the 47 percent interest.}
influence over the partnership is retained through an ownership in the general partner, might arguably avoid the impact of Strangi’s alternative holding without causing a taxable gift to occur.\footnote{107} The more difficult hurdle is section 2035. If death were to occur within three years of transferring the interest(s) to the trust (or, if the concentration-of-voting-rights strategy is utilized, within three years of gifting an interest carrying the problematic voting rights), assuming Strangi’s alternative holding is valid, all of the partnership’s underlying assets that had been originally contributed to the partnership by the decedent would be included in the gross estate under section 2035 without any discount.\footnote{108} That is, whenever a section 2036(a)(2) right is initially retained but then subsequently relinquished or transferred within three years of death, section 2035 in effect creates the fiction that the decedent had retained the right until the time of death. Thus, a gift or transfer of the interest(s) will defeat Strangi’s alternative holding only if made outside the scope of section 2035’s three-year window.\footnote{109}

If the interest(s) were sold instead of gifted, section 2035’s bona fide sale exception might apply. Under the exception, a full consideration sale is not subject to the section even if the seller should die within the three-year window. Thus, provided that the voting rights are relinquished or transferred within three years of death, section 2035 in effect creates the fiction that the decedent had retained the right until the time of death. Thus, a gift or transfer of the interest(s) will defeat Strangi’s alternative holding only if made outside the scope of section 2035’s three-year window.\footnote{109}

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Given Allen,\footnote{110} as a practical matter, the use of the exception in the restructuring of an existing partnership may be available only for married couples. To illustrate, assume a partner has a 99 percent limited partnership interest and virtually all of the stock in the general partner and that both interests carry voting rights that would trigger Strangi’s alternative holding. Assume further that the partnership’s assets have a

however, that section 2036(b) may contemplate that its three-year rule can apply even in the absence of volition in that a mere “cessation” of voting rights during the three-year window is subject to the section. Perhaps Congress’s use of such a passive word in section 2036(b) implies that it contemplates that the words “transfer” and “relinquished in section 2035 are to be understood as requiring more active or affirmative conduct. Cf. Estate of DiMarco v. Commissioner, 67 T.C. 653 (1986) (indicating that volition is an essential component of a taxable gift). For those unwilling to assume the section 2035 risk that liquidation entails, there is another strategy that might prevent Strangi’s alternative holding from applying to the portion of the partnership assets corresponding to the limited partnership interests held by donees: If the donees were to transfer their interests to an incomplete-gift trust, it would seem that, as Byrum indicates, section 2036(a)(2) could not apply to that portion of the partnership’s assets attributable to the transferred interests. See note 102 supra. And since the transfer by the donee partner could not be viewed as a volitional act by anyone else, section 2035 would appear to be inappplicable as well.

\footnote{110}See, e.g., Wheeler v. U.S., 116 F.3d 749, Doc 97-19675 (49 pages), 97 TNT 129-14 (5th Cir. 1997). But see LTR 9143045 (concluding that the sale of incidents of ownership in a life insurance policy for less than its face value was for a sufficient consideration such that section 2035 did not apply); for a further discussion of this ruling, see Blattmachr and Gans, supra note 77.
value of $10 million, but that the partnership interests have a value of $7 million when discount is taken into account. Recognizing that under Strangi the discount would be unavailable and seeking to shed the voting rights without making a taxable gift while qualifying for the section 2035 exception, the partner sells the interests for their discounted value of $7 million. Since the sales price is equal to the value of the interests, no taxable gift occurs. 112 And Strangi’s alternative holding would no longer apply inasmuch as the partner would not have the voting rights at the time of death. The exception, however, would be unavailable, thus requiring a full inclusion of $10 million if the partner were to die within three years of the sale.113 For, under Allen, for the exception to apply, the sales price would have to be $10 million.114 Allen, therefore, makes the use of exception problematic: To qualify, the partner would have to sell the interests for a price that would result in the purchaser making a taxable gift to the partner and that would, in turn, inflate the partner’s estate.115

