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Help for Control Freaks

Trusts & Estates

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Navigating IRC Section 2036(a)(2) in family limited partnerships

"Let me tell you about the very rich. They are different from you and me. They ***possess and enjoy*** *early, and it does something to them, makes them soft, where we are hard, cynical where we are trustful ..."*

—F. Scott Fitzgerald, "The Rich Boy" (1926, emphasis added)

In creating and administering family limited partnerships (FLPs) and family limited liability companies (LLCs), clients and estate planners share a common aim: the orderly management and tax-efficient transition of wealth to future generations. A pervasive tension threatens this noble goal: Clients are reluctant to yield control, particularly if an FLP holds an operating business, while estate planners prefer to sever all ties out of fear that Internal Revenue Code Section 2036 will draw assets back into their clients' estates.

The issue boils down to "possession and enjoyment":

> The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained … 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.[1]

Clients often wish to exert control by acting as manager or general partner (GP), depending on the type of entity. The risk is that this role may allow the transferor-client (donor) to "designate the persons who shall possess or enjoy" the FLP property. To some extent, the decision is one of risk tolerance. Nevertheless, careful drafting of operating agreements and precise oversight of entity administration can eliminate many of these risks.

Contrary to popular myth, management of assets by the donor isn't, in and of itself, fatal under

IRC Section 2036(a)(2). In fact, the Tax Court has specifically enunciated this point both in cases that found in taxpayers' favor and in those that assessed significant tax deficiencies.[2] Instead, Section 2036 is to reach "inter vivos transfers where outright disposition of the property is delayed until the transferor's death."[3] As a result, it's the donor's retention of certain identifiable powers that may trigger Section 2036, not the donor's mere position as a GP or manager.

These powers, of course, are often associated with the position of a manager or GP. Problematic powers include the power to: (1) control distributions,(2) liquidate the entity, and (3) amend the operating agreement.[4] As elsewhere in the law, the legal consequence of a power isn't determined in a vacuum; instead, it hinges on the surrounding facts, and bad facts make bad law.

Discretionary Powers to Avoid

Clients can run into problems if they have the right to:

1. Control distributions. Emblematic of everything not to do when planning with closely held entities, *Estate of Strangi v. Commissioner* looms as a reminder that transferring wealth without transferring control can be fatal.[5] The decedent, Albert Strangi, acting through his attorney-in-fact, formed the Strangi Family Limited Partnership (SFLP) and Stranco, its corporate GP. SFLP was formed with 98 percent of Strangi's wealth, in exchange for a 99 percent FLP interest. Albert also had a 47 percent interest in Stranco. Among the numerous factors resulting in estate tax inclusion was the GP's sole discretion to determine distributions. The court viewed this power as an impermissible retained right to designate who should enjoy property and income within the meaning of Section 2036(a)(2).[6] Perhaps the court would have held differently had the facts of this case not otherwise been so egregious, including the decedent's contribution and continued enjoyment of personal use assets (his home) and SFLP's payment of living, medical and funeral expenses. Nonetheless, the court's analysis was sharply focused on the power to control distributions.

Several years later, the Tax Court emphasized, in *Estate of Turner v. Comm'r*,[7] that this IRC section can be implicated even if the power to control distributions isn't exclusively reserved to a donor as manager. There too, the court focused intently on the sole and absolute discretion of the GP to make income and in-kind distributions as the basis for estate inclusion under Section 2036(a)(2). Rejecting the defense that the decedent's wife shared his powers by virtue of her equal GP interest, the court noted that the statute specifically provides that the retained powers under Section 2036 may be held alone or "in conjunction with" others.

2. Dissolve the FLP. As a corollary to the right to control distributions, the right to dissolve a closely held entity also may trigger estate inclusion. The ability to terminate an entity isn't as problematic as the automatic liquidation provisions that typically ensue under the terms of an operating agreement. A decision to dissolve an entity, therefore, may be tantamount to a decision to make distributions to members. In this arena, as with the power to control distributions, the case law has been no more lenient with taxpayers who hold this power in conjunction with others than those who possess it alone. In *Strangi*, dissolution of the SFLP, which would have immediately triggered liquidation of assets, required the unanimous vote of the limited partners as well as the unanimous consent of the GP. Although Albert only owned a minority interest in the GP, the court found that he could act together with the other GP shareholders to accelerate the enjoyment of the partnership assets.[8]

3. Amend the operating agreement. Often overlooked because of its administrative character, the retention by a manager or GP of the power to amend an entity's operating agreement can bear the same estate inclusion consequences as the power to control distributions and dissolutions.[9] The ability to change the entity's agreement, after all, ensures the powerholder the ability to control enjoyment of all the entity's assets.

