Was Strangi II a Setup?

by Christopher P. Bray

Christopher P. Bray, National City Bank, Naples, Fla., argues that the Fifth Circuit set up the Tax Court's second decision in Strangi to end the latter's questionable foray into the application of section 2036(a)(2) to family limited partnerships.

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The alternative holding in *Strangi II* was a complete surprise to many estate planners. When the Fifth Circuit found in *Strangi II* that the Tax Court abused its discretion in not allowing the IRS to argue the application of section 2036[1] in its review of *Strangi I*, many believed that *Strangi II*'s primary holding was a possible result. In *Strangi II* Judge Mary Ann Cohen, former chief justice of the U.S. Tax Court, found that Mr. Strangi made a transfer to a family limited partnership he established in which he retained an income interest, causing inclusion of the FLP's assets in his gross estate under section 2036(a)(1). The holding fell right into line with the court's recent decisions regarding FLPs and section 2036.[2] However, when Judge Cohen went on to hold that section 2036(a)(2) also applied to include the assets of an FLP in Strangi's gross estate because as a limited partner he could join with other partners to liquidate the entity, the larger implications for valuation discount planning with FLPs became more daunting. Based on a section 2036(a)(2) analysis, the entire universe of FLP planning, including FLPs that might not ordinarily come under section 2036(a)(1) based on the court's prior FLP decisions dealing with that section, was at risk of producing a result never contemplated or intended.[3]

Although the alternative holding was a surprise, was it supposed to be? Or was it obvious to everyone except Judge Cohen that the holding in *Strangi II* was supposed to reverse the court's prior applications of section 2036(a)(1) to FLPs rather than invoke section 2036(a)(2)? More specifically, did the Fifth Circuit set *Strangi II* up to end the Tax Court's questionable foray into the application of section 2036(a)(1) to FLPs? The author believes the answer is yes.

The Fifth Circuit's History on FLPs

It is generally accepted that the Fifth Circuit is the most favorable forum for taxpayers to appeal their tax controversies. In the federal transfer tax arena, the Fifth Circuit has handed the IRS a stunning number of defeats. Consider the court's recent jurisprudence concerning valuation discount planning with FLPs.

In the landmark FLP decision of *Estate of Harrison v. Commissioner*[4] the Tax Court determined that the estate tax value of Daniel Harrison's FLP interest was $33 million, representing a 45 percent discount from the underlying $60 million of property contributed by Harrison to the FLP. The father of FLP planning, Stacy Eastland, was one of the primary architects of Harrison's FLP planning. Because Harrison was a resident of Texas and the FLP was a Texas partnership, the case was appealable to the Fifth Circuit. Based on many factors, not the least of which was likely a realistic assessment of the possibility of success in the forum of the Fifth Circuit, the government chose not to appeal the decision in *Estate of*

Harrison. With this case, the modern trend of estate planning with FLPs sprouted right in the Fifth Circuit's backyard.

In *McLendon v. Commissioner*[5] the Fifth Circuit validated one of Eastland's perennial arguments concerning the proper valuation of a limited partnership interest in an FLP -- that the interest should be valued as an assignee interest rather than a full limited partner interest. The logical conclusion of that holding was that larger valuation discounts would apply to more restricted assignee interests than normal limited partnership interests. Contrary to IRS objections, the court affirmed the fundamental concept that transferees of limited partnership interests (or any FLP interest, for that matter) became mere assignees rather than limited partners, resulting generally in steeper valuation discounts for the transferred interest.

In *Kerr v. Commissioner*[6] the Fifth Circuit provided the first appellate guidance on the application of section 2704(b) in a welcome, taxpayer-friendly fashion. As many commenters, including Eastland, had advocated for years after the enactment of chapter 14 in 1990, the Fifth Circuit affirmed the taxpayer's position that the ownership of a partnership interest by an unrelated party (even if that interest is only 1 percent) would preclude the application of section 2704(b) to prevent valuation discounts from being applied to the subject interest.

