2004

Estate Planning and the New Limited Partnership Act (2001)

Thomas E Geu, *University of South Dakota School of Law*

Selected Estate Planning Aspects of the Uniform Limited Partnership Act (2001)

Thomas Earl Geu†

—Today nearly 95 percent of American businesses are family owned or controlled, including 40 percent of the Fortune 500.[1]

—The basic drives of man are few: to get enough food, to find shelter, and to keep debt off the balance sheet.[2]

TABLE OF CONTENTS

---

† Tom Geu is a Professor of Law at the University of South Dakota where he teaches organizational and transactional law courses. He served as an advisor to the National Conference of Commissioners on Uniform State Laws Uniform Limited Partnership Act (2001) Drafting Committee from the Probate Division of the Real Property Probate and Trust Law Section, American Bar Association. He has served, or is serving, in a similar capacity to several other NCCUSL drafting committees concerning the law of other unincorporated association. Professor Geu is also active in the Business Section of the South Dakota State Bar. He wishes to express his thanks publicly to Teresa Carlisle for the able secretarial support she provided, to students Paul M. Lewis and Joanne Haase for their extraordinary research assistance, and to the editors and staff of the Suffolk Law Review for their patient and helpful editing of this article.

1. ADAM BELLOW, IN PRAISE OF NEPOTISM 489 (2003).
2. Richard Green, *The Joys of Leasing*, FORBES, Nov. 24, 1980, at 59.

I. INTRODUCTION: ESTATE PLANNING, ULPA, AND THE IMPORTANCE OF NONTAX FACTORS

Limited partnerships are an important entity alternative for a segment of businesses that can be categorized as family businesses.[3] Family businesses have many of the same needs as other operating businesses, on one hand, and special purpose asset protection devices on the other.[4] Family businesses, however, often present unique business succession and control issues reflecting family dynamics and intergenerational wealth transfer concerns.[5] The primary purpose of this article is to analyze the new Uniform Limited Partnership Act, ULPA (2001), for its fitness under the federal wealth transfer taxes. It will also briefly identify some of the unique concerns common to many family businesses in conjunction with ULPA (2001).

Federal taxation of intergenerational wealth transfers is, of course, an important part of planning for the family business and, indeed, the almost exclusive focus of this article. Increases in the unified credit, however, make wealth transfer tax issues of little relevance in the *vast* majority of estate plans. Even though it is a mistake to overestimate the role taxation plays in family business planning relative to other planning considerations, tax planning *is* the focus of this article, in part, because a funny thing happened to the Uniform Limited Partnership Act (2001) (ULPA (2001)) on the way to the forum of this symposium: two events have occurred which potentially change the federal wealth transfer tax. One change was statutory and took place when the Economic Growth and Tax Relief Reconciliation Act (EGTRA)[6] became law in 2001, the same year the Uniform Laws Commission's two-year drafting project culminated in the "new" promulgation of the limited partnership act.

3. *See generally* Jerald D. August & Guy B. Maxfield, *Valuation of Interests "In Transit" in Family Limited Partnerships, Part I*, 5 BUS. ENTITIES 6 (2003).

4. *See* FREDRICK K. HOOPS, FAMILY ESTATE PLANNING GUIDE § 1.2 (4th ed. 1994).

5. *Id.* §§ 1.2, 1.8.

6. Economic Growth and Tax Relief Reconciliation Act, Pub. L. No. 107-16, 115 Stat. 38 (2001).

The change by EGTRA represents a sea change; but, given that it goes into full effect in 2010 and is set to sunset in 2011, it really represents a *potential* change that confounds planning. The other change is more immediate and is of a far different nature than the potential statutory changes. It involves the cumulative weight of judicial interpretation and a tentative determination that the weight of interpretation has reached a tipping point poised to cascade through the wealth transfer tax system. The interpretive weight overhangs the application of existing statutory provisions to family entities undeniably formed primarily for purposes of wealth transfer tax savings. This article discusses two recent cases, *Strangi II* (issued in May 2003) and *Hackl* (issued in July 2003) that could be harbingers of a likely interpretive cascade. The cascade may well change the face of the estate planning use of entities like limited partnerships. The interpretive cascade is like an avalanche that changes the face of a mountain. *This* avalanche, however, is still in its early and unpredictable stages. As a result, it is not yet known whether it will gain enough momentum to make it all the way down the mountain or whether its momentum will be arrested at a point of equilibrium somewhere short of the base. Thus, this change, too, arguably remains one of potential.

On one hand, the statutory change would most likely change the purpose for the use of limited partnerships in estate planning but not necessarily the mechanics of such use. The interpretive change, on the other hand, calls into question when, how, and if the use of limited partnerships and other entities will remain viable for purposes of wealth transfer tax savings.

These potential changes in the federal taxation of the gratuitous intergenerational transmission of wealth must be accounted for in any estate planning analysis of ULPA (2001). Nonetheless, even with these potential changes, the law of family business will remain important for "nontax" estate planning. The broad purpose of this article, however, is the same as it would have been had it been written before these changes in the wealth transfer tax. The potential changes, however, do necessarily change its focus.

The broad purpose of this article is to emphasize the use of ULPA (2001) for purposes of estate planning. It assumes a lawyer-based readership without specific knowledge of estate planning but with basic knowledge of limited partnership law and some notion of basic income tax principles. It contains a general overview of the federal wealth transfer tax system as a starting point for the analysis of specific provisions of ULPA (2001) with wealth transfer tax consequences.

The overview also provides the starting point to discuss the changes brought by EGTRA and the interpretive change suggested by the most recent cases. Note, however, that this article does not include, or pretend to include, any comprehensive discussion of all wealth transfer tax cases, and the analysis of only two selected cases may be misleading and *is* biased toward arguing that a basic interpretive shift has taken place. Stated another way, there are a plethora

of cases in the past five years, many of which find for the taxpayer that are neither discussed nor even cited in this article. Other sources with different purposes should, therefore, be consulted.[7] The analyses of *Strangi* and *Hackl*, however, do serve dual purposes. The first is to assess their affect on the operation of the current statute. The second is illustrative of estate plans that aggressively push the wealth transfer tax envelope. They also evidence the dynamic nature of the wealth transfer tax and planning to maximize wealth transfer tax savings.

The basic use of limited partnerships for estate planning was described in the late 1990's by a law firm newsletter as follows:

> While particulars vary by state statute, certain features are common to all FLPs [family limited partnerships]. The owner of a business or stock portfolio contributes the property to an FLP, retaining a 1% interest as a general partner. The rest is then gifted to his children or grandchildren. The general partner retains control over decisions with respect to distributions and investments and can also take a "reasonable" management fee.
>
> The limited partners are limited in both their rights and their obligations. They cannot make investment decisions, remove assets from the partnership while it is in existence or force the liquidation of the partnership.
>
> Nor can a limited partner's interest itself be liquidated by his or her individual creditors . . . Because of their creditor protection features, FLPs have also been used as asset protection devices, in combination with or in addition to estate planning.[8]

Another slightly different use of limited partnerships to minimize taxes is to *freeze* the value of interests held by the *older* generation and to shift future appreciation in value to younger generations. Both uses are discussed in greater detail in the text of the article, as are counter-measures that have been developed to inhibit the "abusive" use of such techniques to avoid wealth transfer taxes. These counter-measures include statutory provisions like special statutory valuation provisions for family arrangements. They also include judicial doctrines like the economic substance doctrine and the expansive interpretation of other existing statutes.

The case-based counter measures reflect a general focus by the Internal Revenue Service on family business entities and, in particular, on family limited partnerships in the estate planning process. Indeed several well-known estate planners have described the Service's focus as an "attack" on the use of

7. *See generally* Louis A. Mezzullo, *Recent Cases Affecting Family Limited Partnerships and LLCs*, 2 14TH ANN. EST. PLAN. SYMP., ABA SEC. OF REAL PROP., PROB. & TR. L. 42 (2003) (analyzing fifteen cases in the year "or so" preceding January 29, 2003).

8. A law firm newsletter, on file with the author.

family limited partnerships.[9] One such commentator, for example, has stated:

> The Service has determined that family limited partnerships may be vehicles for abusive tax avoidance techniques. As a result, transfers of interest in a family partnership and valuation discounts attributable to family limited partnerships includible in an estate are subject to close scrutiny by the Internal Revenue Service . . . . Taxpayers should be cautioned that the use of a family limited partnership may run a high risk of scrutiny by the Internal Revenue Service.[10]

Another concluded after analyzing recent litigation and administrative rulings that, "[w]e expect . . . the Internal Revenue Service will continue to attack partnerships established immediately before the death of a partner and those partnerships whose partners fail to respect the partnership as a separate entity."[11]

The Service relies heavily on three different arguments in approaching family limited partnerships: (1) Inclusion in the decedents estate of property transferred to an entity before death because the decedent retained, for life, the possession of enjoyment of the property, or to the right to income therefrom; or the right to designate others who shall possess or enjoy the property or income therefrom;[12] (2) Denying the use of the annual exclusion for gift tax purposes because the donee did not receive a present interest in the property;[13] and (3) Disregarding the existence of the partnership or revaluing the property transferred under the special family valuation rules under Chapter 14, primarily under I.R.C. sections 2703 and 2704.[14] Each of these approaches is discussed in the body of the article.

It is probably fair to say that the locus of the wealth transfer tax issues involving the use of limited partnerships is the *control* the parent exercises in the limited partnership. This is problematic and troubling because *control* is also a *business* issue in nonfamily limited partnerships and it is difficult to distinguish between this typical kind of control and the kind of control that may spoil even nonabusive estate plans. Further, attempting to get to the issue of control is difficult to parse from the estate tax statute most frequently asserted and under the 1971 United States Supreme Court opinion in *Byrum*. A significant portion of this article is devoted to the topic of control centering on a long discussion of the *Strangi* case trilogy.

The loosely-defined control issue causes friction for estate planners because

9. DONALD H. KELLEY ET AL., 1 ESTATE AND ENTITY PLANNING: FAMILY BUSINESS ORGANIZATIONS 54 (2d ed. 2002); D. John Thornton, *Preferred Partnership Freezes: Giving the Cold Shoulder to the IRS*, 2 14TH ANN. EST. PLAN. SYMP., ABA SEC. OF REAL PROP., PROB. & TR. L. 221, 268 (2003).

10. KELLEY ET AL., *supra* note 9, at 55.

11. Thornton, *supra* note 9, at 276-7.

12. Thornton, *supra* note 9, at 269 (I.R.C. § 2036(a)).

13. Thornton, *supra* note 9, at 273 (I.R.C. § 2503(b)).

14. Thornton, *supra* note 9, at 274.

it is a desired feature by many clients in the estate planning process without regard to wealth transfer taxes (and in many ways a natural desire perhaps extending even outside the human species[15]). That is, control is a fundamental issue in business planning apart from estate planning and will remain so for the vast majority of family businesses for which there are no *estate* tax or *generation-skipping transfer* taxes foreseeably payable.[16] It is only when control issues and wealth transfer tax issues operate in tandem that there is a tax policy problem. High value family limited partnerships, therefore, are

---

15. In the cool confines of academia, management succession tends to be rationally analytical. Maintaining or obtaining control in the real world, however, adds the dimensions of emotion and psychology to succession. In some sense, perhaps, the story of Solomon the alpha-male of a baboon troop conveys the *feeling* of succession:

> He had been alpha male in the troop for three years, an inordinately long time for a male's tenure. The grad student who preceded me with the troop said that Solomon had been a ferocious and canny fighter back when he defeated his predecessor, but by the time I got there (and secretly instituted the name Solomon . . .), he was in his silver years and resting on his laurels, persisting out of sheer psychological intimidation. He was damn good at it. He hadn't had a major fight in a year. He would just glance at someone . . . and that would settle things. Everyone was terrified of him.

ROBERT M. SAPOLSKY, A PRIMATE'S MEMOIR: A NEUROSCIENTIST'S UNCONVENTIONAL LIFE AMONG THE BABOONS 16 (2001).

Nonetheless, according to Robert Sapolsky the author of the book *A Primate's Memoir*: "The threads were unraveling." *Id.* at 24. Several of the other males, especially one Sapolsky named Uriah, repeatedly challenged Solomon and although Solomon continually defeated him: "Uriah was the nightmare of those who age—an opponent too young to know what fatigue feels like." And Solomon "was losing weight, looking more punchy with each fight." One "quiet, small-town morning":

> Uriah appeared and stood a dozen yards from Solomon, staring, the town no longer big enough for the two of them. And Solomon, like the script specified, looking neither left nor right, walked toward Uriah, turned around, and groveled, belly in the grass rear end stuck in the air, a male [baboon] gesture of submission. The transition had occurred.

Id. at 23-24.

Sapolsky also observes that the benevolence and omnipotence of the alpha-male baboon in any troop is an anthropological myth. Apparently genetics and the survival of progeny play an important role:

> When predators attacked the alpha male would be in the thick of it, defending the infant. But only if he was absolutely certain that it was his kid who was at risk of becoming someone's dinner. Otherwise, he had the highest, safest spot in the tree to watch the action. So much for Robert Ardrey and 1960s anthropology.

Id. at 16.

This does not mean people—humans—*are* baboons. Baboons, after all, are fundamentally different than humans. For illustrative purposes, however, sometimes it seems easier to anthropomorphize an animal than to empathize with another human. At that level, and only that level, is the story of Solomon included herein. Sapolsky is extremely careful not to apply observations of the baboon troop to humans:

> Debates rage among animal behaviorists as to the appropriateness of using emotionally laden human terms to describe animal behaviors. Debates as to whether ants have "castes" and make "slaves," whether chimps carry out "wars." One group says the terms are a convenient shorthand for lengthier descriptions. One group says they are the same thing as human examples of these behaviors. Another group says they are very different, and that by saying that all sorts of species take "slaves," for example, one is subtly saying that it is a natural, widespread phenomenon. My bias is to agree somewhat with this final group.

Id. at 24.

16. *See, e.g.*, *infra* notes 66-67 (discussing the exemption equivalent under the unified rate schedule for both estate and gift taxes).

circumstances where these issues collide. As the same law firm newsletter, quoted previously, succinctly stated: "[Family limited partnerships] offer a singular advantage dear to many people—the ability to retain control over assets (including a family business) while reducing estate and gift taxes. For it is usually control, rather than the actual need for income or principal, that impedes much estate planning."[17]

The family business planning literature confirms that control is a major planning feature outside the realm of taxation.[18] Indeed, control is one of the stumbling blocks for successfully perpetuating a business beyond the first generation; and in some ways the business literature helps illuminate what appears to be the competing paradigms of a family business by first-generation business founders (and their planners), on one hand, and the Service on the other. A family business planning book draws the distinction this way within a developmentally based family business model:

> In some ways, the role of entrepreneur seems incompatible with the role of family business leader. The classic view of entrepreneurs emphasizes their individualism, self-determination, comfort with rapid change, and obsessive immersion in the enterprise. The head of a family business, in contrast, is supposed to be group focused, collaborative, committed to long-term continuity, and equally immersed in firm and family. It is true that some successful founders are ill-equipped to manage their businesses after the start-up stage. In other cases, however, what appears as a contradiction is instead an aspect of the stage of the systems development.[19]

The author of the book uses a "Three-Circle Model of Family Business" to illustrate the family business system. It consists of three partially overlapping circles in Venn diagram style. The circles are labeled "Family," "Business," and "Ownership." The use of the Model is helpful because "[s]pecifying different roles and subsystems helps to break down the complex interactions within a family business and makes it easier to see what is actually happening, and why."[20] Thus, "[f]or example, family struggles over dividend policy or succession planning become understandable in a new way if each participant's position in the three-circle model is taken into account."[21]

---

17. *See supra* note 8.

18. *See generally* KELIN E. GERSICK ET AL., GENERATION TO GENERATION: LIFE CYCLES OF THE FAMILY BUSINESS (1997).

19. GERSICK ET AL., *supra* note 18, at 137-8.

20. GERSICK ET AL., *supra* note 18, at 137.

21. GERSICK ET AL., *supra* note 18, at 137. To further illustrate the use of the three-circle model in the context of dividend policy:

> An individual [who is] . . . a family member/owner/nonemployee . . . may want to increase dividends, feeling that it is a legitimate reward of family membership and a reasonable return on investment as an owner. On the other hand, a person . . . [who is] . . . a family member/employee/nonowner . . . may want to suspend dividends in order to reinvest in expansion, which might create better career advancement opportunities. These two individuals may also be siblings—similar in personality and style, and with a close emotional bond—who do not understand

In combination, the developmental model with the subsystem perspective helps tease out the demands placed on the founder of a "family business." Moreover, there is room in the family business for different management/leadership styles and values just as that room exists in unrelated party businesses.[22] The challenges surrounding the successful transition of a family business from one generation to the next are difficult and include such tasks as keeping capable children active in the business, selecting and training a successor, and managing family relationships in such a way to minimize sibling and "in-law" conflict.[23] The estate plan may be designated to meet all these goals and challenges. On the other hand, it may be for more specific purposes within a framework of several different plans each designed for a specific purpose.[24] Achieving these goals may require the transition from one form of business, like the sole proprietorship, to another, like the limited partnership, because roles are more easily assignable within a more formal organization and also because ownership and control may be transferred in measured ways as successors in control have developed the skills to take on more responsibility. The training function by an older generation for a younger related one hints at a broader value-based issue regarding *family* businesses. Sometimes, it appears

---

> why they cannot agree on this question... The three-circle model helps everyone see how organizational roles can color a person's point of view; personality conflicts are not the only explanation.

Id.

22. JOHN L. WARD, KEEPING THE FAMILY BUSINESS HEALTHY: HOW TO PLAN FOR CONTINUING GROWTH, PROFITABILITY, AND FAMILY LEADERSHIP 145-55 (1987). This book, for example, lists eight management models including, but not limited to, "Royal Families," "Laissez-Faire Families," "Representative Democracy Families," and "Democratic Capitalist Families." *Id.* at 145-48. The royal family model is based on primogenitor (oldest males gets the business):

> This approach is the simplest way to keep the business in the family. It keeps leadership and ownership together, and it is an easy rationale for unequal treatment of offspring... [I]f the oldest son is not also the most capable sibling, this approach will be damaging to the business and its employees.

Id. at 146.

The laissez-faire family, on the other hand, allows "everyone to do what he or she wants to do." *Id.* However, the parents "believe so strongly that each child should govern their own affairs that they plan to sell the business at some point." *Id.*

Democratic capitalist families believe "that one should get what one works for or deserves." *Id.* at 147. Thus, rewards are based on merit. "Many families of this kind establish a system of rewards that distinguishes between birthright ('blood equity') and actual contributions to the business ('sweat equity')." *Id.* at 147-48. Finally, by way of example, representative democracy families "appoint a trustee of some sort to represent the extended family in the business." *Id.* at 148. The "trustee" position, for example, might be an outside board of directors. *Id.*

Values also effect organizational design. Values include such things as the relative importance of "flexibility versus rigidity," "security versus risk," "equality of results versus equality of opportunity," "independence versus dependence," and "business first versus family first." *Id.* at 152-53.

23. *Id.* at 74.

24. *Id.* at 10. These plans include a "plan for family participation in the business," a "business strategic plan," a "family strategic plan," an "estate plan" (including the component purpose, "[t]o specify who controls the business decision-making process"), and a "successors' leadership development plan." *Id.*

as if the issue is treated like the dirty little secret of family businesses that everyone is afraid to acknowledge. According to a recent book, part of the difficulty of the hidden issue of nepotism is "our narrow conception of nepotism as favoritism for the undeserving is still at odds with one public creed of equality and merit, America lacks a positive statement of nepotism as an ethical activity."[25] Stated another way, "[t]he reason we have tied ourselves in knots is really quite simple: there is a missing distinction between *good* nepotism and *bad*."[26] The book further suggested, "while nepotism may indeed shelter some incompetent family members from the consequences of their failures, the record of family contributions to the history of capitalism has been overwhelmingly positive"[27] and, "[w]e also know *good* nepotism when we see it, but we tend not to call it nepotism, because it looks like something else."[28] It is sufficient for present purposes simply to acknowledge a possible bias against nepotism in American society. Whether it is good or bad, beneficial or detrimental, is of no import as long as underlying biases (good or bad) about nepotism do not inappropriately creep into the analysis of individual legal issues concerning family businesses.[29]

Lawyers performing estate planning services recognize the importance of business planning because the business, at least in an operating business, *is* the asset that provides income and possible appreciation. More recently there has been more recognition of the fact that, beyond the *business imperative*, family businesses do have an extra level of planning focusing on the family itself. An article appearing in *Probate & Property*, the professional magazine published by the Real Property Probate and Trust Law Section of the American Bar Association, evidences this recognition at a *practical* and practice level:

> In this era of tax avoidance it often seems that the guiding goal of estate planning has become to pass as much wealth to the next generation as tax-free

---

25. BELLOW, *supra* note 1, at 465 (offering descriptive and anecdotal look at nepotism).

26. BELLOW, *supra* note 1, at 15.

27. BELLOW, *supra* note 1, at 469.

28. BELLOW, *supra* note 1, at 470. Examples, according to the book, include the following:

> John Quincy Adams became ambassador to London through his father's manipulations but is still remembered as America's greatest secretary of state. . . Theodore and Franklin Roosevelt both won their first elections purely on the strength of their family name, but are considered two of our greatest presidents. A succession of Cabots and Lowells founded the New England textile and banking industries and turned Boston into the commercial, intellectual, and cultural hub of the country. The DuPonts built a family gunpowder business into a vast commercial empire; many of their scions were not only great businessmen but brilliant chemists and engineers. Tightly intermarried Jewish clans created a series of department store chains, a powerful group of legal and financial firms, and the Hollywood film industry.

Id. at 471.

29. BELLOW, *supra* note 1, at 471.

> The problem, then, is not that nepotism continues to be practiced, but that it is often practiced badly or haphazardly. The solution is not to keep banging it with a hammer like a glob of mercury but to bring it out into the open and subject it to the highest possible standards.

Id.

> as possible. But clients are increasingly concerned that the passage of their wealth may do more harm than good to their family.
>
> The tax-driven goal subtly suggests that protecting the family assets is the primary goal of an estate plan. Clients and planners have begun to recognize that this is a misplaced emphasis that focuses attention on assets rather than family, on structure rather than perspective, on tax savings over family need. When protecting and preserving the *assets* is the (often unstated) primary goal, the emphasis is on structures that preserve the assets from taxes and/or family misuse. When protecting and preserving the *family* becomes the beginning point, planning must deal with difficult family issues that might have been ignored—to the ultimate detriment of the client's family.[30]

The foregoing puts pressure on the idea of *business purpose* and what it means in the context of estate planning (which is now defined to include general business planning, entity selection, and family planning) and how that definition fits within the federal wealth transfer tax system. This, too, is addressed by the *Strangi* trilogy and *Hackl*, where the tension is particularly apparent.

The nontax general *business* planning features are not mutually exclusive to either family or tax savings goals. As a result, selected non-tax factors such as the flexibility of the limited partnership form, limited liability, the relationship between and among partners as well as between the partners and third parties, and the durability of the organization are briefly addressed in the discussion of specific tax sensitive provisions contained in ULPA (2001) (Section III of the article). Rather obviously, however, a full analysis of those broader business planning and entity choice issues falls outside wealth transfer tax specific considerations and, therefore, is beyond the scope of this article. Such considerations are, nonetheless, very important in the broader context of estate planning and are solely determinate for all but the largest estates.

The article concludes that ULPA (2001) is wealth transfer tax sensitive and provides a flexible approach to estate planning that is at least as good for wealth transfer tax planning as the uniform act (the Revised Uniform Limited Partnership Act 1976/1985) which it is intended to replace. It also observes, in summary, that wealth transfer tax planning under ULPA (2001) has coevolved with recent potential changes in the federal wealth transfer tax system to a developmental point analogous to that of the LLC in relationship to the federal tax classification schema immediately *before* the so-called check-the-box treasury regulations were promulgated. Therefore, it ends with a suggestion for continued turning of the application of the federal transfer tax to family limited

30. John J. Scroggin, *Protecting and Preserving the Family—The True Goal of Estate Planning, Part I: Reasons and Philosophy* 16 PROB. & PROP. 29 (May/June 2002); *see also* John Gallo & Eileen Gallo, *Estate Planning, Children and Incentives*, 38TH ANN. HEART OF AM. TAX INST. (October 25-26, 2001, Kansas City) (discussing personality types and classifications of beneficiaries as guide to estate plan design).

partnerships.

Because this article assumes a general audience, Section II of the article includes a basic descriptive overview of selected features of the law of federal wealth transfer taxation necessary to analyze the Act for those purposes. Therefore, readers already familiar with the fundamental features of the federal estate and gift tax may choose to skip Section II.A and most of Section II.B without damaging the internal integrity of the article, and all readers are invited to use the detailed table of contents to select only those portions of the article that best meet their individual needs.

II. FEDERAL ESTATE AND GIFT TAX CONSIDERATIONS

A. An Introduction to Wealth Transfer Taxes

A comprehensive discussion of the federal estate and gift tax, even if limited to selected issues arising in the choice of entity context, is beyond both the purpose and the scope of this article. Nonetheless, federal estate and gift taxation form part of the contextual backdrop for ULPA (2001) and, therefore, a basic understanding of some of the most important estate and gift tax issues assists in understanding the other non-tax estate planning features of limited partnerships under the Act. This section of the article will describe several of the estate and gift tax pressure points that effect entity choice. The most extended technical discussion in this section of the article will concern valuation of partnership interests for purposes of estate and gift taxation. That discussion appears in Section II.B.1. Valuation is emphasized, in part, because it provides a lens through which to examine many limited partnership issues in addition to unique tax planning issues. Section II.B.2 will introduce issues of control and power that may cause the economic value of gifts of partnership interests to boomerang back into the estate of the "giver" ("donor" or sometimes "grantor" in tax parlance), for purposes of the estate tax; or, which may be disregarded for purposes of the gift tax.[31]

Next, Section II.C will illustrate the dynamic relationship between and among the estate and gift tax provisions, state entity law like that governing limited partnerships, and tax planning. The illustration will consist of a narrative analysis of the *Estate of Strangi* decision that was recently decided by the United States Tax Court on remand from the United States Court of Appeals for the Fifth Circuit.[32]

Finally, in Section III of this article, selected provisions of (ULPA 2001) will be analyzed within the context of the federal estate and gift taxation and compared with similar provisions from the current law governing limited

31. *See infra* Section II.B.2.

32. *See infra* Section II.C.

partnerships with occasional references to the law governing other unincorporated entities. Before turning to the more technical discussion beginning in the next section, however, a quick overview and refresher of basic estate and gift tax concepts is necessary.

Basic estate and gift tax concepts necessary to understand the tax planning use of the limited partnership include: (1) "gross" and "taxable" estates; (2) "valuation date"; (3) "value of property"; (4) "marital deduction"; (5) "unified rate schedule" and "unified credit"; (6) "annual exclusion"; and (7) "step-up in basis." Each of these terms and concepts will be defined and described in turn. In so doing, several other related tax concepts will be placed in the planning context.

As a very general matter, estate tax payable is computed by applying the "unified rate schedule," which is a progressive rate structure, to the decedents "taxable estate." The taxable estate is the "value of the property"[33] transferred by the decedent upon death.[34] The taxable estate is the remainder after certain deductions,[35] including the "marital deduction,"[36] are subtracted from the "gross estate."[37] The "unified rate schedule" is applied to the value of the taxable estate which yields an amount called the "tentative tax."[38] Credits are then subtracted from the tentative tax, and the result is estate tax payable. Examples of credits include the "unified credit"[39] and credits for certain taxes already paid.[40]

The "gross estate" is the starting point for the computation of the estate tax. It is governed by I.R.C. sections 2031 through 2046[41] and is statutorily defined very broadly: "The gross estate of the decedent shall be determined by including to the extent provided in this part [I.R.C. §§ 2031-2036], the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated."[42] A short-hand way of stating the definition of the gross estate is that it includes the value of all property owned by the decedent at the

33. *See infra* note 46.

34. I.R.C. § 2001(b) (2003).

35. I.R.C. § 2053 (2003).

36. I.R.C. § 2056(a) (2003).

37. I.R.C. § 2031 (2003) (definition of gross estate).

38. I.R.C. § 2001(d) (2003).

39. *See infra* note 65.

40. I.R.C. § 2001(b)(2) (2003); I.R.C. §§ 2010-2016 (2003).

41. The sections' captions indicate some of the parameters of the term "gross estate." The captions are: "Definition of gross estate" (I.R.C. § 2031); "Alternate valuation" (I.R.C. § 2032); "Valuation of certain farms, etc., real property" (I.R.C. § 2032A); "Property in which decedent had an interest" (I.R.C. § 2033); "Dower or courtesy interest" (I.R.C. § 2034); "Adjustments for certain gifts made within 3 years of decedent's death" (I.R.C. § 2033); "Transfers with retained life estate" (I.R.C. § 2036); "Transfers taking effect at death" (I.R.C. § 2037); "Revocable transfers" (I.R.C. § 2038); "Annuities" (I.R.C. § 2039); "Joint interests" (I.R.C. § 2040); "Powers of Appointment" (I.R.C. § 2041); "Proceeds of life insurance" (I.R.C. § 2042); "Transfers for insufficient consideration" (I.R.C. § 2043); "Certain property for which the marital deduction was previously allowed" (I.R.C. § 2044); "Prior interests" (I.R.C. § 2045); and "Disclaimers" (I.R.C. § 2046).

42. I.R.C. § 2031 (2003).

date of decedent's death and transferred because of his death. The caveat in using the short-hand definition is that "owned" is not a term of art, and the concepts generally thought of as "owned" are expansively defined for inclusion purposes.[43] The valuation date is the date of death[44] unless the executor (personal representative) elects the alternate valuation date, which is six months after the date of death, or the date of sale or distribution for specific items of property by the estate if sold or distributed within the six month period.[45]

Generally the "value of property" included in the gross estate is its *fair market value* at one of two possible valuation dates.[46] The regulations define fair market value as "the price at which the property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts."[47] There are, however, two statutory exceptions to the fair market value rule. While both exceptions are complicated and any comprehensive treatment of them is beyond the scope of this article, they are worthy of mention in order to provide a fuller context to the federal wealth transfer tax issues surrounding ULPA (2001).

The first exception is contained in I.R.C. section 2032A and is designed as a limited adjustment for the value of real property included in the gross estate that is devoted to farming or use in other closely-held businesses. It is available only on a post-mortem election basis for the estate and, then, only if a plethora of technical rules are met.[48] The basic idea that animates section 2032A is that real property used in farming or business estate may not be used at its highest and best use, but fair market value, which is the general standard for valuation, reflects the highest and best use.[49] Therefore, qualifying real property may be valued based on the property's income producing capacity as it is used in the farming or business operation rather than its highest and best use. The *excluded* reduction in value from fair market value from the gross

43. *See supra* note 41; *infra* Section II.B.2.

44. I.R.C. § 2031 (2003).

45. I.R.C. § 2032 (2003).

46. I.R.C. § 2031(a) (2003) (time of death); I.R.C. § 2032 (2003) (alternative valuation date at disposal or sale, but in no event later than six months after death).

47. Treas. Reg. § 20.2031-1(b) (2003).

48. Requirements include that the property (either real or personal) be passed by death to a "qualified heir" and which was being used by decedent on his date of death for a "qualified use." I.R.C. § 2032A(b) (2003). It must be located in the United States. *Id.* Another defined term is "adjusted value." I.R.C. § 2032A(b)(3). The *most* difficult eligibility requirement to describe is a ratio requirement for the value of the property to be valued under section 2032A against the total value of the estate. There are two ratios which must be met in order to make the election: (1) "The 'adjusted value' of the agricultural [or business] land must be at least 25 percent of the 'adjusted value' of the estate"; and (2) "the 'adjusted value' of both land and personal property devoted to the qualifying agricultural use must not be less than 50 percent of the 'adjusted value' of the gross estate." DONALD KELLEY ET AL., 2 ESTATE PLANNING FOR FARMERS AND RANCHERS: A GUIDE TO FAMILY BUSINESS WITH AGRICULTURAL HOLDINGS § 15:2, at 15-27 (2002).

49. KELLEY ET AL., *supra note* 48, § 15:1, at 15-6.

estate, however, is capped. The cap was originally set at $750,000 in 1998, but it is adjusted annually for inflation.

The second statutory exception to the fair market valuation rule of the estate tax is contained in I.R.C. section 2057. This section is conceptually and technically similar to the valuation adjustment provided in section 2032A, except that (1) it applies to "qualified business interests"[50] rather than real property; and (2) it is a *deduction* from the gross estate rather than an *exclusion* not counted in the gross estate.[51] For decedents dying in 2002 or 2003, the deduction is capped at $600,000.[52] Section 2057 has been repealed effective as of December 31, 2001,[53] but it is scheduled to spring back into law on December 31, 2009, unless its repeal is reenacted.[54]

One of the most important deductions for tax planning purposes on the way from the gross estate to the taxable estate is the "marital deduction"[55] provided by the I.R.C. section 2056. Simply, the value of any and all property transferred at death to a surviving spouse may be deducted by the estate for purposes of determining the value of the taxable estate.[56] Thus, the marital deduction is an unlimited deduction and, "[t]his means that all of the couple's assets undiminished by estate . . . taxes, can be made available for the surviving spouse during her [or his] life."[57] From a couple's tax planning perspective, however, the effect of fully using the marital deduction only defers the payment of estate tax because any property remaining in the estate of the second-to-die spouse will be subject to the estate tax.[58]

One of the requirements for property to qualify for the marital deduction is expressed in the negative. The requirement is stated in the Treasury Regulations as "no marital deduction is allowed with respect to certain property interests, referred to generally as 'terminable interests,' passing from a decedent to his surviving spouse."[59] Examples of terminable interests that do not qualify for the marital deduction include life estates, terms of years, and interests subject to conditions like not remarrying.[60] There are many exceptions to this requirement, including a special class of transfers at death of "qualified terminable interest property."[61] Nonetheless, in cartoonish

50. *See* I.R.C. § 2057(b)(1) (2003).

51. *See* KELLEY ET AL., *supra* note 48, § 17:1, at 17-6.

52. *See* KELLEY ET AL., *supra* note 48, at 17-7.

53. *See* KELLEY ET AL., *supra* note 48, at 17-4.

54. *See* KELLEY ET AL., *supra* note 48.

55. RAY D. MADOFF ET AL., PRACTICAL GUIDE TO ESTATE PLANNING § 6.03[A], at 168 (2001).

56. *See* Treas. Reg. § 20.2056(a)-1 (2003).

57. *See* MADOFF ET AL., *supra* note 55, § 6.03[A], at 168.

58. *See* MADOFF ET AL., *supra* note 55, § 6.03[A], at 168.

59. Treas. Reg. § 20.2056(b)-1 (2003).

60. *See* MADOFF ET AL., *supra* note 55, § 6.03[C], at 176.

61. Thus, the gross estate of the *recipient* includes the value qualified terminable interest property, and that allows the bequest to the spouse to qualify for the marital deduction even though the spouse has only an income interest for life. I.R.C. § 2044 (2003). "With a QTIP arrangement, the testator can control the

caricature, the rule means that the surviving spouse must be given complete ownership of the property if its value is to qualify for the marital deduction. One result of this requirement is to enhance the probability that part of the property passing under the marital deduction in the estate of the first spouse to die will not escape estate tax when the second spouse dies because value accumulates in the second estate.

Of course, a deduction is also available for gifts and bequests to charities; for estate and gift tax purposes, these gifts are fully deductible and not limited to any specific percentage limitation.[62] Such limitations, however, exist for purposes of the income tax.[63] The deductibility of charitable gifts and bequests, like many other areas, are governed by remarkably technical legal provisions.[64]

After the taxable estate is computed the "unified rate schedule" is applied to determine a tentative estate tax. The Code then provides for certain credits to be subtracted, dollar for dollar, from the tentative tax. One of these credits is the "unified credit."[65] This credit is allowed for every decedent, and although it mechanically operates with a specified amount credited against tax, its effect is as if an estate value corresponding to the credit amount under the unified rate schedule were excluded from the tax. The exemption equivalent for the estate tax for decedents dying in 2002 and 2003 is $1,000,000, and it will gradually increase until it reaches $3,500,000 in 2009.[66] The operation of the unified credit in 2003, for example, means that estates of $1,000,000 or less will have no estate tax payable. Therefore, with relatively unsophisticated tax planning, a married couple may have combined estates worth $2,000,000 ($1,000,000 in each separate estate) without paying estate tax. The estate tax is scheduled to be repealed for decedents dying in 2010 but will, unless further legislation occurs, spring back to apply to decedents estates in 2011 with a roll-back in the exclusion equivalent to 2001 levels.[67]

Once subject to the estate tax, however, the tax rates provided by the unified

---

disposition of the remainder interest after the spouse's death." CCH FINANCIAL AND ESTATE PLANNING GUIDE ¶ 1210, at 422 (13th ed. 2001); *see* I.R.C. § 2056(b)(7) (2003).

62. I.R.C. § 2055(a) (2003) (regarding estate tax); I.R.C. § 2522(a) (2003) (regarding gift tax).

63. *See generally* I.R.C. § 170 (2003). Generally, a gift is deductible for income tax purposes only up to fifty percent of the donors "taxable base" (I.R.C. § 170(b)(1)(F)), but special limitations and restrictions apply based on such features as the following and their interrelationship: (1) whether the gift is to a public charity or a private foundation (e.g. I.R.C. § 170(b)(1)(B)); (2) whether the gift is of appreciated property and, if so, whether it is long or short-term capital gain property (e.g. I.R.C. § 170(e)(1)(A)), and; (3) whether the property is tangible personal property (I.R.C. § 170(e)(1)(B)(i)). For a more complete discussion of this topic, see, for example, *Hoops*, note 4 above, § 11.1 *et seq.*, pages 11-1 *et seq.*

64. For example, special rules apply to gifts of remainder interests in personal residences or farms. *See* I.R.C. § 170(f)(3)(B)(i) (2003). The tax rules have given rise to specialized trusts like charitable remainder annuity trusts (CRATs) and charitable remainder unitrusts (CRUTs). *See generally* MADOFF ET AL., *supra* note 55, § 10.06[B][3], at 416-19.

