

Estate of Samuel Black v. Commissioner, 133 T.C. No. 15 (Dec. 14, 2009)

**FLP Taxpayer Victory: “Buy and Hold” Investment Policy Satisfies Section 2036 Bona Fide Sale Exception;
Marital Deduction Mismatch Issue Avoided**

December 2009
Steve R. Akers
Bessemer Trust
300 Crescent Court, Suite 800
Dallas, Texas 75201
214-981-9407
akers@bessemer.com
www.bessemertrust.com

Synopsis

Husband and Wife died within five months of each other, after Husband had created an FLP eight years earlier. Husband had previously made gifts of some of the company's stock to his son and to revocable trusts for his two grandsons. Husband was concerned about the son or grandsons eventually disposing of the stock and planners advised that they all contribute their stock to an FLP in order to protect Husband's buy and hold investment philosophy with respect to the stock. The IRS argued that §2036 applied to the transfers by Husband to the FLP, causing a pro rata portion of the FLP assets to be included in Husband's gross estate. The IRS argued that the amount of marital deduction available in Husband's estate would be limited to the discounted fair market value of the FLP interests (which apparently were the only assets that could be used to fund the marital bequest). (This is sometimes referred to as the "marital deduction mismatch issue.") There were also disputes about the deemed funding date of the Marital Trust (which was not funded before Wife died), and the availability of administrative expense deductions in Wife's estate. John Porter represented the estates in the tax litigation.

The Tax Court (in this "regular" Tax Court decision) held that the bona fide sale for adequate consideration exception to §2036 applied, primarily relying on the buy and hold investment philosophy as the nontax reason for creating the FLP. Because §2036 did not apply to Husband's estate, the court did not have to address the marital deduction mismatch issue in Husband's estate. The stock (and therefore the FLP interest) increased in value in the five months between the two spouses' deaths, and the court agreed with the estate that the Marital Trust would be deemed to have been funded on the date of Wife's death. (Therefore, fewer units were allocated to the Marital Trust than if the trust had been deemed funded at Husband's death.) The \$20.3 million of interest on the Graegin note was not deductible; the loan was not "necessary," primarily because it did not avoid having the company stock sold in any event (i.e., the FLP sold stock and loaned sale proceeds to the estate instead of distributing stock to the estate and allowing it to sell the stock directly). Only the portion of the selling expenses attributable to funds needed by the estate for paying federal and state estate and income taxes was allowed as an estate tax deduction. Executor fees and legal fees were allocated equally to Husband's and Wife's estate and only the one-half allocated to Wife's estate could be deducted on her estate tax return to offset the substantial estate taxes payable from her estate.

Basic Facts

1. Husband was a key employee-officer-board member-shareholder of an insurance company, Erie Indemnity Co. (the "company"). (Husband was the second largest shareholder and served on the board of directors for 67 years). [Interesting aside: Upon joining the company in 1927, Husband "installed an extension of the 'home office' telephone in his room at the YMCA across the street from Erie's office, making Erie one of the first insurance companies to offer around-the-clock claims service."] The stock increased substantially over the years and Husband had a strong "buy and hold" investment philosophy with respect to his company stock.
2. In 1988-1993, Husband gave shares of the stock to his son and to trusts for his two grandsons (the son was the trustee). In 1993, those shares had a combined value of \$12 million and represented more than 16.6% of the family's nonvoting stock.
3. By 1993, Husband was concerned about possible transfers or pledging of some of the transferred shares.

Husband was concerned that (1) his son might default on a pledge of 125,000 shares (which apparently had secured loans to provide funds for his son's father-in-law), (2) the son's marriage and that a divorce could result in a transfer of shares to his wife, and (3) that the father-in-law's business and bankruptcies resulted in continuing needs for funds from the son and could conceivably require the sale of some of the son's stock.

As to the grandsons, he was concerned that they could withdraw principal from the trusts at ages 25 and 30. Each was over age 20, "neither held a job or was even looking for one," Husband felt "both grandsons were too close to their mother, whom [he] considered to be lazy," and they "were both inexperienced financially and ... might fall prey to people anxious to have them invest their money."

Husband was also concerned that brewing disagreements among other shareholders might leave his family's shares as the swing vote among the voting shares, and he wanted to be sure to retain his family's voting shares.

