Estate of Holliday v. Commissioner, T.C. Memo 2016-51 (March 17, 2016)

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Assets in FLP Included in Estate Under §2036

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SYNOPSIS

The court concluded that no legitimate and significant reasons for creating an FLP existed and that partnership assets were included in the decedent's estate without a discount in *Estate of Holliday v. Commissioner*, T.C. Memo 2016-51 (Judge Gerber).

The decedent moved to a nursing home in 2003 and her financial affairs were managed by her son under a power of attorney. She created a limited partnership in which she was the 99.9% limited partner, and her wholly owned LLC was the 0.1% general partner. A week later she contributed $5.9 million of marketable securities to the partnership and on that same day sold all of her membership interest in the LLC to her sons and gave a 10% limited partnership interest to an irrevocable trust. She retained significant assets outside the partnership. The partnership made one relatively small ($35,000) pro rata distribution. She died about two years later, and her estate claimed a 40% discount for her remaining 89.9% limited partnership interest.

The IRS argued that the transfer of assets to the partnership triggered §2036(a)(1), requiring that the partnership assets be included in her estate without a discount. Section 2036(a)(1) requires that (i) the decedent made an inter vivos transfer of property, (ii) the decedent retained (either explicitly or by implied agreement) the possession or enjoyment of, or the right the income from the property, and (iii) the transfer was not a bona fide sale for adequate and full consideration. The contribution of assets to the FLP constituted an inter vivos transfer of property, satisfying the first required element. The court focused on the last two required elements.

Implied Agreement of Retained Enjoyment. The decedent by implied agreement retained possession or enjoyment of, or the right to income from the assets transferred to the partnership. The court emphasized that the partnership agreement required the distribution of "Distributable Cash" (in excess of its current operating needs) on a periodic basis. The court pointed to the son's testimony on this issue:

> When asked at trial what he believed the term "operating needs" meant, [the son] testified: "[I]t seemed to me when I reviewed this document, when it was signed, that it was created, that this seemed to come from some sort of boilerplate for Tennessee limited partnerships, this sort of gave you broad powers to do anything you needed to do, including make distributions. But that wasn't necessary. No one needed a distribution.

This testimony, the court reasoned "makes it clear that had decedent required a distribution, one would have been made."

[Some planners prefer to *require* the distribution of "Distributable Cash" (as in the *Holliday* agreement) to minimize a §2036(a)(2) or §2038 inclusion risk. This case, however, points out that doing so increases the risk of inclusion under §2036(a)(1) in a situation in which there are no needs to retain cash for operating purposes. Many partnership agreements, unlike this one, merely *allow* the distribution of distributable cash.]

No Bona Fide Sale for Full Consideration. The court concluded that three nontax reasons asserted for creating the partnership were not legitimate and significant. (1) Protection from litigators' claims–the decedent had never been sued; because she lived in a nursing home her risk of vulnerability to trial attorney extortion was minimal; and she retained significant assets that could be reached by someone trying to extort something from her. (2) Protecting against undue influence of caregivers–while caregivers had taken advantage of or stolen from other family members, the decedent's situation was different because her sons managed her affairs and visited her often; this concern was not discussed with the decedent when the partnership was formed, and there was no evidence she was concerned about undue influence from a caregiver. (3) Preservation of assets for the decedent's heirs–other structures for preserving assets were "quickly dismissed" because they were difficult to manage, but that was unconvincing because the decedent's previously deceased husband's assets were being managed in trusts without difficulty; also the decedent was not involved in selecting the structure used to preserve her assets.

The court also mentioned several other factors that had been raised by the IRS regarding the bona fide transfer issue.

(1) The decedent "stood on both sides of the transaction" and it was not an arm's-length transaction because there was no meaningful negotiation or bargaining associated with the transaction. [Planners argue that this "standing on both sides" argument should have no relevance because a transfer is "bona fide" as long as it is real and not a sham regardless of third party negotiation, but since this argument was first included in a case years ago, it gets repeated in almost every FLP §2036 case. Its relevance was severely questioned in *Purdue v. Commissioner,* T.C. Memo. 2015-249 (discussed below).]