65. I.R.C. § 2010 (2003).

66. I.R.C. § 2010.

67. I.R.C. § 2010; *see* MADOFF ET AL., *supra* note 55, app. A, at 145.

rate schedule are relatively high.[68] Thus, the marginal rate of tax on taxable estates above the exemption equivalent (i.e. after the credit is subtracted from the tentative tax) start at thirty-seven percent and increase quickly, in 2003, to forty-nine percent.[69] The maximum rate is scheduled to decrease one percent a year until it reaches forty-five percent in 2007.[70]

This article has yet to explain the word *unified* in the terms *unified credit* and *unified rate schedule.* The explanation, which follows, provides a conceptual bridge between the estate tax and the gift tax. As a basic introduction, the unified rate schedule means that the same rate schedule is applicable both to transfers at death and gifts during life (*inter vivos* gifts) and that the unified credit may be used to shelter the exemption equivalent amount of combined transfers at death and as inter vivos gifts.[71] The unification of the credit and rate of tax operates to tax life and death gifts uniformly.

Indeed, the uniform credit and rates further one goal of the gift tax which is to make it more difficult to avoid the estate tax. As explained by Professors Hamilton and Booth in a general business primer: "One fairly straightforward way to avoid paying estate tax would seem to be simply giving away the taxable portion of one's estate during one's lifetime. As one might guess, this simple loophole has been blocked [because] [f]ederal law also imposes a gift tax . . . ."[72] In addition to the unified credit and rate schedules, the gift tax shares two other conceptual features with estate tax. These gift tax features perform functions similar to their counterparts in the estate tax. The features are: (1) an unlimited marital deduction for lifetime gifts,[73] and (2) an exemption from gift tax for certain gifts on an annual basis, which under the gift tax is called the annual exclusion.[74] Further, like the estate tax, the gift tax is legislatively scheduled for changes between now and the year 2011.[75]

The *first* gift tax feature that is similar to an estate tax feature is the unlimited marital deduction for gift tax purposes.[76] The unlimited marital deduction for gift tax purposes, again like the estate tax marital deduction, does *not* allow the deduction for certain property like life estates.[77] In addition, property not eligible for the deduction is called *terminable interest* property.[78]

The *second* gift tax feature that is similar to an estate tax feature is a special, and additional, exclusion from the gift tax for certain limited gifts called the

68. *See* MADOFF ET AL., *supra* note 55, § 5.01, at 97.
69. *See* MADOFF ET AL., *supra* note 55, § 5.02[A], at 98.
70. *See* MADOFF ET AL., *supra* note 55, at 98 n.6.
71. *See* I.R.C. § 2505 (2003).
72. ROBERT W. HAMILTON & RICHARD A. BOOTH, BUSINESS BASICS 224 (2002).
73. *See infra* notes 76-77 and accompanying text.
74. *See infra* notes 80-81 and accompanying text.
75. *See infra* notes 80-81 and accompanying text.
76. I.R.C. § 2523 (2003).
77. I.R.C. § 2503(b) (2003).
78. *Id.*

annual exclusion. In 2002, for example, the annual exclusion excluded the first $11,000 worth of gifts made by the donor to each donee of nonterminable interest property.[79] In the words of the statute:

> In the case of gifts (other than gifts of future interests in property) made to any person by the donor during the calendar year, the first $10,000 [indexed for inflation beginning in 1998[80] and rounded down to the nearest $1,000] of such gifts to such person shall not . . . be included in the total amount of gifts made during such year.[81]

Illustratively assume that Arthur Weasley, a mid-level public servant, gave his son Ron $11,000 on January 30, 2002; his daughter, Ginny $11,000 on June 1, 2002; and a friend of his son, Harry, $5,000 on December 24, 2002. Further assume that Arthur's spouse, Molly, gave Ginny $11,000 on September 10, 2002; Fred and George, her twins, $5,000 each on November 14, 2002; and Harry, the friend of her son Ron, $7,000 on December 24, 2002. No gift tax is payable on any of the gifts given by Arthur and Molly because of the annual exclusion because neither Arthur nor Molly individually gave any of the donees more than the exclusion amount for 2002 ($11,000) even though daughter Ginny received an aggregate gift of $22,000 from her parents in 2002, Harry (not a member of the family) $12,000 in 2002, and, moreover, even though Arthur and Molly gave combined total gifts of $55,000 in that year.

Further assume that Molly wants to give Harry another $5,000 on December 31, 2002. If Harry is given the gift he will have received a total of $17,000 from Mr. and Ms. Weasley in 2002. Unfortunately, Molly will have given Harry $12,000 which is $1,000 more than her $11,000 annual exclusion for 2002. At this juncture, Molly faces the choice of paying gift tax by applying the unified rate schedule to the $1,000 taxable gift, or of using up $1,000 of her lifetime *unified credit exemption equivalent*. Of course, Mr. and Ms. Weasley together could have given Harry up to $22,000; $11,000 each. Indeed, because the Weasley's are a married couple, and assuming Arthur was out of cash, Molly could have given Arthur her "excess" $1,000 under the unlimited marital gift tax deduction and he, in turn, could have given it to Harry. The gift tax provisions contemplate such a spousal gift giving scenario and allow spouses to elect to combine annual exclusion without the necessity of the interim spousal gift if specific "split-gift" administrative procedures are followed.[82] Another planning alternative would have been for Molly Weasley to wait until January 1, *2003*, to give the $1,000 taxable gift portion of the gift to Harry because on that date the full amount of her annual exclusion for 2003 would have been available.

---

79. *See, e.g.*, C.C.H. 2002 U.S., Master Estate and Gift Tax Guide ¶ 2014.
80. I.R.C. § 2503(b)(2) (2003).
81. I.R.C. § 2503(b)(1) (2003).
82. I.R.C. § 2513 (2003).

The Weasley illustration assumed cash gifts. What if, instead of cash, Arthur gave Harry a previously owned *Nimbus 2000* recreational vehicle? This question raises the issue of valuation for purposes of determining whether there was a taxable gift; and if not, how much of the annual exclusion and unified credit exemption equivalent remain available for purposes of Arthur's gift and estate planning in the future.

Again, valuation is an issue common to both the estate and gift taxes and, again, the valuation scheme provided by the gift tax is similar to those provided by the estate tax. The basic valuation rule for purposes of the gift tax is that the value of a gift of property is the fair market value on the date of death, and the regulations use the same "willing buyer-willing seller" standard for determining the fair market value of property for the gift tax[83] as they do for estate tax purposes.[84]

The regulations provide that the value, for gift tax purposes, of the previously owned *Nimbus 2000* for gift tax purposes would be "the price at which the item or a comparable item would be sold at retail."[85] If the fair market annual value of the *Nimbus 2000* was $750 (and Arthur had not used any of his 2002 gift tax exclusion), he could give Harry cash or other property valued at $10,250 or less without incurring a taxable gift in 2002 ($11,000 minus $750). If, however, Arthur had given Harry $11,000 cash in 2002 before the gift of the *Nimbus 2000* recreational vehicle, Arthur would face the same kinds of alternatives as did Molly in the previous example.[86] If Arthur sold the Nimbus (fair market value of $750) to Harry for $250, Arthur will be deemed to have given Harry a gift valued at $500 ($750-$250).[87]

Only three items relating to federal estate and gift taxation remain to be

83. I.R.C. § 2512 (2003); Treas. Reg. § 25.2512-1 (2003). The Regulation states:

> Section 2512 provides that if a gift is made in property, its value at the date of the gift shall be considered the amount of the gift. The value of the property is 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. The value of a particular item of property is not the price that a forced sale of the property would produce. Nor is the fair market value of an item of property the sale price in a market other than that in which such item is most commonly sold to the public, taking into account, the location of the item wherever appropriate. Thus, in the case of an item of property made the subject of a gift, which is generally obtained by the public in the retail market, the fair market value of such an item of property is the price at which the item or a comparable item would be sold at retail. For example, the value of an automobile (an article generally obtained by the public in the retail market) which is the subject of a gift, is the price for which an automobile of the same or approximately the same description, make, model, age, condition, etc., could be purchased by a member of the general public and not the price for which the particular automobile of the donor would be purchased by a dealer in used automobiles.

Treas. Reg. § 25.2512-1.

84. *See supra* notes 41-47 and accompanying text.

85. Treas. Reg. § 25.2512-1.

86. *See supra* notes 80-81 and accompanying text.

87. *See* I.R.C. § 2512(b) (2003).

discussed to complete this whirlwind tour of basic estate planning principles. The first is concept of tax basis. The second is the addition of the Generation-Skipping Transfer Tax (GST Tax) to the estate planning tax checklist; and the third is expressly acknowledging the Economic Growth and Tax Relief Reconciliation Act of 2001 as a confounding variable in federal wealth transfer tax planning.

Basis is an important tax term involved in the computation of gains and losses from the sale or exchange of property for purposes of computing the *federal income tax*.[88] It is relevant for estate planning purposes because the basis of property received by an individual (either by inheritance or gift) is the starting point for determining how much gain or loss the recipient of the property must recognize upon its subsequent sale or exchange for purposes of the income tax. Professors Hamilton and Booth, again, provide an elegantly succinct definition of basis sufficient for current purposes of this article:

> Basis is the investment the seller of the property has in the property. It is the cost or purchase price of the property that the seller pays or incurs in acquiring the property. *In the case of property acquired by gift*, the basis in the hands of the donee is usually the same as the basis in the hands of the donor (a *substituted basis*); *in the case of property acquired by inheritance*, it is generally the fair market value of the assets on the death of the decedent (a *stepped-up basis*).[89]

An example may illuminate the importance the distinction between *carry-over basis* for gifts and *stepped-up basis* for inheritances. Assume Earl, a farmer, bought one hundred eighty acres of farmland in Illinois for $500 per acre in 1950, and that the current fair market value of the farmland is $2,500 per acre. If Earl gives Pam the farmland during his life, *her* basis in the property is her father's basis of $500 per acre ($90,000). Thus, Earl's basis carries over to Pam. If Pam inherits the property from Earl, however, she will receive a step-up in basis to the fair market value of the property at the time of his death ($2,500). Thus, Pam's basis in the farmland is to be stepped-up to $2,500 per acre ($306,000). If Pam sells the property immediately after receipt, she has a *gain* of $216,000 that is recognizable for income tax purposes if the land was given to her when Earl was alive (carry-over basis of $90,000), but if she sells the property after inheriting it, she will recognize *no* gain (stepped-up basis of $306,000). In this example (assuming Earl had not previously used all of his unified credit exemption equivalent), neither the gift nor the transfer at death would result in transfer tax (estate or gift) payable,[90] even though Pam's income tax consequences are markedly different under the two scenarios

88. *See generally* I.R.C. §§ 1001-1022 (2003).

89. (Emphasis added, bold typeface deleted.) Very generally, basis is *adjusted* for improvements and expenditures made on the property. *See* I.R.C. § 1016 (2003).

90. *See generally supra* notes 65-71 and accompanying text.

because of the operative rules of basis.

In addition to the estate tax and gift tax, the federal system of wealth transfer taxation includes the generation-skipping transfer tax (GST tax). Any overview of estate planning would be misleading without at least mentioning the GST tax, even though it is far less significant for purposes of this article than the estate or gift tax.

Very generally, the GST tax was designed to capture transactions that function to alleviate successive application of the estate or gift tax by "skipping" generations. For example, assume Evelyn (mom) dies with a *taxable* estate of $100,000 cash and the applicable estate tax rate is forty-five percent. The estate tax due would be $45,000, passing the remaining $55,000 free of tax to Jan (daughter). Jan uses the income during her life (and pays any federal income tax associated with that income) and, in turn, has a *taxable* estate of $55,000 (clearly attributable in this contrived example to her inheritance). Again assume that the estate tax rate is again forty-five percent and that the entire corpus passes to Joan, her daughter (Evelyn's granddaughter). Joan would receive $30,250 ($55,000 – (55,000 x .45)). To avoid the second tax, Mom could skip daughter and pass the estate directly to granddaughter, saving $24,750 in tax. Or, perhaps more to the point, Mom could establish a trust with the $55,000 under whose terms daughter receives the income for life with the corpus distributed outright to granddaughter at daughter's death. Therefore, by "skipping" one or more generations, Mom can avoid significant estate tax that would otherwise be due.[91]

The reason it is possible to "skip" estate tax is, of course, because the estate tax:

> only applies to property that is owned or transferred by a decedent or with respect to which the decedent had a significant power or incident of ownership. It does not require a decedent's estate to include any interest in property in which the decedent held a life interest created by others.[92]

The GST tax "was designed to close this loophole . . . [and it] approximates the estate and gift taxes that would have been imposed if the property had been transferred outright at each generation."[93]

Each donor/decedent has a lifetime exemption from the last GST tax which is an exclusion that, at least conceptually, operates somewhat like the unified credit exemption equivalent. The GST tax exemption in 2003 is $1,060,000 ($1,000,000 plus an inflation adjustment), and after 2003 will equal the amount of the unified credit exemption equivalent for the estate and gift tax.[94] Like its

91. *See generally* JOHN R. PRICE, PRICE ON CONTEMPORARY ESTATE PLANNING § 2.23, at 153-55 (2d ed. 2000).

92. *Id.* at 153. For a discussion of control and retained powers, see Part III.B.2 below.

93. *See* MADOFF ET AL., *supra* note 55, § 9.01.

94. RICHARD B. STEPHENS ET AL., FEDERAL ESTATE AND GIFT TAXATION § 15.01 (7th ed. 2002) (looseleaf).

counterpart the estate tax, the GST tax is repealed December 31, 2009, but is scheduled to spring back into existence on January 1, 2011, when the exemption rolls back to $1,000,000.[95] Like the gift tax, the GST tax provides for a $10,000 annual exclusion.[96] The rate of tax mixes estate and gift tax concepts because it "is the highest federal estate and gift tax rate in effect at the time of the transfer."[97]

The purpose of the GST tax is understandable, even though its computation and statutory terms are technically complicated. The sole purpose of its discussion herein is to identify its existence as a component of planning. It is a separate tax. Its importance might best be emphasized by an example, which, among other things, illustrates that the effective rate of the GST tax may exceed rates over one hundred percent in combination with other wealth transfer taxes. The example assumes a maximum rate of fifty percent:

> A grandfather has used up all available credits and exemptions and is in the 50 percent bracket for gift and estate tax purposes. The grandfather makes a $100,000 taxable gift to his granddaughter. As a result of this transfer the grandfather has a gift tax liability of $50,000 (50 percent of $100,000), a GST tax liability of $50,000 (50 percent of $100,000), and an additional GST tax liability on the gift taxes paid of $25,000 (50 percent of $50,000), resulting in a combined gift tax and GST tax liability of $125,000.[98]

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) was enacted on May 26, 2001.[99] It is best known for repealing the Estate tax and the GST tax beginning in calendar year 2010. Without further legislative action, however, the appeal sunsets at the end of that year, resurrecting those taxes.[100] Its effects on those taxes have been introduced in their previous discussion herein.[101] As explained below, however, the EGTRRA also affects the gift tax and the income tax basis rules of the current estate tax, and is altogether a confounding variable in the area of wealth transfer tax planning.

Importantly the EGTRRA did *not* repeal the gift tax; rather, it modified its top marginal rate from forty-five percent in 2009 to thirty-five percent (the maximum individual income tax rate[102]) in 2010.[103] Moreover, while it increased the exemption credit equivalent for purposes of the estate tax to $3,500,000 in 2009, "the applicable exclusion amount for gift tax purposes . . .

95. *Id.*

96. *See* MADOFF ET AL., *supra* note 55, § 9.03[B].

97. *See* MADOFF ET AL., *supra* note 55, § 9.02[D].

98. *See* MADOFF ET AL., *supra* note 55, § 9.01.

99. KELLEY ET AL., *supra* note 48, § 1:16.

100. KELLEY ET AL., *supra* note 48, at 1027.

101. *See supra* notes 34-70 and accompanying text (estate tax); *supra* notes 91-98 and accompanying text (discussing generation-skipping transfer tax).

102. I.R.C. § 2502(a) (2003).

103. KELLEY ET AL., *supra* note 48, § 1:16.

remains at $1,000,000."[104] Thus, the unified exemption credit equivalent has been *de-unified*.[105] The reason for the retention of the gift tax after the repeal of the estate tax may have been to inhibit wealthy individuals from transferring assets by gift in order to minimize their income taxes.[106] This technique is generally known as income-splitting, and its purpose is to take advantage of the lower marginal income tax rates for lower income taxpayers (often, for example, of the donors children).

One of the results of the de-unification of the credits and the retention of the gift tax is that donors will be unable to transfer substantially all of their assets free of wealth transfer taxes by gift in 2010 in anticipation of the EGTRRA sunset in 2011. The only sure way to take advantage of the changes in the EGTRRA, therefore, is to die in 2010. It also adds dimension in deciding whether to give *taxable* gifts before 2010 because there is a chance that the property given could pass tax free under the estate tax in 2010 if the giver should die in that year, or, if the sunset is overridden legislatively, thereafter.

Another important attribute of the EGTRRA is a significant modification of the basis rules for inherited property. Recall that the general rule prior to EGTRRA was that property transferred at death received a stepped-up in basis to its far market value at time of death or on the alternative valuation date.[107] This, too, is scheduled to change. It will change from a stepped-up regime to a carry-over basis regime upon the repeal of the estate tax in 2010.[108] Succinctly: "Under this system, recipients of inherited property will, in general, receive a carryover basis[109] . . . [instead of] the fair market value of the property on the date of decedent's death. These rules are the same as the carryover basis rules that have long been applicable to gifts."[110]

Subject to exceptions for certain statutorily identified types of property,[111] there is a very important exception to the carry-over basis scheme. In some ways the exception parallels the mechanical operation of the unified credit exemption equivalent, but not its function or effect. At bottom, the executor (personal representative) may increase the basis of property up to its fair market value, but the amount of the *increase* is capped at an aggregate of $1,300,000.[112]

Moreover, the basis of property transferred to a spouse is subject to stepped-

104. *See* MADOFF ET AL., *supra* note 55, § 5.02[B], at 101.

105. MADOFF ET AL., *supra* note 55, § 5.02[B], at 101.

106. MADOFF ET AL., *supra* note 55, § 5.07(B) (citing Jonathon G. Blattmachr & Mitchell M. Geans, *Wealth Transfer Tax Repeal: Some Thoughts on Policy and Planning*, 140 TR. & EST. 49 (Feb. 2001)).

107. *See supra* notes 88-89 and accompanying text.

108. I.R.C. §§ 1014(f), 1022 (2003) (as added by EGTRRA (2001) (P.L. 107-16)).

109. *See supra* note 89 and accompanying text (explaining term "adjusted basis").

110. *See* MADOFF ET AL., *supra* note 55, § 5.07[C], at 136.

111. *See generally* I.R.C. § 1022(d) (2003). For the complete text of section 1022, see the Appendix to this article, at 852-57.

112. I.R.C. § 1022(d) (2003).

up basis limited, in aggregate, to an additional $3,000,000.[113] Together, therefore, each estate with a surviving spouse may receive an aggregated basis step-up of $4,300,000. Other basis adjustments are available for specified income tax attributes of the decedent.[114] The entire statutory language of the basis provision is set forth in the Appendix to this article to illustrate (1) the level of detail in this and other law that is not reflected textually; and (2) evidence the technical nature of tax planning by estate planners.[115] The new carry-over basis rules will place a premium on income tax aspects of estate planning. Again, however, the sunset provisions of EGTRRA technically mean that they will only apply for the year 2010, absent further law-making.

Advice on how to plan for these prospective changes varies. For example it was reported that "Jeff Pennell, a law professor at Emory University School of Law in Atlanta, said that 'Congress will have to rework these provisions, and it's a fool's errand to do any planning and drafting currently.'"[116] On the other hand, Pennell agreed that, "[a]t a minimum, cover your backside."[117] Another commenter quoted in the same news article suggested that "a failure to take action now might lead to a lot of litigation in the future, depending on what happens over the next seven years, particularly when dealing with exemption formulas [allocating the allowable step-up to specific properties or devisees]."[118]

These, and other estate planners, make the following planning suggestions: (1) rethink and consider redesigning trusts that qualify for the unified credit exemption equivalent (so-called Qualified Terminable Interest Property—QTIP—trusts) to enable the estates of both spouses to fully utilize each of their potential basis step-up $1,300,000; (2) consider authorizing the trustee of any newly established trusts to distribute property outright so that it will be included in the estate of the beneficiary and, therefore, be eligible for the beneficiary's step-up limit; (3) consider purchasing life insurance products to provide a source of liquid funds during the interim time period for the payment of additional income tax due, assuming that the estate will distribute appreciated assets to beneficiaries who will receive a carry-over basis; and (4) place a premium on client record keeping in order for the estate and beneficiaries to determine the basis in property in the estate.[119] Finally, remember "that 'carryover basis is a theoretical issue for 99 percent plus of taxpayers' because an estate would have to have $4.3 million of appreciation to

113. I.R.C. § 1022(c)(2)(B) (2003).

114. I.R.C. § 1022(b)(2)(C) (2003).

115. *See infra* app., at 852-57.

116. Tony Wright, *The Loss of Step-Up In Basis—What Can Estate Planners Do?*, LAW. WKLY. USA, Jan. 1, 2003, at 1.

117. *Id.* at 23.

118. *Id.*

119. *Id.*

be affected."[120]

The discussion of some of the biggest changes wrought by the EGTRRA illustrates the contingent nature of planning in a dynamic context. Admittedly, however, it might obscure the primary focus of this section of the article, which is to provide a very shallow overview of the federal wealth transfer taxes necessary to understand wealth transfer tax planning use of limited partnerships under ULPA (2001).[121] A return to that focus requires a return to the current tax law and a summary of the fundamental tax planning techniques suggested by the previous discussion and currently used by estate planners without regard to the EGTRRA. Again, the following description of selected techniques is but a caricature of tax planning in the context of a broader estate planning process.

By way of caveat, introduction, and summary:

> The details of the estate plan for a client must be based upon the client's wishes. To the extent consistent with that goal it should be formulated in light of important tax considerations, which include the gift tax as GSTT [generation-skipping transfer tax] exclusions, the unified credit, and the GSTT exemption. The details of the client's program should take full advantage of the gift tax annual exclusion, the exclusions for the direct payment of the tuition or medical expenses of a donee (which are also available for GSTT purposes), gift splitting between the client and the client's spouse, and the marital deduction. A substantial gift program might consume the unified credits of the client and the client's spouse.[122]

All of the important tax considerations listed in the quote were previously mentioned in this article, except the tuition or medical expense payment exclusions,[123] and therefore, the planning goals are but logical extensions of the principles consideration herein.

By way of further summary, three specific tax considerations were previously mentioned but are not specifically included as the roots of goals in the block quote. They are: (1) special valuation of real property used in farming or another trade or business;[124] (2) the limited deduction from the gross estate of an adjustment in value for family-owned business interests;[125] and (3)

---

120. *See* Wright, *supra* note 116 (quoting Martin M. Shenkman).

121. *No* state has yet adopted ULPA (2001). ULPA (2001) was adopted in Hawaii and has been introduced in Illinois, Iowa, Kentucky and Minnesota according to the web page of the National Conference of Commissioners on Uniform State Laws, www.nccusl.org/nccusl/ActSearch (last visited Mar. 26, 2004).

122. PRICE, *supra* note 91, § 2.42, at 201 (parenthetical in original, brackets added). For an example of an attempt to maximize wealth transfer taxes through use of gift planning see the discussion of the *Hackl* case, see notes 545-76 below.

123. *See* I.R.C. § 2503(e) (2003) (providing for gift tax exclusion). The tuition exclusion is limited to direct tuition costs and does not include amounts paid for room, board, books, or supplies. Treas. Reg. § 25.2503-6(b)(2) (2003). Medical expenses are limited as well, and for example, do not include amounts reimbursed by insurance. Treas. Reg. § 25.2503-6(b)(3).

124. *See supra* notes 41-49 and accompanying text.

125. *See supra* notes 50-54 and accompanying text.

the charitable deduction for gift and estate tax purposes.[126] Admittedly, however, the first two concepts are available to a relatively narrow spectrum of estates and are exceedingly difficult for which to plan, and the latter (the charitable deduction) concerns a dimension of tax planning that is different in kind than others listed.

Stated another way, and in more detail, the principle tax considerations just discussed drive *tax savings* goals. The goals, in turn, suggest (either directly or indirectly) broader strategies "that describe the specific estate planning components of most estate plans."[127] These basic tax strategies include, among others, deferring the payment of any wealth transfer taxes to the future; bypassing, or "skipping," the estates of survivors; shifting income to taxpayers subjected to lower marginal income tax or wealth transfer tax rates; and reducing or freezing the projected size of the estate.[128] The classic technique to achieve deferral of wealth transfer is to use the unlimited marital deduction. That is, "I leave everything to my spouse if he survives me," defers any estate tax to the spouse of the second to die.[129] As previously discussed, the use of trusts or life estates in property may be used to skip the estates of survivors subject to the GST tax.[130] The basic concept is to give the skipped beneficiary an interest in the property, but not control over the property such that it is included in the beneficiaries estate. This is often a technically fine line that, at abstract bottom, begs the nontechnically stated issues of *ownership* and *transfer*.[131]

An outright gift of property can be used as a strategy for both income and wealth transfer tax splitting and for reducing the size of the estate. For example, if an adult son receives a gift of rental property, the future income therefrom will be included and taxed on his individual tax return. Of course the more compressed (and lower) the income tax rates, the less incentive for attempting to split income for income tax purposes. Nonetheless, the value of the gift will no longer be in the donor's gross estate and, therefore, any future accumulation of income derived from the property or appreciation in the value of the property will not be in the donor's estate and subject to the estate tax. Moreover, the beneficiary may have more of his unified exemption equivalent and GST tax exemption available than does the donor.

Techniques like installment sales at fair market rate may be used to freeze a portion of the estate's value for estate tax purposes. For example, assume Mom owns eighty acres of farm land that is forecasted to appreciate in value at ten percent per year. Son could purchase the property by exchanging an

126. *See supra* notes 62-87 and accompanying text.
127. PRICE, *supra* note 91, at 200.
128. PRICE, *supra* note 91, at 201.
129. *See generally supra* note 67 and accompanying text.
130. *See generally supra* note 91 and accompanying text.
131. *See supra* notes 91-98 and accompanying text.

installment note and mortgage on the property to Mom. Mom's estate no longer includes the land; rather, it includes the note and mortgage. Thus, the sales transaction *freezes* the value in Mom's estate at the purchase price and future appreciation in the value of the land will be included in son's estate.[132]

Finally, and by way of transition, another technique that can sometimes satisfy many of the tax planning strategies is the selection and use of an appropriate business entity; for example, a limited partnership. Before turning to the use of entities in estate planning, however, two tax pressure points need to be discussed in somewhat greater depth. They are *valuation*; and ownership and transfer styled as *retention* and *control*.

B. Pressure Points

1. Valuation

a. General Principles of Valuation

The value of decedent's gross estate is the *fair market value* of its includible assets.[133] *Fair market value* also determines the amount of gifts and value limitations on the annual exclusion for gift purposes as well as the exemption equivalent for purposes of the gift, estate, and GST taxes.[134] Further, *valuation* is important for purposes of determining the eligibility for, and limitations on, the special valuation of real property used in farming or another trade or business;[135] and, even though repealed by EGTRRA, the qualified Family-Owned Business Interest Deduction.[136] Finally, fair market valuation determines the stepped-up basis of property passing through an estate and, under EGTRRA in 2010, allocation of the limitation on the amount of value that may be increased.[137] Valuation, therefore, is central to the wealth transfer tax system and its attendant tax planning. Given the computation and purposes of the various exclusions, exemptions, and deductions, and further, given the unique financial and tax scenarios of any given individual, it is foolhardy to assume that individuals would, as a *general matter*, necessarily prefer relatively higher or lower values for their assets. On one hand, large estates, for example, might very well prefer low values that result in a lower aggregate taxable estate.[138] On the other hand, estates with a value beneath the unified exemption equivalent might well prefer higher asset values to increase the basis in those

132. *See* Treas. Reg. §20.2031-4 (2003) (concerning the valuation of notes for estate tax purposes).
133. *See supra* notes 46-54 and accompanying text.
134. *See generally supra* notes 62-98 and accompanying text.
135. *See supra* notes 48-54 and accompanying text.
136. *See supra* notes 99-121 and accompanying text.
137. *See supra* notes 89-108 and accompanying text.
138. *See generally supra* notes 65-67 and accompanying text.

assets when the basis is "stepped-up" at death.[139]

This portion of the general overview of the wealth transfer tax system will focus on the accepted methods of valuation for determining value emphasizing business ownership interests. The next portion of the article will discuss special valuation rules applicable to intrafamily transfers of interests in corporations and unincorporated entities.

The generally excepted definition of fair market value is the same no matter what tax is involved. Thus, the gift tax regulation states:

> The value of the property is 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 sell, and both having reasonable knowledge of relevant facts. The value of a particular item of property is not the price that a forced sale of the property would produce. Nor is the fair market value of an item of property the sale price in a market other than that in which such item is most commonly sold to the public, taking into account, the location of the item wherever appropriate.[140]

Sometimes, of course, value may be difficult to fix with certainty. Perhaps the prototypical example of unique property is real property.

A well known treatise summarized the valuation of real estate as follows:

> No two parcels of real estate are identical. Therefore, the valuation of real property is not automatic, a mere checking of prices in an established market. Nor will the assessed value for local tax purposes be accepted as fixing value. When, as here, an appraisal is necessary, prudence would indicate the employment of a professional. In the case of controversy, the professional's figure is more likely to prevail than the uneducated guess of someone lacking in experience and, where both the taxpayer and the Commissioner [Internal Revenue Service] present the testimony of appraisers, the court is likely to pay heed to the appraiser considered more qualified.[141]

Valuation *methods* for real estate vary dependant upon whether the property is business property used in a trade or business or held for investment, or, whether the property is used as a residence or held for other personal use. The preferred method of valuation for personal use (not business or investment property) is usually the sales analysis method, which is sometimes called the market data approach.[142] Under this valuation method, recent sales of similar property are analyzed to arrive at an estimate of fair market value.[143]

---

139. *See generally supra* notes 89-90 and accompanying text.

140. Treas. Reg. § 25.2512-1 (2003) (discussing determination of value for gift tax purposes); Treas. Reg. § 20.2031-1(b) (2003) (estate tax; see note 46 and accompanying text, above); Treas. Reg. § 1.170A-1(c)(2) (2003) (charitable deduction).

141. STEPHENS ET AL., *supra* note 94, ¶ 4.02[3][b], at 4013 (footnotes omitted).

142. *See* Edward F. Koren, *Basics of Valuation in Estate Planning and Administration*, 2 14TH ANN. EST. PLAN. SYMP., 1 A.B.A. SEC. OF REAL PROP., PROB. & TR. L. 87, 105 (2003).

143. *Id.*

The preferred method of valuation for business or investment property is usually the income or investment value approach.[144] The income or investment value approach forecasts future streams of income and expenses over a reasonable time period and then discounts those future income streams back to a present value using a discount rate that reflects the time value of money.[145] Another approach is the cost approach, which, for example, estimates the cost of rebuilding or replacing the property (replacement cost) or estimates the amount of money previously invested in the property.[146] A variety of factors, of course, may effect valuation under one or more of the approaches.[147]

One frequent issue is whether the fair market value of the property needs to be reduced because the decedent or donor owned only a fractional interest. It is a question of fact to be resolved on the record and the unique facts of the case. Nonetheless, courts have upheld fractional discounts in excess of the cost of partition proceedings.[148]

The *possibility* of a valuation discount based on ownership of a fractional interest in real estate looks very similar to the minority discount that is sometime appropriate when the property being valued is an interest in a business (like a limited partnership interest or corporate stock) rather than real estate.[149]

---

144. *Id.*

145. *Id.* For a good overview of cash-flow analysis and the capitalization method of valuation, see Robert W. Hamilton & Richard A. Booth, *Business Basics for Law Students: Essential Concepts and Applications* §§ 2.1-2.7, at 19-31 (2002). *See infra* notes 162-68 and accompanying text (concerning capitalization valuation technique in context of valuing business as opposed to real property).

146. *See generally* Koren, *supra* note 145. In the context of a residence and stated with more particularity, though not within the wealth transfer tax context:

> Another method of appraisal involves an estimate of the replacement cost of the residence. Appraisers estimating the replacement cost of a residence usually rely on appraisal handbooks that give current construction costs for various materials. This approach often involves long and complicated calculations. Replacement cost is the principal method of valuation used if the property is unique and there are no comparable properties for which independent sales dates are available.

HAMILTON & BOOTH, *supra* note 145, § 3.4, at 40-41.

147. *See* STEPHENS ET AL., *supra* note 94, ¶ 4.02[3][b]. It include the following factors, among others, in a list of factors that may effect the value of real estate: "Recent attempts to dispose of the property, perhaps even including offers made after death; . . . The condition, location and income production of improved realty; . . . The prospect of proposed favorable or unfavorable zoning changes; . . . The existence of easements of the property." *Id.* ¶ 4.02[3][b], at 4-14 (footnotes omitted). Another treatise offers a similar list that includes, among others the following factors that my effect the value of farm land:

> 1. Configuration of the property: the shape of the tract may affect its earning capability in many ways, *e.g.*, efficient use of machinery and adaptability to irrigation;
> 2. Isolated tract or operating unit: the balance and potential efficiency for property as an operating unit:
>
> . . .
>
> 11. Fractional interest: whether the interest to be valued is the entire fee, fraction or a remainder, and whether family members own the fraction.

KELLEY ET AL., *supra* note 48, § 14:7, at 14-11 to 14-12.

148. *See* Koren, *supra* note 142, at 106.

149. *See* MADOFF ET AL., *supra* note 55, § 8.04[D], at 261.

Business interests include such property as shares in a corporation or limited partnership interests in a limited partnership. Thus, the gift tax regulations provide: "In general, if there is a market for stocks and bonds, on stock exchange, in an over-the-counter market or otherwise, the mean between the highest and lowest quoted priced on the date of the gift is the fair market value per share on bond."[150]

Interests in closely held businesses, however, are not traded on an established market. In those cases the process of determining the fair market value of the interests in similar to the process of determining the fair market value of real property. The remainder of this section of the article will discuss *in a general way* the valuation of interests in closely held businesses. Following the discussion of the valuation of closely held businesses, the article will discuss special valuation rules that apply to interests in closely held *family* businesses.

The gift and estate tax regulations expressly address the valuation of business interests whose valuation is not readily ascertainable by reference to a public market. The regulations identify several factors to be considered in such cases. In the case of corporate stock, these factors include "the company's net worth, prospective earning power and dividend paying capacity, and other relevant factors."[151] In the case of interests in other types of business:

> The fair market value of any interest an any business, whether a partnership or a proprietorship, is the net amount which a willing purchaser, whether an individual or a corporation, would pay for the interest to a willing seller, neither being under a compulsion to buy or sell and both having reasonable knowledge of the relevant facts. The net value is determined on the basis of all relevant factors including—
>
> (1) A fair appraisal as of the date of the gift of all the assets of the business, tangible and intangible including good will;
>
> (2) The demonstrated earning capacity of the business; and
>
> (3) The other factors set forth in [the] paragraph . . . relating to the valuation of corporate stock, to the extent applicable.[152]

The regulations further state that "special attention should be given" to the proper valuation of good will of the business and that complete documentation, including financial and other reports, should be submitted.[153]

"Other factors" for both corporations and other businesses include,

150. Treas. Reg. § 25.2512-2(b) (2003). For the parallel estate tax regulations, see Treas. Reg. § 20.2031-2(b)(1) (2003).

151. Treas. Reg. § 25.2512-2(f)(2) (2003) (gift tax); Treas. Reg. § 20.2031-2(f)(2) (2003) (estate tax).

152. Treas. Reg. § 25.2512-3(a) (2003). For the parallel regulatory language concerning estate tax valuation, see Treas. Reg. § 20.2031-3 (2003).

153. Treas. Reg. § 25.2512-3(a) (2003).

nonexclusively, "the company's position in the industry and its management; [and] the degree of control of the business represented by the block of stock to be valued."[154] The list of factors also includes, like in the valuation of real estate, the notion of comparable sales. Finally the regulations acknowledge that valuation and the weight afforded any single factor must be determined on a case-by-case basis.[155]

The Internal Revenue Service gave further administrative guidance for the valuation of closely held corporate stock in Revenue Ruling 59-60[156] and extended it to apply its valuation methodology to other types of interests in Revenue Ruling 68-609.[157] The Ruling explained the regulations. In addition, it addressed several factors not included in the regulations. As an additional factor, it added the "nature and history of the enterprise from its inception," explaining: "The history of a[n] . . . enterprise will show its past stability or instability, its growth or lack of growth, the diversity or lack of diversity of its operations, and other facts needed to form an opinion of the degree of risk involved in the business."[158] Moreover, it included a broad category of factors it called: "The book value of the stock and the financial condition of the business."[159] The description of this category included the necessity to examine the corporate documents, and to ascertain the explicit rights and privileges of the various classes and issues of stock including: (1) voting powers, (2) preferences as to dividends, and (3) preference as to assets in the event of liquidation."[160] Finally, the Revenue Ruling recognized that valuation, "is, in essence, a prophesy as to the future" made on the best available factual evidence at the time of valuation;[161] and, as to process and method echoed the regulations: "Because valuations cannot be made on the basis of prescribed formula, there is no means whereby the various applicable factors in a particular case can be assigned mathematical weights in deriving the fair market value."[162]

---

154. Treas. Reg. § 25.2512-2(f)(2) (2003) (gift tax); Treas. Reg. § 20.2031-2(f)(2) (2003) (estate tax).

155. Treas. Reg. § 25.2512-2(f)(2) (2003) (gift tax); Treas. Reg. § 20.2031-2(f)(2) (2003) (estate tax).

156. Rev. Rul. 59-60, 1959-1 C.B. 237, *as modified by* Rev. Rul. 65-193, 1965-2 C.B. 370; Rev. Rul. 68-609, 1968-2 C.B. 327; Rev. Rul. 77-287, 1977-2 C.B. 319; Rev. Rul. 1980-2 C.B. 101; Rev. Rul, 83-120, 1983-2 C.B. 170. For a discussion of Rev. Rul. 59-60, see Koren, note 142 above, at 110-13, and Madoff et al., note 55 supra, § 11.03[B], at 439-41.

157. Rev. Rul. 68-609, 1968-2 C.B. 327. This ruling stated:

> The general approach, methods, and factors outlined in Revenue Ruling 59-60 . . . as modified, are equally applicable to valuation of corporate stocks for income and other transfer tax purposes as well as for estate and gift tax purposes. *They apply also to problems involving the determination of the fair market value of business interests of any type, including partnerships and proprietorships, and of intangible assets for all tax purposes.*

Id. at 328 (emphasis added).

158. Rev. Rul. 59-60, 1959-1 C.B. 237.

159. *Id.* at 238.

160. *Id.* at 240.

161. *Id.* at 238.