4. Planners suggested forming an FLP to consolidate and protect the family's stock and to minimize estate taxes.
5. In October, 1993 Husband, the son and the trusts for the grandsons contributed almost all of their shares to a newly formed FLP. Father held a 1% and son held a 0.5% general partner interest. The family members held the limited partnership interests in proportion to their contributions (Husband held all of the "A" limited partnership interests and 83.985% of the "B" limited partnership interests.)
6. Husband retained assets of more than \$4 million, and Husband and Wife received annual income from sources other than the stock transferred to the FLP that was more than sufficient to cover their personal living expenses.
7. Husband made gifts of limited partnership interests between 1993 and 2001 to the son and trusts for the grandsons.
8. Husband was the "managing partner" until 1998, when he transferred his 1% general partner interest to his son, who became the managing partner. The partnership agreement required that net cashflow be distributed to the partners and that sufficient distributions be made to allow the partners to pay their income taxes on flow-through income from the partnership. From 1994-2001, the partnership received \$27.8 million of dividends from the stock and distributed \$25.7 million to the partners. The partnership retained all of its stock in the company through 2001.
9. Husband died December 12, 2001, leaving a formula marital deduction bequest to a Marital Trust. Father's 77.0876% limited partnership interest in the FLP was worth \$165 million (agreed by the estate and the IRS).
10. Wife died five months later, on May 25, 2002, before the Marital Trust had been funded. The stock increased in value from the time of Husband's death to the time of Wife's death five months later. Husband's estate tax return (filed by the son as executor) explained that he intended to fund the Marital Trust with a portion of Husband's limited partnership interest in the FLP (apparently, that was the only asset large enough to fund the bequest).
11. More than three months after Wife's death, Husband's estate tax return was filed on September 12, 2002. The appraisal of the FLP limited partnership interests was received on September 11, 2002, and the appraised value of the stock had not been determined on the date of Wife's death.
12. The son, as executor of Wife's estate tried unsuccessfully to borrow funds from various banks and from the insurance company to be able to pay the estate taxes and administration expenses.

Ultimately, a secondary offering was completed to sell about one-third of the FLP's stock, generating about \$98 million to the FLP. The FLP agreed to pay the company's expenses incurred in connection with the secondary offering. On February 25, 2003, the FLP loaned \$71 million to Wife's estate for a note "due and payable not earlier than November 30, 2007." The note could not be prepaid [i.e., it was a "Graegin" note]. The estate agreed to reimburse the FLP for its expenses in connection with the secondary offering (including the amount of the company's expenses that the FLP had to pay).

13. Wife's estate used the \$71 million as follows (in round numbers)

	<u>Millions</u>
Net federal estate tax (\$54 million was paid initially, with a \$22.3 million refund)	\$ 31.74
Pa. inheritance tax	15.74
U.S. fiduciary income tax	.52
Pa. fiduciary income tax	.06
Reimburse company's expenses for secondary offering	.98
Executor fees	1.16
Attorney fees	1.15
Charitable bequest	<u>20.00</u>
Total	\$ 71.31

14. Wife's estate tax return claimed an administrative expense deduction for \$20.3 million of interest on the Graegin note as well as the secondary offering expenses, executor's commission, and attorneys' fee listed above.
15. Husband's and Wife's estates were consolidated for the trial of the estate tax treatment of the estates. The IRS took the position that (1) the FLP assets attributable to the 77.0876% limited partnership interest he held at his death plus the assets attributable to the 2.4907% partnership interest that he transferred within three years of his death, or 79.5183% of the net value of the partnership assets, should be included in Husband's estate under §2036 [the IRS's detailed position as to the amount that should be included under §2036 is in the IRS's brief, but is not stated in the opinion], (2) the estate's marital deduction for Husband's estate is limited to the fair market value of the FLP interest passing to the spouse, (3) the Marital Trust is deemed to have been funded on the date of Husband's death, (4) the interest on the Graegin note (\$20.3 million) was not "necessarily incurred" and is not deductible in Wife's estate, and (5) the secondary offering costs are not deductible in Wife's estate, and only \$500,000 of the executor's fee and \$500,000 of the attorneys' fee can be deducted in Wife's estate.

Holdings

1. The bona fide sale exception to §2036 applies, primarily because using the FLP to implement Husband's buy and hold investment philosophy is a legitimate and significant non-tax purpose, so the FLP's assets are not included in Husband's estate under §2036.

2. The issue regarding limiting the marital deduction to the discounted value of the limited partnership interest passing to Wife even if the undiscounted partnership assets are included in Husband's estate is moot because §2036 does not apply.
3. The Marital Trust is deemed to be funded on the date of Wife's death (as contended by the estate).
4. The interest on the \$71 million loan is not deductible because the loan was not "necessary."
5. Only the portion of the secondary offering costs, the executor's fee, and the attorneys' fee that is attributable to the Wife's estate is deductible, not the full amount of those expenses as contended by the estate (but more than the amount urged by the IRS).