(2) Various formalities were not followed including, the absence of books and records other than brokerage statements, formal meetings were not held and minutes were not kept, the requirement under the agreement to make distributions was not followed, and compensation was not paid to the general partner as required under the agreement.

(3) The marketable securities were not actively managed and were only traded on limited occasions. [The absence of any activity in the partnership gave the appearance that assets were transferred to the partnership merely to get a valuation discount.]

Planning Observations

1. **Two Recent FLP/LLC §2036 Cases.** After going over three years without any FLP/LLC §2036 cases, two cases have now been issued in the last several months, *Estate of Holliday* and *Estate of Purdue v. Commissioner*, T.C. Memo. 2015-249. (There were two cases in 2012. *Estate of Stone v. Commissioner,* T.C. Memo. 2012-48*; Estate of Kelly v. Commissioner,* T.C. Memo. 2012-73.)

2. **Contrast with *Purdue***. The court in *Purdue* found that §2036 did not apply to contributions to an LLC. In *Purdue,* the court was convinced that the LLC was created for various nontax purposes (other than just getting a valuation discount). These included consolidating investments with a single advisor, educating children about management of the family investment company, and creating common ownership of assets for efficient management and meeting minimum investment requirements. After assets were transferred to the partnership, a single investment manager was engaged to manage the assets, and the family met regularly with the investment advisor to discuss family assets and approve cash distributions. Formalities were followed.

   The critical factor is that the court believed the testimony that the LLP was formed for nontax reasons other than getting a discount. How was the decedent's motive satisfied? The court looked to testimony at the trial, an attorney's memorandum describing the purposes and advantages of the LLC, and purposes described in the operating agreement itself. The testimony about the nontax reasons had credibility because of actions that occurred after the FLP was formed. The court observed that simplifying the gift giving process and assuring transfer tax savings alone is not an acceptable nontax motive. The court focused particularly on the purpose of "consolidating investments into a family asset managed by a single advisor." The court noted the significant difference in management of the assets after the LLC was formed (the assets were moved to a single investment advisor, Mr. Purdue no longer handled all financial decisions, and the Purdue children made the LLC investment decisions jointly). The court concluded that "decedent's desire to have the marketable securities and the … [building] interest held and managed as a family asset constituted a legitimate nontax motive for her transfer of property to the PFLLC."

In contrast, in *Holliday*, there was little evidence supporting the alleged nontax reasons for the partnership. Nothing changed after assets were contributed to the partnership.

3. **Do Something**. Making changes in some manner and actually "doing something" after assets are transferred into an FLP seems to be important in establishing some legitimate and significant nontax motive—beyond just getting valuation discounts, especially when the partnership merely holds cash and marketable securities.

4. **Standing on Both Sides of Transaction.** *Holliday* again trotted out the "standing on both sides of the transaction" argument, pointing out that no negotiation existed in the creation and funding of the limited partnership. The reasoning of *Purdue* had practically made that argument irrelevant. *Purdue* stated that if a taxpayer stands on both sides of a transaction there is no arm's-length bargaining and the bona fide transfer exception does not apply, but further reasoning of the court makes this factor all but meaningless. This factor does not apply, according to the *Purdue* court, if there is a legitimate and significant nontax reason (which must exist in any event for the bona fide sale exception to apply) and if the transaction is carried out in the way unrelated parties to a business transaction would act. The *Purdue* court reasoned that last requirement was met because the decedent received interests proportional to the assets contributed (which is also a requirement to meet the full consideration prong of the exception). In effect, if other necessary elements of the bona fide sale for full consideration exception are met, the reasons for distinguishing the "standing on both sides of the transaction" factor will necessarily also be satisfied.

   Appearances are that if a court is going to find that no legitimate and significant nontax reason exists, it will also use the "standing on both sides of the transaction" argument to bolster its conclusion that the bona fide transfer exception to §2036 does not apply.