Estate of Malkin v. Commissioner, T.C. Memo. 2009-212 (September 16, 2009)

IRS Defeats Aggressive FLP Planning; Issues Involving §2036, Indirect Gifts, and Sham Sales and Loans

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Synopsis

The case involves the creation of and sales of interests in two different FLPs to two different sets of trusts for decedent's son and daughter. Decedent was the sole general partner of both FLPs. The decedent contributed about $16.8 million worth of "D&PL" shares to the first FLP ("MFLP"). After the partnership was funded and limited partnership interests were sold to trusts for the children, decedent was diagnosed with pancreatic cancer. About one year after funding the FLP, the partnership pledged almost all of its assets toward a personal debt of decedent, and decedent paid a small fee to the partnership (0.75%) for doing so. Those shares were included in the estate under §2036; the pledging was evidence of an implied agreement of retained enjoyment, and the purported non-tax purposes did not meet the bona fide sale exception to §2036.

Contributions of some D&PL stock and various LLC interests to the second FLP ("CRFLP") were also subjected to transfer tax without a partnership level discount. The D&PL shares were contributed subject to a personal liability of decedent, and that evidenced an implied agreement of retained enjoyment under §2036. Contributions of decedent's interests in the LLCs to CRFLP were treated as indirect gifts of the LLC interests themselves (with no FLP level discount). The trust partners were deemed to be partners before the funding. The court viewed purported sales of limited partnership interests to the trusts as sham transactions and treated the transfers as gifts; therefore the LLC interests were treated as indirect gifts to the trusts. Subsequent contributions to the LLCs (in which the decedent no longer owned a direct interest) were treated as indirect gifts to the decedent's children.

Various cash loans to decedent's children were treated as gifts because there was no expectation of repayment. The estate was insolvent at decedent's death, and deductions were allowed only up to the amount of assets subject to claims. (For purposes of determining the assets subject to claims, the court made clear that there should be no "double inclusion" and that decedent's interest in CRFLP that he retained at his death should be determined without including any of the D&PL stock in that partnership that was included in the estate under §2036.)

Basic Facts

(1) Decedent had been Chairman and CEO of Delta & Pine Land Co. ("D&PL"). He held substantial stock and options and wanted to transfer over $16 million worth of shares to his son and daughter.

Facts Related to MFLP and D&PL Stock

(2) Decedent created trusts for each of his two children and gave $500,000 collectively to the trusts.

(3) On August 31, 1989, the Roger D. Malkin Family Limited Partnership ("MFLP") was formed. Decedent contributed D&PL shares worth about $16.8 million in return for a 1% general partnership ("GP") and a 98.494% limited partnership ("LP") interest. The two trusts collectively contributed $50,000 for 0.506% LP interests collectively.

(4) The same day, decedent sold 88.594% LP interests to the two trusts, collectively, for approximately $880,000 cash and 9-year $7.96 million secured SCINs (reflecting a discount of about 40%). The sale transactions were structured with consideration consisting of 10% downpayments and 90% notes.

(5) At the end of each of the first two years (before decedent died), decedent appeared to make gifts of cash to the children, which they loaned to their respective trusts, and which the trusts used to make the interest payments to decedent. (Footnote 17 says this definitely happened both years for the son and at least one year for the daughter.)

(6) In May 1999, decedent was diagnosed with pancreatic cancer [one of the most lethal cancers].

(7) On September 24, 1999, decedent, as GP of MFLP, pledged almost all of the partnership's D&PL shares to Bank of America to secure decedent's personal debts. (Decedent and two trusts had signed a resolution authorizing the pledge.) Over two months later, decedent gave the partnership a personal guaranty and agreed to pay the partnership a fee of 0.75 percent for the $4,345,000 pledge. [Observe, the value of the D&PL shares appear to have dropped in value from $16.8 million to $4.3 million in a little over a year. The opinion does not describe the value of decedent's other assets at that time, but when he died several years later, he had an insolvent estate.]

(8) Apparently, decedent refinanced his personal debt with Morgan Guaranty, and in April and June, 2000, all of the partnership's D&PL shares were pledged to Morgan Guaranty to secure decedent's personal debt. Decedent again gave a personal guaranty to the partnership and paid a 0.75% fee to the partnership for its pledge.

