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Limited Liability Companies and Estate Planning

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With the widespread adoption of limited liability company acts by state legislatures, limited liability companies (LLC) have become the business organization of choice for small closely held businesses. An LLC also provides tax advantages to transfer wealth from one generation to another while allowing the donor to maintain control over the assets until death.

An LLC consists of members and managers. It can be structured like a limited partnership, with the members being passive investors and the managers actively managing the company. The concepts of wealth transfer are the same for LLCs and limited partnerships: The generation transferring the wealth (the parents) forms an LLC, making themselves both managers and members. The generation receiving the wealth (the children) are made members of the company. Initially, the parents hold all of the membership interest in the company along with the assets it represents. Over time, the membership interest is gifted to the children, within allowable gift tax amounts, and the parents retain the control of the company and its assets as the managers. LLCs can be structured to allow flexibility to accommodate income distribution issues and restrictions on transfers of interests.

IRC section 2036. The driving force behind the estate planning methods described above is IRC section 2036.

IRC section 2036 states that whenever property is transferred (except in an arm's-length transaction for fair market value) and the transferee retains the right to enjoyment (use) or the income, the value of the property transferred is included in the estate of the transferee. Furthermore, if the transferee retains the right to control who will use the property or who will receive income produced by the property, the property will be included in the transferee's estate.

Strangi v. Comm'r

The facts of *Strangi (Estate of Strangi v. Comm'r,* 115 T.C. 35, 2000) are as follows: In 1994, the decedent's attorney son-in-law formed a family limited partnership known as the Strangi Family Limited Partnership (SFLP). At the same time he formed a corporation (Stranco) to act as the managing general partner of the SFLP. The general partner was given the sole, exclusive, and absolute right and authority to act on behalf of the partnership, with all of the customary broad language powers generally granted to a managing partner. The limited partners were without any authority or rights to manage the partnership. The managing general partner was given the sole discretion as to whether income would be distributed and also was given the sole discretion as to whether assets of the partnership would be distributed.

Ninety-eight percent ($9,876,929) of the decedent's estate was transferred to the SFLP. In consideration of the transfer, the decedent received 99% of the interest in the limited partnership. The decedent's children purchased a 53% interest in Stranco, while the decedent purchased the remaining 47%. Stranco then took a portion of these funds and purchased the remaining 1% interest in the SFLP.

Subsequent to the formation of the SFLP, the partnership paid for the decedent's health care and, after his death, paid for his funeral, estate administration expenses, and debts. After the executor filed a Form 706 and estimated tax, the IRS determined that a tax deficiency existed. In Tax

Court, the IRS failed to raise a section 2036 argument in the initial pleadings and made a motion for leave to amend; however, the tax court refused the IRS' request. On appeal, the Fifth Circuit (*Estate of Strangi v. Comm'r*, Tax Court Memo, 2003-145) stated that the tax court abused its discretion and remanded the section 2036 issue back to the trial court.

For a complete understanding of the second decision on remand, it is necessary to look at the court's examination of section 2036 closely. The court stated that "it has long been recognized that the general purpose of this section is 'to include in a decedent's estate transfers that are essentially testamentary' in nature." Relying on *Guynn v. United States* (437 F.2d 1148, 1971), the court stated that when the statute speaks to including assets in the decedent's estate this "described a broad scheme of inclusion in the gross estate, not limited by the form of the transaction, but concerned with all inter vivos transfers where outright disposition of the property is delayed until the transferor's death." The *Guynn* court went on to state that "while the issue of implied agreement must turn on all the circumstances of each transaction, continued exclusive possession by donor and withholding of possession from donee are highly significant factors."

In Estate of *McNichol v. Commissioner* (265 F.2d 667, 1959), the court concluded that the term enjoyment is "synonymous with substantial present economic benefit." In *McNichol*, the decedent's estate argued that because the decedent could not enforce his right under the statute of frauds to receive income from real estate conveyed to his children, he had no right to enjoyment. The court rejected this argument; because the donor retained a present economic benefit, he in fact had "enjoyment" of the property within the meaning of IRC section 2036.

When LLCs are used as an estate planning tool to transfer real estate, there is often an agreement that the donor can remain in the family home without paying rent. This is use and enjoyment, and the courts have stated that whether an implied agreement exists is a factual determination requiring examination of the transfer itself and the subsequent use of the property (*Estate of Reichardt v. Comm'r*, 114 T.C. 9, 151, 2000).

