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Estate of Strangi, Section 2036, and the Continuing Relevance of Byrum

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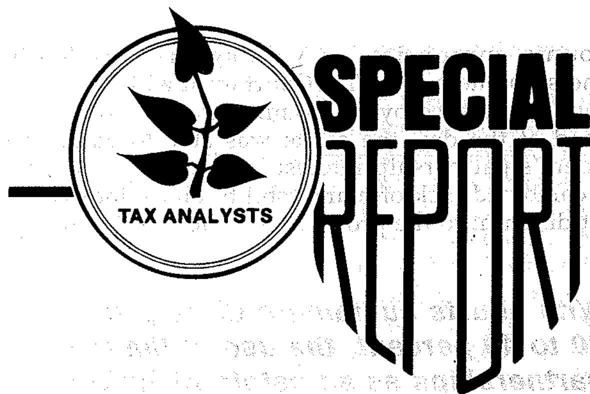

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This report analyzes the potential application of section 2036(a) to limited partnerships employed for estate planning purposes, using the facts of the Tax Court case of *Estate of Strangi v. Commissioner* as a guide. Particular emphasis is placed on the Commissioner's argument for inclusion under section 2036(a)(2) based on the taxpayer's control over the property transferred to the partnership, as well as the taxpayer's argument under the Supreme Court case of *United States v. Byrum* that the existence of the taxpayer's fiduciary duty to the partnership negates the application of section 2036 altogether. The report concludes that, because the essential facts of *United States v. Byrum* are lacking in the estate planning partnership context, the *Byrum* decision should not shield taxpayers using limited partnerships as a trust substitute from the application of section 2036(a)(2).

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ESTATE OF STRANGI, SECTION 2036, AND THE CONTINUING RELEVANCE OF *BYRUM*

By Brant J. Hellwig

Most of the recent discussion regarding the federal estate tax has focused on the debate over whether the tax should be repealed. This debate has diverted attention from what has been identified as a fundamental flaw in the federal transfer tax system — the potential to gut the tax base through the manipulation of valuation discounts.[1] The manipulation can be summarized as follows: Instead of making gratuitous transfers of property that has a readily ascertainable fair market value (such as cash or marketable securities), the taxpayer first transfers these assets to a limited partnership formed by the taxpayer with other family members. The taxpayer then transfers beneficial interests in the partnership, either during life or by reason of death, to his or her intended beneficiaries. In determining what a hypothetical third-party "willing buyer" would pay a "willing seller" for the transferred partnership interest (the valuation standard used for transfer tax purposes),[2] the taxpayer starts with the proportionate amount of the partnership valued as a whole and then applies various discounts to reflect the practical disabilities associated with an interest in a closely held entity. For instance, the value of the interest is discounted to reflect the fact that the transferee is not entitled to participate in partnership management. The partnership interest is further discounted in recognition of the difficulty the transferee would have in selling the interest. After the taxpayer has transferred his or her partnership interests, the partnership can be liquidated with the remaining family members receiving their proportionate amount of the underlying partnership assets. In this manner, the partnership form serves as a convenient vehicle to depress the value of assets for transfer tax purposes. With courts frequently sustaining combined valuation discounts in

[1]For a thorough discussion of the use of valuation discounts to reduce federal estate and gift taxes, see James R. Repetti, "Minority Discounts: The Alchemy in Estate and Gift Taxation," 50 *Tax L. Rev.* 415 (1995).

[2]For estate and gift tax purposes, the value of property subject to tax is defined as "the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts." Reg. section 20.2031-1(b) (estate tax valuation); reg. section 25.2512-1 (gift tax valuation).

the neighborhood of 30 percent to 40 percent,[3] the use of limited partnerships as an estate planning device has amounted to a unilateral election by the taxpayer to reduce his or her transfer tax rate.

The Service has challenged the use of valuation discounts in the family partnership setting on a number of fronts, and the resulting litigation has produced a string of taxpayer victories.[4] While the Service's lack of success highlights the need for a legislative response, legislative action in this area is not likely in the current political environment. The Fifth Circuit's resolution of the appeal from the Tax Court decision in *Estate of Strangi v. Commissioner*,[5] however, provides the Service with one more chance to stop some of the hemorrhaging of the federal transfer tax base.

In *Estate of Strangi*, the Tax Court passed upon a family limited partnership that appeared to have been formed solely to enable the estate of the principal contributor to avail itself of valuation discounts. After dismissing each of the estate's justifications as to the business purposes of the partnership, the Tax Court ultimately held that no business purpose was needed. Noting that the "proverbial 'i's were dotted' and 't's were crossed'" by the formation of a valid limited partnership under state law, the court held that the partnership had sufficient substance to be recognized for estate tax purposes.[6] In other words, legal form constituted the requisite substance. Describing itself as "constrained" to accept some evidence regarding the discounts appropriate in valuing the decedent's partnership interest, the Tax Court went with the lower discounts conceded by the Commissioner's expert.[7] At the end of the day, the estate was able to value the decedent's partnership interest by applying a 31 percent combined lack-of-marketability and minority interest discount to the proportionate net asset value.[8]

With courts sustaining discounts of 30 to 40 percent, the use of limited partnerships as an estate planning device has amounted to a unilateral election by the taxpayer to reduce his or her transfer tax rate.