Analysis

1. Burden of Proof Not Important. The IRS contended that the burden of proof did not shift to the IRS under §7491(a) because the estate failed to produce credible evidence as to the material factual issues. The court did not decide the issue because it determined all factual disputes by a preponderance of the evidence rather than relying on which party bears the burden of proof as to any issue.
2. Bona Fide Sale for Adequate consideration Exception to §2036 — Overview. Section 2036 does not apply if the transfer of stock to the FLP "was both (1) a bona fide sale and (2) for adequate consideration." The case is appealable to the Third Circuit, so the court repeatedly analyzed the facts in light of Estate of Thompson v. Commissioner, 382 F.3d 367 (3rd Cir. 2004). That case requires "some potential for benefit other than the potential of estate tax advantages" in order for the bona fide sale exception to apply. Saving estate taxes must not be the "predominant motive." The case also expressed reservations about whether receiving interests in a partnership proportionate to amounts contributed to the partnership is sufficient to satisfy the "adequate consideration" requirement in situations where (1) the partnership does not operate a legitimate business and (2) obtaining a valuation discount is the sole benefit of the partnership.
3. "Bona Fide" Leg of Bona Fide Sale for Adequate Consideration Exception to §2036 Is Met. The case is very similar to Estate of Schutt v. Commissioner, T.C. Memo. 2005-126, in which a grandfather used business trusts to prevent his grandsons from selling family legacy assets (du Pont and Exxon stock) when their trusts terminated. The court in Schutt held that was a legitimate and significant non-tax reason that satisfied the "bona fide" requirement. The court in Black repeatedly analyzed the facts in light of the facts and holding of the Schutt case.
 - a. Nontax Purposes. Husband's "primary reasons for wanting to form Black LP were to provide centralized long-term management and protection of the Black family's holdings in Erie stock, to preserve Mr. Black's buy-and-hold investment philosophy with respect to that stock, to pool the family stock so that it can be voted as a block (thereby giving the family the swing vote in the not unlikely event of a split between the two [other major] shareholders), and to protect the Erie stock from creditors and divorce."

In particular, the estate argued that the FLP accomplished those goals for various reasons. (i) The "buy and hold" philosophy resulted in the stock value increasing from \$80 million to \$315 million from the time the FLP was created in 1993 to the date of Husband's death in 2001, (ii) the FLP prevented the son from selling or encumbering the stock he contributed to the FLP, (iii) the stock contributed by the grandsons' trusts could not be distributed directly to them at ages 25 and 30, (iv) the family's consolidated holdings allowed it to maintain a seat on the board of directors, and (v) the FLP protected the stock from equitable division on divorce and reduced the value of the marital estate that the son's wife was entitled to receive on divorce.

- b. Two-Pronged Analysis for “Bona Fide” Issue. In footnote 12, the court organized the “bona fide” analysis as a two-step process. First, whether the buy-and-hold philosophy was a legitimate and significant nontax purpose, and second, whether the parties “needed to transfer their Erie stock” to the FLP in order to ensure the implementation of that philosophy. [Observation: This analysis was in response to the IRS’s contention that the transfer of stock to the FLP was not necessary to achieve the goals. Stating this as a two-step process may overstate the requirements to meet the “bona fide” requirement. See Item 4 of the Observations section of this case summary.]
- c. Son’s Stock. The IRS argued that the purported concern over the son disposing of stock was not legitimate or else Husband would not have transferred his managing partner interest to the son in 1998 or arranged for the son to receive all of the limited partnership interests when the Marital Trusts terminated at Wife’s death. The court responded that those arguments overlooked the estate’s “main point, which is that, although Mr. Black may have been satisfied that [the son] shared his goal of retaining the family’s existing investment in the Erie stock, he feared that [the son’s] relationship with his wife and in-laws might require him, against his better judgment or, even, against his will, to dispose of or, alternatively, to pledge as collateral for a new loan additional Erie stock. In particular, Mr. Black worried that [the son’s] marriage would end in a contentious divorce and about his father-in-law’s present and continuing need for financial support.”

Furthermore, the IRS contended the FLP did not enhance divorce protections already available under Pennsylvania law, which provided that property acquired by gift or bequest was not “marital property” subject to equitable division on divorce. The court responded that while the son’s stock might not be “marital property” subject to divorce, “that stock might nonetheless constitute the only significant asset available, as a practical matter, to fund whatever award might have been made to Karen Black under the divorce decree or marital settlement agreement.” Indeed, the son ended up agreeing to transfer to his wife the 125,000 shares that he did not contribute to the FLP when he was divorced in 2005.

- d. Grandsons’ Stock. The IRS contended the Husband’s transfers of stock to the grandsons’ trusts before and after the decision to form the FLP suggests that Husband was not overly concerned with his grandsons disposing of the stock. The court responded that the transfers of stock to the trusts are not inconsistent with a concern that the grandsons would dispose of or borrow against the stock when the trusts terminated. Furthermore, when the initial stock transfers were made to the trusts, the values were relatively low and the grandsons “had not yet reached an age at which their lack of ambition was important.” The later transfers of stock to the trusts were not inconsistent with this concern because Husband and the son as trustee had already decided to transfer the trusts’ stock to the FLP.

