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*“Family Limited
Partnerships
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Special Guest

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**UPDATE ON
USE OF FAMILY LIMITED PARTNERSHIPS
AND DISCOUNT PLANNING**

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**UPDATE ON
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I. INTRODUCTION.

A. Over the past several years, the Internal Revenue Service (the “IRS”) has used various legal theories to combat the application of discounts in family limited partnership (“FLP”) planning.

B. From Sections 2703 and 2704 of the Internal Revenue Code of 1986, as amended (the “Code”), to lack of a business purpose, to substance over form, to gifts on formation, to step transaction theories, the IRS generally has been unsuccessful.

C. The IRS has a very strong weapon in its arsenal – Section 2036. The IRS has successfully argued, in nineteen separate cases, that Section 2036 can cause estate tax inclusion of the assets owned by the FLP.

D. And a new theory seems to be developing – the indirect gift/step transaction theory. The IRS has used this theory in seven separate cases to challenge the taxpayer.

E. Estate planners continue to use FLPs in order to achieve valuation discounts. While FLPs certainly provide a vast array of nontax benefits, such as asset protection, divorce protection and consolidation of assets, to name a few, many clients establish the FLP in order to obtain discounts on the value of their assets for transfer tax purposes.

1. Query: How many of your clients would have established an FLP if no valuation discounts were available?

F. Because FLP planning has become more challenging, practitioners who recommend and implement the FLP must be cognizant of the 2036 issues and advise their clients in such a manner that would make it extremely difficult, if not impossible, for the IRS to attack the FLP using a Section 2036 argument. Practitioners now also have to be particularly concerned about the formation of the partnership and subsequent transfers of partnership interests so that they are not captured under the “indirect gift/step transaction” theory.

G. This outline discusses the following:

1. Section 2036, the regulations promulgated thereunder and, perhaps most importantly, the cases in which the IRS has successfully used Section 2036 to include partnership assets in a decedent’s gross estate. The outline also discusses the seven FLP cases in which the IRS was not successful using Section 2036 (Church, Stone, Kimbell, Schutt, Mirowski, Keller and Murphy), and Byrum, the Supreme Court case which the

IRS may cite as authority in order to assert that the assets owned by the limited partnership should be included in a decedent's estate under Section 2036(a)(2).

2. The cases which question the applicable discounts applied to transfers of general and limited partnership interests.

3. The cases addressing the indirect gift/step transaction theory.

4. The recent proposals regarding the limitations on the discounting of value of an entity interest for lack of marketability and/or control when such interests, such as interests in an FLP and/or limited liability company, are transferred.

5. A couple of years ago, the IRS issued appeals settlement guidelines for FLPs and family limited liability companies. These guidelines are effective beginning October 20, 2006; the issues, positions of the taxpayers and IRS and the guidelines are discussed in this outline and are attached as an exhibit.

6. Questions on Federal gift and estate tax returns, Forms 709 and 706, respectively, have made it easier for the IRS to audit family limited partnerships.

7. A recent case has addressed whether a corporate trustee had a fiduciary duty to transfer marketable securities held in a marital trust to a family limited partnership.

8. On January 9, 2009, the House of Representatives issued H.R. 436, which is known as the Certain Estate Tax Relief Act of 2009 (the "2009 Act"). Section 4 of the 2009 Act addresses valuation rules for certain transfers of non business assets and the limitation on minority discounts.

9. Four checklists have also been provided, one concerning formation of the FLP, one concerning operations of the FLP, one regarding the bona fide sale for adequate and full consideration exception to the application of Section 2036 and one which discusses how to avoid a Section 2036(a)(2) argument.

10. Lastly, at the end of this outline, there are three exhibits. The first exhibit is a compilation of questions used by the IRS in Section 2036 audits. The second exhibit is the IRS appeals settlement guidelines for FLPs. The last exhibit is a copy of H.R. 436, which is the House of Representatives Bill dealing with valuation discounts.

II. THE STATUTE AND THE REGULATIONS.

A. Code Section 2036(a) contains the general rule for "transfers with a retained life estate" as follows:

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 case of a bona fide sale for 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 therefrom.

