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Estate Of Powell: The Service Wins The Latest Round, But Did It Land A Significant Blow?

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In the wake of *Estate of Strangi*, the Internal Revenue Service (the "Service") appeared to have a new weapon against family limited partnerships - Section 2036(a)(2). In *Strangi*, the Tax Court concluded that Section 2036(a)(2) was triggered by a decedent's ability, as a non-controlling general partner, to band together with family members to control partnership distributions and dissolution. The Tax Court's analysis significantly detracted from the fiduciary duty limitation to Section 2036(a)(2) established in *United States v. Byrum*. To some, it foretold the demise of an important segment of family limited partnership planning.

In the fourteen years since *Strangi*, however, the Service has not actively or successfully deployed Section 2036(a)(2) as a weapon against family limited partnerships.[4] As a result, concern that the Tax Court's analysis in *Strangi* would derail partnership planning has slowly faded. Concern regarding Section 2036(a)(2) may be renewed, however, due to the Tax Court's decision in *Estate of Powell*.[5]

In *Estate of Powell*, the Tax Court applied Section 2036(a)(2) in the context of a decedent who owned a 99 percent limited partner interest, but not a general partner interest, in a family limited partnership controlled by her sons.[6] The result is not surprising considering the aggressive nature of the planning – a partnership consisting primarily of liquid assets, involving only family members as owners, formed by the decedent's son via the use of a power of attorney, and funded just seven days prior to the decedent's death.[7]

The Tax Court's analysis, however, is somewhat of a surprise. For one, it arguably expands the scope of Section 2036(a)(2) by applying it to a decedent who did not own (and had never owned) a general partner interest in the family limited partnership.[8] In addition, it creates the possibility that Section 2036 estate inclusion may involve a "duplicative transfer tax" relative to the assets contributed to the partnership.[9] These potential implications, in combination with its resurrection of the Tax Court's analysis in *Strangi*, make *Estate of Powell* a case that practitioners should understand.[10]

Background

In recent years, Section 2036 has been the primary means by which the Service has attacked family limited partnerships. Most Section 2036 challenges involve the assertion that the contributor retained the right to the income or the enjoyment of partnership property under Section 2036(a)(1). On rare occasions, though, the Service has attempted to apply Section 2036(a)(2). In these cases, the Service has asserted that the decedent's retention of managerial authority gives the decedent the right to "designate," within the meaning of Section 2036(a)(2), who receives partnership income or who enjoys partnership property.[11]

Section 2036(a)(2) attacks have been limited, however, due to the result of *United States v. Byrum*. In *Byrum*, the Supreme Court held that Section 2036(a)(2) did not apply when a decedent, who owned a controlling interest in each of three different corporations, transferred shares of stock in each corporation to an irrevocable trust for the benefit of his children and simultaneously retained the right to vote the transferred shares.[12] Following this result, *Byrum* has evolved to stand for the general proposition that a decedent's managerial authority, in connection with a family limited partnership, does not trigger Section 2036(a)(2) if the authority is constrained by one or more fiduciary duties.[13]

In *Estate of Strangi*, however, the Tax Court chipped away at *Byrum's* fiduciary duty limitation on the application of Section 2036(a)(2). In *Strangi*, the decedent's son-in-law, acting as his agent under a durable power of attorney, formed and funded a family limited partnership with liquid assets comprising approximately 98 percent of the decedent's wealth. At the time of the decedent's death (two months from the date that the partnership was funded), the decedent owned a 99 percent limited partner interest. The decedent also owned 47 percent of a corporation that owned the 1 percent general partner interest. The decedent's family owned 52 percent of the corporation, and the remaining 1 percent was owned by a charity.[14]

Under these facts, the Tax Court held that the partnership's assets were includable in the decedent's gross estate under Section 2036(a)(2).[15] The court reasoned that, because the decedent could band together with the other shareholders of the corporation to determine partnership distributions and to dissolve the partnership, the decedent retained the ability to designate who could enjoy partnership income and property. In concluding that the decedent was not subject to *Byrum*-like fiduciary duties, the Tax Court commented that "[i]ntrafamily fiduciary duties within an investment vehicle simply are not equivalent in nature to the obligations created by the [*U.S. vs. Byrum*]...scenario."[16] Although it affirmed the result on appeal,