Facts Related to CRFLP and LLC Units

(9) Decedent and the son owned various interests in five LLCs (Malkin I, Malkin II, Malkin III, Malkin IV, and Malkin V) that owned interests in private equity ventures and interests in a partnership.

(10) On February 29, 2000 (almost a year after decedent was diagnosed with pancreatic cancer), three events occurred:

a) Decedent and two new trusts for son and daughter [although the trusts had not yet been formed] signed the partnership agreement for Cotton Row Family Limited Partnership (CRFLP);

b) Decedent transferred all of his interests in the LLCs to CRFLP in exchange for 1% GP and 99% LP interests [observe: decedent was initially the purported sole partner of the partnership — which, of course, does not create a valid partnership]; and

c) Decedent contracted to sell about 89% of his LP interests in CRFLP to the two trusts, for combined cash downpayments of $80,100 and 9-year secured notes totaling $721,000. (SCINs were not used because at the time of this sale, the parties knew of decedent's cancer and that using SCINs "would not [have been] appropriate." Footnote 17.)

(11) The next day (March 1), decedent signed documents creating the two new trusts.

(12) A week later, decedent gave about $81,000 to the trusts, and two days later, the trusts paid decedent the $81,000 as the cash downpayment and signed the promissory notes. (The court observed the $900 discrepancy between the downpayment amount under the agreement and the amount actually paid)

(13) In November 2000, decedent transferred 80,000 D&PL shares to CRFLP. Decedent had previously pledged the shares as collateral for his personal debt, and the shares were contributed encumbered by the pledge.

Basic Facts Related to Various Loans and Indirect Gifts

(14) In 1998, decedent paid a $64,760 debt of Malkin I (when he owned 30% and his son owned 70% of Malkin I).

(15) In May 2000, after decedent no longer owned any interest in the LLCs, he paid various debts of the LLCs, including a capital call.

(16) In June and November of 2000, decedent transferred various amounts to son and daughter in return for promissory notes (which both later testified they did not remember signing).

Decedent's Death and Estate Tax Return

(17) Decedent died on November 22, 2001.

(18) On March 1, 2002, the estate tax return was filed by the son and daughter as executors of the estate. [The filing was late; with a 6-month extension, the return was due on February 22, 2002. The opinion does not address late filing penalties.] The return reflected an insolvent estate. It reported assets of about $15.5 million to satisfy debts, and there were also two accounts of about $1.25 million that were omitted from Schedule C. The return claimed Schedule J, K, and O deductions of about $18.3 million, the largest claims being a $12.9 million loan secured by D&PL stock worth $10.475 million and a $2.3 obligation to Malkin IV.

Holdings

(1) All of the D&PL shares contributed to MFLP and CRFLP are included in the estate under §2036(a)(1).

(2) The contribution of LLC units to CRFLP by decedent was an indirect gift (i.e., no FLP level discount) "to his children of his interests in the Malkin LLCs". [As discussed below, it seems that the transfers should be indirect gifts to the trusts only to the extent of their interests in CRFLP.]

(3) Decedent's payment of debts of the LLCs (including a capital call) constituted indirect gifts to the children.

(4) The purported cash loans to the children were gifts; the purported loans were a sham because there was no intent to repay the loans.

(5) The estate did not present proof that decedent was personally liable for the loan secured by D&PL stock; the note is treated as a non-recourse note and is deductible only to the extent of the value of the collateral (which was included in the estate under §2036 even though the collateral was owned by MFLP and CRFLP).

(6) Schedule J, K, and O deductions are allowed to the extent they are actually paid and do not exceed the value of property in the estate subject to claims.

Analysis

(1) <u>Burden of Proof</u>. The estate had the burden of proof and did not argue that the burden shifted to the IRS under §7491(a). The court concluded that §7491(a) does not apply "because petitioners have not produced any evidence that establishes the preconditions for its application." It is hard to tell if the burden of proof was the key to any of the holdings, but it is interesting that the court concluded the discussion of each issue by stating that the estate had failed to satisfy its burden of proof.

