

LEGAL UPDATE

CLIENT NEWSLETTER OF CARR, MORRIS & GRAEFF, P.C.

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DISCRIMINATION **SUPREME COURT** **WATCH/ REVERSE AGE-** **DISCRIMINATION CASE**

In 1967, Congress passed the Age Discrimination in Employment Act ("ADEA"), which protects Americans over 40 against age-related discrimination in the workplace. As one would expect, almost all claims arising under the ADEA involve an older worker claiming mistreatment or favoritism benefiting a younger employee. Last year, however, the U.S. Court of Appeals for the Sixth Circuit, sitting in Cincinnati, rendered a decision that was inconsistent with this premise and in conflict with decisions of other Circuit Courts. The Circuit Court in Cincinnati stated that the ADEA forbids any disparate or discriminatory treatment by an employer against a worker over 40, regardless of whether the beneficiary of the disparate treatment was younger or older.

The case that gave rise to the Sixth Circuit's ruling, *General Dynamics Land Systems vs. Cline*, involved the following fact pattern. General Dynamics Corporation is a Falls Church, Virginia based company, which makes combat vehicles for the military in its plant located in Ohio. In 1997, General Dynamics entered into a collective bargaining agreement with the United Auto Workers that limited full

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ESTATE PLANNING **FAMILY LIMITED** **PARTNERSHIP ABUSE** **ATTACKED BY IRS**

A Family Limited Partnership ("FLP") is a limited partnership created for both business and estate planning purposes to facilitate the succession of family assets from one generation to another and to achieve estate and gift tax savings in the process. The general partner ("Dad") controls the partnership; the limited partners (the kids) are equity owners in the partnership, with virtually no say in control or operation of the partnership. Limited partners are entitled to *pro rata* distributions, but cannot be required to contribute additional cash or property.

The IRS has long recognized the practice of discounting the value of limited partnership interests, due to the lack of marketability and lack of control. The rule of thumb is that 25-35% discounts may safely be applied against the actual value of the FLP assets. This valuation discount allows partnership interests to be transferred at a discount to the actual value of the partnership assets, and further allows Dad's retained interest to be discounted for estate tax purposes upon his death.

The same result can be accomplished in a corporate, limited liability company, or limited partnership context, but for the purpose of this article we will refer to the family limited partnership. Some other non-tax benefits of this strategy (having assets such as real estate held by a FLP) are that it facilitates gifts of fractional interests, and also provides the benefit of limited liability for any ongoing business operations.

IRS audit activity in the area of family limited partnerships for estate planning purposes has increased greatly over the last few years in a number of districts in the country. On May 20, 2003, the Tax Court decided the *Estate of Albert Strangi v. Commissioner*, TC Memo 2003-145. This controversial case has been widely criticized by practitioners. This case and other recent audit activity should cause

all estate planners to pause a moment and re-evaluate the use of FLP's in estate planning.

Estate of Albert Strangi v. Commissioner

The *Strangi* case is a textbook example of how *not* to use FLP's. Two months prior to 81-year old Albert Strangi's death from cancer, his tax lawyer son-in-law Mr. Gulig attended a seminar given by Fortress Financial Group, and the very next day, went out and formed the Strangi Family Limited Partnership ("SFLP") and Stranco, a corporation, to act as the general partner for SFLP. Acting under a power of attorney for his now disabled father-in-law, the son-in-law immediately transferred 98% of Mr. Strangi's net worth (\$9,876,926) to the SFLP for 99% of the limited partnership interest. Mr. Strangi's assets were mostly cash and securities, plus a home, and did not include any operating business. In other words, this was an incorporated personal piggy bank, using forms promoted by seminar marketing outfit, but with the expert and "independent" legal supervision of a son-in-law.

Stranco was incorporated and Mr. Strangi and his four children were named as directors. They all approved the company bylaws and signed a shareholders agreement, with Mr. Gulig signing as attorney-in-fact for Mr. Strangi. The directors then authorized a management agreement employing Mr. Gulig to handle the day-to-day business of Stranco and SFLP. Finally, Mr. Strangi purchased 47% of the shares for contributing 47% of the paid-in capital, and his children purchased 53% of the shares for contributing 53% of the paid-in capital. Stranco then contributed all of its capital to SFLP for a 1% general partnership interest.

