



REAL ESTATE JOURNAL

PUBLISHED WEEKLY ■ \$3 ■ APRIL 5, 2004

Life After Strangi

Family limited partnerships and limited-liability companies remain viable estate planning vehicles, even after a recent court decision

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For many years, owners of real property have been able to give money to their heirs by setting up either a family limited partnership or a limited-liability company, thereby reducing the amount of estate taxes that their heirs will pay.

In light of a recent court decision in the *Estate of Strangi v. Commissioner of Internal Revenue*, and increased Internal Revenue Service scrutiny of wealthy taxpayers, family limited partnerships and limited-liability companies may still be viable estate planning vehicles, provided certain precautions are taken.

The Strategy

For generations, one effective estate planning strategy for owners of real property has been to contribute assets to a family limited partnership or a limited-liability company, and gift the limited partnership

units to their children. As long as the entity is determined to be valid, limited partnership units and membership interests are worth less than the equivalent proportionate amount of the underlying assets. The inability of the holder of the interest to control the entity and the lack of an established market for the interests transferred ends up lowering gift taxes, or lower utilization of the lifetime exemption (unified credit).

The History
The IRS has consistently challenged the validity of family limited partnerships. To determine whether family limited partnerships are valid, the IRS assesses several criteria including the following:

An entity must:

- Have economic substance or a valid business purpose;
- Be no more restrictive with respect to the right to sell or lease the property than comparable arm's-length transactions in violation of IRS Code Section 2703; and
- Be no more restrictive with respect to the liquidation of interest to be removed by any family member (collectively alone) than existing state or federal law in violation of IRS Code Section 2704.

The IRS also has argued that the formation of the family limited partnership or limited-liability company itself constituted a gift and that family limited partnerships and limited-liability companies are counted as transferred assets where the decedent had retained possession, enjoyment or income rights to the property during life.



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in violation of Section 2036.

Winning on these arguments or proving that the family limited partnership or limited-liability company was not valid, or its sanctity was violated, would enable the IRS to include the entire value of the underlying assets in a decedent's estate.

Fortunately, prior to Strangi, as long as the family limited partnership was well constructed and the sanctity of the entity was maintained, the IRS consistently lost on all arguments in tax court.

The Problem

Valuation discounts are disallowed, and the entire value of the underlying assets are subject to estate taxes when the IRS can prove any of the following:

- The entity lacks economic substance or business purpose;
- The restrictions on the right to sell, use or liquidate the interest are excessive;
- The taxpayer has retained possession, enjoyment or income rights to the property or has in some other way violated the sanctity of the entity (by commingling funds, for example).

Conversely, if the taxpayer can prove any of the above, the courts will respect the entity's existence. When this occurs, the courts also will accept the use of valuation discounts.

Depending on various factors, these discounts can be substantial, often from 35 percent to 40 percent.

The Facts in the Strangi Case

The Strangi case recently changed the way the law is being applied by the tax courts.

Michael J. Gugli, Albert Strangi's son-in-law acting as Strangi's attorney-in-fact, created the Strangi Family Limited Partnership naming a corporation, Stranco, as general partner.

Albert Strangi contributed 98 percent of his total wealth to the partnership, including his personal residence. He retained ownership of 47 percent of the general partnership interest. The balance of the general partner was held by his children, with the exception of a 1 percent interest in the general partner, which was donated to a charity.

The value of the property held by the Strangi Family Limited Partnership on the date of Strangi's death was \$11 million, while the value of Strangi's interests in the partnership, reported on his federal tax return, was only \$6 million. After the partnership was formed, all distributions were made to Strangi as the sole limited partner and to Stranco, although they were prompted by either Strangi's personal needs or the needs of his estate.

Tax discounts were applied to the underlying asset value because the limited partner did not control the entity as a result of his less than controlling interest in the general partner.

The Court's Findings in Strangi

In the Strangi case, the U.S. Tax Court made a number of rulings. Among these, the court found that despite the fact that his children owned 52 percent of the general partnership, the decedent retained the right through his attorney to designate who would enjoy the property and its income.

The court found that in light of the relative dearth of liquidity outside the partnership, the decedent expected the partnership to be the primary source of his liquidity. Intrafamily fiduciary duties were determined to not be equivalent to those owed to third parties. Last, the charity's ownership of 1 percent was found not to provide any meaningful oversight.

As a result of these findings, the court held that Section 2036(a) was applicable and that the taxpayer had retained an interest in the partnership.

For purposes of settling the estate, the entire value of the assets transferred to the partnership was included in the taxpayer's estate.

Potential Solutions

In light of Strangi, family limited partnerships and limited-liability companies still may be viable estate planning vehicles, provided that certain attributes of the entities are present. However, the way in which family limited partnerships and limited-liability companies are currently constructed will result in a challenge by the IRS.

To increase the chances that the IRS will view the family limited partnership or limited-liability company as valid for estate tax purposes and thereby enable valuation discounts to be accepted, the following guidelines are suggested:

- Maintain sufficient liquidity outside the partnership to meet the majority of the transferee's living expenses.
- Maintain accurate books and records, and avoid the commingling of any funds.
- Prepare support and documentation (a policy) for making distributions not tied to the needs of the primary limited partner.
- Provide for ownership of a meaningful interest in the entity by an outside shareholder (preferably a charity) to create a fiduciary obligation to a third party.
- Maintain evidence that the assets transferred to the entity are retained to reflect the new owner.

While following these suggestions will by no means guarantee that the IRS will honor the validity of an entity, not following them will surely invite intense scrutiny. ■