(2) <u>Section 2036 Inclusion of D&PL Shares</u>.

   (a) <u>Bona Fide Sale Exception Did Not Apply</u>. The estate offered three nontax reasons for the partnerships, which the court rejected.

      (i) Providing for children and keeping growth in the children's hands, not the decedent's hands — The court responded by quoting from <u>Bongard</u>:

> "a 'good faith' transfer to a family limited partnership must provide the transferor some potential for benefit other than the potential estate tax advantages that might result from holding assets in the partnership form."

(ii) Preventing the sale of the family's D&PL shares — The court observed:

> "Had decedent wanted to prevent the sale of any D&PL stock his family owned, he would have demanded (or at least requested) that his son contribute his own D&PL stock. He did not. Obviously, decedent did not need the FLPs to control his own D&PL stock; he already controlled it."

[**Observe:** This argument is similar to the rationale in the <u>Schutt</u> case where the purpose was to preserve the family's duPont stock held in various trusts. In that case, all of the trusts' and decedent's shares were transferred to a Delaware Business Trust — unlike this case where only decedent's shares were transferred to the partnership. The opinion does not cite the <u>Schutt</u> case.]

(iii) Centralized management — The court rejected this because there was no pooling of assets: "[t]he property the FLPs passively held, i.e., the D&PL stock, was simply decedent's wealth."

The court's conclusion as to the bona fide sale exception:

> "Favorable estate tax treatment was the aim of the change in form. We are unable to identify a legitimate and significant nontax reason for the transfers...We find that decedent's transfers of D&PL stock to the FLPs achieved nothing more than testamentary objectives and tax benefits, and thus those transfers do not qualify for the bona fide sale exception in section 2036(a)."

(b) <u>Retained Interest</u>. The pledge of the D&PL shares held by MFLP to secure D's substantial personal debt [observation: at a time that his estate appeared to be in severe financial trouble] reflects at least an implied agreement of retained enjoyment. The estate argued that this was just an investment decision by MFLP. The court concluded that the estate failed to show that the decision to pledge the partnership's shares was made at arm's length. (i) The estate offered no evidence to prove that the 0.75% fee the decedent paid to MFLP was a reasonable fee. (ii) The estate did not explain "what business purpose of MFLP" the pledge served.

CRFLP did not pledge its D&PL shares, but they were encumbered by a pledge at the time they were contributed to the partnership (similar to the situation in <u>Bigelow</u>). The court concluded that

> "we see no relevant distinction between CFLP's pledging shares itself and receiving previously pledged shares. See <u>Estate of Bigelow v. Commissioner</u>, <u>supra</u>. In either case, CRFLP holds property pledged to discharge a personal obligation of decedent."

Because the court concluded there was an implied agreement of retained enjoyment under §2036(a)(1), it did not address the IRS's argument that there was also an express agreement of retained enjoyment. Also, it did not address the IRS's arguments for inclusion of the D&PL shares under §§2035 and 2036(a)(2).

(3) <u>Indirect Gift of LLC Units Contributed to CRFLP</u>. The court reasoned that the facts "are indistinguishable" from the facts in <u>Shepherd</u>. In that case, a father deeded land to a partnership, but his sons did not sign the partnership agreement until the next day. The partnership agreement

was only effective after one of the sons had signed the agreement because state law did not recognize a "one person partnership," and the deed was not effective until the partnership existed. The creation of the partnership preceded the effectiveness of the deed, and the transfer of land to the partnership was treated as an indirect gift to each son of an undivided 25% interest in the land. While LLC interests were purportedly transferred to CRFLP before the trusts acquired interests in CRFLP, the case is similar to Shepherd.

> "Only after CRFLP was validly formed on March 1, 2000, could decedent transfer his interests in the Malkin LLCs to it. Thus, at the time of that transfer, the CRFLP trusts were already limited partners, and they acquired interests in the Malkin LLCs by virtue of their status as limited partners."

