BESSEMER TRUST

Estate of Beyer v. Commissioner, T.C. Memo. 2016-183 (September 29, 2016)

October, 2016

FLP Assets Included in Estate Under Section 2036(a)(1), Including Assets Attributable to Interests Sold to Grantor Trust; No Discount Allowed for Restricted Management Account; Gift Tax (and Penalties) Imposed Because of Failure to Make Five-Year Election for Gifts to Section 529 Accounts

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Synopsis

The decedent, who was a life-long employee and eventually the CFO of Abbott Laboratories and owned a significant portfolio of Abbott stock, transferred much of his assets to a revocable trust in 1999. The decedent created two other revocable trusts in 2003, which created a family limited partnership (the FLP); the "Management Trust" was the 1% general partner interest, and the "Living Trust" was the 99% limited partner. Six months later (April 2004), the decedent as trustee of his 1999 Trust transferred most of his assets (other than $4 million) to the FLP.

About a year after that, the decedent created an irrevocable grantor trust (the Grantor Trust) with $10. Eight months later (in December 2005) the Living Trust sold its entire 99% limited partner interest to the Grantor Trust for a secured note (when the Grantor Trust still only owned $10). The FLP's income tax returns for 2005 and 2006 failed to recognize the Grantor Trust as the owner of the limited partnership interest. (Amended returns were filed correcting this mistake after the decedent's death.)

In the meantime, the FLP had entered into a restricted management agreement as to 75% of its assets with an investment advisor, restricting any withdrawals from the account for four years.

The decedent made contributions to various Section 529 accounts in 2002 and 2005, intending to make the "five-year averaging" election, but failing to file a gift return for 2002 and failing to check the box to make the election on the 2005 gift tax return.

The decedent died in 2007.

The FLP made various distributions directly for the decedent's benefit, including almost $660,000 in 2006 to pay gift taxes, and a payment directly to the IRS for the decedent's estate taxes (even though neither the decedent nor the Living Trust owned the 99% limited partnership interest at those times).

The court determined that all of the FLP assets were included in the decedent's estate under §2036(a)(1). The bona fide sale for full consideration exception to §2036 did not apply. The transfers to the FLP were not bona fide because the purported nontax reasons for the trust were not recognized as the actual legitimate purposes for which the FLP was created. (These included keeping the Abbott stock and investment portfolio intact, providing management transition, and providing continuity of management.) Furthermore, the "full consideration" requirement was not satisfied because of the failure to maintain proper capital accounts. The decedent had an implied agreement of retained enjoyment, based primarily on the actual distributions made to the decedent and for the decedent's estate and because the decedent had not retained sufficient assets to satisfy his anticipated financial obligations.

No discount was permitted for the restricted management account, because the account manager was not prohibited from selling assets.

The decedent was treated as making gifts of the full amounts contributed to the Section 529 accounts in the 2002 and 2005 because the five-year election was not properly made. Failure to file and pay penalties were imposed for the 2002 gifts because no gift tax return was filed (until after the decedent's death), and accuracy related penalties for negligence were applied for the 2005 gifts that were not reported on the 2005 gift tax return. The reasonable cause exception to these penalties did not apply because the decedent did not seek qualified professional advice about filing gift tax returns or making the five-year averaging election. *Estate of Beyer v. Commissioner,* T.C. Memo. 2016-183 (September 29, 2016) (Judge Chiechi).

Basic Facts

The decedent worked at Abbott Laboratories most of his life (eventually becoming the CFO), and acquired substantial Abbott stock through various stock options.

In 1999, the decedent created a revocable trust (the "1999 Trust") and transferred various assets to the trust (including 800,000 shares of Abbott stock). The decedent was the trustee of the 1999 Trust.

In June 1999, a planner sent a letter to the decedent recommending grantor trusts, creating a family limited partnership (FLP), and GRATs, the primary reason being "to discount the value of the assets for transfer purposes."

In May to October 2003, the decedent had various meetings with an estate planning attorney regarding various strategies that would minimize estate tax.

In October 2003, the decedent created two revocable trusts (the "Living Trust" and the "Management Trust") and a family limited partnership (FLP). The Management Trust (of which the decedent was not a co-trustee) was the 1% general partner of the FLP and the Living Trust (of which the decedent was a co-trustee) was the 99% limited partner of the FLP.

