CORPORATE ASSISTANCE
Compliance Management for Business Owners

The Landmark Strangi Case and Its Impact on Private Business Entities

Introduction

For years, limited partnerships (LPs) have been popular legal forms for certain business purposes. An LP is formed by two or more persons in accordance with state law, and must include at least one general partner and one limited partner. Limited partners are only liable for the debts and obligations of the partnership to the extent of their capital investment, but they are prohibited from playing any management role in the partnership. General partners, on the other hand, are responsible for managing the partnership, and have unlimited liability for the actions of the partnership. Like corporations and LLCs, LPs must observe governance formalities not required of a general partnership.

Family limited partnerships (FLPs) are simply LPs among family members and are largely used in estate planning. In general, FLPs are not separate entities under state law - they are simply LPs, but are subject to distinct income tax rules on partnership income and interest transferability.

As business structures, LPs are primarily used in 2 ways: 1) To provide a way for business owners to raise money from passive investors (the limited partners) without having either to take in new partners who will be active in the business or to engage in the intricacies of creating a corporation and issuing stock; 2) To create a vehicle for asset protection and estate planning amongst family members, as in the case of an FLP.

The IRS has taken the position that FLPs should be disregarded for estate and gift tax purposes. Through a series of court cases, the Tax Court has been progressively disallowing the IRS's positions. The long-awaited opinion of the Tax Court in Estate of Strangi, T.C. Memo 2003-145, was issued on May 20, 2003. The May 2003 Strangi ruling was the culmination of 3 separate rulings in the case which spanned several years.

Strangi is viewed as a landmark ruling offering some important guidance regarding FLP formation and post-formation operation of an FLP. While the Strangi case dealt specifically with FLPs, the Tax Court's rulings are seen as impacting LLCs and other entity types as well.

Strangi v. CIR

In Strangi, an FLP was formed in 1994 via a power of attorney given to the decedent's son-in-law, who became the "Attorney-in-Fact". The FLP was formed as a Texas limited partnership, having a Texas corporation as its corporate general partner (the "Corporate GP"). In the year before the creation of the FLP, the decedent had had cancer surgery, was diagnosed with a brain disorder, and also had prostate surgery. At the time of the creation of the FLP, the Attorney-in-Fact believed that the decedent had approximately 12 to 18 months to live.

The FLP was funded with $9.9M of the decedent's liquid assets in return for a 99% limited partner interest. The assets contributed constituted approximately 98% of the decedent's wealth, and included his personal residence. Corporate governance requirements were properly observed by the Attorney-in-Fact. The corporate GP owned a 1% general partnership interest. The decedent owned 47% of the Corporate GP and his four children owned the other 53% (purchased with promissory notes).

The decedent and his four children were the directors of the Corporate GP, and all of the appropriate corporate documents were executed in connection with its formation. In other words, the FLP had been correctly formed in accordance with state law – this is a significant fact.

The FLP agreement provided that the Corporate G.P., as Managing General Partner "shall have the sole, exclusive and absolute right and authority to act for and on behalf of the Partnership and all of the Partners in connection with all aspects of the business of the Partnership." The defined authority of the G.P., together with the decedent's ownership interest in the G.P., became another significant fact.

The decedent died approximately two months after the formation of the FLP. Various payments were made out of the FLP for or on behalf of the decedent or his estate. These included medical expenses, funeral and estate administration expenses and debts of the decedent. These distributions were justified in the FLP's records via accounting measures wherein the Corporate GP received pro-rata distributions either in cash or in the form of adjusted journal entries on the FLP's books. The FLP's expense payments and corresponding accounting practices became yet another significant aspect of the Strangi case.

On the decedent's estate tax return, the estate applied a significant minority interest discount in calculating the estate tax return due to the FLP's ownership of the assets. The IRS determined a deficiency in federal estate taxes, stating the position that the decedent's interest in the FLP should be increased by $4.4M to a value of $10.9M.

The Tax Court's Ruling

The Strangi case represents the culmination of multiple court rulings on a plethora of legal issues. In essence, however, the dispute between the Strangi estate and the IRS boiled down to whether the Strangis had created a bona fide business entity (both in form and in operation), or not.

The Tax Court held in favor of the decedent's estate on a number of issues, determining that: (i) the FLP was a valid partnership formed under state law and would be recognized for federal estate tax purposes; (ii) IRC Section 2703 (tax code rules on asset discounting) did not apply to disregard the partnership agreement; (iii) the transfer of assets to the FLP was not a gift (i.e., there was no gift upon formation); and (iv) the decedent's interest in the FLP and Corporate GP should be valued applying discounts as determined by the IRS expert (a 31% discount).

However, the Tax Court also identified several problems in the way the Strangi FLP had been operated. While noting that correct formalities had been observed in the formation of the FLP, the Tax Court took issue with certain post-formation and post-death operational practices:

- The decedent contributed 98% of his assets to the FLP, leaving him with inadequate assets to meet his living expenses.
- The decedent continued to occupy the primary residence after it was contributed to the FLP without properly paying rent. While the FLP accrued rent on the residence and reported rental income on its income tax return for the year in which the decedent died, this accrued amount was not paid until approximately 2 ½ years after the decedent's death.
- Several distributions were made on behalf of the decedent or his estate without benefiting the FLP itself or the other partners. While bookkeeping entries showed such amounts as distribution advances and 1% pro-rata distributions were made to the corporate GP, the court saw this as mere "accounting manipulations".
- The decedent owned a significant interest in the Corporate G.P., and thereby had the ability, alone or in conjunction with others, to control the distribution of the income of the FLP. In a "bad fact" specific to the structure of the Strangi FLP, the court felt there was no substance to constraints on the decedent's control of the assets within the FLP.

The Bottom Line

Taken together with similar rulings, the Tax Court has clarified how limited partnerships and other business forms will be treated in terms of liability protection and estate and gift tax calculations:

- LPs maintained in accordance with applicable laws are valid business entities, whether used as a primary business or for the purposes of estate planning and asset protection
- It is appropriate to discount the value of assets held within a business entity for estate tax purposes, although there are guidelines and limits that apply to such discounts.
- If there is no substance to constraints on the contributing partner's control over assets in a business entity, the entity provides no estate and gift tax protection.
- Following formation, the operation of a limited partnership is also subject to certain constraints. It must exhibit characteristics of 1) independent control of operations; and 2) decision making that resembles what would happen assuming the influence of objective business demands or unrelated 3rd party requirements.

While the long-term implications of Strangi are still evolving, it already has had a significant effect on attorneys and other advisors who treat the topic of limited liability business entities with their clients. Already, it is becoming common for advisors to ask themselves, "Does my client have a Strangi problem? And if so, what should I advise them to do about it?"

What Strangi clearly shows is that, in the eyes of the law, the long-term viability of a limited partnership or other business entity depends significantly on proper ongoing management of operations to ensure the entity remains in compliance with applicable laws. Setting the entity up correctly initially is not enough – you've got to maintain it for the long haul.