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the Fifth Circuit did not address the Tax Court's analysis of Section 2036(a)(2). As a result, the Tax Court's analysis of Section 2036(a)(2) in *Strangi* remains dictum.[17]

Although some practitioners feared that *Strangi* would result in a wave of Section 2036(a)(2) attacks, the Service has rarely litigated Section 2036(a)(2) claims since this decision. In fact, since *Strangi*, the Service has only pursued Section 2036(a)(2) in two Tax Court cases.[18] Thus, in recent years, concern has faded regarding the impact of the Tax Court's analysis in *Strangi* and the effectiveness of Section 2036(a)(2) arguments.

Estate of Powell

The facts in *Estate of Powell* typify the brand of "aggressive deathbed tax planning" that the Service frequently condemns.[19] On August 6, 2008, Jeffrey Powell ("Jeffrey"), Nancy Powell's son, formed NHP Enterprises LP ("NHP") as a general partner. Two days later, acting as Mrs. Powell's agent under her durable power of attorney, Jeffrey funded NHP with approximately $10,000,000 of marketable securities and cash from Mrs. Powell's revocable trust.[20] At the time NHP was funded, Mrs. Powell may not have had capacity.[21] Just one week after NHP was funded, Mrs. Powell passed away.[22]

As a result of NHP's funding, Mrs. Powell received a 99 percent limited partner interest. Jeffrey and his brother each received a general partner interest, with each contributing an unsecured promissory note. In addition, on the same day that NHP was funded, Jeffrey transferred Mrs. Powell's limited partner interest to a charitable lead annuity trust (the "CLAT"). Jeffrey made this transfer as Mrs. Powell's agent under her power of attorney.[23]

Under the terms of the limited partnership agreement, Jeffrey, as general partner, could unilaterally determine the amount and timing of partnership distributions. NHP could be dissolved with the written consent of all partners, including the consent of the limited partner.[24]

Estate of Powell was fully reviewed by the Tax Court, with seventeen judges participating in the decision. The primary opinion, however, is only a plurality opinion joined by eight of the seventeen judges. Seven judges instead partnered in a concurring opinion, and two judges agreed with the plurality in result only.[25]

The plurality opinion held that Mrs. Powell's right to act in conjunction with the other partners to dissolve NHP was a right "to designate the persons who shall possess or enjoy" the cash and securities, "or the income therefrom," transferred to NHP within the meaning of Section 2036(a)(2).[26] Thus, the value of the assets transferred to NHP was includable in her gross estate under either Section 2036(a)(2) or Section 2035(a), depending upon the validity of her gift to the CLAT.[27] In addition, the plurality noted that Mrs. Powell held the right, through her son as agent under her power of attorney, to determine the amount and timing of partnership distributions. This also triggered the application of Section 2036(a)(2).[28]

The concurring opinion agreed with the plurality's Section 2036(a)(2) analysis.[29] As a result, fifteen of the seventeen judges in *Estate of Powell* explicitly agreed that Section 2036(a)(2) applied. Two other judges agreed with the result.[30]

To reach this holding, the plurality opinion analogized *Estate of Powell* to *Strangi*. The plurality noted that, in both cases, the decedent could act with other family members to dissolve the partnership. In both cases, a partnership dissolution would likely cause the majority of the assets contributed to the partnership to be distributed back to the taxpayer. The plurality also pointed out that, in both *Powell* and *Strangi*, the decedent indirectly retained the ability to control partnership distributions via an agent under a power of attorney.[31]