B. Treasury Regulations Section 20.2036-1, transfers with retained life estate, is instructive. It states, in relevant part, the following:

1. A decedent's gross estate includes under Section 2036 the value of any interest in property transferred by the decedent, whether in trust or otherwise, except to the extent that the transfer was for an adequate and full consideration in money or money's worth, if the decedent retained or reserved (1) for his life, or (2) for any period not ascertainable without reference to his death, or (3) for any period which does not in fact end before his death—

(a) The use, possession, right to the income, or other enjoyment of the transferred property, or

(b) the right, either alone or in conjunction with any other person or persons, to designate the person or persons who shall possess or enjoy the transferred property or its income. Treas. Reg. § 20.2036-1(a).

(i) If the decedent retained or reserved an interest or right with respect to all of the property transferred by him, the amount to be included in his gross estate under Section 2036 is the value of the entire property, less only the value of any outstanding income interest which is not subject to the decedent's interest or right and which is actually being enjoyed by another person at the time of the decedent's death. Treas. Reg. § 20.2036-1(a).

(ii) An interest or right is treated as having been retained or reserved if at the time of the transfer there was an understanding, express or implied, that the interest or right would later be conferred. Treas. Reg. § 20.2036-1(a).

2. The phrase "use, possession, right to the income, or other enjoyment of the transferred property" is considered as having been retained by or reserved to the decedent to the extent that the use, possession, right to the income, or other enjoyment is to be applied . . . or otherwise for his pecuniary benefit. Treas. Reg. § 20.2036-1(b)(2).

3. The phrase "right . . . to designate the person or persons who shall possess or enjoy the transferred property or the income therefrom" includes a reserved power to

designate the person or persons to receive the income from the transferred property, or to possess or enjoy nonincome-producing property, during the decedent's life or during any other period described in paragraph (a) of [Treasury Regulation Section 20.2036-1].

(a) It is immaterial (i) whether the power was exercisable alone or only in conjunction with another person or persons, whether or not having an adverse interest; and (ii) in what capacity the power was exercisable by the decedent or by another person or persons in conjunction with the decedent.

(b) The phrase does not apply to a power held solely by a person other than the decedent. However, if the decedent reserved the unrestricted power to remove or discharge a trustee at any time and appoint himself as trustee, the decedent is considered as having the powers of the trustee. Treas. Reg. § 20.2036-1(b)(3).

(i) Query: Could this regulation apply to a limited partner's right to remove a general partner and replace such general partner without restriction?

III. "IRS FRIENDLY" SECTION 2036 CASES.

A. Estate of Schauerhamer v. Commissioner, T.C. Memo 1997-242.

1. Formation Facts.

(a) Decedent was diagnosed with colon cancer in November of 1990.

(b) Decedent met with estate planning attorney in early December of 1990.

(c) On December 31, 1990, decedent, along with her three children and their spouses, met with estate planning attorney and implemented the following plan:

(i) Three partnership agreements were executed and certificates of limited partnership were filed with the state (Utah).

(ii) Each of decedent's children was a 4% general partner; decedent was a 1% general partner and a 95% limited partner. The partnership agreement stated that each child would contribute \$4 (for his or her 4% general partnership interest) and decedent would contribute \$95 (for her 1% general partnership interest and 95% limited partnership interest).

(iii) Decedent was the managing partner of each partnership.

(iv) Decedent contributed various assets, in undivided one-third interests, to the three partnerships. It appears that the assets contributed were “business” type of assets. There is no indication that the children made any contribution of assets to the partnerships.

(v) Decedent made thirty-three gifts of limited partnership interests, each with a value of a “\$10,000 interest in the partnership.”

(d) On January 1, 1991, decedent made identical gifts of limited partnership interests.

2. Operational Facts.

(a) Each partnership’s initial capital was deposited into a partnership bank account.

(b) The partnership agreements required that all income from the partnership be deposited into a partnership account; decedent deposited such income and income from other sources into an account held jointly between her and her son’s wife.

(c) Decedent did not maintain any records to account separately for the partnership and non partnership funds.

(d) Decedent utilized the account as her personal checking account and paid personal and partnership expenses from the account.

(e) Decedent transferred additional assets to the partnerships on November 5, 1991 (thirty-eight days prior to her death). Again, there is no indication that the children made any contribution of assets to the partnerships.

3. Section 2036 applied for following reasons.

(a) The facts established that an implied agreement existed among the partners.

(b) Decedent owned the assets subsequently transferred to the partnerships and collected the income the assets generated.

(c) In violation of the partnership agreements, decedent deposited the partnership income into an account she used as a personal checking account and commingled it with income from other sources. The Court stated that “[s]uch deposits of income from transferred property into a personal account are highly indicative of ‘possession or enjoyment.’”