An interesting aspect of the Tax Court opinion in *Estate of Strangi* was the court's comments about possible inclusion of the partnership assets under section 2036. The court noted that the facts of the case "suggested the possibility" of including the partnership assets in the decedent's estate under section 2036, but ultimately avoided the issue by determining that the Commissioner's pretrial motion to amend his answer to raise this argument was untimely.[9] The Fifth Circuit recently placed that issue squarely back in the Tax Court's lap by affirming the lower court decision in all respects but one. After noting that "the tax court suggested that if the Commissioner had timely filed his notice to amend to add an IRC section 2036 claim, it probably would have used that section to include in the estate the assets Strangi transferred to the [family partnership]," the Court of Appeals reversed the Tax Court's denial of the Commissioner's motion to amend and remanded the case for consideration of the section 2036 claim.[10]

This article explores the application of section 2036 to partnerships formed to exploit transfer tax discounts, using the facts of *Estate of Strangi* as an example. In the course of this discussion, the article will revisit *United States v. Byrum*,[11] the 1972 Supreme Court decision that serves as the taxpayer's principal defense against application of section 2036 to estate-planning partnerships. The article concludes that the facts that led to the Supreme Court's holding in *Byrum* are lacking in the estate-planning partnership context and that the *Byrum* decision should not be read as a blanket shield against the application of section 2036.

---

[3]*See, e.g., Estate of Jones v. Commissioner*, 116 T.C. 121, 139, *Doc 2001-6611 (34 original pages), 2001 TNT 45-12* (2001) (40 percent combined discount); *Estate of Strangi v. Commissioner*, 115 T.C. 478, 491-93, *Doc 2000-31014 (48 original pages), 2000 TNT 232-12* (2000) (31 percent combined discount), *aff'd in part and rev'd in part* 293 F.3d 279, *Doc 2002-14498 (4 original pages), 2002 TNT 118-10* (5th Cir. 2002); *Estate of Dailey v. Commissioner*, T.C. Memo. 2001-263, *Doc 2001-25453 (7 original pages), 2001 TNT 193-8* (40 percent combined discount); *Estate of Weinberg v. Commissioner*, T.C. Memo. 2000-51, *Doc 2000-4664 (31 original pages), 2000 TNT 32-10* (approximately 50 percent combined discount).

[4]*See, e.g., Church v. United States*, 85 AFTR2d 2000-804, *Doc 2000-4369 (15 original pages), 2000 TNT 30-56* (W.D. Tex. 2000) (rejecting the Commissioner's business purpose argument, gift-upon-formation argument, and section 2703 argument), *aff'd* 268 F.3d 2063, *Doc 2001-21057 (3 original pages), 2001 TNT 152-12* (5th Cir. 2001); *Knight v. Commissioner*, 115 T.C. 506, *Doc 2000-31015 (29 original pages), 2000 TNT 232-11* (2000) (rejecting the Commissioner's economic substance argument); *Estate of Strangi v. Commissioner*, 115 T.C. 478 (2000) (rejecting the Commissioner's economic substance argument, section 2703 argument, and gift-upon-formation argument), *aff'd in part and rev'd in part* 293 F.3d 279 (5th Cir. 2002); *Kerr v. Commissioner*, 113 T.C. 449, *Doc 2000-296 (41 original pages), 1999 TNT 247-58* (1999) (rejecting the Commissioner's section 2704(b) argument), *aff'd* 292 F.3d 490, *Doc 2002-13906 (6 original pages), 2002 TNT 112-15* (5th Cir. 2002).

[5]115 T.C. 478 (2000), *aff'd in part and rev'd in part* 293 F.3d 279 (5th Cir. 2002). The author served as attorney-adviser to the Hon. Juan F. Vasquez of the U.S. Tax Court at the time the original decision in *Estate of Strangi* was released. Judge Vasquez did not take part in the court-reviewed opinion.

[6]*Id.* at 486-87.

[7]*Id.* at 491-93.

[8]*Id.*

[9]*Id.* at 486. The Commissioner filed his motion to amend his answer 52 days prior to trial in the case.

