Rector v. Commissioner, TC Memo 2007-367
Judge Laro Finds Implied Agreement Under §2036; Applies §2036 to the Assets Contributed to the FLP Rather Than to the Gifts of LP Interests Under a "Single Plan" Analysis; Suggestion that Payment of Estate Taxes Out of Partnership Assets Evidences an Implied Agreement of Retained Enjoyment Under §2036

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Synopsis

In this case that is appealable to the 9th Circuit (and that therefore relies heavily on *Bigelow*, 100 AFTR2d 2007-6016 (9th Cir. September 14, 2007)), Judge Laro easily finds the existence of an implied agreement of retained enjoyment under §2036. (Judge Laro somehow seems to be drawing a disproportionately high number of the FLP cases in the Tax Court.) The result is not surprising, and there are strong facts suggesting the existence of an implied agreement that the decedent would retain enjoyment of partnership assets (including that almost all of the decedent's liquid assets were transferred to the FLP and the FLP in fact paid significant amounts of the decedent's living expenses and made significant non pro rata distributions to or for the decedent's benefit). The court also noted that substantial distributions were made for the payment of estate and gift taxes of the decedent. The court also reasoned (interestingly, as part of the §2036(a)(1) analysis rather than under §2036(a)(2)) that the decedent kept control of the FLP because she owned all of the general partnership interest (at first initially, and later through her revocable trust). The court finds that the bona fide sale exception to §2036 does not apply, because there was no change in the underlying pool of assets or the likelihood of profit, and there was not a legitimate and significant nontax business purpose.

Key Facts

Decedent created the FLP when she was 92 (while living full-time in a convalescent hospital), and her revocable trust transferred virtually all of her wealth to the partnership. There was a meeting of the decedent and her two sons with the attorneys, but the FLP was formed without any negotiation over its terms.

When the partnership was formed, the decedent was the sole general partner (2%) and her revocable trust received the 98% limited partnership interests.

There was a $2.5 million credit shelter trust for the decedent created by her predeceased husband, but she only received the income from the trust, and the trust agreement said that principal distributions should be made from that trust for objective standard needs only if assets in a Marital Trust could not be readily used for these purposes.

The partnership was not funded for about 3 months, when the revocable trust transferred practically all of its assets ($174,000 cash and $8.6 million of marketable securities) to the FLP. That same month, the decedent gave each of her two sons an 11.1% limited partnership interest.

The decedent's expenses substantially exceeded the income distributions that she received from the credit shelter trust. The FLP paid about $77,000 of these expenses directly, and transferred about $350,000 to the revocable trust for it to pay the decedent's gift taxes. In the two years prior to decedent's death, 86 to 90 percent of the total distributions were made to decedent (even though she only owned a 2% general partnership interst and a 75.78% limited partnership interest). After decedent's death, the FLP drew on a line of credit to pay the federal and California estate tax liability.

Two years after the partnership was funded (and one week before the decedent died), decedent transferred her 2% general partnership interest to the revocable trust, and her revocable trust transferred a 2.754% limited partnership interest to each of her sons.

Section 2036(a)(1) Retained Enjoyment

The court's analysis and factors that it emphasized provide guidance as to how FLPs should be planned and operated. The court had little difficulty in finding the existence of an implied agreement for retained enjoyment in light of the fact that the revocable trust transferred just about all of its assets to the partnership, and the decedent had a substantial shortfall of cash flow in meeting her living expenses, and she in fact received substantial distributions from the partnership.

Factors mentioned by the court include:

- "The transfer of practically all of decedent's wealth to RLP left decedent with insufficient liquid assets with which to pay her living expenses."
- Decedent's living expenses were about three times as large as the income distributions that she received from the bypass trust.
- Absence of negotiation over terms of the trust.
- Absence of independent counsel for the decedent and her two sons.
- At the time of the creation of the partnership, no one other than the decedent intended to make contributions to the partnership and the decedent intended to make gifts of limited partnership interests to her sons.
- The partnership paid significant personal expenses of the decedent
- Statements of activity and capital accounts were not regularly maintained.
- The decedent never even asked her sons as trustees of the bypass trust to distribute principal of that trust to her in order to cover her living expenses.
- Summary: "Decedent derived economic benefit from using RLP's assets to pay her living expenses, to meet her tax obligations, and to make gifts to her family members. Such use of RLP's assets shows an agreement among decedent and her sons that decedent would retain the enjoyment of and the right to income from the transferred assets by withdrawing those assets and/or income from RLP at will."