162. Rev. Rul. 59-60, 1959-1 C.B. 237, 243. The section in the Revenue Ruling containing the quoted

The Revenue Ruling and the Regulations speak in terms of factors. Those factors hint at a methodology without specifying it. A recent continuing legal education seminar by a business appraiser, however, outlines the methodological taxonomy for determining value.[163] He listed three basic valuation approaches for determining the value of business interests. They are: (1) Income (or Earnings) Approach; (2) Market Approach; and (3) Asset Value Approach.[164] Each of these valuation approaches are categorical and include several specific methodologies.[165]

---

language in the text reads in its entirety:

> Sec. 7. Average of Factors.
>
> Because valuations cannot be made on the basis of a prescribed formula, there is no means whereby the various applicable factors in a particular case can be assigned mathematical weights in deriving the fair market value. For this reason, no useful purpose is served by taking an average of several factors (for example, book value, capitalized earnings and capitalized dividends) and basing the valuation on the result. Such a process excludes active consideration of other pertinent factors, and the end result cannot be supported by a realistic application of the significant facts in the case except by mere chance.

Id. Another general source addresses the *averaging* of different methods for *general* purposes as follows:

> If the numbers vary widely, the general rule should be that the most reliable estimate in the eyes of the person doing the study should be adopted. However, it is always tempting to take an average of the values, and view that average as the best estimate of value. This is a somewhat muddled approach because the averaging process involves combining discrete numbers—apples and oranges, as it were. The decision to take the arithmetic mean of book value, liquidation value, and value based on capitalized earnings estimates, for example, has little theoretical justification since each is based on an inconsistent assumption of what will happen to the business.

ROBERT W. HAMILTON, BUSINESS ORGANIZATIONS: UNINCORPORATED BUSINESSES AND CLOSELY HELD CORPORATIONS § 14.15, at 419 (1996).

163. William A. Lockwood, *Valuation of Closely Held Business Interests*, 2 14TH ANN. EST. PLAN. SYMP., A.B.A. SEC. OF REAL PROP. PROB. & TR. L. 135 (2003); *see, e.g.*, MADOFF ET AL., *supra* note 55, § 11.03[C]-[D], at 442-52.

164. Lockwood, *supra* note 163, at 138.

165. The *income (or earning) approach* categorizes four basic methodologies: (1) Capitalization of Earnings or Cash Flow (typically based on historical earnings); (2) Discounted Cash Flow or Future Earnings ("[r]elies on expected future earnings/cash flow, which are then discounted back to the present at an appropriate discount rate"); (3) Capitalization of Excess Earnings (see Rev. Rul. 68-609, 1968-2 C.B. 327); and (4) Capitalization of Dividends. Lockwood, *supra* note 163, at 138-39.

The *market approach* may look to sales of comparable enterprises or to such things as historical sales transactions, buy-sell agreement price or outside bids considering the "subject company" itself. *Id.* at 140.

The *asset value approach* "considers a company's underlying net asset value as representative of fair market value." *Id.* at 140-41. One of the issues (and controversies in this area is whether the value of the underlying assets should be reduced for "built in capital gains taxes that would be due if the business assets were liquidated. *Id. See generally* Eisenberg v. Comm'r, 155 F.3d 50 (2d Cir. 1998).

A recent article in *Intellectual Property Today* addressed the topic of business valuation. Specifically addressing the asset based approach it states:

> In some business valuation circles, the Asset-Based Approach to Business Valuation is often omitted. Reasons for this are as follows:
>
> The Approach may require the use of a real estate or equipment valuation, which is often unavailable. Also, the development of real estate and equipment valuations is generally considered not to be within the purview of business appraisers.
>
> The Approach often requires the valuation of intangible assets. However, professional appraisal groups do not have valuation standards specifically targeting the valuation of intellectual property or other intangible assets, even though the appraisal of such assets is within the purview of business

Adjustments are made to the value as determined by applying the three basic approaches to determine the preliminary fair market value of the particular interest being appraised.[166] Adjustments that increase the value are "premiums."[167] Adjustments that decrease the value are "discounts."[168]

Secondary resources list typical adjustments and these lists often include control premiums (and more controversially, but relatedly, swing-vote premiums), minority discounts (for lack of control), lack of marketability discounts, and blockage discounts.[169] The adjustments represented by the terms are, for present purposes at least, largely self-explanatory. Most of them, too, will be revisited and further described later in Section II.C of this article. Control premiums and blockage discounts, however, will be briefly described here, as will another valuation factor, effect of the loss of a key person.

The "control premium is the inverse of the minority discount."[170] The Tax Court explained control premium in a closely held corporation context as follows: "[C]ontrol means that, because of the interest owned, the shareholder can unilaterally direct corporate action, select management, decide the amount of distribution, rearrange the corporation's capital structure, and decide whether to liquidate, merge, or sell assets."[171] In other cases where the court has determined a control premium is appropriate, for example, it has applied a control premium of fifteen percent,[172] twenty percent,[173] and thirty-eight percent.[174] Nonetheless, the control premium is but one adjustment and its effect on valuation may be offset by other adjustments in the same case evidencing the additive nature of the adjustments.[175]

The *blockage discount* is not concerned with control; but, rather that the market for the stock (or other ownership interest) is too thin to absorb a large

---

appraisal, *The current lack of such standards creates an additional risk in the valuation of such assets.* This gives some appraisers pause because of the additional risk involved.

Because the Approach often requires a team of appraisers representing different appraisal disciplines (real estate, equipment and business appraiser), it is often more costly to apply than alternative business valuation approaches—*e.g.*, Market or Income Approaches.

For such reasons, and unless there is an over-riding benefit to its use, business appraisers will tend to reject an Asset-Based Approach to Business Valuation.

Tim Crowley, *Business Valuation and Intellectual Property*, INTELL. PROP. TODAY 8 (June 2003).

166. Lockwood, *supra* note 163, at 141.

167. Lockwood, *supra* note 163, at 141.

168. Lockwood, *supra* note 163, at 141.

169. *See, e.g.*, Lockwood, *supra* note 163, at 141-47; MADOFF ET AL., *supra* note 55, § 11.03[C]-[D], at 445-52; STEPHENS ET AL., *supra* note 94, at A 4.02[3][f], at 4-24 to 4-27; BORIS I. BITTKER ET AL., FEDERAL ESTATE AND GIFT TAXATION 671-75 (8th ed. 2000).

170. MADOFF ET AL., *supra* note 55, § 11.03[D], at 449.

171. Estate of Newhouse v. Comm'r, 94 T.C. 193, 251-2 (1990).

172. Estate of Feldmar v. Comm'r, 56 T.C.M. (CCH) 118, 130 (1988) (corporation).

173. Estate of Oman v. Comm'r, 53 T.C.M. (CCH) 52, 69 (1987) (corporation).

174. Estate of Salsbury v. Comm'r, 34 T.C.M. (CCH) 1441, 1451 (1975) (corporation).

175. *See Estate of Feldmar*, 56 T.C.M. (CCH) 118 (corporation).

black of stock "if it were to come onto the market at one time."[176] The Regulations strongly *imply* the blockage discount simply reflects the economic law of supply and demand. Stated in terms of the gift tax, the Regulations, in relevant part, state: "If . . . the block of stock . . . is so large . . . that it could not be liquidated in a reasonable time without depressing the market, the price . . . outside the usual market . . . may be a more accurate indication of value than market quotations."[177] It seems that the blockage discount would apply only rarely in the closely held business scenario.

The *key person discount* is "[p]robably the most obscure discount."[178] Another commenter explained the rationale of this discount in the context of a family business: "In many family owned businesses, the value of the business depends largely upon the knowledge, skills, and personal contacts of one key employee. When that person dies [or retires], the value of the business may decline substantially. . . ."[179] The IRS expressly recognized the theory of this discount in Revenue Ruling 59-60.[180] The Tax Court rejected the application of key person discount under the facts in *Estate of Oman*[181] but it allowed a ten percent key discount in both *Estate of Mitchell*[182] and *Estate of Furman.*[183] In the *Estate of Feldmar,* the Tax Court determined the death of the key person in the case would cause a thirty-five percent discount in value, but reduced the discount to twenty-four percent because of the possibility that a replacement key person might be found by the business.[184]

The key person discount illustrates a twist of sorts, concerning the timing of valuation under the estate tax, and it introduces a general difference in valuation between the estate and gift taxes. *First*, the key person discount is a *post*-death adjustment and at the very least illustrates that death itself might affect valuation.[185] It raises the possibility that other post-death adjustments are appropriate. *Second*, it draws attention to the fundamental nature of the estate tax and, thereby, implies a theoretical distinction with the gift tax. This theoretical distinction may manifest itself in a divergence in value for purposes

176. MADOFF ET AL., *supra* note 55, § 11.03[D][6], at 452.

177. Treas. Reg. § 25.2512-2(e) (2003) (gift tax); *see* Treas. Reg. § 20.2031-2(e) (2003) (estate tax).

178. Thornton, *supra* note 9, at 262.

179. MADOFF ET AL., *supra* note 55, § 11.03[D][5], at 451.

180. *See supra* note 157 and accompanying text.

181. Estate of Oman v. Comm'r, 53 T.C.M. (CCH) 52, 69 (1987).

182. Estate of Mitchell v. Comm'r, 74 T.C.M. (CCH) 872 (1997).

183. Estate of Furman v. Comm'r, 75 T.C.M. (CCH) 2206 (1998).

184. Estate of Feldmar v. Comm'r, 56 T.C.M. (CCH) 118, 130 (1988).

185. *See* Rev. Rul. 59-60, 1959-1 C.B. 237. For example, in *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981), the Federal Court of Appeals for the Ninth Circuit stated:

> It is undisputed that the valuation must take into account changes brought about by the death of the testator. Ordinarily death itself does not alter the value of property owned by the decedent. However, in a few instances such as when a small business loses the services of valuable partner, death does change the value of property.

Ahmanson, 674 F.2d at 768 (internal citation omitted).

of the two primary federal wealth transfer taxes.

Both the gift tax and the estate tax are excise taxes. What that means is the taxes are levied on the *transfer* of property,[186] and therefore, they differ from the income tax, which is a direct tax.[187] The focus of the estate tax is the value of property transferred *from* the decedent in part because, "[u]nder [I.R.C.] § 2001, the estate tax is imposed on the 'transfer' of the 'taxable estate' of the decedent and under § 2031, the value of the gross estate is determined by including the value at the time of death, of all the decedent's property."[188] The focus of the gift tax, however, is the value of what is transferred *to* the donee; that is, the property received. This, too, is consistent with the statute. For example: "Section 2512(b) provides, where property is transferred for less than full consideration in money or money's worth, *the amount by which the value of the property exceeds the value of the consideration is deemed a gift.*"[189]

This theoretical distinction between the gift and estate tax is important because it may help explain how the value of a business for estate and gift tax valuation might simply vanish through a sort of definitional arbitrage when a gift program pursuant to an estate plan is started. Before amplifying this distinction between the gift and estate tax,[190] it is necessary to describe special valuation rules which markedly alter the general valuation principles just discussed.

b. Special Valuation Rules for Certain Family Businesses & Transfers

Sections 2701-2704 of the Internal Review Code were added in 1990 to replace "old" section 2036(c).[191] The purpose of the old (and repealed) section 2036(c) was to prevent abusive techniques used to freeze the estate value for purposes of the estate tax.[192] The four new sections replacing prior section 2036(c) form a new Chapter 14 and "[t]he fundamental premise of the Chapter 14 provisions is that valuation should not be determined by artificial conditions imposed by family members."[193] Nonetheless, Chapter 14 is limited in both purpose and scope and it limits, as opposed to replaces, the general valuation

186. *See supra* notes 34-70 and accompanying text (estate tax); *supra* notes 70-87 and accompanying text (gift tax).

187. For an excellent (and brief) discussion of this distinction and its constitutional significance, see S. Stacy Eastland, *The Art of Making Uncle Sam Your Assignee Instead of Your Senior Partner: The Use of Partnerships in Estate Planning, Planning Techniques For Large Estates*, A.L.I.-A.B.A. COURSE OF STUDY 901, 919 (Apr. 2002).

188. Tec. Adv. Memo. 94-49-001 (Dec. 9. 1994).

189. *Id.* (emphasis added).

190. *See infra* notes 344-70 and accompanying text.

191. Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388-1 (1990) (reprinted in 1991 C.B. 481).

192. For a brief discussion of "freeze," see note 132 and accompanying text, above.

193. Thornton, *supra* note 9, at 225.

principles discussed in the precious part of this article.[194] Perhaps because of its specific purpose, the four sections comprising Chapter 14 are long, detailed, and technical. They add new concepts and new nomenclature.[195]

It is imperative to understand the concepts contained in Chapter 14 because they directly effect whether state organization law, like ULPA (2001), will be useful for family estate planning. The Senate Report clearly indicates Chapter 14 contemplates valuation methodology in specific circumstances and thereby limits the use of certain partnership techniques designed to maximize a new discounting in the family estate planning context. It does so, in part, by way of negative implication. For example, it states: "the bill *does not affect the valuation* of a gift of a partnership interest *if all interests and the partnership share equally* in all items of income, deduction, loss and gain in the same proportion."[196] A precatory caveat, however, must be emphasized: The discussion that follows merely describes the basic concepts contained in Chapter 14. Other sources are available and should be consulted for technical understanding of these rules and their multi-faceted and sometime unexpected application in the planning process.[197]

Each of the four sections of Chapter 14, generally, "operate independently," and each addresses a different rather broad technique.[198] The structure and application of each of the sections follows relatively well rehearsed tax drafting framework again, as a general matter, starting with definitions and, then, "provid[ing] . . . assumptions that adversely affect the taxpayer, unless the transaction fits within a well-crafted exception."[199]

Section 2701 is captioned "Special Valuation Rules in Case of Transfers of Certain Interests in Corporations or Partnerships." The central purpose of this section is to disallow discounted valuation for gift tax purposes for interests in closely held family entities used, typically, to freeze the value of an interest. The result of the operation of this section is to increase the value of some defined gifts, thereby, in many cases, increasing the amount of the taxable gift

194. Thornton, *supra* note 9, at 225.

195. As a leading treatise states:

> Unfortunately, the definitions under Chapter 14 allow flexibility in covering many variations in estate breeze techniques. While attempting to avoid the overbreadth of Section 2036(c), the definitions still result in considerable complexity and often counter-intuitive tax consequences. As such, Chapter 14 represents its own self-contained mechanism in the sense that it comes with its own terms of art and approach.

STEPHENS ET AL., *supra* note 94, ¶ 19.01[2], at 19-6.

196. Informal Senate Report on S. 3209, the Omnibus Reconciliation Act of 1990, 136 Cong. Rec. S. 15679, S. 15683 (daily ed. Oct. 1990) (emphasis added).

197. *See, e.g.*, HOWARD ZARITSKY & RONALD ALLCUT, STRUCTURING ESTATE FREEZES: ANALYSIS WITH FORMS, SECOND EDITION (2002) (looseleaf); LOUIS A. MEZZULLO, VALUATION RULES UNDER CHAPTER 14: THE IMPACT ON GIFT AND ESTATE TAXATION (1995); STEPHENS ET AL., *supra* note 94, at 19-4 to 19-150.

198. STEPHENS ET AL., *supra* note 94, ¶ 19.01[1], at 19-5.

199. STEPHENS ET AL., *supra* note 94, ¶ 19.04[4], at 19-7.

above the claimed annual gift tax exclusion.[200] It achieves this result by valuing certain interests retained by the grantor at zero[201] and using a "subtraction method" in determining the value of the property given.[202] Obviously, this modifies the general valuation rule for gift tax purposes which values the property *received* by the gift recipient donee and any discounts that would apply to the received interest.

The interests to be valued at zero under section 2701 are preferential rights retained by the grantor/transferor in a transfer to a member of the transferor's family.[203] Preferential rights subject to the valuation rules include extraordinary payment rights[204] and retained interest rights.[205]

An *extraordinary payment right*, according to the regulations, includes "any put, call, or conversion right, any right to compel liquidation, or any other similar right, the exercise or nonexercise of which affects the value of the transferred interest."[206] A *call right*, in turn, "includes any warrant, option, or other right to acquire one or more equity interests."[207] A *distribution right* "is the right to receive distributions with respect to an equity interest"[208] *unless* the distribution right is a *qualified payment right*.[209] Qualified payment rights, very generally, are nondiscretionary payments, for example, guaranteed payments from a partnership under section 707(c) (a partnership income tax section).[210]

As even the previous conceptual description illustrates, it is easy to lose the forest for the trees when working with section 2701. Its fundamental concept, however, is simply to disregard discounts in the case of transfers between family members in closely held family entities where the transferor retains preferential payment right defined as either extraordinary payment rights or distribution rights.

Section 2702 is captioned "Special Valuation Rules in Case of Transfers of Interests in Trusts."[211] The regulations describe the scope and purpose of this

---

200. *See supra* notes 71-87 and accompanying text (discussing the annual gift tax exclusion).

201. *See* Treas. Reg. § 25.2701-1(a)(2)(ii) (2003).

202. Treas. Reg. § 25.2701-1(a)(2) (2003).

203. There are two separate definitions relating to family used for different purposes of section 2701. The first is the broadest; thus, *member of the family* means the transferor's spouse, any lineal descendant of the transferor or the transferor's spouse and the spouse of any such lineal descendant. Treas. Reg § 25.2701-2(a)(1)(d)(1) (2003).

The related definition (no pun intended) is for *applicable family member*. It includes the transferor's spouse, any ancestor of the transferor or transferor's spouse, and the spouse of any such ancestor. Treas. Reg. § 25.2701-2(a)(1)(d)(2) (2003).

204. Treas. Reg. § 25.2701-2(b)(2) (2003).

205. Treas. Reg. § 25.2701-2(b)(3) (2003).

206. Treas. Reg. § 25.2701-2(b)(2) (2003).

207. *Id.*

208. Treas. Reg. § 25.2701-2(b)(3) (2003).

209. Treas. Reg. § 25.2701-2(b)(6) (2003).

210. *See* Treas. Reg. § 25.2701-2(b)(5)(iii) (2003).

211. I.R.C. § 2702 (2003).

section as follows: "Section 2702 provides special rules to determine the amount of the gift when an individual makes a transfer in trust to (or for the benefit of) a member of the individual's family and the individual or an applicable family member retains an interest in the trust."[212] Thus, it has no *direct* application to closely held family businesses. It may, however, apply when the estate plan calls for multiple ownership entities, which include trusts.

Even though estate and gift tax planning through the use of trusts is beyond the scope and purpose of the article, it is, perhaps, instructive to mention section 2702 may apply where, for example, "the older family members intend to use interests in a family limited partnership or LLC to fund a grantor retained annuity trust (GRAT)."[213] The quote is instructive, if for no other reason, to acknowledge that an entire area of estate and gift tax planning is largely ignored as outside the scope of this article. Section 2703, unlike section 2702, however, has direct application in the family business planning context.

Section 2703 is captioned "Certain Rights and Restrictions Disregarded."[214] It is probably the least opaque of the four sections in Chapter 14 because, in part, it is the shortest section in the Chapter. Its operation is straightforward. Parroting the statutory language, first, it simply disregards the valuation discount attributable to any restriction on the sale or use of property[215] unless the restriction meets all three of the following requirements: "(1) It as a bonafide businesses arrangement";[216] (2) the terms of the restriction are similar to comparative restrictions "entered into by persons in an arms length transaction";[217] and (3) "It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration."[218] *Second*, the section applies the same rules to "any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right)."[219] Unlike section 2701, which applies only to the gift tax,[220] section 2703 applies for purposes of the gift, estate, and GST tax.[221]

The purpose, too, for section 2703 is readily ascertainable from its terms. A leading treatise plainly states the danger to the public fisc if taxpayers could establish the value of property for wealth transfer taxes by agreement between family members:

---

212. Treas. Reg. § 25.2702-1 (2003).

213. LOUIS A. MEZZULLO, AN ESTATE PLANNER'S GUIDE TO FAMILY BUSINESS ENTITIES: FAMILY LIMITED PARTNERSHIPS, LIMITED LIABILITY COMPANIES, AND MORE 77 (1998).

214. I.R.C. § 2703 (2003).

215. I.R.C. § 2703(a)(2) (2003).

216. I.R.C. § 2703(b)(1) (2003).

217. I.R.C. § 2703(b)(3) (2003).

218. I.R.C. § 2703(b)(2) (2003).

219. I.R.C. § 2703(a)(1) (2003).

220. *Id.*

221. I.R.C. § 2703(a) (2003); Treas. Reg. § 25.2703-1(a) (2003).

> It would be a bonanza for a taxpayer or a taxpayer's estate if the taxpayer could enter into an agreement with a family member to sell property inter vivos or at a taxpayers death for a price equal to a small portion of the property's fair market value and to have that sales price establish valuation for transfer tax purposes, permitting such agreements to establish valuation could lead to an annihilation of the entire federal transfer tax system.[222]

On the other hand, families do own and operate businesses and it would seem that they should be entered into bona fide business arrangements just as do their nonrelated counterparts.[223]

The valuation conundrum addressed by section 2703 is not new, and there is case law, for example, on the effect of buy-sells that predate section 2703 decided under the general valuation principles outside Chapter 14.[224] On the other hand, the Service has used section 2703 literally in the context of family estate planning in new ways.[225]

Section 2704 is the last section in Chapter 14. It is captioned "Treatment of Certain Lapsing Rights and Restrictions."[226] Section 2704 contains two subsections, each of which focus on different issues. Section 2704(a) addresses "lapsing" voting or liquidation rights.[227] Section 2704(b) addresses restrictions on liquidation rights that are more limiting than the state law governing the entity.[228] Both subsections, however, deal with the broad issue of control.[229]

The key to understanding Section 2704(a) is to understand the term "lapse." According to the Regulations: "A lapse of a *voting right* occurs at the time a presently exercisable voting right is *restricted or eliminated*."[230] Similarly:

> A lapse of a liquidation right occurs at the time a presently exercisable liquidation right is restricted or eliminated. Except as otherwise provided, a transfer of an interest that results in the lapse of a liquidation right is not subject to this section if the rights with respect to the transferred interest are not restricted or eliminated.[231]

The following example helps clarify the emphasis on "restricted or eliminated":

> D owns 84 percent of the single outstanding class of stock of Corporation Y. The by-laws require at least 70 percent of the vote to liquidate Y. D gives one-

222. STEPHENS ET AL., *supra* note 94, ¶ 19.04[1][a], at 19-126 to 19-127.

223. STEPHENS ET AL., *supra* note 94, ¶ 19.04[1][a], at 19-126 to 19-127.

224. *See* STEPHENS ET AL., *supra* note 94, ¶ 19.04[1][a], at 19-126 to 19-127; St. Louis County Bank v. United States, 674 F.2d 1207 (8th Cir. 1982).

225. *See infra* notes 301-499 and accompanying text (discussing *Estate of Strangi*); STEPHENS ET AL., *supra* note 94, ¶ 19.04[2], at S19-16.

226. I.R.C. § 2704 (2003).

227. I.R.C. § 2704(a) (2003).

228. I.R.C. § 2704(b) (2003).

229. MADOFF ET AL., *supra* note 55, § 11.03[D][8][a], at 453.

230. Treas. Reg. § 25.2704-1(b) (2003) (emphasis added).

231. Treas. Reg. § 25.2704-1(c) (2003).

> half of D's stock in equal share to D's three children (14 percent each). Section 2704(a) does not apply to the loss of D's ability to liquidate Y, because the voting rights with respect to the corporation are not restricted or eliminated by reason of the transfer.[232]

An example of when a lapse *does occur* also appears in the regulations. The example assumes each family member owned both general and limited partnership interests in a single limited partnership controlled by the family. State law provides that all general partners have management rights (voting rights). The partnership agreement further provided that each general partner has the right to liquidate the partnership. Upon the death of a general partner, the agreement provided that the general partnership interest would be redeemed, but the limited partnership interests would not be redeemed. The regulations conclude:

> Because of a general partner's right to dissolve the partnership, a limited partnership interest has a greater fair market value when held in conjunction with a general partnership interest than when held alone. Section 2704(a) applies to the lapse of . . . [decedent's] liquidation right. . . . [Decedent's] gross estate includes an amount equal to the excess of the value of all D's interests in . . . [the limited partnership] immediately before [her] in death (determined immediately after . . . [her] death but as though the liquidation right had not lapsed and would not lapse) over the fair market value of all . . . [decedent's] interests in . . . [the limited partnership] immediately after . . . [decedent's] death.[233]

Thus, the valuation mechanism in section 2704(a) is somewhat reminiscent of that in section 2701.[234] The *source* of the *right* and its lapse may be: "State law, the corporate charter or bylaws, an agreement, or other means."[235] An example of the need perceived by the enactment of section 2704(a) is the *Estate of Harrison*, which predated Chapter 14.[236] In the *Estate of Harrison,* decedent (through a power of attorney) established a limited partnership to which he contributed real property. The decedent was the general partner, and

> [u]nder the partnership agreement, the general partners had absolute control over the management of the partnership. Each general partner also had the right during life to dissolve the partnership, but neither a limited partner nor a successor to the general partner had such a right. The partnership agreement provided that the partnership was to be automatically dissolved upon the death of a general partner, or upon an election to dissolve by a living general partner,

232. Treas. Reg. § 25.2704-1(f) Ex. 4 (2003).

233. Treas. Reg. § 25.2704-1(f) Ex. 5 (2003).

234. *See supra* notes 201-10 and accompanying text.

235. Treas. Reg. § 25.2704-1(a)(4) (2003).

236. KELLEY ET AL., *supra* note 48, § 13:53, at 13-121 to 13-125 (discussing Estate of Harrison v. Comm'r, 52 T.C.M. (CCH) 1306 (1987)). According to the treatise, the Conference Committee Report expressly cited *Estate of Harrison*, and stated "[t]hese rules are intended to prevent [similar results]." *Id.* § 13.54, at 13-123 (quoting H.R. Rep. No. 101-964, 101st Cong., 2d. Sess.).

unless within 90 days of such death, or such election, all of the other general partners agreed to continue the partnership.[237]

The Service and the estate stipulated the value of the general partnership interest was $757,116. The estate valued decedent's limited partnership interest at $33,000,000. The government argued the limited partnership interest was worth $59,555,020 based on its value had the partnership been dissolved; or, had the partnership interests themselves been sold immediately *before* decedent's death: "The difference between the two values is attributable entirely to the right which decedent had as a general partner up until his death to force a dissolution of the partnership."[238] The dissolution right lapsed on his death because the successor general partner did not have such a right. The Tax Court held the lower $33,000,000 value was appropriate. It stated: "[I]t is apparent that the property transferred at the moment of decedent's death was the limited partnership interest which passed to decedent's estate, which did not include the right to dissolve the partnership."[239]

Moreover, the Tax Court rebuffed the Service's argument that the limited partnership should be ignored stating: "Such an agreement will be ignored only if there is no business purpose for the creation of the partnership or if the agreement is merely a substitute for a testamentary disposition."[240] Thus, the Tax Court, without the aid of section 2704(a), excluded the value of the lapse, which was worth approximately $27,000,000 in the factual context of a limited partnership established under a power of attorney on behalf of decedent.

Section 2704(b), on the other hand, is designed to stop a different technique and, conceptually, it is an expansion of the idea contained in section 2703.[241] Technically, section 2704(b) "disregards" any "applicable restriction" for purposes of valuation of family controlled entities.[242]

"Applicable restriction" is defined to mean any restriction on liquidation rights.[243] There are two exceptions. The first is for "commercially reasonable" restrictions imposed by third parties.[244] The second, more important for purposes of this article, states an exception for "any restriction imposed, or required to be imposed, by any Federal or State law."[245]

In summary, Chapter 14 operates to disregard the value of certain interests for transfers between family members in family controlled businesses. Section 2701 applies to transfers of certain senior rights where the transferee retains

237. *Estate of Harrison*, 52 T.C.M. (CCH) at 1306.
238. *Id.*
239. *Id.*
240. *Estate of Harrison*, 52 T.C.M. (CCH) at 1306 (citation omitted).
241. *See supra* notes 214-25 and accompanying text.
242. I.R.C. § 2704(b) (2003).
243. I.R.C. § 2704(b)(2) (2003).
244. I.R.C. § 2704(b)(3) (2003).
245. I.R.C. § 2704(b)(3)(B) (2003).

subordinated rights;[246] section 2702 applies to transfers in trust;[247] section 2703 applies to transfers of property where the property is burdened by buy-sell or option agreements;[248] and section 2704 applies to the lapse of rights *and* restrictions on property greater than those required by law.[249] These special valuation rules are exceptions to the general valuation rules for gift, estates, and GST tax valuation. The next wealth transfer tax pressure point concerns the quantum, and more importantly the kind, of control that, if retained, will cause the value of the controlled property to be included in the estate of the decedent.

2. *Retention and Control*

> All of the gift tax advantages of making a gift can be lost if the donor retains certain powers over the transferred property or an interest in the property as a result of the *string provisions* contained in IRC Sections 2035 to 2038. Generally, the string provisions will have the effect of including transferred property in the taxable estate of a donor . . . .[250]

Section 2035 is captioned "Adjustments for Certain Gifts Made Within 3 Years of Decedent's Death";[251] section 2036 is captioned "Transfers With Retained Life Estate";[252] section 2037 is captioned "Transfers Taking Effect at Death";[253] and section 2038 is captioned "Revocable Transfers."[254] Additionally, section 2041,[255] captioned "Powers of Appointment" also operates to include value of property in the estate even though it is not *owned* under traditional notions of that term. Each of these sections will be briefly introduced, in turn, except section 2036, which will be discussed as a bridge to the analysis of the *Estate of Strangi* case in the next section.[256]

---

246. The following is an example from the Regulations:

> *Example 1.* D owns a 76 percent interest and each of D's children, A and B, owns a 12 percent interest in General Partnership X. The partnership agreement requires the consent of all the partners to liquidate the partnership. Under the State law that would apply in the absence of the restriction in the partnership agreement, the consent of partners owning 70 percent of the total partnership interests would be required to liquidate X. On D's death, D's partnership interests passes to D's child, C. The requirement that all the partners consent to liquidation is an applicable restriction. Because A, B, and C (all members of D's family), acting together after the transfer, can remove the restriction on liquidation, D's interest is valued without regard to the restriction; *i.e.*, as though D's interest is sufficient to liquidate the partnership.

Treas. Reg. § 25.2704-2(d) (2003).

247. *See supra* notes 211-13 and accompanying text.

248. *See supra* notes 214-25 and accompanying text.

249. *See supra* notes 226-45 and accompanying text.

250. MADOFF ET AL., *supra* note 55, § 8.06[C], at 271 (emphasis in original); *cf.* BITTKER ET AL., *supra* note 169, at 253-481.

251. I.R.C. § 2035 (2003).

252. I.R.C. § 2036 (2003).

253. I.R.C. § 2037 (2003).

254. I.R.C. § 2038 (2003).

255. I.R.C. § 2041 (2003).

256. *See infra* notes 270-301 and accompanying text.

Section 2035 has limited scope; that is, it applies to only two categories of gifts. The limited scope is a significant change from the law prior to 1982.[257] The two categories of gifts that will be included in the transferors estate if they are given within three years of death are life insurance that would have been includible but for the transfer, and gifts of property within three years of death that would have *otherwise* been included by the other three string sections (sections 2036, 2037, and 2038).[258] The latter represents a conceptual echo of lapses.

Section 2037 can be concisely described, though it is abstract and therefore somewhat difficult to grasp. Fundamentally: "Property transferred by the decedent is includible under § 2037 if it could be enjoyed by others only if they survive the decedent *and* the decedent retained a reversionary interest, the value of which immediately before the decedent's death exceeded five percent of the value of the property."[259] Acknowledging the brevity of life, an example from the Regulations, again, appears in a note.[260]

Section 2038 is captioned "Revocable Transfers."[261] The Regulations more fully describe the type of power as to the property transferred as including the retention by decedent of the power "to alter, revoke or terminate" the transfer.[262] It applies regardless of whether the decedent could have gotten the property back or whether the decedents exercise of the power was subject to a fiduciary duty. Indeed, the Regulations state that the retention of an "unrestricted power to remove or discharge a trustee at any time and appoint himself trustee" will cause the decedent/transferor to be deemed to hold the power to alter, amend, or revoke the trust.[263] Relatedly, even though not usually identified as a *string*, the decedent's estate also includes the value of

257. MADOFF ET AL., *supra* note 55, § 5.05[B][3][d], at 126.

258. I.R.C. § 2035 (a)(2) (2003). The inclusion of life insurance in the gross estate is governed by I.R.C. section 2042. For the proceeds of life insurance to be included in the gross estate the proceeds must either be "receivable by the executor" (I.R.C. § 2042(1)) or the decedent must have "possessed . . . incidents of ownership" (I.R.C. § 2042(2)). In turn, *incidents of ownership* include a reversionary interest that is valued as more than five percent of the value of the policy. I.R.C. § 2042(2) (2003). Other incidents of ownership include, e.g., the right to change the beneficiary, the right to surrender or cancel the policy, the right to use the policy as collateral for a loan, and the right to obtain a loan from the policy issuer on the policy. Treas. Reg. § 20.2042-1(c)(2) (2003).

259. PRICE, *supra* note 91, § 2.11, at 131.

260. The example from the Regulations:

> *Example (3).* The decedent transferred property in trust with the income payable to his wife for life and with the remainder payable to the decedent or, if he is not living at his wife's death, to his daughter or her estate. The daughter cannot obtain possession or enjoyment of the property without surviving decedent. Therefore, if decedents reversionary interest immediately before his death exceeded 5 percent of the value of the property, the value of the property, less the value of the wife's outstanding life estate, is includible in the decedent's gross estate.

Treas. Reg. § 20.2037-1(c)(3) Ex. 3 (2003).

261. I.R.C. § 2038 (2003).

262. Treas. Reg. § 20.2038-1(a) (2003).

263. Treas. Reg. § 20.2038-1(a)(3) (2003).

property over which she has a general power of appointment.

Powers of appointment are governed by section 2041 and include "any power of appointment exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate."[264] Moreover: "A power of appointment exercisable for the purpose of discharging a legal obligation of the decedent or for his pecuniary benefit is considered a power of appointment in favor of the decedent or his creditors."[265] The property over which the power may be exercised is includible in the gross estate of the power holder. There is an important exception, however, to the inclusion of property subject to powers of appointment by decedent. The exception is for those powers that are subject to an ascertainable standard. The classic ascertainable standard is for the beneficiaries' "health, education, support or maintenance."[266]

Probably the most important string provision for purposes of this article is contained in section 2036. It is a straightforward provision dealing with the retention of life estates. At bottom, it provides that the gross estate will include the value of all property transferred by a decedent during her life in which the decedent retained a life estate.[267] The statutory language, however, extends far beyond formal life estates by stating that the value of the estate includes any interest transferred "by trust or otherwise, under which he has retained . . . [a life estate]."[268] Thus, one effect of section 2036 is to close an opportunity created by section 2033, because under section 2033 the estate generally does not include interests, like life estates, that are terminated by death, even if the life estate were created by decedent herself.[269]

Further, *retained life estate* is defined to include: "(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" (emphasis added). According to the Regulations, the "capacity [under which] the power was exercisable," "is immaterial" for purposes of inclusion of[270] the statute itself, section 2036(b), which post-dates the issuance of the Regulations for section 2036, underscores the idea that *capacity* is a broad concept by expressly providing for purposes of determining whether the decedent had retained "the possession or enjoyment of, or the right to income from the property"[271] and further provides "[t]he retention of the right to vote (directly or indirectly) shares of stock of a controlled corporation shall be considered to be a retention

264. Treas. Reg. § 20.2041(c)(1) (2003).
265. *Id.*
266. *See generally* MADOFF ET AL., *supra* note 55, § 5.05[B][3][c], at 126.
267. *See* I.R.C. § 2036(a) (2003).
268. I.R.C. § 2036(a) (2003).
269. STEPHENS ET AL., *supra* note 94, ¶ 4.08, at 4-145 to 4-146.
270. Treas. Reg. 20.2036-1(b)(3) (2003).
271. I.R.C. § 2036(a)(1) (2003).

of the enjoyment of transferred property."[272] The United States Supreme Court opined on section 2036(a) in a 1972 case, *United States v. Byrum*.[273] The case predated the enactment of section 2036(b), so the issue therein was narrowly section 2036(a).

In 1958, Milliken C. Byrum (Byrum) established an irrevocable trust and transferred a portion of his stock in three closely held corporations to it. Before the transfer, he owned "at least" seventy-one percent of each corporation.[274] He died in 1964 owning fifty percent of the common stock in two of the corporations and fifty-nine percent of the common stock in the third corporation.[275] Those percentages of ownership, when combined with the shares owned by the trust, still represented a percentage ownership of "not less than 71% of the common stock of each of the three corporations."[276] Importantly: "There were minority shareholders unrelated to Byrum, in each corporation."[277]

Byrum, however, reserved specific rights in the shares transferred to the trust, and the Service sought to include the value of those shares in Byrum's estate predicated on these reserved rights under both subsections (1) and (2) of section 2036(a).[278] The Court delineated the retained rights as follows: "(i) [T]o vote the shares of . . . [the closely held stock]; (ii) to disapprove the sale or transfer of any trust assets, including the shares transferred to the trust; (iii) to approve investments and reinvestments; and (iv) to remove the trustee and 'designate another corporate Trustee to serve as successor.'"[279] Before the youngest beneficiary reached age twenty-one, the trustee had, in its sole discretion, subject to ascertainable standards, the power to distribute income and principal from the trust to the beneficiaries. Ultimately, when the youngest beneficiary reached age thirty-five, and after interim governance provisions specified by the trust instrument, the assets held in trust were to be distributed free of trust to the beneficiaries.[280]

The Service argued that the stock transferred to the trust should be included in Byrum's estate. As to section 2036(a)(2) it asserted that Byrum, through his retained voting power and his ability to substitute a different corporate trustee (both under the trust instrument) had "*de facto* 'control'"[281] to "designate the persons who shall possess or enjoy the property or the income therefrom."[282]

272. I.R.C. § 2036(b)(1) (2003).
273. United States v. Byrum, 408 U.S. 125 (1972).
274. *Id.* at 126.
275. *Id.* at 128.
276. *Id.* at 128-30.
277. *Byrum*, 408 U.S. at 130.
278. *Id.*
279. *Id.* at 127.
280. *Id.*
281. *Byrum*, 408 U.S. at 144.
282. I.R.C. § 2036(a)(2) (2003).

