Estate of Purdue v. Commissioner, 145 T.C. Memo. 2015-249 (December 28, 2015)

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Assets in LLC Not Included in Estate Under §2036; Gifts of LLC Interests Qualify for Annual Exclusion; Interest on Loan from Beneficiaries to Pay Estate Tax is Deductible

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TABLE OF CONTENTS

TABLE OF CONTENTS 1
Synopsis 1
Basic Facts 1
Analysis 3
Observations 5

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Synopsis

This Tax Court case addresses three of the issues "on the IRS radar" that frequently arise in estate and gift tax audits. (1) The decedent and her husband transferred marketable securities, an undivided interest in a building, and several other assets to an LLC in 2000. (2) The decedent made annual gifts of LLC interests to a Crummey trust in 2002-2007. (3) Following the decedent's death in 2007, the estate beneficiaries made a loan to the estate to pay the estate taxes and the estate deducted the interest payments as an administration expense for estate tax purposes.

Section 2036. The case is an excellent summary of principles announced in prior §2036 FLP/LLC cases. The court held that the assets in the LLC were not included in the decedent's estate under §2036 because the contribution to the LLC satisfied the bona fide sale for full consideration exception to §2036. The court focused on the management of the consolidated family assets as a legitimate and significant nontax reason for the LLC (and also noted that the parents were not financially dependent on distributions from the LLC, there was no commingling of LLC and personal assets, formalities were respected, and the parents were in good health at the time of the transfers to the LLC).

Annual Exclusion. Gifts of interests in the LLC were present interest gifts that qualified for the annual exclusion because the donees received income from the interests. The court reasoned that (1) the LLC generated income, (2) some of the income flowed steadily to the donees (they received almost $2 million from 2000 through 2008), and (3) the anticipated income could be estimated. (This is similar to the analysis in *Estate of Wimmer v. Commissioner*, T.C. Memo. 2012-157.)

Deductibility of Interest on Loan to Pay Estate Tax. Interest on the loan from some of the estate beneficiaries to the estate to pay estate taxes was deductible as an administration expense for estate tax purposes. The loan was bona fide and it was "necessary" because one of the decedent's daughters (who was a member of the LLC) refused to consent to a large distribution from the LLC to pay the decedent's estate taxes, and the operating agreement required the LLC members to act unanimously in making decisions. *Estate of Purdue v. Commissioner*, T.C. Memo. 2015-249 (December 28, 2015) (Judge Goeke).

Basic Facts

Mr. and Mrs. Purdue owned substantial marketable securities held in five different accounts at three different brokerage firms. In 1995, Mr. Purdue sought the estate planning advice of one of the lawyers in his law firm, who recommended forming a family limited partnership "to centralize management and take advantage of valuation discounts." Apparently, the Purdues did not act on that advice and five years later, the attorney again advised the parents to create a family LLC and various trusts. The attorney sent a draft agreement which listed the following purposes (also contained in the final agreement): "to (1) consolidate the management and control of certain property and improve the efficiency of the management by holding the properties in a single, flexible entity; (2) avoid fractionalization of ownership; (3) keep ownership of the assets within the extended family; (4) protect assets from unknown future creditors; (5) provide flexibility and management of assets not available through other business entities; and

(6) promote education of, and communication among, members of the extended family with respect to financial matters."

Before the LLC was created, the attorney sent a memorandum to the Purdues and their children summarizing five advantages—a tax advantage and four nontax business advantages. These five advantages included (1) limited liability, (2) passthrough income taxation, (3) minimal formalities, (4) an ideal entity for owning real estate, and (5) tax savings.

In November 2000 the Purdues contributed to a family LLC $22 million of marketable securities, a one-sixth interest in a commercial building in Honolulu (worth about $900,000), a $375,000 promissory note from one of their children, and an $865,523 certificate of deposit. The Purdues received 100% of the member interests in the LLC.

The Purdues had some health issues. Mrs. Purdue had significant leg injuries from an accident in 1984 and became semi-invalid. She had a stroke or transient ischemic attack (TIA) in October 2000 (her physician believed it was a TIA and not a stroke; she had no residual neurological impairment). She required in-home healthcare from August 2001 until her death. Mr. Purdue was in good physical health and enjoyed an active lifestyle when the LLC was funded, but he had memory problems and subsequently was diagnosed with Alzheimer's disease.

In April 2001 Mr. Purdue engaged Rainer Group as an investment manager. An Investment Policy Statement was signed by the Purdues and their children in July 2001, and all of the marketable securities were subsequently managed by the Rainier Group under an "overall, well-coordinated professional investment strategy." Beginning in June 2001, the Purdue children met regularly with the investment manager and have held annual meetings since 2001 to discuss the family assets and approve cash distributions from the LLC.