- The FLP agreement listed 28 purposes of the FLP.
- The Management Trust did not maintain a bank account until two years after the decedent died (in 2007).
- The Living Trust agreement obligated the trust to pay estate taxes due following the decedent's death.
- (The court opinion expressed reservations about whether the FLP should be treated as a partnership for tax purposes, because a partnership for tax purposes requires at least two members, and the two living trusts were both considered to be owned by the decedent for purposes of §671-679. (Footnote 33).)

The decedent also signed a will in October 2003 naming a nephew as his executor and directing that estate taxes would be paid as provided in the Living Trust. In addition, the decedent gave three specific powers of attorney to the nephew (to deliver assets to the Living Trust, to make health care decisions, and to act on the decedent's behalf after his disability). (The decedent had previously given that nephew a general power of attorney in 2001.)

Six months later, in April 2004, the attorney recommended that the decedent transfer most of his securities to the FLP and that cash be left in his personal account, saying "We need to establish to the IRS that Edward has enough assets outside of [the FLP] to live on, and, given Edward's modest lifestyle, I think 1.5M will do that." Later that same month, the decedent directed the transfer of various assets (including the 800,000 shares of Abbott stock) from the 1999 Trust account directly to the FLP's brokerage account.

About a year later (in March 2005), the attorney recommended additional estate planning strategies, including (i) the use of a restricted management account for some of the FLP assets, and (ii) selling the Living Trust's 99% limited partnership interest in the FLP to a newly formed grantor trust.

In April 2005, the decedent formed a new irrevocable grantor trust (the "Grantor Trust"), funding the trust with $10.

At the same time, the FLP (acting through two co-trustees of the Management Trust as general partner of the FLP) signed an agreement requiring that the FLP transfer 75% of its assets into a restricted management account (RMA) with a financial manager. The RMA provided that for four years, the account would make no principal distributions and the FLP could not transfer any of its interest in the account. The agreement did not prohibit the sale of assets that the RMA held. Assets were transferred from the FLP into the RMA in July 2005. (The RMA account terminated four year later in August 2009, at which time the assets were transferred to the FLP's account.)

On December 30, 2005 (about one year and eight months after the FLP had been funded), the Living Trust sold its 99% limited partnership interests in the FLP to the Grantor Trust in return for a $20,866,725 secured note (secured by all "accounts and accounts receivable" of the Grantor Trust). The note bore interest at 4.45%, compounded annually, and required quarterly minimum interest payments of $116,071.16 (with "certain options regarding those minimum payments"). The value of the 99% interest was determined by an appraisal. (The 2004 tax return filed for the FLP reflected that the Living Trust made capital contributions of about $41 million. Assuming the assets did not change in value from April 2004 to December 2005, the $20.9 million valuation reflected a discount of about 49%.) At the time of the sale, the Grantor Trust "had only $10 of assets," and the Living Trust owned only the $20.9 million note from the Grantor Trust and $600,000 in a brokerage account.

The decedent died on May 19, 2007.

The FLP made various distributions for the benefit of the decedent or his estate.

- In April 2006, it distributed $659,660 to the Living Trust, and the Living Trust paid the IRS $659,660 to pay the decedent's 2005 federal gift tax.
- An attorney advised that the $116,071.16 quarterly interest payments due from the Grantor Trust to the Living Trust (on the note that the Grantor Trust used to purchase the limited partnership interest from the Living Trust) should be made directly from the FLP to the Living Trust (rather than first being distributed from the FLP to the Grantor Trust (as the limited partner), and then from the Grantor Trust to the Living Trust). The FLP made such quarterly payments to the Living Trust from June 2006 to February 2008.
- The FLP sold various securities in January and February 2008, and distributed $250,000 to the Living Trust on February 12, 2008 (which, on the same date, distributed $75,000 to the executor and another nephew as an "Administration Fee."
- On February 14, 2008, a check on the FLP bank account for $9,345,334 was written payable to the Internal Revenue Service, with the notation "IRS 706." Four days later, the FLP transferred $9,945,000 to the Living Trust account.

The decedent funded several Section 529 accounts. It funded 10 accounts for relatives in December 2001 with $10,000 each, and funded them with $55,000 each in January 2002. He also funded 8 accounts for other relatives in December 2004 with $11,000 each and in January 2005 with $55,000 each. The decedent did not file a federal gift tax return for 2002. He did file a gift tax return for 2005 but did not report the $55,000 transfers to each of the Section 529 accounts or check the box on the return to elect to treat the transfers as being made over a five-year period.

