Estate of Miller v. Commissioner, T.C. Memo. 2009-119

Taxpayer Section 2036 Partial Victory For Marketable Securities FLP; Purpose of Providing Active Management of Portfolio Satisfied Bona Fide Sale Exception For Initial Contributions to FLP; For Additional Contributions Made Days Before Death, Court Looked Primarily to Post-Death Distributions to Pay Estate Taxes as Triggering §2036(a)(1) Inclusion

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Synopsis:

The bona fide sale for full and adequate consideration exception to §2036 applied to transfers of marketable securities to an FLP made about 13 months prior to the decedent's death. The court concluded that there were legitimate and significant nontax reasons for the contributions to the partnership, finding credible the witnesses' testimony "that the driving force behind decedent's desire to form [the FLP] was to continue the management of family assets in accordance with Mr. Miller's investment strategy." The court emphasized that there was active management of the partnership's assets by the decedent's son as the general partner, that there was a change in the investment activity after formation of the FLP, and that the decedent retained sufficient assets for living expenses.

The court refused to apply the bona fide sale exception to additional contributions to the FLP made only 13 days before the decedent's death following very serious health problems, finding that "the decline in her health and the decision to reduce her taxable estate were clearly the driving forces" behind the subsequent contribution of assets to the FLP. As to those assets, the court held §2036(a)(1) applied, primarily pointing to pro rata post-death distributions from the partnership 8 months after the date of death, where the estate used its 92% pro rata portion of the distributions to pay estate taxes. The court also observed (after a detailed discussion of the post-death distributions for paying estate taxes) that the additional contribution was almost all of the decedent's assets and that an implication arose that the assets would be made available to her for living expenses if needed.

Basic Facts:

1. H devoted his time following retirement to researching and investing securities and used a specific charting methodology to purchase and sell securities "on the basis of an analysis of their daily high and low values."
2. H died on February 2, 2000 with a gross estate of about $7.67 million, 99.6% of which was securities held by his revocable trust.
3. H's executor made a QTIP election as to $1,060,000 of assets passing to a QTIP trust, funded on October 6, 2000. While W was entitled to all income from the QTIP trust, no distributions were made to her from the trust. (The oldest son was the trustee of the QTIP trust.)
4. On October 9, 2000, the remaining assets in the revocable trust (approximately $3.6 million — apparently, there were significant market declines from the $7.67 million value at the date of death in early 2000) were distributed to W's revocable trust. (The opinion does not make clear, but the oldest son might also have been a co-trustee of W's revocable trust. He clearly was a co-trustee of the trust in 2003.)
5. On November 21, 2001, a certificate of limited partnership was filed for Miller Family Limited Partnership ("MFLP") on the advice of W's estate planning attorney. A December 31, 2001 valuation indicated that MFLP had marketable securities with a net value of about $3.8 million (net of a margin account payable), after applying a 35% discount. (Apparently this was based upon amounts that the oldest son said would be contributed to the partnership.) A limited partnership agreement was signed in late February, 2002 and a revised agreement was signed and limited partnership units certificates were issued in late March, 2002. The documents reflected that W owned 92% of the units as a limited partner, and four children owned the remaining 8% — each owned a 2% limited partnership interest except that the oldest son owned a 1% general partnership and 1% limited partnership interest.