A difference from Shepherd is that the trusts purportedly acquired their interests by purchase rather than by gift. However, the court viewed the purported purchase as a sham and treated the transfer as a gift. (i) At the time of the "sale," the decedent was terminally ill; (ii) the decedent provided all the cash for the downpayment even though the children both had the ability to pay a downpayment, so the decedent's actions do not reflect an arm's length sale; and (iii) there is no evidence that decedent expected the trusts (or the children) to pay the notes, particularly in light of the fact that decedent gave his children the money for the first set of trusts to make the interest payments on the notes for purchasing the MFLP interests. [Observe: the fact that the children did not make the downpayments from their own funds may be explainable — if the purchasing trusts were grantor trusts, they would no longer have been wholly grantor trusts as to decedent if the children made contributions to the trusts to make the downpayments. The children could have loaned the amounts to their trusts, but that would have left the trusts with almost no "equity cushion" let alone having equity of 10% following the purchase of CRFLP LP interests.]

[**Observe:** It would seem that there could still have been an indirect gift even if the sale had been respected. The contribution to the partnership was effective only after a partnership existed, and that occurred only after the transfers to the trusts. Therefore, the conclusion may still have been that the contribution was an indirect transfer to the other partners at that time, however they acquired their interests. The effect would be that the purchase price would not have equaled the fair market value of the indirect transfers, determined without an FLP level discount, so a gift would have resulted only to the extent of the difference in value. Under the court's reasoning, the entire value of the LLC interests transferred to CRFLP was treated as a gift.]

[Observe that an appropriate discount would be allowed for the value of the LLC interests; the indirect gift holding just precludes an additional level of discount for the LP interests.]

(4) Cash Loans Treated as Gifts. Decedent's various loans to his children were not respected as loans but were treated as gifts.

Loans to the daughter of $68,000 and $149,000 in 1998 and 1999 were not evidenced by promissory notes, and the daughter "never repaid a dollar on the alleged debt." The daughter's testimony that she offered to repay the debt but decedent told her to keep it in her company was not credible because the daughter closed her company in 1999 to take care of decedent. The court viewed the transfers as decedent's attempt, after almost a decade of estrangement, to reconcile with his daughter.

Loans to the son and daughter of $830,000 and $100,000 in 2000 also were not respected. While there were notes, the son testified that he did not recall signing a note and that a portion of the advanced funds were to pay his family's travel expenses while visiting decedent during his illness. The daughter testified that she did not recall the transfer at all. Decedent never demanded any payments, and neither child made any note payments. The court quoted Rosen (which discussed when notes would be respected in the context of §2036):

> "Security, adequately stated interest, and repayment arrangements (or efforts to secure the same) are important proofs of intent, and such proofs are notably lacking here."

(5) Transfers to LLCs as Indirect Gifts. Decedent's transfers to the LLCs (most of which were made when he no longer owned *any* direct interest in the LLCs) were treated as indirect gifts to his children. [Observe: This is confusing. The second set of trusts, not the children, were the 89% limited partners of CRFLP, which owned what had previously been decedent's interests in the LLCs. Decedent retained an 11% interest in CRFLP. It would seem that the gifts should be to the trusts, but only to the extent of their 89% ownership interests in CRFLP. The opinion says that the gifts were made "to the beneficial owners of Malkin I and Malkin IV (i.e., his children)."] The estate argued that decedent was personally liable for debts "by virtue of his having made capital commitments to two of the LLCs." However, the court reasoned that the estate did not satisfy its burden of proof "to explain how decedent could be obligated to contribute capital to an LLC of which he was no longer a member."

(6) Deductions. The largest claim was a $12.9 million debt secured by $10.48 million of D&PL stock. The IRS allowed that as a deductible expense only to the extent of the value of the collateral, in effect treating the debt as a nonrecourse debt. The court concluded that the estate failed to satisfy its burden of proof: "The several exhibits petitioners cite relating to the debt fail to show decedent was personally liable for it." [Observation: That does not make sense. Presumably the actual notes signed by decedent were offered as evidence and they would seemingly clearly specify if they were nonrecourse. However, the treatment of the debt as nonrecourse does not seem to impact the ultimate result, because there are not sufficient assets in the estate subject to claims to cover all of the deductions, even without adding the additional $2.4 million of purported personal liability on this debt.]

