2017

Family Limited Partnerships and Section 2036: Not Such a Good Fit

Mitchell M. Gans
Maurice A. Deane School of Law at Hofstra University

Jonathan G. Blattmachr

Family Limited Partnerships and Section 2036: Not Such a Good Fit

By: Mitchell M. Gans and Jonathan G. Blattmachr*

Abstract

The IRS has struggled to close down abusive family limited partnerships. At first unreceptive to IRS arguments, the courts eventually embraced section 2036 as an estate-tax tool for attacking such partnerships. Because the section was not designed to apply to partnerships, difficulties have arisen as the courts have struggled with the fit. In its most recent encounter, the Tax Court in Powell grappled with a fit-related issue that implicates the Supreme Court's landmark decision in Byrum. The Powell court, it will be argued, misread Byrum, conflating the majority opinion with the dissent – and converting the rule-based approach adopted by the majority into the standard-based approach advocated by the dissent. The article examines Powell, its reading of Byrum and its struggle with fit-related issues. Before concluding, planning suggestions will be offered.

INTRODUCTION

Use of family limited partnerships to achieve estate-tax discounts is a very common estate-planning strategy. The IRS has tried to close it down in the case of abusive partnerships. At first, the courts were not accommodating, rejecting various arguments that the IRS had asserted. Eventually, the courts embraced a novel argument: that the partnerships could in effect be disregarded and the discounts denied under section 2036. While this section of the Code was certainly not drafted with such partnerships in mind, it has become the IRS's most effective weapon in its battle against abusive partnerships. But since the fit between the section and partnerships is less than perfect, the courts have had to reexamine or adjust conventional principles to maintain the effectiveness of the section in the partnership context.

In its recent decision in *Powell*,[1] the Tax Court grappled with two such principles in the context of a difficult-to-defend deathbed partnership. First, it revisited a theme first sounded by the court

* Mitchell M. Gans is the Rivkin Radler Professor of Law, at Hofstra University School of Law, Adjunct Professor of Law at NYU School of Law, and Academic Editor of the ACTEC Law Journal. Jonathan G. Blattmachr is director of estate planning for the Alaska Trust Company and a director of Pioneer Wealth Partners, LLC, a boutique wealth advisor firm in Manhattan. He is a retired member of Milbank, Tweed, Hadley & McCloy and of the New York, California and New York bars. He is the author or co-author of eight books and over 500 articles, and has been chair of several committees of the New York and American Bar Associations and the American College of Trust and Estate Counsel. He is co-developer of Wealth Transfer Planning, a computerized system for lawyers that automatically generates estate planning documents, such as Wills and trusts, and provides specific client advice using a form of artificial intelligence. The authors wish to thank Ashleigh Gough, Special Professor of Law at Hofstra University School of Law and Coordinating Editor of the ACTEC Law Journal, for her insight and assistance offered in the preparation of this article.

[1] Estate of Powell v. Comm'r, 148 T.C. No. 18, 2017 WL 2211398 (T.C. May 18, 2017).

fourteen years ago in its well-known decision in *Strangi*,[2] where in dicta the court indicated that, despite the Supreme Court decision in *Byrum*,[3] a partnership could be disregarded and discounts denied under section 2036(a)(2). While the courts have not elaborated on this theme to any significant extent in the intervening years, fifteen Tax Court judges in *Powell* have now endorsed the *Strangi* theme.

In a post-Strangi article,[4] the authors critiqued the decision, arguing that it failed to respect the "bright line" rule established in *Byrum*. The *Powell* court cites the article but indicates its disagreement, maintaining that there is no need to read *Byrum* as establishing such a rule. As will be argued, *Powell* conflates the majority opinion in Byrum with the dissent.[5] It reads the majority as having established a standard, rather than a bright-line rule, as the methodology for implementing section 2036(a)(2) – when, in fact, it was the dissenting justices who argued for a standard-based methodology.

Perhaps, the *Powell* court's expansion of the provision beyond what was contemplated by the majority in *Byrum* can be understood as an attempt to compensate for its now-perceived error: seeking to minimize harm from its rejection of IRS arguments that would have more directly addressed family-partnership abuse. Indeed, the effect of *Powell* will be to require more family partnerships to satisfy a non-tax-purpose requirement – a requirement the IRS had sought to impose in its earlier arguments as a threshold test for all partnerships implicating gift or estate tax discounts. In any event, given the importance of a fifteen-judge consensus, it is time to reconsider the issue -- and for practitioners to adapt their planning strategies to accommodate this new line of attack that the IRS will presumably be pursuing.

Second, the *Powell* court grappled with the applicability of section 2043 in the context of a partnership that runs afoul of section 2036. Simply put, the question concerns the treatment of partnership units received by the decedent in exchange for a partnership interest: how to avoid including in the gross estate the units as well as the partnership assets. The *Powell* majority applied section 2043. While doing so effectively avoided a double inclusion, it conceded that in other cases its approach could produce problematic outcomes. The concurring opinion, in contrast, rejected the application of section 2043, arguing instead that the partnership units should be disregarded once it is determined that the partnership assets are subject to inclusion.

This article will explore *Powell*, its reading of *Byrum* and the implications. Before concluding, some planning suggestions will be provided for practitioners who are concerned about the possible application of section 2036(a)(2) to partnerships in light of the court's approach.

I. *Powell* Facts and the Issues before the Court

[2] Estate of Strangi v. Comm'r, T.C. Memo. 2003-145, 85 T.C.M. (CCH) 1331 (2003), *aff'd on other grounds*, 417 F.3d 468 (5th Cir. 2005).
[3] United States v. Byrum, 408 U.S. 125 (1972).
[4] *See infra* note 21 and accompanying text.
[5] *See* discussion *infra* Part III.

A. Facts

One week before the decedent's death, her agent under a power of attorney withdrew approximately $10 million in cash and marketable securities from her revocable trust and contributed these assets to a limited partnership in exchange for a 99% limited partnership interest. The decedent's son was the general partner, having contributed a promissory note to the partnership in exchange for his interest. The son formed the partnership by filing the necessary certificate with the appropriate state authority two days before the contribution of the decedent's assets was effected. At the time of the transfer, the decedent was apparently incapacitated.[6] While, under the partnership agreement, the son, as general partner, had exclusive authority to determine the timing and amount of distributions, dissolution of the partnership could only be accomplished with the written consent of all partners, including the decedent – i.e., the consent of both the decedent and her son was required to effect a dissolution.

Either before the partnership was created or at about the same time, the decedent gave her son the power of attorney. On the same day the decedent's assets were transferred to the partnership, the son again used the power of attorney to transfer the decedent's entire limited partnership interest to a CLAT.[7] Under the terms of the CLAT, the decedent's son and his sibling were entitled to the remainder on the death of the decedent.

B. Issues before the Court

The court resolved four issues on the summary judgment motion: 1) whether the value of the partnership's assets had to be included in the decedent's gross estate; 2) how, if the assets were included, to apply section 2043 in calculating the amount of the net inclusion under section 2036 or 2035; 3) whether the limited partnership units transferred to the CLAT were includible in the decedent's gross estate; and 4) whether the transfer of the limited partnership units to the CLAT constituted a taxable gift.

C. IRS Arguments

The IRS argued that the partnership's assets had to be included in the decedent's gross estate under section 2036(a)(1), 2036(a)(2) or section 2038, which would have the effect of eliminating

---

[6] Two hospital doctors indicated, on the day before the partnership was funded, that the decedent lacked capacity and "could not act on her own behalf." *Powell*, 2017 WL 2211398, at *2.

[7] A charitable lead annuity trust, or "CLAT," is one that provides for annuity payments to be made to charity for a time (either a term of years or until a measuring life dies), and then for what remains in the trust to pass to or for others who are not necessarily charitable organizations, such as the descendants of the trust's grantor. *See* I.R.C. §§ 170(f)(2)(B), 2055, 2522. There is a definition of charitable lead trust for generation-skipping transfer tax purposes under section 2642(e)(3)(A). Properly structured, a deduction is allowed for income, gift and estate tax purposes for the actuarial value of the interest in the trust committed to charity but, for income tax purposes, only if the trust is a so-called "grantor trust" whose treatment is described in section 671. *See generally*, Jonathan G. Blattmachr, *A Primer on Charitable Lead Trusts: Basic Rules and Uses*, 134 TR. & EST., Apr. 1995, at 48.

the discount the estate had claimed. The IRS also argued that gift tax was due in connection with the funding of the CLAT.

