TAX COURT CASE UPDATE

Citation:

Thomas Lane Keller et al. v. U.S., 110 AFTR 2d 2012-6061 (697 F.3d 238), September 25, 2012.

Overview:

The Court of Appeals for the Fifth Circuit, affirming a district court, has determined that a decedent capitalized a family limited partnership (FLP) before her death, even though she had not completed certain documents. This resulted in an over $115 million refund to the estate, which initially reported the assets to be owned outright, rather than in the FLP. The refund arose from a valuation discount for the FLP interest and because the Court also allowed the estate a deduction for interest on a retroactively structured loan from the FLP that was used to pay estate tax.[1]

The Facts:

Mr. Williams and his spouse lived in Texas and became interested in estate planning after their daughter's divorce. To that end, they established a revocable trust to preserve family assets. In 1998, they transferred $300 million into this Family Trust, which, on the death of either spouse, was to terminate and split into two shares (Share A and Share M), which would be used to fund two respective trusts (Trust A and Trust M). The agreement also provided that on the surviving spouse's death, Trust A and Trust M would terminate and the proceeds would be used to fund six family trusts for the couple's grandchildren.

After Mr. Williams passed away in 1999, Mrs. Williams became the trustee of both the shares and the trusts and began exploring further options for protecting her family's assets, including establishing a FLP. The FLP had been created, but the community property bonds that were to fund it had not been transferred to the FLP on the date of Mrs. Williams’ death on May 15, 2000. Mrs. Williams’ advisers initially believed that they had failed to fully create and fund the FLP before Mrs. Williams’ death and ceased attempts to activate the FLP and the limited liability company that was to serve as its general partner. The estate paid over $147 million in estate taxes in February 2001. An adviser reconsidered this position in May 2001 and resumed activity with the creation of the FLP, including formally transferring the community property bonds to the FLP.

The advisers realized that having successfully established the FLP resulted in the estate lacking the liquid assets to make a $147 million tax payment. Consequently, they retroactively restructured this transaction as a $114 million loan from the FLP, effective February 2001. The estate issued a promissory note to the FLP at the applicable federal interest rate effective February 2001.

[1] The citation to the original case is *Thomas Lane Keller et al. v. U.S.,* 107 AFTR 2d 2011-2025, April 29, 2009.

The estate filed a claim for a refund with the IRS in November 2001 on two grounds: (1) the estate's initial fair market value assessment of Mrs. Williams' assets failed to appropriately discount the value of the partnership interests, thereby leading to an initial overpayment; and (2) the estate accrued interest on its loan from the FLP to pay estate taxes, entitling the estate to a deduction.

After six months passed without IRS action, the estate sued in District Court. There, the estate argued that, under Texas law, Mrs. Williams' intent to transfer bonds into the partnership transformed those bonds into partnership property, notwithstanding her failure to complete the partnership documents. This transfer, the estate argued, rendered the tax payment a loan from the FLP, entitling the estate to an interest deduction as an actual and necessary expense of administrating the estate.

The IRS raised several objections to the estate's arguments. However, upon reviewing Texas law, the district court held that Mrs. Williams' intent to transfer the bonds to the FLP was sufficient, regardless of title or the absence of a writing confirming that transfer. Moreover, it found that because the bonds sold to satisfy estate taxes were in fact FLP property, the transfer from the FLP to the estate was actually and necessarily incurred in the administration of the estate, entitling the estate to a corresponding deduction for the interest on the loan. The district court therefore granted the estate a refund of $115,375,591.

Discussion:

The parties agreed that a substantial valuation discount hinged on whether the community property bonds were transferred effectively to the FLP. The Fifth Circuit said that it had to look to state partnership law to resolve this issue. After doing so, it determined that Texas law provides that the intent of an owner to make an asset partnership property will cause the asset to be treated as partnership property.

In lieu of challenging the District Court's factual finding that Mrs. Williams intended to transfer the bonds in question to the FLP, the IRS argued that various provisions of the Texas Revised Limited Partnership Act prevented a transfer from occurring.

As to the interest deduction, The Fifth Circuit observed that an estate may deduct those expenses "actually and necessarily incurred" in administration of the decedent's estate, which includes interest on loans taken to pay debts of an estate, such as estate taxes, if those loans are necessary to pay estate debts.

The district court concluded that, following Mrs. Williams' transfer shortly before her death, the estate lacked the liquid assets necessary to pay estate taxes as estimated at that time, and allowed the resultant loan interest deduction. The IRS challenged this deduction by asserting that the loan could have just as easily been retroactively characterized as a distribution, rendering it not "actually and necessarily incurred" under the meaning of the Internal Revenue Code and its Regulations.

Conclusion:

In relationship to the existence of the FLP, The Fifth Circuit rejected the IRS's arguments, finding that they did not overcome the Texas rule that intent is controlling. It therefore held that

Mrs. Williams transferred the full amount of the applicable community property bonds to the FLP before her death, and that the District Court correctly applied the relevant discount reflecting the encumbrance on the partnership interests.

As to the loan, the Fifth Circuit rejected the IRS's argument. It stressed that the estate, having realized it improperly disposed of bonds belonging to another legal entity (the FLP, which was actually controlled by other family members), was forced to rectify its mistake by using the assets it had available-largely illiquid land and mineral holdings. In lieu of liquidating these holdings, it borrowed from the FLP. The District Court correctly permitted a deduction for the interest on the resulting loan and the Fifth Circuit upheld this decision.