The federal income tax returns for the FLP were inconsistent with the Grantor Trust owning the 99% limited partnership interest that it purchased from the Living Trust on December 30, 2005.

- The 2005 return showed the Living Trust, rather than the Grantor Trust, as owning the 99% limited partnership interest at the end of 2005.
- The 2006 FLP income tax return showed the Living Trust as owning a 24.75% limited partnership interest and the Grantor Trust as owning a 74.25% limited partnership interest at the end of 2006.
- The 2007 FLP income tax return inconsistently reported the Grantor Trust as owning the 99% limited partnership interest at the beginning of 2007. (Other Schedules K-1 attached to the 2007 return, however, failed to show the Grantor Trust as owning a limited partnership interest.)

In 2008 (after the decedent's death), the FLP filed amended 2005 and 2006 returns (which reflected the Living Trust as owning the 99% limited partnership interest at the beginning of 2005 and the Grantor Trust as owning the 99% interest at the end of 2005 and during 2006). In 2009, the FLP filed second amended returns for the 2005 and 2006 years (as well as amended returns for 2004, 2007, and 2008). Among other things the amended returns filed in 2009 reflected that non-pro rata distributions impacted the percentage interests over time which were not reflected in the filed returns, and that a catch-up proportionate distribution was made in November 2009 to bring the interest back to 1% for the Management Trust as general partner and 99% for the Grantor Trust as limited partner.

The decedent's estate tax return filed in February 2008 included on Schedule G assets of $24,838,479, including the note from the Grantor Trust and the 1% general partnership interest in the FLP owned by the Management Trust. In addition, the return included the portion of the Section 529 accounts attributable to the "unexpired period of the special 5-year-averaging election." The return showed net estate tax of $9,345,334, which was paid with a check from the FLP account made payable to the IRS dated February 18, 2008. The IRS began an examination of the estate tax return in May 2009; it determined an estate tax deficiency of $19.07 million as well as gift taxes and penalties for 2002 and 2005 gifts, and issued a notice of deficiency on February 8, 2011.

[**Observation**: While this summary the basic facts may seem rather long, it truly is a very brief summary of the **111 page** recitation of facts in the opinion (which included long excerpts from the various trust agreements and the partnership agreement.]

Analysis

1. **Burden of Proof is Not Shifted to IRS**. The estate did not present credible evidence as to any issue sufficient to shift the burden of proof to the IRS under §7491(a).

2. **Section 2036(a)(1) General Requirements.** The issues to establish inclusion under §2036(a)(1) are: (i) Was there a transfer of property by the decedent?; (ii) Was such a transfer not a bona fide sale for adequate and full consideration in money or money's worth?; and (iii) Did the decedent retain possession or the enjoyment of, or the right to

the income from, the property transferred? The transfer of assets to the FLP satisfied the first requirement. The opinion's analysis of the applicability of § 2036(a)(1) focused on the last two issues.

3. **Section 2036 Bona Fide Sale For Full Consideration Exception Not Satisfied**. The exception requires (i) a bona fide sale (ii) that is in full consideration for what was transferred.

   a. **Bona Fide Sale.** The bona fide sale prong requires a transfer "motivated by a legitimate and significant nontax purpose," (citing *Estate of Bongard v. Commissioner*). Factors in making that determination include whether the decedent stood "on both sides of the transaction," was dependent on distributions from the partnership, commingled partnership funds with the decedent's assets, failed to transfer property to the partnership, and failed to follow partition formalities.

      The IRS and the estate agreed that the decedent purported to have three nontax reasons for creating the FLP: "Mr. Beyer desired to keep the Abbott stock in a block and keep his investment portfolio intact, wanted to transition [his nephew] into managing assets, and wanted continuity of management." The court observed that none of these three reasons were one of the 28 boilerplate purposes listed in the FLP agreement and did not find any of these three reasons to be legitimate and significant nontax reasons.

