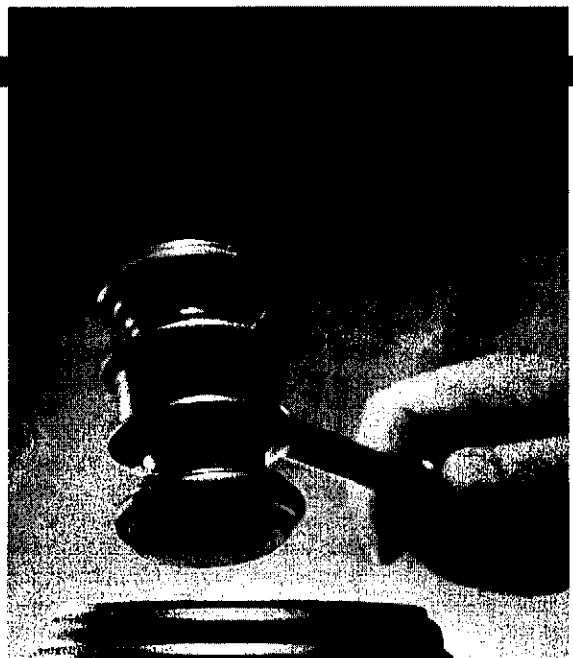


FLP Litigation

Have *Strangi* and *Bongard* Provided Clarification, Guidance on FLPs?

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For years, taxpayers and estate planners have enjoyed relative certainty in using family limited partnerships as an effective means of transferring assets at reduced estate tax costs to the next generation. Largely, this resulted from applying discounts for estate tax purposes in valuing fractional interests that are retained by a deceased transferor.

In a typical case, courts apply a combined discount in excess of 30 percent for lack of control and lack of marketability. However, in several relatively recent cases, the IRS has argued successfully that the transfer of assets to an FLP should be disregarded by applying Internal Revenue Code Sec. 2036(a).

Under this approach, the contribution of assets to an FLP are disregarded for estate tax purposes. Instead, the decedent is treated as the owner of the assets transferred or contributed to an FLP. As a result, these assets, not the partnership interests, are subject to valuation and the assets valued for estate tax purposes are not subject to a discount.

Recent case law provides clarification of some of the issues and affords guidance in planning for successful use of FLPs.

IRC SEC. 2036(A)

IRC Sec. 2036(a) includes in a decedent's gross estate those assets that were transferred during life, but to which the transferor retained significant rights. The retained rights may relate to either the transferor's use of the property or enjoyment of the income from the property, or to the ability to designate the persons who could use the property or benefit from its income.

IRC Sec. 2036(a) reads:

"The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in the case of a bona fide sale for

an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—

"1. the possession or enjoyment of, or the right to the income from, the property, or

"2. the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income there from."

Recent cases have focused on the application of Sec. 2036(a)(1) and the exception to the application of Sec. 2036(a) for transfers constituting bona fide sales for full and adequate consideration.

Recent case law provides clarification of some of the issues and affords guidance in planning for successful use of FLPs.

In all cases there is never an express reservation of the "possession or enjoyment of, or the right to the income from" the property contributed to an FLP. Rather, courts look to the facts and circumstances to determine whether there was an implied right retained. Also, the courts have developed fairly clear standards for when the exception to the application of Sec. 2036(a) applies for bona fide sales for full and adequate consideration.

Two cases from 2005, *Strangi v. Commissioner* and *Estate of Wayne C. Bongard v. Commissioner*, shed light on both issues.

STRANGI V. COMMISSIONER

The decision of the Fifth Circuit Court of Appeals in July 2005 in *Strangi*, 293 F.3rd

279 (Fifth Cir. 2005) was a victory for the IRS. However, the case is most useful to illustrate to taxpayers what steps to avoid in forming and operating FLPs.

Strangi had bounced twice between the Tax Court and the Court of Appeals. In the end, the issue that the Court of Appeals decided was whether Sec. 2036(a)(1) applied to the transfer by Albert Strangi of approximately \$10 million of assets to an FLP in exchange for a 99 percent limited partnership interest, or whether the transfer of assets to the partnership would be respected for estate tax purposes so that the asset subject to valu-

ation in Strangi's estate would be the limited partnership interest.

If Sec. 2036(a) did not apply, the Tax Court already had determined a discount in excess of 30 percent to reflect the lack of control and marketability inherent in Strangi's limited partnership interest.

The Court ruled that Sec. 2036(a)(1) applied and that the exception for bona fide sales did not apply. Further, the Court ruled that there was an implied agreement that Strangi would retain the right to the income from the assets transferred to the partnership. The following was found to be important:

- The decedent, as a practical matter, retained the same relationship to his assets that he had before the FLP's formation.

- The decedent contributed approximately 98 percent of his wealth, including his residence, to the FLP.
- The decedent continued to physically occupy his residence after the transfer to the FLP. Rent was not paid for more than two years, although it was accrued on the FLP's books.
- Distributions were made in response to the needs of the decedent or his estate, (e.g. to pay for the back surgery of the decedent's nurse; the decedent's funeral and estate administration expenses, debts, nursing services before the decedent died, a specific bequest under the decedent's will; and estate taxes of approximately \$3 million).

Additionally, the Court rejected all of the FLP's alleged business purposes and found that the transfer of assets did not qualify for the exception as a bona fide sale.⁵ The standard adopted by the Court was very similar to the standard set forth in *Estate of Wayne C. Bongard v.*

Commissioner, which requires a showing of a significant nontax business purpose.