Alone or "In Conjunction With"

By introducing the notion that management powers exercised merely "in conjunction with" others can still have calamitous estate inclusion effects, *Strangi* and *Turner* took the complexities of a donor serving as manager to a whole new level. Taken to the extreme, if a donor of a closely held entity has certain voting rights as a member, Section 2036(a)(2) could come into play.[10] Indeed, the taxpayer enunciated this frustration in *Strangi*, noting that the court in the earlier case of *United States v. Byrum* could have never reached its decision in favor of the taxpayer if it had employed such faulty reasoning.[11]

The U.S. Supreme Court case of *Byrum* involved a gift of shares in three closely held companies to an irrevocable trust. The gifted shares, plus the shares retained by the settlor, together would have constituted a controlling block. Although an independent trustee determined whether income would be paid or withheld, the settlor retained the right to: (1) vote the shares of stock held by the trust, (2) veto the sale or transfer of trust assets, and (3) remove the trustee and name another corporate trustee as successor. The IRS asserted that the settlor's voting and veto rights, coupled with his pre-existing right to vote non-transferred shares, gave him the ability to control the flow of income to the trust and, thereby, shift beneficial enjoyment of the property between present and future beneficiaries, directly violating Section 2036(a)(2).[12] Although not specifically enunciated in this case, the "in conjunction with" argument, presumably, came into play in that the settlor couldn't determine the payout of dividends but could elect the directors of the corporations who wielded that control. The court in *Byrum* held in favor of the taxpayer for a variety of reasons, but the *Strangi* court explicitly distinguished the points that:(1) electing directors having the power to declare dividends isn't the equivalent of declaring a dividend, and (2) the independent trustee in *Byrum* acted as a stop gate by exercising control over whether distributions would actually be made to beneficiaries.[13] Even if the settlor could flood the trust with income, the independent trustee determined which beneficiaries would receive it and when.

Thus, *Byrum* limits the application of the "in conjunction with" prong of Section 2036(a)(2). However, because the *Byrum* court didn't directly address the "in conjunction with" issue, it's difficult to know whether it glossed over that issue because the settlor's ability to control the trust assets was too speculative or because that sort of literal interpretation of the statute would simply be too harsh. Indeed, in the context of Section 2038(a)(1), which is similar in wording to Section 2036(a)(2), courts have been less apt to apply the statute so strictly.[14] Still, *Strangi* and *Turner* remain good law, and given that the "in conjunction with" argument in those cases stemmed from direct statutory language, planners should tread precisely in this regard.

The Sway of Fiduciary Duties

For a long time, *Byrum* was touted as certain proof that the fiduciary constraints set forth by state law could overpower any personal desire for abuse and, thereby, counteract any prohibited retained powers under Section 2036(a)(2). As the Supreme Court related in that case, a board of directors is responsible for safeguarding corporate financial well being for the long term; therefore, it can't declare dividends at whim. Similarly, under applicable state law, a majority shareholder has a fiduciary duty that prevents him from using that position of power to promote personal or family benefit, to the detriment of other shareholders.[15] Accordingly, the settlor couldn't control the flow of dividends, let alone designate who would enjoy them.

Since then, however, courts have diverged on whether fiduciary duties truly mitigate the effects of Section 2036(a)(2). In *Strangi*, the court rejected this argument and distinguished *Byrum* on the basis that *Byrum* concerned unrelated individuals, stating that the fiduciary duties in SFLP had "no comparable substance."[16] In addition, the courts in both *Strangi* and *Turner* emphasized that the corporate entities in *Byrum* were actual operating enterprises rather than mere holding companies for monetary or investment positions.[17]

The recent case of *Mirowski v. Comm'r*,[18] in contrast, gives hope that courts will be reasonable in applying Section 2036(a)(2) and recognize the binding effect of state law fiduciary duties in limiting a manager's powers. Even though *Mirowski* concerned an LLC whose sole assets were marketable securities and whose partners were all related, the Tax Court accepted that the manager's fiduciary duties under state law, as specifically referenced by the operating agreement, limited the powers of the donor-managing partner. Unfortunately, while helpful, *Mirowski* doesn't supersede either *Strangi* or *Turner*.

Roadmap and Practical Suggestions

The idea that a donor of a closely held entity shouldn't retain certain powers is simple enough, but it creates a quandary as to who should exercise such control. If the donor, as manager, can't retain such powers, thenarguably, the donor, as member, can't hold such powers either. Even if the donor isn't a majority interest holder, under the "in conjunction with" argument, his ability to exercise anycontrol is sufficient to invoke Section 2036(a)(2).

Some practitioners believe that as long as others can outvote the donor with respect to the pertinent powers, such that his consent is never necessary to exercise those powers, Section 2036(a)(2) remains at bay. This argument isn't specifically supported by case law, but it might be tenable under a laxer reading of the statute. *Mirowski* and *Byrum*, however, provide more substantiated possibilities for planning with FLPs.