D. Estate's Concessions

The estate made two critical concessions. First, it agreed that the decedent's ability to cause a dissolution of the partnership by joining together with her son, the other partner, could serve as a predicate for inclusion under section 2036(a)(2): She had retained the right in conjunction with her son to control the possession or enjoyment of the transferred property through dissolution. Second, the estate conceded that the decedent's transfer of cash and marketable securities to the partnership did not qualify for the bona fide exception in section 2036 (i.e., the estate did not argue that the transfer to the partnership was a bona fide sale for adequate and full consideration). The only argument the estate advanced in its attempt to avoid section 2036(a)(2) inclusion was that the decedent, having transferred her limited partnership units to the CLAT before her death, did not own the units at her death and therefore did not retain the right to effect a dissolution for her life, as the section requires.

E. Court's Analysis: Overview

Utilizing the estate's concessions, the court held that section 2036(a)(2) applied, obviating the need to consider inclusion under section 2036(a)(1) or section 2038. [8] The court rejected the estate's argument that the decedent had not retained the rights within the scope of section 2036(a)(2) on two alternative grounds. First, the court held that the transfer of the partnership units to the CLAT was either void or voidable given that the gift was not within the scope of the agent's authority under state law.[9] In either case, the decedent should be treated as owning the units on the date of death and therefore holding whatever rights inhered in the units. Second, the court held that, assuming the gift was valid, the partnership assets would still be included in the gross estate under section 2035 provided that section 2036(a)(2) would have required such inclusion had the decedent not made the transfer to the CLAT[10]– a transfer that had occurred one week before death and therefore within section 2035's three-year window.

The court did not explain its rationale for focusing exclusively on section 2036(a)(2). It is possible that the court concluded that inclusion under section 2036(a)(1) would be questionable – perhaps because no distributions had been made to the decedent during the one-week period between partnership formation and her death and that, therefore, the basis for a finding of an implied understanding concerning distributions to the decedent would have been tenuous.[11] Or perhaps the court wanted to use this clearly abusive case – a deathbed partnership with no non-

---

[8] *See Powell*, 2017 WL 2211398, at *4 n.4 (indicating that the court intentionally expressed no view on the applicability of section 2036(a)(1) or section 2038).
[9] *Id.* at *12.
[10] *Id.* at *5.
[11] Note, however, that a failure to retain sufficient non-partnership assets to pay estate tax can serve as a basis for an implied understanding under section 2036(a)(1). *See* Strangi v. Comm'r, 417 F.3d 468, 477 (5th Cir. 2005).

tax purpose – as a vehicle to establish a clear precedent concerning the applicability of section 2036(a)(2).[12]

In any event, in invoking section 2035, the court turned to the question whether section 2036 would have applied had the transfer of the partnership units to the CLAT not occurred – i.e., whether the partnership assets would have been included in her estate under section 2036 had she not severed her ties to the assets through the gift of the units to the CLAT.[13] The court therefore had to determine whether the partnership units conferred rights on the decedent that could serve as a basis for applying 2036(a)(2) with respect to the partnership assets – and, if so, how to treat the limited partnership units.

II. Section 2036 and Family Limited Partnerships: Evolution

In practically all of the cases in which the courts have invoked section 2036 in the context of a family limited partnership, section 2036(a)(1) has served as the basis for the analysis.[14] The inclination to rely on section 2036(a)(1) is not surprising. The IRS can invoke this provision where the decedent retained a legally enforceable right or where there was a mere implied understanding concerning the assets transferred by the decedent even if the understanding was not legally enforceable. In contrast, in the case of section 2036(a)(2), the statute itself requires the presence of a "right" in the decedent. And, in *United States v. Byrum,*[15] the Supreme Court held that an understanding that is not legally enforceable is an insufficient basis for inclusion. Until the courts began to consider the applicability of section 2036 to partnerships, this was the considered reading of *Byrum*.[16]

In the partnership context, there are often, as a practical matter, facts from which an inference of an implied understanding can be drawn: e.g., a pattern of distributions to the decedent based on the decedent's needs; or the decedent's failure to retain sufficient assets outside of the partnership to cover the decedent's cost of living or potential estate tax obligations.[17] Where such facts are present, the IRS can bring the partnership's assets into the gross estate without having to establish the existence of a legally enforceable right.[18]

---

[12] The court's decision not to consider section 2038 is not surprising given its overlap with section 2036(a)(2). *See, e.g.*, Estate of Wall v. Comm'r, 101 T.C. 300, 313-14 (1993).
[13] *See also* Estate of Hurford v. Comm'r, T.C. Memo. 2008-278, 96 T.C.M. (CCH) 422 (2008) (section 2035 applicable where tie to assets contributed to the partnership severed by reason of a sale within three years of death).
[14] *See, e.g.*, Estate of Bigelow v. Comm'r, 503 F.3d 955 (9th Cir. 2007); Estate of Korby v. Comm'r, 471 F.3d 848 (8th Cir. 2006); Estate of Abraham v. Comm'r, 408 F.3d 26 (1st Cir. 2005); Estate of Thompson v. Comm'r, 382 F.3d 367 (3rd Cir. 2004); *but see* Estate of Bongard v. Comm'r, 124 T.C. 95 (2005), *and* Estate of Turner v. Comm'r, T.C. Memo. 2011-209, 102 T.C.M. (CCH) 214 (2011).
[15] 408 U.S. 125 (1972).
[16] *See Wall*, 101 T.C. at 313-14. The IRS itself agreed with this reading. *See* PLR 9415007 (Apr. 15, 1994); PLR 9310039 (Mar. 12, 1993); TAM 9131006 (Aug. 2, 1991).
[17] *See, e.g.*, *Strangi*, 468 F.3d at 477-78.
[18] For a less conventional application of section 2036(a)(1) in the partnership context, see *Estate of Bongard v. Commissioner*, 124 T.C. 95 (2005).

But what about cases where the decedent is careful to avoid taking partnership distributions and retains sufficient assets outside of the partnership? With decedents who take such care, there may well be no facts from which an inference of an implied understanding can be drawn, making section 2036(a)(1) unavailable to the IRS – even if the partnership is designed for the sole purpose of reducing estate tax. In such cases, the question becomes whether the IRS can deploy section 2036(a)(2).

While, as indicated, the *Byrum* Court concluded that the term "right" in section 2036(a)(2) required a "legally enforceable" or "ascertainable" right or power, the Tax Court in a memorandum opinion in *Estate Strangi v. Commissioner*,[19] disregarded restrictions on the decedent's right in concluding that section 2036(a)(2), as well as 2036(a)(1), required the inclusion of the partnership's assets in the gross estate.[20] The application of section 2036(a)(2) was entirely academic given the inclusion under section 2036(a)(1). Nonetheless, the decision did not go without notice among practitioners. It led to precautions in the drafting of partnership documents designed to preclude the IRS from invoking section 2036(a)(2).[21] With no court adopting a full-throated defense of the section 2036(a)(2) analysis in the fourteen years since *Strangi* was decided, concern among practitioners had presumably abated. The court's decision in *Powell*, however, should bring an abrupt end to this period of quiescence. Of the seventeen judges participating in the *Powell* decision, fifteen endorsed *Strangi* and its use of section 2036(a)(2) – with the two judges concurring in the result but without offering any rationale. And while the issue may well continue to percolate in the courts, it would not be surprising if such a solid Tax Court consensus had a substantial impact at the appellate level.

