Thrilla in Manila (Folders): The IRS battles the Taxpayer's Partnerships in the Courts: Round 14, Has there been a TKO?

Not Again?

Many of our recent estate planning columns have focused on developments in the partnership area. The reason: the law in this area keeps evolving as more partnership decisions are handed down. And practitioners keep using partnerships as an estate tax strategy.

The axiom to the planner: Be nimble and pay attention to the most recent developments. For example, the taxpayers (and therefore planners) almost had a TKO in their favor in the first *Strangi* decision.[1] The IRS wobbled but did not fall down.

And in an amazing resurgence of energy, the IRS has turned the fight around. All of a sudden, somewhat unexpected to many planners, the IRS has shifted its attack on family limited partnerships away from traditional arguments –chapter 14, gifts on formation, step transaction – to section 2036. With success.

Now practitioners need to know how, in light of the most recent cases, to avoid chapter 2036 in structuring partnerships.

But beware, all the old punches are still available for an improperly structured partnership, so be careful with chapter 14 and other Code sections.

Post *Strangi* Concerns

Since *Strangi*, the courts have essentially used a lack-of-economic substance argument to ignore partnerships under 2036[2] for estate tax purposes, to conclude that the value of the underlying assets should be fully included in a deceased person's (the "decedent") gross estate. This position has led to considerable litigation.

Most recently, the case law has developed that ignore partnerships when there is no economic justification for them other than to save estate taxes.[3]

In addition to the Tax Court, Federal Appellate Courts have also disregarded partnerships that have no economic substance. For example, in *Estate of Thompson v.*

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[1] 115 T.C. 478 (2000).

[2] This argument prevents the adequate and full consideration exception from applying.

[3] *See, e.g. Strangi v. Comm'r, Biegleow, Turner, infra*.

Commissioner,[4] the court determined that section 2036 applied and was not excepted out under the bona-fide sale for adequate and full consideration. First, although the partnership engaged in economic activities, these did not constitute "the type of legitimate business operations that might provide a substantive non-tax benefit" for the transfers. Second, the type of assets that constituted most of the transfers (marketable securities) made it appear unlikely to the court that there were any significant "potential non-tax benefits." Third, the reduction in value that occurs when assets are contributed to a partnership argues against the possibility of full and adequate consideration being paid.[5]

As to the bona fideness of the transaction, the *Thompson* court required substantial business and other non-tax reasons for the transaction. To substantiate a partnership, and therefore to satisfy the bona fide prong, the partnership must be established, clearly and demonstrably, for a primary reason other than to save estate taxes.

Since *Thompson* and *Strangi,* the Courts have continued to apply this application of section 2036 and have continued to clarify how section 2036 will apply to family limited partnerships. In *Bongard*, the court emphasized:

> "[T]he 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…The objective evidence must indicate that the nontax reason was a **significant factor** that motivated the partnership's creation" (emphasis added).[6]

In *Bigelow,* T.C. Memo 2005-65 (2005), decedent formed the partnership at age 85 and died a few years later. In holding that section 2036 applied to disregard the partnership, the court emphasized:

> "The transfer did not provide and had no potential to provide any nontax benefit, to the decedent because management of the assets did not change as a result of the transfer."

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[4] 382 F.3d 367, 376 (3d Cir.2004), *affg.* T.C. Memo 2002-246

[5] The court referenced the *Wheeler* case, 116 F. 3d 749 (5th Cir. 1997), for this proposition. *Wheeler* noted that that for the exception to apply, a transfer out of the estate had to be accompanied by a corresponding transfer to "augment the estate by a commensurate (monetary) amount."

[6] *Bongard v. Comm'r,* 124 T.C. 95 (2005). *See also Bigelow v. Comm'r,* T.C. Memo 2005-65 (2005) family partnership set up by 85 year old "did not provide and had no potential to provide any nontax benefit to decedent because management of the assets did not change as a result of the transfer and there was no pooling of assets.

To ignore the partnership structure, those cases essentially look at the following two elements:

(1) Was section 2036 invoked?

(2) If so, does the full and adequate consideration exception take the taxpayer out of that section?

(1) Section 2036 (a)(1)

Did the decedent receive cash flow immediately from the partnership or transfer most of the decedent's assets to the partnership? If so, the cases indicate that this may show an implied or express retention of income, sufficient to invoke this prong.

(2) Section 2036 (a)(2)

As set forth in *Strangi*, any time the decedent retains the right to control partnership decisions, this is a retained right to "designate," requiring inclusion of the partnership in the decedent's estate under 2036 (a)(2):

> "The Stranco shareholders, including decedent (through Mr. Gulig) then acted together to delegate this authority to Mr. Gulig through the management agreement. The effect of these actions placed decedent's attorney in fact in a position to make distribution decisions."

It was not necessary that the decedent be the sole person in control of this decision, just merely participate:

> "The SFLP/Stranco arrangement placed decedent in a position to act, alone or in conjunction with others, through his attorney in fact, to cause distributions of property previously transferred to the entities or of income therefrom. Decedent's powers, absent sufficient limitation as discussed *infra*, therefore fall within the purview of section 2036 (a)(2)."

(3) Non Application of Full and Adequate Consideration Exception

Once in section 2036, a partnership can be excepted only if the decedent's transfers to it fall within the full and adequate consideration exception. Based on what is know well developed case law in this area, the full and adequate consideration exception will not apply if there is no economic purpose to the partnership other than to save taxes.