Furthermore, the plurality opinion distinguished *Byrum* on the same grounds that the Tax Court distinguished *Byrum* in *Strangi*. In distinguishing *Byrum*, the plurality noted that, while Jeffrey had fiduciary duties as NHP's general partner, he also owed duties to Mrs. Powell as an agent under her power of attorney.[32] Moreover, the plurality noted that nothing suggests that Jeffrey would have "exercised his responsibility as general partner of NHP in ways that would've prejudiced [Mrs. Powell's] interests."[33] It also remarked that, because Mrs. Powell owned a 99 percent limited partner interest, "whatever fiduciary duties limited [Jeffrey's] discretion in determining partnership distributions were duties that he owed almost exclusively to [Mrs. Powell]."[34] Therefore, like the Tax Court did in *Strangi*, the plurality concluded that any limitations imposed by the general partner's fiduciary duties to the decedent were "illusory" and do not prevent the application of Section 2036(a)(2).[35]

The plurality opinion does not address, however, a key distinction between *Estate of Powell* and *Strangi* - the decedent in *Strangi* retained a general partner interest; Mrs. Powell did not.[36] Also noteworthy is that, for some reason, the *Powell* estate did not contest Section 2036(a)(2) inclusion.[37] Furthermore, the *Powell* estate conceded that Section 2036's "bona fide sale for an adequate consideration" test was not met.[38]

The plurality opinion, *sua sponte*, also analyzed the amount of estate inclusion. The plurality held that, regardless of whether inclusion was under Section 2036(a)(2) or Section 2035(a), neither section requires inclusion of the "full date-of-death value of the cash and securities transferred to the [NHP]; only the excess of that value over the value of the limited partner interest" that Mrs. Powell received in connection with the funding of the partnership.[39] Additionally, the plurality noted that, if Mrs. Powell's gift to the CLAT was either void or revocable, then the deemed retained partnership interest would also be included in her gross estate.[40] Per the plurality's analysis, both the "doughnut" (the limited partner interest, including future appreciation) and the "hole in the doughnut" (the future appreciation) would be included in Mrs. Powell's gross estate.[41] In footnote 7 of the opinion, the plurality

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acknowledged that, under its approach, a "duplicative transfer tax" would apply to the extent of the post-contribution increase in the value of the assets that funded the partnership.[42]

The plurality's double inclusion analysis is technically dictum and lacks precedential value.[43] The amount of estate inclusion was not an issue being litigated by the parties and was not central to resolving the other litigated issues.[44] Moreover, the seven-judge concurring opinion did not adopt the plurality's technical analysis regarding the amount of estate inclusion.[45] The concurring opinion reasoned that only the value of the partnership's assets should be included in Mrs. Powell's gross estate because Section 2036 inclusion renders the partnership a mere alter ego of its assets.[46]

Assessing the Impact

To some, *Estate of Powell* is the most significant family limited partnership case in years.[47] It arguably strengthens Section 2036(a)(2) as a weapon for the Service by expanding its application to a limited partner that did not concurrently own a general partner interest.[48] Through this lens, the plurality's Section 2036(a)(2) analysis is important because it illustrates that the decedent need not retain, nor formerly own, a general partner interest in order to trigger estate inclusion.[49] Under the plurality's reasoning, the "mere possibility" that a limited partner may vote or band together with the general partner appears to be sufficient to cause inclusion under Section 2036(a)(2).[50] Notably, per this analysis, a taxpayer cannot circumvent the application of Section 2036(a)(2) by simply relinquishing or avoiding a general partner interest.[51]

In addition, under its most expansive interpretation, *Estate of Powell* could be read as causing Section 2036(a)(2) to apply when a decedent retains *any* interest in a family limited partnership.[52] While it seems doubtful that the plurality opinion intended this result, without further explanation, the door remains open to this type of argument.

Estate of Powell also bolsters the effectiveness of Section 2036(a)(2) by resurrecting *Strangi's* limitations on the application of *Byrum*-like fiduciary duties.[53] In distinguishing *Byrum* on the same grounds that it did in *Strangi*, the plurality opinion incorporates the *Strangi* limitations to *Byrum* in a manner that could have precedential value.[54] This is important considering that the Section 2036(a)(2) analysis in *Strangi* is dictum.