As the *Powell* court explains, *Strangi*'s application of section 2036(a)(2) was based on two grounds. First, the *Strangi* court pointed to the decedent's ability to join together with the other partner (or shareholders in the corporate partner) to cause a partnership dissolution.[22] Second, it focused on the fact that the decedent's son-in-law had discretion under the partnership agreement concerning the timing and amount of partnership distributions.[23] The *Strangi* court attributed this discretion to the decedent on the theory that the son-in-law was the decedent's attorney in fact under a power of attorney. Thus, on either of these grounds, inclusion was required under section 2036(a)(2), according to the court.

III. Does *Powell*, as Well as *Strangi*, Misread *Byrum*?

[19] T.C. Memo. 2003-145, 85 T.C.M. (CCH) 1331 (2003), *aff'd on other grounds*, 417 F.3d 468 (5th Cir. 2005).
[20] *Strangi*, 417 F.3d at 478 n.7. *But see* Estate of Hurford v. Comm'r, T.C. Memo. 2008-278, 96 T.C.M. (CCH) 422 (2008) (applying section 2036(a)(2) in the partnership context); *see also* Estate of Turner v. Comm'r, T.C. Memo. 2011-209, 102 T.C.M. (CCH) 214 (2011).
[21] For a discussion of *Strangi* and the planning implications, see Mitchell M. Gans & Jonathan G. Blattmachr, Strangi: *A Critical Analysis and Planning Suggestions*, 100 TAX NOTES 1153 (2002).
[22] Estate of Powell v. Comm'r, 148 T.C. No. 18, 2017 WL 2211398, at *5-6 (T.C. May 18, 2017).
[23] *Id.* at *6.

Shortly after the decision in *Strangi*, the authors wrote an article that was critical of the decision.[24] In the authors' view, *Byrum* established a bright-line test, precluding the application of section 2036(a)(2) where the decedent lacked a legally enforceable right. The majority opinion in *Powell* acknowledges the critique with a "but see" citation, arguing that *Byrum* need not be so read.[25] As the *Byrum* Court indicated, however, in order for section 2036(a)(2) to apply, by its express terms, the decedent must have retained a "right." [26] The Court reasoned that the term "right" "connotes a legally enforceable power."[27] If not legally enforceable, it is "not a right in any normal sense of that term."[28] And, according to the Court, one cannot be deemed to have a legally enforceable right if exercising it would be actionable.[29]

A. Fiduciary Duty Constraint

Thus, the Court in *Byrum* turned its focus to the question of fiduciary duty: To the extent that the decedent was constrained by such a duty, it would be inappropriate to treat him as having retained a right. In holding that the decedent was so constrained, the Court considered each of the following questions:

> Did the decedent, as a majority shareholder in a corporation conducting an active business, owe fiduciary duties to the minority shareholders, some of whom were unrelated, that constrained him from ignoring the corporation's business interests in favor of his personal or familial predilections?
>
> Did the corporation's directors owe a fiduciary duty to the minority shareholders that would constrain them from simply carrying out the decedent's directions concerning dividend-related decisions?
>
> And would the corporate trustee of a trust holding stock in the corporation for the benefit of the decedent's descendants seek to hold the decedent accountable for any breach of his duty in order to discharge its own duties as trustee?

Concededly, the Court did in fact reach an affirmative answer in the case of all three questions. The decision makes more sense, however, if it is understood to require a finding of constraint

---

[24] Gans & Blattmachr, *supra* note 21.
[25] The *Powell* majority says: "… Byrum need not be read as having established a 'bright-line test' under which control rights circumscribed by fiduciary duties owed to minority owners (whether related or unrelated to the holder of the rights) prevent the rights from triggering the application of section 2036." *Powell*, 2017 WL 2211398, at *6 n.7.
[26] United States v. Byrum, 408 U.S. 125, 136-37 (1972).
[27] *Id.*
[28] *Id.*
[29] *Id.* at 137-44. "[T]his case concerns a statute written in terms of the 'right' to designate the recipient of income. The use of the term of 'right' implies that restraints on the exercise of power are to be recognized and that such restraints deprive the person exercising the power of a 'right' to do so." *Id.* at 139 n.14.

sufficient to negate estate-tax inclusion based on an affirmative answer to *any one* of these questions.

Consider, for example, the last question. If the decedent had sought to force the directors to withhold dividend distributions based on an argument he had with his children, the trustee would have been obliged to sue him as a matter of its own fiduciary duty. Given the constraint of such a possible suit, the decedent could not be treated as having retained a legally enforceable right to force his dividend-related preferences on the directors. This would be true even if there were no unrelated minority shareholders – i.e., if the only other shareholder were the trust for the benefit of the descendants – or if the corporation held only investment (portfolio-type) assets rather than operating an active business. And even though claims based on a failure to pay dividends have a very low likelihood of success,[30] the potential for the assertion of such a claim was a sufficient constraint, according to the *Byrum* majority.[31]

Undeniably, as a matter of state law, one cannot owe oneself a fiduciary duty. Or, put differently, a person cannot possess a breach-of-duty claim against herself. For example, if the decedent owned a ninety-nine percent limited partnership interest and owned all of the membership interests in an LLC that owned the one percent general partnership interest, no argument could be made that fiduciary-duty constraints so impaired the decedent's interest under state law so as to render it other than a legally enforceable right. On the other hand, once other parties have an interest in the entity, even if related and irrespective of the passive nature of the assets in the entity, fiduciary duties cannot be ignored under the *Byrum* framework.[32]

To suggest, moreover, as *Strangi* and *Powell* do, that a fiduciary duty can only serve as a sufficient constraint if it runs in favor of unrelated parties or if an active business is involved is contrary to the premise of both the majority and the dissent in *Byrum*.[33] To be sure, the majority and the dissent did disagree about the kind of fiduciary duty that could serve as a sufficient constraint. But, as will be explained, both opinions endorsed the notion that a fiduciary duty in and of itself can constitute a constraint that negates inclusion even where the duty runs only to family members or passive assets are involved.[34]

B. Fiduciary Duty and *O'Malley*

---

[30] *Id.* at 158-59 (White, J., dissenting) (indicating that such claims are often unsuccessful).
[31] *Id.* at 137-38.
[32] The IRS itself acknowledged as much, concluding that, under *Byrum*, fiduciary-duty constraints precluded the application of section 2036(a)(2) in the case of family limited partnerships. *See* PLR 9415007 (Apr. 15, 1994); PLR 9310039 (Mar. 12, 1993); TAM 9131006 (Aug. 2, 1991).
[33] Although not directly applicable, for valuation purposes, it may be noted that the identity of parties or their relationship to a decedent normally is generally not relevant. *See, e.g.*, Estate of Bright v. United States, 658 F.2d 999 (5th Cir. 1981); Rev. Rul. 93-12, 1993-1 C.B. 202.
[34] *See also* Estate of Gilman v. Comm'r, 65 T.C. 296 (1975), *aff'd*, 547 F.2d 32 (2d Cir. 1976) (fiduciary duties owed to family members sufficient constraint under *Byrum* to preclude application of section 2036(a)(2)); Estate of Cohen v. Comm'r, 70 T.C. 1015 (1982) (finding fiduciary duties in the familial context was a sufficient constraint under *Byrum* in the context of a trust owning rental real estate).

The two *Byrum* opinions divided over the significance of the Court's earlier decision in *United States v. O'Malley*.[35] The settlor in *O'Malley* was one of three trustees of a discretionary trust for the benefit of his children and wife.[36] Under the instrument, the trustees had discretion concerning distributions to the beneficiaries.[37] No standard limiting or guiding the trustee's discretion was included in the instrument.[38] Despite the settlor's fiduciary duty as trustee and the resulting possibility that he could have been held accountable by the beneficiaries for breaching his duty, the Court held that section 2036(a)(2) applied because the settlor could exercise his discretion in conjunction with his co-trustees.[39]

The *Byrum* dissent argued that since the fiduciary duty normally imposed on trustees was determined not to constitute a sufficient constraint in *O'Malley*, the corporate fiduciary duty in *Byrum* could not negate inclusion.[40] It argued that *O'Malley* was controlling on the theory that the corporate fiduciary duty in *Bryum* was no different from the trustee's fiduciary duty in *O'Malley*.[41] The majority replied that, under the terms of the *O'Malley* instrument, the settlor had explicitly retained the legally enforceable right to exercise discretion concerning distributions, whereas, in *Byrum*, the decedent had not inserted in any of the documents such a right[42] to make decisions based on personal (non-corporate) interests.