It is interesting to speculate on what the result would

have been if Strangi had retained substantial assets outside the partnership, including his home and sufficient liquid assets so that he could pay his living expenses for the rest of his life and still have enough cash to pay the estimated estate taxes. In that situation, it is not clear that a court would have found an implied right to retain the income or property to apply Sec. 2036(a).

Also, it is interesting to note that the Court did not address the potential application of Sec. 2036(a)(2), as had Judge Cohen in the Tax Court. A holding that Sec. 2036(a)(2) applied would pose a more serious challenge to taxpayers and practitioners in using FLPs.

ESTATE OF WAYNE C. BONGARD V. COMMISSIONER, 124 T.C. 95 2005

The facts of *Bongard* are simple. Wayne Bongard, owner of a successful corporation, had transferred some of the corporation's stock to a trust for his children.

His business lawyer advised him to combine the ownership of the corporation into a single holding company to facilitate a liquidity event. On the advice of his lawyer, Bongard and the children's trust

transferred their corporate stock to an LLC in exchange for both Class A and Class B interests.

Bongard then transferred his Class B interests to a separate FLP. Upon his death, the estate claimed a discount for the Class A interest in the LLC and a separate, additional discount for the interest in the FLP that held the Class B interests.

The Tax Court ruled in favor of *Bongard* for the Class A interest, holding that the transfer of the corporate stock to the LLC in exchange for the Class A interest was a bona fide sale for full and adequate consideration. The sale was bona fide in the Court's view because it was on the advice of Bongard's lawyer and thus the transfer was made for a significant nontax business purpose.

Also, the transfer was for full and adequate consideration because (i) the transferors received interests in the LLC in proportion to the assets transferred; (ii) the transfers were credited to their

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capital accounts; (iii) capital accounts were adjusted for contributions and distributions; and (iv) liquidating distributions were to be based upon capital account balances.

For reasons that are not clear, the Court held that the transfer of the Class B interests to the FLP was subject to Sec. 2036(a)(1). However, the bulk of the value was in the Class A interests. Thus *Bongard* was a substantial taxpayer win.

OTHER RECENT CASES

Estate of Edna Korby v. Commissioner, T.C. Memo 2005-102—The Tax Court found an implied agreement in the *Korby* case between the deceased husband and his four sons that income from assets transferred to a family partnership would be used as needed by the parents. Therefore, the Tax Court applied Sec. 2036(a)(1) to include the value of the partnership assets in the decedent's estate.

Following *Bongard*, the Tax Court found that there was no legitimate significant nontax reason for the transfer of the assets to the partnership. The following four factors were cited as to why there was an absence of a bona fide sale:

- The taxpayer was on both sides of the transaction;
- The taxpayer was financially dependent on distributions from the partnership;
- The partners commingled partnership funds with their own; and
- The taxpayer failed to transfer the property to the partnership.

Estate of Bigelow v. Commissioner,

T.C. Memo 2005-65—The Tax Court concluded that this transaction did not satisfy the bona fide sale for full consideration exception to Sec. 2036, relying upon the following four factors:

- The transfer of decedent property to the partnership left decedent unable to meet her financial obligations.
- Failure to observe partnership formalities. The parties did not properly maintain capital accounts.
- There was no potential to provide any nontax benefit. This case did not involve a pooling of assets. The court

rejected the nontax factors because there was no additional creditor protection because the decedent's trust was the sole general partner and there was no

change in continuity of management because the partnership would terminate if the general partners unilaterally decided to terminate.

- Transfers to partnerships solely to reduce taxes and to facilitate gift giving are not made in good faith or for a bona fide purpose.

Estate of Shutt v. Commissioner,

T.C. Memo. 2005-126—The Tax Court held that there were legitimate and significant nontax purposes for the formation of two Delaware business trusts that held substantial amounts of the stock of DuPont and Exxon. The bona fide sale and Sec. 2036 issues addressed were identical to the issues related to FLP transactions.

The Court found that the decedent's concerns regarding sales by family members of core stockholdings and his desire to extend and perpetuate his buy-and-hold investment philosophy over family assets were legitimate and significant nontax reasons for forming the trusts, and were the decedent's primary motivation.

The Tax Court also found that the transfer of assets to the business trusts

satisfied the requirement for full and adequate consideration in money or money's worth following the reasoning in *Bongard*:

- The interests received by the participants in the entity were proportionate to the value of the property each contributed to the entity;
- The respective assets contributed were properly credited to the capital accounts of the transferors;
- Distributions from the entity required a negative adjustment to the distributee's capital account; and
- There existed a legitimate and significant nontax reason for engaging in the transaction.

Thus, the transfers to the business trusts were held to be bona fide sales for adequate and full consideration, so that Sec. 2036 did not apply, and the Court did not consider it further.

LESSONS LEARNED

So, what can we learn from these cases?

1. Courts will readily find an implied agreement for the transferor to retain the income from the property transferred to an FLP unless the facts establish to the contrary. Therefore, taxpayers should not transfer substantially all of their assets to the partnership.

Instead, they should leave out sufficient assets so that they will

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not need partnership distributions for any anticipated purposes.

2. To meet the exception to the application of Sec. 2036(a) there must

be a significant nontax business purpose for the partnership's formation and the capital accounts should be maintained in a manner that would satisfy the regulations under Sec. 704(b).

3. Taxpayers should conduct an active trade or business through the FLP.

4. Taxpayers should observe all formalities in forming and operating the partnership. In particular, there should be no commingling of personal and business assets.

5. There still is no clarification on the potential application of Sec. 2036(a)(2) in those instances when the exception to Sec. 2036(a) does not apply. As a result, there is some risk that Sec. 2036(a)(2) could apply when the decedent was the general partner of the partnership. 

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