The IRS tried to distinguish the Schutt facts, because in that case the trust held about \$50 million of DuPont and Exxon stock while the value of stock in the grandsons’ trusts was relatively insignificant in terms of value (about \$1 million) and percentage (about 1%) of the family wealth. Also, in Schutt, there was a history of prior stock sales by the grandchildren. The court’s reaction was that the Husband’s concerns as to the grandchildren were not speculative and were not merely a “‘theoretical justification’ rather than an ‘actual motivation.’” The concern was real in light of the grandsons’ “unwillingness to seek employment.” Also, it was improper to focus on just the grandsons

because Husband was concerned about protecting stock held by his son as well as the grandsons' trusts and the combined stock holdings were substantial in value (\$12 million) and percentage of the family stock (16.6%).

4. "Adequate Consideration" Leg of Bona Fide Sale for Adequate Consideration Exception to §2036 Is Met. The court in Schutt identified four factors to satisfy the "adequate consideration" requirement:

"(1) The participants in the entity at the issue received interests proportionate to the value of the property each contributed to the entity; (2) the respective contributed assets were properly credited to transferors' capital accounts; (3) distributions required negative adjustments to distributee capital accounts; and (4) there was a legitimate and significant nontax reason for the formation of the entity."

While those four factors were met in Black, the court specifically addressed the reservations expressed by the Third Circuit in Thompson to treating the receipt of proportionate interests as adequate consideration in light of the fact that the value of interests received in the partnership is often less than the value of assets contributed. Thompson reasoned:

"Where, as here, the transferee partnership does not operate a legitimate business, and the record demonstrates the valuation discount provides the sole benefit for converting liquid, marketable assets into illiquid partnership interests, there is no transfer for consideration within the meaning of §2036(a)."

Even though the IRS conceded that the partners received interests proportionate to their contributions, the IRS argued that was not sufficient because Bongard and Thompson said the receipt of proportionate interests do not satisfy the adequate consideration test "in the absence of a tax-independent purpose." The IRS noted further that in Thompson, the Third Circuit said there is not a transfer for consideration if the FLP "does not operate a legitimate business" and if obtaining a valuation discount "provides the sole benefit" for transferring liquid marketable assets to an illiquid FLP.

The court summarizes the IRS's argument as saying there must be proportionate interests and a legitimate and significant nontax purpose to meet the full consideration leg of the exception. (In other words, a legitimate and significant nontax reason is important for both the "bona fide" leg and the "adequate consideration" leg of the exception to §2036.) The court noted that this issue was resolved because it had found the existence of a legitimate and significant nontax reason.

The court concluded the "adequate consideration" discussion by observing that the Third Circuit's decision in Thompson does not require that the FLP must "operate a legitimate business" to meet the adequate consideration requirement as long as there is a legitimate and significant nontax purpose and obtaining a valuation discount is not the "sole benefit" of the FLP. The court noted in footnote 14 that the IRS did not argue in its brief or at the trial that the purpose of the partnership must be the "operation of a business" in order to meet the bona fide transfer sale for adequate consideration exception to § 2036.

5. Sections 2036(a)(1) and 2036(a)(2) Not Addressed. Because the exception to §2036 applies, the court did not address whether the elements of §§2036(a)(1) and 2036(a)(2) were met or addressed the parties' intentions as to those sections. (Items 6-7 of the Observations section of this case summary describe the IRS's arguments in its briefs.)
6. Deemed Funding of Marital Trust at Wife's Death. The Marital Trust could not be funded before Wife's death, because the value of the limited partnership units had not yet been determined, so the executor could not know how many units to transfer to the Marital Trust. The date of the

deemed funding is important because the value of the units increased during the five months between the spouses' deaths. If the funding of the Marital Trust is deemed to occur on the date of Wife's subsequent death, fewer units would be required to fund the trust (and less value would be includable in Wife's gross estate) than if the deemed funding occurred at Husband's death (in which event the appreciation in the funded units would also be included in Wife's estate). The IRS contended that under the terms of Husband's revocable trust, Wife's legacy "passed to her upon Sam Black's death," so the deemed funding occurred at Husband's death. The court rejected that approach because the revocable trust merely provided that if Wife survived Husband, the trustee would hold in the Marital Trust "a legacy equal to * * * [the pecuniary bequest]," and the amount of the bequest was not known at Husband's death. Indeed, the appraisal of the limited partnership units was not obtained until more than three months after Wife died. Having rejected using the date of Husband's death as the deemed funding date, the court then proceeded to reason that it was "logical and reasonable" to use the date of Wife's death as the deemed funding date. That is the last possible date because the Marital Trust terminated on that date, and it is the closest to what would have been the actual date of distribution had Wife survived.