Most important, in the course of arguing that *O'Malley* was controlling, the *Byrum* dissent acknowledged that, if a provision had been inserted in the *O'Malley* trust instrument limiting the trustees' discretion by an ascertainable standard (i.e., one enforceable under state law) – for example, a standard based on health, education or support – it would have constituted a sufficient constraint to negate inclusion.[43] The dissent referred to a line of authority holding that an ascertainable standard creating a duty to family members does constitute such a constraint without regard to the active or passive nature of the trust's investment.[44] The majority implicitly agreed with the dissent on this point. Indeed, even the IRS accepts that such an ascertainable standard is a constraint.[45] Thus, all nine Justices, as well as the IRS itself, agree that a fiduciary duty owed to family members is a sufficient constraint without regard to the active or passive nature of the underlying investments.

C. *Powell*'s Reading of *Byrum* Belied by *Byrum* Dissent

---

[35] 383 U.S. 627 (1966).
[36] *Id.* at 629.
[37] *Id.*
[38] *Id.* at 629 n.3.
[39] *See* United States v. Byrum, 408 U.S. 125, 135-38 (1972) (summarizing and explaining *O'Malley*).
[40] *Id.* at 157 (White, J., dissenting).
[41] *Id.*
[42] *Id.* at 136.
[43] *Id.* at 166 (White, J., dissenting).
[44] *Id.* The dissent cited Jennings v. Smith, 161 F.2d 74 (2d Cir. 1947).
[45] *See* Rev. Rul. 73-143, 1973-1 C.B. 407.

Although not acknowledged by the *Powell* court, the nature of the divide between the majority and the dissent in *Byrum* supports the reading that section 2036(a)(2) cannot apply in the absence of a legally enforceable right. The principal point of contention between the majority and dissent concerned the decedent's raw or *de facto* power to control dividend policy. The dissent argued that the *O'Malley* Court, having used the word "power," contemplated a focus on the practical reality of the settlor's retained power, not a theoretical inquiry as to whether the decedent had retained a legally enforceable right.[46] But the majority categorically rejected this argument, saying that the use of the word "right" in section 2036(a)(2) requires that it be legally enforceable.[47]

Indeed, the majority repeatedly used the phrase "legally enforceable" or some variation on the phrase. The dissent openly acknowledged the majority's "legally enforceable right" holding, arguing at some length that Congress, in using the word "right," did not devote sufficient "care in the articulation" to warrant a literal construction.[48] Thus, although the dissent obviously did not agree with the majority's holding, it is nonetheless clear that all nine Justices understood that, under the majority approach, estate-tax inclusion under section 2036(a)(2) required a legally enforceable right. In short, to read the majority as contemplating a focus on raw or *de facto* power, rather than legal enforceability, would be nothing short of conflating the majority opinion with the dissent.

D. Rules versus Standards

A second aspect of the majority-dissent divide – which also supports the "legally enforceable right" reading – stems from the jurisprudential distinction between rules and standards.[49] According to the *Byrum* majority, the dissent's raw-power approach entailed the creation of a standard, rather than a rule.[50] The majority was of the view that a standard would create uncertainty, permitting courts to decide on a case-by-case basis the facts that should be given determinative consideration.[51] A rule, in contrast, would enable taxpayers to engage in planning

[46] United States v. Byrum, 408 U.S. 125, 161 (1972) (White, J., dissenting) ("[I]tt is quite repugnant to the words and sense of our opinion in *O'Malley* to read it as though it pivoted on an interpretation of 'right' rather than a power. The opinion could hardly have been more explicitly concerned with the realities of a settlor's retained power rather than the theoretical legal form of the trust.").
[47] *Id.* at 136 n.9 ("Although Mr. Justice White's dissent argues that the use of the word 'power' in *O'Malley* implies that the Court's concern was with practical reality rather than legal form, an examination of that opinion does not indicate that the term was used other than in the sense of legally empowered.").
[48] *Id.* at 159 (White, J., dissenting).
[49] *See generally* Kathleen M. Sullivan, *The Supreme Court, 1991 Term – Foreword: The Justices of Rules and Standards*, 106 HARV. L. REV. 22 (1992) (indicating that a rule must be followed even if inconsistent with the underlying principle or policy, whereas a standard gives the court more discretion to take into account the underlying policy); Ernest Young, *Rediscovering Conservatism: Burkean Political Theory and Constitutional Interpretation*, 72 N.C. L. REV. 619 (1994) (citing Professor Sullivan).
[50] *Byrum*, 408 U.S. at 137 n.10 ("The 'control' rationale, urged by the Government and adopted by the dissenting opinion, *would create a standard* – not specified in the statute – *so vague and amorphous as to be impossible of ascertainment* in many instances." (emphasis supplied)).
[51] *Id.*

their transactions without fear of having a court pull the proverbial rug out from under them. Other aspects of the majority opinion further support the conclusion that the majority was sensitive to the plight of taxpayers and their need for reliance.[52]

This is not, however, to suggest that the majority was correct as a policy matter or that rules are universally preferable to standards. The application of a standard can produce salutary outcomes. For example, a standard might enable a court to close down an abusive transaction that would otherwise escape a rule[53] – which explains the dissent's preference for the use of a standard. But the majority traded off abuse for certainty – i.e., accepted the possibility that abusive cases might escape from section 2036 in return for a clear rule on which taxpayer could rely. Whatever one may think about this tradeoff in the abstract – and different judges will certainly hold different views depending on the context – it is difficult to deny that the *Byrum* dissent would have preferred to implement section 2036(a)(2) as a standard and that the majority emphatically rejected this in favor of a legal-enforceability rule.[54]

Without discussing or mentioning the *Byrum* majority's characterization of the dissent's approach as a standard and its concern that it would be "so vague and amorphous as to be impossible of ascertainment in many instances," the *Powell* court simply says that "*Byrum* need not be read as having established a 'bright-line test.'"[55] Although the majority, as well as the dissent, in *Byrum* repeatedly references the majority's "legally enforceable right" approach, the *Powell* court never once mentions this phrase.[56] Instead, it twice uses the word "illusory" in the course of deciding whether there were sufficient fiduciary-duty constraints to negate inclusion.[57] The *Powell* court has thus unwittingly converted the bright-line test adopted by the *Byrum* majority into a standard that will turn on whether a constraint on the decedent's right is found to be illusory.[58]

---

[52] *Id.* at 135 ("When courts readily undertake such tasks, taxpayers may not rely with assurance on what appear to be established rules lest they be subsequently overturned.").

[53] For example, the economic substance doctrine, now codified in section 7701(o), is an example of a standard.

[54] It is worth noting that Congress has not altered the *Byrum* Court's construction, although it had an opportunity to do so when it enacted section 2036(b) to deal with retained voting rights in transferred stock in 1978. And given the strong claim to stare decisis enjoyed in the statutory-construction context and particularly in the tax realm, see *Battat v. Commissioner*, 148 T.C. No. 2, 2017 WL 449951 (T.C. Feb. 2, 2017), it would seem unlikely that the Supreme Court would be willing to revisit the issue. Perhaps, the Court's holding could be overturned by a regulation, see *United States v. Home Concrete & Supply, LLC*, 566 U.S. 478 (2012) (leaving open the possibility that a regulation could overturn a Supreme Court decision), but that would seem equally unlikely given that the holding was based on the unambiguous word "right" contained in the statute. *See also* JONATHAN G. BLATTMACHR & MITCHELL M. GANS, THE CIRCULAR 230 DESKBOOK, ch. 1 (Practising Law Inst. 2017) (discussing *Home Concrete*).

[55] *Battat,* 2017 WL 449951, at *1 n.5.

