PERKINS & CO

FCG VALUATION CASE E-FLASH

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Estate of Clyde W. Turner, Sr., Deceased, W. Barclay Rushton, Executor, Petitioner, V. Commissioner of Internal Revenue, Respondent T.C. Memo. 2011-209, Docket No. 18911-08, Judge: Hon. L. Paige Marvel, August 30, 2011

The court ruled that assets contributed to a family limited partnership were includable in Decedent's gross estate. Even so, premium payments on life insurance made by Decedent's trust were gifts of present interests to the trust's beneficiaries.

TAKEAWAY

Commingling funds, lack of significant non-tax reason for formation, continued use/enjoyment of assets, disproportionate and inappropriate distributions, and receipt of improper compensation caused the Taxpayer's gift to be treated as retained interests.

THE FACTS

Clyde W. Turner ("Decedent" or "Clyde") and his wife ("Wife", collectively with Decedent, the "Turners") acquired, throughout the course of their lives more than 170,000 shares of stock in a local bank ("Bank," the acquisition of which came about primarily as a result of each Turner being related to an officer of the bank). Because of the familial relationship, the stock had sentimental value, and the Turners rarely sold shares.

Clyde also acquired shares of various other marketable securities throughout his life. He invested in real estate, had several bank accounts, and bought life insurance for himself through a trust, for the benefit of his children and grandchildren.

Although his investments spanned many asset classes, the Decedent had no particular investment strategy. Beginning in approximately 1994, one of Clyde's grandchildren began helping the Turners manage their bookkeeping and finances. In 2001, the Turners met with the grandchild to discuss what to do with their assets. The Turners specifically mentioned they were getting older and were looking for an asset-pooling vehicle.

The Turners and grandchild met with an estate planning attorney in early 2002, and in March of that year, the attorney sent a letter to the Turners suggesting the use of a family limited partnership. The March 2002 letter mentioned that an important element of their gifting plan was "a sound appraisal of the partnership for tax purposes."

In April 2002, the Turners formed Turner & Co. ("T&C" or the "Partnership"), a limited liability partnership, with each Turner owning a 0.5-percent general partner interest and a 49.5-percent limited partner interest. The provisions of the partnership agreement for T&C came from a stock form the attorney routinely used for partnership agreements. As a result, the court ruled some of the provisions were not applicable to the Partnership and its assets, and the Turners' motivations for creating T&C were not necessarily reflected in the partnership agreement.

In an attempt to comply with existing FLP court rulings, the Turners retained more that $2 million in assets that were not contributed to T&C. Retained assets included their personal residence, investment real estate, and dividend paying stock. The retained assets provided more than $90,000 in annual income.

The list of assets contributed to the Partnership was prepared in July and the transfers were completed in December of that year. Nearly 60 percent of the contributed assets were Bank stock. The remaining assets included stock in other banks, certificates of deposit, and marketable securities (comprised primarily of dividend paying stocks).

During Clyde's life, the Partnership occasionally purchased dividend paying stock or bonds, but the portfolio composition changed little. In particular, the Turners' grandchildren were unable to convince them to sell Bank stock.

On December 31, 2002, and again on January 1, 2003, the Turners gifted limited partnership interests in T&C to their children and various grandchildren. The gifts were valued by an outside appraisal firm, and gift tax returns were filed for the transactions.

T&C also participated in the purchase and sale of two separate parcels of land. In September 2002, Clyde paid - out of his personal funds and without an agreement with T&C to do so - a two-week old note owed by the Partnership. He did not inform his accountant and made no attempt to attain repayment from T&C. The Partnership's accountant was not informed of the payment until late 2003, at which time she made an adjustment to T&C's books indicating a note payable to the Decedent.

For the second land parcel purchase, the Partnership was unable to secure a bank note before closing. The Decedent paid the Partnership's portion from personal funds but was repaid the next day after T&C received a loan disbursement from a local bank.