Mr. Purdue died unexpectedly in August 2001. His estate passed primarily to a family trust and two QTIP trusts under his will.

Mrs. Purdue made gifts of LLC member interests to an irrevocable Crummey trust from 2002 through 2007. From 2001 to 2007 the Purdue children received almost $2 million of cash distributions from the trust, about $1.95 million of which was from distributions to the trust from the LLC.

Mrs. Purdue died in November 2007. In August 2008 the estate planning attorney sent a letter to the Purdue children describing alternatives for paying estate taxes. The alternatives included a $6.2 million loan from the LLC to the estate and the QTIP trusts, or a large dividend distribution from the LLC. One daughter refused to approve the dividend from the LLC (as leverage in an attempt to get her siblings to approve a larger distribution that she wanted but they opposed). In light of the deadlock over distributions, some of the estate beneficiaries loaned about $1.2 million to the estate and the QTIP trusts to fund the shortfall in making estate tax payments.

The estate timely filed its estate tax return in March, 2009. The IRS issued an estate tax notice of deficiency (about $3.1 million) in February 2012 and gift tax notice of deficiencies for various years between 2001-2 and 2003-2007 (totaling about $925,000) in September, 2012.

ANALYSIS

1. **Burden of Proof**. The taxpayer had the burden of proof and did not contend that the burden shifted to the government.

2. **Bona Fide Sale for Adequate and Full Consideration Exception to §2036**. The IRS maintained that the contribution of assets to the LLC was a transfer with a retained interest includible in Mrs. Purdue's estate under §2036. The estate contended that the transfer was covered by the bona fide sale for full consideration exception to §2036. The court analyzed the exception under a two-pronged approach: (1) bona fide sale, and (2) full consideration.

    a. **Bona Fide Sale.** The bona fide sale prong requires a legitimate and significant nontax reason for creating the LLC. The objective evidence must indicate that the nontax reason was a significant actual modification and not just a theoretical justification. The court repeated a list of factors that have been stated in prior cases that are considered in deciding whether a nontax reason existed:

    > (1) the taxpayer's standing on both sides of the transaction; (2) the taxpayer's financial dependence on distributions from the partnership; (3) the taxpayer's commingling of partnership funds with the taxpayer's own; (4) the taxpayer's actual failure to transfer the property to the partnership; (5) discounting the value of the partnership interests relative to the value of the property contributed; and (6) the taxpayer's old age or poor health when the partnership was formed.

    The estate argued that the decedent had seven nontax motives (that are somewhat different than the purposes of the LLC stated in the operating agreement):

    > (1) to relieve decedent and Mr. Purdue from the burdens of managing their investments; (2) to consolidate investments with a single advisor to reduce volatility according to a written investment plan; (3) to educate the five Purdue children to jointly manage a family investment company; (4) to avoid repetitive asset transfers among multiple generations; (5) to create a common ownership of assets for efficient management and meeting minimum investment requirements; (6) to provide voting and dispute resolution rules and transfer restrictions appropriate for joint ownership and management by a large number of family members; and (7) to provide the Purdue children with a minimum annual cash.

    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."

    The court also addressed the miscellaneous other factors summarized above. The IRS argued that the decedent "stood on both sides of the transaction" because there were no negotiations and there were no other parties than Mr. and Mrs. Purdue. The court acknowledged 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 the court reasoned that "an arm's-length transaction occurs when mutual legitimate and significant nontax reasons exist for the transaction and the transaction is carried out in a way in which unrelated parties to a business transaction would deal with each other" (citing *Estate of Bongard v. Commissioner*). There was a legitimate nontax motive, and the decedent received an interest in the LLC proportional to the property contributed, so "this factor does not weigh against the estate."

The remaining miscellaneous factors all come out in the taxpayer's favor: the parents were not financially dependent on distributions; there was no commingling of personal and LLC funds; formalities were respected; the LLC maintained its own bank accounts and held meetings at least annually with written agendas, minutes, and summaries; the parents transferred properties to the LLC timely; and the parents were in good health at the time of the transfer to the LLC.

b. **Adequate and Full Consideration**. The court repeated the conclusion of prior cases that the full consideration prong is satisfied if "the transferors received partnership interests proportional to the value of the property transferred." There were no allegations that the Purdues failed to received interests proportional to their transfers, but the IRS argued, based on reasoning in *Estate of Gore v. Commissioner*, that the transaction represented a mere change of form and a circuitous "recycling" of value. The court rejected that argument, citing *Estate of Schutt v. Commissioner* for its conclusion that when a "decedent employ[s] his capital to achieve a legitimate nontax purpose, the Court cannot conclude that he merely recycled his shareholdings."