[56] This is to be contrasted with *Estate of Wall v. Commissioner*, 101 T.C. 300 (1993), where the court repeatedly referenced *Byrum*'s conclusion that section 2036(a)(2) requires a legally enforceable right.

[57] Estate of Powell v. Comm'r, 148 T.C. No. 18, 2017 WL 2211398, at *6-7 (T.C. May 18, 2017).

[58] This is reminiscent of the common law approach used in determining whether a non-probate form of transfer should be considered in calculating the elective share – an approach that has largely been rejected in favor of clear-cut statutory rules. *See, e.g.*, Newman v. Dore, 9 N.E.2d 966 (N.Y. 1937); John H. Langbein & Lawrence W. Waggoner, *Redesigning the Spouse's Forced Share*, 22 REAL PROP. PROB. & TR. J. 303 (1987).

In *Powell*, the court determined that there were two grounds on which application of section 2036(a)(2) could be predicated. One of the grounds related to the general partner's discretion concerning the timing and amount of partnership distributions. Although the decedent's son was the general partner and not the decedent, the court nonetheless in effect attributed the general partner's discretion to the decedent based on the fact that the son was also the decedent's attorney in fact under a power of attorney. As the court indicates, the facts relating to the power of attorney were also present in *Strangi* and led the court to apply section 2036(a)(2).[59] Thus, applying *Strangi*, the court concluded that inclusion was appropriate on this basis.

Two premises would appear to underlie the court's analysis of the power of attorney: 1) that it is appropriate to attribute to the decedent the powers held by the son as a general partner; and 2) that any fiduciary duty that the decedent would have owed to his son in the exercise of these attributed powers is to be ignored. Both of these premises may be difficult, however, to square with *Byrum*. Unless, under state law, the powers held by the son as general partner must be attributed to the decedent by reason of the power of attorney, the son's powers did not give the decedent a legally enforceable right. Similarly, unless, under state law, the son's ability to enforce his rights as a partner were somehow eliminated by reason of the power of attorney, the decedent, again, did not have a legally enforceable right. But the court does not supply a careful analysis of these two issues under state law. Instead, the court finds that any constraints on the decedent were "illusory" as a matter of federal law and must therefore be disregarded in making the *Byrum* analysis.[60] In effect, the question became, not whether the decedent had a legally enforceable right, but rather whether the more amorphous standard favored by the *Byrum* dissent was satisfied.

E. Right to Vote on Dissolution: *Powell* versus *Byrum*

The second ground on which *Powell* relied in invoking section 2036(a)(2) was the provision in the partnership agreement that permitted the decedent, as a limited partner, to effect a dissolution of the partnership with the consent of the other partner.[61] In *Strangi*, the court had engaged in a similar analysis, pointing, as did *Powell*, to the language in the statute making it applicable if the decedent's right could be exercised alone or in conjunction with others.[62] While the *Powell* analysis is similar to the *Strangi* analysis, there may be a subtle difference. In *Strangi*, the court appeared to contemplate that if the ability to liquidate was constrained by a fiduciary duty, inclusion would not be appropriate.[63] In contrast, in *Powell*, although not entirely clear, the court appears to intimate that such ability is a *per se* ground for inclusion, thus rendering superfluous a fiduciary-duty analysis.[64]

---

[59] *Powell*, 2017 WL 2211398, at *6.
[60] *Id.* at *7.
[61] *Id.* at *6.
[62] *Id.* at *5 (citing Estate of Strangi v. Comm'r, T.C. Memo. 2003-145, 85 T.C.M. (CCH) 1331 (2003)).
[63] *Strangi*, T.C. Memo. 2003-145, at *17-18.
[64] The *Powell* court says: "And although decedent's ability to dissolve NHP [the partnership] is sufficient to invoke section 2036(a)(2), the second factor we relied on in *Estate of Strangi* is also present here." Estate of Powell v. Comm'r, 148 T.C. No. 18, 2017 WL 2211398, at *6 (T.C. May 18, 2017).

Perhaps the court assumed that, as a matter of state law, a limited partner does not owe a fiduciary duty to other partners. Such an assumption may not, however, be entirely accurate.[65] Moreover, the Tax Court itself has previously suggested that a limited partner holding a substantial interest in the partnership could face litigation from the other partners should he or she force a liquidation on the partnership.[66] Given the possible state law constraints on the ability of a limited partner to force a liquidation, any suggestion that such an ability constitutes a *per se* ground for inclusion is questionable.

The ability-to-liquidate rationale is questionable on other grounds, as well. The in-conjunction-with language in the statute is not a limitless concept. Courts have held that a power to persuade other equity holders is not within the scope of the concept.[67] In addition, in *Byrum*, the majority rejected the government's argument that the ability to force a liquidation should trigger section 2036(a)(1), saying that any such ability is speculative and should not serve as a basis for inclusion.[68] Given that section 2036(a)(1) is broader in scope than section 2036(a)(2) – in the sense that, under the former provision, there is no requirement that the decedent retain a legally enforceable right – it would be surprising if an attribute found speculative under section 2036(a)(1) could serve as a basis for inclusion under section 2036(a)(2).[69]

F. Is an Implied Understanding Sufficient to Trigger Section 2036(a)(2) Under *Powell*?

The *Powell* court's standard, focusing on whether a fiduciary-duty constraint is illusory, presumably has its limits. It should not, for example, be used to import into section 2036(a)(2) the section 2036(a)(1) principle that a legally unenforceable understanding is a sufficient predicate for inclusion.

To illustrate, assume that a decedent had created a trust qualifying as a so-called SLAT (spousal limited access trust), naming her husband as trustee and giving him discretion unconstrained by

---

[65] *See* Sletteland v. Roberts, 16 P.3d 1062, 1067 (Mont. 2000) (fiduciary duty can be imposed on a minority-interest holder who "has power to do damage" to the entity); Gilbert v. El Paso Co., 490 A.2d 1050, 1055 (Del.Ch.1984) (non-controlling equity holder who can dominate the entity owes fiduciary duty).

[66] *See* Estate of Jones v. Comm'r, 116 T.C. 121 (2001); *see also* Estate of Curry v. United States, 706 F.2d 1424 (7th Cir. 1983) (holding that, in valuing a majority interest, a discount should be permitted to reflect a fiduciary-duty constraint on liquidation); *but see* Estate of Koons v. Comm'r, No. 16-10646, No. 16-10648, 2017 WL 1501062 (11th Cir. Apr. 27, 2017) (indicating that there is no fiduciary-duty constraint with respect to forcing a liquidation provided that all equity holders receive a pro rata share).

[67] *See* Estate of Tully v. United States, 528 F.2d 1401, 1404 (Cl. Ct. 1976) (power to persuade co-shareholder outside the scope of "in conjunction with" language); *but see* Estate of Levin v. Comm'r, 90 T.C. 723, 730-31 (1988) (applying the "in conjunction with" principle over an argument that other board members were not likely to acquiesce and saying that "the ability of the other board members to go against decedent's wishes is largely illusory.")

[68] United States v. Byrum, 408 U.S. 125, 149 (1972) ("The first of these, the power to liquidate or merge, is not a present benefit; rather, it is a speculative and contingent which may or may not be realized.").

[69] See *Tully*, 528 F.2d at 1405 (concluding that section 2038, which is substantially same as section 2036(a)(2) in all relevant respects, does not apply where the power is speculative).

any standard to make distributions for the benefit of their descendants. *Byrum* should preclude application of section 2036(a)(2) inasmuch as the decedent, who was not a trustee, did not retain the legally enforceable right to make distribution decisions. And even if the decedent had an understanding with her husband that he would defer to her wishes, the section should still not apply given the absence of a legally enforceable right.[70]

It would be inappropriate to read *Powell* as suggesting that, under its illusory standard, section 2036(a)(2) could be invoked in such a case. For if *Byrum* is to retain any vitality, the illusory standard must be limited, applying for the sole purpose of determining whether a fiduciary-duty constraint imposed on the decedent is real or illusory. To apply *Powell*'s illusory standard more broadly – to require, for example, 2036(a)(2) inclusion in the posited SLAT on the rationale that the lack of legal right should be ignored as illusory – would leave little of *Byrum* intact.