Section 2036(a) Bona Fide Sale for Full Consideration Exception

Judge Laro stated that the exception was not met for two general reasons: (1) There was no change in the underlying pool of assets or likelihood of profit, which Judge Laro says is necessary to constitute full and adequate consideration; and (2) The transfer to the partnership was not in "good faith," which considers whether "the terms of the transaction differed from those of two unrelated parties negotiating at arms' length" and which "requires that the transfer be made for a legitimate and significant nontax business purpose." (Judge Laro repeatedly adds the word "business" to the "legitimate and significant nontax reason" standard announced by the full Tax Court in *Bongard*, despite Judge Laro's failure to convince the majority of the full Tax Court in that case there must be a "business" purpose to satisfy the bona fide transfer for full consideration exception to §2036.)

As to the lack of a change in the underlying pool of assets, the opinion repeatedly observed that the decedent made all contributions to the FLP.

As to the terms differing from those of unrelated parties negotiating at arm's length, the court noted the absence of negotiation, the absence of independent counsel, that decedent made all contributions, that her contributions constituted the "vast bulk of her wealth," that the partnership was not actually funded until nearly 3 months after it was formed, and that the decedent intended to be the only person contributing to the partnership although the partnership agreement contemplated that more than one partner would contribute property.

As to the "need for a significant nontax business purpose" the court concluded that transfer of asserts to the partnership was not reasonably likely to serve such a purpose. The opinion rejected the various purposes asserted by the estate, including facilitating gift giving (which the opinion said is always a testamentary purpose), providing efficient management (because the assets did nor require any special kind of active management), asset protection (because of the absence of any legitimate concern about liabilities of decedent, and because decedent or her revocable trust was a general partner at all times), and diversification (because the ownership and management of assets was the same as in the revocable trust, and because there was no investment strategy or business plan of providing added diversification of investments). The opinion also pointed to the decedent's age and health, and the fact that only decedent's cash and marketable securities were contributed to the partnership.

<u>Observations</u>

(1) <u>Result not surprising</u>. The result is not surprising. The facts strongly suggest the existence of an implied agreement of retained enjoyment. (Indeed, the case was tried before the 9th Circuit's decision in *Bigelow*. Had the planners known the 9th Circuit's viewpoint and the small likelihood of overturning the decision on appeal, they may not have even chosen to proceed to trial after drawing Judge Laro as the judge.)

(2) <u>Full consideration requires change in pool of assets or likelihood of profit</u>. Judge Laro reverted to the pre-*Bongard* position of the Tax Court that full consideration for purposes of this exception is not met if there is mere recycling where there is no change in the underlying pool of assets or prospect for profit. That standard was rejected in *Bongard* (which instead focused on receiving interests proportionate to contributions and a legitimate and significant nontax business reason [that is the only time in *Bongard* that it inserted the word "business" in that standard; the court stated the "legitimate and significant nontax reason" standard many other times without inserting the word "business"]). Judge Laro interestingly cites *Bongard* as well as *Bigelow* for support of his statement that "Without such a change [in the underlying pool of assets] or a potential for profit, decedent's receipt of the partnership interests does not constitute the receipt of full and adequate consideration."

Bigelow does literally require (a) the "genuine" pooling of assets, AND (b) "a potential [for] intangibles stemming from pooling for joint enterprise" to meet the §2036 exception. The literal requirement in that case of a genuine pooling of assets has not been taken seriously because of the almost total lack of contributions by anyone other than the decedent in that case.

(3) Decedent serving as sole general partner. It is never a good idea for the decedent to serve as the sole general partner in order to avoid §2036 and to sustain valuation discounts. In *Rector*, the decedent served as the sole general partner up until about one week prior to her death (when her revocable trust became the general partner). Following Judge Cohen's memorandum decision in *Strangi* (T.C. Memo 2003-145), planners have generally avoided having the decedent serve as sole general partner (or often even as a co-general partner) in order to avoid an argument of applying §2036(a)(2) (right to designate who shall possess or enjoy the transferred assets or the income from them). Interestingly, Judge Laro points to the decedent's ability to control the assets as part of his analysis under §2036 (a)(1).