6. Despite the filing of the certificate (in November 2001) and the subsequent signing of the partnership agreement and issuance of units certificates in February-March of 2002, no assets were actually contributed to MFLP until April 2002. [Observe: When assets were contributed to MFLP, the four children already owned 8% of the partnership units.] W contributed about 77% of her assets to MFLP. (The court acknowledged that she retained enough assets to pay her day-to-day living expenses.) Within days of contributing securities to MFLP, the partnership sold some securities and distributed cash back to W's revocable trust to pay off the net liability on her margin accounts.
7. H had taught the oldest son his special charting and securities management process, and W wanted the oldest son to continue managing the family assets using that process after H died. The oldest son actively managed the securities in MFLP (through his wholly owned company). He devoted about 40 hours a week to the management of the partnership assets, including continuing the sale and purchase analysis based on his father's charting system. Before W contributed assets to MFLP, her accounts made very few trades, and "trading activity increased after the securities were transferred to MFLP." However, the actual trading activity was relatively small ("about $3,000 to $4,000 per month"), representing sales and purchases of only about 1% per year of MFLP's securities.
8. On April 25, 2003, W fell and broke her hip. As with a lot of people in their 80s who suffer broken hips, various serious health problems followed. Within days, W had pacemaker implantation surgery and a subsequent surgery to repair her hip. A week later, W was moved from the hospital to a continuing care facility, but returned to the hospital on May 12, 2003 with congestive heart failure. On May 19, 2003, a CT scan revealed a traumatic brain injury, and W died on May 28, 2003.
9. The oldest son, in his capacity as co-trustee of W's revocable trust, transferred almost all of the remaining assets in the trust (about $878,000) to MFLP on May 15, 2003 (after knowing that W was in seriously declining health and suffered from congestive heart failure).
10. Eight months after W died, MFLP made a pro rata cash distribution to its partners of about $1.2 million, about $1.1 million of which passed to W's revocable trust. A portion of the $1.1 million was used to pay W's estate's federal and state estate tax liabilities.
11. W's estate tax return was filed on February 22, 2004, reporting a gross estate of about $2.64 million, almost all but about $48,000 of which consisted of W's limited partnership units in MFLP. A 35% discount was applied in valuing the units. The $878,000 of assets in the QTIP trust were not included in the gross estate (but the return did disclose the existence of the trust and that H's estate had been granted a marital deduction under §2056(b)(7) for assets in the QTIP trust).

Issues and Holdings:

1. Should the QTIP assets be included in W's estate, even though she did not in fact receive any income distributions from the trust?
   - The QTIP assets are includable in W's gross estate.
2. Is the full value of the partnership assets included in the gross estate under §2036, or do "those transfers [to MFLP] qualify for a discount"? [The IRS did not contest the amount of the discount (35%) if §2036 did not apply.]
   - The approximate $4 million of contributions to MFLP in April 2002 (13 months before W's death) qualified for the bona fide sale exception to §2036 because the driving force in the

creation of the partnership was to continue H's special approach to investing the securities and not tax savings.)

- The approximate $878,000 of contributions made in May 2003 (13 days before W's death) did not qualify for the bona fide sale exception because "the decline in her health and the decision to reduce her taxable estate were clearly the driving forces" behind the contribution. Section 2036(a)(1) was triggered, primarily because of the use of partnership assets to pay W's federal and state estate taxes.

Analysis:

1. Burden of Proof. Neither party addressed the burden of proof, and the court's decision was based on a preponderance of the evidence.

2. QTIP Inclusion. The estate argued that W never needed the income, never received income or distributions from the trust, and was therefore never considered to have an interest in the trust (or if she did have an interest, she "refuted it before her death.") The court rejected that argument. The instrument required that all income be distributed to W, H's estate made a valid QTIP election and was allowed a marital deduction, and W did not dispose of her income interest in the trust before she died.

3. Section 2036 Bona Fide Sale Exception — Positions of Parties.

   a. Taxpayer Position. The exception in §2036 for bona fide sales for full and adequate consideration applied because there were legitimate and significant nontax business reasons for the transfer to the partnership, including asset protection, succession of management, centralized management, and continuation of the family's investment strategy. Also, taxpayer pointed out "that the securities were actually transferred to MFLP and never co-mingled with decedent's personal assets, and partnership formalities were satisfied."

   b. IRS Position. "Respondent points to the following factors as evidence that the transfer was not bona fide: (1) MFLP's lack of a functioning business operation; (2) the delay in making contributions to MFLP after MFLP was formed and the partnership agreement was signed; (3) the type of assets transferred; (4) decedent's age; (5) that decedent stood on both sides of the transaction; (6) decedent's failure to retain sufficient assets outside of MFLP; and (7) the stated reason for MFLP's formation [apparently referring to the reason of buying, selling and trading securities]."

   c. Full Consideration Requirement Not Contested. The IRS apparently did not argue that contributions to the partnership failed to satisfy the full consideration requirement. The court simply quoted Bongard in saying that the exception applies in the context of an FLP "where the record establishes the existence of a legitimate and significant nontax reason for creating the family limited partnership, and the transferors received limited partnership interests proportionate to the value of the property transferred."