***

In sum, despite the abusive nature of the *Powell* partnership, it is difficult to square the court's use of section 2036(a)(2) with *Byrum*, proving the adage that hard cases make for problematic law.

IV. The Difficulties with Section 2036 as Applied to Partnerships

As suggested, the outcome in *Powell* makes sense in policy terms. For it is difficult to view *Powell* as other than an abusive case: The partnership was literally created on the decedent's deathbed, and the estate did not even attempt to establish a non-tax purpose for its formation. Indeed, the estate conceded the applicability of section 2036(a)(2).[71] The discounts that the family sought through the partnership arrangement simply cannot be justified. Why, after all, should a family like the Powells be permitted a discount based on this kind of deathbed planning while other families must pay tax on the full value of transferred assets? Simply put, equity cannot tolerate a discounted estate tax for families who manage to implement such a partnership paper shuffle.

A. Alternative Approaches: What Might Have Been?

The difficulty with *Powell* is the analytical methodology on which it is based, not the outcome. The methodology stems from the first the Tax Court's first decision in *Estate of Strangi v. Commissioner*,[72] where the court failed to embrace a more appropriate methodology for closing down abusive partnerships. The IRS had made two arguments that, if successful, would have permitted a denial of discounts for tax-driven partnerships: 1) that a partnership formed to avoid

[70] *See* Jay A. Soled & Mitchell Gans, *Related Parties and the Need to Bridge the Gap Between the Income Tax and the Transfer Tax Systems*, 62 ALA. L. REV. 405, 420-21 (2011).
[71] Estate of Powell v. Comm'r, 148 T.C. No. 18, 2017 WL 2211398, at *5 (T.C. May 18, 2017).
[72] 115 T.C. 478 (2000), *rev'd on other grounds*, 293 F.3d 279 (5th Cir. 2002).

the estate tax should be disregarded;[73] and 2) that a taxable gift can occur upon the formation of a partnership.[74]

Under either of these approaches, the question of inclusion would appropriately turn on the presence of a non-tax purpose, rather than the applicability of section 2036. Under the first approach, a partnership such as the Powells', with no non-tax purpose, would be disregarded at the time of death, leading to inclusion of the partnership assets in the estate on an undiscounted basis. Under the second approach, a contribution of assets to a partnership in exchange for a partnership interest having a lesser value, based on discount, would make a taxable gift equal to the difference, unless it could be shown that the partnership was formed in the ordinary course of business.[75]

To illustrate the second approach, consider a contribution of $1 million in securities to a partnership in exchange for a limited partnership interest having a discounted value of $700,000. If it could be shown that the partnership was formed in the ordinary course of business – in an arm's length transaction that is bona fide and free from donative intent[76] -- no gift would occur on formation. But if the partnership were formed to move wealth on a discounted basis, it would not be in the ordinary course of business and the difference of $300,000 would constitute a taxable gift.[77]

B. Section 2036 in Partnership Context: Square Peg into Round Hole

Having closed down these paths in its first *Strangi* decision and having been affirmed in the Fifth Circuit,[78] the Tax Court on remand[79] opened a new path for the IRS in its second *Strangi* decision: section 2036.[80] But the use of section 2036 to combat abusive partnerships is like trying to put a square peg into a round hole, raising several issues.

First, the courts had to determine whether the decedent had retained a sufficient interest with respect to the partnership's assets. The courts have issued many decisions that wrestle with this issue, most of which hinge on whether there was an implied understanding that the decedent would continue to have access to partnership assets.[81] If the court can find such an implied

---

[73] *Id.* at 484.
[74] *Id.* at 489. The IRS had also unsuccessfully argued against the discounts based on section 2703. *See id.* at 488.
[75] The ordinary-course-of-business exception is contained in Treas. Reg. § 25.2512-8.
[76] *Id.*
[77] If a transaction is driven by a tax-avoidance motive and desire to pass wealth to family members, it should not qualify for the ordinary-course-of-business exception in Treas. Reg. § 25.2512-8. For a suggestion that the regulation be amended to incorporate such an analysis, see Mitchell M. Gans, *Deference and Family Limited Partnerships: A Case Study*, 39 U. MIAMI HECKERLING INSTITUTE ON EST. PLAN. ch. 5 (2005).
[78] 293 F.3d 279 (5th Cir. 2002).
[79] The Fifth Circuit remanded for the Tax Court to consider the applicability of section 2036. *Id.* at 281-82.
[80] The IRS had previously sought to invoke section 2036 in the partnership context in *Estate of Harrison v. Commissioner*, T.C. Memo. 1987-8, 52 T.C.M. (CCH) 1306 (1987).
[81] For a case where the court had difficulty with this issue but nonetheless concluded that section 2036(a)(1) applied, see *Estate of Bongard v. Commissioner*, 124 T.C. 95 (2005).

understanding, it can apply section 2036(a)(1). The difficulty with these decisions, however, is that, if the decedent does not receive any distributions and retains sufficient assets outside of the partnership to cover the cost of living, there may well be no basis for finding an implied understanding.[82] This difficulty is exacerbated by a practical reality: Wealthier clients, who may be more comfortable "locking up" a portion of their assets in a partnership while retaining sufficient non-partnership assets, may find it easier to exploit these cases. The use of section 2036(a)(2), as in *Powell*, addresses these difficulties by expanding the IRS arsenal and thereby erecting another hurdle for taxpayers seeking to avoid the impact of section 2036. Perhaps, the expansion reflects the Tax Court's discomfort with its earlier rejection of IRS arguments that would have imposed a threshold requirement of non-tax purpose on all partnerships – compensating for its perceived error. In any event, as suggested, the expansion comes at the price of muddying up the contours of the provision: It converts the *Byrum* majority's rule into the standard sought by the dissent, in effect accepting the uncertainty that concerned the *Byrum* majority in order to close down abuse.

Second, the courts had to consider how to apply the bona fide exception in section 2036. Under conventional thinking, the exception applies if the decedent had received adequate consideration in the exchange (i.e., a consideration equal in value to the transferred asset). The exception in effect prevents against the double inclusion that might otherwise result: section 2033 inclusion of the consideration received by the decedent in addition to section 2036 inclusion of the assets transferred to the partnership. Even if the exchange or transaction were tax-driven, the exception appropriately applied to prevent double inclusion as long as adequate consideration was received.[83]

With the application of section 2036 to partnerships, the exception had to be modified to take into account whether a non-tax purpose for forming the partnership was present. Otherwise, section 2036 would be rendered useless in the partnership setting: A contribution of assets to a partnership in exchange for a partnership interest could be seen as an exchange for adequate consideration if the contribution of the transferor partner were properly reflected in the capital accounts, thus making the exception applicable – and section 2036 inapplicable – in all partnership cases as long as its formation was properly implemented. To make sure that section 2036 had teeth in the partnership context, it was necessary to make the exception turn on the presence of non-tax purpose. Thus, even if the decedent's contribution to the partnership were properly reflected in the capital accounts, the exception would not be available in the absence of a non-tax purpose.[84]

---

[82] *See, e.g.*, Estate of Stone v. Comm'r, T.C. Memo. 2003-309, 86 T.C.M. (CCH) 551 (2003) (refusing to apply section 2036(a)(1) on the ground, in part, that an accountant's analysis at the time of partnership formation showed that the decedent had retained sufficient assets outside of the partnership).
[83] *See* Wheeler v. United States, 116 F.3d 749, 763-64 (5th Cir. 1997) (explaining, in a case arising prior to the use of section 2036 in the partnership context, the limited function of the "bona fide" component in the application of the exception and how the exception should apply to prevent double inclusion where the decedent received a substitute asset with a value equal to the transferred asset).
[84] *See* Estate of Bongard v. Comm'r, 124 T.C. 95, 124 (2005) (requiring non-tax purpose as well as proper crediting to the capital account for an estate seeking to invoke the "bona fide" exception).