7. Interest on Graegin Note Not Deductible. When an executor borrows money to pay debts and expenses of an estate rather than sell illiquid assets, the interest on the loan is generally deductible (the court cited the Bahr, Todd, and Graegin cases). An interest deduction has also been allowed where an executor anticipated a closely held stock would increase in value and "borrowing funds, rather than selling stock, allowed the decedent's estate to more easily meet its burdens by taking advantage of the increasing value of the stock" (quoting Estate of McKee v. Commissioner, T.C. Memo. 1996-362).

The estate argued four reasons for allowing an interest deduction. (1) The executor exercised reasonable business judgment when he borrowed funds, (2) the FLP was not required to make a distribution or redeem a partnership interest from Wife's estate, (3) the son was the managing partner and executor and owed fiduciary duties to both Wife's estate and the partnership, and (4) the loan itself was a bona fide loan.

The IRS argued that the loan was (1) unnecessary and (2) not bona fide (because the transaction had no economic effect other than to generate an estate tax deduction).

The court found that the loan was not necessary, basing its analysis primarily on the "no economic effect" rationale that the IRS gave in its "no bona fide loan" argument. The court noted that the partnership agreement allowed modifications, and a modification permitting a distribution of stock to the partners or a partial redemption of the estate's interest would not have violated the son's fiduciary duties, as managing partner, to any of the partners. The court reasoned further that the estate had no way to repay the loan other than actually receiving a distribution from or having its partnership interest redeemed by the partnership in return for the stock, which it would then use to discharge the debt. Instead, the partnerships sold the stock and loaned the sale proceeds to the estate.

"The loan structure, in effect, constituted an indirect use of Erie stock to pay the debts of Mrs. Black's estate and accomplished nothing more than a direct use of that stock for the same purpose would have accomplished, except for the substantial estate tax savings. Those circumstances distinguish these cases from the cases on which petitioner relies in which loans from a related, family-owned corporation to the estate were found to be necessary to avoid a forced sale of illiquid assets, see Estate of Todd v. Commissioner, 57 T.C. 288 (1971); Estate of Graegin v. Commissioner, T.C. Memo. 1988-477, or to enable the estate to retain the lender's stock for future appreciation, McKee v. Commissioner,

T.C. Memo. 1988-362. ... Moreover, as respondent points out, the principal beneficiary of the estate, [the son], was also the majority partner in Black LP. Thus, he was on both sides of the transaction, in effect paying interest to himself. As a result, those payments effected no change in his net worth, except for the net tax savings.”

8. Deductibility of Fees. Expenses for administering nonprobate property (such as assets in the Marital Trust) may be deducted if “actually and necessarily incurred in the administration of the decedent’s estate.”
 - a. Reimbursement of Secondary Offering Costs. The FLP agreed to reimburse the company for its expenses in the secondary offering, and the estate agreed to reimburse the FLP for those same expenses in connection with the loan from the FLP. Accordingly, the selling expense relates to an asset that the estate did not own directly. However, the court reasoned that the estate’s indirect ownership, through its interest in the FLP, is sufficient to bring the sale of the stock within the regulation that allows the deductibility of expenses of selling “property of the estate.” However, only a proportionate part of the costs were allowed as a deduction. Of the \$98 million that the FLP received in the secondary offering, only \$71 million was made available to the estate, and of that only about \$48 million was used to pay federal and state estate taxes or fiduciary income taxes, representing 49% of the \$98 million of proceeds. Therefore, only 49% of the secondary offering costs could be deducted.
 - b. Executor’s Fee. The son received a \$1,155,000 executor fee and attempted to deduct all of that. However, the fees attributable to services performed for Husband’s estate could not be deducted on Wife’s return. The portion of the fee related to the secondary offering of stock could be deducted in the same 49% ratio described above. Fees related to obtaining information and appraisals benefitted both the estates and could be deducted only one-half by Wife’s estate. Fees related to managing the Marital Trust could also be deducted only one-half by Wife’s estate because the Marital Trust has an equal nexus to both estates (i.e., the Husband’s estate needed the marital deduction afforded by the Marital Trust). In conclusion, the court found “that one-half of the \$1,155,000 executor's fee paid to petitioner was attributable to his efforts on behalf of Mrs. Black's estate.”
 - c. Attorneys’ Fees. The IRS did not contest the reasonableness of the \$1,155,000 legal fees, but merely contested how much should be allocated to Wife’s estate. With similar reasoning as for the executor’s commissions, the court concluded that only 50% of the legal fees could be deducted by Wife’s estate.