> "The RLP agreement reflects an understanding among decedent and her sons that decedent would retain her interest in the transferred assets by virtue of her ability to control those assets, including the management and disposition thereof. Initially, as the direct general partner of RLP, decedent was given the right by the RLP partnership agreement to cause a distribution of RLP's net cashflow to RLP's partners in proportion to their partnership interests, and she was given the power 'to do anything reasonably connected' with RLP's assets. Later, as an indirect (through the 1991 revocable trust) general partner of RLP, decedent continued to retain that right and power directly in that she was a cotrustee of the 1991 revocable trust and, most importantly, she had the absolute power to revoke the trust as if it had never been created in the first place. Thus, at all relevant times, decedent held both a majority interst in RLP and the powers incident to serving as RLP's general partner."

(4) Payment of estate taxes by partnership. *Erickson* (T.C. Memo 2007-107) emphasized the payment of estate taxes by the FLP as the primary reason supporting its application of §2036(a)(1) (in light of the fact that no distributions were made to the decedent in that case, and no distributions to her from the partnership were anticipated in light of the fact that she had a $1 million bypass trust that could pay her living expenses). That analysis seems wrong, because §2036 refers to retained enjoyment *for life*. (If §2036 applies in that circumstance, then it would also seem to apply to all irrevocable life insurance trusts under the same reasoning.)

Rector is not nearly as direct as *Erickson* in relying primarily on the payment of estate taxes using partnership assets to trigger the application of §2036, but it does state explicitly (in footnote 9) that the payment of estate taxes using assets transferred to the partnership evidences an implied agreement of retained enjoyment under §2036:

> "RLP transactions in 2002 and 2005 also illustrate the implied agreement among decedent and her sons that the transferred assets would continue to be used for the liabilities of decedent, even after her death. In those years, an RLP credit line was used to pay decedent's Federal and State tax liabilities of $2,038,098 and $262,654, respectively. A check also was written on the RLP credit line for $384,535 to pay some of decedent's Federal estate tax."

(5) Application of §2036 to all assets transferred to partnership rather than just being applied to transfer of limited partnership interests. The decedent transferred assets to the partnership and immediately gave 11.11 % limited partnership interests to each of her two sons (and made further gifts of limited partnership interests about a week before her death). If §2036 just applies to the gifts of the limited partnership interests, those interests would come back into the estate (but the interests would likely be valued with a discount). On the other hand, applying §2036 to the assets transferred to the partnership means that no discount is allowed.

If §2036 applied to the assets transferred to the partnership before the gifts of limited partnership interests, §2035(a)(2) would continue to cause §2036 to apply to the assets contributed to the partnership (thus avoiding any discount) because the retained interest was relinquished within three years of the date of death. However, Judge Laro did not rely on a §2035 analysis, but rather he relied on a "part of a single plan" analysis to apply §2036 to the partnership assets attributable to partnership interests that she had given to her sons during her lifetime. (Interestingly, this discussion also appeared in a footnote—footnote 7.)

> "The estate further argues that sec. 2036(a), to the extent it applies to this case, applies only to decedent's transfer of the limited partner interests to her sons and not to her transfer of the assets to RLP. To this end, the estate asserts, decedent received 100 percent of the interests in RLP in exchange for the assets, which means that the value of decedent's gross estate was not depleted by that transfer but was depleted when decedent gave away the limited partner interests….As detailed herein, we find on the basis of the credible evidence at hand that **decedent's transfer of her assets to RLP and her ensuing gifts of the limited partner interests to her sons were part of a single plan to minimize decedent's Federal estate tax**, lacked a significant nontax business purpose, and accomplished no genuine pooling of assets. On the basis of those findings, we reject this argument." (emphasis added)

That concept might suggest that partnership assets attributable to gifts of limited partnership assets would still be included in the estate even though the gifts were made long before the decedent's death—if the IRS could show that there was an intent to make gifts to minimize federal estate taxes as part of the plan of creating the partnership. That is a far reaching and quite troublesome suggestion. For example, it might also apply to the somewhat analogous situation of making gifts under a "single plan" for the recipient to acquire life insurance on the decedent's life, resulting in the inclusion of the life insurance owned by the third party in the donor's estate. Section 2035(b) is intended to deal with these kinds of transfers, and to extend the three rule of §2035 indefinitely under a "single plan" doctrine makes §2035(b) somewhat meaningless and seems unsupportable.