Further, the plurality opinion raises the risk that a "duplicative transfer tax" may apply in the context of Section 2036 inclusion.[55] Although its analysis is dictum, the plurality's approach is important because the inclusion of both the "doughnut" and the "hole in the doughnut" could produce a dramatically unfavorable result. In some cases, a taxpayer may be worse off than had they retained the contributed assets and done no further planning.[56] Since seven judges explicitly rejected the plurality's analysis, however, and since the plurality's approach deviates from that of prior cases, it remains unclear how the Tax Court would address this issue in the future.[57]

From another perspective, it seems premature to elevate *Estate of Powell* to the status of a landmark family limited partnership case. For one, *Estate of Powell* can easily be characterized as a product of bad facts and a suspect litigation strategy.[58] Along with the aggressive nature of the planning, the estate did not contest the application of Section 2036(a)(2). As the concurring opinion suggested, the analysis in *Estate of Powell* seems propelled by the Tax Court's view that NHP was a sham partnership which was "invalid ab initio."[59] Despite the fact that the Service "had available a number of theories on which to challenge the transactions," it did not clearly articulate a "partnership invalidity" theory.[60] The concurring opinion also suggests that Section 2036(a)(2) was employed by the plurality because the record may have been insufficient to prevail under a partnership invalidity claim.[61] Considering this, the plurality's Section 2036(a)(2) analysis could be nothing more than a means to an end.[62]

If this characterization is accurate, then the plurality's analysis may be more of a warning shot at similar brands of planning rather than a true extension of the law.[63] Going forward, if the Tax Court's reasoning was primarily a means to an end, then it may not apply similar reasoning in cases involving less egregious facts. Considering this backdrop, *Estate of Powell* seems unlikely to usher in a Section 2036(a)(2) offensive against family limited partnerships. Moreover, to the extent that the plurality's reasoning is another means of saying that sham partnerships won't be respected, it fails to chart new territory.[64]

Additionally, an argument can be made that *Estate of Powell* does not necessarily strengthen the force of Section 2036(a)(2). Per this theory, the plurality merely follows the Tax Court's approach in *Strangi* and, in doing so, does not expand the scope of Section 2036(a)(2). From one viewpoint, *Strangi* stands for the proposition that, if a partnership is funded by and controlled by an agent of the decedent under the decedent's power of attorney, then the agent's authority as controlling general partner will in effect be attributed to the decedent. The Tax Court in *Strangi* did not expressly discuss an attribution of authority, but the concept seems consistent with the court's Section 2036(a)(2) holding and its focus on the fiduciary duties owed by the agent to the decedent under the decedent's power of attorney. Because of these fiduciary duties, the Tax Court in *Strangi* seems to have impliedly attributed the agent's control-flavored authority to the decedent. It is as if the Tax Court deemed the decedent to have retained, at death, a controlling interest in the general partner.

The plurality in *Estate of Powell* seems to take a similar approach when assessing similar facts. By observing that Jeffrey would not have "exercised his responsibility as general partner of NHP in ways that would've prejudiced [Mrs. Powell's]

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interests," the plurality seems to be using Jeffrey's fiduciary duties to her as a basis to impliedly attribute to Mrs. Powell his authority as the controlling general partner.[65] While the plurality does not discuss attribution, a *Strangi* form of "implied attribution" seems to be embedded in its analysis. It's as though the Tax Court deemed Mrs. Powell to have retained, at death, a controlling interest in the general partner because of Jeffrey's duties under her power of attorney. And if you tack this hypothetical controlling general partner interest to Mrs. Powell's 99 percent limited partner interest for purposes of analyzing Section 2036(a)(2), the result in *Estate of Powell* parallels that of *Strangi* and seems far less remarkable. From this perspective, by adopting *Strangi's* implied attribution approach, the plurality's Section 2036(a)(2) analysis does not expand existing law.

Furthermore, while the plurality's double taxation analysis could certainly discourage partnership planning, whether or not the Tax Court would adopt this analysis remains unclear. Not only is the analysis dictum, seven judges explicitly disagreed with this technical approach, an approach that deviates significantly from that of existing case law.