Observations

1. Well Reasoned Analytical Opinion. The opinion is very analytical in reviewing in depth the arguments of the parties and in providing sound reasons for the court’s conclusions.
2. “Scorecard” of §2036 FLP Cases. Of the various FLP cases that the IRS has chosen to litigate, ten have held that at least most of the transfers to an FLP qualified for the bona fide sale exception — Church (preserve family ranching enterprise, consolidate undivided ranch interests); Stone (partnerships to settle family hostilities); Kimbell (“substantial business and other nontax reasons” including maintaining a single pool of investment assets, providing for management succession, and providing active management of oil and gas working interests); Bongard (placing ownership of closely held company in a single entity for purposes of shopping the company by a single seller rather than by multiple trusts); Schutt (maintaining buy and hold investment philosophy for family du Pont stock); Mirowski (joint management and keeping a single pool of assets for

investment opportunities); Miller (continue investment philosophy and special stock charting methodology); Keller (protect family assets from depletion in divorces); Murphy (centralized management and prevent dissipation of family “legacy assets”), and Black (maintaining buy and hold investment philosophy for closely held stock). In every FLP case resulting in taxpayer successes against a §2036 attack the court relied on the bona fide sale exception to §2036.

Interestingly, four of those ten cases have been decided by (or authored by) two Tax Court judges. Judge Goeke decided the Miller case and authored the Tax Court’s opinion in Bongard. Judge Chiechi decided both Stone and Mirowski. (Judge Wherry decided Schutt and Judge Halpern decided Black, and Church and Kimbell were federal district court opinions ultimately resolved by the 5th Circuit. Keller and Murphy are federal district court cases.)

Including the partial inclusion of FLP assets in Miller and Bongard, 19 cases have applied §2036 to FLP or LLC situations: Schauerhamer, Reichardt, Harper, Thompson, Strangi, Abraham, Hillgren, Bongard (as to an LLC but not as to a separate FLP), Bigelow, Edna Korby, Austin Korby, Rosen, Erickson, Gore, Rector, Hurford, Jorgenson, Miller (as to transfers made 13 days before death but not as to prior transfers) and Malkin. In addition, the district court applied §2036 in Kimbell, but the 5th Circuit reversed.

3. Growing Body of Cases Relying on Maintaining Buy and Hold Philosophy for Family Assets. Schutt based its determination that the bona fide sale exception applied based primarily on the intent of the donor of maintaining his buy and hold investment philosophy overpayment legacy assets (du Pont and Exxon stock). Two additional recent cases (Murphy and Black) have similarly treated the desire to maintain family legacy assets as a legitimate and significant nontax purpose that satisfied the bona fide sale exception to §2036. (Both Murphy and Black involved companies in which the family held a relatively high percentage ownership interest and in which the family had been intimately involved with the operation of the company.)

It is ironic that while the buy and hold philosophy was the primary rationale for applying the bona fide sale for adequate consideration exception, the son as managing partner of the FLP in fact sold one-third of the company stock in the secondary offering soon after Wife’s death in 2002, and sold the remaining two-thirds of its company stock in 2005-2006, at which time the company was publicly traded. While the court noted this fact in footnote 4, that fact did not seem to impact the court’s discussion at all as to Husband’s intent when the FLP was formed.

4. Is There a Requirement That the FLP Be “Needed” to Accomplish the Nontax Purpose? Footnote 12 organized the “bona fide” leg of the §2036 exception analysis as a two-step process. First, whether the buy and hold philosophy was a legitimate and significant nontax purpose, and second, whether the parties “needed to transfer their Erie stock” to the FLP in order to ensure the implementation of that philosophy. Is it really essential that the FLP is “needed” (if that is another way of saying it is the “only way”) to achieve the nontax purposes? For example, if the goals are legitimate and significant, but could have been achieved by some different strategy, does that mean that the transfers do not meet the “bona fide” leg of the bona fide sale exception? Other cases have not required a showing that contributing assets to the FLP was the only way to meet the nontax goals. The court did not state that the estate must establish that the FLP must be the only way to make the nontax goals, but that is one way to interpret a requirement that the FLP must be “necessary to achieve [the] goal.” The taxpayer responded with the reasons that the FLP constituted the “best means of implementing his high-and-hold philosophy to protect [the] family’s Erie stock.” Even that seems overstated. Is there a requirement to show that of all the possible ways to meet the goals, forming an FLP was the “best” way in order to satisfy the “bona fide” requirement?

5. Operating Business Not Required. In addressing the Third Circuit's reference in Thompson to an FLP not operating “a legitimate business,” the opinion emphasizes that there is no need that the FLP conduct an active trade or business in order to be able to satisfy the bona fide sale for adequate consideration exception.