Finally, in *Church v. United States*[7] the Fifth Circuit affirmed one of the most taxpayer-friendly decisions since the advent of valuation discount planning with FLPs. The favorable holdings that the Fifth Circuit affirmed in *Church* included:

(1) an FLP could be formed just days before death and still be respected for valuation discount purposes;

(2) the assets assigned to an FLP in the FLP agreement, but not formally transferred into the name of the FLP, would be deemed to be owned by the FLP and thus subject to valuation in the partnership solution;

(3) section 2703 did not operate to disregard the partnership agreement for valuation purposes; and

(4) state law requirements for the existence of an FLP (that is, that the corporate general partner actually exist on the decedent's date of death) need not be observed for the FLP to be valid for valuation discount purposes.

The Fifth Circuit's affirmation of the trial court decision was, of course, no surprise. As one respected commenter sarcastically observed about the government's chances of overturning the trial court on appeal to the Fifth Circuit, "[w]hat do you think the odds are the government can win in that circuit?"[8]

The Fifth Circuit hasn't limited its taxpayer-friendly decisions to the FLP field. The court has extended its generosity to taxpayers liberally on other estate-tax-related issues. In *Estate of Bonner* [9] the Fifth Circuit affirmed the application of a 45 percent fractional interest discount in two parcels of real property that together represented the entire ownership of the property, but because they were included in the decedent's estate under separate taxing provisions (sections 2033 and 2044) the court permitted a bifurcation of the real estate for valuation purposes. In *Wheeler v. United States*[10] the Fifth Circuit permitted a taxpayer to engage in a related- party split purchase without adverse tax consequences, basically reversing almost 40 years of prior authority on the issue.[11] The holding, as examined with cross-application to FLPs, generally foreclosed IRS arguments that the formation of FLPs resulted in taxable transfers to other partners by setting forth the proposition that there cannot be a taxable gift if the transaction does not deplete the transferor's estate.

Section 2036 as an 'End-Run'

Much of the comment on the Tax Court's recent use of section 2036 to collapse FLPs has ranged from mild indignation[12] to outright anger,[13] and justifiably so. Section 2036 is an inappropriate tool for the Service to use in attacking FLPs. It is more inappropriate for the judicial branch to approve of that use (or misuse). The last two decades of statutory history related to valuation discount planning have borne that out.

Remember section 2036(c)? That was Congress's first foray into the use of section 2036 to curtail the use of valuation planning for estate tax reduction purposes. Section 2036(c) was intended to end the use of closely held corporate preferred stock recapitalizations.[14] Alas, section 2036(c) proved to be -- to borrow an expression used among the Democratic candidates for the 2004 U.S. presidential election -- a "miserable failure." The statute was soon repealed after its original enactment in 1986.[15] The framework of section 2036 was found to be an unsatisfactory remedy for the perceived valuation abuses resulting from the use of business entities.

Because section 2036 was an unsuitable platform to combat perceived valuation abuses related to the use of business entities, chapter 14 was enacted in 1990, apart from the normal estate tax inclusion provisions, including section 2036, within chapter 11.[16] The legislative history of chapter 14 is replete with observations that deride the section 2036 framework in attacking perceived valuation abuses. According to the Senate Finance Committee explanation that accompanied the legislation repealing section 2036(c):

> The committee believes that an across-the-board inclusion rule is an inappropriate and unnecessary approach to the valuation problems associated with estate freezes. The committee believes that the amount of any tax on a gift should be determined at the time of the transfer and not upon the death of the transferor . . . . In developing a replacement for current section 2036(c) the committee sought to accomplish several goals: (1) to provide a well defined and administrable set of rules; (2) to allow business owners who are not abusing the transfer tax system to freely engage in standard intra-family transactions without being subject to severe transfer tax consequences; and (3) to deter abuse by making unfavorable assumptions regarding certain retained rights.[17]

Not everyone, however, was comfortable with the proposed language of chapter 14 in achieving its intended purposes, namely ending preferred stock recapitalizations (section 2701), ending GRITs (section 2702), curtailing valuation abuses with buy-sell arrangements (section 2703), and shutting down the use of valuation discounts with FLPs by legislatively overturning the holding in *Harrison* (section 2704).[18] As a precursor to chapter 14, House Ways and Means Committee Chair Dan Rostenkowski released a discussion draft of a replacement for section 2036(c) in March 1990. In July 1990 a joint task force of the Section of