      - **Keeping Abbott Stock and Maintaining Investment Portfolio Intact.** The estate maintained that at the termination of the 1999 Trust the assets would have been distributed among various recipients at the decedent's death if the assets had not been transferred to the FLP. The court's reaction was that the decedent could have amended the 1999 Trust at any time to prevent the distributions. [Observation: That seems impractical; the decedent wanted eventually to leave the value of his estate among various relatives. Whenever that occurred, the assets would be owned by the relatives directly and could be sold by each of them.] Also, the FLP agreement did not require that the FLP continue to hold the Abbott stock or its other assets.
      - **Management Transition**. The nephew who was the trustee of the Management Trust that served as the general partner of the FLP in fact managed the 1999 Trust's assets and held a power of attorney for the decedent. In addition, the decedent could have amended the 1999 Trust to name the nephew as a trustee or co-trustee.
      - **Continuity of Management**. The court viewed the estate's argument that if the assets had not have been transferred to the FLP, they would not have continued to be managed by the same managers. But the decedent could have amended the 1999 Trust to name the nephew as the trustee or a co-trustee, but did not do so.

   b. **Adequate and Full Consideration**. Prior cases have reasoned that the adequate consideration requirement is satisfied in the context of transferring assets to an FLP if (i) the decedent received an interest in the FLP proportionate to the value of assets transferred to it, (ii) capital accounts were properly maintained, and (iii) at the liquidation or dissolution of the FLP, the partners had the right to distributions in accordance with their respective capital accounts. Among the various ways in which formalities were not followed in this case, the record before the court did not establish that the FLP "established and maintained respective capital accounts for the partners, let alone that it showed in those accounts the respective interests that those partners received in exchange for any initial and subsequent contribution that such partner made to [the FLP]."

3. **Section 2036(a)(1) Retained Enjoyment**. An implied agreement or understanding of a retained interest has been demonstrated in some prior FLP cases (i) by continued use of assets that were transferred to the partnership and (ii) by transferring almost all of one's assets to a partnership (citing *Bongard*, *Reichardt*, *Miller*, *Jorgenson*, and *Harper*). The court addressed each of these separately. The "estate bears the burden, which is especially onerous for transactions involving family members," of establishing that no implied agreement of retained enjoyment existed.

   a. **Continued Use**. The IRS pointed to three "uses" of partnership assets. With respect to these uses, keep in mind that the decedent or his Living Trust was not a limited partner on these dates; the Living Trust had sold all of its limited partnership interest to the Grantor Trust in December 2005.

   - **$659,660 Transferred From FLP to Living Trust April 17, 2006**. The FLP transferred $659,660 to the Living Trust on April 17, 2006, which the Living Trust paid to the IRS to pay the decedent's gift taxes on his 2005 gift tax return. The estate argued that this payment reflected interest payments on the note, but this amount was not equal to the $116,071.16 amount that was payable quarterly, and no interest payment was due when the $659,660 payment was made (though the court acknowledged that the $116,071.16 payment that was due on March 15, 2006 perhaps had not been made and the payment could have included that late payment).

   - **$116,071.16 Quarterly Payments From June 2006-February 2008.** The court agreed with the taxpayer, that these interest payments, made in accordance with the terms of the note from the Grantor Trust to the Living Trust, did not support the finding of an implied agreement of retained enjoyment.

   - **$9,945,000 Transfer from FLP to Living Trust on February 19, 2008**. The FLP transferred $9,945,000 from the FLP account to the Living Trust on February 19, 2008. The estate argued that under *Estate of Mirowski*, "post-death treatment of the Partnership's assets is irrelevant to a section 2036 inquiry." The court found that *Mirowski* was materially distinguishable [without explaining how it was distinguishable]. The court reasoned that the Living Trust was obligated to pay the decedent's estate taxes, the Living Trust did not have enough liquid assets to pay the estate tax, and the decedent knew when the FLP was created and the interest was sold to the Grantor Trust that the Living Trust "no longer had sufficient liquid assets to satisfy that obligation and that the Living Trust was no longer entitled to any assets of [the FLP]." The conclusion was that the $9,945,000 transfer from the FLP to the Living Trust supported the existence of an implied agreement of retained enjoyment. [**Observation**: This portion of the opinion is confusing. The reasoning relates to a February 18, 2008 check from the FLP to the IRS of $9,345,334, rather than the distribution from the FLP to the Living Trust on February 19, 2008 of $9,945,000. Query why the IRS did not argue that *both* of those payments reflected an implied agreement of retained enjoyment?]

b. **Failure to Retain Sufficient Assets to Pay Financial Obligations.** The decedent retained about $4 million of assets that were not transferred to the FLP. The parties disagreed whether that was sufficient to satisfy his anticipated financial obligations. A year after the FLP was funded, the decedent made gifts totaling $2.5 million, on which he owed gift tax of $659,660. The court reasoned that decedent would not have used FLP assets to pay the gift tax if he had retained sufficient assets to satisfy his anticipated financial obligations and/or if there was no implied agreement of retained enjoyment of the assets transferred to the FLP. [**Observation**: The court's analysis about retaining sufficient assets focused on a substantial gift made *a year after* the FLP was funded, which may not have been foreseeable when the FLP was funded, rather than focusing on the eventual estate tax, which was a virtual certainty.]