(d) Decedent managed the assets and income generated by the assets exactly as they had been managed in the past. The Court stated that “[w]here a decedent’s relationship to transferred assets remains the same after as it was

before the transfer, Section 2036(a)(1) requires that the value of the assets be included in the decedent's gross estate."

B. Estate of Reichardt v. Commissioner, 114 T.C. 144 (2000).

1. Formation Facts.

(a) Decedent, after just being diagnosed with terminal cancer, and his son met with certified public accountant on June 5, 1993.

(b) On June 17, 1993, decedent executed his revocable trust and family limited partnership agreement. Decedent and his children were the co-trustees of the revocable trust; it appears that each trustee had independent authority to act on behalf of the trust.

(c) The revocable trust was the limited partnership's only general partner.

(d) The certificate of limited partnership was filed on June 21, 1993.

(e) Decedent transferred all of his property (except for his car, personal effects and a nominal amount of cash) to the partnership.

(f) Decedent was the beneficiary and co-executor (with his children) of his wife's estate. He signed deeds individually and on behalf of his wife's estate which conveyed his and the estate's interest in various pieces of real estate, including his residence, to his revocable trust. He also signed deeds as trustee conveying such real estate to the limited partnership.

(g) Within the next two months, decedent transferred to the trust, and then to the partnership, investment accounts, a note receivable and some cash (approximately \$33,000).

(i) At least \$20,540 of the cash was attributable to rental income from the real property he had previously contributed to the partnership.

(h) A portion of the real estate contributed to the partnership was owned by decedent's wife's estate; his wife was the beneficiary of her late uncle's estate. When a portion of the real estate was sold, the proceeds were paid to decedent's wife's estate; the money was then contributed directly into the partnership's bank account.

2. Operational Facts.

(a) Decedent controlled and managed, or allowed the co-owners to control and manage, the partnership assets in the same manner both before and after he transferred them to the partnership.

(b) Decedent used the same brokers and asset managers before and after he transferred the property to the partnership.

(c) Decedent was the sole individual who signed partnership checks and documents.

(d) While some of the real property owned by decedent was conveyed to the partnership, the co-owners of such property continued to manage such property.

(e) Decedent's accountant made adjusting entries in the partnership's accounting records in an attempt to classify items of income and expense between decedent and the partnership. There was no evidence that the partnership or decedent transferred any funds to the other as a result of the adjusting entries.

(f) While decedent continued to live in the residence contributed to the partnership, he did not pay any rent to the partnership.

3. Section 2036 applied for the following reasons.

(a) Decedent did not "curtail" his enjoyment of the transferred property after he formed the partnership.

(b) Nothing changed except legal title. Decedent managed the trust which managed the partnership. He was the only trustee to sign the articles of limited partnership, the deeds, the transfer of lien, and any document which could be executed by one trustee on behalf of the trust. He was the only trustee to open brokerage accounts or sign partnership checks. He did not open any accounts for the trust.

(c) Decedent commingled partnership and personal funds. He deposited some partnership income in his personal account and he used the partnership's checking account as his personal account.

(d) Decedent lived in the residence before and after he contributed it to the partnership, and he did not pay rent to the partnership for his right to live in the residence.

(e) Decedent transferred nearly all of his assets to the trust and partnership. The Court stated that "[t]his suggests that decedent had an implied agreement with his children that he could continue to use those assets."

C. Estate of Harper v. Commissioner, T.C. Memo 2002-121.

1. Formation Facts.

(a) Decedent was an attorney specializing in entertainment law. However, he had experience in the areas of tax, and wills and trusts law.

(b) Decedent was diagnosed with prostate cancer in 1983 and rectum cancer in 1989.

(c) Decedent was the sole trustee of his revocable trust; his two children were the successor trustees.

(d) It is not exactly clear when decedent decided to form a limited partnership. However, it was formed in 1994 with an effective date of January 1, 1994 stated in the preamble of the partnership agreement. There was also a provision in the partnership agreement indicating that the partnership shall commence upon the date a certificate of limited partnership is filed with the Secretary of State. The certificate of limited partnership was filed with the Secretary of State on June 14, 1994.

(e) From June 17th through June 20th of 1994, decedent was hospitalized. The medical records indicate that he was “well known to have metastatic colonic carcinoma and prostatic carcinoma.”