Taxation and Section of Real Property, Probate and Trust Law of the American Bar Association and the American College of Trust and Estate Counsel submitted draft statutory language for consideration in compiling chapter 14. The task force expressed concern over the possible violation by chapter 14 of the Article I, Section 9 prohibition under the U.S. Constitution against levying a direct tax on the property of U.S. citizens. The constitutional concerns regarding the use of chapter 14 to correct perceived valuation abuses were strong enough to cause its drafters to pause and reconsider its language so that it would not violate the Constitution.[19]

Remember the subchapter K antiabuse regulations? On January 29, 1994, the IRS issued Treasury reg. section 1.701-2, which included two examples directly attacking perceived valuation abuses with FLPs. The anti-FLP examples were so controversial in the professional community because they represented a furtive attempt by the government to accomplish through income tax regulations what could not be appropriately achieved by the proper application of the constitutionally conscious provisions of chapter 14.

The suspect anti-FLP examples were not included in the proposed regulations that were issued in May 1994. As a result, the examples were promulgated as part of the final regs without any public hearings or an adequate opportunity for comment. Interestingly, the examples were identified as a clear violation of the Fifth Circuit's holding in *Aldrich v. United States*[20] that income tax provisions have no relevance in determining the transfer tax consequences of a transfer of a limited partnership interest.[21] The Service, recognizing that it had grossly overstepped its authority, withdrew the anti-FLP examples from the final regulations shortly after they appeared by issuing Announcement 95-8 on January 23, 1995.

Remember Bill Clinton? Not even the Clinton administration, generally regarded as "unfriendly" to wealthy taxpayers who might try to avoid federal estate taxes, believed that section 2036 could or should be used to close FLP valuation discount planning as a perceived loophole for the rich. Twice the Clinton White House sent Congress annual budget proposals that included recommendations for the drafting of a new statute that might be developed to eliminate the use of discounts with FLPs.[22] The Clinton administration sought a new statute because it believed, and rightly so, that the existing statutory framework, section 2036 and chapter 14 included, couldn't get the job done.

Until the Tax Court's recent FLP decisions, section 2036 had not been "approved" for use as a weapon to combat valuation discount planning with business entities. Section 2036 was never used for that purpose because it was never intended for it, as the history of section 2036 and chapter 14 illustrates.

The *Strangi I* Rulings

In *Strangi I* the Tax Court determined the following:

(1) the FLP was valid under state law and would be recognized for estate tax purposes;

(2) the transfer of assets to the FLP in its formation did not result in taxable gifts by Strangi to the other partners;

(3) the FLP agreement itself did not constitute a restriction under section 2703; and

(4) Strangi's interest in the FLP should thus be valued on a discounted basis.

As a consequence of those rulings, *Strangi I* appeared at the time to be yet another taxpayer victory in using FLPs for valuation discount planning. After all, as a result of *Strangi I*, Strangi's estate would be able to reduce its estate tax liability by applying discounts to his interest in the FLP that held the bulk of his assets.

The *Strangi II* Setup

Although the Fifth Circuit readily affirmed all of the Tax Court's holdings in *Strangi I*, it reversed and remanded the decision solely on the issue of section 2036. The Fifth Circuit's stated purpose for the remand was its finding that the Tax Court had abused its discretion in refusing to consider the government's argument under section 2036. Considering the Tax Court's recent decisions on FLPs and section 2036, and given the Tax Court's pro- taxpayer findings in *Strangi I*, why did the Fifth Circuit bother to send the case back to the Tax Court to conclude it on the merits of section 2036? Based on the Fifth Circuit's history on valuation discount matters, the author is convinced that the case was remanded on section 2036 so that the Tax Court would reverse its troublesome trend of endorsing the IRS's misuse of the section to eliminate the use of FLPs for estate planning purposes.

