TAX COURT CASE UPDATE

Citation:

Estate of Clyde W. Turner, Sr., et al. v. Commissioner, T.C. Memo 2011-209, August 30, 2011.

Overview:

In another Section 2036 case, the facts did not bode well for the taxpayer.

The Facts:

Clyde W. Turner, Sr. passed away on February 4, 2004. Prior to his death, the decedent had formed a successful lumber company with his bothers and used income generated by the company to acquire further wealth primarily comprised of stock in Regions Bank. The decedent's father was the first depositor to Regions Bank, with various family members serving on the board of directors. The decedent had a sentimental attachment to the Regions Bank stock, and banking stocks in general. In 2001, the decedent recognized that his and his wife's investments were "really in a scrambled situation" and contacted one of his grandsons to come up with an idea to manage their assets. In 2002, the family retained an estate planner who established the Turner & Company Limited Liability Partnership. The partnership was formed on April 15, 2002, and funded with cash, shares of Region Bank stock, other bank stocks, CDs, and various investment accounts. 60 percent of the assets by value consisted of the Regions Bank stock. At this point, the decedent was in his 80s and was in good health. He also retained $2 million of assets outside the partnership.

The three primary purposes listed in the partnership agreement were:

a. To make a profit,
b. To increase the family's wealth, and
c. To provide a means whereby family members can become more knowledgeable about the management and preservation of the family's assets.

In addition to the three general purposes, the agreement also listed nine specific purposes, including management by the best qualified person, elimination of fractional ownership, facilitation of gifting, protection of assets, creditor protection, protection against failed marriages, enhancement of family involvement with regard to investments, avoiding family disputes, and governing of family transfers.

On December 31, 2002 and January 1, 2003, the decedent and his wife gave limited partnership interests in the partnership to their three children and grandchildren. The values reported on the gift tax return were derived from an outside valuation. The decedent became seriously ill and passed on February 4, 2004. At his death, he still held a 0.5 percent general partner interest and a 27.8 percent limited partner interest in the partnership. In August 2008, the IRS issued a notice of deficiency in the amount of $660,000 in which the IRS determined

that the value of all of the assets the decedent had transferred to the partnership should be included in his gross estate under Section 2035, 2036, and 2038.

Discussion:

The purpose of Section 2036(a) is to include in a decedent's gross estate the values of inter vivos transfers that are essentially testamentary in nature. Section 2036(a) applies when three conditions are satisfied: (1) the decedent made an inter vivos transfer of property, (2) the decedent's transfer was not a bona fide sale for adequate and full consideration, and (3) the decedent retained an interest or right that he did not relinquish before death. Since the inter vivos transfer took place when the assets were transferred to the partnership in exchange for the general and limited partner interest, the primary analysis focused on points 2 and 3.

The bona fide sale exception depends on two requirements: (1) A bona fide sale, meaning an arm's-length transaction, and (2) adequate and full consideration. The Court went on to state that in the context of a family limited partnership, the bona fide sale exception is satisfied "where the record establishes the existence of a legitimate and significant nontax reason for creation of the partnership." To answer the question of a bona fide sale, the Court noted that it is a question of motive and that the Court had to determine if the record supported the notion that the decedent had a legitimate and significant nontax reason for forming the partnership. Initially the attention was turned to the partnership agreement. Since the Court noted that the three general purposes came from the law firm's template partnership agreement, the taxpayer asked the Court to specifically focus on some of the nine sub-reasons, primarily, the purpose of consolidating assets to perpetuate asset management, resolving family disputes and protecting the family assets.

The Court noted that the objective facts in the record failed to establish that any of these reasons was a legitimate and significant reason for formation of the partnership. Although the Court noted that the consolidation of assets could be a legitimate nontax purpose, consolidation is not a legitimate nontax purpose if the partnership is "just a vehicle for changing the form of the investment in the assets, a mere asset container." The Court also quoted from the *Estate of Harper*, stating that without significant activity within the portfolio, there exists nothing but a "circuitous recycling of value." In this case, the assets were all passive and there was very little change in them during the period the partnership existed prior to the decedent's death. The Court went on to state that the assets consisted of passive investments that did not require active management and that the decedent did not have a unique or distinct investment philosophy that he hoped to perpetuate.

