TAX COURT CASE UPDATE

Citation:

Estate of Paul H. Liljestrand v. Commissioner, T.C. Memo 2011-259, November 2, 2011.

Overview:

Sustaining an estate tax deficiency of over $2.5 million, the Tax Court held that real estate transferred from a revocable trust to a family limited partnership was includible in the trust grantor's gross estate under Code Section 2036.

The Facts:

Dr. Paul H. Liljestrand practiced medicine in Hawaii from 1939 until he retired in 1978. One year after retiring, he exchanged a hospital building located in Hawaii, where he continued to live, for various properties in Oregon, California, Arizona and Florida. In 1984, one of his four children, Robert, took over management of the real estate. In that year, Dr. Liljestrand transferred the real estate to a revocable trust (Trust). As trustee, he retained control and management over the contributed real estate.

Dr. Liljestrand was the sole beneficiary of the Trust during his lifetime. Under the Trust's terms, he had access to all Trust income and corpus without restriction and the trustees had a duty to administer the Trust solely for his benefit. Upon his death, the Trust's assets were to be distributed to trusts for his children.

In 1993, the Trust entered into a management agreement with Robert to manage its real estate. Under its terms, Dr. Liljestrand or Robert could terminate Robert's employment at any time during Dr. Liljestrand's life. After Dr. Liljestrand's death, only Robert could terminate his employment.

In 1997, Dr. Liljestrand and Robert met with an estate planning attorney. According to the attorney and Robert, Dr. Liljestrand wanted to leave his property to his four children equally, but he wanted to ensure Robert's continued employment as manager of the real estate. The attorney suggested that Dr. Liljestrand form a limited partnership and transfer the real estate held by the Trust to the partnership. The attorney was concerned with two Hawaii statutes which in his opinion could jeopardize Robert's management of the real estate if the property remained in Trust. Additionally, a limited partnership could be used to satisfy Dr. Liljestrand's desire to gift interests in the real estate to his children during his life.

In 1997, Dr. Liljestrand formed the Paul H. Liljestrand Partners Limited Partnership (PLP). Dr. Liljestrand, through the Trust, transferred $5,915,167 in real estate to PLP in exchange for his initial partnership interest. Dr. Liljestrand's children did not contribute to PLP, but Robert was granted one unit of Class A limited partnership interest. The children received interests in PLP through gifts from Dr. Liljestrand.

Despite having transferred legal title of the real estate to PLP, the parties continued to treat the real estate as an asset of the Trust. The failure to treat the real estate as a partnership asset was discovered in 1999. Dr. Liljestrand and his advisers decided to treat the partnership as having commenced on January 1, 1999, even though legal title to the real property had been transferred to it by December 1997.

Dr. Liljestrand contributed almost all of his income-producing assets to PLP. His retained assets were insufficient to pay his living expenses. In order to offset the shortfall in his income, the partnership made disproportionate distributions to the Trust and directly paid a number of Dr. Liljestrand's personal expenses. Dr. Liljestrand also used PLP funds to pay a number of personal expenses.

Dr. Liljestrand died on May 31, 2004. The estate reported a taxable estate of $5,696,011 and tax due of $2,370,000. The IRS issued a notice of deficiency that included the value of the real property that Dr. Liljestrand had transferred to PLP. As a result, the IRS determined that over $2.5 million in estate tax was due. The estate sought a redetermination in Tax Court.

Discussion:

The Tax Court said that Code Section 2036 is applicable when three conditions are met: (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 enumerated in Code Section 2036 in the transferred property which the decedent did not relinquish before his death.

In light of the estate's acknowledgment that Dr. Liljestrand made transfers of property to PLP, the Tax Court found that his transfers to PLP were transfers of property under Code Section 2036(a).

The Tax Court observed that whether a sale is bona fide is a question of motive. The Court said it had to determine whether Dr. Liljestrand had a legitimate and significant nontax reason for transferring his property. The estate argued that he had several nontax reasons for transferring his property to PLP. The IRS disputed the significance and legitimacy of those reasons and offered several factors to support its argument that tax savings were the primary reason Dr. Liljestrand transferred his real estate to PLP.

Taking into account the totality of the facts and circumstances surrounding the formation and funding of the partnership, the Tax Court concluded that Dr. Liljestrand did not have a legitimate and significant nontax reason for transferring his assets to PLP, and therefore, these were not bona fide sales. It found especially significant that the transactions were not at arm's length and that the partnership failed to follow the most basic of partnership formalities.

The Tax Court noted that the general test for deciding whether transfers to a partnership are made for adequate and full consideration is to measure the value received in the form of a partnership interest to see whether it is approximately equal to the property given up. This involves a look at:

> ... whether the interests credited to each of the partners was proportionate to the fair market value of the assets each partner contributed to the partnership,
> ... whether the assets contributed by each partner to the partnership were properly

credited to the respective capital accounts of the partners, and
... whether on termination or dissolution of the partnership the partners were entitled to distributions from the partnership in amounts equal to their respective capital accounts.

The Tax Court determined that the interests credited to each partner were not proportionate to the fair market value of the assets contributed by the partner. It further found that the assets contributed by each partner were not properly credited to their respective capital accounts. Accordingly, it concluded that Dr. Liljestrand did not contribute the real estate to PLP for adequate and full consideration.

The Court found that there was no significant change in Dr. Liljestrand's relationship with the assets before his death. He received a disproportionate share of the partnership distributions, engineered a guaranteed payment equal to the partnership's expected annual income, and benefited from the sale of partnership assets. The evidence pointed to the fact that he continued to enjoy the economic benefits associated with the transferred property during his lifetime. With regard to his motivation for forming PLP, the Tax Court determined that Dr. Liljestrand was concerned with the disposition of his property after death. It thus found that PLP was created principally as an alternate testamentary vehicle to the Trust. This and other factors caused the Court to conclude that Dr. Liljestrand retained enjoyment of the contributed property within the meaning of Code Section 2036.

Conclusion:

In summary, the Tax Court found that: (1) Dr. Liljestrand transferred assets to PLP within the meaning of Code Section 2036, (2) the transfer was not a bona fide sale for adequate and full consideration, and (3) he retained enjoyment of the transferred assets. Therefore, it concluded that, under Code Section 2036(a)(1), the value of the his gross estate included the values of the assets he transferred to PLP.