Estate of Shurtz, T.C. Memo. 2010-21 (February 3, 2010)

# Bona Fide Sale Exception to §2036 Applied Based on Asset Protection and Facilitating Management Concerns; Marital Deduction Mismatch Issue Avoided

**February 2010**

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## Synopsis

Wife and her siblings created a limited partnership (Timberland, L.P.) to own and manage undivided interests in timberland. Several years later, Wife transferred her 16% interest in that partnership to a new limited partnership (Doulos L.P., sometimes referred to below as Doulos) together with some timberland that she owned directly. Wife and Husband each owned a 1% general partnership interest and Wife owned a 98% limited partnership interest in Doulos. There were three reasons for creating the partnership. First, Wife and her siblings were concerned about "jackpot justice" in Mississippi and they were each advised to transfer their limited partnership interests in Timberland into their own limited partnerships. Second, Wife also wanted to transfer some directly owned timberland into a new partnership because she wanted to make gifts of interests in the timberland to her descendants and wanted to provide management of the timberland after making gifts. Third, Wife was interested in reducing estate tax. After creating the partnership, Wife made 26 annual exclusion gifts of limited partnership interests, reducing her limited partnership interest in Doulos to 87.6% by the time of her death.

The court held that the transfers to Doulos qualified for the bona fide sale exception to §2036, so neither §§2036(a)(1) nor 2036(a)(2) applied. The asset protection and management reasons were legitimate and significant nontax reasons. Full consideration was received because the partners received interests proportional to their contributions and capital accounts were properly maintained. Also, the formation of the partnership was arm's length because the transaction was carried out in the way that ordinary parties to a business transaction would do business with each other.

In an extension from prior cases, the court stated explicitly that tax savings should not be the "predominant motive" in order for the bona fide sale exception to apply. If that rationale were to be followed, nontax reasons must not only be "legitimate and significant" (as held in numerous prior cases), but must also be the "predominant" motive for the transfers to a partnership or LLC (or at least half of the underlying motive so that tax savings is not the "predominant" factor).

Because §2036 did not apply, the court did not have to decide whether the marital deduction would be limited to the fair market value of the Doulos limited partnership interests passing to her husband if the gross value of the assets in the partnership had been included in her gross estate under §2036, thus generating estate taxes at her death even though her husband survived and the revocable trust had a formula marital deduction clause. Also, late filing penalties did not apply because no additional estate tax was due.

## Basic Facts

1. Wife and her brother and sister owned undivided interests in family timberland that they contributed to a limited partnership (Timberlands L.P.) in 1993 to facilitate management of the timberland.
2. They were also concerned about "jackpot justice" they thought existed in Mississippi and an attorney advised that each of them should contribute their limited partnership interests in Timberlands L.P. to their own respective limited partnerships to help assure that if the business were sued they would not lose control of the family business.
3. Wife owned some additional directly owned timberland. She wanted to make gifts of interests in the timberland to her descendants and was concerned about management of undivided interests that would exist if she made gifts of undivided interests in the

timberland. Wife wanted to create a partnership to hold the timberland to provide for management after making gifts.

4. In 1996, Wife made a gift of a small undivided interest in the timberland to Husband, and Wife and Husband created their own family limited partnership, Doulos. Husband's undivided interest in the timberland was valued by an accountant to be equal to a 1% general partnership interest in Doulos. Wife contributed the rest of the land and her 16% limited partnership interest in Timberlands, L.P. to Doulos in return for a 1% general partnership interest and a 98% limited partnership interest.

5. After creating the partnership, Wife made annual exclusion gifts to her children and trusts for her grandchildren. (There were 26 gifts of 0.4% interests — each valued at $19,700 or less — between 1996 and 2000.)

6. Partnership formalities were not always followed perfectly. Instead of maintaining "books of account," as required by the partnership agreement, the accountant created "work papers like a trial balance" to prepare the partnership's tax returns. There was a four month delay in opening a partnership bank account. Because the partnership bank account was a money market fund with limited checks that could be written each month, Husband and Wife paid some of the partnership expenses and were reimbursed (and amounts that were not reimbursed were added to their capital accounts).

7. In addition, there were some disproportionate distributions. Distributions were made just to Wife in 1997 and to Husband and Wife in 1999. A disproportionately large distribution was made to Wife in 2000. The partnership made equalizing distributions to the other partners in subsequent years. (Other than mentioning the formalities discrepancies in the facts, the court did not comment on them further. Apparently, they were not a significant concern to the court.)

8. The estate plan of Husband and Wife included a bequest to a credit shelter trust and a formula marital deduction bequest at the first spouse's death. Wife died on January 21, 2002.

9. The estate tax return was filed 8 months after the extended due date. (The planners believed no tax was due because of the marital deduction so were not concerned about failure to file penalties.) The major assets in Wife's estate were her 87.6% limited partnership and 1% general partnership interests in Doulos, but there were $1.5 million of other assets. (The opinion does not reflect how much discount was claimed on these interests. The estate may have claimed a dual level "tiered" discount for the Timberlands L.P. interest that was held within Doulos. The estate valued that 16% interest at about $10.0 million and the IRS valued it at about $13.3 million.)