Various other debts, administration expenses and a charitable transfer are allowed as deductions only to the extent actually paid and only to the extent of the value of property in the estate subject to claims. [Observe: The charitable deduction must have been generated by something other than a charitable bequest since this is an insolvent estate.] (For purposes of determining the value of the estate subject to claims, the value of decedent's 11% interest in CRFLP must be adjusted by disregarding the D&PL shares as assets of CRFLP. Those shares are included in the estate under §2036 and there should not be double inclusion by also including them indirectly as assets of CRFLP.)

Planning Implications

(1) Bad Facts. In a variety of ways, this case illustrates how "not to plan" FLP and loan transactions. Having an FLP pledge almost all of its assets for a personal debt of decedent a year after the FLP is created and after substantial interests were transferred to trusts is highly indicative of an implied agreement of retained enjoyment. Perhaps there was an explanation — the D&PL stock appears to have cratered in value during that year and perhaps all of the financial difficulty was totally unanticipated. Even so, such unusual actions seem consistent with the finding of an implied agreement that decedent could enjoy use of the partnership assets if needed. Furthermore, the court never had to get to the §2036(a)(2) inclusion argument based on the fact that decedent was the sole GP.

(2) Shifting Burden of Proof to IRS is Important. Judge Halpern appears to have viewed this as an egregious situation and it is impossible to know if any of his conclusions would have been

different had the burden of proof been shifted to the IRS under §7491(a). There is no explanation of why the estate failed to make the argument to shift the burden. There are no indications in the opinion that the estate failed to reasonably cooperate during the estate tax audit to be able to comply with the requirements of §7491(a)(2)(b), but the opinion concluded that the estate had not "produced any evidence that establishes the preconditions" for the application of §7491(a). It is clear, however, that the court many times in the opinion concluded its discussion of issues by observing that the estate did not satisfy its burden of proof.

(3) Pledge of All FLP Assets For Personal Debt. Pledging all of the FLP's assets to satisfy a personal obligation of the parent creates a huge red flag of an implied agreement of retained enjoyment.

(4) Contribution of Encumbered Property to FLP. This is the second case (the other being Bigelow, a 9th Circuit Court of Appeals case) that has treated a contribution of property, encumbered to satisfy a continuing personal debt of the parent, as retained enjoyment under §2036(a)(1).

(5) Bona Fide Sale Exception.

- This case, like most of the cases (other than Mirowski) have refused to recognize the facilitation of making gifts or estate planning transfers as a legitimate nontax reason to satisfy the "bona fide" requirement of the exception to §2036.
- If preserving the family's stock in a certain corporation is important, consider also having other family members (or trusts) transfer their stock to the partnership as well.
- Similarly, to support a centralized management claim, have other family members also contribute assets, so that centralized management of family assets results. However, some cases have not required "pooling" to support a centralized management nontax reason, including situations in which the partnership will be able to provide centralized management on a long term basis, after transfers are made to other family members. Furthermore, a partnership with contributions by parents and trusts for children may permit the trusts to invest in venture investments requiring a qualified purchaser and accredited investor where the trusts might not otherwise qualify. (If that is the nontax reason for the partnership, it is important to implement such an investment program under the actual operation of the partnership.)

(6) Respecting Sales — Ability to Make Cash Downpayment. The sales were planned to have a 10% downpayment, apparently to satisfy the common practice of having a 10% "equity cushion" to support the bona fides of a purported sale transaction. However, it seems suspicious in the case of the sale of CRFLP interests to the new trusts that the trusts had no ability to make the cash downpayment at the time of the sale and decedent made a cash gift to the trusts, after entering into the sale transaction, to permit the trusts to make the cash downpayments. (For MFLP, the trusts held about $450,000 cash before the sale, but not enough for the entire $880,000 downpayment. The validity of that sale transaction was not addressed, because the court found that the decedent had a §2036(a)(1) retained enjoyment of all assets in the partnership. The note was a SCIN, so the issue of double inclusion of partnership assets and the note did not arise for that partnership.) At a minimum, make a gift to the trust of cash sufficient to make required cash downpayments *before* entering into the sale transaction, so that the trust has the 10% equity value at the time of the sale transaction. [Query whether the IRS will make a step transaction argument if the gift is made soon before the sale?]