4. **Sections 2035(a), 2036(a)(2) and 2038(a) Not Considered.** The IRS apparently argued that the FLP assets should be included in the estate under §§2035(a), 2036(a)(2), and 2038(a), but the court did not consider those alternative arguments in light of its finding that the assets were included in the estate under §2036(a)(1). (See footnotes 42-43.)

   Apparently, §2035(a) was not needed to trigger estate inclusion under §2036(a)(1) because the court found that the sale of the limited partnership interests to the Grantor Trust did not bring an end to the continued use of the FLP's assets for the decedent or his estate and the implied agreement of retained enjoyment. Therefore, the court did not need to find that a termination of retained enjoyment within three years of death triggered inclusion under §2035(a).

5. **No Discount for Restricted Management Account Agreement**. The IRS relied on two cases that had refused to apply a discount for estate tax purposes of assets in accounts even though the decedent was not allowed to sell its interest in the account in one case (*Estate of Kahn v. Commissioner*, 125 T.C. 227 (2005)) or to withdraw assets from the account in the other case (*Estate of Foster v. Commissioner*, T.C. Memo 2011-95, *aff'd*, 565 F. App'x 654 (9th Cir. 2014)). In both cases, as well as in this situation, the manager was not prohibited from selling assets. Therefore, even though the restricted management account prohibited the distribution of assets form the account to the FLP, so that the manager could invest the assets as it thought best without fear that the assets would be withdrawn for the fixed term of the agreement, the court concluded that no discount was allowed because the manager was allowed to sell assets within the account during that fixed term. [**Observation**: The court seemed to have missed the point by relying on the fact that the manager could sell and reinvest assets during the fixed term. That is what managers do. The rationale for a discount is that the owner had limited rights to the assets for a four-year period of time, and the court did not focus on that restriction.]

6. **Section 529 Accounts; Five-Year Averaging Not Elected**. The court treated all of the contributions to the Section 529 accounts as gifts in the year of the contributions, rather than over a five-year period, because the five-year election was not made. For the 2002 gifts, a gift tax return was not filed. For the 2005 gifts, a gift tax return was filed, but the box (at Line B of Schedule A) to make the five-year election was not checked. The estate argued that the decedent "intended to, and therefore did, elect to treat the … contributions in question during his taxable year 2000 and … 2005 as made ratably over a five-year period. The court looked to the legislative history as to how the five-year election permitted under §529(c)(2)(B) could be made, and pointed out that the election "must be made on the contributor's gift tax return."

7. **Penalties on Gift Taxes.** For 2002, the IRS imposed failure to file and failure to pay penalties under §§6651(a)(1) and 6651(a)(2). The estate argued that the reasonable cause and lack of willful neglect exception should apply because the decedent "was advised and reasonably believed that [the decedent] had elected five-year averaging … and that no gift was required to be reported on a gift tax return." The court disagreed, concluding that "the record does not establish that [the decedent] considered obtaining, let alone sought, qualified professional advice as to whether [the decedent] was required to file a gift tax return for his taxable year 2002." The court pointed to testimony by the nephew who was the decedent's advisor (and the eventual executor) that "based on my understanding that it was within the usual exclusion I didn't even look at it."

   For 2005, the IRS applied the 20% accuracy-related penalty for negligence or disregard of rules or regulations under §6662(b)(1). The estate argued that the reasonable cause exception under §6664(c)(1) should apply. The court concluded that the failure to ask a qualified tax professional whether or how the five-year averaging election must be made constituted negligence. Furthermore, the reasonable cause exception did not apply because the record failed to establish that the decedent considered obtaining, let alone sought, qualified professional advice regarding the election.

Observations

1. **New FLP/LLC §2036 Case.** Few FLP/LLC §2036 cases have been decided in the last four years. There were two cases in 2012 (*Stone* and *Kelly).* No other cases were issued until the *Purdue* and *Holliday* cases were published in late 2015 and early 2016. The *Purdue* case held for the taxpayer, and the *Holliday* case came down in favor of the IRS. A key distinguishing feature in those cases was the failure to follow formalities and the failure to make any management changes in *Holliday* after the assets were transferred to the FLP. *Beyer* follows in the line of cases in which a court was not convinced that an FLP was created for nontax purposes, perhaps in part because of a massive failure to follow formalities respecting the partnership.