Based on its rulings in *Strangi I*, the Fifth Circuit likely observed that the Tax Court had provided its own rope with which to hang itself regarding the inappropriate use of section 2036 to curb perceived valuation abuses with FLPs. Most scholars of section 2036 (the Fifth Circuit included) would likely never have fathomed that section 2036(a)(2) could have any application to a scenario in which (1) a business entity is deemed to be wholly valid and distinct from the decedent for tax purposes, (2) no taxable gift has been found to occur, and (3) chapter 14 otherwise does not apply. Similarly, the Fifth Circuit likely perceived that it would be impossible for the Tax Court, taking into consideration its own rulings on *Strangi I*, to use section 2036 on remand to include FLP assets in Strangi's estate. Given that observation, the Fifth Circuit may have found an irresistible opportunity for the Tax Court itself to turn back the tide of its decisions on the misuse of section 2036 to collapse FLPs. Hence the remand to the Tax Court solely on the issue of section 2036 with the understanding that this time the Tax Court might "get it right" on the use of section 2036 and FLPs.

Finally, based on the well-recognized *Golsen*[23] rule, the Fifth Circuit also knew that in deciding the 2036 issue in *Strangi II* on remand, the Tax Court would be obligated to apply the rule of law as firmly established within the circuit -- namely, that section 2036 doesn't apply when (1) a business entity is deemed to be wholly valid and distinct from the decedent for tax purposes, (2) no taxable gift has been found to occur, and (3) chapter 14 otherwise does not apply.[24]

The *Strangi II* Surprise

Unfortunately, the Tax Court in *Strangi II*, as decided by Judge Cohen, failed to "get it right." That was a monumental surprise to the estate planning community. More than likely, it was a greater surprise to the Fifth Circuit.

Despite the holding in *Strangi I* that the FLP was a valid entity and by deduction was not the alter ego of Strangi, Judge Cohen found the arrangement to be a sham whereby Strangi "recycled"[25] the value of his assets. Having constructively revised the holding in *Strangi I*, Judge Cohen misused section 2036(a)(1) to include the assets of a valid and independent business entity into the estate of a decedent partner.

Despite the holding in *Strangi I* that no gift on formation of the FLP occurred, Judge Cohen did not follow the holding's almost axiomatic result regarding section 2036. If no gift occurred on the formation of the FLP, then the exchange represented a transfer for fair and adequate consideration in money or money's worth *ex lege*.[26] Consequently, the transaction fell within the parenthetical language of section 2036(a), and therefore the Strangi FLP fell outside the scope of section 2036.

Despite the holding in *Strangi I* that section 2703 could not be misused and applied entirely apart from its proper context to ignore in toto a valid partnership agreement, Judge Cohen misused and applied section 2036 instead entirely apart from its proper context to ignore both the partnership agreement and, for all intents and purposes, the entity itself.

The *Strangi III* Redemption

Recently the Fifth Circuit took up Judge Cohen's controversial holding in *Strangi II* on appeal.[27] The case will also represent the first review by a federal appellate court of the Tax Court's misuse of section 2036 on FLPs. Given the Fifth Circuit's history, it is likely that *Strangi II* will be reversed on every conclusion. Consequently, the anticipated holding in *Strangi III* should finally end the Tax Court's misuse of section 2036 and redeem this time- honored statute for proper application in the proper context for which it was intended and enacted.

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FOOTNOTES

[1] All section references are to the Internal Revenue Code of 1986, as amended.

[2] *See Estate of Thompson v. Commissioner*, T.C. Memo. 2002-246, *Doc 2002-22023 [***PDF***] (50 original pages), 2002 TNT 188- 7*; *Estate of Harper v. Commissioner*, T.C. Memo. 2002-121, *Doc 2002-11394 [***PDF***] (75 original pages), 2002 TNT 95-11*; *Estate of Reichardt v. Commissioner*, 114 T.C. 144, *Doc 2000-6219 (24 original pages), 2000 TNT 42-11* (2000); and *Estate of Schauerhamer v. Commissioner*; T.C. Memo. 1997-242, *Doc 97- 15298 (11 pages), 97 TNT 103-7*.

[3] *See* Gans and Blattmachr, "*Strangi*: A Critical Analysis and Planning Suggestions," Tax Notes, Sept. 1, 2003, p. 1153; Mulligan, "Courts Err in Applying Section 2036(a) to Limited Partnerships," 30 *Estate Planning* 486 (October 2003).

[4] T.C. Memo. 1987-8.