The partnership as a significant tool to resolve family disputes was also dismissed by the Court. Although resolution of family disputes or promotion of family harmony may be a legitimate and significant nontax purpose, the Court could find no such purpose here. The Court found that any ill will among the children was not about money and could not be solved by way of the partnership. The Court discarded the argument as an after-the-fact hypothetical justification for the creation of the partnership.

The family asset protection reason also did not persuade the Court. Although the Court acknowledged that asset protection could be a legitimate and significant nontax reason for the formation of a partnership, the same argument was not found to be credible in this case. Although one of the grandchildren had a significant drug problem, previous transfers to this grandchild were made voluntarily and there was nothing in the record that indicated that the

grandson was a threat to the assets. Further, since $2 million were held outside the Partnership, exposure to this grandson continued.

Accordingly, the Court concluded that the transfers failed the bona fide sale prong of the bona fide sale exception.

The Court went on to list several additional factors indicating that the transfers were not bona fide sales. These reasons included:

- The decedent stood on both sides of the transaction
- The partnership was set up without involving the other family members
- The decedent commingled personal and partnership funds
- The decedent paid estate planning fees from the partnership's funds
- Assets were not transferred to the partnership until eight months after formation

The Court did find that the assets the decedent contributed to the Partnership were properly credited to his capital account and that he received an interest proportionate to the fair market value of his contribution. However, since the transfer failed the bona fide sale test, the fact that it passed the full and adequate consideration prong did not matter.
The Court concluded:

> The bona fide sale exception of section 2036(a) does not apply to The decedent's transfer of property to the Partnership. We therefore consider whether The decedent retained for his life the possession or enjoyment of the transferred property.

Property is included in a decedent's gross estate if the decedent retained, by express or implied agreement, possession, enjoyment, of the right to income from the transferred property. Factors indicating that a decedent retained an interest in transferred assets under Section 2036(a)(1) include a transfer of most of the decedent's assets, continued use of transferred property, commingling of personal and partnership assets, disproportionate distributions to the transferor, use of the entity's funds for personal expenses, and testamentary characteristics of the arrangement.

The first issue that the Court identified had to do with the management fees that the decedent was paying himself. Although the partnership agreement allowed for reasonable management fees, the Court found that $2,000 per month was excessive. This was specifically based on the Court's observation that evidence suggested that the decedent did not manage the partnership at all. The Court noted:

> This is not indicative of a business or investment activity conducted for profit. Rather, it resembles an investment account from which withdrawals could be made at will. This impression is reinforced by the provision in the Partnership agreement that gave The decedent the right, as general partner, to amend the Partnership agreement at any time without the consent of the limited partners.

The second issue had to do with the decedent's personal and sentimental attachment to the bank stock. The decedent had made it very clear that he was fond of the stock and it was never to be sold. The Court interpreted this as an implied agreement.

The Court also frowned upon the decedent drawing a management fee from the partnership although he had left enough assets outside of the partnership to fund his living needs. Further, the Court noted that the decedent used partnership funds to make personal gifts and to pay life insurance premiums on policies held by the decedent for the benefit of his children and grandchildren. Lastly, the Court noted that there was a case of commingling personal and partnership funds when he personally paid a debt incurred by the partnership.

A final issue that the Court took offense to was the vehement denial by the taxpayer and his professionals that during the course of estate planning, tax savings offered by a family entity were never discussed. The Court stated:

> We do not find testimony to that effect to be credible, and that lack of credibility infects all of the testimony petitioner offered about what The decedent allegedly said or intended about the purpose of the Partnership.

Conclusion:

In summary, the Court concluded that the formation of the partnership had testamentary characteristics and the decedent did not curtail his enjoyment of the transferred assets after formation of the partnership.

Although the Court did not need to address Section 2036(a)(2) issues, the Court went on to state that the decedent also retained the right, either alone or in conjunction with any person, to designate the person who shall enjoy or possess. The Court arrived at this conclusion by noting that the decedent, as general partner, had the sole and absolute discretion to make pro rata distributions of partnership income and to make distributions in kind. Further, the decedent had the authority to amend the partnership agreement at any time without the consent of the limited partners.

In summary, the Court concluded that under Section 2036, all transferred property was includible in the decedent's gross estate.