2. **Failure to Follow Formalities**. Formalities were not followed in a number of ways in *Beyer*, and one suspects this failure to respect the partnership may have had a significant impact on the credibility of the position that the partnership was created for legitimate and significant nontax purposes. Various cases have pointed to the failure to follow formalities as underlying a court's conclusion that partnership assets be included in a decedent's estate. *E.g., Bigelow v. Commissioner*, *Liljestrand v. Commissioner*, *Hurford v. Commissioner*.

Among the formalities glitches in *Beyer* were:

- statements from planners that the primary reason for the partnership was to discount the values for transfer tax purpose,

- the failure of listing reasons in the partnership agreement that reflected the purported reasons the partnership was created,

- the partnership was funded by a direct contribution from the 1999 Trust, rather than from the two revocable trusts that were actually the partners (the Management Trust as the 1% general partner and the Living Trust as the 99% limited partner),

- the failure of the Management Trust (which served as the 1% general partner and therefore entitled to 1% of distributions) to have a bank account until two years after the decedent died,

- the failure to fund the Grantor Trust with significant assets to support the commercial viability of the trust's purchase of the limited partnership interests,

- the failure of the FLP income tax returns and K-1s over two years to recognize the interest owned by the Grantor Trust after it purchased the limited partnership interests,

- the distribution of about $660,000 from the FLP to the decedent's revocable trust (to pay the decedent's gift taxes) after it no longer owned an interest in the partnership,

- the payment of the estate's estate taxes (about $9.35 million) directly from the FLP when the estate (or revocable trust) was not even a partner,

- the distribution of $9.45 million from the FLP to the revocable Living Trust when it was no longer a partner,

- distributions from the FLP to the Living Trust in the exact amount of interest payments that a partner (the Grantor Trust) owed (suggesting that distribution amounts were determined based on the partners' needs rather than on what made sense based on management of partnership assets),

- distributions were made directly from the partnership to the Living Trust to make interest payments that the Grantor Trust owned to the Living Trust (which was done at the direction of the attorneys), and

- the failure to make proportionate distributions to partners when distributions were made.

The glitches no doubt were largely innocent and explainable. A number of the prior FLP/LLC §2036 cases that refused to find estate inclusion under §2036 have involved some degree of failure to follow formalities. *E.g., Estate of Shurtz v. Commissioner.* But the large number of glitches may have given the impression to the court that the family was not respecting the partnership and that it merely existed on paper for the purpose of creating valuation discounts. Perhaps the fact that first aroused an IRS agent's suspicion about the case was the payment of the estate's estate taxes by a check from a partnership in which the estate owned no interest.

3. **Maintaining "Legacy Assets" or Keeping an Investment Portfolio Intact**. In *Beyer*, the decedent had been a life-long employee of Abbott Laboratories, ultimately becoming its CFO, and may understandably have wanted the Abbott stock to be retained as a family "legacy asset." The failure to recognize the desire to keep the Abbott stock and maintain the investment portfolio intact as being a legitimate purpose in this case does not mean that reason will never be recognized as a legitimate nontax reason. Again, the massive formalities failures may have colored the court's view of whether this stated purpose was legitimate in this situation.

   Various cases have recognized variants of this nontax reason as satisfying the "bona fide sale" exception. *E.g.*, *Estate of Murphy v. Commissioner* (prevent dissipation of family legacy asset and centralized management); *Estate of Black v. Commissioner* (keep in force the decedent's "buy and hold" investment philosophy); *Estate of Schutt v. Commissioner* (protecting buy-and-hold investment philosophy for duPont stock); *Mirowski v. Commissioner* (joint management and keeping a single pool of assets for investment opportunities); *Kimbell v. United States* (Maintaining a single pool of investment assets, providing for management succession, and providing active management of oil and gas working interests); *Miller v. Commissioner*, (continue investment philosophy and special stock charting methodology); *Estate of Joanne Stone v. Commissioner* (managing woodland parcels as a family asset for later development, centralized management); *Purdue v. Commissioner* (consolidation of asset management).