The main argument centered on Byrum's ability to elect directors and thereby mandate dividend policy in the corporations whose shares had been transferred in trust. Therefore, the argument concerned the retention of voting rights in the underlying stock of the corporation which Byrum transferred to the trust.[283]

The majority opinion, in which six justices joined, including Justice Rehnquist (the only of the justices still on the bench in 2003),[284] rebuffed the argument distinguishing control of the corporation and the requisite "right . . . to designate"[285] under the statute. The opinion stated:

> The term "right," certainly when used in a tax statute, must be given its normal and customary meaning. It connotes an ascertainable and legally enforceable power . . . . Here, the right ascribed to Byrum was the power to use his majority position and influence over the corporate directors to "regulate the flow of dividends" to the trust. That "right" was neither ascertainable nor legally enforceable and hence was not a right in any normal sense of the term.[286]

The Court listed several reasons why the voting control of the corporations did not equate to "the right" required by section 2036(a)(2). *First*, it emphasized the fiduciary duty under applicable state law owed to the corporation[287] and to the minority shareholders by the directors[288] *and* the majority shareholder (Byrum in this case).[289] *Second*, the Court reasoned that like other small businesses, Byrum's three corporations and, derivatively his ability to control the flow of dividends, was "subject to business and economic variables over which he had little or no control."[290] *Third*, even *if* Byrum could control the flow of dividends, "he had no way of compelling the trustee to pay it out rather than accumulate it."[291]

The dissent, on the other hand, questioned all of the majority's reasons, stating in part, "I do not deny the existence of such constraints, but their restraining effect on an otherwise tempting gross abuse of the corporate dividend power hardly guts the great power of a controlling director to accelerate or retard, enlarge or diminish, most dividends."[292] The dissent addressed the fiduciary duty constraint in the context of derivative litigation

283. *Byrum*, 408 U.S. at 132.

284. *See id.* at 126.

285. I.R.C. § 2036(a)(2) (2003).

286. *Byrum*, 408 U.S. at 136-37 (footnote omitted).

287. *Id.* at 138. Interestingly the Court stated: "It (the board of directors) must balance the expectation of stockholders to reasonable dividends when earned against the corporate needs for retention of earnings. *The first responsibility of the board is to safeguard corporate financial validity for the long term.*" *Id.* at 140 (emphasis added).

288. *Id.* at 138, 141-42.

289. *Id.* at 137, 142.

290. *Byrum*, 408 U.S. at 140.

291. *Id.* at 143.

292. *Id.* at 158 (White, J., joined by Brennan, J., and Blackmun, J., dissenting).

and the business judgment rule and concluded that it is difficult for the plaintiff to win those cases and the controlling shareholder may "circumvent" any real threat through "arrang[ing] his affairs."[293] For the dissent, therefore, voting control would suffice for purposes of section 2036(a)(2)'s "right."[294]

The Service also attacked the *Byrum* transfer on the basis of section 2036(a)(1)'s "possession or enjoyment of, or the right to income from, the property."[295] The majority refuted this argument by, *first*, suggesting there was scant support for it in lower court decisions.[296] And, *second*, by focusing on the statute which requires "the 'possession or enjoyment' of the '*property*' transferred . . . or the '*income*' therefrom."[297] The Court stated the property contemplated by the statute was the transferred stock, rather than the *enjoyment* of voting control. Moreover, Byrum had practical voting control through this direct ownership of at least fifty percent of the voting shares in each corporation free of trust. Therefore, the Court also reasoned Byrum never *transferred* control as part of the stock that was transferred.[298]

Obviously, *Byrum* was decided prior to the enactment of section 2036(b), which directly addresses voting as it relates to corporate stock. Nonetheless, the case illustrates the operation of section 2036(a), which is a weapon recently sharpened by the Service in the context of limited partnerships, and which is discussed in the next section of this article in that context. More generally, the *Byrum* case illustrates the broad type of factual scenarios to which all the string provisions apply, and illustrates some of the subtle retention of specific ownership rights that may cause the value of property to be included in the gross estate.[299] To the extent this portion of the article accomplishes even that modest task, it is a fitting end to the overview of the fundamental concepts of the federal wealth transfer tax system and two of its pressure points: (1) Valuation; and (2) Retention and Control.

---

293. *Id.* at 159.

294. The majority specifically noted the dissent's *control* argument:

> 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. . . . Neither the Government nor the dissent sheds light on the absence of an ascertainable standard. The Government speaks vaguely of drawing the line between "an unimportant minority interest" (whatever that may be) and "voting control." The dissenting opinion does not address this problem at all.

Byrum, 408 U.S. at 137 n.10 (citations omitted).

295. I.R.C. § 2036(a)(1) (2003).

296. *Byrum*, 408 U.S. at 147.

297. *Id.* at 148.

298. *Id.*

299. *See supra* notes 273-98 and accompanying text.

C. *An Avalanche of Tea Leaves: A Deeper Look at Wealth Transfer Taxes & Limited Partnerships*

1. *The New, New Thing: Estate of Strangi*

a. *Introduction to Strangi*

On May 20, 2003, the United States Tax Court (Tax Court)[300] issued an opinion in *Estate of Strangi v. Commissioner* (*Strangi II*) on partial remand from the United States Court of Appeals for the Fifth Circuit.[301] The case squarely revisited the application of section 2036(a) in the context of a family controlled limited partnership (family limited partnerships or FLPs).[302] Not only is it the Tax Court's latest pronouncement on the issue, but it also joins a list of recent cases finding that section 2036(a) requires inclusion of partnership interests in the gross estate of decedent.[303] Further, the Tax Court's application of section 2036(a) to include property in the gross estate is remarkable, in the

---

300. The United States Tax Court is a court of limited substantive jurisdiction governed by enabling legislation in the Internal Revenue Code. *See* I.R.C. §§ 7441-7479 (2003). For example, it does not have the power to grant equitable relief (including the authority to order a refund). LAURENCE F. CASEY, FED. TAX PRACTICE § 6.03 (2002). There is no jury in Tax Court. *Id.* § 6.02. On the other hand, it is the only judicial forum in which the taxpayer can contest IRS deficiency without first paying and suing for a refund. *Id.* §§ 6.01, 6.13. The Tax Court, however, does have national geographic jurisdiction and the court acts as a trial court where the judges travel to destinations outside their home and administrative offices in Washington, D.C. *Id.* § 6.05, at 6-11; § 6.06, at 6-12. It generally follows the precedence of the Court of Appeals where the appeal for a particular case lies. *Id.*

The Court was initially an independent agency in the executive branch of government called the Board of Tax Appeals but ultimately became an Article I Constitutional Court. *Id.* § 6.01-.02, There are nineteen judges on the Tax Court and the Chief Judge is authorized to appoint "Special Judges." *Id.* § 6.04.

The decisional process of the Tax Court is somewhat unique. The judge presiding over the trial writes an opinion that is referred to the Chief Judge. The Chief Judge has the discretion to refer the opinion to all the judges for review in conference. If the opinion is reviewed it is a decision "reviewed by the court." MARVIN JOSEPH GARVIS ET AL., FEDERAL TAX LITIGATION: CIVIL PRACTICE AND PROCEDURE § 2.02, at 2-5 (1991). If the opinion is not selected for review, the Chief Judge determines whether it will be officially published or if, instead, it will appear in memorandum form. If it appears in memorandum form, it is not officially published. LEANDRA LEDERMAN & STEPHEN W. MAZZA, TAX CONTROVERSIES: PRACTICE AND PROCEDURE § 16.02[a] (2d ed. 2002). However, there are several private services which publish memorandum decisions and they are available in most law school libraries or on-line.

Note that only officially published opinions, sometimes called regular opinions, "have unquestioned precedential value." *Id.* Also note that regular opinions are authored by the single presiding judge for the Court. Reviewed opinions, however, may have concurring and dissenting opinions because they are decided by a conference of all nineteen "regular" judges (special trial judges do not participate in conference). *Id.*

301. Estate of Strangi v. Comm'r, 85 T.C.M. (CCH) 1331 (2003) [hereinafter *Strangi II*], 293 F.3d 279 (5th Cir. 2002), *reh'g and reh'g en banc den.* 2002 WL 31017825 (5th Cir., Aug. 22, 2002); Estate of Strangi v. Comm'r, 115 T.C. 478 (2000) [hereinafter *Strangi I*].

302. *Strangi II*, 85 T.C.M. (CCH) 1331, at *3 (2003). For a post-*Strangi II* case holding that section 2036(a) did not apply, see *Stone v. Commissioner*, No. 15004-03S, 2004 WL 722664 (U.S. Tax Ct. Apr. 5, 2004).

303. *See, e.g.*, Estate of Thompson v. Comm'r, 84 T.C.M. (CCH) 374 (2002); Estate of Harper v. Comm'r, 83 T.C.M. (CCH) 1641 (2002); Estate of Schauerhamer v. Comm'r, 73 T.C.M. (CCH) 2855 (1997).

pathological sense; because, unlike other cases where it has reached the same result, the facts in *Estate of Strangi* were much cleaner. That is, "the participants involved in the . . . arrangement generally proceeded" so "the proverbial 'i's were dotted' and 't's were crossed.'"[304]

The case is significant for current purposes, too, because in the initial opinion (*Strangi I*), the Tax Court again rebuffed several of the Service's well-worn arguments.[305] Those other holdings were affirmed on appeal.[306] Thus, the case serves to examine the newest FLP decision under section 2036, identify other common attacks on FLPs by the government, and provide a narrative of the use of limited partnerships, which, if used aggressively, are designed to be at the edge of the transfer tax planning envelope. Finally, the case illustrates the factually intensive nature of estate planning. The next section of the article, following this examination of *Strangi*, will de-nature, reorganize, supplement, and summarize tax planning with limited partnerships and explore an even more recent case as the final stage setting before turning to ULPA (2001).

In *Strangi II*, the Tax Court determined Albert Strangi's gross estate included the value of property transferred to the Strangi Family Limited Partnership (SFLP), a Texas limited partnership, and to Stranco, its corporate general partner incorporated under Texas law, under section 2036(a)(1) because Albert (the decedent) retained "possession, enjoyment, or the right to income" in the transferred property.[307] In the alternative, the Court determined that the decedent's gross estate included the value of the transferred property by operation of section 2036(a)(2) because he retained "the right to designate the persons who shall possess or enjoy the property or its income."[308]

The amount of the inclusion in the case was limited, however, to the original amount the Service claimed as a deficiency because it "never asserted an increased deficiency in connection with the section 2036 issue."[309] The section 2036 issue was first raised by a motion to amend by the Service in *Strangi I*, denied by the Tax Court, but reversed and remanded by the Court of Appeals for further proceedings in *Strangi II*.[310] Nonetheless, the total value of the transferred property held by SFLP (the limited partnership) at decedent's death was $11,100,922.[311] Decedent's partnership interests, together with the corporate shares in Stranco, were valued by the estate at $6,823.582.[312] Thus,

304. *Strangi II*, 85 T.C.M. (CCH) 1331, at *10 (*quoting Strangi I*, 115 T.C. at 486).

305. *See infra* notes 332-55 and accompanying text.

306. *See infra* notes 332-55 and accompanying text.

307. *Strangi II*, 85 T.C.M. (CCH) 1331, at *4, *9, *12.

308. *Id.* at *12.

309. *Id.* at *19. Therefore, to some extent, the discussion of I.R.C. section 2036(a) was theoretical because it made little difference in the actual tax due.

310. Estate of Strangi v. Comm'r, 293 F.3d 279 (2002).

311. *Strangi II*, 85 T.C.M. (CCH) 1331, at *7.

312. *Id.*

according to taxpayer's valuation, there was a reduction of value of decedent's gross estate of $4,277,340, reflecting a decrease of 38.5 percent, because of the property transferred to the partnership.

The factual saga of Albert's estate tax litigation began in 1965 when Albert (decedent) and his first wife, Genevieve, divorced after more than twenty five years of marriage.[313] Albert then married Irene Seymour. In 1975, ten years after the divorce, he sold his company through a share exchange with another company.[314] The Court called Albert "a self-made millionaire."[315]

Albert had four children (two sons and two daughters) from his first marriage, and Irene had two daughters from a previous marriage.[316] In early 1987, Albert and Irene "executed wills that named the [four] Strangi children and the [two] Seymour daughters as residual beneficiaries in the event that either spouse predeceased the other."[317] Later that same year, and continuing into 1988, Irene suffered serious medical problems. During that time, Albert hired a housekeeper, Sylvia Stone, who also assisted caring for Irene. In mid-1988, Albert executed a power of attorney naming the spouse of one of his children his attorney in fact (Michael Gulig, who was also a lawyer). In 1990, Albert changed his will to leave his entire estate to his own children if Irene predeceased him.[318] This change was made at about the same time Irene added a codicil to her will leaving a significant portion of her property to her own children.[319] Irene died late in 1990.

Albert's health failed in 1993. He had a cancerous growth removed from his back in May, in the summer he was diagnosed with a chronic degenerative brain disease, and in September he had prostate surgery. Frankly, it appears at this juncture that planning entered the end-game stage and that planning occurred thereafter at an accelerated pace.[320]

Sometime shortly after Albert's prostrate surgery in September 1993, his son-in-law Gulig "took over decedent's affairs pursuant to the 1988 power of attorney."[321] In August 1994, both Michael Gulig and his spouse (Albert's daughter) believed Albert would die in the next twelve to twenty-four months:[322]

> On August 11, 1994, Mr. Gulig attended a seminar provided by Fortress Financial Group, Inc . . . , on the use of family limited partnerships as a tool for (1) asset preservation, (2) estate planning, (3) income tax planning, and (4)

313. *Strangi I*, 115 T.C. at 479.
314. *Id.*
315. *Id.*
316. *Strangi II*, 85 T.C.M. (CCH) 1331, at *3.
317. *Id.*
318. *Strangi I*, 115 T.C. at 480.
319. *Id.*
320. *Strangi II*, 85 T.C.M. (CCH) 1331, at *4.
321. *Id.*
322. *Id.*

> charitable giving. The following day, on August 12, 1994, Mr. Gulig, as decedent's attorney in fact, formed SFLP, a Texas limited partnership, and its corporate general partner, Stranco, a Texas corporation . . . ."[323]

Gulig, as Albert's attorney in fact, transferred $9,876,929 worth of Albert's property to the limited partnership. The property transferred was approximately ninety-eight percent of Albert's wealth.[324] About seventy-five percent of the value of the transferred property was in the form of cash and securities.[325] Other assets transferred included insurance policies, an annuity, partnership interests in other partnerships, and real estate. The real estate included Albert's house where he continued to reside.[326] In return for his property contribution, Albert received a ninety-nine percent limited partnership interest in SFLP. Albert, through Mr. Gulig, also contributed approximately $50,000 to the corporate general partner, Stranco, and received a forty-seven percent ownership interest of the corporation. The other fifty-three percent of Stranco's stock was purchased by *Mrs.* Gulig (Albert's daughter) "on behalf of herself and her three siblings" for approximately $56,000.[327] Thus, each of Albert's children owned a 13.25 percent stake in the corporate general partner of SFLP and no limited partnership interest. In turn, on August 18, 1994, each of the children gave their fractional one-quarter shares to an unrelated charity (MCC Foundation). The result was that the charity became one percent owner of Stranco.[328]

Albert died of cancer on October 14, 1994,[329] approximately two months after his attorney in fact had attended the seminar on the use of limited partnerships and created and executed Albert's estate plan.

b. Strangi I

i. Economic Substance and Section 2036(a)

In *Strangi I*, the Tax Court took the section 2036(a) issue procedurally off the table by denying the government's motion to amend its answer to include it.[330] In that opinion, however, the Court acknowledged the possible validity of a section 2036 attack. Specifically it stated: "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

323. *Id.*
324. *Strangi II*, 85 T.C.M. (CCH) 1331, at *5.
325. *Id.*
326. *Id.*
327. *Id.*
328. *Strangi II*, 85 T.C.M. (CCH) 1331, at *6.
329. *Id.*
330. *Strangi I*, 115 T.C. at 486.

2036."[331]

The Tax Court did reach judgment on the merits in the case on the other issues raised by the Service. These issues were: (1) the economic substance doctrine; (2) the special valuation rule of section 2703(a)(2); (3) the gift at inception theory; and (4) whether the estate properly determined the fair market value of the limited partnership interests in SFLP and the shares of Stranco that were included in this case under general valuation principles. These issues were reviewed, and affirmed, on appeal.[332]

The first of the issues decided on the merits was the economic substance doctrine. Upon first reading, it may appear the Tax Court simply swept it into the same dust bin as it did the section 2036 issue. It did not. Indeed, the issue divided the Court. Succinctly, the Court stated that "[a]pplying the economic substance doctrine in this case would be equivalent to applying section 2036(a) and including the transferred assets in decedent's estate.... [A]bsent application of 2036(a), Congress has adopted an alternative approach to perceived valuation abuses."[333] This statement is interesting and possibly problematic, because, on one hand, it seems to indicate that the economic substance doctrine is swallowed up by the statutory analysis of 2036. That may be an analytical problem based on the specificity of the statutory language of section 2036 that calls for *retention* of rather specific power over transferred property, if interpreted any more broadly than the two notions have on the *result* in the case.[334]

On the other hand, the statement can be interpreted to mean that "control" is a slightly different issue than the one represented by the economic substance doctrine. The latter interpretation is supported by the opinion in *Strangi I* because the Court stated: "[T]he tax effects of a particular transaction are determined by the substance of the transaction not the form."[335] Further, it stated: "Family partnerships must be scrutinized by the courts because the family relationship 'so readily lends itself to paper arrangements having little or no relationship to reality.'"[336] In other words, there may yet be a difference between "control" and the economic substance doctrine, because the Court seemed to draw a distinction between the *existence* of a valid organization under the economic substance doctrine and its inclusion due to the retention of powers under a section 2036(a) issue. More directly on point, to *exist* in law seems to minimally require an enforceable agreement of some sort. In the end, the Tax Court adopted this minimalist approach acting to limit the economic substance doctrine to the issue of existence of the entities, when it stated:

331. *Id.* (internal citation omitted).
332. *See generally* Estate of Strangi v. Comm'r, 293 F.3d 279 (2002).
333. *Strangi I*, 115 T.C. at 484.
334. *See supra* notes 331-33 and accompanying text.
335. *Strangi I*, 115 T.C. at 484.
336. *Id.*

"Mere suspicion and speculation about decedent's estate planning and testamentary objections are not sufficient to disregard an agreement in the absence of persuasive evidence that the agreement is not susceptible of enforcement or would not be enforced by the parties."[337] Thus, in *Strangi I*, the Court seemed to later erode the broad initial statement that section 2036(a) and the economic substance doctrine shared the same analysis. Nonetheless, it did little to clarify the confusion in the area. Some of the inconsistency may have been a result of addressing the concurring and dissenting opinions, which indicate a deep analytical divide on the Tax Court concerning its general approach to FLPs.[338] Indeed, the combinatorial nature of the separate opinions adds meaning to the interpretive analogy of "reading of tea leaves" that is included as part of the heading of this subsection of the article.

The Court of Appeals applied a "clear error" standard of review to the economic substance doctrine issue and, in affirming the Tax Court, very nearly repeated its ultimate statement: "SFLP's partnership agreement changed the legal relationship between decedent and his heirs and creditors. Potential purchases of decedent's assets would not disregard the partnership."[339]

ii. Section 2703(a)(2)

The *second* issue raised by the Service and resolved by the Tax Court concerned the application of the special intrafamily valuation rule section 2703(a)(2), which, in the context of intrafamily transfers, disregards "any restriction on the right to use of sell the property."[340] In effect, the Service

---

337. *Id.*

338. *Id.* In concurring, Chief Judge Wells, joined by Judge Foley, observed a circularity in the majority opinion: "Because the majority has rejected the alleged business purposes underlying the formation of the partnership in issue in the instant case, a proper application of the economic substance doctrine, if it were to apply, would ignore the partnership and disallow the discounts for minority interest and lack of marketability." *Id.* at 493 Therefore, Chief Judge Wells would go further and simply clarify the area by simply carving from the economic substance doctrine any application to entities validly formed where the issue is the valuation of property transferred to the entity *and* where the issue is federal estate and gift taxation. *Id.* at 493-94.

Judge Parr dissented and would have used the economic substance doctrine to *value* the partnerships:

> Assuming, arguendo, that the partnership must be recognized for Federal estate tax purposes [because it validly exists under state law], I would value the interest under the agreement that existed in fact, rather than under the written partnership agreement that had no relationship to the reality of decedent's ownership and control of the assets contributed to the partnership.

Id. at 495.

Finally, Judge Beghe dissents on this issue by acknowledging that he generally supports the use of the economic substance argument but he agrees with the majority, here, because it would operate "to alter . . . [a] conclusion about a real world fact, . . . the fair market value of property." *Id.* at 501. Therefore he would formulate a new "end-result test" which would be derived from the step-transaction doctrine. That is, the various transfers in and out of the entities, whose sole purpose was to lower estate taxes, would be collapsed into one transaction: "the transfer at Mr. Strangi's death of the underlying assets." *Id.* at 503. The key to applying the new test would be determining that the formation of the partnership had no business purpose. *Id.* at 501.

339. Estate of Strangi v. Comm'r, 293 F.3d 279, 281 (2002); *Strangi I*, 115 T.C. 478, 486 (2000).

340. *Strangi I*, 115 T.C. at 487.

argued that the statutory phrase "any restriction" could be replaced with "the SFLP agreement," and "property" was not the partnership interest, but, rather, the underlying transferred property.[341] The Tax Court cites the statutory language itself, regulatory language, the legislative history, and two of its previous decisions to refute the government's position.[342] The Court of Appeals affirmed the 2703(a) holding by the Tax Court, "for essentially the reasons stated in that court's [the Tax Court] opinion.[343]

iii. Gift at Inception

The "Gift at the Inception of SFLP" argument was the *third* issue discussed in *Strangi I*.[344] The argument is grounded on the theoretical assumption that value cannot simply *vanish* upon the formation of a partnership or other entity. Implicitly, the assumption means the value of the partnership interests after a transfer of contributed property *should* be the same as the value of the contributed property before its contribution. The difference between the property's fair market value in the hands of the transferor and the discounted fair market value of the interests received in return, therefore, *must* accrue to the owners of the other partnership interests under the logical operation of the assumption. The Tax Court restated the argument and implicitly illustrated the underlying assumption in the context of *Strangi I* as follows: "Using the value reported by petitioner on the estate tax return, if decedent gave up property worth in excess of $10 million and received back a limited partnership interest worth approximately $6.5 million, he appears to have given a gift equal to the loss in value."[345] Finding a business purpose for the acceptance by the donor of a reduction in value under like circumstances has become a focal point of analysis.[346] The Court first stated there was no business purpose for setting up SFLP or, if there was, it was not worth the $3 million decedent gave-up in valuation.[347]

The basic elements of a gift include the notion that the "donor has so parted with dominion and control as to leave in him no power to change its disposition, whether in his own benefit or for the benefit of another."[348] Obviously, this supposes there to be some sort of a transfer.[349] The Tax Court determined there was no *gift at inception* in this case. Its analysis determined there was no gift for two related reasons. One reason is because it was difficult

341. *Id.* at 488.
342. *Id.* at 488-89.
343. *Estate of Strangi*, 393 F.3d at 282.
344. *Strangi I*, 115 T.C. at 489.
345. *Id.*
346. *See id.*
347. *Strangi I*, 115 T.C. at 489-90.
348. Treas. Reg. § 25.2511-2(b) (2003).
349. *See* I.R.C. § 2511(a) (2003).

to find a transfer that is requisite in finding a gift. Here, the fact generally cited previously in the opinion that "[f]ormalities were followed, and the proverbial 'i's were dotted' and 't's were crossed'"[350] became important in distinguishing the creation of SFLP from the few cases that have found a gift at inception. Simply, it seems, there was not an evidence trail that could easily be followed to show acceptance of value by others. The fact was, Albert's entire contribution to the limited partnership was included in *his* capital account and Albert possessed ninety-nine percent of the limited partnership interests. This distinguished his circumstances, according to the Tax Court, from cases like *Shepherd v. Commissioner*[351] "where contributions by the taxpayer . . . [were] allocated to the capital accounts of other partners."[352] Moreover, finding the transferee is exacerbated in the gift tax concept because gifts are valued based on what is received by the transferee, though the point is not made in the opinion.[353] This squarely places the focus on the *vanishing* value provided by the discounts and away from a more direct gift that results from shifting (transferring) value into capital accounts of others.

The Tax Court directly addressed the *vanishing* value by denying its existence: "[I]n this case, . . . we do not believe that decedent gave up control over the assets."[354] This is a subtler and more technical statutory analysis rooted in the Courts suggestion that, had section 2036(a) been timely raised, the value of the underlying property would have been included in the estate.[355] If 2036(a) had been properly brought to bear, therefore, there would be no vanishing value *in this case.*

The Court's analysis of capital accounts and the vanishing value argument combined to yield the following conclusion:

> [I]n view of decedent's continuing interest in SFLP and the reflection of the contributions in his own capital account, he did not transfer more than a miniscule proportion of the value that would be "lost" on the conveyance of his assets to the partnership in exchange for a partnership interest.[356]

The Court of Appeals summarily affirmed this portion of the decision.[357]

Again, as in its section 2036(a) analysis, it seems the Court found itself straddling the theoretical line bifurcating control and retained rights of property causing inclusion in the gross estate, on one side, and basic valuation principles

350. *Strangi II*, 85 T.C.M. (CCH) 1331, at *7.

351. *Strangi I*, 115 T.C. at 490 (referring to Shepherd v. Comm'r, 115 T.C. 376 (2000)).

352. *Id.*

353. *See supra* notes 189-90 and accompanying text.

354. *Strangi I*, 115 T.C. at 490.

355. *Id.* at 486.

356. *Id.* at 490. Judge Ruwe wrote a dissenting opinion that would have applied the gift at inception theory in *Strangi I*. *Id.* at 497. The dissent was joined by four other judges. *Id.* at 500. Thus, a full one-third of the "regular" judges agree with the legitimacy of the theory.

357. Estate of Strangi v. Comm'r, 293 F.3d 279, 282 (2002).

taking control into account, on the other. The reason for the distinction is because valuation principles are based on the hypothetical willing buyer-willing seller standard,[358] which is an objective standard not taking into account the existence of such things as family attribution of stock ownership for purposes of the valuation of the property,[359] even though the Service has given somewhat mixed signals on the issue of attribution.[360] Moreover, as previously discussed in this article, under general valuation, and adding to the admixture, ownership of a significantly large amount of an entity may result in control premium being added to increase the fair market value. More controversially, the swing-vote premium may similarly apply.[361] In sum, formal control may be used more surgically in the context of valuation. Discussing control in the context of the *string* provisions under the estate tax or to find absence of a completed gift under the gift tax is somewhat confusing and may be analytically contaminated, given the statutory taxonomy of the federal wealth transfer system.

The theoretical heart of the gift at inception argument is this: valuation does not occur within the closed confines of a system like algebra or balancing both sides of a chemical reaction in chemistry. Simply, *sometimes* value does just go away without it being received by anyone. For example, assume yesterday Hermione bought a car for $100 which is its published fair market value. Today, while legally parked on the curb, it is destroyed by a bus reducing its value to zero. Where did the *value* of the car go? True, the bus driver may be liable for damages associated with destroying the car but that is a separate issue than the locus of the $100 of value lost when the car was wrecked. In the accident example, the loss might be allocated between the parties, but there is simply no equation that can be balanced to conserve the vanishing $100 car value. The *system* lost $100 of value and making the driver pay $100 in damages shifts the loss based on fault, but does not restore $100 systemically. Likewise, Albert doing something *wrong* to *destroy* value is a different inquiry than determining where the vanishing value *went*.

358. *See supra* notes 152-53 and accompanying text.

359. *See, e.g.*, *Strangi I*, 115 T.C. at 490-91; Thornton, *supra* note 9, at 244; Koren, *supra* note 142, at 125-26.

360. Koren, *supra* note 142, at 125-26. Family attribution is one way that the Service has tried to mitigate or minimize the effect of the minority discount. According to a leading practitioner: "Only one case accepted the Service's family attribution theory, a District Court that has not been followed . . . since it was handed down. *Wallace v. U.S.*, 82-1 USTC ¶ 13, 442 (D. Mass, 1981)." *Id.* at 127. Nonetheless, he cites inter alia TAM 9608001, TAM 9504004 as evidence that the Service has not fully ceded the argument. *But see* Rev. Rul. 93-12, 1993-1 C.B. 202.

361. The concept of a swing vote premium is that if two owners own most of the interests equally in an entity, a third owner with a small minority of shares may be able to demand a premium price because the third owner's power as tie-breaker gives her stock control beyond that based on interest owned. *See, e.g.*, Estate of Davis v. Comm'r, 110 T.C. 530 (1998), *cited by* Koren, *supra* note 142, at 122.

iv. Discounts and Valuation

Finally, in *Strangi I*, the Tax Court applied general valuation principles to determine the value of Albert's interests in SFLP and Stranco transferred at his death. The experts for both the estate and the government agreed that the appropriate valuation methodology in the case was the "net asset value approach" rather than the "going concern value."[362] The Court accepted the choice of methodology without comment, and it certainly seems that the net-asset value approach is reasonable in this case because SFLP was never an operating business. Evidence that SFLP was not an operating business is included the fact that approximately seventy-five percent of the assets in the partnership were cash and securities.[363] Under those circumstances, the net asset approach is often used because it values the underlying assets owned by the entity rather than capitalizing earnings.[364] It is probably worth adding that the partnership existed for such a short time that it would also make calculating any earnings rate for the partnership a rather difficult task. The latter, too, favors using the net asset value.

Both the estate's expert and the government's expert then applied marketability discounts and minority discounts to arrive at fair market value of Albert's limited partnership interest in SFLP. The experts agreed that a lack of marketability discount of twenty-five percent was appropriate.[365]

By way of explanation, and although not discussed in the opinion, the rationale for the marketability discount is that there is not a readily accessible market to resort for the sale of closely held business interests. This increases ownership risks associated with interests in closely held businesses because it is more difficult to liquidate those interests quickly.[366] Therefore, the marketability discount is a sort of *salability* measure.

The experts disagreed, however, as to the valuation affect of Albert's ownership of Stranco shares on the valuation of the SFLP interests he owned. The government expert also "considered decedent's ownership of Stranco stock"[367] as a separate component of valuation because of its relationship to the limited partnership interest. The estate's expert treated the shareholder agreement between the related parties as controlling. The Tax Court adopted the reasoning of the government's expert, in part, because it opined Stranco stock and the SFLP interests separately were unlikely.[368] The experts agreed again that a minority discount for the limited partnership interests was

362. *Strangi I*, 115 T.C. 478, 491 (2000). For a discussion of the methods of valuation see notes 133-48 and accompanying text, above.

363. *Strangi I*, 115 T.C. at 481.

364. *See supra* note 165 and accompanying text.

365. *Strangi I*, 115 T.C. at 491.

366. Thornton, *supra* note 9, at 258.

367. *Strangi I*, 115 T.C. at 491.

368. *Id.* at 492.

appropriate because it was the general partner (Stranco) that possessed almost all management rights. Taxpayer's expert determined a twenty-five percent minority discount was appropriate. The government's expert, on the other hand, examined minority discounts of closed-end investment funds and considered the "effective control of the limited partnership interest and the interest in Stranco" to mitigate part of the minority discount. He arrived at an eight percent minority discount.

There is a compounding effect of the discounts because the minority and marketability discounts apply *in seriatum*. Thus the government's expert applied a 31 percent combined discount to Albert's limited partnership interest and the taxpayer's expert arrived at a combined discount of 43.75 percent. The Tax court accepted the government's discount argument, but did not give the valuation a resounding vote of confidence because it said the result of the discounts "may still be over generous to petitioner" given the rejection of the section 2036 issue on procedural grounds.[369] The Tax Court had the opportunity to revisit the section 2036 issue on remand in *Strangi II*.[370]

c. Strangi II

i. Section 2036(a)

The only issue considered in *Strangi II* was whether the value of the property transferred by Albert to SFLP and Stranco was includible in his gross estate under section 2036(a).[371] More specifically, the statutory issue turned on whether Albert *retained* "the possession or enjoyment of, or the right to income from, the property" under section 2036(a)(1); or, whether Albert retained "the right, either alone or in conjunction with any other person, to designate the persons who shall possess or enjoy the property or income therefrom" under section 2036(a)(2).[372] The section 2036(a)(2) issue is the same one addressed by the United States Supreme Court in *United States v. Byrum*,[373] which was previously analyzed in this article.[374]

On remand, the Court grounded its analysis by quoting section 2036(a) in its entirety and included the following quote from the Regulations: "An interest or right is treated as having been retained or reserved if at the time of transfer there was an understanding, *express or implied*, that the interest or right would

369. *Id.* at 492-93.

370. *Strangi II*, 85 T.C.M. (CCH) 1331, at *3.

371. *Id.*

372. *Id.* at *8. For a general discussion of section 2036(a)(2), see notes 282-94 and accompanying text, above.

373. 408 U.S. 125 (1972).

374. *Strangi II*, 85 T.C.M. (CCH) 1331, at *8. For an analysis of *Byrum*, see notes 273-98 and accompanying text, above.

later be conferred."[375]

The Court also analyzed the factual and legal context to which it applied the law. *First*, it quoted at length from the power of attorney executed by Albert in 1988 naming his son-in-law, Mr. Gulig, as attorney in fact.[376] The power of attorney contained broad powers. In part it authorized Mr. Gulig: "To exercise, do, or perform any act, right, power, duty, or obligation whatsoever that I now have or may acquire . . . relating to any person, item, thing, transaction, business property, real or personal, tangible or intangible, or matter whatsoever . . . ."[377]

Second, the Tax Court described several relevant provisions in the SFLP (Strangi Family Limited Partnership) Agreement, including provisions relating to the general partner's rights, powers and authority, and dissolution and liquidation. The Agreement establishes that the "Managing General Partner" is the only authorized agent for the partnership "in connection with all aspects of the business of the Partnership."[378] In addition, it grants the general partner broad power and authority *inter se* to make decisions on behalf of the partnership, including the power "to determine the use of the revenues of the Partnership for Partnership purposes"[379] and "to determine and make distributions in its sole discretion," but only after "taking into account the reasonable business needs of the partnership."[380] The distributions, however, were required "to be made to each Partner in accordance to the Partnership."[381] Further, the Agreement stated: "Assets of the Partnership may be distributed in kind in the sole discretion of the Managing General Partner."[382] The Court also observed that the Partnership Agreement required the general partner "to use its good faith efforts to manage the partnership affairs in a prudent and business like manner and to act at all times in the best interests of the partnership."[383]

The other part of the Agreement with relative significance concerned dissolution. As summarized in the opinion dissolution *and* termination occurred on:

> (1) A unanimous vote of the limited partners and unanimous consent of the general partners; (2) a decision of the managing general partner after the disposition of substantially all partnership assets; (3) an entry of judicial dissolution; (4) the death, insolvency, bankruptcy, removal, or withdrawal of any general partner, unless limited partners within 90 days unanimously elect a

375. *Strangi II*, 85 T.C.M. (CCH) 1331, at *8 (quoting Treas. Reg. § 20.2036-1(a) (2003)) (emphasis added).

376. *Id.* at *3.

377. *Id.* (first set of ellipses in original, second set added).

378. *Id.* at *4.

379. *Strangi II*, 85 T.C.M. (CCH) 1331, at *4.

380. *Id.* at *5.

381. *Id.*

382. *Id.*

383. *Strangi II*, 85 T.C.M. (CCH) 1331, at *4.

> new general partner to continue the business; (5) the involuntary transfer of a general partnership interest in the event there is only one general partner, unless the limited partners within 90 days vote unanimously to continue the partnership; or (6) December 31, 2014.[384]

Finally, the Court described the organic documents of Stranco (the corporate general partner of SFLP) of which Albert owned forty-seven percent, each of his four children owned thirteen percent, and McLennan Community College (MCC) Foundation owned one percent.[385] Stranco also owned a one percent interest in SFLP.[386] The bylaws set forth that (1) a majority of the outstanding shares constitute a quorum, but shareholders may take action by unanimous consent without a meeting;[387] (2) the board of directors shall consist of five directors; (3) the board shall elect one of its members as president who would be chief executive officer; (4) the board is responsible for declaring "dividends on its outstanding shares in any manner and upon any terms not restricted by the Articles of Incorporation and not prohibited by law"; (5) quorum and consent action mirroring that of the shareholders; and (6) the typical duties of president, "subject to the control of the board."[388]

The other documents attendant to the operation of Stranco were a shareholders agreement and a management agreement with Mr. Gulig. The shareholder's agreement included provisions whereby Albert and each of his children, or their individual nominees, were to comprise the board of directors and, if a vacancy occurred, "they would cause the bylaws to be amended so as to reduce the number of directors."[389]

The management agreement gave Mr. Gulig day-to-day management authority, obligated him to manage the rental properties and the cash and securities portfolio, and required him to prepare and file reports like the income tax return.[390] Forms used for the organic documents were licensed from Fortress Financial Group, Inc.[391]

The Court addressed sections 2036(a)(1) and 2036(a)(2), in turn, after identifying who bore the burden of proof. The burden of proof is noteworthy only because section 2036 was a new matter procedurally; and, therefore, the government uncharacteristically bore the burden of proof.[392] Typically, the burden is allocated the taxpayer/petitioner whose burden in intrafamily situations is "particularly onerous."[393] Thus, in this case, *ties* went to the

384. *Id.* at *5.
385. *Id.* at *5-6; *see supra* notes 324-28 and accompanying text.
386. *Strangi II*, 85 T.C.M. (CCH) 1331, at *6.
387. *Id.*
388. *Id.*
389. *Id.*
390. *Strangi II*, 85 T.C.M. (CCH) 1331, at *6.
391. *Id.* at *4.
392. *Id.* at *9.
393. *Id.*

taxpayer/estate rather than the government. The opinion is silent concerning how the "onerous" standard, borne by the taxpayer as part of its burden of proof, is translated, if at all, to this situation where the government carries the burden of proof.

ii. Section 2036(a)(1)

Section 2036(a)(1), like its cousin section 2036(a)(2), is subject to the flush statutory of section 2036(a). The flush language requires a *transfer* of property "under which he [the decedent] has *retained*" enumerated powers or rights under (1) and (2) "for his life."[394] The triggering mechanisms under subsection (1) are "possession or enjoyment of property" or the "right to the income from . . . the property."[395] The Court matter-of-factly stated: "Enjoyment in this context is equated with present economic benefit."[396] It then took one paragraph to analyze the right to income, basing its analysis on a regular opinion in a 1967 Tax Court case, which states "right" means merely the string (right) *exists* and does not require the string to be *pulled*.[397] The interpretation certainly comports with a reasonable interpretation of the statutory language.