If no non tax purpose, a court will disregard the partnership for estate tax purposes.[7] This point is demonstrated clearly in the *Estate of Schutt v. Comm'r*.[8]

In *Schutt*, the Tax Court concluded that if it were merely a case of Mr. Schutt transferring his Exxon stock to the partnership in an attempt to prevent it from being sold, no economic substance would have been shown; the partnership would have been disregarded. But where, as in Mr. Schutt's case, the partnership resulted in other family members having to contribute substantial Exxon stock to the partnership, and locking up those interests from being sold because of the partnership, then the forming of the partnership had economic substance. In a real sense, Mr. Schutt's contribution was a *quid pro quo* to get other family members to contribute and to lock up their shares, an objective of Mr. Schutt's:

> "The record on the whole supports that decedent's greatest worry with respect to wealth dissipation centered on outright distribution of assets to the beneficiaries of the various WTC trusts. It is clear from the structures of the WTC trusts involved that outright distribution created the single largest risk to the perpetuation of a buy and hold philosophy, and testimony confirmed decedent's concern over a termination situation."[9]

Statements throughout the court's opinion demonstrated that, were only Mr. Schutt to have contributed Exxon stock to the partnership, in a guise to continue the buy and hold philosophy, the partnership would have been disregarded:

> "In this unusual scenario, we cannot blindly apply the same analysis appropriate in cases implicating nothing more than traditional investment management considerations…. In that decedent employed his capital to achieve a legitimate nontax purpose [*author's note – to get others to contribute their Exxon stock subject to the buy and hold philosophy*],

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[7] Unlike the Service, I believe that elderly individuals have many economic motives to establish partnerships, motivations that could provide economic substance to a partnership sufficient to take a partnership outside of the 2036 context. *See* "The Interplay Of Behavioral Economics And Portfolio Management With The Current Examination Of Family Partnerships By The Courts," Real Property, Probate and Trust Journal, Vol. 40, Issue 1 (2005). In practice, I have also often encountered situations in which those reasons just do not exist, and in fact, no reasons other than estate tax savings exist for the establishment of the partnership.

[8] T.C. Memo 2005-126 (2005).

[9] *Id*. at 16.

the Court cannot conclude that he merely recycled his shareholdings." [10]

I Pick Door # 3: The Proper Structure

In addition to the proper restrictions in the partnership agreements and proportional funding/equity interests, a partnership should focus on the following actions, structuring (items 1 through 3) and administrative (items 4 through 6) actions, as a result of *Bongard, Bigelow,* and *Schutt.* Many of these items are identical to this column's recommendations from last year. However, the economic purpose requirement now takes on the focal point.

1. There must be demonstrated "substantial business and other non-tax reasons."[11] Without this, any partnership stands a difficult time being taken seriously, that is, being respected for tax purposes.

2. There must be actual consideration received in terms of the partnership interests: equity interests, cash flow and tax implications should be proportional.[12]

3. Outside of the partnership, partners should retain other assets for his or her support. [13] [Reason: to avoid the argument that there is an implied retention sufficient to invoke section 2036 (a)(1)];

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[10] *Id*. at 18-19.

[11] In *Kimbell*, non-tax purposes were demonstrated by affidavits of parties involved in the establishment and administration of the partnership (emphasize "demonstrated," no credulity test was established): creditor protection, pooling of capital, reduced administrative costs, preservation of property for descendants, and provision for management succession. Note, however, that under the *Thompson/Turner* decision these may not be sufficient when a large portion of the partnership's assets consist of marketable securities. *See also Estate of Kelley v. Comm'r*, 96 AFTR 2005 (D.C. Tx. 2005), in determining whether there is a bona fide purpose to the partnership "these issues turn on a detailed and thorough analysis of the facts of each case."

[12] Mrs. *Kimbell* received back a proportion of the equity in the partnership equivalent to the proportion of the total capital in the partnership that she put in (more on this below). Under the *Thompson/Turner* analysis, however, the receiving back of proportional interests will not be full and adequate consideration unless there are enough non-tax benefits to take the matter out of "estate planning" and into "ordinary commercial transactions."

[13] This is extremely important after the *Thompson/Turner* decision. One test of the sufficiency of the assets retained would be whether those retained assets would be adequate to support the decedent's monthly expenses through life expectancy.

4. There must be actual transfers: the assets have to be re-titled in the partnership name; the i's must be dotted and t's crossed. [Reason: create credibility that the establishment of the partnership was really intended for economic purposes; ignoring formalities creates the impression that the partners do not really intend to operate as a partnership. Further, ignoring partnership formalities makes it easier to argue Code section 2036 (a) (2) should apply.]

5. The partnership must be maintained as a separate entity; there can be no commingling.

6. Investments within the partnership should maintain some integrity: who is monitoring them, are they being re-invested, actively managed, consistent with some end game on the investment world? [Reason: need to establish an economic justification for the partnership; contributing assets to a partnership with no activities within the partnership changing sort of indicates that there is no reason for the partnership even though this would not be true in all circumstances (e.g., divesting control in order to prevent third parties from exercising undue influence); still, changing the investments within the partnership after contribution provides a good indicia that the partnership was established for a real business reason]

7. The requisite returns should be filed.

8. The partnership should actually be managed pursuant to the purposes set forth for its establishment. [Reason: consistency demonstrates the economic substance of the partnership.] .