Two months later, Mr. Strangi died, owning 99% of the SFLP and 47% of Stranco. So you would think that the estate tax return would include 99.47% of the value of the assets held, right? Wrong. The executor claimed an approximate 40% discount off the \$11,100,922 value of the assets, claiming that the 99.47% equity

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interest was only worth \$6,823,582 because of lack of control and lack of marketability discounts.

The IRS argued in *Strangi* that the transfer of assets fell under Internal Revenue Code §2036(a). Section 2036(a) provides that for estate tax purposes, property transferred by a decedent during his lifetime must be included in the decedent's estate if the decedent retains (1) the use, possession, right to income, or other enjoyment of the transferred property, or (2) the right either in conjunction with any other person, to designate the persons who will possess or enjoy the transferred property or the income from it. The exception to this is if the property was transferred in a *bona fide* sale for full and adequate consideration.

The Tax Court ruled that Mr. Strangi retained a life estate in the assets transferred to SFLP and Stranco; therefore, the assets would be included in his estate under §2036(a)(1). The Tax Court concluded that an implied agreement between Mr. Strangi and Mr. Gulig allowing Mr. Strangi the use of the transferred assets and income therein in the event he needed them amounted to a retention of rights by Mr. Strangi. The Court created this implied agreement because they found it implausible that someone in declining health would give away 98% of his assets and leave himself with no means to meet his needs or expenses.

In this case Mr. Strangi's relationship to his assets did not change much after they were transferred to SFLP and Stranco. He retained the right to enjoy the economic benefit of the transferred property, including continuing to live in his house rent free after the real estate had been transferred to SFLP. Further, Mr. Gulig managed all the assets for Mr. Strangi's benefit prior to (as attorney-in-fact) and after (as attorney-in-fact and manager of the companies) the transfer to the companies. Specifically, Mr. Gulig authorized over \$3 million in partnership distributions for Mr. Strangi's benefit to pay for Mr. Strangi's personal expenses, his funeral, estate administration expenses, state and federal estate taxes, and a specific bequest under Mr. Strangi's will.

The Tax Court held that Mr. Strangi retained an absolute right to determine who would enjoy the income from the assets because his attorney-in-fact was

the individual authorized to declare distributions and dividends. Also, Mr. Strangi was not subject to a fiduciary duty to act in the best interests of the other partners or shareholders under the partnership or shareholder agreements because of the family dynamic, and neither SFLP distributions nor Stranco dividends were subject to the approval of an independent party. These facts resulted in a determination that under §2036(a)(2), the transferred assets were also includible in the estate. The Tax Court noted that a retained power does not need to be exercisable alone, but could require the joint exercise of others to be effective under §2036(a)(2).

In *Strangi* the taxpayer attempted to manipulate favorable legal precedents in order to achieve an estate and gift tax savings. In so doing, the taxpayer produced a set of facts so obviously crafted to avoid tax that the Tax Court had to find that the transferred assets were part of the estate.

The *Strangi* case has created concern in the estate planning field because the Tax Court did not clearly cite the legal standard for rejecting the exception to IRC §2036(a) for transfers made pursuant to a *bona fide* sale for adequate and full consideration to hold that retention of these rights of enjoyment required inclusion of transferred assets into the taxpayer's estate. The fear is that the "*bona fide* sale for an adequate and full consideration" exception, which is well recognized under gift tax rules and principles, is being rejected under the estate tax rules. Specifically, at the time the *Strangi* partnership was organized, the Tax Court held that there was no gift for gift tax purposes because sufficient consideration was exchanged, however for estate tax purposes there was no similar finding of a *bona fide* sale for an adequate and full consideration (the exception). Either the Tax Court did not view the transfer of property in exchange for a 100% partnership ownership interest as a "*bona fide* sale" or the Tax Court rejected the exception altogether because of the taxpayer abuses.

The decision in the *Strangi* case emphasizes the need to be vigilant in operating and managing a FLP. Until the Tax Court has determined the course of tax acceptance for future FLP's, avoiding the abuses the Court discussed in *Strangi* would be wise. Here are some recommendations:

1. Create the FLP for a valid business

reason, and document that reason. Don't incorporate your personal pocket book, but instead, incorporate a going business, for business reasons.