(f) Decedent’s revocable trust was named as the initial 99% limited partner. His two children were named as the general partners; his son held a .6% interest and his daughter held a .4% interest. His son was also designated to serve as the managing partner of the partnership.

(g) The partnership agreement requires the decedent’s revocable trust to contribute the “Portfolio” and the general partners are not obligated to make any capital contribution to the partnership.

(h) The “Portfolio” was not defined in the partnership agreement. However, there was no dispute that it consisted of securities held in various investment accounts, shares in a company known as “Rockefeller Center Properties, Inc.” and a note receivable.

(i) Decedent contributed the “Portfolio” to the partnership. The value of the assets contributed to the partnership represented approximately 94% of the decedent’s assets. Decedent did not contribute his personal effects, a checking account, his automobile and his residence.

(j) There were conflicting provisions regarding distributions from the partnership. One provision gave the managing general partner the “sole and absolute” discretion to make distributions to the partners. Another provision required distributions of “Ordinary Net Cash Flow” to be distributed to the partners based on their percentage interests in the partnership.

(k) Decedent gifted 60% of his limited partnership interests (owned by his revocable trust) to his children in an assignment with an effective date of July 1, 1994. The gifted limited partnership interests were designated as “Class B” limited partnership interests. The partnership agreement was amended so that decedent’s remaining (39%) limited partnership interests (owned by his revocable

trust) became a "Class A" limited partnership interest which was entitled to a "Guaranteed Payment" of "4.25% annually of its Capital Account Balance on the Effective Date."

(l) Decedent commenced the funding of the partnership on July 26, 1994; it continued for approximately four months.

(m) In a letter dated September 29, 1994, decedent instructed one of the brokerage firms to sell all the securities in his revocable trust's investment account and use the proceeds to repurchase the same securities in a partnership account.

(n) On September 23, 1994, decedent's son, as general partner, opened a checking account in the name of the partnership. A deposit of interest was made into the account and various distributions were made to the partners.

(o) In January of 1995, decedent entered hospice care in Oregon; he died on February 1, 1995.

2. Operational Facts.

(a) A certified public accountant was engaged after Decedent's death to prepare financial books and tax returns for the partnership.

(b) The accountant established a general ledger for the partnership to categorize and account for partnership transactions as of June 14, 1994, the date of the entity's formation. Capital accounts and ledger accounts were established for partners to reflect partnership distributions.

(c) The accountant established an account named "Receivable from Trust." The account was created to reflect amounts received by decedent's revocable trust after the partnership's formation; such amounts should have been received by the partnership, but were not so received because of the delay in transferring assets to the partnership and opening the partnership account. The "Receivable from Trust" account balance was treated as a distribution to the decedent's revocable trust; no funds were transferred between the revocable trust and partnership.

3. Section 2036 applied for the following reasons.

(a) Circumstances were very similar to Reichardt and Schauerhamer.

(b) Decedent commingled partnership and personal funds. The partnership account was opened more than three (3) months after the partnership was formed. Prior to the opening of the account, partnership income was deposited into decedent's revocable trust account resulting in an unavoidable commingling of funds.

(c) Lack of respect of the entity as a true business enterprise. The Court focused on hiring of the accountant only after decedent's death, and the delay in opening the partnership account and the transferring of assets to the partnership. The Court stated that the "partners had little concern for establishing any precise demarcation between partnership and other funds during decedent's life."

(d) Decedent transferred the majority of his assets to the Partnership. Thus, the distribution of partnership funds indicated an implied understanding that the partnership would "not curtail decedent's ability to enjoy the economic benefit of assets contributed."

(e) Distributions from the partnership to the decedent's revocable trust were found to be contemporaneously used for decedent's personal expenses.

(f) Partnership was viewed as an alternate vehicle for decedent to provide for his children at death (i.e., an estate plan). The Court focused on the testamentary characteristics of the partnership scheme: Decedent made all decisions regarding creation and structure of the partnership, decedent continued to be the principal economic beneficiary and there was little change in the portfolio composition. Any practical effect of the partnership was not meant to occur until after decedent's death.

(g) The Court also took note of decedent's advanced age, serious health conditions and experience as an attorney.

D. Estate of Thompson v. Commissioner, T.C. Memo 2002-246.

1. Formation Facts.

(a) Decedent executed a durable power of attorney in favor of his children, Robert Thompson ("Robert") and Betsy Turner ("Betsy").