4. April 2002 Contributions to MFLP; §2036 Bona Fide Sale Exception Applies.

   a. Continue H's Investment Philosophy.

      "Decedent established and funded MFLP to ensure that her assets continued to be managed according to Mr. Miller's investment philosophy...

… We find credible the witnesses' testimony that the driving force behind decedent's desire to form MFLP was to continue the management of family assets in accordance with Mr. Miller's investment strategy.

… Decedent wanted her assets to be traded according to her husband's investment philosophy and set up MFLP to do just that. Virgil G [i.e., the oldest son] was the only family member versed in Mr. Miller's trading philosophy, and he was given authority to trade securities on behalf of MFLP."

b. Active Trading. The court emphasized the active management of the partnership assets by the oldest son. "Before contribution, the assets in decedent's accounts were not regularly traded. However, Virgil G. began monitoring and trading the assets regularly once they were contributed to MFLP."

c. Business Not Required; Marketable Securities Partnership. The IRS argued that the trades MFLP actually made were not sufficient "to qualify MFLP as a legitimate operation." Also, it argued that the types of assets (i.e., marketable securities) weigh against the finding of a valid nontax business purpose. The court disagreed.

> "MFLP's activities need not rise to the level of a 'business' under the Federal income tax laws in order for the exception under section 2036 (a) to apply [citing Mirowski and Stone]. Respondent's argument concerning the types of assets transferred fails for the same reason. The nontax purpose behind formation of MFLP was to continue Mr. Miller's investment philosophy and to apply it to family assets. This goal could not have been met had decedent not transferred securities to MFLP."

The court distinguished the Thompson and Rosen cases, which had referred to the absence of a business enterprise, because those cases involve "property that was not actively managed by family limited partnerships."

d. Age and Health. The IRS argued that the transfers were made to MFLP because the decedent's health was failing and to reduce her taxable estate. The court did not agree. At the time of the April 2002 transfers, "decedent, although dealing with some chronic conditions, was generally in good health. Neither decedent nor her family expected any significant decline in decedent's health in the near future."

e. Retained Sufficient Assets. The IRS argued that the decedent would need to rely on the distributions from MFLP to pay living expenses. The court disagreed, pointing out that she kept about $1 million in securities and also was a beneficiary of the QTIP trust. The sale by the partnership and distribution to W's revocable trust to pay off the margin account was not evidence of retained personal enjoyment. "This is not an example of partnership funds being used to pay personal expenses of the decedent."

f. Delay and "Standing on Both Sides of Transaction" Arguments Not Addressed. There was a significant delay between the date of filing the certificate of limited partnership, and the signing of the partnership agreement, and the funding of the partnership, but the court did not see any need to respond to the "delay in funding" argument at all. The court began its discussion of the bona fide sale exception with a general statement that it applies "where the transferor 'has received benefits in full consideration in a genuine arm's length transaction.' Estate of Goethchius v. Commissioner, 17 T.C. 495, 503 (1951)." It made no further mention of the "standing on both sides of the transaction" issue.

g. Summary. The bona fide sale for full consideration exception applied, so §2036 did not apply to the partnership assets attributable to the April 2002 contributions.

5. May 2003 Contributions to MFLP; §2036(a)(1) Applied.

a. Bona Fide Sale Exception Not Apply Due to Poor Health.

"In addition to breaking her hip, decedent had just undergone pacemaker implantation surgery. Further, decedent's rehabilitation was not progressing, and she was forced to return to the hospital with congestive heart failure.