While Clyde used personal funds to pay Partnership expenses, he and Wife took draws from the Partnership for other expenses. Wife took $2,000 per month in distributions, took a draw from the Partnership for a personal car, and made draws of varying amounts after Clyde's death. Clyde used T&C funds to pay the insurance premium owned through his trust and took draws for his taxes. After becoming limited partners, the Turners' family took non-pro-rata distributions after the Decedent's death, as well. Finally, Clyde and Wife each took a $2,000 per month management fee authorized under the partnership agreement. T&C treated these as non-deductible distributions rather than deductible expenses.

Clyde became hospitalized in October 2003 and passed away in February 2004. His estate obtained an appraisal of the 0.5-percent general partner interest and 27.8-percent limited partner interest (after gifts to his children and grandchildren), which were valued at $30,744 and $1,578,240. Those amounts were listed on the estate tax return filed by his estate.

The IRS issued a notice of deficiency in August 2008. It asserted that the transfers of assets to T&C were includable in the Decedent's taxable estate under § 2035, § 2036, and § 2038. The notice of deficiency determined that the February 4, 2004, net asset value of the Partnership was more than $9.4 million, of which half was includable in Clyde's estate. The IRS also reduced the value of the adjusted gifts by the reported values by the amounts of the Decedent's gifts of limited partner interests.

DISCUSSION

SECTION 2036(a) – *Inter vivos* transfers

§ 2036(a) includes in the gross estate of an individual those assets which the transferor has transferred but over which he or she maintains control. It applies when the decedent has made an *inter vivos* transfer of property, the transfer was not a *bona fide* sale for full and adequate consideration, and the transferor retained an interest or right in the transferred property.

Court Analysis

The tax court determined a transfer had occurred, citing the *Estate of Bongard v. Commissioner* at 112, which broadly defined transfer to include in the value of the gross estate the values of all property transferred but in which the Decedent retained an interest during his life. Further, the transfers were *inter vivos* voluntary acts of transferring property. The court determined that the transfers were transfers within the meaning of IRC Section 2036(a).

SECTION 2036(a) – *Bona fide* sales

§ 2036(a) does not apply if the sale meets the *bona fide* sale exception; that is, the sale must be an arm's length transaction, for full and adequate consideration. For an FLP such as T&C, Judge Marvel, citing *Bongard,* determined "the exception is satisfied where the record establishes the existence of a legitimate and significant nontax reason for creation of the family limited partnership and the transferors received partnership interests proportionate to the value of the property transferred."

The Court ultimately decided that the full and adequate consideration portion of the exception had been met and the partnership interests received by the Turners were proportionate to the contributed assets.

Next, the *bona fide* sale portion of the requirement was considered by the Court.

- **Non-tax reasons for partnership formation**

The Estate

The estate argued that T&C had been formed for several non-tax reasons (as outlined in the Court Analysis below).

Court Analysis

The tax court considered the estate's reasons for forming the Partnership:

a. Asset Consolidation & Centralized Planning Pursuant to a Formalized Strategy

The Court ultimately decided that the general partners' activities did not rise to the level of active management. Indeed, the Court (in a later portion of the ruling) determined "some of the evidence suggests that [Decedent] and [Wife] did not manage the partnership at all" and that there was "nothing in the record to suggest that the $2,000 [per month] management fee was reasonable."

The Court further ruled that the Decedent did not have a "unique or distinct investment philosophy that he hoped to perpetuate." In fact, his lack of a plan for the investments was a primary cause for the formation of T&C.

Finally, the Court determined that efficient management (by providing a mechanism by which one of the Decedent's grandsons could aid in the management of his grandparents' finances) was not a significant non-tax reason for the Partnership's creation. The grandson had been assisting with his grandparent's finances for approximately eight years before the formation of T&C. The Estate failed to prove the Partnership's formation aided the grandson's ability to more effectively manage his grandparents' finances.