The question that arises is whether the non-tax-purpose requirement will now be made applicable in non-partnership cases. In effect, the requirement aids in distinguishing between tax-driven (abusive) partnerships and those formed for a legitimate business reason. Had the court in its first decision in *Strangi* embraced one of the IRS arguments, it could have more easily integrated such a requirement into the analysis. But, having rejected those arguments, it became necessary for the courts to "smuggle" a non-tax or business requirement back into the analysis via the bona-fide exception – reshaping the exception and raising questions about its contours in the non-partnership context.[85]

The third type of difficulty engendered by the application of section 2036 in the partnership context relates to the offset permitted under section 2043. Where a transfer is made that triggers section 2036 and the transferor receives consideration in the exchange but not consideration equal to the value of the transferred asset, the bona fide exception cannot apply. Nonetheless, under section 2043, the amount of the inclusion under section 2036 is offset (reduced) by the amount of the consideration received by the decedent (based on the value of the consideration at the time of the exchange). In the absence of the offset, both the transferred asset and the asset received as consideration for the transfer would be included in the transferor's gross estate. Such double inclusion would not be consistent with the purpose of section 2036 – to prevent the transferred asset from escaping taxation where the transfer is in substance testamentary by reason of rights or access retained by the transferor.[86] Thus, even though the transferor did not receive full consideration and the bona fide exception therefore cannot apply, the section 2043 offset nonetheless applies to prevent double inclusion.

Having decided that section 2036 can be used to eliminate partnership discounts, the courts had to address the double-inclusion problem in the partnership setting: If the section is used to include the partnership assets in the gross estate, how should the partnership interest be treated?[87] If the partnership interest is included under section 2033 and the partnership assets are included, as well, under 2036, a mechanism is needed to prevent double inclusion. Assuming the bona fide exception does not apply because the estate fails to establish a sufficient non-tax purpose for

[85] *See* Estate of Trombetta v. Comm'r, T.C. Memo. 2013-234, 106 T.C.M. (CCH) 416, at *10 (2013) ("Although a number of cases have applied the 'legitimate and significant nontax reasons' to determine whether a bona fide sale exception was satisfied, all of the cases applied the standard in the context of a transfer to a family limited partnership."). *Cf.* Estate of Hughes v. Comm'r, T.C. Memo. 2005-296, 90 T.C.M. (CCH) 630 (2005) (intimating that the exception requires a showing of good faith in addition to a showing that the decedent had received adequate consideration). For a discussion of *Trombetta*, see Mitchell M. Gans & Jonathan G. Blattmachr, *Private Annuities and Installment Sales:* Trombetta *and Section 2036*, 120 J. TAX'N 227 (2014). Note also that, in 2009, Treas. Reg. § 20.2053-4(d)(5) was amended to provide that a deduction for a claim against the estate is only permitted if it was the product of arm's length bargaining. To what extent this additional requirement stems from the reshaping of the bona fide provision in the partnership context is not clear.
[86] Comm'r v. Estate of Church, 335 U.S. 632, 646 (1949) ("Testamentary dispositions of an *inter vivos* nature cannot escape the force of this section by hiding behind legal niceties . . . .").
[87] See Jonathan G. Blattmachr, Mitchell M. Gans & Diana S.C. Zeydel, Turner II *and Family Partnerships: Avoiding problems and Securing Opportunity*, 117 J. TAX'N 32 (2012), for a discussion of this double inclusion issue.

the partnership, there would appear to be two alternative mechanisms: disregard of the partnership units or a section 2043 offset.

In *Powell*, the court divided on this question. The concurring opinion argued that, once it is determined that the partnership assets must be included under section 2036, the partnership units should be disregarded, resulting in the section 2036 inclusion of the partnership assets and no 2033 inclusion of the units.[88] The majority, on the other hand, concluded that the section 2043 offset is the proper mechanism.[89] Under the majority's approach, the offset is equal to the value of the limited partnership units measured at the time the assets were contributed to the partnership.[90]

To illustrate, assume the decedent transferred $10 million in assets to a partnership and received in exchange a limited partnership unit with a value of $7 million (the partnership unit is hypothesized to be worth less than the contributed assets on account of an assumed thirty-percent discount). If, at the time of death, the assets still have a value of $10 million, the net section 2036 inclusion would be $3 million (the $10 million value of partnership assets at the date of death less the $7 million value of the partnership units on the date of the initial transfer to the partnership). In addition, the limited partnership units, having a value of $7 million, would be included under section 2033. Since the objective is to tax the estate on the value of the partnership's assets, $10 million, the majority's approach produces the correct result on these facts. The approach taken in the concurring opinion would also lead to the same (correct) result inasmuch as it would require a $10 million inclusion under section 2036 and a disregard of the limited partnership units (i.e., no inclusion under section 2033).

Difficulty arises, however, if the value of the partnership's assets has fluctuated by the time of death. If, in this example, the partnership assets doubled in value by the time of death, the net section 2036 inclusion would be $13 million: the value of the partnership assets at the time of death, $20 million, less the value of the units at the time of the transfer to the partnership, $7 million. In addition, the units would produce a section 2033 inclusion of $14 million (the units having doubled in value, as well). Thus, under the majority approach, the total inclusion would be $27 million (section 2033 inclusion of $14 million and a net section 2036 inclusion of $13 million) – a problematic result given that only $20 million would have been in the gross estate had the partnership never been formed.

An equally problematic result arises, as the majority acknowledges,[91] if the partnership assets decline in value. For example, if in the example the partnership assets had declined in value to

---

[88] Estate of Powell v. Comm'r, 148 T.C. No. 18, 2017 WL 2211398, at *17 (T.C. May 18, 2017) (Lauber, J., concurring). As a technical matter, the Code, surprisingly, fails to provide a mechanism that would prevent double inclusions. Nonetheless, given that such inclusion would be inconsistent with the fundamental principles underlying the estate tax, one might conclude that a prohibition against double inclusion is implicit in the Code. *Cf.* Rev. Rul. 84-25, 1984-1 C.B. 191. *See also* Blattmachr, Gans & Zeydel, *supra* note 87.
[89] *Powell*, 2017 WL 2211398, at *9.
[90] *Id.*
[91] *Id.* at *9 n.7.

$5 million by the date of death, the net section 2036 inclusion would be zero (i.e., value of the partnership assets at death of $5 million reduced under section 2043 by the $7 million value of the limited partnership units at the time of formation – with the section 2043 offset being available to reduce the amount otherwise includible under section 2036[92]) And, of course, the date-of-death value of the limited partnership units would be included in the gross estate under section 2033. Thus, assuming again a thirty-percent discount, the $5 million in partnership assets would produce a section 2033 inclusion of $3.5 million -- a problematic outcome given that a discount is permitted even if there were no non-tax purpose for forming the partnership. Put differently, the example illustrates that section 2036 can be ineffective in combating abusive partnerships.

It also suggests that the approach taken by the concurring opinion in *Powell* might be preferable. On the assumed facts, under the concurring opinion's approach, the $5 million in partnership assets would be included under section 2036, and the limited partnership interest would be disregarded. Given that the decedent's intended beneficiaries would receive $5 million in assets, including $5 million in the gross estate and thereby denying the estate any discount would appear to be consistent with the policy objective of denying discounts for tax-driven partnerships.

In sum, section 2036 is not a perfect fit in the partnership context. As suggested, other approaches might have been a more effective, and less problematic, weapon to close down partnership abuse. But having chosen section 2036, the courts are left with the complications such as those that surfaced in *Powell*.

V. Planning

The principal focus in partnership planning has been section 2036(a)(1). Thus, in addition to documenting a non-tax purpose for the partnership, conservative planners seek to avoid an IRS implied-understanding argument: recommending that sufficient assets be retained outside of the partnership to cover the cost of living, as well as anticipated estate tax, and that distributions be avoided. While *Strangi* suggested the need to consider the threat of section 2036(a)(2), many may have dismissed it as a memorandum decision and its analysis as mere dicta given the conclusion that section 2036(a)(1) applied as well. But things have now changed. With fifteen Tax Court judges now endorsing *Strangi*, it is important for planners to rethink their approach.