(b) In an effort to reduce their father's estate tax exposure, Robert and Betsy consulted with various advisors regarding the establishment of two (2) FLPs on behalf of decedent, and his two children and their families – the Turner Partnership ("Turner FLP") and the Thompson Partnership ("Thompson FLP"). The financial advisor worked for the company which was the licensee for Fortress Financial Group, Inc. Such group was also involved with the Strangi family in Strangi.

(c) The Turner FLP was established under Pennsylvania law for the benefit of Betsy and her husband, George Turner ("Mr. Turner"), and their family. The Turner Corporation was the corporate general partner owning a 1.06% interest in the Turner FLP. Decedent was a 95.4% limited partner and Mr. Turner was a 3.54% limited partner. Regarding the Turner Corporation, decedent owned 490 shares, Betsy and Mr. Turner each received 245 shares and an unrelated tax-exempt entity received the remaining 20 shares.

(d) The Turner FLP and Turner Corporation were formed on April 21, 1993 and were funded in the same year. The Turner FLP was funded as follows: Decedent contributed marketable securities with an approximate value of \$1,286,000 in addition to notes receivable from Betsy's children in the amount of \$125,000. Mr. Turner contributed \$1,000 in cash and real property located in Vermont with a value of \$49,000. The Turner Corporation issued a non-interest bearing note in favor of decedent for its interest in the Turner FLP.

(e) The Thompson FLP was established under Colorado law for the benefit of Robert and his family. The Thompson Corporation was the corporate general partner owning a 1.01% interest. Decedent was a 62.27% limited partner and Robert was a 36.72% limited partner. Regarding the Thompson Corporation, decedent and Robert each owned 490 shares and Robert H. Thompson, an unrelated party, received the remaining 20 shares.

(f) Similar to the Turner entities, the Thompson FLP and Thompson Corporation were formed on April 21, 1993 and were funded in the same year. The Thompson FLP was funded as follows: Decedent contributed marketable securities with an approximate value of \$1,118,500 in addition to notes receivable from Robert's family members in the amount of \$293,000. Robert contributed his interest in mutual funds with an approximate value of \$372,000 and his Norwood ranch which was appraised at \$460,000.

(g) In summary, the decedent had contributed \$2.5 million in assets to the two partnerships and had retained \$153,000 in personal assets.

(h) At the time of the transfers, decedent had an annual income of \$14,000 from two annuities and social security, and had annual expenses of \$57,202.

(i) At the time of the transfers, decedent had an actuarial life expectancy of 4.1 years.

2. Operational Facts.

(a) Before forming the entities, decedent and his children agreed that decedent "would be taken care of financially."

(b) Before and after the formation of the FLPs, Betsy and Robert consulted with the financial advisors regarding decedent's accessibility to assets in the FLPs for purposes of continuing his practice of gift giving around Christmas time to various family members. Based upon such consultations, distributions were made from the FLPs in 1993, 1994 and 1995 to decedent in order for him to continue such gifting practice.

(c) Decedent contributed the majority of his assets to the FLPs. Thus, distributions from the FLPs were made for purposes of satisfying decedent's personal expenses.

(d) Regarding the Turner FLP, investment strategies for assets did not change upon the transfer of assets to the partnerships and the same advisors were employed. Account activity was “low,” trading activity of the account recognized as not even “moderately” traded.

(e) Turner FLP owned insurance policies on lives of Betsy and Mr. Turner and paid annual premiums on such policies.

(f) Turner family engaged in a real estate venture involving Lewisville Properties, a modular home construction venture. Turner FLP financed the purchase and construction costs through a margin loan made on the Turner FLP account. The property was eventually sold for a loss of \$60,000 and Phoebe Turner received a commission of \$9,120 on the sale.

(g) Betsy and Mr. Turner assigned their interest in a real estate partnership to the Turner FLP; however, after such assignment the partnership interest remained titled in the name of Betsy and Mr. Turner rather than the Turner FLP.

(h) Turner FLP engaged in various loans to the Turner children and grandchildren. Monthly interest payments owed on the notes were often late or not paid. No enforcement action was taken regarding the repayment of the interest. No loans were made to anyone outside of family members.

(i) During the funding process, Robert contributed his Colorado ranch to the Thompson FLP and entered a lease for such property paying rent of \$12,000 per year. Robert maintained the ranch in the same manner before and after the contribution (i.e., raised and trained mules on the ranch). Any income from the sale of the mules went to Robert, rather than the partnership. However, the Thompson FLP claimed losses in various years from the operation of the ranch.