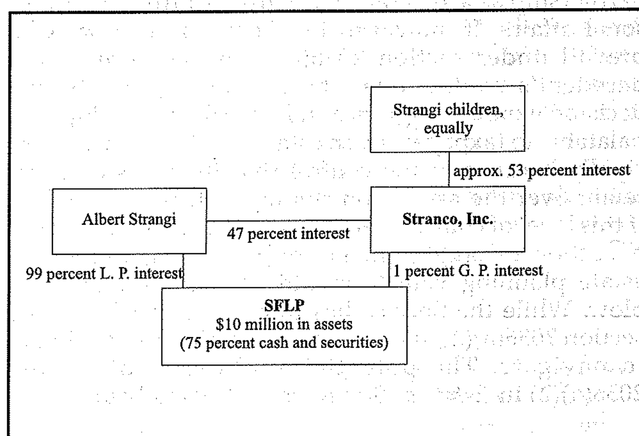
[10]*Gulig v. Commissioner*, 293 F.3d 279 (5th Cir. 2002).

[11]408 U.S. 125 (1972).

I. Illustrative Facts of *Estate of Strangi*

The decedent, Albert Strangi, was a self-made millionaire in failing health when his son-in-law, an attorney with estate planning experience, assumed responsibility of his financial affairs pursuant to an existing power of attorney. The day after attending a seminar on the tax benefits offered by the use of family limited partnerships, the decedent's son-in-law, Michael Gulig (Gulig), formed two entities: SFLP, a Texas limited partnership, and Stranco, Inc. (Stranco), a Texas corporation. Stranco was designated as the general partner of SFLP and, under the partnership agreement, it possessed sole authority over the management of SFLP's business affairs. The decedent contributed assets worth $9,876,929, mostly in the form of cash and securities, to SFLP in exchange for a 99 percent interest as limited partner. The decedent and his four children capitalized Stranco, which transferred approximately $100,000 to SFLP in exchange for a 1 percent general partner interest. The decedent owned 47 percent of Stranco's stock, and the remaining 53 percent was held by the decedent's children equally except for 100 shares that the children had donated to a local community college.[12] To round things out, the decedent and his children, as directors of Stranco, executed a unanimous consent to employ Gulig to manage the day-to-day affairs of Stranco and SFLP.[13]

The structure of SFLP and Stranco is depicted below:



Gulig handled all matters related to the formation, funding, and operation of SFLP and Stranco. During this time period, the decedent was at home under round-the-clock home health care. Roughly two months after SFLP was formed, the decedent died of cancer.

II. The Argument for Inclusion Under Sec. 2036

Section 2036(a) provides two alternative grounds for including in a decedent's gross estate assets that the decedent has transferred. The first ground, section 2036(a)(1), applies where the decedent has retained beneficial enjoyment of the transferred property. In contrast, section 2036(a)(2) applies where the transferor retains the right to determine who else the property will benefit. As stated by the Supreme Court, the general purpose of section 2036 is "to include in a decedent's gross estate transfers that are essentially testamentary—i.e., transfers which leave the transferor a significant interest in or control over the property transferred during his lifetime."[14] Relevant portions of section 2036 are reproduced below:

> Sec. 2036. Transfers With Retained Life Estate.
>
> (a) General Rule. — The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death —
>
> (1) the possession or enjoyment of, or the right to income from, the property, or
>
> (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

Based on the following passage from *Estate of Strangi* in which the Tax Court mentions the possibility of including the assets transferred by the decedent to SFLP in his gross estate under section 2036, it is not altogether clear what subsection of section 2036(a) the court had in mind:

> The actual control exercised by Mr. Gulig, combined with the 99-percent limited partnership interest in SFLP and the 47-percent interest in Stranco, suggest the possibility of including the property transferred to the partnership in decedent's estate under section 2036.[15]

The mention of the control exercised by the decedent's representative under power of attorney indicates that the Tax Court was referring to section 2036(a)(2). The reference to the decedent's beneficial ownership in SFLP and Stranco could have been made in the same vein; that is, the court could have been implying that the decedent's voting rights as a 99 percent limited partner and 47 percent owner in the 1 percent corporate general partner added to the control of SFLP's assets that the decedent possessed through Gulig. On the other hand, the court may have been noting the decedent's 99.47 percent beneficial interest in SFLP as a means of implying that the decedent retained beneficial enjoyment of the partnership assets for purposes of section 2036(a)(1). Given the lack of specificity in the Tax Court's statement, the Commissioner will likely argue both subsections of section 2036(a) on remand.

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[12]It is not clear from the opinion what percentage ownership the 100 donated shares represented.

[13]*Estate of Strangi*, 115 T.C. at 479-82.

[14]*United States v. Estate of Grace*, 395 U.S. 316, 320 (1969).

[15]*Estate of Strangi*, 115 T.C. at 486.

The potential application of each subsection is addressed below.

A. Section 2036(a)(1)

The Commissioner has had some success in using section 2036(a)(1) to attack abusive family limited partnerships. This success, however, is typically dependent upon a certain degree of taxpayer sloppiness. A recent case that illustrates this point is *Estate of Harper v. Commissioner*.[16] That case involved a decedent who transferred liquid assets to a limited partnership in exchange for a 99 percent interest as limited partner. The decedent's son and daughter held the remaining interest as general partners, with the son designated as the managing general partner. Shortly after the partnership was formed, the decedent assigned a 24 percent limited partnership interest to his son and a 36 percent limited partnership interest to his daughter.