[5] 96-1 USTC Para. 60,220, *Doc 96-4283 (25 pages), 96 TNT 29-16* (5th Cir. 1996).

[6] 2002-1 USTC Para. 60,440, *Doc 2002-13906 [***PDF***] (6 original pages), 2002 TNT 112-15* (5th Cir. 2002).

[7] 2001-1 USTC Para. 60,369, *Doc 2000-4369 (15 original pages), 2000 TNT 30-56* (W.D. Tex. 2000), *aff'd without published opinion* 268 F.3d 1063, *Doc 2001-21057 [***PDF***] (3 original pages), 2001 TNT 152-12* (5th Cir. 2001).

[8] Kasner, "IRS's 'Gift in the Air' Theory Is Grounded," *Tax Notes*, July 17, 2000, p. 390.

[9] 84 F.3d 1996, *Doc 96-16744 (4 original pages), 96 TNT 111-13* (5th Cir. 1996).

[10] 116 F.3d 749, *Doc 97-19675 (49 pages), 97 TNT 129- 14* (5th Cir. 1997).

[11] *See* Jensen, "Estate and Gift Tax Effects of Selling a Remainder: Have *D'Ambrosio*, *Wheeler*, and *Magnin* Changed the Rules?" *Doc 2000-7640 (76 original pages), 2000 TNT 52-36*.

[12] *See* Mulligan, "Courts Err in Applying Section 2036(a) to Limited Partnerships," 30 *Estate Planning* 486 (October 2003).

[13] *See* Kasner, "Applying *Byrum* to Family Business Entities," *Tax Notes*, Sept. 23, 2002, p. 1741.

[14] The first version of section 2036(c) was introduced in 1987. Omnibus Budget Reconciliation Act of 1987, P.L. 100-203, section 10402(a).

[15] Section 2036(c) was repealed on October 8, 1990, with the enactment of chapter 14, which applies to transfers after that date. Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, section 11602(e)(1)(A)(i), 104 Stat. 1388-1 (1990).

[16] *Id.*

[17] Informal Senate report accompanying the Revenue Reconciliation Bill of 1990 (S. 3209) as printed in the Oct. 18, 1990, *Congressional Record*, vol. 136, s. 15679 (Daily Edition).

[18] The Conference Committee report accompanying the legislation stated the intent to overrule the rule of law in *Harrison v. Commissioner*, T.C. Memo. 1987-8. H.R. Conf. Rep. No. 101-964, 101st Cong., 2d Sess. 1137 (1990).

[19] *See generally* Aucutt, "New Valuation Rules of Chapter 14," 3 *Tax Management Estates, Gifts and Trusts Journal* (January/February 1991).

[20] 346 F.2d 37 (5th Cir. 1965).

[21] *See* Eastland, "What's New With IRS Treatment of Family Limited Partnerships?" *Trusts & Estates* 67 (August 1995).

[22] *See* Treasury Department, General Explanation of the Administration's Revenue Proposals (Feb. 1, 1999), and Staff of the Joint Committee on Taxation, Description of Revenue

Proposals Contained in President Clinton's Fiscal Year 2000 Budget Proposal (JCS-1-99, Feb. 22, 1999).

[23] *Golsen v. Commissioner*, 54 T.C. 742 (1970).

[24] *Church v. United States,* note 7 *supra*. Also, *Wheeler v. United States*, note 10 *supra*, arguably stands for the proposition that when there is an exchange of property (for example, assets for partnership interests) when no gift is deemed to have occurred, then the parenthetical language of section 2036(a) ("except in case of a bona fide sale for an adequate and full consideration in money or money's worth") is invoked causing the transaction to fall outside the purview of the section.

[25] The Tax Court's application of the doctrine of *stare decisis* is unique in that, instead of relying on the rule of law as established by the Fifth Circuit under *Golsen v. Commissioner*, 54 T.C. 742 (1970), the Tax Court relies on its own so-called recycling theory invented in *Estate of Harper v. Commissioner*, note 2 *supra*.

[26] Note 25 *supra*.

[27] *See* Silverman, "Popular Tool for Estate Plans Under Scrutiny," D1 *Wall Street Journal* (Dec. 2, 2003).

END OF FOOTNOTES

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