4. **Post-Death Use of Partnership Assets as Retained Enjoyment Under §2036(a)(1).** Attorneys have argued in various cases that post-death use of partnership assets should not be used as evidence of retained enjoyment by the decedent (§2036 refers to retained enjoyment by the decedent for his life or for any period up to his death), but various cases have viewed the use of partnership assets to pay post-death obligations as reflecting retained enjoyment under §2036(a)(1). Those cases are *Rosen*, *Korby*, *Thompson*, *Erickson*, *Jorgensen*, *Miller*, *Liljestrand*, *Rector*, and now *Beyer* (Tax Court cases) and the *Strangi* Fifth Circuit Court of Appeals case. *Miller* and *Erickson* are two cases in which the court looked *primarily* to post-death distributions and redemptions to pay estate taxes as triggering §2036(a)(1). In *Erickson*, T.C. Memo. 2007-107, the court emphasized particularly that the partnership provided funds for payment of the estate tax liabilities. (The only liabilities mentioned in the case were gift and estate tax liabilities.) The court viewed that as tantamount to making funds available to the decedent. Although the disbursement was implemented as a purchase of assets from the estate and as a redemption, "the estate received disbursements at a time that no other partners did. These disbursements provide strong support that Mrs. Erickson (or the estate) could use the assets if needed."

   Interestingly, Judge Chiechi (the trial court judge in *Beyer*) was not troubled by post-death payments of estate taxes and other liabilities of the decedent's estate in *Estate of Mirowski v. Commissioner*. In *Mirowski*, the LLC distributed $36 million to the decedent's estate to pay transfer taxes, legal fees and estate obligations. The court observed that the decedent's death was not anticipated at the time of the transfers, and there was no understanding to make LLC distributions to pay the taxes or other amounts due after her death. A distinction in *Mirowski* is that the decedent held a 52% in the LLC at her death that would have been sufficient to support the $36 million of distributions, but the distribution was not accomplished by purchasing assets form the decedent's estate or redeeming her interest in the LLC.

5. **Sale to Grantor Trust.** The IRS has recently argued that §2036 applied to assets that a decedent had sold to his grantor trust. *Estate of Donald Woelbing v. Commissioner,* Tax Court Docket No. 30261-13. That case was settled with no additional estate taxes; the IRS reportedly dropped the §2036 argument in the settlement. *Beyer* involved a sale to a grantor trust, and the court applied §2036 to include all of the assets in the FLP in the decedent's estate even though a 99% limited partnership interest had been sold to the Grantor Trust. However, the court reasoned that the FLP directly continued to allow the decedent to use assets he had transferred to the partnership even after the trust owned the 99% interest. Even if he had not continued to have enjoyment of the assets attributable to the 99% interest, the IRS could have argued that he relinquished the retained interest within three years of his death, triggering §2035(a). Finally, the sale was made at a time when the trust only owned $10, whereas a traditional rule of thumb is that the trust should have about 10% equity to support a purchase.

6. **Grantor Trusts as Only Partners**. The court was skeptical as to whether the FLP should be treated as a partnership for federal tax purposes, because a tax partnership must have at least two partners and the grantor trusts that are the general and limited partners are both treated as owned by the grantor for income tax purposes. (See footnote 33 of *Beyer*.) Conservative planning would suggest to avoid this argument by having at least one partner other than the grantor and/or his or her grantor trusts.

7. **Formalities; Planning Operational Issues**. In light of the relative importance of the failure to follow formalities in this case, the following is a summary of planning formalities in overseeing the funding and operation of partnerships and LLCs.

- Complete state law requirements for formal creation of the entity before making any transfers of interests in the entity. *Strangi I, Shepherd, Gross*
- Document the transfer of assets and record them as appropriate as soon as possible after the partnership is formed. *Harper*
- Do not transfer a residence and other personal use assets to entity. If any of these assets are transferred, the parent should pay fair rentals to the entity and, if appropriate, have a formal lease agreement. Payments should actually be made, not just accrued. *Reichardt, Strangi II, Disbrow*
- Be careful in making distributions, particularly disproportionate distributions. The parent must understand that he or she no longer has access to the entity's assets—other than receiving proportionate distributions of "net cash flow" of the entity. Furthermore, even proportionate distributions may bolster a §2036(a)(1) claim by the IRS.
- In making funding decisions, retain sufficient liquid assets to provide the parent's living expenses and amounts needed to fund desired cash gift, loans, etc. for a

considerable period of time (certainly more than two years). (In *Thompson*, the decedent retained sufficient assets for two years of living expenses, but the court still found an implied agreement to retain the right to income from or possession of the partnership assets). *Harper (94% of assets transferred to FLP), Thompson (bulk of assets transferred), Strangi II (98% of assets transferred), Bongard, Bigelow (immediate deficiency in monthly cash flow), Rosen, Hurford, Jorgensen, Miller*