The process of transferring formal title to the assets that the decedent assigned to the partnership took approximately four months. A checking account was not established on behalf of the partnership until three months after the partnership was formed. In the interim, amounts received with respect to the securities assigned to the partnership were deposited to the decedent's personal checking account. Two days prior to the decedent's death, a $4,000 distribution was made from the partnership to enable the decedent to make a personal gift. Following the decedent's death roughly seven months after the partnership was created, various expenses of the estate (including the federal estate tax liability) were paid via distributions from the partnership. Citing the commingling of partnership funds with the decedent's personal account,[17] the history of disproportionate distributions to the decedent and his estate,[18] and the testamentary characteristics of the arrangement,[19] the Tax Court concluded that the decedent retained the economic benefit of the property transferred to the partnership within the meaning of section 2036(a).

Because the limited partnership in *Estate of Strangi* was in existence for only two months prior to the decedent's death, there simply may not have been sufficient time for the decedent to engage in the type of behavior (i.e., using partnership assets for personal expenses) that would invoke section 2036(a)(1). Yet the Tax Court opinion mentions one distribution that could be problematic for the taxpayer. The decedent's caretaker injured her back while working for the decedent, which necessitated surgery. The cost of the surgery was paid by SFLP.[20] Even if the distribution was made in violation of the partnership agreement, its existence may show that the partnership assets stood at the decedent's disposal.[21]

Given the Tax Court's recent use of section 2036(a)(1) in *Estate of Harper*, it may well be the Commissioner's best ground for inclusion under section 2036 on remand in the *Estate of Strangi* case. A victory on this ground, however, would do little for the Service in its ongoing battle against valuation abuses occasioned by the use of limited partnerships as estate planning vehicles. Inclusion of partnership assets under section 2036(a)(1) requires a measure of ill-advised taxpayer behavior that can be easily avoided by those taxpayers who follow their counsel's advice and respect the partnership as a separate entity distinct from their personal affairs. If, however, the Commissioner were to prevail under section 2036(a)(2) on account of the decedent's control over the partnership assets, the decision would be significant. Limited partnerships are palatable to taxpayers as an estate planing vehicle principally because of the control that the transferor can retain over the assets contributed to this partnership. If this level of control were found to be within the ambit of section 2036(a)(2), the use of partnerships as a pure estate planning vehicle would be dealt a significant blow. While the Service has more to gain by arguing section 2036(a)(2), it also has a more difficult legal road to navigate. The potential application of section 2036(a)(2) in *Estate of Strangi* is addressed below.

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[16] T.C. Memo. 2002-121, *Doc 2002-11394 (75 original pages), 2002 TNT 95-11* (2002).

[17] Other cases in which the commingling of partnership assets with personal accounts led to inclusion under section 2036(a)(1) include *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*.

[18] Oddly enough, the Tax Court opinion utilized distributions to or for the benefit of the decedent's estate as a basis for determining that the decedent retained beneficial ownership of the property transferred to the partnership: "[S]ignificant is the evidence that certain of the distributions to the Trust were linked to a contemporaneous expense of decedent personally or of his estate. . . . This evidence buttresses the inference that decedent and his estate had ready access to partnership cash when needed." *Estate of Harper*, T.C. Memo. 2002-121. The relevance of post-mortem distributions from the partnership to the decedent's estate under section 2036(a)(1), however, is questionable. The statute makes clear that the period for which the transferor must retain beneficial enjoyment is "for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death." Section 2036(a).

[19] The Tax Court referred to the statement made by the Supreme Court in *United States v. Estate of Grace*, 395 U.S. 316, 320 (1969), that the purpose of section 2036 is to include in a decedent's gross estate transfers that are essentially testamentary in nature. *See Estate of Harper*, T.C. Memo. 2002-121.

[20] *Estate of Strangi*, 115 T.C. at 482.

[21] The beneficial enjoyment of transferred property under section 2036(a)(1) can be established through evidence of an implied understanding among the parties, even if the transferor's retained interest is not legally enforceable. *See Estate of Maxwell*, 3 F.3d 591, 593, *Doc 93-9321 (26 pages), 93 TNT 182-6* (2d Cir. 1993); *Guynn v. United States*, 437 F.2d 1148, 1150 (4th Cir. 1971); *Estate of Reichardt v. Commissioner*, 114 T.C. 144, 151 (2000); *Estate of Rapelje v. Commissioner*, 73 T.C. 82, 86 (1979); *see also* reg. section 20.2036-1(a) (last sentence).