2. Don't wait until the last possible minute to establish a FLP, for example, when you are dying of cancer at age 81.
3. Don't use your son-in-law for your lawyer.
4. Don't name the partnership something like the "Morris Family Limited Partnership." Give it an impersonal, business-like name, with no cute puns or signs pointing back to you in the name. Why advertise to the world what you are doing?
5. Don't use packaged panacea programs from seminar operations like Fortress Financial Group. These cookie-cutter document packages come with a road map the IRS can easily read.
6. Include contributions from other family members during organization of a new FLP.
7. Ensure that partnership formalities are respected at all times. Do not commingle personal assets with partnership assets. Maintain books for the partnership and comply with state and local filings, such as obtaining a certificate of limited partnership, and filing state and federal tax returns.
8. If real estate is transferred to the partnership, prepare a deed and file it with the appropriate governmental agency. When transferring other assets to the partnership, prepare and execute assignments for such transfer.
9. Do not artificially impoverish yourself by transferring 100% of your personal assets to the FLP. Instead, transfer only assets that have a business or investment reason for being in the FLP and document the transfer. If there is a transfer of a residence, make sure that your lease of the property for personal use is in writing, for fair market value, and that rent is actually paid.
10. Make sure all agreements between you and the FLP are in writing. Do not leave yourself open to a ruling that there is an implied agreement for the partners to use the assets transferred to the FLP.
11. Review the partnership agreement to ensure that it is properly structured and drafted to achieve appropriate discounts.
12. Make sure that there is a fiduciary duty of the managing partners toward the

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limited partners expressly stated in the partnership agreement.

13. When distributions are made, make sure they are *pro rata* based on ownership percentages.

14. Give up control as general partner.

Strangi is currently on appeal (again) and the lasting implications for legitimate family limited partnerships (as opposed to bogus scams of the *Strangi* variety) have yet to be revealed. We are advising a wait-and-see approach, coupled with common sense avoidance of obviously abusive tax planning tactics.

BRENDA HANKINS

BUSINESS ORGANIZATION
WHEN ARE L.L.C. INTERESTS
SECURITIES?

The question of when Limited Liability Company (LLC) interests are deemed “securities” under the Securities Act of 1933 and state “blue sky” laws is of great practical interest for two reasons: first, many new businesses are organized as LLC’s; and, second, many of these new businesses in turn must raise capital. If LLC interests are deemed securities, then they must be registered under the Act and state laws or an exemption from registration must be found. Because exemptions from registration are strictly construed, the threshold issue of “security” definition is paramount. Because of space limitations this article focuses exclusively on this issue. In future articles we will discuss private placement of securities, resale of restricted securities issued pursuant to private placements, and the anti-fraud provisions in Federal/state statutes and common law. Because LLC’s are a comparatively new phenomenon, readers are cautioned that the law on the issue discussed is subject to rapid changes.

At present the Securities Act of 1933 does not contain LLC interests among the “laundry list” of instruments that are *per se* securities. By way of contrast, “stock” is listed and virtually all common stock is a “security” by definition. Therefore, the analysis of LLC interests under Federal law must proceed under the rubric of “investment contract.” Over the years courts have used various verbal formulas to flesh out the meaning of “investment contract” in various contexts. An early test

defines an “investment contract” security as one where money is invested in a common enterprise with the expectation of profit to be derived *substantially or significantly* from the efforts of others. In the partnership context, from which LLC interests are analogized, limited partnerships generally *are* held to be securities since limited partners are not entitled to participate in management. In contrast, general partnerships are generally held *not* to be securities since general partners are entitled to participate in management.

Most courts, however, have also held that a general partnership interest can be a security if the investors have no effective voice in management because of specific provisions in the partnership agreement, the investors’ inexperience in business, or their dependence on the unique skills of the promoter or manager. Courts that have considered LLC’s treat them in a manner quite similar to partnership interests. Thus, if the investment is largely a passive one, LLC interests will be deemed securities. On the other hand, when the members are active participants in the business, LLC interests will not be securities. This is not a black and white issue, and bright lines are difficult to draw. It is best to view the question as a continuum, with “security” found at one extreme and “security” not found at the other, depending on the degree of involvement of the investor in management of the enterprise.