3. **Annual Exclusion**. The court's analysis is similar to the analysis of the Tax Court in *Estate of Wimmer.* To qualify as a gift of a present interest, the gift must confer on the donee "a substantial present economic benefit by reason of the use, possession, or enjoyment (1) of property or (2) of income from the property." In the context of a gift of LLC or limited partnership interests, this requires that the donees "obtained use, possession, or enjoyment (1) of the limited partnership interests or (2) of the income from those interests within the meaning of section 2503(b)."

The donees' rights as to LLC member interests were limited, however, because they could not transfer their interests without unanimous consent by the other members; accordingly, "the donees did not receive unrestricted and noncontingent rights to immediate use, possession, or enjoyment of the PFLLC interests themselves."

The court reasoned, however, that the donees did receive income from those interests to satisfy the present interest requirement. It applied a three-pronged test (citing *Calder v. Commissioner*): (1) the LLC would generate income; (2) some portion of that income would flow steadily to the donees, and (3) that portion of the income could be readily ascertained. Each of those three tests was satisfied. (1) The LLC held income producing real estate and dividend paying marketable securities. (2) The LLC made distributions to the trust and the trust made distributions to the beneficiaries over eight years of almost $2 million. Furthermore, the operating agreement and applicable state law imposed a fiduciary duty on the LLC to make proportionate cash distributions sufficient for the

members to pay their income tax liabilities. (3) The rent from the building was readily ascertainable and the marketable securities were publicly traded and the partners could therefore estimate the expected dividends.

4. **Deductibility of Interest on Loan from Beneficiaries.** The estate deducted $20,891 in interest that had accrued on loans from the LLC members to the estate. For interest expense to be deductible as an administration expense under §2053, "the loan obligation must be bona fide and actually and necessarily incurred in the administration of the decedent's estate and essential to the proper settlement of the estate."

   The IRS never contended that the loan was not bona fide and the facts prove that the loan was bona fide. (The attorney's memorandum to the family did not assure that the interest could be deducted and mentioned the possibility of taking a distribution from the LLC as opposed to the loan).

   The loan was necessary because the LLC operating agreement required its members to vote unanimously to make decisions, and one daughter created deadlock by not voting for the recommended option, thus "making the loan necessary."

Observations

1. **"IRS Radar Screen" Issues.** The *Purdue* case addresses three of the IRS hot button issues that have been litigated frequently, and in this case, the court resolves all three of those issues in the taxpayer's favor.

2. **A New FLP/LLC §2036 Case.** There have not been any FLP or LLC §2036 cases that have been issued for over three years. (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. **Bona Fide Sale Exception to §2036 Regarding Contributions to FLP/LLC**.

   a. **Centralized Management**. The court primarily relies on a nontax reason that has been recognized in various other FLP/LLC §2036 cases: centralized asset management. That reason was also cited as a primary nontax reason supporting application of the bona fide sale exception in the *Stone*, *Kimbell*, *Mirowski*, and *Black* cases.

      The court emphasizes the importance of an actual change in management activities to support that this is an actual purpose rather than just a "theoretical justification." (It cites the *Estate of Hurford* case as a contrary example, where the court found no advantage to consolidating asset management because the partner's relationship to the assets did not change after the formation of the limited partnership.)

   b. **Standing on Both Sides of Transaction.** Various cases have repeated the "standing on both sides of the transaction" reason as one factor suggesting the absence of a bona fide sale. The reasoning of this case practically makes that argument irrelevant. It states 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 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 court reasons that last requirement is 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.

c. **Evidence to Establish Motive. "**Whether a transfer is a bona fide sale is a question of motive." How was the decedent's motive satisfied? The court looked to testimony at the trial, the attorney's memorandum describing the purposes and advantages of the LLC, and purposes described in the operating agreement itself.

d. **Roadmap**. The consolidation of asset management has now been accepted as a legitimate nontax reason in several of the more recent FLP/LLC cases. Beyond that, the court laid out a course of action to assist in meeting the bona fide sale exception:

> First, decedent and Mr. Purdue were not financially dependent on distributions from the PFLLC. Decedent retained substantial assets outside of the PFLLC to pay her living expenses. Second, aside from a minimal dollar amount across three deposits to the PFLLC account, there was no commingling of decedent's funds with the PFLLC funds. Further, the formalities of the PFLLC were respected. The PFLLC maintained its own bank account and held meetings at last annually with written agendas, minutes, and summaries. Third, Mr. Purdue and decedent transferred the property to the PFLLC. Lastly, the evidence shows that decedent and Mr. Purdue were in good health at the time the transfer was made to the PFLLC.