Planning Implications

At this point, it's difficult to gauge the weight that practitioners should give *Estate of Powell*. The good news is that, even if you believe it heightens the risk relative to partnership planning, a number of helpful techniques remain available to mitigate this risk. At the end of the day, a family limited partnership should be respected if it has economic substance and meets the "bona fide sale for adequate and full consideration" exception.[66] As such, practitioners should continue to emphasize the "legitimate and significant non-tax reason[s]" for forming a family limited partnership.[67] Practitioners should also guide clients towards the proper documentation and maintenance of partnership capital accounts.[68] To date, virtually all successful defenses to a Section 2036 challenge have involved satisfying this exception.[69]

In addition, a taxpayer can still mitigate the risk of estate inclusion by effectively parting with partnership interests before death. The plurality's analysis in *Estate of Powell* does not change this result. Instead, it amplifies the importance of this planning technique.[70]

Finally, a decedent's retained power over partnership distributions may avoid Section 2036(a)(2) if the distribution power is ascertainable and can be enforced by a court. Although a discussion of this concept is beyond the scope of this article, Revenue Ruling 73-143 bolsters this concept.[71]

Conclusion

Estate of Powell is certainly a case with which practitioners should be familiar. It arguably extends the reach of Section 2036(a)(2), and it generates the risk of double taxation relative to assets contributed to a family limited partnership. Despite this, *Estate of Powell* is in many ways a prototypical case of "bad facts make bad law." In addition to the view that *Estate of Powell* may not expand the scope of Section 2036(a)(2), the plurality's "duplicative transfer tax" analysis is merely dictum and may never be established as binding precedent. While the Service prevailed in this round, time will tell whether *Estate of Powell* will ultimately be considered a ground-breaking family limited partnership case. At this point, however, the author would bet against *Estate of Powell* becoming an important round in the fight for family limited partnership planning.


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Endnotes

1 T.C. Memo 2003-145, aff'd, 417 F.3d 468 (5th Cir. 2005).

2 *Id.* at 37.

3 408 U.S. 125 (1972).

4 *Estate of Turner* is the only reported decision since *Strangi* in which the Service prevailed arguing for Section 2036(a)(2) inclusion. *Estate of Turner*, 138 T.C. No. 14 (March 29, 2012). *See also*, Steve R. Akers, Esq., *In Plurality Opinion, Tax Court Holds that FLP Assets are Included in Estate Under §2036(a)(2): Possibility of Double Inclusion Remains Uncertain*, 42 EGTJ Issue No. 04 (July 13, 2017), at 156-157.

5 148 T.C. No. 18 (May 18, 2017).

6 *Powell*, 148 T.C. at 20.

7 *Id.* at 5.

8 *See* Akers, *supra* note 4, at 155.

9 *Powell*, 148 T.C. at 27.

10 Akers, *supra* note 4, at 157.

11 Akers, *supra* note 4, at 156, 158, 164, 169.

12 *Byrum*, 408 U.S. at 144.

13 Ronni G. Davidowitz and Jonathan C. Byer, *United States V. Byrum: Too Good To Be True?*, 42 ACTEC LJ No. 1, Spring 2016 at 97, 98.

14 *Strangi*, T.C. Memo 2003-145 at 2-14.

15 *Id.* at 37.

16 *Id.* at 41.

17 *See* Akers, *supra* note 4, at 169.

18 *See Id.* at 156, 168, 169.

19 *Powell*, 148 T.C. at 48.

20 *Powell*, 148 T.C. at 5-10.

21 Mitchell M. Gans and Jonathan G. Blattmachr, *Family Limited Partnerships and Section 2036: Not Such a Good Fit* (2017), http://scholarlycommons.law.hofstra.edu/faculty_scholarship/1055, at 3.

22 *Powell*, 148 T.C. at 5.

23 *Id.* at 5-7.

24 *Id.* at 5, 6.

25 *See Id.*

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