(7) Respecting Sales — Ability to Make Note Payments. The court specifically observed that decedent made cash gifts to the children, which they loaned to their respective trusts, in order for the trusts to make required annual interest payments on the MFLP sale transaction. The court concluded

that those actions suggested that decedent did not expect repayment of the loans in the subsequent CRFLP transaction. At the time a sale transaction is structured, the planner should consider how the purchaser will be able to make note payments.

(8) Follow Formalities to Assure Existence of Partnership Before Contributions to Partnership and Consider Step Transaction Doctrine. The indirect gift issue arose in this case because only one "partner" signed the partnership agreement before contributions were made. The partnership did not really exist until there were other partners, so the contributions were determined to have been made after the other partners held their interests. First, make sure there are multiple partners who have signed the partnership agreement and that all state formalities for creating a partnership are satisfied before making initial contributions to the partnership. Planning Tip: Do not structure the partnership (like the CRFLP Agreement) to reflect parent as the initial sole GP and LP owner with an agreement to sell LP interests to trusts. The partnership agreement should list some at least two partners at the outset. Second, include provisions in the partnership agreement clearly stating that if any partner makes a contribution to the partnership, it increases the capital account and sharing ratio of only that partner rather than being allocated pro rata to the capital accounts of all partners.

Furthermore, under the step transaction analysis of Holman, Gross, Linton, and Heckerman, there should be some appropriate lapse of time between the time of funding the partnership and making transfers of partnership interests. In Malkin, even if the contributions to CRFLP of LLC interests had clearly been effective before the transfers of LP interests to the trusts, the court may have still treated the transfers as indirect gifts of the contributed LLC interests under the step transaction doctrine if the transfers were made soon after the contribution. This is true particularly in light of Judge Halpern's reasoning in Holman and Gross that the step transaction doctrine applies if there is not a "real economic risk of a change in value" between the time of funding and a gift of partnership interests.

(9) Cash Advances; Respect Loans and Make Payments. Cash advances should be documented with formal promissory notes, and the borrower should actually make at least some payments on the notes. During the current economy with very low interest rates, simple loan transactions with interest at the AFR can be powerful transfer planning strategies. However, keep in mind that the formalities of arm's length loans transactions should be followed, including having solvent borrowers who can repay the loans (and having security arrangements if there are any questions about the borrowers' abilities to repay the notes.)

(10) Sole General Partner. Decedent in this case was the sole GP. That was not an important factor in this case because of the court's finding of a §2036(a)(1) retained enjoyment of the D&PL stock in MFLP and CRFLP and of an indirect gift of LLC interests in CRFLP. However, having a decedent as sole GP raises the specter of possible inclusion of all partnership assets (even following transfers of partnership interests) under §2036(a)(2); the taxpayer's defense would be that the GP's fiduciary duties would preclude §2036 inclusion under the reasoning of the Byrum U.S. Supreme Court case, but that defense was rejected by Judge Cohen in a controversial opinion in Strangi. In addition, having the decedent as sole GP seems to have assisted some courts in finding an implied agreement of retained enjoyment under §2036(a)(1), where there is a heightened suspicion that the GP has the ability to access the partnership assets personally if needed. Having the decedent as sole GP also raises the question of whether any (or much discount) is available for LP interests owned at death if the sole GP has the power to withdraw and force the dissolution of the partnership under the laws of many states.

(11) No Double Inclusion. The court observes that there should be no double inclusion of partnership assets both under §2036 and §2033, at least for purposes of determining the assets of the estate subject to creditors' claims. However, the court's language is broader than just determining the value of property subject to claims — footnote 23 says that "the value of the estate's Schedule F property" should be adjusted because the D&PL stock is included under Schedule G. Some commentators have suggested that when §2036 applies, the partnership assets would be included on Schedule G, the full value of the partnership interest would be included on Schedule F, and a "§2043 offset" reduction would be allowed for the value of assets contributed to the partnership at the time of the contribution. However, this court suggests that the same assets should not be included under both the "string" statutes and under §2033 for directly owned assets.