The witnesses' testimony that decedent's family hoped for her recovery is credible, but her health was in decline. Given the lapse in time between the April 2002 contributions and the May 2003 contributions, the decline in her health and the decision to reduce her taxable estate were clearly the driving forces behind Virgil G."s decision to make additional contributions to MFLP."

b. Post-Death Distributions to Pay Estate Tax Evidences §2036(a)(1) Retained Enjoyment. After determining that the exception to §2036 did not apply, the court then had to determine if §2036(a)(1) applied by virtue of the decedent's retention (either directly or by implied agreement) "the possession or enjoyment of, or the right to the income from, the property." The court primarily pointed to the post-death distribution of $1.1 million to W's revocable trust, which was used to pay federal and state estate taxes, as causing §2036(a)(1) to apply, quoting the 5th Circuit opinion in Strangi: "[P]art of the 'possession or enjoyment' of one's assets is the assurance that they will be available to play various debts and expenses upon one's death."

There were pro rata distributions to all partners, but the court viewed the approximate $100,000 distributions to the four children "as de minimis amounts."

After discussing the post-death distribution for paying estate taxes in a full page of the opinion, the court also briefly observed that the 2003 transfer resulted in completely depleting W's resources (citing Strangi, Rector, and Rosen). "It is inconceivable that had decedent recovered and faced, for example, increased day-to-day living expenses or catastrophic medical costs, Virgil G., as general partner of MFLP, would not have provided her with access to the securities used to fund MFLP."

Observations:

1. "Cut to the Chase" on Discounting. The court phrased the issue regarding the FLP matter as whether transfers to the partnership qualified for a discount. That is the ultimate effect of a successful §2036 argument, but the court cut right to the bottom-line effect.

2. QTIP Ruling Not Surprising. The court readily concluded that inclusion of QTIP assets in the spouse's estate under §2044 cannot be avoided by merely failing to make distributions of income to the surviving spouse. That result seems clearly correct.

3. One of Relatively Few Successes For Taxpayers Under §2036. Only six prior cases held that the taxpayer established that 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); and Mirowski (joint management and keeping a single pool of assets for investment opportunities). This is now the seventh FLP case in which the taxpayers have survived an attack under §2036 (at least as to part of the assets contributed to FLPs). (This case continues the unbroken string of analysis in cases resulting in taxpayer successes against a §2036 attack — in every case the court relied on the bona fide sale exception to §2036.)

Interestingly, four of those seven 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 Church and Kimbell were federal district court opinions ultimately resolved by the 5th Circuit.)

Including the partial inclusion of FLP assets in Miller (with respect to the 2003 contributions 13 days before death), 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, Disbrow, Rosen, Erickson, Gore, Rector, Hurford, Jorgenson, and now Miller. In addition, the district court applied §2036 in Kimbell, but the 5th Circuit reversed.

4. Successful Nontax Reason — Preserve Investments Strategy, Provide Active Management, Change of Investment Activities. The court emphasized that the driving force behind the 2002 transfer was to continue the management of the family's assets according to H's investment strategy, that the partnership had active management, and that the nature of the management of the assets changed after assets were contributed to MFLP.

Observe that some courts have suggested that proper management could be provided by the trustee of the revocable trust rather than by needing to form an FLP. In this case, the oldest son could have provided the same management services as co-trustee or agent of the revocable trust. (Indeed, after MFLP was created, he gave investment advice to other family members.) In this respect, the court's observation that the purpose of continuing Mr. Miller's investment philosophy "could not have been met had decedent not transferred to securities to MFLP" seems to be somewhat of an overstatement. In Bigelow v. Commissioner, 503 F.3d 955 (9th Cir. 2007), affg, T.C. Memo 2005-65, the court held that providing management did not constitute a nontax reason for creating the partnership, reasoning in part that decedent's son managed the property as trustee of her revocable trust, and nothing changed after the property was contributed to the FLP. See also Rector (ownership and management of assets was the same as in the revocable trust).

In addition, while the son worked 40 hours a week on the partnership management, the extent of the actual transfers was rather small, resulting in a turnover of only about 1% of the partnership assets each year. The court distinguished Thompson and Rosen on the basis of the presence of active management rather than just passively holding marketable securities. Having more actual sales would seem to provide a stronger active management argument.