Planners may therefore want to consider a few possible approaches in terms of *Powell*'s section 2036(a)(2) analysis. First, *Strangi* and *Powell* involved what might be considered "low-hanging fruit" in the sense that the general partner, who had discretion with respect to distributions, was also the decedent's attorney in fact under a power of attorney. Given *Powell*, it would not be prudent to permit the person designated as general partner to serve as such an agent.

---

[92] Section 2043 would offset the amount otherwise includible under section 2036, but it would not permit a deduction for the amount of the offset in excess of the amount of the inclusion.

Second, the partnership agreement should eliminate any right in the limited partner to vote on the question of dissolution.[93] In the case of an existing partnership, the agreement could be amended to eliminate this right, although exposure under section 2035 would continue for three years after the elimination of the voting right.[94] While it is plausible that the elimination of the voting right could be treated as an applicable restriction under section 2704(b) and therefore disregarded,[95] this would not permit the IRS to argue that the decedent should be treated as having retained the right for purposes of section 2036(a)(2).[96]

Third, the use of trusts as the owner of limited partnership interests could be helpful. In *Byrum*, a trust owned a minority interest in the corporation. In finding that the decedent did not have a legally enforceable right, the Court relied on the fact that the corporate trustee had a fiduciary duty to the beneficiaries, i.e., the decedent's descendants, to enforce the decedent's duties as a controlling stockholder and corporate director.[97] Thus, the presence of a trustee with a duty to enforce the decedent's fiduciary duties could be effective in undercutting an argument based on *Powell* that the decedent's duties were illusory. Whether a corporate trustee, or some other independent trustee, would be necessary to support this argument remains unclear.[98]

In addition, if *all* of the limited units are held in trust, the estate would have two additional arguments: that the trustee, not the decedent, had the right to vote on dissolution; and that, even if a partnership liquidation were to occur, partnership assets would be distributed to a discretionary trust over which the trustee, not the decedent, could control distributions.[99] The

---

[93] The IRS might plausibly argue in reply that the right to vote on dissolution could have been conferred on the decedent with the consent of the other partners, invoking the "in conjunction with" principle in the section. Faced with such an argument, the estate would have two replies: 1) that the decedent's mere ability to persuade other partners to confer such a voting right is not within the scope of the "in conjunction with" principle, *see supra* note 67 and accompanying text; and 2) the mere possibility that the right could have been conferred on the decedent does not satisfy the requirement in the section that the right be retained.

[94] *See* United States v. Allen, 293 F.2d 916 (10th Cir. 1961), *cert. denied*, 368 U.S. 944 (1961) (applying section 2035 in the case of a transfer within three years that would have defeated the application of section 2036).

[95] *See* Treas. Reg. § 25.2704-2(b) (defining an applicable restriction as "a limitation on the ability to liquidate the entity (in whole or in part)"). Note that, in *Kerr v. Commissioner*, 113 T.C. 449 (1999), *aff'd on other grounds*, 292 F.3d 490 (5th Cir. 2002), the court, in construing this regulation, concluded that a restriction on a put right was not an applicable restriction. It would seem, however, that a restriction on the right to vote on dissolution is somewhat distinguishable from the limitation in *Kerr* and perhaps, therefore, an applicable restriction.

[96] Section 2704(b) provides that applicable restrictions "shall be disregarded in determining the value of the transferred interest." While this provision could therefore affect the value of the transferred interest, it cannot be used as a predicate by the IRS to claim that the decedent should be treated as having retained a right for purposes of section 2036.

[97] United States v. Byrum, 408 U.S. 125, 143-44 (1972).

[98] In *Byrum*, the corporate trustee could have been removed and replaced by the decedent. *See id.* at 127. The Court nonetheless relied on the corporate trustee's fiduciary duty to hold the decedent accountable. *Id.* at 142-43.

[99] The authors have previously suggested the use of such a "buffer trust," under which the trustee who is not the decedent had discretion with respect to distributions. *See* Gans & Blattmachr, *supra* note 21. The Court in *Byrum* indicated that, in such a case, the decedent could not be treated as having a right within the scope of section 2036(a)(2). *See Byrum*, 408 U.S. at 143 ("Even had Byrum managed to flood the trust with income, he had no way of compelling the trustee to pay it out rather than accumulate it.").

use of trusts to accomplish these objectives need not entail the making of a taxable gift or the payment of gift tax.[100]

Fourth, less conventional forms of planning might be considered. For example, the authors have previously suggested that, in the case of a married couple, one spouse can transfer assets to a partnership in which the other spouse is the limited partner. Even if the bona fide exception is inapplicable because of insufficient non-tax purpose, neither section 2036(a)(1) nor section 2036(a) should apply: When the spouse who makes the transfer dies, neither provision can apply because there was no retention by the transferor of any right or access with respect to the transferred assets; and when the non-transferor spouse (who is the partner) dies, neither provision can apply given that the section is only applicable in the case of a decedent who made the transfer.[101]

The decision in *Powell* will presumably reignite interest in the *Strangi* court's application of section 2036(a)(2) in the partnership context. And while *Powell*, as argued, misreads the bright-line test established by the *Byrum* majority, practitioners cannot ignore the decision given that fifteen judges endorsed this approach. With proper planning, however, the threat that *Powell* poses can be neutralized.

CONCLUSION

As the title of this paper suggests, the application of section 2036 in the partnership setting can be problematic. First, as the courts have construed the section, the presence of non-tax purpose is irrelevant if it can be established that the decedent did not retain a right or interest within the scope of section 2036(a)(1) or 2036(a)(2). This, of course, creates the potential for a well-planned partnership to escape the section even where the partnership was formed for the sole purpose of tax minimization. Second, conventional principles, such as the bright-line rule

---

[100] First, it may not be necessary to have all of the limited units held in trust. As indicated, in *Byrum*, only a minority interest was held in trust, and the Court nonetheless found that the decedent could be held accountable by the trustee. Thus, a gift of only a portion of the limited units might suffice. Second, if all of the units are to be held in the trust and there is a concern about gift tax, an installment sale might be utilized. Or, as an alternative, the units could be transferred to a trust the terms of which render the gift incomplete for gift tax purposes. For a further discussion, see Gans and Blattmachr, *supra* note 21.

Note, however, that if a transfer of the units to an incomplete-gift trust were made, the retained modification power would cause the partnership units to be included in the gross estate under section 2036(a)(2). The IRS might then seek to use this as a predicate for inclusion of the partnership assets as well: Once the decedent is treated as having owned the partnership units, she must also be treated as having held the rights inherent in the units, including the right to vote on liquidation, triggering application of section 2036(a)(2) to the partnership assets under *Powell*. *Cf.* Rev. Rul 79-7, 1979-1 C.B. 294 ("Consequently, the value of property included in the decedent's gross estate under section 2035 should be treated, for purposes of the estate tax, in the same manner as it would have been if the transfer had not been made and the property had been owned by the decedent at the time of death."); *Compare* Estate of Fontana v. Comm'r, 118 T.C. 318 (2002) (aggregating for valuation purposes property subject to a general power of appointment, includible under section 2041, and property includible under section 2033), *with* Estate of Mellinger v. Comm'r, 112 T.C. 26 (1999) (refusing to aggregate in the QTIP context and distinguished on this ground in *Fontana*).

[101] *See* Mitchell M. Gans & Jonathan G. Blattmachr, *Family Limited Partnership: Dueling Dicta,*35 CAP. U. L. REV. 1 (2006).

established in *Byrum*, need to be reshaped, or recast as a standard, to make the section more effective in combating abusive partnerships. And even with such reshaping or recasting, the section's effectiveness can still be undercut with proper planning – thus producing less upside on the policy front than a threshold rule requiring non-tax purpose for all family partnerships. Third, as the divide between the majority and concurring opinions in *Powell* reflect, application of the provision in the partnership context can create other difficulties – for example, the double-inclusion problem, which produced a disagreement between the two opinions. Ultimately, while other lines of attack might have been more effective, the courts have made their choice and will be required to continue sorting through the resulting complexity.