TAX COURT CASE UPDATE

Citation:

Estate of Beatrice Kelly, et.al, v. Commissioner, T.C. Memo 2012-73, March 19, 2012.

Overview:

The Tax Court held that neither the value of certain assets transferred from a widow to family limited partnerships, nor the value of the partnership interests gifted to her children, were includible in her gross estate. The Court found that the decedent had valid nontax reasons for the asset transfers, including her inability to manage the assets and reduction of personal liability; that she received partnership interests equal in value to the contributed assets; and that she did not retain an interest in the transferred partnership interests.

The Facts:

Beatrice Kelly and her husband had four children: William (Bill), Betty, Claudia, and Roy. Mr. Kelly and Bill, Betty, and Claudia (collectively, the children) each worked in the family business throughout their lives. Roy suffered from Down syndrome and was not involved with the transactions in this case.

On January 25, 1990, Mr. Kelly died and Mrs. Kelly inherited his estate which consisted of two quarries, real property, promissory notes, and stock. The children helped Mrs. Kelly manage the family business and her financial investments. Mrs. Kelly was diagnosed with Alzheimer's disease in 1998. On October 21, 2001, the children signed a settlement agreement to divide her estate equally among themselves. The children later petitioned for, and were granted, guardianship of Mrs. Kelly on account of her incapacity. By March 2002, Mrs. Kelly was admitted to an Alzheimer's unit in a nursing home.

In the summer of 2002, the children found that Mrs. Kelly's will did not divide her estate equally among them. They signed a second agreement to honor all specific bequests to non-signatories and distribute the remainder equally among themselves. The children were required to petition the probate court with respect to all matters relating to Mrs. Kelly's property, including routine maintenance and upkeep. In 2002, Mrs. Kelly had 27 parcels of real estate, including two rock quarries and a post office. There were liability concerns associated with the real estate, largely due to public access on certain parcels and dangerous activities on others. The children hired an attorney to ensure that certain settlement agreements were legally enforceable, and also informed him about dangerous incidents and liability issues regarding Mrs. Kelly's property.

The attorney prepared a plan which was approved by the Superior Court on June 3, 2003. Pursuant to the plan, acting through her children/co-guardians on this and subsequent transactions, Mrs. Kelly incorporated KWC Management, Inc. (KWC), created three LPs (one for the benefit of each of the children and their families), transferred equally valued assets to each in exchange for a 99 percent limited partner interest, formed a fourth LP (Kel-Tex) and contributed both quarries to it for a 99 percent limited partner interest, and retained over $1,100,000 in liquid assets in her own name. KWC became the general partner and 1 percent

owner of all four partnerships, and received a management fee in exchange for handling certain responsibilities relating to the partnerships.

Mrs. Kelly then contributed various stocks to the LPs and gifted partnership interests to the children and their descendants, reporting these gifts on Forms 709, United States Gift (and Generation-Skipping Transfer) Tax Return. Each of the children provided services to KWC, collectively amounting to approximately 60 to 80 hours per week, for which each received an annual salary of $21,600.

On March 17, 2005, Mrs. Kelly died. At her death, Mrs. Kelly owned none of Betty's LP; 33.8837 percent of Claudia's LP; 35.2808 percent of Bill's LP; 99 percent of Kel-Tex; and 100 percent of the shares of KWC. These ownership interests were reported on her estate tax return.

The IRS determined a $2,205,392 deficiency, based on its finding that the value of the assets contributed to the partnerships should have been included in Mrs. Kelly's estate.

Discussion:

The Tax Court engaged in a two-part analysis, first of Mrs. Kelly's transfer of property to the LPs, and then of the transfer of partnership interests to her heirs, and found that neither transfer triggered inclusion in her estate under Code Sec. 2036(a).

The Tax Court found that the main factors driving Mrs. Kelly's transfer of assets to the partnerships were to ensure equal distribution of her estate, limit her liability, and promote effective management of her assets. By contributing the quarries and other properties to partnerships, Mrs. Kelly limited her liability and reduced her management responsibilities, and the children, through KWC, were able to manage the properties as individuals rather than as co-guardians.

Although the Superior Court petition mentioned estate tax savings, there was no evidence that the parties were motivated by tax savings. Further, Mrs. Kelly received partnership interests equal in value to the assets she contributed to the limited partnerships, and her contributions were properly credited to her capital account.

The Tax Court also found that, contrary to the IRS's assertion, there was no evidence of an implied agreement that Mrs. Kelly would continue to enjoy the income from the limited partnerships. Rather, she respected the partnerships and KWC as separate and distinct entities, observed partnership formalities, and retained sufficient assets to meet her personal needs.

The IRS's contention that the management fees paid by the family limited partnerships constituted an express retention of income in the partnership interests, so as to render the value of those interests includable in Mrs. Kelly's gross estate, was also rejected. The Court found that there was no binding agreement to provide her support and maintenance, and fiduciary duty further prevented Mrs. Kelly from requiring that the partnerships pay anything more than a “reasonable” fee to the general partner. In fact, the management fees paid were lower than the industry standard.

Finally, the Court found that the creation of KWC changed Mrs. Kelly's rights to, and relationships with, the contributed assets. Mrs. Kelly also had a bona fide purpose—that her

health prevented her from managing the partnership property—for creating KWC to manage the partnerships. Accordingly, the Tax Court held that the value of the transferred family limited partnership interests was not includible in Mrs. Kelly's estate.

Conclusion:

This case shows that when the taxpayer follows the proper procedures and maintains separation between personal assets and business assets, a taxpayer's transaction can prevail in the Tax Court. Despite many bad fact cases in this area, this is one of the good fact cases.