Mirowski represented a significant taxpayer victory and is often described as the blueprint for planning with intra-family closely held businesses. Anna Mirowski created an LLC and then gifted a combined 48 percent interest to trusts for the benefit of her daughters. Notwithstanding that Anna was the sole manager of the LLC, the court found no implication of Section 2036(a)(2). The operating agreement gave Anna, as manager, the power to manage and operate the business and affairs of the corporation and to make all relevant decisions. As to any prohibited powers under Section 2036(a)(2), however, the operating agreement removed all discretion:

1. Distributions of profits and loss from capital transactions were to be made pro rata to members in accordance with their profit interest, immediately after any expenses in connection with the transaction were paid and cash reserves were established. Likewise, distributions of profits and losses from ordinary transactions were to be distributed pro rata to members within a specified period of time;
2. Anna, as manager, couldn't engage in any capital transaction and dissolve the company without the express approval of all members. As to liquidation of assets on dissolution of the LLC, here too a pro rata distribution in accordance with member interests was mandated once creditors were paid; and
3. Although the operating agreement provided that the members with a majority interest could determine the timing and amount of distributions, which in and of itself might have proven fatal to Anna as a52 percent interest holder, this provision, along with the provision endowing powers to the manager, were specifically made subject to the other provisions of the operating agreement.[19]

The robotic approach employed in *Mirowski* survived Section 2036(a)(2) scrutiny, but it poses certain practical problems. First, it may not serve the needs of an entity. Second, it arguably reduces the likelihood of a favorable valuation discount for gifted interests, given that minority interest holders are no less favorably positioned than the majority. Finally, and perhaps most significantly, automatic income distributions could potentially create an inference of a retained right to income under Section 2036(a)(1) as to the interests in the entity owned by the donor at death. Because Anna's 52 percent ownership interest in the entity was addressed under the "bona fide sale" prong of Section 2036(a), the court never addressed Section 2036(a)(1) as it applied to Anna's interest in the entity, but the result might have been different if the bona fide sale argument proved unsuccessful. When the donor's estate is seeking a valuation discount for a minority interest, inclusion in the donor's estate of the assets contributed to the LLC, rather than the discounted LLC interest, could have severe tax consequences.

As an alternative to the *Mirowski* model, *Byrum* posits the possibility, by analogy, of an independent manager who has full control over all discretionary decisions that could have consequences under Section 2036(a)(2). It was, after all, the presence of an independent trustee in *Byrum* that ensured that any investment and management decisions that the trust grantor made didn't necessarily result in a distribution of income to particular beneficiaries. Similarly, the presence of an independent trustee, and by extension, an independent manager, obviates the "in conjunction" dilemma, as the court in *Strangi* concluded. Although it may be less than ideal for a donor to yield this sort of power to another party, it may be worthwhile if it means that he can retain the ability to manage and invest assets without risk of estate inclusion. In addition, the ability of the donor to remove and replace the independent manager, provided such successor isn't related to or employed by the donor, may provide the donor with sufficient peace of mind.

Ultimately, planners need to understand and balance the risk tolerance of a client against his need for control to devise a management plan for closely held entities. However, even the most aggressive of planners will do their clients a service by paying close attention to the drafting of operating agreements and avoiding, to the extent possible, the Section 2036(a)(2) triggers.

Endnotes

1. Internal Revenue Code Section 2036(a)(2).
2. *See United States v. Byrum*, 408 U.S. 125 (1972), *Estate of Mirowski v. Commissioner*, T.C. Memo. 2008-74, and *Estate of Turner v. Comm'r*, T.C. Memo. 2011-209.
3. *Estate of Strangi v. Comm'r*, T.C. Memo. 2003-14 (supplementing 115 T.C. 478 (2000)).
4. The power of a limited partner or member to remove and replace a general partner without limitation may also have the unintended effect of triggering IRC Section 2036(a)(2). *See, e.g., Kimbell v. U.S.*, 244 F. Supp.2d 700 (Dist. Ct. Tex. 2003). This aspect of Section 2036(a)(2) is outside the scope of this article.
5. *Strangi, supra* note 3.
6. *Ibid.*, at 743-744.
7. *Turner, supra* note 2.
8. *Strangi, supra* note 3.
9. *Turner, supra* note 2.
10. Note that this illustration isn't intended to extend to the retention of the right to vote shares of stock of a controlled corporation, which is addressed by Section 2036(b) and is beyond the scope of this article.
11. *Strangi, supra* note 3 at 743.
12. *Byrum, supra* note 2.
13. *Strangi, supra* note 3 at 743.
14. *See, e.g., Tully Estate v. Comm'r*, 528 F.2d 1401 (Ct. Cl. 1976).
15. *Byrum, supra* note 2.

16. *Strangi, supra* note 3 at 744.
17. *Strangi, ibid., Turner, supra* note 2 at 1415-1416.
18. *Mirowski, supra* note 2 at 402.
19. *Mirowski, supra* note 2 at 402-405.

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