10. The IRS argued: (1) Section 2036(a)(1) and (a)(2), combined with §2035(apparently with respect to gifts of limited partnership interests that were made within three years of Wife's death) apply to include most of the assets of Doulos in Wife's gross estate; (2) If §2036 applies, the marital deduction for the limited partnership interest is limited to its fair market value; and (3) Failure to file penalties apply under §6651(a)(1).

**Holding**

1. The court (Judge Jacobs) held that the bona fide sale exception to §2036 applied, so the partnership assets were not includible in the estate under §2036(a)(1) or (a)(2). Therefore, the court did not have to address the "marital deduction mismatch" issue and there were no late filing penalties.

**Analysis**

1. Bona Fide Sale Requirement. The bona fide sale test was met primarily because of two "legitimate and significant nontax reasons."
    a. Threat of Litigation. Wife and her siblings had a legitimate concern about preserving the family business, their "concern regarding the threat of litigation… went beyond mere speculation," establishing limited partnerships was a "customary response in Mississippi to possible lawsuits," and the partnership agreement was "designed to limit the exposure of partnership interests from seizure and the automatic conversion of general partnership interests to limited partnership interests." This reason was given primarily to justify the need to transfer the Timberland L.P. interests into Doulos. (Presumably, it would also be applicable to the timberland contributed to Doulos.)
    b. Facilitate Management. Having multiple undivided ownership interests in timberland impeded management of the farmlands owned by Wife and her siblings, and it was reasonable for Wife to form Doulos to provide management efficiency with respect to directly owned farmland in which she wanted to give interests to her descendants. Wife and Husband were consulted before any major decisions were made, and "business activities occurred with respect to the timberland." The court cited cases indicating that providing management is not a recognized nontax reason where there is no need for management. However, it is a recognized reason even though only a portion of the assets need management (the court calculated, based on the IRS's valuation of the assets of Doulos, that the directly owned timberland was 15.8% of the value of Doulos).
    c. Conclusion. "[A]lthough we recognize that reducing estate tax was a motivating factor in establishing Doulos L.P., decedent had valid and significant nontax reasons for establishing the partnership."
2. Full and Adequate Consideration Requirement. The parties met the tests described in Bongard. (1) Contributors received interests in the partnership proportionate to the assets that each contributed. (2) Contributions were properly credited to capital accounts. (3) Distributions were subtracted from the respective capital accounts. (4) "Fourth, and most importantly, we have found the presence of a legitimate and significant nontax business reason for the establishment of Doulos L.P…"
3. Arm's Length Transaction. The court said the bona fide sale for full consideration exception applies only where there was an arm's length transaction. The court's conclusion was that the formation of Doulos "was carried out in the way that ordinary parties to a business transaction would do business with each other."
4. Section 2036(a)(1) and (a)(2) Not Considered. Because the exception applied, the court did not have to address whether §§2036(a)(1) and (a)(2) applied. The court does not describe the IRS's arguments for alleging that those sections applied. (Wife's estate tax return listed $1.5 million of assets in addition to the interests in Doulos.)
5. Marital Deduction Mismatch Not Addressed. Because §2036 did not apply, the IRS did not have to address whether large estate taxes would be due at Wife's death because the marital deduction would be limited by the value of the partnership interests passing to Husband. (The IRS raised this same issue in Black.)
6. No Penalties. Because no tax was due, there were no failure to file penalties.