From the practical perspective of the organizers of a new business to be structured as an LLC, first, the organizers must decide what they want from investors. If all they want is money, then the LLC operating agreement is likely to be drafted in such a fashion that the interests will almost certainly be securities. On the other hand, if the organizers also want and need the expertise, work and energy of the investors, then they should draft the operating agreement in such a fashion that the investors are given great voice in management, so there will be no question that the interests will not be considered securities. Since, at this writing, LLC’s are not listed as securities under Federal law, enterprise organizers have a great deal of leeway in structuring the business to fit their business purpose. At the same time, though, they must draft the operating agreement taking into consideration the realities of Federal securities regulation.

After considering Federal law, moreover, organizers of an LLC must then

look to state “blue sky” laws which are a veritable Tower of Babel. Some states merely list LLC interests as securities, thereby disposing of the issue. Others list such interests as securities but then exempt LLC’s where every member is actively engaged in management. Still other states list LLC interests as securities but have complex definitions of members actively engaged in management for purposes of the exemption. The only safe generalization that can be made with respect to state “blue sky” laws in this area is that no generalizations are possible. The law of each state with significant contacts with respect to the organization and initial financing of the business must be examined.

Please feel free to call Roy Morris or the author if there is an LLC in your future.

NÉSTOR CRUZ

DISCRIMINATION
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retiree health benefits to workers who were at least 50 years old as of the date of the collective bargaining agreement. Until the 1997 agreement employees with General Dynamics who had 30 years seniority were entitled to full health benefits upon retirement, regardless of age. The 1997 collective bargaining agreement changed that seniority rule and effectively limited benefits to workers with full seniority who were at least 50 years of age as of the 1997 contract. Dennis Cline, in 1997, was 48 years old and had worked at General Dynamics for approximately 28 years. He had expected to be eligible for full health benefits upon retirement in two years. The union contract of 1997 deprived Cline and approximately 195 of his co-workers—all in their 40’s—of health benefits they would have otherwise received.

Cline and his co-workers filed suit under the ADEA claiming that they were over 40 years old and were victims of age discrimination that disfavored them and benefited older workers. The Sixth Circuit ruled in favor of Cline and his similarly situated co-workers, in effect holding that the ADEA created an age-blind workplace. This ruling is significant in that it created a split in the circuits as to whether claims of reverse age discrimination, that is, claims by younger employees who are over 40 against older employees who are also over 40, are actionable under the ADEA. The

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Carr, Morris & Graeff, P.C., was established in 1982 by the named principals—Lawrence Carr, Roy Morris and Stephen Graeff. It is a diversified firm structured primarily to meet the legal needs of businesses and their principals.

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STAFF NOTES

As President of the Cornell Graduate School of Management alumni club for the Washington metropolitan area, Néstor Cruz, organized the first business-topic lunch. The speaker, an alumnus in the investment banking business, discussed the role of the securities industry in the financing of the for-profit higher education sector.

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On November 6, 2003, Margarita and Néstor Cruz became the grandparents of Sebastián Aloysius Cruz. Congratulations!

* * *

We welcome back Dana Theriot from maternity leave. Dana graciously invites advice, recommendations and guidance of all nature from all sources regarding the raising of Aiden.

* * *

Power grab. Roy Morris stands unopposed in his bid for a second term as Treasurer of the National Capital chapter of the BMW Car Club of America. Meanwhile, Roy's garage repair of modest body damage to his BMW M-3 was a huge success. Roy is *way beyond* auto store touch-up spray; his unfortunate brush with a track retaining wall is but a fading memory after his masterful repair.

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case becomes more significant in that the collective bargaining agreement entered into by General Dynamics and the United Auto Workers in 1997 is typical of many in the industrial work force and, accordingly, the legal and financial ramifications of upholding the Sixth Circuit's ruling would be substantial.

It is always difficult to predict how the Supreme Court will rule on any issue. However, the oral argument of earlier this month does suggest that the Justices have some problems with the decision of the Sixth Circuit. They questioned whether Congress, in passing the ADEA, actually intended to protect younger workers over

age 40 in their treatment in relation to older workers over age 40. Counsel for Mr. Cline and the plaintiffs argued that Congress intended to protect younger workers as well as older workers with the actual intent being to make the workplace age neutral. Counsel for General Dynamics countered that the ADEA was specifically intended to foster the interests of older employees and was not meant to create an age-blind workplace.

Because of its potential implication for all employers with over 20 employees, the statutory threshold for ADEA application, we will report in a future *Legal Update* on how the Supreme Court decides this case.

STEPHEN GRAEFF

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