The Court then determined such a right existed under the organic documents of SFLP and Stranco: "The governing documents contain no restrictions that would preclude decedent himself, acting through Mr. Gulig, from being designated the recipient of income."[398] It is difficult to quibble with the statement as written except, perhaps, for noting a difference between the Courts determination that Albert's power *was not precluded* with the statutory requirement that *a right be retained*. The Court's reasonable assumption that the broad power of attorney gave Mr. Gulig the same authority as Albert had over his affairs logically puts direct pressure on the organic documents.

The opinion did not parse the documents at this juncture of its analysis. Nonetheless, it seemed to paint with a rather broad and nontechnical brush in assessing Albert's power. As discussed previously in the opinion, the Shareholders' Agreement *does* operate to give Albert the right to serve on the board of directors for life. It *does not*, however, give him a right to be president of Stranco (the corporate general partner of SFLP), because the president is to be elected by the directors. This is not necessarily an insignificant point, because the Court expressly stated the documents alone were enough to "suggest" the right without a need to resort to any implied agreement[399] such as contemplated by the quoted Regulations.[400] Interestingly,

394. I.R.C. § 2036(a).
395. I.R.C. § 2036(1).
396. *Strangi II*, 85 T.C.M. (CCH) 1331, at *9.
397. *Id.* at *10 (*quoting* Estate of Pardee v. Comm'r, 49 T.C. 140, 148 (1967)).
398. *Id.*
399. *Id.*
400. *See supra* note 375 and accompanying text.

neither the *Strangi I* nor *Strangi II* opinions identify the president of Stranco to whom the bylaws assign the duties of principal executive officer,[401] nor do the opinions clearly indicate who signed the management agreement on behalf of the corporation except to indicate that the board consented in lieu of a meeting to authorize the president to do so.[402] Nonetheless, Mr. Gulig (who for these purposes *is* Albert because of the power of attorney) was named as an "employee" of Stranco to manage the day to day affairs of both Stranco (termed "employer"[403]), and presumably by derivative default SFLP, presumably by causing Stranco to fulfill its duties as general partner,[404] even though Mr. Gulig was the employee and executed the agreement in his personal capacity.

The management agreement, therefore, was an employment agreement with Mr. Gulig (Albert). The opinion does not state the term of the agreement nor any compensation provisions it may have contained. Employment appears from the language of the agreement to be predicated on "diligent" performance of the duties delegated the employee "to the best of his ability."[405] It would carry other agency duties as a matter of default. In addition to managing the day-to-day affairs of Stranco and, as an employee of Stranco, the partnership under the auspices of Stranco's status of general partner, the agreement delineated Mr. Gulig's duties as follows: "The duties of the employee shall include, *but not be limited to*, management of the Partnerships rental properties, cash and investment management, and the preparation and filing of all required government reports including tax returns."[406] Frankly, but for possibly placing enormous interpretive pressure on the emphasized language appearing before the enumerated list of duties, the contract seems to be a job description for a chief operating officer rather than as a chief executive officer. The latter observation is buttressed by the bylaw provision naming the president as principal executive officer of the corporation.

Finally, the organic documents addressed the payment of dividends by Stranco consistent with notions of general state corporate law by vesting authority for dividends in the board of directors.

Thus, in summary, Albert (through his attorney-in-fact) held the following powers and possessed the following rights as to Stranco, the general partner, under the agreements delineated in the opinion as supplemented by general notions of corporate law: (1) the contractual right to serve on the board of directors for life; (2) the right to be nominated as president (principal executive officer) in his position as a board member and to cast one in five votes to elect

401. *Strangi II*, 85 T.C.M. (CCH) 1331, at *6.
402. *Id.* at *5.
403. *Id.* at *6.
404. *Id.*
405. *Strangi II*, 85 T.C.M. (CCH) 1331, at *6.
406. *Id.*

himself; (3) the right as a board member to help formulate dividend policy and to exercise his one in five right to vote on such policy; (4) to serve Stranco as a management employee and to exercise day-to-day authority for the corporation under a management agreement that appears to contemplate operational rather than executive authority; (5) as a forty-seven percent shareholder, he *likely* had the voting power to block extraordinary corporate action or to receive appraisal rights, but probably did not have voting power to alone cause the corporation to take extraordinary action because he did not have majority shareholder voting control nor, because of the shareholder agreement, the right to elect more than himself to the board which recommends such extraordinary action. Finally, but perhaps only as a theoretical matter, he owed the corporation some fiduciary duty as a board member and as an employee, agent, and officer under the management agreement.

To reiterate the Court's statement that, "[t]he governing documents contain no restrictions that would preclude himself . . . from being designated as recipient of income from . . . Stranco,"[407] is technically correct.[408] Moreover, the Court's statement that an analysis of the express documents "suggests inclusion . . . based on 2036(a)(1)" is also ambiguous enough to be technically correct. Nonetheless, it is difficult to find sufficient evidence in the express documents alone *as delineated by the opinion* to meet the government's burden of proof for the existence of the retention of a right to income for life from the property transferred to Stranco. Almost by definition, the same conclusion may be reached under SFLP because Albert's right to income for life in the partnership would arise only derivatively based on his rights in the corporate general partner (Stranco).

In its analysis under the heading "*Possession and enjoyment*" but still under section 2036(a)(1), the Tax Court again clearly held for the government but this time on an implied agreement theory as opposed to an express agreement theory: "The facts of this case support the finding of an *implied agreement* for retained possession or enjoyment."[409] Here, in *Strangi II*, the Tax Court also consolidated and attempted to better demarcate the boundary between inclusion under section 2036(a) and the application of premiums and discounts under general valuation principles. In doing so, the Court helped clear any fog of confusion obscuring the differences in the two separate mechanism in the text of *Strangi I* or caused by the dissents and concurrences thereto.[410]

407. *Id.* at *10.

408. *See supra* note 398 and accompanying text.

409. *Strangi II*, 85 T.C.M. (CCH) 1331, at *10 (emphasis added).

410. For an analysis of *Strangi I* on this issue, see notes 301-70 and accompanying text, above. Note, however, that *Strangi I* was a reviewed regular decision while *Strangi II* is a memo case. This creates a theoretical distinction in the precedential weight given the opinions. For a comparison or reviewed, regular, and unpublished Tax Court opinions, see note 300, above. Trying to tease out what that potential precedential distinction might mean in the real world is beyond the scope of this article. Moreover, any results from such an analysis are speculative enough to be thrown in the cup with the tea leaves.

The Court concedes that the taxpayer carefully heeded formal structural and organizational rules and used this fact to help fence the distinct concepts: "Such measures may give SFLP and Stranco sufficient substance to be recognized as legal entities in the context of valuation, which requires assumptions of a hypothetical buyer and seller. They do not preclude implicit retention by decedent of economic benefit from the transferred property for purposes of section 2036(a)(1)."[411]

The Court used a list of six indicators of possession or enjoyment ("circumstances") as a breastwork for analyzing the facts surrounding Albert's plan even in absence of longitudinal operational evidence.[412] The following six factors were distilled from other cases as indicative of "implicitly retained" possession or enjoyment under section 2036(a)(1): (1) the "transfer of the majority of the decedents assets"; (2) "continued occupation of transferred property"; (3) "commingling of personal and entity assets"; (4) "disproportionate distributions"; (5) "use of entity funds for personal expenses;" and (6) testamentary characteristics of the arrangement."[413]

Albert did, indeed, transfer most of his assets to the organizations involved. He contributed ninety-eight percent of his wealth. Although Albert argued he kept $172,000 worth of "liquifiable" assets from Stranco and SFLP, the Court cited evidence that of this amount only $762 was truly *liquid* as opposed to "liquifiable." The whole distinction seems to beg the definition of *liquid.* The Court also analyzed Albert's reasonable needs and cash flow. There is little evidence of the cost of his living expenses, and his estate argued that his combined monthly pension and social security payments of approximately $3,000, when coupled with his other assets, was more than enough *to meet his needs for his life expectancy of one to two years.*[414] It appears this planning approach might be sound for asset protection purposes. The Court's inference that "decedent and his children and Mr. Gulig all expected that SFLP and Stranco would be a primary source of decedent's liquidity," however, also seems reasonable under the circumstances.[415] In retrospect, Mr. Gulig simply put *way too much* value of decedent's assets into the enterprise in order for a reasonable person to conclude that Albert personally owned enough property to adequately meet expected expenses and maintain a reasonable lifestyle. As a purely speculative matter, perhaps a *reasonable* Albert would have negotiated for guaranteed payments in return for at least a portion of his investment in Stranco or, perhaps, would have loaned the enterprise a portion of his investment for a reasonable fixed return rather than contributing it all for equity.

411. *Strangi II*, 85 T.C.M. (CCH) 1331, at *10.
412. *Id.*
413. *Id.*
414. *Id.*
415. *Strangi II*, 85 T.C.M. (CCH) 1331, at *11.

It was not just the nominal and relative amounts of his investment that raised questions with the Service and the Tax Court, it was also the *type* of assets contributed to the partnership. The Court rightly observed the contribution of his personal residence, in which he continued to live, was "highly probative" of an implicit agreement for retention of possession or enjoyment of transferred property.[416] Again, SFLP had a response that went to the details of the arrangement but which could not overcome the real factual heart of the factor. The estate responded that SFLP charged Albert rent and it accrued on the books of the partnership as a receivable, even though it was never paid while Albert was alive. The charging of rent without any attempt to collect it is analogous to adding salt and a fresh mushroom to a typical fast food burger, presenting it on a silver platter, serving it with wine, and calling it French cuisine. No matter how it is dressed up, at base, it is a fast food burger. Likewise, Albert dressed up his transfer, but the only logical and reasonable conclusion was that there was an implied retention of possession and use of the property. As stated by the Tax Court:

> A residential lessor dealing at arm's length would hardly be content merely to accrue a rental obligation for eventual payment more than 2 years later [at decedent's death]. As we have remarked, accounting entries alone are of small moment in belying the existence of an agreement for retained possession and enjoyment.[417]

Indeed, a reasonable transferor would probably expect some assurance that she would not be thrown out of the residence even though the Court does not so observe. To the extent the documents do *not* provide for these express rights indeed makes the case for an *implied* retention agreement even stronger because it looks *less* like arms-length residential planning with other tax and financial planning tools like reverse annuity mortgages or sale-leasebacks. The cost of those tools in contexts like *Strangi*, of course, is that the *value* of the asset machined with those tools is transformed rather than transferred (out of the estate in exchange for a discountable instrument roosting with decedent). In sum, and as a general rule, perhaps it is typically a bad idea to transfer the personal residence in an attempt to achieve maximum tax discounting.[418]

The next several circumstances (factors) listed by the Court as probative of an implied agreement find their gravaman in commingling or personal use of company assets.[419] And these factors have a shared analysis in the opinion.[420] From the perspective of the estate, "bad facts" exist whether or not those facts precisely match the mandates of the statutory language of section 2036(a)(1).[421]

416. *Id.*
417. *Id.* (citations omitted).
418. *See* PRICE, *supra* note 91, § 7.24.
419. *Strangi II*, 85 T.C.M. (CCH) 1331, at *11-12.
420. *Id.*
421. *See infra* notes 422-24 and accompanying text.

Those facts included: (1) SFLP paid for the back surgery of decedent's housekeeper (and sometimes caretaker) necessitated by an injury sustained before the formation of SFLP;[422] (2) SFLP paid nearly $40,000 for "funeral expenses, estate administration, and related debts, including a $19,810.28 check . . . to pay for nursing services rendered to decedent before his death";[423] (3) SFLP paid another $65,000, or so, for estate expenses and a specific bequest made by decedent; and (4) SFLP paid approximately $3,000,000 "toward decedent's estate and inheritance taxes."[424]

Albert's estate made defensive arguments. The best argument, perhaps, was that every distribution made to Albert was based on his (or his estate's) ownership of limited partnership interests, and every distribution was made pro-rata to every partner.[425] The estate makes two legal arguments based on this fact. *First*, because the distributions were pro-rata, they do not evidence any retained use or enjoyment of property or any right to the income from that property. *Second*, and as a more technical legal matter, because the distributions were made in relation to the ownership interests in SFLP, they bear no relationship to the underlying transferred property.

The Court made short-shrift of both arguments by using logical, but not technical, reasoning. As to the *first* defense:

> In these circumstances, pro rata disbursements are insufficient to negate the probability that the decedent retained economic enjoyment of his or her assets. After all, distributing . . . [a one] percent [share] to Stranco [on account of its one percent share of the limited partnership] would not in any substantial way operate to curb decedent's ability to benefit from SFLP property.[426]

And as to the *second* defense: "[T]his argument relies on paper title to the exclusion of the praticabilities that are the focus of section 2036(a)(1). The property contributed by decedent was the source of payments."[427]

The overarching vector of the entire analysis of section 2036(a)(1) by the Court is directed at the last listed factor, which is "the testamentary characteristics of the arrangement."[428] In that regard, the extensive discussion of business purpose in *Strangi I* is an important context for much of *Strangi II*, whether or not always acknowledged by the Court in *Strangi II*. Succinctly, business purpose can be used to crowd out testamentary intent or at least mitigate the dominance of testamentary characteristics. Testamentary characteristics, however, will expand to fill any void created by a lack of business purpose. Expressly: "[A]s discussed in *Strangi I* . . . , the purpose of

422. *Strangi II*, 85 T.C.M. (CCH) 1331, at *11.
423. *Id.*
424. *Id.*
425. *Id.*
426. *Strangi II*, 85 T.C.M. (CCH) 1331, at *11.
427. *Id.*
428. *Id.* at *10.

the partnership arrangement was not to provide a joint investment vehicle for the management of decedent's assets, but was consistent with testamentary intent."[429] Further, "the . . . arrangement also bears greater resemblance to one man's estate plan than to any sort of arm's-length, joint enterprise."[430] "[N]othing beyond the formal title changed . . . ."[431] Moreover, the children "did not obtain a meaningful economic stake in the property during decedent's life," and, "[t]hey raised no objections or concerns when large sums were advanced for expenditures of decedent or his estate, thus implying an understanding."[432] Through cynical eyes: Why would the children complain? The big pay off was in estate tax savings. Under the organic documents, the limited partnership would dissolve and the investments it held would most likely be distributed in kind in two years or less (Albert's life expectancy).

iii. Section 2036(a)(2)

The Court continued with an analysis of section 2036(a)(2). It did not end its analysis after finding the value of the transferred property was includible in Albert's gross estate under section 2036(a)(1).[433] Section 2036(a)(2) requires inclusion of transferred property if the decedent retained "the right, either alone or in conjunction with any other person, to designate the persons who shall possess or enjoy the property therefrom."[434] This is the statutory section the Supreme Court adjudged inapplicable in *United States v. Byrum*,[435] and the Tax Court in *Strangi II* discussed *Byrum* at length before turning to the facts of the case on remand.[436]

The Tax Court bifurcated its discussion of section 2036(a)(2) by first analyzing whether Albert Strangi possessed *legally enforceable rights*. It then turned to whether there were any *constraints* upon the exercise of those rights that would warrant exclusion based on *Byrum*.

Concerning "legally enforceable rights," the Tax Court observed that the statutory language, as reflected and animated by the regulations, state that the rights may be held "either alone or in conjunction with any other person."[437] It then proceeded with a discussion that was dominated by distinguishing the facts in *Strangi II* from *Byrum* and concluded:

> To summarize, review of the documentary evidence discussed . . . [in *Strangi*

429. *Id.* at *12.
430. *Strangi II*, 85 T.C.M. (CCH) 1331, at *11-12.
431. *Id.* at *12.
432. *Id.*
433. *Id.*
434. *See supra* notes 282-94 and accompanying text (discussing I.R.C. § 2036(a)(2)); *see also Strangi II*, 85 T.C.M. (CCH) 1331, at *13.
435. *See supra* notes 273-98 and accompanying text.
436. *Strangi II*, 85 T.C.M. (CCH) 1331, at *13-14.
437. *Id.* at *14 (citing Treas. Reg. § 20.2036-1(b)(3) (2003)).

> *II*] reveals that decedent here retained rights of a far different genre from those at issue in *United States v. Byrum. Rather than mere "control", management, or influence, there are traceable to decedent through the explicit provisions* of the governing instruments *ascertainable and legally enforceable rights* to designate persons who shall enjoy the transferred property and its income. *The estate's reliance on a limited partner's lack under the [Texas Revised Uniform Partnership Act] of participation in control . . . and under the SFLP agreement of management authority is thus misplaced.*[438]

Perhaps, but the documentary facts upon which the opinion actually rests are far from conclusive when carefully analyzed. The Court lists the following facts to establish Albert retained the right to designate persons who "shall" enjoy SFLP income:[439] (1) Stranco was managing general partner of SFLP; (2) as managing general partner, Stranco had sole discretion to determine distributions; (3) the "Stranco shareholders, including decedent . . . , then acted together to delegate this authority to Mr. Gulig through the management agreement."[440] As to the first fact, the existence of a corporate general partner is common in limited partnerships, including those formed as operating businesses, as opposed to investment vehicles.[441]

Regarding the second fact, the Tax Court makes a good point. The Revised Uniform Limited Partnership Act (1976/1985) (RULPA (1976/1985)) provides that a general partner in a limited partnership "has the rights and powers" of a general partner in a general partnership,[442] and it expressly authorizes the existence of only one general partner.[443] In turn, the default rule of the Uniform Partnership Act (1914) (UPA (1914)) gives general partners equal rights "in the management and conduct of the partnership interest."[444] Moreover, RULPA (1976/1985) states, as a general rule, that interim distributions are required as a default matter only "to the extent and at times specified in the partnership agreement."[445] Unless otherwise provided, therefore, the only distributions required liquidation and winding up (or upon certain other extra-ordinary events).[446] Here, the corporate general partner had discretion to make such distributions under the agreement, and this discretion made the existence of retained rights, if any, possible.

The third and final fact stated: "The Stranco shareholders, including

438. *Id.* (emphasis added, internal citations removed).

439. *Id.*

440. *Strangi II*, 85 T.C.M. (CCH) 1331, at *14.

441. *See, e.g.*, DEBRA POGRUND STARK ET AL., COMMERCIAL REAL ESTATE TRANSACTIONS: A PROJECT AND SKILLS ORIENTED APPROACH 1 (2001) (defining "General Partner" in a hypothetical limited partnership agreement).

442. REV. UNIF. LTD. P'SHIP ACT § 403 (1976/1985) [hereinafter RULPA (1976/1985)].

443. RULPA (1976/1985) § 101(7); *see, e.g.*, STARK ET AL., *supra* note 441.

444. UNIF. P'SHIP ACT § 18(e) (1914) [hereinafter UPA (1914)].

445. RULPA (1976/1985) § 601.

446. *Id.*

decedent (through Mr. Gulig), then acted together to delegate this authority to Mr. Gulig through the management agreement."[447] Whether the management agreement provided authority to make distributions was contested, based only on a very broad delegation of authority. That is, the management agreement neither expressly gave nor forbode the power to declare dividends to the manager. The Court's statement is, however, inconsistent with a statement of fact earlier in the opinion indicating that it was the directors who agreed to the management contract rather than the shareholders.[448] The inconsistency is remarkable because there was no majority shareholder in Stranco. The absence of a majority shareholder, by design, mitigates that as a source of fiduciary duty. Albert owned forty-seven percent of the shares. Directors, on the other hand, do have such duties by position. Additionally, Albert had but one in five votes on the board of directors rather than forty-seven percent of the vote on shareholder matters, though the voting difference is probably not significant because shareholder action in lieu of a meeting required unanimity.[449]

To summarize, each of the three documentary steps the Court used find that Albert had an ascertainable and legally enforceable right to designate the persons who shall enjoy the transferable property under the SFLP agreement and management contract are weak, and each do little to distinguish Albert from nonfamily arrangements or from *Byrum*.

The Court went on to make an additional finding that the "decedent *also* retained the right, acting in conjunction with other *Stranco* shareholders, to designate who shall enjoy the transferred SFLP property itself."[450] It relied on *Byrum* and cases cited therein for the proposition that the power to terminate a trust "and thereby designate the beneficiaries at a time selected by the settler" is a retained right subject to section 2036(a)(2).[451] Albert's entity plan required unanimous consent of the general and the limited partners for dissolution and further, Stranco, as general partner, also required the unanimous vote of the shareholders for dissolution.[452] In the event of dissolution, the general partner was required to pay outside creditors, then inside creditors, followed by the capital accounts.[453] Such a distribution scheme is consistent with general limited partnership law and is slightly more protective than the distribution scheme *required* by RULPA (1976/1985).[454] The general partner's only deal specific authority under the facts of *Strangi* appears to be that it can distribute

447. *Strangi II*, 85 T.C.M. (CCH) 1331, at *14 (2003).

448. *Id.* at *5.

449. *Strangi II*, 85 T.C.M. (CCH) 1331, at *5.

450. *Id.* at *14 (emphasis added).

451. *Id.*

452. *Id.* at *15.

453. *Strangi II*, 85 T.C.M. (CCH) 1331, at *5, *15.

454. RULPA provides the same distribution scheme except inside and outside creditors are treated at the same level. RULPA (1976/1985) § 804. Prior uniform law contained the same formulation as in the agreement and it may be that the agreement followed Texas law in effect at the time.

the assets in-kind, rather than first reducing them to cash at the request of any partner, which is the general rule under partnership law.[455]

Of course, Albert owned all the limited partnership interests, so whatever he decided could easily be, and probably would be, unanimous as to those interests. But he only owned forty-seven percent of the voting stock of Stranco and the shareholder vote *within* the corporate general partner also required unanimity.[456] On these facts the Tax Court concluded: "Accordingly, decedent can act together with other Stranco shareholders essentially to revoke the SFLP arrangement and thereby to bring about or accelerate present enjoyment of partnership assets."[457]

The final retention of affirmative rights to designate beneficiaries under section 2036(a)(2) discussed in *Strangi II* concerned Albert's ability (through his power holder Mr. Gulig) to affect dividends from the corporate general partner. At one point in the Court's analysis, it observed that Albert had the right to be a director under the shareholder's agreement.[458] Therefore, the Court concluded Albert "held the right, in conjunction with one or more other Stranco directors, to declare dividends."[459] The opinion also discussed the quorum and voting provisions concerning Stranco's board of directors and concluded as a factual matter that it was *possible* for Albert (through Mr. Gulig) and *one* other director to declare dividends at a meeting where the minimum quorum of three directors was present. The Court *must* believe this possibility is probative of retained rights. Without further explanation, however, it is not clearly apparent why that is so. There are legal impediments to manipulating the state law procedure to result in a minimum quorum; for example, notice requirements for board meetings are typical under corporate law.[460] Thus it is difficult to understand where the hypothetical voting scenario is probative of the existence of "ascertainable and legally enforceable rights" for which it is analytically used. Even without the quorum hypothetical, however, it *is* true that as a member of the board, Albert had rights to declare dividends, in the words of the statute, "in conjunction with others."[461]

With the exception of the existence of the right to determine distributions delegated under the management contract, the other "rights" that may affect the right to enjoy the transferred property are rather pedestrian in the law of business associations. Any reasonable interpretation of the Court's use of those facts to establish that Albert retained "rights" places great pressure on section 2036(a)(2)'s language "either alone or in conjunction with others."

455. *See* UPA (1914); REV. UNIF. P'SHIP ACT (1997) [hereinafter RUPA (1997)].
456. *Strangi II*, 85 T.C.M. (CCH) 1331, at *15 (2003).
457. *Id.*
458. *Id.*
459. *Id.*
460. *See, e.g.*, REV. MOD. BUS. CORP. ACT §§ 8.22-8.24, at 8-25 to 8-30 (2002).
461. I.R.C. § 2036(a)(2) (2003).

Albert made the foregoing argument in the context of his rights *vis a vis* Stranco, although it seems to apply equally to the "ascertainable and legally enforceable power[s]"[462] that the Court found Albert possessed in SFLP as well:

> If the mere fact that a shareholder could band together with all the other shareholders of a corporation and such banding together would be sufficient to cause inclusion under 2036, then it would have been impossible for the United States Supreme Court to reach the decision that it did in *Byrum*.[463]

Presumably, Albert is addressing the point in *Byrum* illustrated by the Supreme Court's statement: "Here, the right ascribed to Byrum was the power to use his majority position and influence over the corporate directors to regulate the flow of dividends 'to the trust.' That 'right' was neither ascertainable nor legally enforceable and hence was not a right in any sense of the term."[464]

The Tax Court answers Albert's argument by distinguishing the facts in *Byrum* from those in *Strangi II*. It specifically explained Byrum's right to designate the possession or enjoyment of the property was subject to a separate trust instrument not present under Albert's scenario, *and* Byrum's business had third-party unrelated shareholders, unlike Stranco and SFLP. The Tax Court opined the absence of those facts in *Strangi II* thwarted Albert's reliance on *Byrum*. The Court is, again, technically right, but unfortunately, unresponsive to the bigger practical issue raised by the argument. The Tax Court seemed to view the argument as constrained by the precedence the question cited. Thus, somewhat like true-false questions which are false *if any portion* of the statement is false, rhetorically and logically, by distinguishing the precedence for the argument, the Tax Court disposed of the entire question. The Tax Court was technically and rhetorically *correct* because the Supreme Court *does* follow its statement quoted above, with a new paragraph discussing the mitigation of any "majority . . . influence" by the existence of a trust and decedent Byrum's limited powers under the trust.

Before beginning the new paragraph however, the *Byrum* opinion drops a footnote which reads, in part, as follows:

> 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. [internal citation omitted]. Neither the government nor the dissent sheds light on the absence of an ascertainable standard. The Government speaks vaguely of drawing the line between "an unimportant minority interest" (whatever that

462. United States v. Byrum, 408 U.S. 136 (1972).
463. *Strangi II*, 85 T.C.M. (CCH) 1331, at *15.
464. *Byrum*, 408 U.S. at 136-37.

may be) and "voting control."[465]

If the bigger question raised by Albert's estate was placed in the context of the footnote, which it may have intended in the first place, the Tax Court's answer is, at *best*, unresponsive. Worse, it is confusing because it leaves open the bigger question about the effect and meaning of control. Worse yet, the opinion compounds the confusion by its second factual distinction: "It also ignores the identity of the shareholders in this case and the dual role played by Mr. Gulig."[466] The quote purportedly answered the question by clearly implicating a typical corporate control relationship and section 2036(a)(2) through reference to unique *facts* in *Byrum*. In doing so, it *reinforced* the interpretation that garden-variety control may well be a problem in the context of section 2036(a)(2) in regard to related parties. It ignores the Supreme Court's footnote. Finally, the Court's unresponsive answer blurs the analytical framework (hermeneutic in law-review-speak) that *Strangi II* attempts to model because it uses "constraints upon rights to designate" (which mitigate rights)[467] to answer a question posed in the context of identifying "legally enforceable rights."[468] The opinion uses each of the quoted phrases as separate headings in a two-step analysis.[469]

In summary, the Tax Court used a two-step analysis in *Strangi II*, and found that Albert had retained "ascertainable and legally enforceable rights to designate who shall enjoy the transferred property and its income" under section 2036(a)(2). It found these retained rights in the documentary evidence, including the limited partnership agreement, the bylaws, a shareholders agreement and, perhaps most importantly, the management agreement. More specifically, it stated these ascertainably and legally enforceable rights "are traceable to decedent through the explicit provisions of the governing instruments."[470] It also said these rights were more than "mere 'control,' management, or influence."[471] The clearest and strongest rationale for its holding centers on the powers held by Mr. Gulig under the management agreement. The weakest part (weak to the point of failure) of the rationale centers on distinguishing "mere 'control' or management rights" from ascertainable legally enforceable rights.

The second step of the two-step analysis of section 2036(a)(2) in *Strangi II* was determining whether the existence and effect of "constraints upon rights to designate" effectively mitigated the rights found to include the transferred property in the gross estate. The Tax Court did not find sufficient constraints

465. *Id.* at 136 n.10.
466. *Strangi II*, 85 T.C.M. (CCH) 1331, at *15.
467. I.R.C. § 2036(a)(2) (2003).
468. *Strangi II*, 85 T.C.M. (CCH) 1331, at *14.
469. *Id.* at *14-15.
470. *Id.* at *15.
471. *Id.*

on Albert's retained rights to render inclusion unwarranted stating, "the constraints alleged by the estate are illusory."[472]

The Tax Court's discussion and analysis on the constraint leg of the analysis is straightforward and clear. Once again, it focused on *Byrum*. The longest part of the discussion concerned the existence and effect of fiduciary duties. The opinion first observed, unlike *Byrum*, there was no independent trustee to act as a governor on the exercise of Albert's rights.[473] It then discussed the absence of "economic and business realities consequent upon the status of the relevant [business entities] . . . as typical operating enterprises" that the Supreme Court found existed in *Byrum*.[474]

The lack of the economic and business realities under the facts of *Strangi II* is rooted in the distinction between operating companies and those used for investment pooling and management, which primarily own "monetary or investment assets."[475] In *Strangi II*, the Tax Court simply states businesses who have readily saleable assets are not subject to the kind of market and business discipline as are small operating companies "affected by . . . changes in products, in competition, or in industry regulation and outlook; use of funds for replacement of plant and equipment or for growth and expansion; and the need to retain sufficient earnings for working capital."[476] At base, this distinction of *purpose* makes sense, though there seems to be a business continuum on this metric rather than a bright line. One also wonders whether this metric or factor is not a play on the existence of a business purpose, discussed at length in *Strangi I*.[477]

The Tax Court devoted its longest discussion in this part of the opinion to fiduciary duties as a *constraint to designate*. It focused not only on the existence of those duties, which it acknowledged as a theoretical matter,[478] but also whether there was a realistic chance of enforcement. Once again, the Court looked to the relational identity of the parties to determine there was no presence of an enforcement mechanism to constrain Albert's right to designate the enjoyment of the transferred property. It introduced its discussion by stating: "Intrafamily fiduciary duties within an investment vehicle simply are not equivalent in nature to the obligations created by the *United States v.*

472. *Strangi II*, 85 T.C.M. (CCH) 1331, at *15.

473. *Id.* at *16.

474. *Id.*

475. *Id.* Recall here the irksome distinction Albert tried to draw between *liquid* and *liquefiable* assets.

476. *Strangi II*, 85 T.C.M. (CCH) 1331, at *16.

477. *See supra* notes 330-69 and accompanying text. The lack of business purpose was also used in *Strangi II* to dispense with Albert's argument that inclusion should be avoided "on the basis of the parenthetical exception for a bona fide sale for an adequate and full consideration in money or money's worth." *Strangi II*, 85 T.C.M. (CCH) 1331, at *17. The Court stated: "[T]he SFLP/Stranco arrangement patently fails to qualify as the sort of functioning business enterprise that could potentially inject intangibles that would life the situation beyond mere recycling." *Id.* at *18.

478. *Strangi II*, 85 T.C.M. (CCH) 1331, at *17.

Byrum . . . scenario."[479] It concluded with two statements: (1) it does not interpret *Byrum* to require that fiduciary duties must be presumed in the absence of "safeguards of business operations and meaningful independent interests or oversight"; and (2) there were no "factors in this case that would encourage the use of enforcement of fiduciary duties in constraint of Albert's exercise of his rights."[480]

The Tax Court specifically addressed the transparent attempt to design such safeguards by donating one percent ownership share of *Stranco* to the MCC Foundation.[481] The Tax Court applied common sense when it stated that section 2036(a)(2) does not require giving decisional weight to "window dressing" and further stated: "A charity given a gratuitous 1-percent interest would not realistically exercise any meaningful oversight."[482] The statement is also consistent with the Court's several statements directed at accounting niceties that do not reflect underlying substance in *Strangi I*.[483]

d. Final Comments on Strangi

Both *Strangi I* and *Strangi II* emphasize the realities of the operation of the specific arrangement of Albert's affairs in applying the statutory provisions of the estate tax. The law applied, of course, includes the string provisions that bring property back into decedent's gross estate for purposes of calculating the estate tax. This section of the article, therefore, ends with two final observations about those strings before finally leaving the illustrative *Strangi* cases.[484] The first observation is a narrow one concerning the effect of the identity of the parties in intrafamily arrangements, and it implies a policy connection between current interpretation of the wealth transfer tax and the larger body of the general law of business. The second is more global and suggests a different theory that may help elucidate the issues raised in *Strangi* and similar cases and, in application, may represent an alternative way for planners to assess intrafamily "arrangements" in a holistic way. A portion of the first observation is somewhat troubling, the second is wildly speculative.

The first observation relates back to the notion that intrafamily businesses are categorically different from other businesses. The bifurcation of family and non-family businesses is expressly repeated and implicitly emphasized throughout *Strangi*. The observation is that any treatment of family businesses as categorically different from other businesses is both potentially under-inclusive and potentially over-inclusive and has the policy potential of introducing macroeconomic inefficiencies by creating a headwind for family

479. *Id.*
480. *Id.*
481. *Id.*
482. *Strangi II*, 85 T.C.M. (CCH) 1331, at *17.
483. *See supra* notes 331-33 and accompanying text.
484. *See supra* notes 330-69, 370-77 and accompanying text.

enterprise. Of course, the foregoing statement is largely mitigated in a general way because of the unified exemption equivalent. Even so, one troubling aspect of *Strangi* is that it squarely confounds all the wealth transfer tax issues that revolve loosely around control. *Strangi I* and the Fifth Circuit's opinion *directly* discuss *control*.[485] Therein, the Tax Court used *implied control* to reduce valuation discounts but *did not* use implied control to set aside the *legal* existence of the limited partnership and its general partner. *Strangi II* is far more constrained in its discussion of control in part because of the limited issue on remand, but the issue is implied in various places, including the discussion of fiduciary duties as a constraint on the power to affect possession and enjoyment under section 2036(a)(2).[486]

One of the problems that confronted the *Strangi* Court was the very short existence of the business before Albert's death. As observed by the Tax Court itself, that fact made for a paucity of evidence. It is in just such cases, however, where the temptation to substitute general taxonomic default rules for proof will be strongest. In *Strangi II*, the intrafamily nature of the enterprise, together with the lack of identifiable parties with competing interests, effectively mitigated any constraint provided by fiduciary duty constraint. In *Strangi I*, implied control was used to reduce the minority discounts based on similar evidence. The use of implied control on the facts in *Strangi* raises the somewhat troubling question of whether the same facts and the same kind of implied argument might be successful in the related issue of the attribution of ownership between family members for purposes of *control premium*.[487]

The first observation yields the prescription that care must be taken in the probative value given certain evidence of implied control in the family context because the same kind of implied control, complete with covering accounting entries and careful the "crossing of t's and dotting of i's" has made headlines of late in the publicly traded corporate world.[488] Indeed, Jack Welch's retirement

485. *Strangi I*, 115 T.C. 478 (2000).

486. *See supra* notes 433-74 and accompanying text.

487. *See supra* notes 375-77 and accompanying text.

488. For example:

> After more than a year of criminal and regulatory investigations, the nation's two largest banks agreed yesterday to pay almost $300 million in fines and penalties to settle accusations and they aided Enron in misrepresenting its true financial condition for years before the company collapsed. . . .
>
> But the bank settlements—reached with the Securities and Exchange Commission and the Manhattan district attorney's office—have a significance far beyond the issues in the Enron case. That is because, for the most part, the transactions between Enron and the banks met legal and accounting requirements but still led to what regulators said was misleading information in the company's financial reports. [Cite omitted.]
>
> As a result, these settlements are a strong signal that corporate advisers will be held responsible for the financial effect of their dealings with clients—meaning that banks, accountants and lawyers can be held responsible if a transaction is legal in every respect but results in a outcome that deceives investors.
>
> "These two cases serve as yet another reminder that you can't turn a blind eye to the

terms, for example, seem to be evidence of the type that in the family estate tax context are now used in the Tax Court to show implied control. Thus, there needs to be a redoubling of effort to vet and analyze the objection evidence in cases like *Strangi*. This observation may also show some connection between the world of the estate tax and the larger business world. The Tax Court's treatment of such things as accounting and its analysis of fiduciary duties may reflect the same *zeitgeist* that is beginning to punish overreaching in the larger society.

The *second observation* stems, in part, from the difficulty of applying statutory *tax law* like section 2036 to situations like *Strangi I* without resorting to underlying state law. After all, issues similar to business purpose and control exist in state law. The second observation, therefore, is one of simple comparative analysis between tax law and state law. The hypothesis inchoate in the second observation is that the underlying issue of economic reality and business substance addressed in *Strangi* for purposes of the wealth transfer tax has a counterpart in the state law of piercing the corporate veil (as applied to all entities which afford owners limited liability). The fundamental issue in both situations is when and to what extent to disregard the existence of a legal entity. In the estate tax context, the purpose of the inquiry is to ascertain the proper value and ownership of assets and transferred at death. In the piercing context, the purpose of the inquiry is to determine the identity of assets that are available to creditors. The law and doctrine have rightly evolved separately in both contexts.

As a very general matter, the doctrine of piercing the veil of limited liability has evolved into a two-prong test. The first prong of the test is the "separate corporate identity prong" and its function is to test whether the owner and the entity have maintained separate identities.[489] Factors which are considered under the first prong include, according to one court, "(1) undercapitalization; (2) failure to observe corporate formalities; (3) absence of corporate records; and (4) payment by the corporation of individual obligations."[490] This prong is the *control* prong and "[i]mplicit in the first prong of the test is the idea that the person or persons whom the plaintiff wants to hold individually liable must have exercised such *control* over corporation that the notion of separate legal entity no longer exists."[491] Other terms used to describe this notion include *alter ego* or *instrumentality*.[492]

---

consequences of your actions," said Stephen M. Cutler, director of the enforcement division of the S.E.C.

Kurt Eichenwald & Riva D. Atlas, *2 Banks Settle Accusations They Aided in Enron Fraud*, N.Y. TIMES, July 29, 2003, at A1.

489. Kan. Gas & Elec. Co. v. Ross, 521 N.W.2d 107, 112-13 (S.D. 1994).

490. *Id.*

491. *Id.*

492. *Ross*, 521 N.W.2d at 112-13.