5. Business Purpose. It is not essential to have an operating business. This partnership held 100% marketable securities. The court clearly focused on active management rather than requiring activities that "rise to the level of a 'business' under the Federal income tax laws."

6. Satisfying Qualified Purchaser and Accredited Investor Rules. Analogous to the concern of providing appropriate managements of a securities portfolio is the very real concern of being able to qualify for investment opportunities available only to qualified purchasers and accredited investors. A concern of many wealthy families is that the parents have sufficient wealth to qualify as "qualified purchasers" (which generally requires that individuals have $5 million of net

"investments" — not including the home or assets that are not held for investment) and "accredited investors" and are able to invest in unregistered securities, but their children may not. Pooling of assets in this situation, to allow the flexibility of making future investments in such opportunities if they arise, is an important nontax reason for pooling investments in a partnership. That reason apparently did not exist in the Miller situation, but if it applies in another family situation, highlight that nontax reason. (It is important to implement such an investment program under the actual operation of the partnership.)

7. Post-Death Payments of Estate Taxes by Distributions From Partnership Assets. With respect to the May 2003 contribution, the court looked *primarily* to post-death distributions from the partnership that were used to pay the decedent's estate tax liabilities as the justification for finding retained personal enjoyment of assets contributed to the partnership triggering the application of §2036(a)(1). Furthermore, the partnership did not just make payments directly to the IRS as an implied non-pro rata distribution, but instead made pro rata distributions to all partners, and the decedent's revocable trust used its distribution to pay estate taxes. Still, the court viewed the post-death distribution, the estate's pro rata portion of which was used to pay estate taxes, as indicating retained "personal enjoyment" under §2036(a)(1).

   This is now the *seventh* case that has viewed the use of partnership assets to pay post-death obligations as triggering §2036(a)(1). The prior cases are the Rosen, Korby, Thompson, Erickson, and Jorgensen Tax Court cases and the Strangi Fifth Circuit Court of Appeals case. Miller and Erickson are two cases in which the court looked *primarily* to post-death distributions and redemptions to pay estate taxes as triggering §2036(a)(1).

   Not all judges take the same view; Judge Chiechi was not troubled by post-death payments of estate taxes and other liabilities of the decedent's estate in Mirowski. However, many judges clearly now do take that position.

8. Don't Be Piggish With Deathbed Contributions. By making the 2003 contributions of almost all of the decedent's assets while she was "circling the drain," the family risked tainting the entire FLP with an overall purpose of getting estate tax discounts. Some judges may have viewed the situation differently.

9. Arm's Length Negotiations. There were statements in the Jorgensen case placing more emphasis on having arm's length negotiations to satisfy the bona fide sale requirement than in any of the prior cases. However, the court did not mention the complete absence of negotiations in this case as a factor regarding the bona fide sale issue.

10. Indirect Gift. This is an estate tax case, and the opinion does not indicate whether the IRS took the position that the initial and subsequent contributions to the partnership constituted indirect gifts of an undivided 8% interest in the assets contributed (without a discount based on partnership restrictions). If not, the estate was fortunate that the IRS did not catch that argument.

11. IRS Not Contest 35% Discount For Marketable Securities FLP. The IRS only contested whether §2036 applied; it did not contest the applicability of a 35% discount for this partnership that consisted entirely of marketable securities.

12. Appealable to 7th Circuit. The decedent's executor resided in Indiana, so the case is appealable to the 7th Circuit Court of Appeals.

13. Planning Implications From Miller. If possible, include the following in the planning structure.

    a. Change the management of the assets in some significant manner.

    b. Provide for active management rather than merely passively holding partnership assets.

c. Do not transfer all (or almost all) of the owner's assets to the partnership.

d. Retain assets for living expenses.

e. Retain assets for paying estate taxes (or at least a substantial part of the estate taxes, or make arrangements for other family members to purchase the decedent's interest in the FLP without using the FLP's assets).

f. Do not make transfers of partnership interests until after the partnership has been funded. The IRS could clearly take the position in situations like Miller that the gift tax amount is based on a pro rata value of assets contributed rather than the discounted increased value of the donees' limited partnership interests.