Quoting *United States v. Byrum* (408 U.S. 12, 1972), the court stated "right" has been construed to connote an ascertainable and legally enforceable power. The court was addressing the issue of retaining the right over managerial power. The *Byrum* court stated that retaining managerial power over transferred assets does not automatically result in the inclusion of transferred assets in an estate. The *Byrum* court focused on whether the settler of the trust retained a "substantial present economic benefit." Broad powers of management do not necessarily subject an inter vivos trust to the federal estate tax. It is when the settler retains management control coupled with retained economic benefits that assets may be included in the settler's estate.

***Strangi* Court's Reasoning**

The IRS took the position that transfers made to the limited partnership and to the corporation acting as the general partner were includable in the decedent's gross estate pursuant to IRC section 2036(a)(1) or 2036(a)(2). They based their argument in part on the structure of the SFLP and the Stranco Corporation: "the governing documents gave Gulig authority to specify distributions from SFLP, which is entirely consistent with his authority under the 1988 power of attorney." The estate argued that the managing partner did not have authority beyond day-to-day affairs of the corporation; however, the IRS contented that none of the documents precluded making distributions from the SFLP.

The court focused on IRC section 2036(a)(1). If the transferor retains by expressed or implied agreement the possession, the enjoyment, or the right to income, the transfer is includable in the transferor's estate. The court equated enjoyment with a present economic benefit. The court concluded that the decedent did retain a right to income. Nothing in the documents governing the SFLP and Stranco prevented the decedent from receiving income from either of the entities.

The court was prepared to conclude that the transfers were includable in the decedent's estate. The court made a factual determination that the decedent at any time could have directed that the income, or a portion thereof, from the SFLP or from Stranco be given to him.
The court went on to show that the decedent "as a practical matter retained the same relationship to his assets that he had before formation of SFLP and Stranco." There need not be an actual retained interest in possession or enjoyment, but merely an implied retained interest under IRC section 2036(a)(1). The court listed circumstances that are probative of an implicit retained interest: transfer of the majority of the decedent's assets, continued occupation of transferred property, commingling of personal and entity assets, disproportionate distributions, use of entity funds for personal expenses, and testamentary characteristics of the arrangement.

The court examined the factual circumstances carefully. The decedent transferred almost all of his assets to the SFLP and Stranco, leaving him with very few assets to meet his living expenses. The court characterized the decedent's continued physical possession of his residence after transfer to the SFLP as "highly probative under section 2036(a)(1)." The estate argued that the decedent was obligated to the SFLP for accrued rent. *Citing Reichardt*, the court stated, "accounting entries alone are of small moment in belying the existence of an agreement for retained possession and enjoyment."

Regarding the use of the SFLP funds, the estate argued that any payments made to the decedent were "de minimis." The court flatly disregarded this argument, noting that the SFLP made a series of expenditures on behalf of the decedent: the decedent's caregiver's back surgery, his funeral, nursing services, estate administration expenses, estate expenses and a specific bequest, and disbursements for the decedent's estate for estate and inheritance taxes. The estate countered the IRS' argument by stating that the payments were accounted for on the books of the SFLP as "advances to partners and later closed as distributions, with pro rata amounts either advanced or distributed to Stranco." The court did not accept this argument, stating that "accounting adjustments do not preclude a conclusion that those involved understood that the decedent's assets would be made available as needs materialized."

The court also considered that the SFLP and Stranco were actually estate planning vehicles. The court could not find that the purpose was to provide for "a joint investment vehicle for the management of the decedent's assets, but was consistent with testamentary intent." The court focused on the substance of the arrangement, as opposed to the formal legal structure; the decedent did in fact retain possession of, enjoyment of, or the right to income from the property within the meaning of IRC section 2036(a)(1).

In concluding that the decedent's transfers were includable in his estate under IRC section 2036, the court looked very carefully at the factual circumstances. Relying on the Supreme Court's reasoning in *Byrum (United States v. Byrum*, 1972), the *Strangi* court agreed with the IRS that the decedent did in fact retain the right to designate who shall enjoy the property and the income from the SFLP and Stranco. The court then went on to state that not only did the decedent retain the right to control the income of the transferred assets, but also the property itself. Relying once again on *Byrum*, the court concluded on a factual basis that:

Once dissolution and termination occur, liquidation is accomplished as set forth in the SFLP agreement. The managing general partner is named as the liquidator, which in turn disburses partnership assets first in payment of debts and then in repayment of partners' capital account balances. Authority is expressly granted for distributions in kind. 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.