The second prong of the test is "the 'fraud or inequitable consequences' prong."[493] Another court described this prong as requiring "an element of unfairness, injustice, fraud, or other inequitable conduct."[494] Under that prong, disregard of the entity in the corporate setting requires evidence that the corporate form was used to further "fraud, injustice, or evasion of a legal obligation."[495]

The extension of the application of the two-prong test as a framework to disregarding entities in the context of the estate tax is, of course, an imperfect analogy. Moreover, its application does not result in more predictable or certain results. Nonetheless, it avoids the doctrinal pinch of squeezing facts into ill-fitting and narrowly-drafted statutes. It is conceptually similar to the sham transaction doctrine in tax law that has been applied in various federal tax contexts, including the use of disclaimers in the estate and gift tax area[496] and interest deductions in the income tax area.[497] The sham transaction doctrine, as a general matter, revolves around the issue of business purpose; that is, if the taxpayer cannot show a business purpose for the transaction, it will be considered a sham and be disregarded.[498] Finally, the analogy with the piercing cases might be one way for lawyers without a background in estate planning to better understand the fundamental issues involved.[499]

---

493. *Id.*

494. NLRB v. Greater Kan. City Roofing, 2 F.3d 1047, 1052-53 (10th Cir. 1993).

495. *Greater Kan.*, 2 F.3d at 1054-55.

496. *See generally* Estate of Monroe v. Comm'r, 104 T.C. 352 (1995), *rev'd*, 124 F.3d 699 (5th Cir. 1997).

497. *See generally* Colleen Morgan, *Deduction and Interest* (Ch. 26 II.C. *Sham Transactions*), *in* 7 MERTENS LAW OF FEDERAL INCOME TAXATION § 26:11 (2004).

498. *See, e.g.*, Knetsch v. United States, 364 U.S. 361 (1960) (interest deduction disregarded); Durkin v. Comm'r, 872 F.2d 1271 (7th Cir. 1988) (interest deductions disallowed for income tax purposes involving a motion picture investment limited partnership; an example of income tax shelter).

499. In particular, the *piercing* analogy would seem to present comparable facts and results to three oft-cited Tax Court cases decided under section 2036(a). The *first* case is *Estate of Schauerhamer v. Commissioner*, 73 T.C.M. (CCH) 2855 (1997), which involved three separate family limited partnerships. Each one of the limited partnerships was formed with a different child and the decedent was able to transfer a material amount of her interests in each partnership to her children using the annual exclusion. Although like in *Strangi I*, the Service argued that the limited partnerships should be disregarded under section 2703, *see supra* notes 336-37, the Court did not reach that issue determining that the value of the transferred interests were includible in her gross estate under section 2036(a) (retained interests) and section 2038 (revocable transfers). The gravaman of the case was the commingling of funds. For example, income from the partnerships was deposited directly into her personal accounts and those accounts were used to pay for her living expenses.

The *second* case is *Estate of Reichardt. v. Commissioner*, 114 T.C. 144 (2000), in which, like in *Strangi II*, the Tax Court there found an implied agreement under section 2036(1) in which the decedent retained enjoyment of transferred property during his life. The facts in *Reichardt* included commingling, deposit of *some* partnership income in decedent's personal account and the retention of possession in his personal residence, without rental obligation, even though it was transferred to the partnership.

The *third* case is *Estate of Harper v. Commissioner*, 83 T.C.M. (CCH) 1641 (2002). Although there was an intervening trust that actually created the limited partnership, the Tax Court determined that there was an implicit agreement under section 2036(a) which caused the value of the property transferred from the trust to the limited partnership to be included in the gross estate. The Tax Court cited evidence for the implied

2. *Limited Partnership Interests: Planning, Patterns, and Pitfalls in a Post-Hackl World*

a. *Tax Planning with Gifts of Limited Partnership Interests*

Section I of this article discussed the key elements of the Federal wealth transfer tax provisions, and the last section illustrated several of those elements in dynamic interaction with facts in a particularly important recent case concerning a family limited partnership and the estate tax. This section of the article builds upon the previous discussion and analysis by summarizing wealth transfer tax planning with limited partnerships and will briefly extend the discussion of the dynamic interaction of wealth transfer taxes to gift tax planning. The discussion in the next section of the article, Section III, includes analysis of critical provisions of the existing state law of limited partnerships. Finally, Section III will compare and contrast ULPA (2001) with current limited partnership law (with some regard to the law of other entities) for wealth transfer tax purposes—the holy grail of the article.

The broad *basic* techniques to maximize wealth transfer tax savings summarized at the end of Section II.A included the deferral of payment of potential tax payable; bypassing or skipping the estates of a surviving spouse and of whole generations through measured use of the marital deduction and navigating the GST tax and its exemptions; use of the unified exemption equivalent for purposes of the estate tax at death and the gift tax for lifetime gifts; use of the annual exclusion for gift tax purposes and for possible income splitting for income tax purposes; and valuation freezing techniques like installment sales.[500] The concept of *basis* was discussed in that section of the article in conjunction with the scheduled repeal of the estate tax in 2010, to spring back in 2011. The discussion of basis, an income tax measuring device, is included in this discussion on estate planning because of the *step-up* in basis at death, and allocation of a limited *step-up* amount when (and if) the estate tax is repealed.[501] It was also suggested that entities like limited partnerships might be used to accomplish these goals.

Section II.B also introduced general valuation issues, including several special valuation rules applicable to family transfers or closely held businesses.[502] Certain statutory *string provisions* were discussed in that portion of the article, which operate generally to bring specific property transferred

---

agreement included short-term commingling of trust and limited partnership funds that was not rectified until after decedent's death and a delay in transferring formal title in the assets from the trust to the limited partnership. The decedent also received distributions from the partnership which were larger than his proportionate ownership interest in the partnership. Moreover, the Court observed that no property was transferred until after decedent had been diagnosed with cancer.

500. *See supra* notes 55-132 and accompanying text.

501. *See supra* notes 89-90 and accompanying text.

502. *See supra* notes 191-246 and accompanying text.

during life by the decedent back into the gross estate for estate tax purposes.[503] The availability of minority discounts and marketability discounts for interests in business entities were discussed in that section,[504] building on the previous suggestion that entities could help accomplish wealth transfer tax goals.[505]

Finally, the long analysis of the *Estate of Strangi* case trilogy raised specific wealth transfer tax issues focusing on, but not limited to, the estate tax.[506] The discussion of *Strangi I* included an illustrative example of the application of Chapter 14 special valuation rules. In that regard, both the Tax Court and the Court of Appeals for the Fifth Circuit analyzed section 2703(a)(2) and determined that the partnership agreement itself was not the kind of restriction to be ignored based on the definition of transferable property under the statute.[507] *Strangi I* also illustrated how valuation "works" for closely held business interests in the context of an estate;[508] analyzed the idea of a gift at inception; generally provided a bit more depth on the theoretical nuances of the definition of a gift; and discussed at some length the economic substance doctrine and its relationship to section 2036(a).[509]

The final discussion in the previous section of the article concluded with an extended discussion of *Strangi II*. The case, and the discussion of it herein, focused on section 2036(a), and, just beneath the surface, the appropriateness of *control* as a factor of retention of the benefits of transferred property.[510] Lastly, a speculative comparison of *strings* and the idea of "piercing" under state law liability cases was briefly presented as an analogue presenting similar issues to control in the estate planning context.[511] The latter discussion echoed themes, without identifying them, discussed in *Strangi I* under the rubric of the economic substance doctrine. Virtually all of the ideas play a role in understanding the state law of limited partnerships in the context of estate planning.

The reason the *typical* gift tax strategies were not vetted in the *Strangi* trilogy is, more likely than not, because Albert died before his power-of-attorney holder (his son-in-law Mr. Gulig) could execute them. Albert, recall, died just months after the establishment of SFLP.[512] Nonetheless, the SFLP arrangement was established in a way that it could act as a platform from which to launch a prototypical gifting plan. Recall Albert received a ninety-nine percent interest in SFLP through his limited partnership interests and,

503. *See supra* notes 250-61 and accompanying text.
504. *See supra* notes 169-77 and accompanying text.
505. *See supra* notes 7-10 and accompanying text.
506. *See supra* notes 300-499 and accompanying text.
507. *See supra* notes 340-43 and accompanying text.
508. *See supra* notes 362-69 and accompanying text.
509. *See supra* notes 330-39 and accompanying text.
510. *See supra* notes 371-413 and accompanying text.
511. *See supra* notes 489-99 and accompanying text.
512. *See supra* note 329 and accompanying text.

separately, received a forty-seven percent interest in Stranco, the corporate general partner that had a one percent share of the limited partnership as general partner.[513]

The result of the SFLP arrangement, at bottom, converted (or pejoratively as latter suggested in *Strangi II*, "*recycled*") assets from one form of property contributed by Albert to limited partnership interests in SFLP and corporate stock in Stranco. Had Albert lived longer, he could have "gifted" either his limited partnership interests or his corporate stock to his children (or grandchildren, if any, or anyone else, for that matter). The plan would be, typically, that those gifts would qualify for the annual exclusion for gift taxes. Thus, he could give each donee interests worth the annual exclusion, this year, of over $11,000.[514] From a wealth transfer tax standpoint, the limited partnership arrangement is *better* than not forming the partnership and giving away the underlying property he contributed to SFLP and Stranco for two reasons: (1) the value of the stock and limited partnerships interests would be given based on a discounted valuation; and (2) more speculatively under the *Strangi* facts, Albert might be able to choose the type of interest to give based on his opinion of which interest would appreciate more in the future. The two advantages will be briefly explained in reverse order.

The second advantage, just identified, is known as a freeze technique. It is an extension of the simple idea that, all other things being equal, it is better to give away *appreciating* property than *nonappreciating* property in order to maximize wealth transfer tax savings. The simple idea underlying freeze techniques is easily illustrated outside the limited partnership context. Assume that Harry owns two paintings. Painting A is a good piece of art painted by a solid regional living artist. It currently has a fair market value of $10,000 and it is expected to hold its value into the foreseeable future but not to increase in value (appreciate). Painting B is also by a regional artist but it possesses, according to critics, certain magical features. Moreover, its artist, who is now ninety-five years old, is beginning to receive international attention by the market. It, too, is currently valued at $10,000. Harry is sixty years old and he wants to give one of the paintings away. Which painting should he give away if his only consideration is maximum federal wealth transfer tax savings?

The answer is painting B because it will be worth more than painting A if held until, and transferred because of, his death. Just to play out the scenario by continuing the illustration: Assume Harry dies in thirty years *and* the estate and gift taxes remain unchanged from today. Consistent with the current guess of future appreciation, painting A is worth $11,000 (appreciation of $1,000) while painting B is worth $250,000 (appreciation of $240,000). Therefore, if Harry gave away painting B, his estate will be $239,000 smaller than if he gave

513. *See supra* notes 327-28 and accompanying text.

514. *See supra* notes 76-87 and accompanying text.

away painting A.

Assuming that the entire value of either painting will be in Harry's *taxable* estate at the maximum rate, this yields an estate tax savings of over $120,000. Of course, the example contains a lot of assumptions. The note in the margin gives examples of what might happen if those assumptions are relaxed, including possible income tax ramification of the step-up in basis received by legatees but not donees.[515]

Extending the simple estate tax saving technique of giving away appreciating assets to limited partnerships requires an organizational planning twist that does not necessarily appear to be present in the facts of *Strangi*. The twist is organizing the limited partnership such that the appreciation accrues *either* to the general partnership interests or the limited partnership interests but *not* to both. The interests to which appreciation accrues would then be given away during life for the same reason and tax effect that painting A was given away in the example, above.

Generally the freeze is achieved in the value of the limited partnership interests in the limited partnership by providing a fixed yield to those interests forcing all appreciation into the general partnership interests. Thus: "The design of the partnership freeze typically results in freezing the value of the parents' interests in the partnership. Generally, the parents receive virtually all of the income from the partnership, and future generations receive all future appreciation without imposition of the estate or gift tax."[516] From a taxpayer's planning perspective, of course, the Chapter 14 "Special Valuation Rules" and section 2036(a), *inter alia*, must be carefully considered in attempting to use freeze techniques.[517]

---

515. For example, change the assumption so that the value of the paintings will *not* be in Harry's taxable estate because the value of the paintings plus his other property do not exceed his unified exemption equivalent at death, i.e., he has no taxable estate. In that scenario, the gift recipient is disadvantaged for income tax purposes because of the step-up in basis rules. *See supra* notes 89-90 and accompanying text. Thus, if Harry paid $10,000 for each painting (and had an adjusted income tax basis equal to that amount) the *gift* recipient would have a carry-over basis of $10,000.

When the recipient sells painting B for $250,000, she must recognize a gain of $240,000 for income tax purposes. Had Harry kept the painting, the same recipient under Harry's will would receive a step-up in basis to $250,000 and, if she sold it immediately after it was distributed from the estate, recognize *no* gain for income tax purposes. Basis considerations concerning limited partnership interests are discussed in notes 518-20 and accompanying text, below.

The other caveat is a non-tax consideration. Assume Harry falls on hard financial times and he has no available financial resources for reconstructive surgery to remove an ugly, and sometimes painful, lightning-shaped scar on his forehead. If he had kept painting B, he could have sold it to pay for the surgery. If he gave it away, it won't be available to pay for his surgery. Economists, of course, call other possible uses of the value of the gift *opportunity costs*. Opportunity costs are important considerations to Harry because, after all, he's dead if and when the estate tax comes due.

516. Thornton, *supra* note 9, at 224.

517. The application of these, and other, provisions on freeze planning is generally beyond the scope of this article and unnecessary for its purpose beyond helping establish the planning environment in which the provisions discussed above may apply. For a discussion of the basic Chapter 14 provisions, see notes 193-99 and accompanying text, above. For a discussion of section 2036(a), see notes 330-39 and accompanying text,

Another advantage of using limited partnerships or other unincorporated entities for purposes of wealth transfer tax planning is the discounting of those interests. In the gift tax context, the notion is that the lower the valuation of the interest, the greater the portion of the business that can be given within the annual exclusion.[518] The easiest illustration uses shares of corporate stock. For example, if the donor owns all one hundred shares of a corporation and the prediscounted value is $1,000 per share, the donor may give about eleven shares and be within the annual exclusion. If, however, the discounted value is $500 per share; the donor may give about twenty-two shares and still be within the annual exclusion. Thus, in the first instance she can give away eleven percent of the corporation per year, and in the second she may give away twenty-two percent of the corporation.

General valuation principles have been discussed previously in this article,[519] but a special state law attribute of unincorporated entities in general, and limited partnerships in particular, acts to magnify the discount available under the application of these principles. The attribute is, generally, that interests in limited partnerships may not be freely transferable as a matter of state organizational law.[520] It is necessary to understand the valuation effect of the lack of transferability. And the discussion is most appropriate here. A more complete discussion of the state-based statutory provisions governing transferability will be discussed in the next section of the article.[521] State law is important to valuation in the context of business entities because it is state law that describes and defines the property to be valued. For example, in a case involving a Texas general partnership, the Fifth Circuit Court of Appeals stated: "To determine the exact nature of the property or interest in property that is transferred federal courts must look to state law, in this case Texas partnership law."[522] Thus, various features of state law, including transferability, must be considered for valuation purposes.

These state law attributes can be seen easily in the case of *general partnerships*. Under UPA (1914), for example, the *property* rights of partners in a general partnership consist of: (1) rights in specific partnership property;[523] (2) the interest in the partnership; and (3) the rights to participate in

above. For a more detailed application of wealth transfer taxes to freeze techniques, see Thornton, note 9 above, ¶ 19.01 to ¶ 19.05, and *CCH Financial and Estate Planning Guide*, ¶ 2301 to ¶ 2320 (2001).

518. *See generally supra* notes 79-87 and accompanying text.

519. *See supra* notes 133-90 and accompanying text.

520. *See* generally Robert R. Keatinge et al., *Choice of Entity in Colorado*, 23 COL. LAW. 293 (1994).

521. *See infra* notes 529-30 and accompanying text.

522. Adams v. United States, 218 F.3d 383, 386 (5th Cir. 2000).

523. Under UPA (1914), property "owned" by the partnership was really owned as tenants in partnership. UPA (1914) § 25(1). The tenancy was much like a joint tenancy. The more modern partnership law provides that the partnership is an entity. RUPA (1997) § 201. Therefore no individual partner has any type of ownership title in the underlying property owned by the partnership. *Id.* § 203.

management.[524] The partner in a general partnership also has other rights including, generally under UPA (1914), the right to inspect and copy any partnership books to the extent the partnership keeps books,[525] and, upon most events of dissolution, to wind-up the partnership business.[526] Moreover, after dissolution, except in instances of wrongful dissolution, each partner has the right to have the partnership assets liquidated and receive her share of the proceeds paid to her in cash.[527] Additionally, in the case of a general partner under UPA (1914), "every partner is an agent of the partnership for the purpose of its business."[528]

Finally, two features of UPA (1914) directly relate to transferability of the property interest owned by a partner. *First*, unless otherwise agreed: "No person can become a *member* of a partnership without the consent of all the partners."[529] *Second*, and following from the unanimous vote required for membership, a partner may transfer her interest in the partnership, but such transfer entitles the transferee, called an assignee under UPA (1914), to very limited rights. The language of UPA (1914), though relatively long to be included in the text of an article in a block quote, set forth the transferees rights to which the valuation principles of the wealth transfer tax system apply:

> § 27. Assignment of Partner's Interest
>
> (1) A conveyance by a partner of his interest in the partnership does not of itself dissolve the partnership, nor, as against the other partners in the absence of agreement, entitle the assignee, during the continuance of the partnership, to interfere in the management or administration of the partnership business or affairs, or to require any information or account of partnership transactions, or to inspect the partnership books; but it merely entitles the assignee to receive in accordance with his contract the profits to which the assigning partner would otherwise be entitled.
>
> (2) In case of a dissolution of the partnership, the assignee is entitled to receive his assignor's interest and may require an account from the date only of the last account agreed to by all the partners.[530]

Subsection 27(2) evidences the limited rights of the assignee and suggests that assignees are *locked-in* for the duration of the partnership, whatever that duration may be, and, therefore, the assignee/transferee has little access to the value of the underlying property owned by the partnership.[531] On the other

524. UPA (1914) § 18.
525. UPA (1914) § 19.
526. UPA (1914) § 37.
527. UPA (1914) §§ 38(1), 40.
528. UPA (1914) § 27.
529. UPA (1914) § 18(g) (emphasis added).
530. UPA (1914) § 27.
531. *See supra* note 530 and accompanying text. The partner has only "an equal right with his partners to possess specific partnership property for partnership purposes." UPA (1914) § 25(2)(a). Moreover: "A

hand, subsection 32(2) suggests that a transferee may apply for a judicial dissolution: "(a) After the termination of the specified term or particular undertaking, [or] (b) At any time if the partnership was a partnership at will when the interest was assigned. . . ."[532] While the two subsections are not *necessarily* inconsistent, they can be interpreted inconsistently, or at least for cross-purposes, in the valuation setting because the assignee does, eventually, have the right to go to court for a dissolution.

Moreover, definitions of *interest* in different acts and statutes are inconsistent. This inconsistency leading a well-known commenter to state: "[I]n various statutes governing unincorporated business organizations, the term 'interest' has become almost hopelessly confused."[533] This is even true within the linked but separate definitions of interest and partnership interest in the Revised Uniform Partnership Act (1997) (RUPA (1997)) and RULPA (1976/1985).[534] Sometimes the difference in rights is delineated by calling one "economic rights" and the other "management rights."[535] In any event, given the importance of state law rights in valuation issues, the difference between a partner or owner with full rights and an assignee with limited rights is of self-evident importance in wealth transfer tax planning, and it will be illustrated in an integrated case example later in this section.[536] If valuation discount maximizing is a primary purpose of a plan, therefore, assigned/transferee interests are important conceptual tools. The identity of who gets or keeps these interests, or whether they are created and used separately or as a backdrop to valuing full interests that are marketable to others only as assignee interests, depends on the plan and, in part, whether its purpose is maximum discounting on one had, or accomplishing a freeze on the other, though discounting and freezing are not *necessarily* mutually exclusive goals.

There are, of course, other issues. Basic gift tax concepts must be

---

partner's right in specific partnership property is not assignable except in connection with the assignment of rights of all the partners in the same property." *Id.* § 25(2)(b).

532. UPA (1914) § 32(2).

533. Robert R. Keatinge, *Transfers of Partnership and LLC Interests—Assignees, Transferees, Creditors, Heirs, Donees and Other Successors*, 32ND ANN. UNIV. OF MIAMI PHILIP E. HECKERLING INST. ON EST. PLAN. ¶ 501.4 [A], at 5-9 (1998).

534. Keatinge further explained:

> In some contexts it represents only the rights of a partner, member, assignee, transferee or holder of a charging order to a share of the profits and losses of an organization and a right to receive distributions of the organizations assets but does not include rights to participate in management or to demand information. [citing RULPA § 101(10)] . . . . Other statutes refer to "membership interests" and "partnership interests" as including not only economic interests but also . . . the rights of a partner or member to participation in management of the organization and to demand information. [citing RUPA § 101(7)].

Id. Note that RUPA in many states now serves as the underlying law "for issues not specifically addressed" by RULPA, so the different definitions must be carefully kept in mind in interpreting questions under RULPA that are answered through linkage to RUPA.

535. *Id.*

536. *See infra* notes 546-76 and accompanying text.

considered beyond the notions of freezes and valuation. Two of them, previously introduced, are the concept of *completed gift* and the specific requirements for gifts to qualify for the annual exclusion.

The gift tax applies only to transfers by gift that are completed gifts. State property law provides the basic elements of a gift. Very generally, the elements are: "(1) a donor competent to make a gift; (2) . . . intention by the donor to make a gift (including absence of adequate consideration); (3) a . . . transfer that vests legal title in the donee without power of revocation; (4) relinquishment of dominion and control by delivery . . . ; and, acceptance by the donee."[537]

The Gift Tax Regulations provide additional explanation for when a gift (or *transfer*) is complete for gift tax purpose. For example, "[a] gift is incomplete in every instance in which a donor reserves the power to revest the beneficial title to the property itself" or if she reserves the power to "name new beneficiaries or to change the interests of the beneficiaries as between themselves."[538] A donor will be deemed to reserve such powers even if they are held in conjunction with another person unless that other person has "a substantial adverse interest in the disposition."[539] These notions are broadly consonant with the estate tax string provisions discussed previously.

Finally, a gift will be subject to tax as a completed gift; that is, will *not* be considered incomplete, even though, according to the regulations:

> *[T]he donor reserves the power to change the time and manner or time of enjoyment.* Thus, the creation of a trust the income of which is to be paid annually to the donee for a period of years, the corpus being distributable to him at the end of the period, and the power reserved by the donor being limited to a right to require that, instead of the income being so payable, it should be accumulated and distributed with the corpus to the donee at the termination of the period, *constitutes a completed gift.*[540]

The notion that gifts are complete even though the donee has no present right to possession of income is important for gift planning in a comprehensive estate plan because it is at odds with the requirements for qualifying for the *annual exclusion* from the gift tax. In short, this means that a donor might give away property by a completed gift, but *not* qualify for the $11,000 annual exclusion and, therefore, be required to pay gift tax on the first dollar of the value of the gift rather than the first dollar *above* the annual exclusion amount.[541] In the words of the regulations defining the present interest requirements for qualifying for the annual exclusion:

537. 34 AM. JUR. 2D *Federal Taxation* § 40051, at 472 (2003) (footnote omitted).

538. Treas. Reg. § 25.2511-2(c) (2003). There is an exception for such powers which are held as "fiduciary powers limited by fixed or ascertainable standard[s]." *Id.*

539. Treas. Reg. § 25.2511-2(e) (2003).

540. Treas. Reg. § 25.2511-2(d) (2003) (emphasis added).

541. *See generally supra* notes 79-81 and accompanying text.

> (a) No part of the value of a gift of a future interest may be excluded in determining the total amount of gifts made during the "calendar period" . . . . "Future interest" is a legal term, and includes reversions, remainders, and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession, or enjoyment at some future date or time. The term has no reference to such contractual rights as exist in a bond, note . . . , or in a policy of life insurance. . . .
>
> (b) An unrestricted right to the immediate use, possession, or enjoyment of property or the income from property (such as a life estate or term certain) is a present interest in property.[542]

A second recent and closely watched case analyzes gifts of business interests within the completed gift—annual exclusion framework.[543] It is every bit as important as *Strangi*[544] and, therefore, an analysis of the case, *Hackl v. Commissioner*,[545] is unavoidable and follows. It, too, provides an illustration of the changing and dynamic nature of the *law* of wealth transfer tax planning.

b. Hackl: Gift Tax and the Annual Exclusion Redux

In *Hackl,* the Court of Appeals for the Seventh Circuit affirmed the Tax Court's decision that transfers of interests in an unincorporated entity (in this case a family limited liability company) did not qualify for the section 2503(b) annual exclusion because the interests did not represent "any substantial present economic benefit."[546] The case involved a retired CEO and his "search for a hobby that would allow him to keep his hand in the business world, diversify his investments, and provide a long-term investment for his family."[547] In 1995, the retired CEO, A.J. Hackl, bought two tree farms worth around $4.5 million, and later in the year contributed the farms to an LLC.[548] He, together

542. Treas. Reg. § 25.2503-3 (2003).

543. *See* Thomas S. Flickinger, *Comment: Gifts of Family LLC Units in a Post Hackl Era: Present Interests or Future Interests?*, 8 FORDHAM J. CORP. & FIN. L. 853, 861 (2003) (noting *Hackl* as landmark case). "The Tax Court's decision in *Hackl* caught many people off guard since the Tax Court had not yet determined how restrictive . . . agreements could be without affecting the annual exclusion . . . ." *Id.* at 864; *cf.* Michael V. Bourland et al., *Hot Topics Under the 2001 Tax Act and Transfer Planning: Maintaining/Operating the Family Limited Partnership*, A.L.I.-A.B.A. EST. PLAN. FOR BUS. OWNER 1190 (Aug. 2002) ("This will certainly be an interesting case to watch for in the appellate court. . . ").

544. *See supra* notes 300-499 and accompanying text.

545. Hackl v. Comm'r, 335 F.3d 664 (7th Cir. 2003) [hereinafter *Hackl II*], *aff'g* 118 T.C. 279 (2002) [hereinafter *Hackl I*].

546. *Hackl II*, 335 F.3d at 667.

547. *Id.* at 665.

548. *Hackl I*, 118 T.C. at 281. The Tax Court further detailed the two farms:

> (1) A 3,813.8 acre tract in Putnam County, Florida . . . and (2) a 7,771.88 acre tract in McIntosh County, Georgia. . . . The Putnam County Farm was purchased on January 6, 1995, for $1,945,038 and contained merchantable timber valued at $140,451 as of the time of purchase. The McIntosh

with his spouse, eventually also contributed "about $8 million in stock and securities to Treeco, LLC [the family LLC]."[549] The liquid investments were contributed "to serve as working capital and to finance additional purchases of tree farm property."[550]

The Tax Court stated that A.J. established the LLC for the following reasons: (1) to shield his assets not related to the tree farming business from potential liability associated with that business; (2) to create a separate enterprise in which family members could participate; and (3) to facilitate the transfer of ownership interests in the tree farming business to his children, their spouses, and his grandchildren.[551] Treeco LLC began life owned equally by A.J. and his spouse, that is, each owned a fifty percent interest. It consisted of both voting and nonvoting units.[552] Together, they were the LLC's initial members and signed the operating agreement.

The relevant business arrangement, as discussed by the Tax Court, involved management rights, distributions, withdrawal conditions and transfer ability of interests, and dissolution. A.J. was named manager for life (really), meaning that he was to remain manager until "resignation, removal, or incapacity."[553] He also had authority to name a successor manager, including the authority to do so by will.[554] *Management* was vested in the manager (A.J.) and the manager had authority to declare pro rata *distributions* from a defined pool called "Available Cash."[555] Available cash was limited by its terms to include only sums, for example, in excess of outstanding current obligations and a working capital reserve.[556] Moreover, no member could *withdraw* capital or demand any distribution in lieu thereof without the manager's permission.[557]

Transfer of interests was also limited by the operating agreement, though the terms seem consistent (if not more permissive) than the default rules contained in many state statutes. Basically, the operating agreement followed the member-assignee dichotomy with the transferee receiving only financial and not governance rights. Nonetheless, under the operating agreement, the

---

County Farm was purchased on June 23, 1995, and contained no merchantable timber as of that date. *Id.* at 285.

Also, according to the Tax Court, the entity planted "approximately 8 to 10 million trees" on the farms; A.J. Hackl "devotes approximately 750 to 1000 hours per year to the farming operations"; and, "Georgia Pacific Corporation and F&W Forestry Services, Inc., were retained . . . to provide consulting and management services." *Id.* The Seventh Circuit added that "[w]hile Treeco has yet to turn a profit, A.J. was named 'Tree Farmer of the Year' in Putnam County, Florida, in 1999." *Id.* at 666.

549. *Hackl II*, 335 F.3d at 665.

550. *Hackl I*, 118 T.C. at 284.

551. *Id.* at 281.

552. *Id.* at 282.

553. *Id.*

554. *Hackl I*, 118 T.C. at 282.

555. *Id.*

556. *Id.*

557. *Id.*

manager could, in his *sole discretion*, either permit or deny transfer upon request. If permitted, the transferee would become a substituted member. If denied, the transferee would receive an assignment of economic rights only.[558]

Additionally, the operating agreement expressly addressed *dissolution*. A.J., while he remained manager, could dissolve the company. After A.J. ceased being the manager, dissolution could occur upon agreement of eighty percent of the voting units. Finally, the company would be dissolved by events contained in the state LLC law or upon the occurrence of a "Dissolution Event" which included the manager's "resignation, expulsion, death, insanity, or retirement," but the company would continue after a dissolution event if a majority of the members voted to do so within ninety days of the event.[559]

The Tax Court summarized the *rights of members* as follows:

> (1) Voting members had the right to remove the manager and elect a successor by a majority vote; (2) voting members had the right to amend the Operating Agreement by an 80-percent majority vote; (3) voting and nonvoting members had the right to access the books and records of the company; (4) voting and nonvoting members had the right jointly to decide whether the company would be continued following an event of dissolution; and (5) after the tenure of A.J. Hackl as manager, voting members could dissolve the company by an 80-percent majority vote.[560]

The case is a good illustration of the tax leverage achieved by the annual exclusion because the Hackls' began giving individual gifts of the maximum exclusion amount using the split-gift election beginning in 1995 (of both voting and nonvoting indicating this was not a "freeze" plan), and, by early 1998, had reduced their joint holdings of voting interests to forty-nine percent or less.[561] The Service challenged the exclusion of these gifts by the use of the annual exclusion arguing that the interests were not *present interests*. The result, therefore, was the Service assessed a deficiency on the entire value of the gifts.

In affirming the Tax Court, the Court of Appeals cleaved closely to the operating agreement and focused on the distinction between present and future interests in the regulations. The opinion first reiterated that deficiencies assessed by the Service were correct and, therefore, the burden of proof was on the taxpayers.[562] It then disposed of the argument that the meaning of the term "future interest" was plain in the statute and, therefore, also disposed of A.J.'s argument that the regulations were appropriate to use as guidance.[563] As a result, the Courts rejected Hackls' argument that the donees received "the full

558. *Hackl I*, 118 T.C. at 283.

559. *Id.*

560. *Id.*

561. The split-gifts went to each of their eight children and to the spouse of each child. An irrevocable trust was established to receive gifts on behalf of their twenty-five minor grandchildren. *Id.*

562. *Hackl II*, 335 F.3d 664, 666 (7th Cir. 2003).

563. *Id.* at 667.

bundle of rights" conferred by the interests and therefore by definition were not future interests.

Similarly the Court of Appeals also rejected an argument advanced by the Hackls' under the regulations and stated that "'present interest' connotes *the right to substantial* present economic benefit."[564] Therefore, according to the Court of Appeals, substantial present economic benefit must be determined on the unique rights received under the facts of each case. It then held that "[i]n this case, Treeco's operating agreement clearly foreclosed the donee's ability to realize any substantial present economic benefit."[565] The Tax Court made the same determination more forcefully when it stated that "[a]ll facts and circumstances must be examined to determine whether a gift is a present interest within the meaning of section 2503(b) [the section concerning the annual exclusion], and this will be true only where all involved rights and restrictions, wherever contained, reveal a presently reachable economic benefit."[566] The only specific restriction the Appeals Court cited as limiting the present economic rights in the gifted interests was the operating agreement's restriction on transferability. It expressly accepted the Tax Court's reasoning by stating "the possibility that a shareholder might violate the operating agreement and sell his or her shares to a transferee who would then not have any membership or voting rights can hardly be called a substantial economic benefit."[567] Thus, while gifts of the interests may convey future value, they convey no *present* economic benefit to qualify for the exclusion.

Moreover, the Court of Appeals stated (1) it did not matter that the Hackls' own interests contained the same restrictions; or, (2) that restrictions on transferability are common in closely held companies.[568] Concerning the latter the Appeals Court expressly stated:

> The Hackls protest that Treeco is set up like any other limited liability corporation [sic[569]] and that its restrictions on the alienability of its shares are common in closely held companies. While that may be true, the fact that other companies operate this way does not mean that shares in such companies should automatically be considered present interests for purposes of the gift tax exclusion.[570]

The Seventh Circuit did not specifically address the argument that the interests represented a present economic right to income. The Tax Court did. In response to the taxpayer's argument, the Tax Court observed, like the Seventh Circuit, that distributions were governed by the operating agreement,

564. *Id.*
565. *Id.*
566. *Hackl I*, 118 T.C.at 294.
567. *Hackl II*, 335 F.3d at 667.
568. *Id.*
569. The Court undoubtedly *meant* limited liability *company*.
570. *Hackl II*, 335 F.3d at 668.

which by its terms gave the manager (A.J.) discretion as to "the timing and amount of distributions."[571] In so doing, however, the Tax Court relied on a case involving a trust for establishing a "three-part test for ascertaining whether rights to income satisfy the criteria for a present interest under section 2503(b)."[572]

The first part of the test is that "the trust will receive income."[573] In its analysis of this part of the test, the Tax Court indicated how far into the business it will look to find restrictions on present interests. Here, the Tax Court looked to the tree industry, the fact this was a start-up business, and the stipulated facts that the business purpose of Treeco was not to produce immediate income and that the Hackls "anticipated that . . . [Treeco] would operate at a loss for a number of years, and therefore, they did not expect . . . [to] be making distributions to members during such years."[574]

The business is the tree business, but the underlying assets are timber property. Thus, at least to the extent a business reflects the nature of the assets it owns, the Tax Court appears to be willing to look through the entity to the assets held *in the context of the gift tax annual exclusion.*[575] The taxpayers were probably trying to avoid or inhibit the Tax Court from going so deeply into the business by stipulating with the Service, "that Treeco was a legitimate operating business."[576] It is at least interesting, nonetheless, that the Court of Appeals is silent as to the detail of business and industry but rather, presumably, is satisfied, in this case, that the operating agreement alone provided sufficient evidence on which to affirm.

The Tax Court's willingness to go beyond the legal existence of the business and its organic documents is *presumably* for the narrow purpose of the *annual exclusion of gift tax*. It does not necessarily mean, for example, such inquiry is appropriate elsewhere and, indeed, the distinction is helpful to illustrate the technical and separate nature of different types of taxes and the specificity of the purposes of individual provisions. Note again, for example, that the state law existence of a partnership is important, though not controlling, for purposes of section 2036(a) of the estate tax. There the inquiry beyond state law existence concerns such things as lack of a business purpose to show intent or, in the alternative, lack of *economic* substance and the retention of enjoyment or possession of property.[577] The inquiry is deceptively similar, but if the statutory language its purpose is given due regard, decidedly different.

---

571. *Hackl I*, 118 T.C. 279, 298 (2002).

572. *Id.* The three parts of the test are: "(1) That the trust will receive income, (2) that some portion of the income will flow steadily to the beneficiary, and (3) that the portion of income flowing out to the beneficiary can be ascertained." *Id.* (quoting Calder v. Comm'r, 85 T.C. 713, 727-8 (1985)).

573. *Id.*

574. *Id.*

575. For an introductory discussion of the annual exclusion see notes 79-87 and accompanying text, above.

576. *Hackl I*, 118 T.C. at 296.

577. *See supra* notes 333-57 and accompanying text.

In contrast, however, the existence of a valid state entity and its default provisions *control* the special valuation of intrafamily transfers made under section 2704(b), which ignores any voluntary restrictions that would lower value beyond those default rules.[578] To focus exclusively on the requirements of any single provision of any single type of tax, therefore, may cause unforeseen consequences under another provision or tax. Yet another dimension of the tangled technical planning web and the final one to be discussed before finally, and perhaps anticlimactically, turning toward specific provisions of ULPA (2001), is the definition of partnership for the federal income tax.

c. Entity Tax Classification & An Overview of the Income Tax Features of Corporations and Partnerships for Estate Planning Purposes

By this point in time, almost everyone with even a passing familiarity of unincorporated organizations is familiar with the "check-the-box" regulations promulgated under section 7701.[579] These regulations provide the first analytical step in determining whether an *entity* will be treated as a corporation, a partnership, or a trust for purposes of the Internal Revenue Code. Section 7701, in tandem with regulations thereunder, provides a switching mechanism for the *classification* of entities for the entire Internal Revenue Code.[580] Basically the check-the-box regulations provide that most unincorporated entities will be classified as partnerships *unless* an election is filed electing corporate status.[581] The basic mechanics of classification can be rather easily stated. First, the defined term *business entity* does not include trusts.[582] Then, a specific set of decisional rules applies to sort entities that are corporations, partnerships, or which will be disregarded. A business entity having two or more members will be classified as either a partnership or a corporation.[583] A business entity with only one member will be classified as a corporation or will be *disregarded* for purposes of taxation.[584] An entity will be classified as a corporation if it is organized "under a Federal or State statute . . . [that] describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic."[585] The default classification for all other entities

578. *See supra* notes 138-39 and accompanying text.

579. *See generally* John DeBruyn, *Choice of Entity and Structuring Limited Liability Entities for the Best of Both Worlds*, 31ST ANN. UNIV. MIAMI PHILIP E. HECKERLING INST. ON EST. PLAN. 9-1, ¶ 907.2, at 9-28 (1998).

580. I.R.C. § 7701 (2003). It begins: "(a) when used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof." *Id.* It is the equivalent of the "sorting hat" of Harry Potter fame.

581. *See* HAMILTON & BOOTH, *supra* note 145, § 10.44 , at 276.

582. Treas. Reg. § 301.7701-2 (2003).

583. *Id.*

584. *Id.*

585. Treas. Reg. § 301.7701-2(b)(1) (2003) (this is a *partial* quote; there are other exceptions).

having two or more members is partnership classification unless: (1) it elects to be classified as a corporation; or (2) a special provision applies to classify it as a corporation, for example, if it is a publicly traded partnership.[586]

The classification of entities under the check-the-box regulation is generally beyond the scope of this article and may not be of particular relevance in any given context; but, counterintuitively, it must be mentioned to understand that it is *not* necessarily controlling for all tax planning purposes. Moreover, a very broad awareness of such classification is relevant for two reasons: (1) check-the-box, for practical purposes, replaces the prior classification scheme which focused on the specific characteristics of entities which, as a vestigial matter, may cause a confusion of emphasis in planning; and (2) classification forms a rhetorical bridge from the wealth transfer tax provisions back to two income tax planning features that *are* directly related to estate planning.