If, however, the partner were married and sold the interests to her spouse,116 because of the marital deduction, the sales price could be set at the amount that would bring the transaction within the exception ($10 million) without triggering a taxable gift. So, in this example, with the purchasing spouse paying $10 million for the interests, there would be no taxable gift and no section 2035 inclusion even if the selling spouse were to die within three years117 (as well as no taxable gain for income tax purposes118). While the selling spouse’s estate would be increased as a result of the sale (receiving $10 million in consideration for the interests valued on a discounted basis at $7 million), the purchasing spouse’s estate would be concomitantly decreased (after making the purchase at a price of $10 million, the purchasing spouse would have interests valued at only $7 million).119 Thus, while leaving the couple’s aggregate estate tax wealth unaffected, the interspousal sale may enable a partner concerned about Strangi’s alternative holding to eliminate the problematic voting rights before death and thereby preserve the discount—all without producing a gift tax, without triggering section 2035, and without causing a taxable gain for income tax purposes.

In sum, in the case of existing partnerships where problematic voting rights have been retained, caution suggests that the interests carrying these rights be transferred. For those concerned about gift tax liability, an incomplete gift trust may provide an attractive solution, although section 2035 will cause the plan to fail if death should occur within three years of funding the trust. Where, however, a married couple is involved, the ability to avoid section 2035 makes the interspousal sale the approach of choice.

B. New Partnerships

In terms of structuring new partnerships, Strangi itself suggests a straightforward method for avoiding its alternative holding. If other members of the family also contribute assets to the partnership at the time of formation in exchange for partnership interests and each receives a partnership interest equal in value to their contribution, Strangi indicates a willingness to treat the transaction as a so-called “pooling.” If it qualifies, section 2036’s bona fide sale exception would preclude the section from being applied at the death of any contributing partner.120 Two caveats are necessary, however. First, Strangi is prepared to make the exception available only if the partnership has a business purpose. Second, it is presumably necessary for each contributing partner to use independent wealth; other-
wise, the Service would argue that, under the step-
transaction doctrine, a pooling did not occur. Thus, for
families who have members in lower generations with
independent wealth, as long as the business-purpose
test can be satisfied, the pooling approach may be rela-
tively easy to implement. It would allow each contrib-
uting partner to retain full voting rights as to liqui-
dation and distributions without running afoul of
Strangi’s alternative holding, provided the partnership
can satisfy the business-purpose requirement.

Pooling may not, however, be the perfect solution.
As indicated, lower-generation family members must
have independent wealth, and that often will not be
the case. Also, some might be concerned that a pooling
would cause a taxable gift to occur at the time of for-
mation: Strangi intimated, in rejecting the Service’s
gift-on-formation argument, that the decedent’s reten-
tion of virtually all of the interests in the partnership
was crucial to its reasoning. In a pooling, in contrast,
no one contributing partner receives all interests in
the partnership, thus creating the possibility that the Ser-
vice might be able to argue successfully that a gift on
formation occurs in the case of a pooling. Although, in
Jones, the court appears to retreat from its intimation
in Strangi I — indicating that no gift on formation can
occur if all contributions are properly reflected in each
contributing partner’s capital account — cautious ad-
visers might prefer a structure that would be unques-
tionably invulnerable to a gift-on-formation argument.

One such structure that could be easily implemented
is the structure adopted in Strangi with one critical
modification: Upon formation, as in Strangi, the con-
tributing partner receives a 99 percent limited part-
nership interest and a 47 percent stock interest in the
general partner; however, unlike Strangi, the governing
documents provide that the stock and partnership in-
terests are not permitted to vote on liquidation or dis-
tributions. Under this structure, Strangi’s alternative
holding could not apply given that, at the time of
death, the decedent does not hold any problematic
voting rights. And even if death were to occur within
three years of partnership formation, section 2035
should not apply inasmuch as the decedent never held
the voting rights.

Three concerns might be raised, however, about this
structure. First, the Service might argue that Strangi’s
alternative holding should be extended to cover this
type of arrangement on the ground that the decedent
could have joined with the owners of the 53 percent
interest in the general partner to amend the govern-
ing documents and thereby confer full voting rights on
the 47 percent stock interest and the 99 percent limited
partnership interest. Although such an argument ap-
ppears to be a rather weak one given the voting limita-
tion, it would be prudent, perhaps, to prohibit expressly
any such amendment (or to prohibit the contributing
partner from participating in such an amendment
process). It is, of course, difficult to predict whether
such a prohibition would suffice. Second, for those who
remain concerned about a gift-on-formation argument,
it must be conceded that the limitation on voting could
be the basis for an argument that the contributing
partner did not retain, unlike Strangi, virtually all of
the partnership interests. Third, some clients may be
made uncomfortable by their limited ability to control
the partnership under this structure.

