TAX COURT CASE UPDATE

Citation:

Estate of Joanne Harrison Stone v. Commissioner, T.C. Memo 2012-48, February 22, 2012.

Overview:

The Tax Court determined that Mrs. Stone's transfer of woodland parcels to a family limited partnership was a bona fide transfer for which she received full and adequate consideration. Therefore, Code Section 2036(a) did not apply to the transfer and did not operate to include the values of the woodland parcels in the value of Mrs. Stone's gross estate.

The Facts:

The decedent, Joanne Harrison Stone (Mrs. Stone) was married to Roy A. Stone (Mr. Stone). They had six adult children and numerous grandchildren at the time of her death in 2005. The Stones were a prominent family in their hometown of Crossville, Tennessee. They owned a significant amount of real estate in the area for several generations including 740 acres of undeveloped woodlands. One son acquired real estate near these parcels and collaborated with the local authorities in forming a lake near them.

Once the lake had been constructed, Mr. and Mrs. Stone concluded that they wanted the woodland parcels to become a family asset. To that end they sought the advice of an attorney. They informed the attorney that they wanted to give gifts of real estate to various family members and were seeking the best way to do so. The attorney told them that a limited partnership would simplify the gift-giving process by not requiring execution and recording of new deeds every year. He also said it would help guard against partition suits, which could cause the land to be divided into smaller tracts.

The Stones took his advice and formed Stone Family Limited Partnership of Cumberland County (SFLP). The SFLP agreement provided that its purpose was to hold and manage property for the family members. It listed various ways in which SFLP could be terminated, including by written agreement of partners owning 67 percent of SFLP or upon sale of all of SFLP's property and distribution of the proceeds. The agreement placed various restrictions on a partner's ability to transfer his or her partnership interest and allowed SFLP to purchase the interest of any partner upon his or her death.

Upon its formation, Mr. Stone and Mrs. Stone each obtained 1 percent general partnership interests and 49 percent limited partnership interests in SFLP. On December 30, 1997, they quitclaimed the woodland parcels to SFLP and the parcels became SFLP's only assets. Shortly before that, the combined parcels were appraised at a value of $1,575,600. On December 31, 1997, they gave portions of their limited interests in SFLP as gifts to their 21 children, children's spouses, and grandchildren. They valued each 1 percent interest in SFLP at $15,756 for gift tax purposes or, in other words, at 1 percent of the pro rata value of the assets (no discounts).

Discussion:

The Tax Court discussed several issues with respect to Code Section 2036. 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.

The IRS argued that the three conditions were satisfied by Mrs. Stone's transfer of the woodland parcels to SFLP, while the estate argued that the latter two conditions were not satisfied. The parties agreed that she made an inter vivos transfer of property.

The Tax Court observed that, in the context of family limited partnerships, the bona fide sale for adequate and full consideration exception is met where the record establishes the existence of a legitimate and significant nontax reason for creating the family limited partnership and the transferors received partnership interests proportional to the value of the property transferred.

The estate argued that Mrs. Stone had two nontax motives for transferring the woodland parcels to SFLP: (1) to create a family asset which later might be developed and sold by the family; and (2) to protect the woodland parcels from division as a result of partition actions. The IRS countered that she was motivated only by a desire to simplify the gift-giving process by not having to execute deeds each time a gift of a portion of the woodland parcels was made.

The Tax Court disagreed that gift giving was her only motive. Testimony at trial established that a significant purpose of the transfer was to create a family asset managed by Mrs. Stone's family. She and Mr. Stone desired that their children, their children's spouses, and their grandchildren work together to develop and sell homes near the lake. The Tax Court found that the desire to have the woodland parcels held and managed as a family asset constituted a legitimate nontax motive for her transfer of the woodland parcels to SFLP.

The IRS also argued that because Mrs. Smith stood on both sides of the transaction, as both transferor of the woodland parcels and general manager of SFLP, there was no arm's length bargaining and thus the bona fide transfer exception did not apply. The Tax Court rejected this argument because it had already found a legitimate nontax motive for the transaction. In addition, the Court found that this factor did not weigh against the estate because Mrs. Stone received interests in SFLP proportional to the property she contributed.

The IRS further argued that partners of SFLP failed to respect partnership formalities because: (1) in divorce proceedings, divorcing spouses of two Stone children quitclaimed their interests in the woodland parcels to their former spouses but did not transfer actual SFLP interests; (2) some inadequate documentation was kept for the partnership, such as using bills of sale to make gifts of SFLP interests; and (3) the Stones paid SFLP property taxes out of their personal funds.

The Tax Court agreed with IRS that the partners of SFLP failed to respect some partnership formalities. The Court found, however, that other factors supported the estate's argument that a bona fide sale occurred. First, the Stones did not depend on distributions from SFLP as no distributions were ever made. Second, they actually did transfer the woodland parcels to SFLP. Third, there was no commingling of partners' personal and partnership funds, as SFLP had no partnership funds. Fourth, no discounting of SFLP interests for gift tax purposes occurred. Also, the Stones were in good health at the time the transfer of the woodland parcels was made to SFLP. Accordingly, the Tax Court found that Mrs. Stone had a legitimate and actual nontax motive in transferring the woodland parcels to SFLP. It therefore found that the bona fide sale prong was satisfied.

The Tax Court also noted that a taxpayer's receipt of a partnership interest is not part of a bona fide sale for full and adequate consideration where an intra-family transaction merely attempts to change the form in which the decedent holds property. The Tax Court stressed that it had already found that Mrs. Stone had a legitimate and actual nontax purpose for transferring the woodland parcels to SFLP. It therefore found that the transaction was not merely an attempt to change the form in which she held the woodland parcels and that the full and adequate consideration prong was satisfied.

Conclusion:

Mrs. Stone's transfer of the woodland parcels to SFLP was a bona fide transfer for which she received full and adequate consideration from SFLP. Therefore, Code Section 2036(a) did not apply to the transfer and did not operate to include the values of the woodland parcels in the value of Mrs. Stone's gross estate.