B. Section 2036(a)(2)

The Commissioner's argument for inclusion under section 2036(a)(2) would be relatively straightforward. First, since Gulig managed the decedent's financial affairs pursuant to a power of attorney, all powers held by Gulig in the SFLP/Stranco arrangement should be attributed to the decedent. This attribution is logical, given that SFLP was capitalized by Gulig almost exclusively with the decedent's assets to facilitate the decedent's estate planning objectives.[22] Next, given that the decedent's agent controlled the day-to-day management of Stranco, which as sole general partner was delegated authority to manage SFLP's business affairs, the decedent effectively retained control over the assets that he transferred to the partnership. The Tax Court apparently has already accepted this argument: In addressing the Commissioner's gift-upon-formation argument, the court stated that "we do not believe that decedent gave up control over the [partnership] assets."[23] The decedent's control over the partnership assets gave him the ability to determine if, when, and in what amounts distributions would be made from the partnership to the partners. In this manner, the decedent retained "the right . . . to designate the persons who shall possess or enjoy the property or the income therefrom" under section 2036(a)(2). If this argument proves successful, all assets transferred by the decedent to SFLP would be included in the decedent's gross estate at their date of death value, with no valuation discount.

This argument makes it seem as if the Service will have a walk in the park arguing section 2036(a)(2) on remand in *Estate of Strangi*. It won't. As general partner of SFLP, Stranco served in a fiduciary role to the other partners. As the unanimously appointed manager of Stranco, Gulig (the decedent's agent) assumed this fiduciary role. Accordingly, any decisions that the decedent's agent made regarding distributions from SFLP were subject to a fiduciary duty in favor of SFLP, and correspondingly, the beneficial owners of SFLP (decedent and Stranco). The existence of this fiduciary duty constitutes the principal legal hurdle that the Service must clear if its argument under section 2036(a)(2) is to prove successful.

III. The Taxpayer's Defense: *Byrum*

The Supreme Court case of *United States v. Byrum*[24] has been oft-cited for the proposition that powers limited by a fiduciary duty are outside the scope of section 2036(a)(2).[25] *Byrum* involved a decedent who created an irrevocable trust for the benefit of his children and funded the trust with shares of stock that he owned in three closely held corporations. The decedent named an independent corporation as trustee, and the trust instrument provided that the trust was authorized, in its sole discretion, to pay income and principal of the trust to or for the benefit of the trust beneficiaries. Nonetheless, the decedent retained the right to vote the shares of closely held stock that he transferred to the trust, as well as the right to veto any sale or other transfer of such stock by the trust. The trust retained the corporate stock until the decedent's death, at which time the decedent possessed the right to vote not less than 71 percent of the stock of each corporation. Each corporation had minority shareholders unrelated to the decedent.[26]

> ***The existence of this fiduciary duty constitutes the principal legal hurdle that the Service must clear if its argument under section 2036(a)(2) is to prove successful.***

The Commissioner argued that the stock of the closely held corporations owned by the trust should have been included in the decedent's gross estate under section 2036(a)(2). The specifics of the Commissioner's argument were as follows: Through his ability to vote a majority of the shares of each corporation, the decedent was able to select the corporate directors. The ability to determine board membership gave the decedent effective control over the corporate dividend policy. According to the Commissioner, the decedent's ability to control the flow of dividends to the trust was tantamount to the ability to accumulate trust income or to distribute it currently to the trust beneficiaries. The Court earlier had held that this latter power constituted the right to designate the persons who shall

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[22]Judge Beghe made this point in his dissenting opinion:

> Against the grain of the majority's conclusions that the SFLP arrangements were neither a factual nor a substantive sham, I would observe that another "conceivable basis for concluding that decedent retained control over the assets that he contributed to the partnership" (Ruwe, J., dissenting opinion page 38 note 2) are the multiple roles played by Mr. Gulig, who had decedent's power of attorney and caused himself to be employed by Stranco to manage the affairs of SFLP, and the tacit understanding of the other family members that he would look out for their interests.

Estate of Strangi, 115 T.C. at 501 n.1 (Beghe, J., dissenting).

[23]*Id.* at 490. Judge Ruwe, a proponent of the gift-upon-formation argument, questions the majority opinion's statements regarding the decedent's control over SFLP:

> While the basis for finding that decedent did not give up control of the assets is not fully explained, it appears not to be based on the literal terms of the partnership agreement which gave control to Stranco, the corporate general partner. Decedent retained only 47 percent of the Stranco stock.

Id. at 499 n.2 (Ruwe, J., dissenting).

[24]408 U.S. 125 (1972).

[25]*See* S. Stacy Eastland, "The Art of Making Uncle Sam Your Assignee Instead of Your Senior Partner: The Use of Partnerships in Estate Planning," *SF79 ALI-ABA* 1103, 1114, 1226-29 (2001); *see also* Rev. Rul. 81-15, 1981-1 C.B. 457; TAM 9131006 (Aug. 2, 1991); LTR 9415007, *94 TNT 94-22; LTR 9332006, 93 TNT 170-42;* LTR 9310039, *93 TNT 59-43;* LTR 9026021 (July 2, 1990).