For married clients, these concerns could be largely,
if not entirely, eliminated under a different structure.
If one spouse were to make the contribution of assets
to the partnership and the other spouse were to be
made the sole limited partner and were to own all
interests in the entity serving as the general partner,
the availability of the marital deduction should
preclude the Service from taking a gift-on-formation
position. And any Service argument that the ability to
amend the governing documents should trigger section
2036(a)(2) would certainly be even more attenuated
given that the noncontributing spouse owns exclu-
sively all interests. In terms of control, while the contrib-
uting spouse could as a nonowner be unable to exer-
cise any direct influence, the other spouse would have
complete control over all partnership issues. At the
death of the contributing spouse, the absence of all
ownership, as well as voting rights, should prevent the
Service from invoking Strangi’s alternative holding.

And even if the contributing spouse should die within
three years of partnership formation, section 2035
should not apply. At the same time, section 2036
cannot apply at the death of the noncontributing
spouse, thus preserving the discount, since the asset
transfer was made by the contributing spouse.

123 See Leder v. Commissioner, 893 F.2d 237 (10th Cir. 1989)
(holding that section 2035 does not apply where the decedent
did not directly own the transferred interest or right); Estate
of Headrick v. Commissioner, 918 F.2d 1263 (6th Cir. 1990).

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of Headrick v. Commissioner, 918 F.2d 1263 (6th Cir. 1990).
For a critique of these cases, see Jeffrey G. Sherman,
"Hairsplitting Under IRC 2035(d): The Cause and the Cure,"
16 Va. Tax Rev. 111 (1996). Note that if the contributing partner were
to receive a partnership interest or stock carrying full voting
rights and then surrender these rights, section 2035 would
apply if death occurred within three years of the amendment
effecting the surrender.
For unmarried clients or those who are uncomfortable ceding control to a spouse, a structure utilizing an incomplete gift trust might be appropriate. Upon partnership formation, the contributing partner would receive all of the limited partnership interests, which would carry no voting rights as to liquidation or distributions. An incomplete gift trust would be designated as the owner of the general partner. With the contributing partner deemed to owned all interests for transfer tax purposes, the Service would again be unable to make a gift-on-formation argument. And given the trustee’s exclusive control over the general partner and the limitation on the contributing partner’s voting rights with regard to the limited partnership interest, Strangi’s alternative holding should not apply. Nor, if the contributing partner were to die within three years of partnership formation, should section 2035 apply since ownership of the general partner was vested in the trustee from inception.

As indicated in the discussion of restructuring existing partnerships, there is a variation on the incomplete gift trust that would permit the contributing partner to retain more direct influence over the partnership: The use of the incomplete gift trust as the owner of the limited partnership interest with the contributing partner retaining an ownership interest in the general partner. As suggested, Strangi’s alternative holding might arguably in this context only to that portion of the partnership’s assets corresponding to the general partner’s percentage interest in the partnership.

As indicated in the existing-partnership discussion, the trust instrument might be fashioned to give the grantor some influence over the trustee and, perhaps, some access to partnership assets. See notes 102 and 103 supra.

If the trust were drafted to qualify as a grantor trust, it would be disregarded for all income tax purposes. See Rev. Rul. 85-13, 1985-1 C.B. 184. See also Jonathan G. Blattmachr, Mitchell M. Gans, and Hugh Jacobson, “Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor’s Death,” 97 J. Tax’n 149 (2002). And since at least two owners are required to have a partnership for income tax purposes, see Treas. reg. section 301.7701-3(a), it is likely that the partnership will not be recognized as such for income tax purposes if the trust qualifies as a grantor trust. While this should not affect the availability of discounts for transfer tax purposes, caution might suggest that the trust be drafted as a nongrantor trust.

See note 107 supra.

See notes 108 and 109 and accompanying text supra.