As a result of the preceding, the Court dismissed the asset consolidation and centralized planning reasons for T&C's formation.

b. Resolution of Family Discord

The family discord among the Decedent's children was related to personality conflicts among them. No evidence was produced that the children's discord was, in any way, related to the Turners' investments.

Accordingly, the Court determined that there was no proof that the Decedent's transfer of assets into an FLP would serve to resolve existent family problems.

c. Protection of Wife from Grandchild, as well as Grandchild from himself

Although Wife occasionally provided grandchild (who had a known drug problem and long arrest record) with money, the Estate failed to prove that the gifts of cash were anything other than voluntary. It also failed to prove Wife needed protection from grandchild. Although the FLP provided a built-in excuse not to give grandchild money, Wife had significant non-FLP assets from which she could give cash to grandchild.

Finally, grandchild had a trust into which Wife could deposit money if she wished to protect grandchild from himself. The Estate failed to prove the creation of the FLP protected Wife from grandchild or that the FLP protected grandchild from himself.

The Court also faulted the Turners for commingling personal funds when they made personal gifts of Partnership funds to grandchildren, paid life insurance premiums from T&C funds, and used Partnership distributions to pay legal fees associated with personal estate planning.

As a result of the preceding, the Court determined that the transfers of assets to the FLP failed the *bona fide* sale prong of the *bona fide* sale exception.

SECTION 2036(a) – Possession or enjoyment of, or the right to income from, property transferred to partnerships

The Estate

The estate was required to prove no implied or explicit agreement existed regarding the Turners' possession or enjoyment of Partnership assets.

Court Analysis

As noted above, the Court criticized the Turners for their $2,000 per month management fee, for which the Court found no evidence of its reasonableness. The family's ability and willingness to take distributions at will, Clyde's commingling of personal and Partnership funds, and his receipt of disproportionate distributions all were factors the Court cited as indicative of an implied agreement that the Decedent enjoyed possession of the assets contributed to T&C.

The Court also determined the formation of the Partnership was essentially testamentary in nature. In particular, the Court noted the initial meeting regarding the formation of T&C in which the Turners noted they were not getting any younger. The estate's witnesses at trial testified that Clyde wanted to provide for Wife after his passing, convey his wealth to future generations, and protect his assets from creditors.

The estate contended tax savings were not a consideration when forming the Partnership. This contention was rejected by the Court. The Court noted the March 2002 letter from the estate planning attorney which specifically mentioned tax purposes of creating T&C. As a result of the Court's incredulity at such testimony, the Court found the estate's credibility suspect regarding all matters associated with the Partnership's formation.

For all of the reasons noted above, the Court found an implied agreement existed between the Partnership and the Decedent to retain possession, enjoyment, and right to income from contributed assets.

SECTION 2503 – Additional taxable gifts

The IRS

The IRS contended that the Decedent's indirect gifts (the payment of life insurance premiums) to his children and grandchildren were gifts of future interests. The claim was based on its contention that the beneficiaries of the trust had no meaningful opportunity to withdraw contributed funds. Because it believed the contributions were gifts of future interests, the gifts were not subject to the annual exclusion.

The Estate

The estate argued that the trust agreement permitted withdrawal demands at any point after each direct or indirect contribution. As a result, the contributions were gifts of present interests and subject to the annual exclusion.

Court Analysis

The Court determined that the trust's language permitted demand withdrawals by the beneficiaries after gifts by the Decedent. The fact that they didn't do so, or the fact that they didn't know they had the right to do so, did not impede their legal right. Accordingly, the Court found the gifts were gifts of present interests and therefore subject to the annual exclusion.

CONCLUSION

The Court determined that the Decedent made *inter vivos* transfers of property, but the transfer was not a *bona fide* sale even though they were for full and adequate consideration. As a result, the property transferred was includable in the Decedent's estate under § 2036(a). Further the payments of life insurance premiums for the benefit of his descendants constituted gifts of present interests. Therefore, the gifts were subject to the annual exclusion and could be deducted from the Decedent's taxable estate.

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