[26]*Byrum*, 408 U.S. at 125-130.

receive the income from transferred property under section 2036(a)(2).[27]

The Court soundly rejected the Commissioner's argument. First, the Court explained that the "right" under section 2036(a)(2) to designate the persons who shall possess or enjoy the income from property "connotes an ascertainable and legally enforceable power."[28] The Court then pointed out that any influence the decedent may have had over the corporate directors as the majority shareholder "was neither ascertainable nor legally enforceable and hence was not a right in any normal sense of that term."[29] The Court further noted that a majority shareholder's influence over a corporation is limited by the shareholder's fiduciary duty not to misuse his power by promoting his personal interests at the expense of the corporation, as well as the fiduciary duty owed by the directors to promote the corporation's best interests.[30]

While it appears the Court could have ended its analysis there, it went on to further discredit the Commissioner's argument on grounds that it "misconceiv[ed] the realities of corporate life."[31] The Court noted that, in a typical small business, there is no guarantee that funds will exist for distribution in the first place:

> There is no reason to suppose that the three corporations controlled by Byrum were other than typical small businesses. The customary vicissitudes of such enterprises — bad years; product obsolescence; new competition; disastrous litigation; new inhibiting Government regulations; even bankruptcy — prevent any certainty or predictability as to earnings or dividends. There is no assurance that a small corporation will have a flow of net earnings or that income earned will in fact be available for dividends. Thus, Byrum's alleged de facto "power to control the flow of dividends" to the trust was subject to business and economic variables over which he had little or no control.[32]

The Court stressed that even if funds were available for distribution, the directors of the closely held corporation would expose themselves to derivative suits if they subordinated the interests of the corporation to the will of the majority shareholder.[33] To bolster this argument, the Court reiterated that in each of the corporations at issue there existed a substantial number of minority shareholders unrelated to the decedent who would have had a cause of action against the decedent and the corporate directors had they violated their fiduciary duties.[34] Accordingly, the Court concluded that the decedent's ability to elect the board of directors was not tantamount to the power to regulate the flow of dividends to the trust.[35]

On one hand, the *Byrum* decision provides a powerful defense to the taxpayer in *Estate of Strangi* against any argument that the Commissioner may make for inclusion under section 2036(a)(2). Like the majority shareholder in *Byrum*, the powers that the decedent (through his agent, Gulig) possessed over Stranco and SFLP were held in a fiduciary capacity. Accordingly, any discretion that the decedent possessed over the timing and amount of distributions from SFLP had to be exercised to promote the best interests of the partnership as opposed to serving his personal interests. The decedent would have disregarded this fiduciary obligation at his peril. Just as the fiduciary powers placed upon the decedent and the board of directors in *Byrum* prevented the controlling shareholder's influence over the corporations' dividend payments from amounting to the right to designate the persons who enjoyed the income generated by the corporate stock, the fiduciary duties placed upon the decedent's agent in *Estate of Strangi* with respect to his management of SFLP prevent those rights from constituting a right to determine who enjoyed the income generated by the partnership assets. Simply put, because the decedent's powers were held in a fiduciary capacity, they are outside the scope of section 2036(a)(2).[36]

The Byrum precedent should not prove insurmountable to the Commissioner's argument under section 2036(a)(2).

On the other hand, the argument that *Byrum* dictates a similar result under the facts of *Estate of Strangi* appears almost laughable when stated. The two cases bear little if any resemblance to one another. The corporations at issue in *Byrum* were actual operating businesses that would have had legitimate business and economic considerations to weigh in determining the

[27] *See United States v. O'Malley*, 383 U.S. 627 (1966).

[28] *Byrum*, 408 U.S. at 136. It is interesting to compare the Court's strict interpretation of a right to control beneficial enjoyment under section 2036(a)(2) with the taxpayer's retained right to beneficial enjoyment over transferred property under section 2036(a)(1), which can be satisfied through evidence of an implied understanding among the parties.

[29] *Id.* at 136-37.

[30] *Id.* at 137-38.

[31] *Id.* at 139.

[32] *Id.* at 139-40.

[33] *Id.* at 141.

[34] *Id.* at 142.

[35] *Id.* at 143.

[36] The Commissioner has accepted this argument in the past. *See* authorities cited in note 25 *supra*. Of these authorities, only one, Rev. Rul. 81-15, would be potentially binding on the Commissioner. The Commissioner could distinguish this ruling, however, on grounds that it involved the transfer of corporate stock, a matter specifically addressed by the addition of section 2036(b) in the Tax Reform Act of 1976, Pub. L. No. 95-600, section 702(i), 92 Stat. 2767, 2931, 1976-3 C.B. (Vol. 1) 1, 165.

corporate dividend policy.[37] Thus, the determination of the timing and amount of dividends necessitated taking into account something more than the shareholders' need for income. The partnership at issue in *Strangi,* however, was a mere holding vehicle for the decedent's securities and other investment assets. There were no real business considerations to weigh in determining the timing and amount of distributions from the partnership. Rather, the decision came down to whether the decedent needed current funds or was content to leave them invested.