The check-the-box regulations were promulgated in December 1996 and became effective January 1, 1997.[587] Prior to the check-the-box regulations the "so-called Kintner regulations govern[ed] the determination of what constituted an 'association' [corporation]."[588] The Kintner regulations first required that an entity had to be formed for a business purpose. They then sorted the entities based on the existence of four specified characteristics. If an entity had three or more of these characteristics, the entity was taxed as a corporation. Alternatively, the entity would be taxed as a partnership if it had two or fewer of the characteristics. The characteristics were: continuity of life separate and apart from the life of its owners (e.g., a corporation generally has perpetual life); centralization of management (e.g., a board of directors and officers including specified agents); limited liability; and free transferability of interests.[589] Therefore, general partnerships formed under the default rules of UPA (1914) were prototypical partnerships for tax purposes because, absent agreement to the contrary, they had none of the four characteristics.[590]

The Kintner regulations had the effect of *locking-in* traditional *state law* business organization features. The best evidence of this lock-in was probably what occurred when the IRS recognized that a Wyoming LLC could be classified as a partnership for tax purposes in an *administrative* ruling under the Kintner regulations.[591] The result? "This ruling opened the flood gates. Within six years, 47 states have adopted LLC statutes, and the remaining

586. Treas. Reg. § 301.7701-3(a) (2003). *See generally* ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG & RIBSTEIN ON LIMITED LIABILITY PARTNERSHIPS AND THE REVISED UNIFORM PARTNERSHIP ACT § 7.05, at 249-54 (2001).

587. BROMBERG & RIBSTEIN, *supra* note 586, at 250 n.142.

588. BROMBERG & RIBSTEIN, *supra* note 586, at 250.

589. BROMBERG & RIBSTEIN, *supra* note 586, at 250.

590. Compare these characteristics with the discussion of UPA (1914) in notes 523-32 and accompanying text, above.

591. HAMILTON & BOOTH, *supra* note 145, § 10.30, at 264.

handful of states followed shortly thereafter."[592] It encouraged the development of other entities like the LLP under state law.

The time period between the administrative ruling and the promulgation of the check-the-box regulations is critical because it was a time when many state statutes regarding both LLCs and LLPs were in gestation or their early developmental stages. As a result, some of the first generation LLC statutes, for example, were *bullet-proof*; that is, they mandated the *absence* two of Kintner's corporate characteristics in LLCs organized under their authority.[593] Under these statutes, tax classification as a partnership, therefore, was mandated by statutory compliance.

While states have modified their LLC statutes, their initial use, plus years of planning analysis under the Kintner regulations, remains a vestigial analytical framework that may easily cause misplaced overemphasis on specific features of entities across all types of taxes. Indeed, this is the reason that this historical discussion is a relevant caveat for such misplaced emphasis and a warning about interpretation of older case law.

Another reason the broad topic of tax classification is introduced is because partnership income taxation affords advantages in certain planning situations in association with estate tax planning. Obviously, even the most rudimentary income tax comparisons between partnership and corporate taxation are beyond the scope of this article. As a very *general* matter, however, it is important to suggest that such a comparison shows contribution of property to a partnership is less likely to be a taxable income tax event than contribution of property to a corporation. Liquidating distributions upon termination are less likely to be an income tax event than similar distributions in the corporate setting (though there is a basis distinction for distributed property between corporate and partnership distribution). Finally, partnerships are fundamentally pass-through entities for income tax purposes, which typically avoid the double taxation of distributions that are a hallmark of C corporations, but not necessarily S corporations.[594]

Further, partnership income taxation allows "special allocations" of income and loss items to specific partners for overall income tax advantages under very limited circumstances.[595] There may be planning advantages for corporate classification, on the other hand, under specific planning scenarios including *inter alia*, possible avoidance of self-employment tax.[596] All these income tax

592. HAMILTON & BOOTH, *supra* note 145, § 10.30, at 264.

593. *See generally* Leslie H. Loffman & Sanford C. Present, *Choice of Entity-Business and Tax Considerations*, PLI–5th ANN. REAL EST. F. 561 PLI/TAX 599 (2003).

594. For a comprehensive but somewhat dated comparative chart, see Keatinge et al. in note 520 and accompanying text, above.

595. *See generally* MEZZULLO, *supra* note 213, at 112 (containing excellent overview of partnership income taxation).

596. *See* BROMBERG & RIBSTEIN, *supra* note 586, § 7.05(e), at 255.

features of partnerships, in comparison to the income tax features of corporations, *among many others*, are typical choice-of-entity matters present outside the estate planning context and thus outside the detailed scope of this article. Nonetheless, they apply equally to choice-of-entity issues raised in estate planning, and their inclusion in this article is a reminder that general income tax planning needs to be considered under the umbrella of any comprehensive estate plan even if the stated purpose of any particular estate plan is maximizing wealth transfer tax savings.

There are, however, two income tax features that are directly applicable to the estate planning process. They are the special rules that apply to recognition of family partnerships and the specific application of the more generally applicable election to increase the basis of partnership *property* upon the transfer of a partnership *interest* under sections 743(b) and 754. Again, any detailed discussion of either feature is beyond the scope of this article. The import of the features here, therefore, is simply to acknowledge their existence and possible application in the estate planning context.

The *first* income tax feature that is particularly related to estate planning concerns the recognition of a family partnership, or the donee of the recipient of a partnership interest as a partner, for income tax purposes. There is need for a special recognition rule for partnership interests received as gifts by family members because "[f]amily partnerships were first used for tax purposes principally to shift income from family members in higher income tax brackets to family members in lower income tax brackets."[597] Section 704(e) and the regulations thereunder determine whether the donee of a partnership interest will be a partner for income tax purposes based on "all the facts and circumstances of the particular case" and "the reality of the donee's ownership . . . determined in the light of the transaction as a whole."[598]

The objective test turns on the broad issue of control. The donee must be the *real* owner of the interest and the donor must not have retained disqualifying dominion and control.[599] This is the converse of the "issue addressed under the present interest" exclusion in the gift taxation where *lack* of income to the transferees indicating a gift was *not* really made of the present interest. Here, the income tax is concerned with income splitting where the income goes inappropriately to an ostensible partner. Both address the *realities* of the entity.

In the limited partnership context, the retention of management rights as a general partner will not be held to constitute dominion and control over limited partnership interests to require the nonrecognition of the recipient of the limited partnership interest, so long as it is consistent with the control exercised in

597. LOUIS A. MEZZULLO, FAMILY LIMITED PARTNERSHIPS AND LIMITED LIABILITY COMPANIES (1999).
598. Treas. Reg. § 1.704-1(e)(2) (2003).
599. MEZZULLO, *supra* note 597, at 13.

similar nonfamily limited partnerships.[600] Nonrecognition of a donee partner for income tax purposes, however, does not govern recognition of the partnership, the partner, or the interest for estate or gift tax purposes, so it may be a "secondary" consideration in situations where the primary purpose of the estate plan is *wealth* transfer.[601]

The *second* income tax feature that is directly related to estate planning concerns important operational detail for determining the income tax basis of partnership *property* upon the inheritance of a partnership interest. It is an election and, therefore, is not automatic. The general rule under section 743(a) is that any increase in the basis of a partnership *interest*, including the step-up in basis for an interest transferred on account of death,[602] will not affect the basis of any *property* owned by the partnership. The partnership *property*, however, *as to the partner who acquired the interest*, may be adjusted if the *partnership* makes an election under section 754. Thus, if the election is perfected, the person who inherits the interest will be treated as having previously paid an estate tax toll when the underlying property is sold and gain allocated to her capital account. Making the "754" election, therefore, may result in income tax savings to the recipient of the partnership interest whom receives the interest by inheritance.[603]

In summary, and although technical, the notion of the existence of special income tax rules for the recognition of partners in family partnership and an awareness of the possibility of increasing the basis of partnership property for the limited purpose of reflecting the step-up in basis of a transferee of partnership property provides a more complete overview of income tax planning directly adjunct to estate planning for wealth transfer purposes. Moreover, the special income tax recognition rules for family partnerships iterate another variation on the *control* theme present in the gift tax under the completed gift and the present interest topics discussed in this portion of the article. The most significant development discussed in this portion of the article was the *Hackl* case, which determined that even completed gifts of business interests in a legitimate business may fail to be present interests for purposes of the annual exclusion from the gift tax.

Finally, the brief overview of the evolution of the entity classification rules for federal tax purposes helps identify possible sources of misinterpretation and confusion in analyzing entities for different purposes under various statutory provisions of separate kinds of federal taxation. Estate planning patterns and, perhaps, trends, are at least discernibly emerging when taken together with the

600. MEZZULLO, *supra* note 597, at 13 (citing Treas. Reg. § 1.704-1(e)(2)(ii)(d) (2003)).

601. MEZZULLO, *supra* note 597, at 13.

602. I.R.C. § 743(b) (2003).

603. *See supra* note 597 (describing the basis of property distributed from a partnership); *see* DeBruyn, *supra* note 579, ¶ 904.1, at 9-19.

discussion of the *Strangi* case in a prior part of this section of the article.[604]

III. ULPA (2001): FEDERAL WEALTH TRANSFER TAXES AND SELECTED NONTAX FACTORS

Estate planning is multi-faceted, and entities are used to achieve different goals in different planning contexts. In the transfer tax area, for example, discount planning is not in complete identity with valuation freeze planning; but, neither are they mutually exclusive. Likewise, the availability of the exemption equivalent to the size of the estate and the step-up in basis may reverse the discounting goal. In the nontax area, on the other hand, the stage of business maturity may dictate different control (and training) structures at different business stages. Moreover, the personal financial circumstances of the parents may either emphasize or deemphasize the need for current distributions or the desirability of partnership recognition for income tax splitting techniques. Therefore the first desirable planning feature for any entity used in estate planning for both tax and nontax reasons is flexibility.

ULPA (2001) is at least as flexible as RULPA (1976/1985) but probably not as flexible as most limited liability company acts. The lodestar for flexibility is ULPA (2001) section 110, which provides the general rule that ULPA (2001) is a default statute whose provisions apply only in absence of a specific agreement on the matter in question.[605] The Act then lists thirteen specific exceptions to the general rule.[606] A couple of these mandatory exceptions

604. *See supra* notes 300-499 and accompanying text.

605. It states: "(a) Except as otherwise provided in subsection (b), the partnership agreement governs relations among the partners and between the partners and the partnership. To the extent the partnership agreement does not otherwise provide, this [Act] governs relations among the partners and between the partners and the partnership." UNIF. LTD. P'SHIP ACT § 110(a) (2001) [hereinafter ULPA (2001)].

606. Section 110(b) of ULPA (2001) states:

(b) A partnership agreement may not:

(1) vary a limited partnership's power under Section 105 to sue, be sued, and defend its own name;

(2) vary the law applicable to a limited partnership under Section 106;

(3) vary the requirements of Section 204;

(4) vary the information required under Section 111 or unreasonably restrict the right to information under Sections 304 or 407, but the partnership agreement may impose reasonable restrictions on the availability and use of information obtained under those sections and may define appropriate remedies, including liquidated damages, for a breach of any reasonable restriction on use;

(5) eliminate the duty of loyalty under Section 408, but the partnership agreement may:

(a) identify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable; and

(b) specify the number or percentage of partners which may authorize or ratify, after full disclosure to all partners of all material facts, a specific act or transaction that otherwise would violate the duty of loyalty;

(6) unreasonably reduce the duty of care under Section 408(c);

(7) eliminate the obligation of good faith and fair dealing under Sections 305(b) and 408(d), but the partnership agreement may prescribe the standards by which the performance of the

relate to the relationship between the limited partnership and third parties.[607] Moreover, several of the remaining provisions operate to establish minimum requirements (floors), but allow for flexibility beyond those minimum requirements. Thus, ULPA (2001) establishes minimum information rights,[608] minimum duties for care[609] and loyalty,[610] and may not "vary the power of a person to dissociate as a general partner."[611] Moreover, the agreement may not "vary the power of a court to decree dissolution in the circumstance specified in Section 802,"[612] which, in turn, confirms that a court has the power to dissolve the limited partnership "if it is not reasonably practical to carry on the activities of the limited partnership."[613]

The language establishing the minimum duty of care illustrates how the limitations generally operate. It states that the partnership agreement may not "unreasonably reduce the duty of care" as prescribed by another specifically cited provision.[614] The cited provision itself, however, sets a relatively low standard, "limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or knowing violation of law."[615] It is the latter standard that cannot be "unreasonably" reduced by the partnership agreement. Therefore the baseline mandatory duty is low, and is itself subject to reasonable *reduction*. As a result, the agreement has no limitation or ceiling on establishing a duty of care and has some theoretical flexibility to vary even the standard prescribed by the Act.

The standard of care stated in ULPA (2001) is the same as stated in RUPA (1997) and, therefore, is familiar to many practitioners,[616] as are many other

---

obligation is to be measured, if the standards are not manifestly unreasonable;

(8) vary the power of a person to dissociate as a general partner under Section 604(a) except to require that the notice under Section 603(1) be in a record;

(9) vary the power of a court to decree dissolution in the circumstances specified in Section 802;

(10) vary the requirement to wind up the partnership's business as specified in Section 803;

(11) unreasonably restrict the right to maintain an action under [Article] 10;

(12) restrict the right of a partner under Section 1110(a) to approve a conversion or merger or the right of a general partner under Section 1110(b) to consent to an amendment to the certificate of limited partnership which deletes a statement that the limited partnership is a limited liability limited partnership; or

(13) restrict rights under this [Act] of a person other than a partner or a transferee.

ULPA (2001) § 110(b).

607. ULPA (2001) § 110(b)(1)-(3). *See generally* Robert R. Keatinge, *The Partnership Agreement and Third Parties: ReRULPA § 110(13) v. RUPA 103(b)(10)*, 37 SUFFOLK UNIV. L. REV. 873 (2004).

608. ULPA (2001) § 110(b)(4).

609. ULPA (2001) § 110(b)(5).

610. ULPA (2001) § 110(b)(6).

611. ULPA (2001) § 110(b)(8).

612. ULPA (2001) § 110(b)(9).

613. ULPA (2001) § 802.

614. ULPA (2001) § 110(b)(6) (citing section 408(c)).

615. ULPA (2001) § 408(c).

616. ULPA (2001) § 404(c).

ULPA (2001) provisions based on similar provisions found in RUPA (1997), RULPA (1976/1985), or ULLCA.

The standard of care provision in ULPA (2001) begs the issue of whether it varies the current law of limited partnerships because it uses the same formulation of the duty as RUPA (1997). Whether it does or does not change the law depends on whether the given state law in question has adopted RUPA (1997) *and* the interpretive navigation of the relationship between RUPA (1997) and RULPA (1976/1985). In short, any comparison of ULPA (2001) and existing limited partnership law raises the issue of linkage.[617] Linkage is an issue under existing law because RULPA (1976/1985) is not free-standing; that is, it incorporates the law of general partnerships by nonspecific reference by providing: "In any case not provided for in this [Act] the provisions of the Uniform Partnership Act govern."[618] While that may seem straightforward, linkage causes interpretive uncertainty because the definitions are not necessarily consistent between RUPA (1997) and RULPA (1976/1985).[619] As stated by George Coleman in 1995:

> Before going any further, from the viewpoint of RULPA, what is supposed to happen when one goes to RUPA for guidance? How does this linking together work? Is it meant as an incorporation by reference of a specific provision of RUPA into RULPA or does it mean that RUPA serves as a rule book providing definitions and rules for determining the rights, powers, and liabilities of a general partner?[620]

After delineating the duty sections and offering several possibilities Coleman concludes: "It seems none of these possibilities work."[621] The purpose here is not to resolve the linkage issue but to illustrate it for juxtaposition against ULPA (2001). The *new* Act does not suffer linkage issues because it is free-standing and, thus, does not have the umbilical cord back to general partnership law.[622] As a theoretical matter, therefore, ULPA (2001) should not suffer the same practical interpretive problems represented by the linkage of RULPA (1976/1985) to RUPA (1997). Thus, ULPA (2001) is flexible and, as a theoretical matter, should be more interpretively predictable than RULPA (1976/1985) because it is not linked to another statute. Both comparative features are significant *general* planning advantages for ULPA (2001) over RULPA (1976/1985). As a result, the partnership agreement needs to be complete and may, from time to time, need amending. As in RUPA

617. Elizabeth Miller, *Linkage and De-Linkage: A Funny Thing Happened to Limited Partnerships When The Revised Uniform Partnership Act Came Along*, 37 SUFFOLK U. L. REV. 891 (2004).

618. RULPA (1976/1985) § 1105.

619. *See* George Coleman, *Linkage Between RULPA and RUPA—Is it a Problem? or a 'Tempest in a Teapot,'* A.B.A. WORKSHOP BUS. L. SEC. SPRING MEETING & C.L.E., Mar. 25, 1995, at 1.

620. *Id.* at 5.

621. *Id.*

622. *See* ULPA (2001) Prefatory Comments.

(1997), it is not necessary for the agreement to be in writing. The definition of "partnership agreement" contained in ULPA (2001) is as follows: "[It] means the partners' agreement, whether oral, implied, in a record [a defined term substituted for *writing*], or in any combination, concerning the limited partnership. The term includes the agreement as amended."[623]

There are two other general features of ULPA (2001) that are less restrictive than RULPA. Both will require explanation. The *first* is duration. As a default rule, section 104(c) simply states the limited partnership has a perpetual duration.[624] Current RULPA (1976/1985), on the other hand, requires the certificate of limited partnership to state "the latest date upon which the limited partnership is to dissolve."[625] The *second* less restrictive feature is the purpose for which a limited partnership may be formed. Under RULPA (1976/1985), a limited partnership could be formed for "any business that a partnership without limited partners may carry on."[626] In turn, the linkage to RUPA (1997) limits the limited partnership purpose to "carry on . . . a business for profit."[627]

The *expanded purpose* has particular relevance for the use of ULPA (2001) limited partnerships because it allows the limited partnership to be used as a receptacle for assets like residences and vacation homes that are not help primarily for business or income producing activity. This achieves the state law advantages of a measure of asset protection,[628] and allows property to be divided among the family without resorting to the use of more cumbersome real property techniques like co-tenancies or life estates. The flexibility afforded by state law, however, is a double-edged sword because it may not be respected for federal wealth transfer tax or federal income tax purposes.[629] As previously discussed in this article, the use of the limited partnership to hold a personal residence may be particularly troublesome because it is subject to section 2036(a), which operates to bring the value of the property transferred back into the gross estate for estate tax purposes based on the retention of beneficial use or income.[630]

Moreover, non-income producing assets run the risk of failing to qualify for the gift tax annual exclusion as evidenced by cases like *Hackl*, also previously discussed,[631] and may risk losing partnership income tax classification under

623. ULPA (2001) § 102(13).

624. ULPA (2001) § 104(c).

625. RULPA (1976/1985) § 201(4).

626. RULPA (1976/1985) § 106.

627. RULPA (1976/1985) § 202(a).

628. *See generally supra* notes 489-99 and accompanying text (for a general discussion of piercing in the corporate context).

629. *See generally supra* notes 300-499 and accompanying text (*Strangi* discussion); *supra* notes 250-69 and accompanying text (string provisions generally); *supra* notes 79-87 and accompanying text (annual exclusion for gift tax generally).

630. *See* notes 372-77 and accompanying text (generally discussing I.R.C. § 2036(c)).

631. *See supra* notes 545-76 and accompanying text.

the special family partnership rules of section 704(e).[632] Further, a lack of business purpose may be a marker for the gift at inception,[633] sham transaction,[634] economic substance,[635] or step-transaction[636] arguments by the Service. Thus, the flexibility of purpose provided by ULPA (2001) should not lull planners into tax complacency. Indeed, the flexibility under ULPA (2001) requires a finer degree of planning, with potentially larger benefits, than required or possible under RULPA (1976/1985).

The other less restrictive general feature of the ULPA (2001) limited partnerships is the default rule for perpetual duration. The facially beneficial value of perpetual duration for wealth transfer tax issues relate to its effect on pre-discount valuation of interests in limited partnerships and on the analysis of applicable restrictions under section 2704(b). The basic frameworks for both general valuation principles and section 2704(b) have been introduced previously herein.[637]

The effect of the perpetual default on the section 2704(b) special valuation is easier to explain than the effect on general valuation, though they are related and the special valuation rule is less intuitive. Recall that section 2704(b) provides that certain "applicable restrictions" are ignored for purposes of valuation if the entity is a family business.[638] These restrictions include both management rights and, more importantly for the current discussion, liquidation rights. There is, however, a statutory exception for "any restriction imposed, or required to be imposed, by any Federal or State law."[639] The perpetual duration default rule gives estate planners the argument that perpetual life is imposed by law because their clients do *not* voluntarily choose perpetuity. Obviously the argument is not a perfect fit because the taxpayers had the flexibility to choose a different term but, rather, *choose* to allow the default rule to govern. Even so, it is the best potential statutory argument available for the taxpayer, and ULPA (2001) does not foreclose the taxpayer making it. It is worth mentioning, however, that there has been a rather spirited theoretical debate on whether choosing a term or event of dissolution, which RULPA (1976/1985) requires is in any event, is an applicable restriction under section 2704(b).[640]

632. *See supra* notes 597-98 and accompanying text.

633. *See supra* notes 348-61 and accompanying text.

634. *See supra* notes 496-98 and accompanying text.

635. *See supra* notes 335-39 and accompanying text.

636. The step-transaction doctrine is an income tax concept applied primarily to corporate liquidations and reorganizations. *See generally* I.R.C. § 368 (2003). Basically it is an analytical tool that disregards the technical and chronological steps in a transaction and focuses on the end result.

637. *See supra* notes 242-46 and accompanying text.

638. *See supra* notes 242-46 and accompanying text.

639. I.R.C. § 2704(b)(3)(B) (2003).

640. *See* DeBruyn, *supra* note 579, ¶ 902.4, at 9-15. This may also be one of the "buried bodies" in ULLCA which requires the articles of organization to state whether the company is one for a term but is silent

The other effect of perpetual duration, whether as a matter of election or statutory default, concerns the application of general valuation principles. The general idea is based on the fact that the fair market value of interests in a limited partnership will vary based on which valuation approach is most appropriate. As Louis Mezzullo stated in a commentary on section 2704(b):

> In many closely held and family-owned businesses, the going concern value may be significantly lower than the liquidation value, particularly if the going concern value can be validly based on a cash flow analysis because such a business may be retaining most of its earnings for expansion rather than distributing the earnings for expansion rather than distributing the earnings to the shareholders or partners.[641]

Perpetual duration makes the use of cash flow valuation (or other nonliquidation based valuation methods) more appropriate because it makes it more *unlikely* that the limited partnership will dissolve, liquidate its assets, and distribute the proceeds to interest holders in the foreseeable. This issue is brought into focus by the valuation methods used in *Hackl* and *Strangi*. In both cases, the taxpayers asserted that going concern value, and not the liquidation value of the underlying assets held by the partnership, was the appropriate method of valuation. And the courts agreed.[642] By way of further illustration, the difference between going concern value and liquidation value is the value asserted in the Service's gift on inception argument.[643]

The default rule for perpetual duration in ULPA (2001) is only the starting point for determining the fair market value of interests under the fundamental willing buyer-willing seller standard.[644] Other features that directly effect the valuation include causes of dissolution or dissociation, rights upon dissolution or dissociation, transferability of interests, and a covey of interrelated governance provisions. Many of these features, by necessity, require concurrent analysis because they are interrelated as matters of both state law and the federal wealth transfer tax. That is, by their nature, the features come in prepackaged patterns.

The new limited partnership act adopts the *dissociation-dissolution* dichotomy contained in RUPA (1997) and ULLCA, and as distinguished from, for example, UPA (1914). Moreover, dissolution and duration are intimately related under RULPA (1976/1985), and therefore duration, too, is inextricably tied to whether a given state's version of RULPA is linked to UPA (1914) or RUPA (1997).[645] Thus, the comparative difference between a state-by-state

---

as to whether that term may be perpetual.

641. Mezzullo, *supra* note 7, at 126-27.

642. *See supra* notes 300-499 and accompanying text (*Strangi*); *supra* notes 545-76 and accompany text (*Hackl*).

643. *See supra* notes 348-61 and accompanying text.

644. *See supra* notes 140-41 and accompanying text.

645. *See generally* Miller, *supra* note 617.

analysis. Nonetheless, the new act's limited partnerships are at least as *durable* (or resilient) as those under RULPA (1976/1985) that are linked to RUPA (1997); and the more durable limited partnership, all other things being equal, will in most circumstances have a lower valuation than the less durable limited partnership.

Limited partnerships under ULPA (2001) are *dissolved* "upon the happening of an event specified in the partnership agreement"[646] just as under RULPA (1976/1985). Unlike current law, however, limited partnerships under ULPA (2001) do not dissolve upon the withdrawal (dissociation) of a general partner[647] as a default rule. Even if the dissociating general partner is the last remaining general partner, the "limited partners owning a majority of rights to receive distributions" may consent to admit a new general partner and continue the business.[648] Moreover, as a default matter, a remaining general partner, the same voting quantum as above, must vote to dissolve or the partnership automatically continues.[649] The new Act also provides, for the first time, a statutory default procedure to avoid dissolution upon the withdrawal of the last remaining limited partner.[650]

Finally, it is worth emphasizing that ULPA (2001) varies the voting quantum for its several continuation provisions from the one found in RULPA (1976/1985) away from unanimity. The change in voting quantum may arguably change valuation because the taxpayer/donor under a gifting program, for example, will not *retain* a veto power *theoretically*, at least, making it more difficult for the Service to argue that the taxpayer retained power over the timing and designation of use or income from the property transferred under section 2036(a).[651] It might also make it more unlikely that there will be a lapse of a liquidation power under section 2704(a).[652] These theoretical advantages, however, should not be overemphasized because careful drafting can avoid the problems; and, as illustrated by *Strangi II*, the typical facts to which section 2036(a) apply involve agreements *coupled* with statutory rights.[653] In summary, ULPA (2001) limited partnerships are more desirable than those under RULPA (1976/1985) under their respective nonjudicial dissolution procedures.

Both Acts also provide for judicial dissolution and they share the common standard that "it is not reasonably practicable to carry on the activities of the limited partnership in conformity with the partnership agreement."[654] The

646. ULPA (2001) § 801(1).
647. *Compare* RULPA (1976/1985) § 801(4), *with* ULPA (2001) § 801(4).
648. ULPA (2001) § 801(3)(B).
649. ULPA (2001) § 801(3)(A).
650. ULPA (2001) § 801(3)-(4).
651. *See generally supra* notes 372-78 and accompanying text.
652. *See supra* notes 226-40 and accompanying text.
653. *See supra* notes 335-37 and accompanying text.
654. RULPA (1976/1985) § 802; ULPA (2001) § 802.

Act's language differs, however, because ULPA (2001) states that "a partner" may apply for dissolution, while RULPA (1976/1985) includes a prefatory clause so that it reads "by or for a partner."[655] Although there is a dearth of case law on the meaning of the clause, it seems the ULPA (2001) formulation avoids a possible ambiguity. Of course, "partner" is defined under both Acts to include both general and limited partners.[656] If there is an ambiguity under RULPA (1976/1985), it would be most likely manifest in the case of a *transferee* of a partner.

Two features central to wealth transfer tax valuation *and* nontax estate planning concern the transferability of interests in a limited partnership and the rights accorded a partner whom withdraws or dissociates. As with other topics highlighted in this article, the rights of transferees are discussed in more detail in other articles.[657] The transferee topic, however, is another topic with significant affect on valuation and control for estate planning purposes.

The essence of a transferee under ULPA (2001) may be succinctly summarized as follows: (1) the only transferable interest of a partner are its rights to receive distributions, limited to distributions the transferring partner would otherwise receive,[658] and ULPA (2001) does not mandate that interim distributions before liquidation be made to partners unless otherwise agreed;[659] (2) the transferee has no *express* statutory right to request a judicial dissolution;[660] and (3) upon dissolution, the transferee has a right to an accounting *but only from the date of the dissolution.*[661]

A negative definition of transferee rights also informs the scope of the positive rights. The new Act expressly provides a partial negative definition. It states that a transfer of the transferable interest:

> Does not, as against the other partners or the limited partnership, entitle the transferee to participate in the management or conduct of the limited partnership's activities, to acquire access to information concerning the limited partnership's transactions except . . . [for an accounting upon dissolution limited to the period of time after the date of dissolution], or to inspect or copy

655. RULPA (1976/1985) § 802.

656. ULPA (2001) § 802.

657. *See generally* Keatinge, *supra* note 533.

658. ULPA (2001) § 702(b).

659. ULPA (2001) § 504.

660. Charging orders, their redemptions and their foreclosure are governed by ULPA (2001) section 703. The issue of whether ULPA (2001) changes RULPA is complicated by the linkage of RULPA to either RUPA or UPA. *See supra* notes 617-19, 734 (discussing "linkage"). Neither ULPA (2001) nor RULPA contain language that the charging order is the "exclusive remedy" for judgment creditors of individual partners. Section 504 (e) of RUPA, however, so provides. Nonetheless, under all the relevant acts the purchaser of the interest upon foreclosure of the charging order becomes *only* a transferee. Moreover, the charging order provisions are limited to application to judgment creditors and do not address voluntary creditors under Articles 8 and 9 of the U.C.C. These issues are complicated, and while they may affect estate planning, they should not significantly vary valuation for tax purposes. *See supra* note 534 (mentioning "charging order").

661. ULPA (2001) § 702(c).

the required information or the limited partnership's other records.[662]

The restricted nature of the transferees rights is buttressed by several other provisions. *First,* and of independent significance in the probate and administration of an estate, is that a "deceased partner's personal representative or other legal representative" has the rights of a transferee but, in addition, also has the informational rights of a limited partner.[663] This statutory grant of additional information rights would not be necessary if the express rights of transferees were intended to *imply* other rights.

Second, upon dissociation, a partner (either general or limited) becomes a transferee of its own interest.[664] Special provision is made, however, for additional information rights for former partners.[665] These statutory grants of additional information rights would not be necessary if the express rights of transferees were intended to *imply* other rights.

Third, ULPA (2001) expressly distinguishes a partner from nonpartners in section 1003, which identifies the proper plaintiff in a "derivative action may be maintained *only* by a person that is a partner at the time the action is commenced."[666] Moreover, the plaintiff must also have been a *partner* at the time "when the conduct giving rise to the action occurred."[667]

Finally, it is important to circle back to the essence of a transferable interest. A transfer "in whole or part of a partner's transferable interest," "does not by itself cause the partners dissociation."[668] Rather, a partner may be *expelled,* as a default matter, "by unanimous consent of the other partners"[669] only if "there has been a transfer of all of the person's transferable interest in the limited partnership, other than a transfer for security purposes, or a court order charging the person's interest, which has not been foreclosed."[670] Thus, in many cases the *transferor* will remain the partner and be able to exercise all the rights and privileges attendant thereto. It is not reasonable, given the entire

662. ULPA (2001) § 702(a)(3).

663. ULPA (2001) § 704.

664. ULPA (2001) § 602(3) (limited partners).

665. ULPA (2001) § 605(53) (general partners).

666. ULPA (2001) § 1003 (emphasis added).

667. ULPA (2001) § 1003 (1)-(2); *see also* ULPA (2001) § 1001.

668. ULPA (2001) § 702(a)(2).

669. ULPA (2001) § 601(b)(4) (limited partners); ULPA (2001) § 603(4)(B) (general partners).

670. *Id.* Charging orders, their redemptions and their foreclosure are governed by ULPA (2001) section 703. The issue of whether ULPA (2001) changes RULPA is complicated by the linkage of RULPA to either RUPA or UPA. *See supra* notes 617-19, 645, 734 (discussing "linkage"). Neither ULPA (2001) nor RUPA contain language that the charging order is the "exclusive remedy" for judgment creditors of individual partners, but rather the charging order coupled with foreclosure of the charging order provided by the same section is the "exclusive remedy." Nonetheless, under all the relevant acts, the purchaser of the interest upon foreclosure of the charging order becomes at most *only* a transferee. Moreover, the charging order provisions are limited to application to judgment creditors and do not address voluntary creditors under Articles 8 and 9 of the U.C.C. These issues are complicated, and while they may affect estate planning, they should not significantly vary valuation for tax purposes. *See supra* note 534 (mentioning "charging order").

Act, that a transfer of even part of a transferable interest by a partner would multiply the number of persons deemed to be partners for purposes of asserting the rights of partners.

The conclusion that must be drawn from the analysis, nonperjoratively, is transferees have few rights, and because the transferee interest is all that a partner may sell, the value of the partnership interest, absent other factors, must be low. If an estate holds these nontransferable interests, therefore, its value will be relatively lower as well.

It also means that a high percentage of these relatively low value interests may be given away within the annual exclusion for gift taxes.[671] The rub, of course, is an interest with no right or reasonable possibility, to receive present income will not qualify for the annual exclusion under the reasoning of *Hackl*. Planners, then, must carefully consider whether it fits the goals of the client to use the flexibility of ULPA (2001) to draft a present interest into the limited partnership. On the other hand, if the estate's expected value is sheltered by the unified exemption equivalent, the lower value of the interests held by the decedent will be reflected in a lower step-up basis for federal income tax purposes of the legatee.[672]

The previous rudimentary discussion of transferee rights stated dissociated partners under ULPA (2001) become transferees of their own transferable interest.[673] The statutory *procedure* dealing with withdrawals under RULPA (1976/1985) was materially different. It provides that the withdrawing partner, "if not otherwise provided in the agreement, he [or she] is entitled to receive, within a reasonable time after withdrawal, the fair value of his [or her] interest in the limited partnership as of the date of withdrawal based upon his [or her] right to share in distributions from the limited partnership."[674] The right to payment of the fair value based on going concern, as the statute expressly states, is a default rule to be applied only "if not otherwise provided in the agreement." It also applies to fewer situations than it might first appear because the right of withdrawal of limited and general partners is restricted by other provisions.

The amount of payment received by a withdrawing *general* partners is adjusted if the withdrawal breaches the partnership agreement: "[T]he limited partnership may recover from the withdrawing general partner damages for breach of the partnership agreement and offset the damages against the amount otherwise distributable to him [or her]."[675] The limited partner may withdraw only in an at-will partnership and, then, only upon six months notice. The comparative chart in the Official Prefatory Note to ULPA (2001) summarizes

671. *See generally supra* notes 79-87 and accompanying text.

672. *See supra* notes 88-90, 113 and accompanying text.

673. *See supra* note 664 and accompanying text.

674. RULPA (1976/1985) § 604.

675. RULPA (1976/1985) § 602.

the status of limited partner withdrawal under RUPA (1976/1985). It states, in part: "[T]heoretically, limited partners may withdraw on six months notice . . . ; practically, virtually every partnership agreement specifies a term, thereby eliminating the right to withdraw."[676]

Moreover, the note acknowledges parenthetically: "Due to estate planning concerns, several States have amended RULPA to prohibit limited partner withdrawal unless otherwise provided in the partnership agreement."[677] The parenthetical relates to the special valuation rules for family businesses in Chapter 14.[678] More specifically, it relates to section 2704(b), which ignores restrictions on liquidation as "applicable restrictions," but which recognizes "any restriction imposed, or required to be imposed, by any Federal or State law."[679] This is the same *tax* issue discussed in the context of perpetual duration under ULPA (2001) and the same caveats apply.[680] Nonetheless, section 2704(b)(3)(B) arguably operates to make the *default* provisions of state law mandatory for valuation purposes in the family wealth transfer tax planning context. From the taxpayer's and planners perspective, therefore, the default rule for withdrawal is tax advantaged *if the goal* is to reduce the value of the interests for a gift, estate, or GST tax purposes. In wealth transfer tax planning, section 2704(b)(3) is but one bookend on the parenthetical. The other tax bookend that constrains planning is, of course, section 2703.

Section 2703(a)(1) ignores for valuation purposes, "any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right)."[681] Thus, the estate planner cannot easily use buy-sell agreements or other techniques to avoid the effects of section 2704(b)(3).[682]

The effect of the two sections in tandem is to freeze the economic and financial deals within a family rather rigidly, much like the federal tax definition of partnership froze the state law of unincorporated organizations in the pre-check-the-box classification rules.[683] The baseline point to this discussion is those using limited partnerships for uses other than family business planning (and then only in circumstances that make wealth transfer tax planning desirable or necessary) have the flexibility to override default provisions as by agreement as contemplated by both RULPA (1976/1985) and ULPA (2001). The flexibility of estate planners working within the context of Chapter 14, however, only have flexibility *one way*; that is, these planners can

676. ULPA (2001) Prefatory Comments, at 5.
677. *Id.*
678. *See generally supra* notes 193-95 and accompanying text.
679. I.R.C. § 2704(b)(3)(B) (2003).
680. *See supra* notes 637-43 and accompanying text.
681. I.R.C. § 2703(a)(1) (2003).
682. *See supra* note 245 and accompanying text (for a discussion of the exceptions).
683. *See supra* notes 579-87 and accompanying text.

liberalize the default rules by agreement within the plan but they cannot advise providing greater restrictions than those contained in the state law statute.

The discussion of the default rules of ULPA (2001) concerning duration, transferability, and withdrawal from the perspective of wealth transfer planning may be misleading because these same features arguably serve the needs of businesses outside the family business or estate planning contexts. The discussion of the use of ULPA (2001) in those other contexts is generally outside the scope of this article, which focuses on wealth transfer tax planning. It should be remembered, however, that family businesses share many of the more general *business* needs and concerns of the larger universe businesses. A hypothetical example may help illustrate that the needs of nonfamily businesses are also served by the same features of ULPA (2001) previously discussed from the wealth transfer tax perspective.

Assume Pam is a pharmacist, but she worked summer construction jobs during college, recently acted as the general contractor on the construction of her own home, and she makes cabinetry for friends in her spare time. A house in her neighborhood is for sale, but it is barely habitable. She wants to purchase the house, rehabilitate and remodel it, and resell it for profit. She is willing to personally perform all the finish construction and wants to act as the general contractor for the project. In addition to her services, she is willing to contribute $20,000 of her own money but is only willing to take-on personal debt of $30,000. She believes she needs a total of $300,000 to complete the project. Jan, a local computer entrepreneur, is willing to contribute $50,000 to the project, and Carol, who recently inherited a large sum of money, is willing to contribute the other $200,000. Pam knows and trusts both Jan and Carol.