**Observations**

1. Appealable to 9th Circuit. The case is appealable to the 9th Circuit.
2. Tell a Good Story. This is another winning case for taxpayers where the estate had a "good story" to tell of missionaries who lived modestly and donated almost $1.0 million to charity between 1989-2001.
3. Formalities. Tax litigators indicate that the IRS scours partnership agreements to see if all formalities under the agreement are followed. Apparently that happened here, and the IRS complained that the partnership kept "work papers" instead of "books of account," waited four months to set up a bank account, and allowed the spouses to pay some partnership expenses for which they were later reimbursed or had adjustments to their capital accounts. The court did not seem concerned about these minor "glitches." Be aware that the IRS looks for glitches and will point them out.
4. Non Pro Rata Distributions. Some non pro rata distributions were made to Wife in several years and to Husband and Wife in one year. However, the partnership "made up the missed distributions in subsequent years." If possible, avoid non pro rata distributions. If they are necessary, make up the missed distributions as soon as possible.
5. Arm's Length Requirement. The case very clearly states that to meet the bona fide test, not only must there be "legitimate and significant nontax reasons" and proportional interests received with capital accounts, but there must be "an arm's length transaction." The court says (quoting Bongard) that means the transaction is "carried out in the way that the ordinary parties to a business transaction would deal with each other." Despite stating that there is a separate arm's length requirement, observe that in this case there were *not* significant contributions by others. Wife made a small undivided interest gift in the farmland to Husband, just because of the requirement of having multiple partners to create a partnership. Husband contributed that undivided interest for a 1% general partnership interest. Therefore, the court's statement of a separate arm's length requirement should not be interpreted to require having significant contributions to the partnership by other partners. Indeed, the court summarized at the end of its analysis of the exception to §2036 that the partnership was formed in the way ordinary parties to a business transaction would deal with each other. According to this court, that is what the "arm's length transaction" requirement means.
6. Nontax Reason Is Predominant Reason. The IRS argues that the nontax reason must not only be a legitimate and significant reason, but must be the "predominant" reason for creating the partnership. (It made this same argument in Black.) The court explicitly agreed with that argument, stating directly that "[a] finding that the transferor sought to save estate taxes does not preclude a finding of a bona fide sale *so long as saving estate taxes is not the predominant motive.*" The case cites Mirowski and Schutt. (Neither of those cases directly stated that the tax reason must not be the predominant reason.) This suggests that if there are nontax reasons that represent 49% of the purpose for creating a partnership but tax savings represent 51% of the real reason for the partnership, the bona fide sale exception would not be satisfied. *This is a new development, and is an extension of the Tax Court's legitimate and significant nontax reason test in Bongard and all prior §2036 cases.*

7. Bona Fide and Full Consideration Tests are Interrelated. This case continues the approach of other cases in saying that the bona fide test and full consideration tests are interrelated, citing Bigelow ($9^{th}$ Circuit). The bona fide test requires that proportionate interests be received for contributions in addition to having a legitimate and significant nontax reason, and the full consideration test requires "most importantly" the presence of a "legitimate and significant nontax business reason" in addition to the partners receiving proportionate interests and having properly maintained capital accounts. This is merely a matter of semantics; as a practical matter there must be both legitimate and significant nontax reasons, and proportionate interests with properly maintained capital accounts to satisfy both legs of the exception. (In addition, according to this case and some others, there must be an arm's length transaction.)

8. Active Business Not Required. Like the recent Black case and various other cases, the court went out of its way to point out (in footnote 11) that an FLP may be recognized "even if it does not conduct an active trade or business."

9. Convey an Interest to Persons Involved in Management. As a planning pointer, the court observed that Husband was involved in management and he acquired an ownership interest in the business. It cited Kimbell as a situation where giving the son, who managed the business, an ownership interest "was a factor in finding that a bona fide sale occurred."

10. Facilitating Transfers. Some cases have stated that facilitating transfers can never be a legitimate and significant nontax reason. For example, the $9^{th}$ Circuit Court of Appeals reasoned:

> "The Estate also argues that consolidation of the real property, with its fractionalized interests and absentee ownership, into an FLP facilitated management of the Padaro Lane property and enhanced the ease of gifting interests to decedent's children and grandchildren. The Tax Court correctly rejected this claim. First, gift giving is considered a testamentary purpose and cannot be justified as a legitimate, non-tax business justification." Estate of Bigelow, 503 F.2d 955 ($9^{th}$ Cir. 2007), aff'g same reasoning in, T.C. Memo. 2005-65.

This is a case (like some others) where a prime reason was to facilitate management, but this was in light of Wife's desire to make gifts of undivided interests in the timberland to her children and grandchildren. But for those gifts, Wife would have continued to own all of the timberland that she owned directly, and no management concerns over having undivided interests would have existed for her lifetime. Even though it was not stated explicitly, the concern over management was really a concern for management to facilitate gifts. (The estate in Keller listed making the passage of assets from generation to generation easier as one of the purposes of the partnership, in addition to divorce protection concerns.)

11. "Scorecard" of §2036 FLP Cases (11-19, With 2 on Both Sides). Of the various FLP cases that the IRS has chosen to litigate, eleven 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"), Black (maintaining buy and hold investment philosophy for closely held stock), and Shurtz (asset protection and management of timberland following gifts of undivided interests). 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 eleven 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, Judge Halpern decided Black, Judge Jacobs decided Shurtz, 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.

12. Never a Good Idea to File Late. This case is a good example of why it is never a good idea to file the estate tax return late intentionally, thinking that there is no tax due so no penalties could apply. If the IRS had been successful in its §2036 and marital deduction mismatch argument, there would have been large failure to file penalties.

13. Tiered Discounts. While the court does not explicitly address whether tiered discounts were allowed, the facts hint that they were. This is similar to Murphy and Astleford which also allowed tiered discounts where an FLP owned an interest in another partnership or LLC.

14. Annual Exclusions Not Contested. Even though there were 26 annual exclusion gifts of limited partnership interests over five years, the IRS did not contest the availability of the annual exclusion. We can anticipate that the IRS will be looking more closely at annual exclusions for gifts of limited partnership interests in light of the Price case.

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