Even if one ignored that the fiduciary obligations placed upon the decedent's agent in managing SFLP provided little in the way of an actual restriction, *Estate of Strangi* differs from *Byrum* in another significant way: There were no unrelated equity holders in SFLP to enforce the fiduciary obligations. The Supreme Court in *Byrum* emphasized the existence of a substantial number of unrelated minority shareholders who would have had a cause of action against the majority shareholder and the board of directors had they abrogated their fiduciary duties to the corporation. SFLP, on the other hand, was owned 99 percent by the decedent and 1 percent by Stranco. Stranco, in turn, was owned by the decedent and his children, except for 100 shares that the children had contributed to a local community college. Would anyone seriously suggest that the community college, which received the 100 shares through a donation and was in all likelihood anticipating a liquidating distribution following the decedent's death, would have balked at the pattern of distributions from SFLP, particularly if the distributions had no effect on Stranco's capital account balance? Of course not. Unlike *Byrum,* the fiduciary duty that the estate may attempt to invoke in *Estate of Strangi* existed in name only. For this reason, the *Byrum* precedent should not prove insurmountable to the Commissioner's argument under section 2036(a)(2).[38]

IV. Looking Past Fiduciary Duty

The Supreme Court's opinion in *Byrum* provides much in the way of ammunition for taxpayers in combating the Service's attempt to apply section 2036 to assets transferred to closely held businesses. However, *Byrum* does not exempt from section 2036(a)(2) any power the exercise of which happens to be subject to a fiduciary duty. If that were the case, then section 2036(a)(2) would not apply to discretionary trusts over which the transferor serves as trustee, the classic example of a retained power to designate the persons who shall enjoy the income from transferred property.

Rather, the holding in *Byrum* cannot be read apart from the central facts of that case.[39] Those facts include the participation of the closely held corporations at issue in the active conduct of a trade or business and the presence of substantial minority shareholders that were not related to the majority shareholder. The participation of the companies in the active conduct of a trade or business meant that there existed actual business variables that the board of directors (elected by the majority shareholder) had to take into consideration in exercising its fiduciary duty in setting the corporate dividend policy. The existence of unrelated minority shareholders provided practical assurance that those who owed a fiduciary duty to the corporation would take their obligations seriously. Each of these facts is absent in estate-planning partnerships. First, the assets of such partnerships typically consist of cash, marketable securities, or other nonoperating assets that are typically held for investment purposes. Accordingly, the factors considered in determining whether distributions will be made from the partnership generally boil down to the partners' need for capital and the wisdom of allowing them to have it. In short, the managing partner's fiduciary duty provides little if any restraint on the partner's ability to set distribution policy to conform to his personal will, provided distributions are not made in contravention of the partnership agreement. Second, the equity holders of typical estate-planning partnerships tend to consist of members of the immediate family of the principal contributor. In addition to their relationship to the principal contributor, these individuals generally stand to benefit through future gratuitous transfers of partnership interests. These individuals therefore are the least likely to rock the boat by being vigilant enforcers of the managing partner's fiduciary duty. The fiduciary duty that may exist in a typical estate-planning partnership context provides little if any basis to exempt powers retained over partnership distributions under section 2036(a)(2).

Does this mean that assets transferred to a closely held partnership should always be included in the transferor's gross estate? Not at all. Rather, if the facts similar to those relied upon by the Supreme Court in *Byrum* are not present, then the statutory requirements of section 2036 simply should be analyzed without giving the taxpayer a free pass on account of some nominal fiduciary duty. In short, estate-planning partnerships should be evaluated on their substance. At their core, these partnerships are nothing more than disguised trusts. The partnership (or LLC) form is chosen in an attempt to avoid the adverse estate tax

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[37]The Supreme Court noted "[t]here is no reason to suppose that the three corporations controlled by Byrum were other than typical small businesses." *Byrum,* 408 U.S. at 139. The names of the companies themselves at least suggest that they conducted some form of business instead of serving as mere investment vehicles: Byrum Lithographing Co., Inc., Graphic Realty, Inc., and Bychrome Co. *Id.* at 130.

[38]Note that the Commissioner's argument in this regard does not necessitate disregarding the partnership entity for tax purposes, an argument that the Tax Court rejected in its initial opinion in *Estate of Strangi. See* 115 T.C. at 486-87.