The court said it was "noteworthy" that such an action would likely revert the majority of the contributed property to the decedent himself, as the 99% limited partner.

According to the court, the distinguishing fact between *Strangi* and *Byrum* was that Strangi retained the right to designate who would enjoy the property and its income. The *Byrum* court noted that the entity the property was transferred to had an independent trustee. In *Strangi* there was no independent trustee; the decedent made all the decisions through his attorney. In Strangi, the SFLP and Stranco, Inc., merely existed to hold monetary assets and make investments.

The court noted that the fiduciaries in *Byrum* had duties that "ran to a significant number of unrelated parties and had their genesis in operating businesses that would lend meaning to the standard of acting in the best interests of the entity." Although the *Strangi* estate argued that the decedent's rights were severely limited by others with fiduciary duties, the court disagreed. The court could not find on a factual basis that those in a position of fiduciary control were in a position to make independent decisions. The court was particularly concerned with Gulig's (the decedent's son-in-law, attorney, and attorney-in-fact) ability to make any decisions independent of what the decedent directed. The Strangi estate simply could not establish that Gulig and the Stranco directors were in a position to exercise independent decisions apart from the decedent.

Next the court turned its attention to the lack in *Strangi* of a bona fide sale at arm's length in the transfer from the decedent to the SFLP and Stranco. The court examined this point in two parts. First, it pointed out that there were no "meaningful negotiations or bargaining with other anticipated interest-holders"; Gulig made all the arrangements. Because of this, the court concluded that the decedent "stood on both sides of the transaction." In addition, the court called the transaction "merely a recycling of value through partnership or corporate solution," citing *Estate of Thompson v. Commissioner* (T.C. Memo. 2002-246); *Estate of Harper v. Commissioner* (T.C.M. 2002-121, 2002); and *Kimbell v. United States* [244 F. Supp.2d 700 (N.D. Tex. 2003)]. The court found no distinguishing facts between *Strangi and Harper*. The decedent contributed assets to the SFLP and Stranco and then received back an interest the value of which derived almost exclusively from the assets he had just assigned.

Lastly, the court addressed the issue of how much of the transfer is properly includable in the decedent's gross estate. The decedent's estate argued that IRC section 2036 requires inclusion only to the extent the decedent retained an interest in the transferred property, not all of the property. The court flatly rejected this argument, and concluded that all of the transferred assets were includable in the decedent's estate. The court said that no part of the transferred property was exempt from the rights or enjoyment retained by the decedent.

Kimbell v. United States

In 2003, *Kimbell v. United States* affected the use of LLCs as estate planning vehicles. The facts of *Kimbell* are as follows: The decedent created a limited partnership two months before her death. This partnership was owned by an LLC and it owned 1% of the limited partnership and was its general partner; the trust owned 99% of the limited partnership, thus becoming its limited partner. The decedent was the cotrustee of the trust along with her son, who was also the manager of the LLC.

The case centered around the transfer to the limited partnership from the trust created in 1991. Because it was a revocable trust, all parties acknowledged that the assets of the trust were includable in the decedent's estate. Presumably, the motivation to transfer the assets of the trust to the limited partnership was to claim a discounted value at the time of the decedent's death. The executor valued the assets at $1.257 million, and the IRS valued them at $2.463 million. The executor paid the additional tax due and sued for a refund, claiming that the IRS overvalued the estate.

The court focused on two issues. First, it discussed the IRC section 2036(a) exemption of transferred property from a decedent's estate. The court cited the "bonafide sales for an adequate and full consideration" exception and transfers where the decedent retains neither the "possession or enjoyment of or the right to income from the property" nor "the right, either alone or in conjunction with any other person, to designate the persons who shall benefit or enjoy the property exception." The court dismissed the executor's contention that these exceptions apply, and found that the decedent stood on both sides of the transaction. Because the trust was revocable, ownership of its assets were attributable to the grantor/decedent. Thus, the 99% contributed to the limited partnership by the trust was de facto contributed by the decedent.

The court did not find that the decedent received adequate and full consideration for the sale. Citing *Wheeler v. U.S.* (116 F.3d 749), the court noted that although the IRC does not define adequate and full consideration, it does not include paper transactions. This court cited the same passage from *Harper* as the *Strangi* court when addressing the issue of consideration for the transfer. Based on this, the court dismissed the estate's claim that the transfer was exempt under the two exceptions in IRC section 2036.