“[R]espondent concedes, and, as demonstrated by our opinion in Estate of Schutt, this Court agrees, that a family limited partnership that does not conduct an active trade or business may nonetheless be formed for legitimate and significant nontax reason.”

In footnote 14, the court noted the IRS did not attempt to argue in its brief or at the trial that an operating business is required. The court very clearly interpreted the reservation about satisfying the bona fide sale exception in the Third Circuit's Thompson case as applying if *either* there was no legitimate business *or* there was no potential nontax benefit. Therefore, if there is a nontax benefit, whether or not there is also a legitimate operating business is irrelevant.

6. Section 2036(a)(1) Issues. The court did not have to address §2036(a)(1) because the bona fide sale exception applied. However, the IRS's arguments are interesting.

a. Mandatory Net Cashflow and “Tax Distributions” Requirement in Partnership Agreement. The IRS's brief argued that §2036(a)(1) applied in part because of an express agreement, in light of the mandatory “net cashflow” distribution requirement and because of the “tax distributions” requirement in the partnership agreement. When Husband was managing partner, he could determine in his sole discretion what cash had to be retained to cover projected expenses, and even after he was no longer the managing partner, the mandatory “net cashflow” distributions constituted retained enjoyment. Furthermore, the partnership agreement required minimum distributions to cover the tax liabilities attributable to the partners' interests. “Thus, although there was no guarantee that Sam Black would receive the full amount of the dividends earned on the Erie stock he contributed, he nevertheless retained an express right to receive at least a significant portion of those dividends through the mandatory cash distribution provision contained in the partnership agreement.”

b. Substantial Actual Distributions. In addition, the IRS argued that there was an implied agreement that Husband's allocable share of the Erie stock dividends would be distributed to him, evidenced by the fact that 92% of the Erie dividends received by the partnership were distributed to the partners on a pro rata basis.

c. Failure to Retain Assets to Pay Estate Taxes. In addition, an implied agreement existed because of Husband's failure to retain sufficient liquid assets to fund a charitable endowment and to pay the federal and state transfer taxes attributable to the stock. The fact that the transfer of partnership assets to pay the estate's taxes was structured as a loan, as opposed to a partnership distribution, should make no difference in the analysis, according to the IRS. “[T]his Court's prior holdings regarding the post-death use of partnership assets to pay estate obligations cannot be circumvented by simply distributing partnership assets in the form of a loan that has little economic consequence to the parties involved, and that the parties are essentially dealing with themselves.”

The facts of this case raise interesting question regarding retaining assets for making estate tax payments. When one spouse transfers assets to an FLP and contemplates that there will be no estate taxes at that spouse's death because of the marital deduction, is the failure to retain sufficient assets to pay estate taxes that will be due at the surviving spouse's subsequent death relevant? Section 2036 would not be applicable at the other

spouse's subsequent death because he or she did not make any contributions to the partnership. In that situation, particularly if the contributing spouse dies first, is the failure to retain enough assets to pay estate taxes that will be incurred by the other spouse's estate on the full *undiscounted* value of the partnership assets a retained enjoyment of benefits that can trigger §2036(a)(1)? Furthermore, is the failure to retain enough assets to pay estate taxes that will be incurred by the other spouse's estate on the full *discounted* value of the partnership assets a retained enjoyment of benefits that can trigger §2036(a)(1)?

7. Section 2036(a)(2) Issues. The IRS's brief made the argument suggested by Judge Cohen in the lower court Strangi opinion that the decedent's power, "in conjunction with others" triggered §2036(a)(2). The brief argued that the FLP could be dissolved and liquidated on the approval of all partners, and the Husband, "in conjunction" with the other partners could have amended the partnership agreement or simply dissolved the partnership and accelerated the enjoyment of the partnership's assets. Furthermore, Husband, acting alone as the holder of a majority of limited partnership interests, retained the right to approve transactions not in the ordinary course of business.

"Each of these rights conferred by the BILP agreement constitutes the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the transferred assets or the income therefrom during the decedent's lifetime for purposes of §2036(a)(2). . . And none of these rights were circumscribed by any meaningful fiduciary duty [citing a provision in the agreement that the managing partner will be indemnified for all claims except those based on gross negligence, fraud, deceit or wrongful taking]... Stated another way, on these facts, the existence of limited fiduciary duties is not a meaningful constraint on the powers conferred under the BILP agreement."

8. Marital Deduction Mismatch Issue. The IRS argued that the partnership assets were includable in the estate under §2036, but that the marital deduction is allowed only for the value of the partnership interest passing to the surviving spouse. This issue was not addressed by the court, because 2036 did not apply. The net effect, if the IRS succeeds in arguing that §2036 applies at the death of the first-decedent spouse, is that there could be significant estate taxes owing at the first spouse's death, even where the spouse is left a formula marital deduction bequest, if the partnership interest constitutes about the only assets available to fund the surviving spouse's bequest.