[39]In his dissent to the application of *Byrum* in *Estate of Gilman v. Commissioner,* 65 T.C. 296 (1975), Judge Tannenwald voiced a similar concern: "What bothers me most about the majority approach is that it appears to escalate the rational of *United States v. Byrum,* 408 U.S. 125 (1972), which was developed in light of the particular facts of that case, into a mandated rigid doctrine of wide application." 65 T.C. at 323 (Tannenwald, J., dissenting).

consequences attendant to trusts while retaining the benefits of typically associated therewith, namely control over investment decisions as well as the timing and amount of distributions. A leading article on the use of family limited partnerships in estate planning highlights the potential trust-like nature of these entities:

> A limited partnership . . . can serve as a "wrapper" around family assets and allow those assets to be managed like a unitrust. The managing partner can invest in a way that produces the highest rate of return consistent with his or her tolerance for risk, whether the source of that return in appreciation or current income. The managing partner then may distribute the percentage of the partnership's assets that he or she deems appropriate to the current "beneficiaries" (i.e., partners) of the partnership.[40]

If estate-planning partnerships are the functional equivalent of trusts, then they should be evaluated accordingly for transfer tax purposes. Namely, if the individual who transfers assets into an estate-planning partnership retains control over the partnership distributions, then all of the assets that the individual transferred to the partnership should be included in the individual's gross estate under section 2036(a)(2) at their undiscounted date of death value. On the other hand, if the individual who transferred the assets to the partnership was content to relinquish control over partnership distribution decisions, then the transferor would not have retained the right to designate the persons who shall possess or enjoy the income from the transferred property within the meaning of section 2036(a)(2). Control over distributions, as opposed to the managing partner's nominal fiduciary duty, would be the deciding factor.

The approach to employing section 2036(a)(2) outlined may be critiqued for its lack of definitive boundaries. At what point does the managing partner's fiduciary duty have insufficient substance to warrant disregarding the fiduciary duty in evaluating the application of section 2036(a)(2) to the assets transferred to the partnership? The lack of hard and fast rules in this area will make it more difficult for taxpayers to structure their business affairs to avoid untoward transfer tax consequences.[41]

While the lack of bright-line rules may be a drawback to the proposal, it is not substantial. First, it should not be too difficult to distinguish between those closely held entities that constitute what the *Byrum* court referred to as "typical small businesses"[42] from those investment partnerships that exist as vehicles designed to facilitate the transmission of wealth from one family member to another in the most tax-advantaged manner. Estate-planning partnerships tend to jump of the page as such.[43] Furthermore, to the extent that the courts would be forced to draw the line in questionable cases, in all likelihood they would err to the taxpayer's benefit. Courts would likely continue to apply the *Byrum* holding given any hint of a legitimate business operation being conducted by the entity, and would decline to apply *Byrum* only in situations where the taxpayer is employing the partnership form as solely for purposes of depressing transfer tax valuation. Finally, if a limited interpretation of the *Byrum* decision would give pause to those taxpayers who would otherwise dump liquid assets into a partnership and then claim valuation discounts of upwards to 60-70 percent from net asset value, that altogether may not be a bad thing.

V. Conclusion

The expansive interpretation of the Supreme Court's holding in *United States v. Byrum* has provided the foundation for the proliferation of family limited partnerships designed principally to allow the taxpayer to apply various transfer tax valuation discounts to assets otherwise having a readily ascertainable fair market value.[44] Yet upon closer examination, the weight that the Supreme Court placed upon the fiduciary duty owed by the majority shareholder and the board of directors in determining the nonapplicability of section 2036(a)(2) was dependent in large part upon the business activities conducted by the entity and the presence of minority shareholders who could enforce such fiduciary duty if violated — facts that are utterly lacking in typical estate-planning partnerships. The Fifth Circuit's remand of *Estate of Strangi* to the Tax Court with instructions to consider the section 2036 issue provides the ideal opportunity for the court to apply section 2036(a)(2) to a trust-like family limited partnership arrangement. If the Tax Court does so, it will likely hear much less testimony regarding minority interest discounts and lack of marketability discounts in the future.

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[40]S. Stacy Eastland, note 25 *supra*.

[41]The fact that so many have structured their estate planning affairs on the assumption that *Byrum* will prevent the application of section 2036(a)(2) is one reason for courts not to adopt a limited reading of the case. The following passage from *Byrum* is relevant in this regard:

> Courts properly have been reluctant to depart from an interpretation of tax law which has been generally accepted when the departure could have potentially far-reaching consequences. When a principle of taxation requires reexamination, Congress is better equipped than a court to define precisely the type of conduct which results in tax consequences.

United States v. Byrum, 408 U.S. 125, 135 (1972). That being said, if courts were to adopt a less expansive reading of the *Byrum* decision, it would be relatively easy for taxpayers potentially exposed to section 2036(a)(2) to liquidate their partnerships.

[42]*Id.* at 139.

[43]In addition to the *Estate of Strangi* case, see *Knight v. Commissioner*, 115 T.C. 506 (2000).

[44]Equally important to the proliferation of family limited partnerships as an estate planning vehicle was the decision in *Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. 1981), holding that family attribution shall not be applied in valuing interests in closely held entities.