The hypothetical is a highly personal deal. Jan and Carol are willing to put their money at risk because of Pam's skill and knowledge. They do not want her to be able to quit performing her part of the deal when the house is only partially completed. Similarly, Pam knows and trusts Jan and Carol and does not want them to be able to substitute others who might meddle with her plans. Finally, it would be a disaster to the project if any of the three could demand a return of capital before the house is completed and resold because there is no liquidity or surplus in the business plan to provide for the return. The ULPA (2001) limited partnership fits the rough parameters of their needs. The negotiation point will be the length of the project, that is, the term of the limited partnership. Observe that no default rule could anticipate the unique term provision to be negotiated and certainly cannot be said to do *more* harm than the RULPA (1976/1985) default which would be "at-will" under these circumstances.[684]

Even the perpetual duration default rule may represent some value added, however, because it emphasizes the need for the parties to negotiate the term.

684. *See* RULPA (1976/1985) § 201(a); *supra* notes 637-44 and accompanying text (discussing duration).

That is, there is no ambiguity in the perpetual life default.[685]

The hypothetical does not *prove* that the choice of policies concerning transferability and withdrawal are the best choices. It does *illustrate* that these choices are in the range of reasonable choices based on the general needs of business outside wealth transfer tax planning, and that tax planning concerns did not artificially push the statute outside the bounds of reasonableness. It also underscores the importance of the final features of ULPA (2001) to be briefly highlighted in this article. These last features include, but not exclusively, governance (control) and fiduciary duties on wealth transfer taxes under ULPA (2001). These features, too, effect the valuation of the interests under the willing buyer-willing seller standard.[686]

Control is an important issue for estate planning just as it is for more general business planning.[687] It can be divided into three areas for analysis: (1) internal political control or governance; (2) control of relations with third parties (agency control); and (3) control of the internal financial affairs of the enterprise. These types of internal political decisions can then be analyzed by role: general partner, limited partner, or transferee. The role of transferee has been discussed previously in the discussion of transferability of interests.[688] Therefore, this discussion will deal only with general and limited partners.

Internal political control includes ordinary decision making in day-to-day operations, extraordinary decision making, and personnel decisions such as the appointment of officers in a corporation. ULPA (2001) provides for strong centralized management residing in the general partner or partners. This general rule is stated clearly in section 406(a), which states in part, "[e]xcept as expressly provided in this [Act], any matter relating the activities of the limited partnership may be exclusively decided by the general partner or, if there is more than one general partner, by a majority of the general partners."[689] Here the vote is one vote per general partner.

The three exceptions provided in the same section, however, require the *unanimous* consent of all general and limited partners, giving each of the limited partners veto power over the exceptions. The exceptions are to amend the partnership agreement, to sell substantially all the assets of the limited partnership outside the normal course of business, and to elect limited liability limited partnership (LLLP), or, if already an LLLP, to elect out of that status.[690] Moreover, mergers and conversions are treated the same as an amendment to

685. ULPA (2001) § 801(3)(B); *see* ULPA (2001) § 102(13) (definition of agreement).

686. *See generally supra* notes 641-45 and accompanying text (discussing valuation principles).

687. *See supra* note 24 and accompanying text (discussing the general goals of estate planning).

688. *See supra* notes 657-70 and accompanying text.

689. ULPA (2001) § 406(a).

690. ULPA (2001) § 406(b); *see infra* notes 734-40 and accompanying text (discussing LLLP status generally).

the agreement and require the consent of *all* partners;[691] again, giving limited partners power to stop, but not initiate, major changes that may likely significantly change the original "deal."

Admissions of new general partners[692] and of new limited partners[693] also require the consent of all partners. A major exception to the admission rules exists in the case of the dissociation of the last remaining general partner where the limited partners "owning a majority of rights to receive distributions as limited partners" may admit a general partner and continue the limited partnership.[694] As an aside, the Official Comment to the section addressing the admission of a general partner to avoid dissolution provides an illustration of how voting is calculated and states: "Distribution rights owned by non-partner transferees are irrelevant."[695]

The second area of *control* of a limited partnership is control of relations with third parties. As in RULPA (1976/1985), general partners are agents of the partnership[696] and limited partners are not agents.[697] As with most other provisions, the grant of agency authority may be varied by agreement. Agency authority, first and foremost, is a matter that concerns the partners and third parties. Nonetheless, because authority must be granted, it also implicates internal governance and power. The default rule granting the general partner agency authority is broad but not unlimited. The agency is limited to those activities that have a limited partnership purpose in the ordinary course of the limited partnership activities.[698]

The third area of control concerns the internal control of the limited partnership's finances. The day-to-day political control and management, as previously stated, is vested in the general partner. Those activities include financial management. More particularly, unless otherwise agreed, the decision to make interim distributions also rests with the general partner (or general partners).[699] This is significant for purposes of wealth transfer tax planning for at least two familiar reasons.

The first reason is, if the planning client is the general partner, she has the ability to control interim distributions and under section 2036(a) as interpreted by *Strangi*;[700] this right might be used to argue that the taxpayer retained "the right, either alone or in conjunction with any person, to designate the persons

691. ULPA (2001) § 1103(b).
692. ULPA (2001) § 401 (selection and admission of new general partner).
693. ULPA (2001) § 301 (expulsion).
694. ULPA (2001) § 801.
695. ULPA (2001) § 801(3)(A) cmt.
696. ULPA (2001) § 402; RULPA (1976/1985) § 403(a).
697. ULPA (2001) § 302; *see* RULPA (1976/1985) §§ 302, 303.
698. ULPA (2001) § 402(a).
699. *See* ULPA (2001) § 504 (and Official Comments); ULPA (2001) § 406(a).
700. *See supra* notes 370-90 and accompanying text.

who shall possess or enjoy the property or income therefrom;"[701] or, if the decedent owns most of the interest in the partnership at death, that the taxpayer retained "the right to income from . . . the property."[702] Recall that in *Strangi II*, the Tax Court used the fact that Albert owned forty-seven percent of the corporate general partner, among other facts, for just this purpose under section 2036(a)(2) to bring value back into the gross estate.

The second reason that the management of interim distributions may be important for wealth transfer taxes is also a familiar one: The requirement that gifts be of a present interest for purposes of qualifying for the annual exclusion under section 2503(b).[703] Recall that in *Hackl,* the Tax Court used a distribution policy in the operating agreement to help it determine the transfer of interest were not present interests. It borrowed a three-part test from a case concerning a trust, and two parts of the test were "that some portion of the income will flow steadily to the beneficiary" and "that the portion of income flowing out to the beneficiary can be ascertained."[704] The courts in *Hackl*, of course, did not rely solely on distribution authority for determining the lack of a present economic interest, but it was part of the fact pattern that was recited and analyzed.

Again, of course, the interim distribution default rule may be altered by agreement. Given *Hackl*, however, it appears it may be difficult for start-ups looking toward retained earnings as a financing source to come up with a satisfactory formulation for dividends.[705]

One of the taxpayer's section 2036(a) defenses in *Strangi II* was based on *Byrum*.[706] In *Byrum*, the Supreme Court determined that the fiduciary duties owed a corporation by its directors and officers acted as a constraint that mitigated the retention arguments related to control under section 2036.[707] It also relied on the competitive nature of business, what this article once called the *business imperative*, to supply a market discipline constraint on controlling owners.[708] A brief overview of fiduciary duties under ULPA (2001) is necessary before analyzing them under *Byrum* and *Strangi II.* The topic of fiduciary duties is treated more comprehensively and in far greater depth in a separate article in this symposium.[709]

Fiduciary duties under ULPA (2001) were introduced as an illustration of

701. I.R.C. § 2036(a)(2) (2003)

702. I.R.C. §2036(a)(1) (2003).

703. *See supra* notes 565-67 and accompanying text.

704. *See supra* notes 572-78 and accompanying text.

705. *But see* United States v. Byrum, 408 U.S. 125, 138 (1972).

706. *See supra* notes 462-80 and accompanying text.

707. *See supra* notes 478-80 and accompanying text.

708. *See supra* note 373 and accompanying text (the case analysis); *supra* notes 27-30 and accompanying text ("business imperative").

709. J. William Callison & Allan W. Vestal, *The Want of a Theory, Again*, 37 SUFFOLK U. L. REV. 719 (2004).

the flexibility of the Act previously in this article. These duties are modifiable by the partnership agreement but, unlike most provisions, are not waivable in their entirety.[710]

The duties popularly referred to as fiduciary duties are imported from RUPA (1997).[711] They are strictly delineated as the duties of loyalty and care. The duty of loyalty for general partners exclusively includes the duty to "hold as trustee" and "account to the limited partnership" the "property, profit, or benefit" that accrues to the general partners based on its activities related to or derived from the limited partnership.[712] It expressly includes partnership opportunity.[713] The duty of loyalty for general partners also expressly includes the duty "to refrain from" self-dealing[714] and competition with the partnership.[715] The fiduciary duty of general partners also includes a statutory standard for the duty of care.[716] The standard is gross negligence, "reckless conduct, intentional misconduct, or . . . knowing violation of the law."[717]

The same section of ULPA (2001) provides for an "obligation" that is *not* termed a fiduciary duty. It is the duty of good faith and fair dealing: "A general partner shall discharge the duties to the partnership and the other partners under this [Act] or under the partnership agreement and exercise any rights consistently with the obligation of good faith and fair dealing."[718] The

710. *See* ULPA (2001) §§ 305, 408, 110.

711. ULPA (2001) Official Prefatory Comment, at 5.

712. ULPA (2001) § 408(b)(4).

713. *Id.*

714. ULPA (2001) § 408(b)(2).

715. ULPA (2001) § 408(b)(3).

716. ULPA (2001) § 408(c).

717. *Id.*

718. ULPA (2001) § 408(d). The Official Comments to this subsection incorporate the comments to ULPA (2001) section 305(b), which states:

> SUBSECTION (B)—Source: RUPA Section 404(d). The same language appears in Section 408(d), pertaining to general partners.
>
> The obligation of good faith and fair dealing is *not* a fiduciary duty, does not command altruism or self-abnegation, and does not prevent a partner from acting in the partner's own self-interest. Courts should not use the obligation to change *ex post facto* the parties' or this Act's allocation of risk and power. To the contrary, in light of the nature of a limited partnership, the obligation should be used only to protect agreed-upon arrangements from conduct that is manifestly beyond what a reasonable person could have contemplated when the arrangements were made.
>
> The partnership agreement or this Act may grant discretion to a partner, and that partner may properly exercise that discretion even though another partner suffers as a consequence. Conduct does not violate the obligation of good faith and fair dealing merely because that conduct substantially prejudices a party. Indeed, parties allocate risk precisely because prejudice may occur. The exercise of discretion constitutes a breach of the obligation of good faith and fair dealing only when the party claiming breach shows that the conduct has no honestly-held purpose that legitimately comports with the parties' agreed-upon arrangements. Once such a purpose appears, courts should not second guess a party's choice of method in serving that purpose, unless the party invoking the obligation of good faith and fair dealing shows that the choice of method itself lacks any honestly-held purpose that legitimately comports with the parties' agreed-upon arrangements.
>
> In sum, the purpose of the obligation of good faith and fair dealing is to protect the arrangement

good faith and fair dealing provision appears, too, in the fiduciary duty section for limited partners.[719] Another clarifying provision that applies to both limited and general partners states that a partner "does not violate a duty or obligation under this [Act] or under the partnership agreement merely because the limited partner's conduct further limits the [general or limited] . . . partner's own interest."[720]

How do these default provisions compare to the facts of a real case? Illustratively, *Strangi II* found that the decedents gross estate should include the value of the intrafamily gifts based on section 2036(a). In part, it quoted but did not necessarily rely on the Regulations that state the retention or reservation of an interest may be *implied* from the facts of a case. In *Strangi*, the Tax Court described several provision of the SFLP Agreement. The limited partnership agreement provided that the managing general partners are the sole authorized agent "in connection with all aspects of the business of the Partnership."[721] If *the general partner* is substituted for "managing general partner" in the SFLP Agreement, the Agreement simply restates the ULPA (2001) rule.[722]

The Agreement also granted the general partner broad power and authority *inter se* including "to determine the use of the revenues of the Partnership for Partnership purposes."[723] That, too, is the default rule for ULPA (2001).[724] The power to make distributions provided for by the Agreement was in the general partner "taking into account the reasonable needs of the partnership;"[725] distributions were to be allocated consistent with the interest in the partnership;[726] and the general partner was required "to use its good faith efforts to manage the partnership affairs in a prudent and business like manner and to at all times the best interests of the partnership."[727] All these provisions are near the default rules of ULPA (2001) and, for that matter, RULPA (1976/1985). Finally, the Tax Court listed the terms of the agreement concerning dissolution and termination, with two exceptions, operate to simulate ULPA (2001) or reflect the more general law of limited partnerships.[728] The first exception was the managing general partner could

---

> the partners have chosen for themselves, not to restructure that arrangement under the guise of safeguarding it.

ULPA (2001) § 305 cmt. b.

719. ULPA (2001) § 305(b).
720. ULPA (2001) §§ 305(c), 408(e).
721. *See supra* notes 378-83 and accompanying text.
722. *See supra* notes 439-41 and accompanying text.
723. *See supra* note 379 and accompanying text.
724. ULPA (2001) § 406.
725. *See supra* note 380 and accompanying text.
726. *See supra* note 380 and accompanying text.
727. *See supra* note 383 and accompanying text.
728. *See supra* notes 384-88 and accompanying text.

unilaterally decide to dissolve SFLP after the disposition of substantially all the assets of the partnership; the second was the addition of a fifteen-year term (rather than the prior default rule which under RULPA (1976/1985) is at-will). These documentary rights, according to the Tax Court, "suggests inclusion . . . based on 2036(a)(1)" without the necessity of using the "implied" language of the Regulations.[729]

This article was critical of this portion of *Strangi II* in its previous analysis of it outside the comparative content of ULPA (2001).[730] It remains critical because *almost* the same provisions found in the SFLP Agreement serve as the default position under ULPA (2001) and which a hypothetical illustration earlier in this section *imply* are appropriate in at least some non-family situation.[731] The same criticism about fiduciary duties and its relationship to the *Byrum* footnote are also reiterated here by reference.[732]

While the purpose of the discussion in this section of the article is not to rehash *Strangi*, one way to make sense out of the holding based on section 2036(a)(1) and the interpolation of the various agreements in the *Strangi* plan is to import the other and undeniably bad facts into the analysis as a matter of equitable touch, even though those facts don't fit the technical analysis concerning the *express* retention or rights. Those bad facts, recall, included the transfer of most of Albert's assets into the partnership, the transfer of his personal residence into the partnership even though he continued to live in it and, among others, the payment of at least some personal expenses with entity sums.[733] Additionally it *was* difficult to discern a business purpose beyond the management of the passive assets transferred to the entity by Albert who was sick and had a limited life expectancy. Finally, and frankly, the bad facts were coupled with a plan that was purchased as a product from the financial services industry. It is difficult to ascertain how the purchase of the plan affected the court because, though it is recited in the facts, it is not extensively used in the analysis portion of the opinions. Undeniably, however, the marketing of the plan is similar to how some income tax shelters are marketed.

So, what is the purpose of reviewing *Strangi* here? To illustrate that ULPA (2001) is not designed as "bullet-proof" for purposes of the wealth-transfer tax system. That is, once again, that planners must plan. The new Act is, however, calibrated to give planners as much flexibility as possible to pick and choose features that meet the needs of their clients. The flexibility afforded by ULPA (2001) is no mean feat because of the complexity of the wealth transfer tax laws.

There are three miscellaneous topics that should be mentioned in this

729. *See supra* note 384 and accompanying text.
730. *See supra* notes 409-11 and accompanying text.
731. *See supra* notes 386-88 and accompanying text.
732. *See supra* notes 478-80 and accompanying text.
733. *See supra* notes 413-14 and accompanying text.

analysis of ULPA (2001) for estate planning purposes to complete this whirlwind tour. The first is limited liability and the use of ULPA (2001) to govern limited liability limited partnerships.

Limited liability limited partnerships were the result of linkage between RULPA (1976/1985) and the limited liability partnership amendments to RUPA (1997). This feature provides limited liability for general partners and is elective under RUPA (1997). Limited liability limited partnership (LLLP) status is also elective under ULPA (2001), following its roots in general partnership law. As a result, the default rule of ULPA (2001) provides that general partners are "jointly and severally" liable for the obligations of the partnership "unless otherwise agreed by the claimant or provided by law."[734] The election for LLLP status is reflected in the certificate of limited partnership.[735]

The Official Prefatory Comments to ULPA (2001) state: "This Act is designed to serve preexisting limited partnerships formed after the Acts enactment. Most of these preexisting limiting partnership [sic] will not be LLLPs, and accordingly the Act does not prefer or presume LLLP status."[736] Thus one reason for making LLLP elective, rather than providing a statutory default rule providing such status on an elect-out basis, is a matter of transitional ease between ULPA (2001) and RULPA (1976/1985), which it is designed to replace.

The elect-in procedure also probably belies a path-dependancy from the original policy of elect-in status under RUPA (1997) and, perhaps, an acknowledgment of the varied uses of limited partnerships in a broad array of contexts including those that may be highly regulated by other law. While the latter may not be a great reason for the policy decision on ULPA (2001) because the status of an individual limited partnership could have been changed by an elect-out provision, it still conceivably reduces the change of unintended consequences in highly regulated contexts.

There is at least one other *potential* reason for not defaulting into LLLP status, and though it is related to the transactional reason, it is decidedly different. Simply stated, the change to LLLP status cascades throughout the relationship between the partners, and arguably, *should* require a careful analysis of all the internal default rules using the flexibility provided by ULPA (2001). For example, and as a theoretical matter, it seems *unlimited* liability should inject the kind of market discipline that the *Strangi* case found lacking in the SFLP arrangement. which used a corporate general partner because the general partner is at significant financial risk.

Moreover, this discipline operates between the general and limited partners

734. ULPA (2001) § 404(a).
735. ULPA (2001) § 102.
736. ULPA (2001) Prefatory Comments, at 3.

to reduce monitoring or agency cost for limited partners and its election *should* require negotiation of other features. Because of the varied uses of a limited partnership, it would be difficult to tune the Act in any reasonable way to account for the *terms of any given deal.*

A counter-argument is that under most uses, the limited partnership will elect LLLP status, and that retaining unlimited liability for default is an anachronism. That practical argument, however, does ignore the difficulty of drafting a limited partnership rule patter any other way and the notice value of the necessity of electing into the status. On the other hand, once elected, the LLLP provides so called "full shield" liability protection which is not bifurcated on the basis of the nature of the liability, and is intended to be the "equivalent to the shield enjoyed by corporate shareholders."[737] The LLLP provisions once again emphasize the synergism between and among the various default rules. Paradoxically, given the varied circumstances to which limited partnerships are applied both inside and outside estate and federal wealth transfer tax planning, it is likely that each default feature of ULPA (2001) is the correct choice for the Act, but the packaged pattern of the default features will rarely be adopted as a package for planning in any given circumstance. That is, both illustratively and arguably, most limited partnerships will choose most of the default rules most of the time, but few will choose all the default rules at once because the synergism created by those rules will not fit most situations. Thus, ULPA (2001) creates the necessary baseline for planning purposes, but does not necessarily create the default entity that most limited partnerships will choose.

The foregoing observation is not a negative criticism of the Act, rather, it is a simple observation because: (1) no other pattern would necessarily provide a *better* pattern of defaults for the various purpose; (2) the theory and settings of the defaults are easily understood and consistent possibly avoiding unintended planning consequences; (3) some defaults would foreclose some specific uses for federal wealth transfer tax planning; (4) each default when viewed in isolation makes sense; (5) unlike general partnership law, limited partnerships are formal statutory entities and are not status entities that persons in undefined relationship will default into without specific intent; and (6) it is difficult to provide synergism in any *flexible* act, no matter of the default rules (though this author has suggested a politically unpalatable way to provide such flexibility in a previous article[738]).

737. *Id.*

738. The drafting approach was called the "protective cocktail approach" and gave "points" to choices made by planners on a variety of protective features, e.g., information rights, fiduciary duties, liquidity of interests, etc. Minimum statutory floors would be statutorily provided for each protective feature but the point total for all minimums would not meet a separately created statutory minimum. Thomas Earl Geu, *Chaos, Complexity, and Coevolution: The Web of Law, Management Theory, and Law Related Services at the Millenium (Part II)*, 66 TENN. L. REV. 137, 248-51 (1998).

Even though ULPA (2001) continues the liability rule for general partners found in RULPA (1976/1985), it strengthens, or at least cleans up, the liability rules for limited partners whether or not the LLLP election is made, "even if the limited partner participates in the management and control of the limited partnership."[739] It therefore eliminates the "control rule" of RULPA (1976/1985).[740] The elimination of the control rule, again theoretically, increases the flexibility of the Act because it makes protection more certain for limited partners who may have governance or agency authority delegated them by the partnership agreement. The reason for the theoretical clause in the previous sentence is because RULPA (1976/1985) made it difficult to successfully assert personal liability against limited partners through a different and more complicated statutory formulation.[741]

The second miscellaneous planning feature of the last three such features to be discussed can be seen as a disadvantage of the use of limited partnerships (under *either* ULPA (2001) or RULPA (1976/1985)) when compared to the general law of LLCs. It may be stated succinctly: Limited partnerships require at least one general partner and at least one limited partner,[742] and subject to the withdrawal provisions previously discussed, must maintain both kinds of interests. More significantly it must "be formed *by two or more persons*"[743] and continually have a membership of two persons; again subject to the withdrawal and dissolution provisions previously discussed.[744] This means that limited partnerships may not be solely owned; that is, unlike LLCs, they may not have a single member. As a result, limited partnerships may not be a disregarded entity for income tax purposes under the check-the-box regulations.

The final selected miscellaneous matter to be mentioned in this article is a reminder that there are significant general planning issues in entity selection raised by the federal income tax. A few of the comparative distinctions were introduced previously in this article[745] but, in any event, limited partnerships under either ULPA (2001) or RULPA (1976/1985) are classified as partnerships for tax purposes under the check-the-box regulations.[746]

By way of summary, ULPA (2001) is wealth-transfer-tax friendly and provides great flexibility for estate planners. It is not, however, a bullet-proof statute that defaults users into maximum wealth transfer tax savings even though it provides the necessary flexibility to allow for the use of limited partnerships for that purpose. As a general mater of state law, it is generally

739. ULPA (2001) § 303.
740. ULPA (2001) § 303 cmt.
741. RULPA (1976/1985) § 303.
742. ULPA (2001) § 102(11).
743. ULPA (2001) § 102(11) (emphasis added).
744. *See supra* notes 647-50 and accompanying text.
745. *See supra* notes 579-602 and accompanying text.
746. *See supra* notes 579-86 and accompanying text.

easier to use than RULPA (1976/1985) because ULPA (2001) avoids issues associated with a linked act. For that and other reasons, it should provide for more predictable *state law* results than RULPA (1976/1985).

IV. SUMMARY AND CONCLUSION

The purpose of this article was to analyze the fitness of ULPA (2001) for federal wealth transfer tax savings purposes. This necessitated a rather extensive (but not necessarily comprehensive) description of the estate, gift, and GST tax systems. In that regard, it provides a basic primer for the federal wealth transfer tax system, including a brief description of the possible sea-change in that system brought about by recent federal legislation.

The purpose of the article reasonably required the analysis of two very recent cases, which may represent the beginning of an avalanche of interpretive change in the use of limited partnerships and other entities for *maximizing* wealth transfer tax savings. These cases were selected because of the number and kind of wealth transfer tax issues they discuss; their recency, indeed as of this writing the appeals period has not yet run on *Strangi II*; and because on several issues, they represent significant victories by the government thereby representing the most conservative cases with which to compare the provisions of ULPA (2001). Their choice illustrates the technical and dynamic nature of wealth transfer tax planning and the analysis of the cases themselves may provide a modicum of value added even for seasoned estate planners. The selected cases, however, do not *necessarily* represent settled law on all the issues they discuss, and readers are cautioned to use them only for the illustrative purposes they are intended to serve.

In part because of the adaptability and speed with which courts can react to what they perceive as inappropriate tax avoidance, it was suggested that federal wealth transfer tax planning is in a developmental stage, analogous to broader planning issues before the check-the-box regulations were promulgated. The article negatively criticized portions of the rationale of the selected cases and, as an aside, suggested a different method of approach than used in those cases to reach the same result.

The discussion and analysis suggest a few planning guides both in conjunction with, and beyond, the article's primary purpose. *First*, pedantic estate planning overemphasizing the minimization of federal wealth transfer tax planning may not serve the real goals of the client of which such minimization is but one part. *Second*, most estates will not be large enough to have traditional wealth transfer tax "problems." *Third*, recent legislative changes to the wealth transfer tax system may have the effect of *increasing* a desire to maximize the *value* of assets for income tax basis purposes. *Fourth*, care should be taken when selecting assets to be transferred into an entity; that is, the taxpayer should retain enough property outside the entity to avoid the

appearance that there is an implied agreement that the entity's assets may be tapped for personal needs—personal residences are high risk assets to contribute to the entity. *Fifth*, it is important to be able to clearly articulate a business purpose for the entity beyond tax planning and the safest, but not fail-safe, type of business to be used is an operating business generating current income holding a minimum of passive assets. The deceptively simple primary purpose of the article, however, was to vet selected provisions of ULPA (2001) against the wealth transfer tax system and, where possible, against estate planning needs outside the wealth transfer tax system. The general conclusion based on this comparison is that ULPA (2001) provides for the basic needs of estate planners better than RULPA (1976/1985).[747] It also suggests the tax law may have been a reason, *among other reasons*, for the formulation of at least one default rule. Perhaps the fairest summary of ULPA (2001) for wealth transfer taxes is that it is formulated in a way that alleviates or minimizes the use of specific rules that *mandate* negative tax consequences, and thereby creates a very flexible statute for all purposes *including* estate planning.

The flexibility that is the state law hallmark of ULPA (2001), however, comes with a cost similar to the cost of "nonbullet-proof" or "flexible" LLC Acts before the check-the-box regulations. The cost is that it is possible to design a plan that complies with state law but will run afoul of wealth transfer tax provisions. The benefit is, when used judiciously, ULPA (2001) can be used to meet almost all reasonable goals of an estate planning client to the same or greater extent as using other entity vehicles in the various states. At bottom, the use of ULPA (2001) for wealth transfer tax planning purposes gives clients and planners, to borrow a well-known trite phrase, "enough rope to hang themselves."

747. Although not discussed in the main text of this article it is interesting to note that ULPA (2001) incorporates virtually every substantive amendment to RULPA (1976/1985) suggested in a draft of such amendments in John DeBruyn's 1997 Heckerling Estate Planning Institute materials. DeBruyn, *supra* note 579. The basic "patches" pending a major review of all of RULPA (1976/1985). These patches included (1) clarification that limited partnerships were allowed to elect LLLP status; (2) flip the default from at-will to perpetual duration, change the voting procedure to allow the continuation of the partnership (upon the withdrawal of the last remaining general partner) *to* a majority vote of the remaining partners; (3) do away with the ability of a limited partner to force the partnership to distribute the fair value of her share upon her withdrawal; and (4) do away with the "control rule" for limited partners where the limited partnership elects LLLP status. DeBruyn, *supra* note 579, ¶ 9.09, at 9-32 to 9-34.

APPENDIX

I.R.C. section 1022 (2003) is captioned "Treatment of Property Acquired from a Decedent Dying After December 31, 2009." It is reproduced in its entirety below:

(a) IN GENERAL.–Except as otherwise provided in this section–
  (1) property acquired from a decedent dying after December 31, 2009, shall be treated for purposes of this subtitle as transferred by gift, and
  (2) the basis of the person acquiring property from such a decedent shall be the lesser of–
    (A) the adjusted basis of the decedent, or
    (B) the fair market value of the property at the date of the decedent's death.

(b) BASIS INCREASE FOR CERTAIN PROPERTY.–
  (1) IN GENERAL.–In the case of property to which this subsection applies, the basis of such property under subsection (a) shall be increased by its basis increase under this subsection.
  (2) BASIS INCREASE.–For purposes of this subsection–
    (A) IN GENERAL.–The basis increase under this subsection for any property is the portion of the aggregate basis increase which is allocated to the property pursuant to this section.
    (B) AGGREGATE BASIS INCREASE.–In the case of any estate, the aggregate basis increase under this subsection is $1,300,000.
    (C) LIMIT INCREASED BY UNUSED BUILT-IN LOSSES AND LOSS CARRYOVERS.–The limitation under subparagraph (B) shall be increased by–
      (i) the sum of the amount of any capital loss carryover under section 1212(b), and the amount of any net operating loss carryover under section 172, which would (but for the decedent's death) be carried from the decedent's last taxable year to a later taxable year of the decedent, plus
      (ii) the sum of the amount of any losses that would have been allowable under section 165 if the property acquired from the decedent had been sold at fair market value immediately before the decedent's death.
  (3) DECEDENT NONRESIDENTS WHO ARE NOT CITIZENS OF THE UNITED STATES.–In the case of a decedent nonresident not a citizen of the United States–
    (A) paragraph (2)(B) shall be applied by substituting "$60,000" for "$1,300,000", and
    (B) paragraph (2)(C) shall not apply.

(c) ADDITIONAL BASIS INCREASE FOR PROPERTY ACQUIRED BY SURVIVING SPOUSE.–
  (1) IN GENERAL.–In the case of property to which this subsection applies

and which is qualified spousal property, the basis of such property under subsection (a) (as increased under subsection (b)) shall be increased by its spousal property basis increase.

(2) SPOUSAL PROPERTY BASIS INCREASE.–For purposes of this subsection–

(A) IN GENERAL.–The spousal property basis increase for property referred to in paragraph (1) is the portion of the aggregate spousal property basis increase which is allocated to the property pursuant to this section.

(B) AGGREGATE SPOUSAL PROPERTY BASIS INCREASE.–In the case of any estate, the aggregate spousal property basis increase is $3,000,000.

(3) QUALIFIED SPOUSAL PROPERTY.–For purposes of this subsection, the term "qualified spousal property" means–

(A) outright transfer property, and

(B) qualified terminable interest property.

(4) OUTRIGHT TRANSFER PROPERTY.–For purposes of this subsection–

(A) In GENERAL.–The term "outright transfer property" means any interest in property acquired from the decedent by the decedent's surviving spouse.

(B) Exception.–Subparagraph (A) shall not apply where, on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur, an interest passing to the surviving spouse will terminate or fail–

(i) (I) if an interest in such property passes or has passed (for less than an adequate and full consideration in money or money's worth) from the decedent to any person other than such surviving spouse (or the estate of such spouse), and

(II) if by reason of such passing such person (or his heirs or assigns) may possess or enjoy any part of such property after such termination or failure of the interest so passing to the surviving spouse, or

(ii) if such interest is to be acquired for the surviving spouse, pursuant to directions of the decedent, by his executor or by the trustee of a trust.

For purposes of this subparagraph, an interest shall not be considered as an interest which will terminate or fail merely because it is the ownership of a bond, note, or similar contractual obligation, the discharge of which would not have the effect of an annuity for life or for a term.

(C) INTEREST OF SPOUSE CONDITIONAL ON SURVIVAL FOR LIMITED PERIOD.–For purposes of this paragraph, an interest passing to the surviving spouse shall not be considered as an interest which will terminate or fail on the death of such spouse if–

(i) such death will cause a termination or failure of such interest only if it occurs within a period not exceeding 6 months after the decedent's death, or only if it occurs as a result of a common disaster resulting in the death of the decedent and the surviving spouse, or only if it occurs in the case of either such event, and

(ii) such termination or failure does not in fact occur.

(5) QUALIFIED TERMINABLE INTEREST PROPERTY.–For purposes of this subsection–

(A) IN GENERAL.–The term "qualified terminable interest property" means property–

(i) which passes from the decedent, and

(ii) in which the surviving spouse has a qualifying income interest for life.

(B) QUALIFYING INCOME INTEREST FOR LIFE.–The surviving spouse has a qualifying income interest for life if–

(i) the surviving spouse is entitled to all the income from the property, payable annually or at more frequent intervals, or has a usufruct interest for life in the property, and

(ii) no person has a power to appoint any part of the property to any person other than the surviving spouse.

Clause (ii) shall not apply to a power exercisable only at or after the death of the surviving spouse. To the extent provided in regulations, an annuity shall be treated in a manner similar to an income interest in property (regardless of whether the property from which the annuity is payable can be separately identified).

(C) PROPERTY INCLUDES INTEREST THEREIN.–The term "property" includes an interest in property.

(D) SPECIFIC PORTION TREATED AS SEPARATE PROPERTY.–A specific portion of property shall be treated as separate property. For purposes of the preceding sentence, the term 'specific portion' only includes a portion determined on a fractional or percentage basis.

(d) DEFINITIONS AND SPECIAL RULES FOR APPLICATION OF SUBSECTIONS (B) AND (C)–

(1) PROPERTY TO WHICH SUBSECTIONS (B) AND (C) APPLY–

(A) IN GENERAL.–The basis of property acquired from a decedent may be increased under subsection (b) or (c) only if the property was owned by the decedent at the time of death.

(B) RULES RELATING TO OWNERSHIP.–

(i) JOINTLY HELD PROPERTY.–In the case of property which was owned by the decedent and another person as joint tenants with right of survivorship or tenants by the entirety–

(I) if the only such other person is the surviving spouse, the decedent shall be treated as the owner of only 50 percent of the property,

(II) in any case (to which subclause (I) does not apply) in which the decedent furnished consideration for the acquisition of the property, the decedent shall be treated as the owner to the extent of the portion of the property which is proportionate to such consideration, and

(III) in any case (to which subclause (I) does not apply) in which the property has been acquired by gift, bequest, devise, or inheritance by the decedent and any other person as joint tenants with right of survivorship and their

interests are not otherwise specified or fixed by law, the decedent shall be treated as the owner to the extent of the value of a fractional part to be determined by dividing the value of the property by the number of joint tenants with right of survivorship.

(ii) REVOCABLE TRUSTS.–The decedent shall be treated as owning property transferred by the decedent during life to a qualified revocable trust (as defined in section 645(b)(1)).

(iii) POWERS OF APPOINTMENT.–The decedent shall not be treated as owning any property by reason of holding a power of appointment with respect to such property.

(iv) COMMUNITY PROPERTY.–Property which represents the surviving spouse's one- half share of community property held by the decedent and the surviving spouse under the community property laws of any State or possession of the United States or any foreign country shall be treated for purposes of this section as owned by, and acquired from, the decedent if at least one-half of the whole of the community interest in such property is treated as owned by, and acquired from, the decedent without regard to this clause.

(C) PROPERTY ACQUIRED BY DECEDENT BY GIFT WITHIN 3 YEARS OF DEATH.–

(i) IN GENERAL.–Subsections (b) and (c) shall not apply to property acquired by the decedent by gift or by inter vivos transfer for less than adequate and full consideration in money or money's worth during the 3-year period ending on the date of the decedent's death.

(ii) EXCEPTION FOR CERTAIN GIFTS FROM SPOUSE.–Clause (i) shall not apply to property acquired by the decedent from the decedent's spouse unless, during such 3-year period, such spouse acquired the property in whole or in part by gift or by inter vivos transfer for less than adequate and full consideration in money or money's worth.

(D) STOCK OF CERTAIN ENTITIES.–Subsections (b) and (c) shall not apply to–

(i) stock or securities of a foreign personal holding company,

(ii) stock of a DISC or former DISC,

(iii) stock of a foreign investment company, or

(iv) stock of a passive foreign investment company unless such company is a qualified electing fund (as defined in section 1295) with respect to the decedent.

(2) FAIR MARKET VALUE LIMITATION.–The adjustments under subsections (b) and (c) shall not increase the basis of any interest in property acquired from the decedent above its fair market value in the hands of the decedent as of the date of the decedent's death.

(3) ALLOCATION RULES.–

(A) IN GENERAL.–The executor shall allocate the adjustments under subsections (b) and (c) on the return required by section 6018.

(B) CHANGES IN ALLOCATION.–Any allocation made pursuant to subparagraph (A) may be changed only as provided by the

Secretary.

(4) INFLATION ADJUSTMENT OF BASIS ADJUSTMENT AMOUNTS.–

(A) IN GENERAL.–In the case of decedents dying in a calendar year after 2010, the $1,300,000, $60,000, and $3,000,000 dollar amounts in subsections (b) and (c)(2)(B) shall each be increased by an amount equal to the product of–

(i) such dollar amount, and

(ii) the cost-of-living adjustment determined under section 1(f)(3) for such calendar year, determined by substituting "2009" for "1992" in subparagraph (B) thereof.

(B) ROUNDING.–If any increase determined under subparagraph (A) is not a multiple of–

(i) $100,000 in the case of the $1,300,000 amount,

(ii) $5,000 in the case of the $60,000 amount, and

(iii) $250,000 in the case of the $3,000,000 amount,such increase shall be rounded to the next lowest multiple thereof.

(e) PROPERTY ACQUIRED FROM THE DECEDENT.–For purposes of this section, the following property shall be considered to have been acquired from the decedent:

(1) Property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent.

(2) Property transferred by the decedent during his lifetime–

(A) to a qualified revocable trust (as defined in section 645(b)(1)), or

(B) to any other trust with respect to which the decedent reserved the right to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust.

(3) Any other property passing from the decedent by reason of death to the extent that such property passed without consideration.

(f) COORDINATION WITH SECTION 691.–This section shall not apply to property which constitutes a right to receive an item of income in respect of a decedent under section 691.

(g) CERTAIN LIABILITIES DISREGARDED.–

(1) IN GENERAL.–In determining whether gain is recognized on the acquisition of property–

(A) from a decedent by a decedent's estate or any beneficiary other than a tax- exempt beneficiary, and

(B) from the decedent's estate by any beneficiary other than a tax-exempt beneficiary, and in determining the adjusted basis of such property, liabilities in excess of basis shall be disregarded.

(2) TAX-EXEMPT BENEFICIARY.–For purposes of paragraph (1), the term "tax-exempt beneficiary" means–

(A) the United States, any State or political subdivision thereof, any possession of the United States, any Indian tribal government (within the meaning of section 7871), or any agency or instrumentality of any of the foregoing,

(B) an organization (other than a cooperative described in section 521) which is exempt from tax imposed by chapter 1,
(C) any foreign person or entity (within the meaning of section 168(h)(2)), and
(D) to the extent provided in regulations, any person to whom property is transferred for the principal purpose of tax avoidance.

(h) REGULATIONS.–The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section.