- Also retain sufficient assets to pay a substantial part of the anticipated estate taxes. *Miller*, *Erickson, Rector, Jorgensen, Rosen, Korby, Thompson, Liljestrand, Strangi (5th Cir. Case); but see Mirowski (payment of estate taxes with distributions from partnership did not trigger §2036 because death not anticipated)*
- Do not make withdrawals out of the FLP to pay routine living expenses of the limited partner. *Reichardt, Harper, Thompson, Strangi II, Bigelow, Rector*
- In light of the focus by some cases on partnership distributions, consider making no distributions for several years after creation.
- Create entity bank accounts soon after the entity is created. *Harper, Hillgren*
- Have meetings of the partners and keep minutes of the meetings. *Hillgren, Jorgensen*
- Do not commingle entity and personal funds. *Reichardt*
- Deposit entity income to and pay entity expenses from the entity bank account. *Reichardt*
- Do not use the entity's bank account as the owner's personal account. *Reichardt*
- Recognize all of the formalities of operating as a partnership. Maintain formal records for the entity. Respect in all ways that the entity owns the assets, not the individual owners of the entity. *Schauerhammer, Bigelow, Hurford*
- Employ an accountant soon after the entity is created to advise on accounting/reporting procedures and procedures for setting up appropriate capital accounts, etc. *Harper, Hillgren*
- Do not make any distributions that are not permitted in the agreement. For example, do not make non-pro rata distributions. *Harper, Strangi II (fact that distributions were proportionate did not help because interests held by other partners were de minimis), Bigelow (payment of individual debt of partner)*
- Personal loans to partners may create an implication that the decedent can use the partnership assets to benefit himself or others, especially if loan repayments are not made in a timely manner. *Bigelow*
- Document business factors impacting the decision to make distributions; do not just make distributions whenever owners need personal funds. *Harper*
- Do not continue management of assets outside the partnership by an entity controlled by the parent. *Reichardt, Hillgren*
- If possible, have a change of management or in management activities. *Bongard, Miller; However, the fact that decedent's son was the manager before and after creation of the partnership was not critical in Kimbell.*

- If possible, the general partner will make investment changes after the partnership is created. *Bongard*
- Having significant contributions by others helps.
- Professional advisors should provide an "operational manual" and should consult with the entity at least annually to review operations of the entity.
- Utilize expert appraisals to value ongoing gifts or sales of partnership interests. *Abraham (full consideration exception not applied partly because no appraisals to support purchase price), Hurford.* Values reported on a gift tax return may be treated as an admission against interest and appraisals obtained for trial may be given less weight. *Estate of Leichter*
- Any transactions between parent and the partnership should be fully documented.
- If there are subsequent gifts of limited partnership interests, the IRS might attempt to treat the transaction as an indirect gift of assets originally contributed to the partnership under a step transaction theory. *See Tech. Adv. Memo. 200432015, 200212006. The Tax Court applies a "real economic risk of a change in value" test. Holman, Gross, Linton, Heckerman*
- Additional contributions to the FLP should be documented as being made in return for an additional limited partnership interest in the FLP, or else the IRS will argue that the contribution is an indirect gift of assets (without a discount) to other partners. *Senda, Shepherd, Tech Adv Memo 200432015, 200212006.* Address whether any additional interests received in return for the additional contribution must be valued at a discount. *The reasoning supporting that the creation of an FLP does not result in a gift on creation would seem to support valuing the additional interest on a proportionate basis without a discount.*
- If there are sales of partnership interests to grantor trusts, do not make distributions that are equal to note payments.
- To pay estate taxes at partner's death, avoid large non pro rata distributions from FLP, to help thwart a §2036(a)(1) claim by IRS. Instead consider (1) purchase of the estate's limited partnership interests by other family members, and the estate can use that cash to pay estate taxes; (2) a bank loan to the estate, secured by the estate's partnership interest and perhaps supported by guarantees from estate beneficiaries, (3) a loan from an ILIT or other family entity, secured by the estate's partnership interest, (4) a partnership loan to the estate, secured by the estate's partnership interest, (5) a redemption of some of the estate's interest in the partnership (consider whether a discount should be applied).
- K-1s should properly reflect capital accounts. *Bigelow*