The IRS's brief argued:

"[A]s of the date of death, only a 77.0876% BILP limited partnership interest remained in the trust, which was the only property available to fund the marital bequest.... Petitioner overlooks the fact that §§2036 and 2035 include the value of property that has previously been transferred, while the marital deduction is limited to the value of the property actually passing to the surviving spouse. There is good reason for this limitation. On the death of the surviving spouse, only that property (here, the discounted value of the BILP interest) will be includable in the spouse's gross estate under I.R.C. §2044."

(To avoid this argument, some planners suggest leaving voting and non-voting stock of an LLC to the surviving spouse at the first spouse's death, so there is little or no discount for marital deduction purposes. After the first spouse's death, the surviving spouse could sell the voting stock so that he or she is left with only non-voting stock (which should be discounted).)

9. Key to Avoiding Limitation on Interest Deduction on Graegin Note. Under the court's analysis, the key factor in denying any deduction for loans obtained to pay debts and expenses seems to be

that the loan was not necessary to avoid selling assets. The other cases cited by the taxpayer in which an interest deduction was allowed involved situations where the estate avoided a forced sale of illiquid assets or company stock.

“In none of those cases was there a sale of either the stock or assets of the lender to pay debts of the estate borrower, as occurred in these cases.”

In this case, the company stock that was owned by the FLP was in fact sold by the FLP. That seems to be the key distinguishing factor from the prior cases that have allowed interest deductions for Graegin loans.

10. Deductibility of Administration Expenses of Marital Trust. IRS agents sometimes raise questions about allowing an estate tax deduction for expenses attributable to a Marital Trust at the surviving spouse's death. However, expenses attributable to assets in a QTIP trust at the surviving spouse's death, which are the type of expenses that would be deductible for estate tax purposes if they were incurred directly by an estate, are deductible under §2053. §2053(b) (deductibility of expenses of administering “property not subject to claims”); Reg. §20.2053-8(a), (b) (expenses of administering property not subject to claims that are deductible include expenses “occasioned by the decedent's death and incurred in settling the decedent's interest in the property or vesting good title to the property in the beneficiaries”); Tech. Adv. Memo. 9121002 (specifically applying §2053(b) and Reg. §20.2053-8 to expenses of QTIP trust, and allowing deductibility of QTIP trust expenses incurred in the settlement of the estate).

An additional limitation on deducting expenses administrating “property not subject to claims” is that the expenses must be paid before the expiration of the period for assessing additional estate taxes under §6501. I.R.C. §2503(b). That time limitation does not apply to expenses of administering probate property.

The Black case confirms this result by allowing the deduction of administration expenses attributable to the Marital Trust. However, the court apportioned the expenses. In this situation where both spouses died within five months of each other, the court divided the expenses about equally between the two estates, even though estate taxes were only payable with respect to the surviving spouse's estate (by reason of the marital deduction at the first spouse's death). This is a practical concern whenever spouses die in quick succession. The effect is that only about one half of the administration expenses are deductible. On the one hand, that may seem fair because if the spouses do not die in quick succession, at the first spouse's death the administration expenses do not generate any estate tax savings (because of the marital deduction), and only the administration expenses in the second spouse's estate generate estate tax savings. On the other hand, that treatment is often unfair as a practical matter, because the fees are almost always substantially greater at the second spouse's death due to the fact that estate taxes are paid at that spouse's death.

11. Selling Expenses. The secondary selling expenses in this case probably were about the same whether the partnership sold \$70 million or \$100 million worth of stock. However, by selling roughly \$100 million of stock rather than just the \$70 million that the FLP loaned to the estate, the estate's deduction for selling expenses was limited proportionately to approximately 70/100ths of the expenses (and even some of that was further reduced to reflect the portion of the \$70 million that the estate used to pay federal and state estate and income taxes). In this kind of situation, in order to maximize the estate tax deduction, sell approximately only the amount of assets actually needed by the estate for administration purposes. A lesson to be learned from this case is that, the estate should not sell significantly more than the amount actually needed for administration purposes in order to be able to deduct all of the selling expenses.

Copyright © 2009 Bessemer Trust Company, N.A. All rights reserved.

This summary reflects the views of Bessemer Trust and is for your general information. The discussion of any estate planning alternatives and other observations herein are not intended as legal or tax advice and do not take into account the particular estate planning objectives, financial situation or needs of individual clients. This summary is based upon information obtained from various sources that Bessemer believes to be reliable, but Bessemer makes no representation or warranty with respect to the accuracy or completeness of such information. Views expressed herein are current opinions only as of the date indicated, and are subject to change without notice. Forecasts may not be realized due to a variety of factors, including changes in law, regulation, interest rates, and inflation.