The court also addressed the estate's claim that the decedent did not retain the possession or enjoyment of, or the right to the income from, the property. The court in *Kimbell* rejected the estate's claims that there was no retained interest, claiming that the partnership agreement itself serves as an actual agreement between the parties that the decedent did in fact retain possession or enjoyment of the property. The court noted that the decedent had the authority under the partnership agreement to remove the general partner at any time and appoint either herself or someone else.

Citing *Byrum*, the estate argued that the decedent could not have possibly removed the general partner and appointed herself because that would have resulted in a breach of her fiduciary duties. The court stated that the estate's arguments were without merit, that *Byrum* was distinguishable on its facts, and thus that the transfer of assets to the partnership was governed by IRC section 2036(a) rather than any of its exceptions.

The executor appealed the district court's decision to the Fifth Circuit Court of Appeals (371 F.3d 257, 5th Cir. 2004), which vacated the trial court's grant of summary judgment in favor of the government on the question of whether the transfer to the partnership was a bona fide sale for full and adequate consideration. It also remanded to the trial court the question of whether the decedent's partnership interest was an assignee interest or a limited partnership interest.

The court's decision was driven by a factual determination on the question of whether the transfer from the decedent would escape the reach of IRC section 2036(a) on the basis of two exceptions: the bona fide sale for adequate and full consideration, and whether the decedent retained an interest in the assets transferred. In addressing the first exception, the court concluded that Wheeler required an examination of whether or not "the sale … was, in fact a bona fide sale or was instead a disguised gift or a sham transaction."

The court then referenced *Thompson, Harper*, and *Strangi* with regard to the proposition that if a family partnership is only a vehicle for changing the form in which the decedent held his property—a mere "recycling of value"—the decedent's receipt of a partnership interest in exchange for his testamentary assets does not qualify as an exception. The court pointed out that all of these prior cases recognized that an exception could apply if the transaction indicates the exchange was more than a sham or a disguised gift. The court found that Kimbell did not retain sufficient control of the assets transferred to the LLC. The decedent retained only a 50% interest in the transferred assets; her son had sole management powers, and because of that, the decedent did not have the right to designate who would enjoy the property.

Implications

Neither the *Strangi* nor the *Kimbell* case should be treated lightly. Although the

Kimbell court found for the estate on appeal, it did not disturb prior case law or statutes. It left *Strangi* intact. A close reading of both cases reveals the federal courts' narrowing approach to transfers made within the confines of IRC section 2036. The aggressive practice of transferring wealth from one generation to other needs to be reexamined in light of these recent court decisions.

It is no longer advisable for the grantor to retain control or use of transferred property through an LLC or limited partnership. Fair market value should be paid for the use of the property, and be properly documented. Current practice—wherein the grantor transfers the property but retains control as the manager of the company—is no longer sound practice. The transfer must not have any strings attached. Combining management control along with a present economic benefit will result in close scrutiny by the IRS and the courts.

The contributions to the LLC should come from more than one family member. Both the *Strangi* court and the Kimbell court objected to the fact that the decedent contributed the bulk, if not all, of the property to the LLC or limited partnership. The *Kimbell* appeals court stated that one of the factors to be considered is whether the interests credited to each of the partners were proportionate to the fair market value of the assets contributed to the partnership.

Another issue closely examined by both of these courts was the voting arrangements of the LLC or limited partnership. In particular, the *Strangi* court found the decedent's ability to control the distribution of income or assets from the limited partnership to be problematic. To avoid a similar judgment, a grantor/decedent cannot retain voting control of the company/partnership and implicitly retain the economic benefits of the property transferred.

The one thing that stands out in Strangi is the decedent's use of transferred assets to pay his living expenses. If there is any chance the transferor/decedent will need the assets (or income therefrom), the assets should not be transfered. Transferors should retain enough assets in their own name to meet their living expenses.

Last, LLC and limited partnership formalities should be followed. This includes completing required filings with state authorities on time, filing tax returns on a timely basis, holding regular meetings of the members and documenting them, preparing resolutions authorizing action on the part of the company when contemplating a significant transaction, and having notes and security documents in place when loans are made. In short, all the activities of the company should be formalized. This will not, however, save an otherwise questionable transfer.

With careful planning, LLCs and limited partnerships can still be effective vehicles for transferring wealth from one generation to another. Transferors must understand, however, that a transfer is a complete separation from the transferred assets, with no strings attached. The federal courts have demonstrated their intolerance for attempts to stretch the literal meaning of IRC section 2036.

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