V. Planning and Section 2036(a)(1)

One final caution is appropriate. Strangi, as well as the earlier partnership cases on which it relies, denied the claimed discount on two grounds, section 2026(a)(1) and 2036(a)(2). Although the focus of this article was on the latter provision, those who fail to address the risk posed by the former provision do so at their peril. For if either provision is found to be applicable, no discount will be allowed (and, as discussed, previous gifts of limited partnership interests may be ignored). Thus, in addition to adopting one of the suggested structures, additional precautions must be taken to minimize the section 2036(a)(1) risk.

First, partnership distributions should not be made to the contributing partner. Indeed, it may be prudent to include in the partnership agreement a prohibition against distributions during the partnership’s term. Given that the section 2036(a)(1) argument turns on whether there was an implied understanding at the time of the initial transfer that possession would be retained, it would appear that a lack of distributions would create an insurmountable hurdle for any section 2036(a)(1) argument the Service might make. Second, closely related to the first suggestion, the contributing partner must retain outside of the partnership sufficient assets to continue funding the normal cost of living, as well as any anticipated estate tax and cost of estate administration. Third, personal use assets should not be contributed to the partnership. Fourth, needless to say, the partnership should be carefully respected, with no commingling of assets. Fifth, if feasible, consideration should be given to forming the partnership through a pooling of capital from different family members.

For those who are married, a suggestion made previously regarding new partnerships could prove to be a valuable strategy for avoiding section 2036(a)(1), as well as section 2036(a)(2). If one spouse were to contribute assets to the partnership, the other spouse were to receive the partnership interests, and no distributions were made to the contributing spouse, the following conclusions would appear to be appropriate. First, section 2036 should not apply with respect to the partnership’s assets at the death of the partner spouse (given that the contributing spouse, not the partner spouse, made the transfer of the assets to the partnership). Second, provided that the partner spouse no longer controls the general partner at the time of death, the limited partnership interest should be entitled to an appropriate discount. Third, section 2035 should not apply even if the contributing spouse were to die within three years. Fourth, section 2036 should not apply with respect to the partnership’s assets at the time of the initial transfer that possession would be retained. If either provision is found to be applicable, no discount will be allowed (and, as discussed, previous gifts of limited partnership interests may be ignored). Thus, in addition to adopting one of the suggested structures, additional precautions must be taken to minimize the section 2036(a)(1) risk.

death of the contributing spouse (assuming no distributions are in fact made to the contributing spouse).

In the case of existing partnerships where distributions have been made, consideration must obviously be given to discontinuing the practice. Whether this would suffice to show that there was no implied agreement to retain possession at the outset is, of course, not clear. And whether section 2035 would apply if the discontinuation were to occur within three years of death is also unclear (though, as previously suggested, for a married couple, an interspousal sale at a price based on the undiscounted value of the partnership assets should make it more difficult for the Service to invoke section 2035). For those clients who cannot afford to forgo distributions, perhaps a sale of the partnership interests (conceivably to a grantor trust to avoid taxable gain for income tax purposes) would demonstrate the absence of an implied agreement or would permit an argument that any implied understanding terminated at the time of the sale (but this argument might presumably trigger section 2035 if the client were to die within three years of the sale). Finally, as an alternative to a sale, the partnership might be divided into two separate partnerships, with distributions continuing to be made by one of the partnerships and distributions ceasing to be made for the other (perhaps even amending the agreement for the latter partnership to prohibit distributions).

Conclusion

Strangi’s alternative holding is an understandable response to abusive family partnerships. It misreads, however, the Supreme Court’s decision in Byrum and is therefore of doubtful validity. Nevertheless, as a Tax Court decision, it cannot be cavalierly disregarded in planning. At first blush, if one assumes that it will withstand a Byrum challenge, it appears to create an insurmountable threat to virtually all family partnerships. On further reflection, however, it becomes apparent that, if properly addressed in the structuring of new partnerships and the restructuring of old ones, its threat can be neutralized. Indeed, as a practical matter, Strangi’s alternative holding will be significant only for those who are unaware of it or who otherwise fail to do the proper planning, thus suggesting that as a matter of policy its solution to family-partnership abuse is, at best, an imperfect one.