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Strangi II -- Summary

Fifth Circuit Affirms Strangi's Application of Section 2036 to FLP

The Fifth Circuit Court of Appeals recently affirmed the Tax Court's decision in Strangi v. Commissioner, No., 03-60992 (5th Cir. July 15, 2005). This is the much anticipated appellate review of "Strangi 3" by the Fifth Circuit Court of Appeals, following up on its decision in Kimbell v. U.S., 371 F.3d 257 (5th Cir. 2004) which held that the bona fide sale for full consideration exception to §2036 did apply under the facts of that case.

The court emphasized that the essential issues were based on fact issues, and the appellate court was reviewing the Tax Court's finding under a "clear error" review standard. The court's specific holdings are as follows:

- a. There was no clear error in the lower court's finding of an implied agreement for retained enjoyment of assets transferred to the partnership under §2036(a)(1).
- b. There was no need to determine if §2036(a)(2) applied (having found that §2036(a)(1) applied.)
- c. There was no clear error in the lower court's finding that the bona fide sale for full consideration exception to §2036 did not apply.
- d. The lower court did not abuse its discretion in refusing to apply equitable recoupment in light of overpayment of income taxes because of the inclusion of partnership assets in the estate without a discount.

Here are several brief observations.

1. Section 2036(a)(1): Importance of Retaining Assets to Pay Living Expenses AND Post-Death Expenses. The court pointed to the fact that the decedent did not retain enough assets outside the partnership to pay anticipated living expense for his expected life expectancy AND to pay certain post-death expenses, including funeral expenses, administration expenses, specific bequests, and personal debts of the decedent. This is a significant extension from prior cases of what assets should be retained in order to avoid a §2036(a)(1) claim. (The court is not clear as to whether sufficient assets to pay estate and inheritance taxes must also be retained.)

2. No §2036(a)(2) Guidance. The court's refusal to comment on Judge Cohen's expansive application of §2036(a)(2) to family entities is disappointing. (This is not surprising, however. Despite the strong urging by ACTEC in its amicus curiae brief that the Fifth Circuit correct Judge Cohen's misstatement of the law, the judges reportedly did not ask a single question about §2036(a)(2) at the oral argument.) One wonders if the IRS may be emboldened to make §2036(a)(2) claims in light of the fact that no case has questioned the Judge Cohen's analysis in Strangi 3. However, the IRS may be inclined to use §2036(a)(2) as a scare tactic and not risk a reported case that responds to Judge Cohen's broad extension of §2036(a)(2).

3. Bona Fide Sale Standard. The court does not give a clear test for meeting the "bona fide sale" requirement in the bona fide sale for full consideration exception to §2036. The court does not give any credence to the Fifth Circuit's prior analysis in Kimbell v. U.S., 371 F.3d 257 (5th Cir.

2004) that bona fide means that the transfer actually took place, and that when the transaction is between family members, it is subject to heightened scrutiny to insure that the sale is not a sham transaction or disguised gift and that the transaction is “real, actual, genuine and not feigned.” Instead, the Strangi case just says that the issue is whether the transfer was “objectively likely to serve a substantial non-tax purpose.”

The precise standard is unclear, because the court refers to several alternative phrases in the same paragraph. However, the court seem to say that a “business purpose” is not required—in large part because the case restates a phrase from Kimbell and intentionally changes “substantial business AND other non-tax reason” to “substantial business [OR] other non-tax reason.” Furthermore the court recognized that the partnership never conducted an active business, but that fact alone was not sufficient to resolve the bona fide sale issue.

4. Keep Perspective. The IRS undoubtedly is overjoyed with this victory in the Fifth Circuit, and may react by being more aggressive in negotiating FLP discounts for gift and estate tax purposes. However, the case does not mean that clients must avoid using FLPs. The case involved terrible facts under §2036, and the appellate court deferred to the Tax Court’s findings of fact that it did not believe the purported non-tax reasons for the partnership. Well-planned FLPs should be able to avoid §2036(a)(1) attacks even if the bona fide sale exception is not met. Furthermore, the case (like so many of the recent cases) is a §2036 case, and is not directly applicable to gift tax cases.

A more detailed analysis of the case is attached.