(j) After decedent’s death, distributions were made from the FLPs to fund specific bequests set forth in decedent’s will. Additionally, the FLPs provided funds to pay for the decedent’s estate taxes.

3. Section 2036 applied for the following reasons.

(a) The Court recognized that an “implied agreement” existed whereby decedent would retain the benefit and enjoyment of the assets transferred to the FLPs during his lifetime.

(b) Decedent transferred the majority of his assets to the FLPs retaining an insufficient amount for his support. Thus, a distribution from the FLPs would be necessary, and was made, to satisfy decedent’s personal expenses. The Court reasoned that transfers from the FLPs to decedent can only be explained if decedent had at least an “implied understanding that his children

would agree to his requests for money from the assets he contributed to the partnerships, and that they would do so for as long as he lived.”

(c) Assets were “formally” transferred from decedent to the FLPs; however, there was no meaningful change in the composition of the asset portfolio nor in decedent’s relationship to the assets. Decedent was still the “principal economic beneficiary” of the contributed property after such contribution and the Court recognized that only a “legal title” change occurred with respect to the property transferred.

(d) Property transferred to the FLPs was merely “recycled,” meaning that the form of ownership of the property had changed (from individual ownership to entity ownership), but decedent’s relationship to such assets had not.

(e) Decedent’s family members also engaged in this “recycling” of their assets through the FLPs. The assets contributed to the FLPs were not pooled with the other partner’s contributions. Specifically, although the partner transferred property to the FLP, he or she continued to receive the sole benefit of income generated by such property after the contribution rather than having income generated by the FLP property disbursed to the partners in accordance with their partnership percentages.

4. Turner v. Commissioner, 382 F.3d 367 (3rd Cir. 2004).

(a) The taxpayer in Thompson appealed the Tax Court’s decision to the United States Court of Appeals for the Third Circuit; such Court affirmed the decision of the Tax Court, discussed above.

(b) If there is an express or implied agreement at the time of the transfer that the transferor will retain lifetime possession or enjoyment of, or right to income from, the transferred property, such property will be included in the transferor’s gross estate under Section 2036(a)(1) of the Code. The Court, after reviewing the evidence, determined that there was no clear error in the Tax Court’s finding of an implied agreement between the decedent and his family whereby the decedent would retain the enjoyment of the transferred property during his lifetime. The decedent transferred the majority of his assets to the partnership and did not retain sufficient assets to support himself. Thus, it was likely that the decedent would need funds from the partnership for such purpose and the record indicates that his family recognized this fact and would distribute assets to him as necessary. Although the formal title of the assets changed from individual ownership to ownership in the name of the partnership, decedent’s relationship to the assets before and after the transfer did not change.

(c) The Court recognized that Section 2036 of the Code provides an exception for any inter vivos transfer that is a “bona fide sale for adequate and full consideration in money or money’s worth.”

(d) The Court referred to Harper and stated that the bona fide sale exception to an inter vivos transfer will be denied when there exists nothing but a circuitous “recycling” of value and when the transaction does not appear to be motivated primarily by legitimate business concerns. The Court concluded that there was no transfer for consideration under Section 2036. Although the partnerships did conduct some economic activity, it was not enough to support any valid, functioning business enterprise. Indeed, the estate conceded that the primary objective in forming the partnership was not to engage in or acquire active trades or businesses.

(e) The Court referred to the specific activities conducted on behalf of the partnerships to conclude that no valid business was conducted. The Court addressed the fact that loans made on behalf of the Turner FLP were intra-family loans only, with interest payments being late or not paid. The Court agreed with the Tax Court that the loans were a way to use the decedent’s money as a source of financing the needs of family members, rather than a way to use the money for a business purpose. Regarding the Thompson FLP, the Court addressed that the only active operations involved the Norwood ranch. However, such ranch was not operated as an income producing business either before or after the property was contributed to the partnership. Income generated with respect to the property went to Robert Thompson, the contributor, rather than to the partnership. The Court referred to Norwood ranch as a “putative business arrangement” which “amounted to no more than a contrivance and did not constitute the type of legitimate business operations that might provide a substantive nontax benefit for transferring assets to the Thompson FLP.”

(f) Although Turner FLP’s investment in the Lewisville Properties (\$186,000) seemed to qualify as a legitimate business transaction, it was not enough to outweigh the testamentary nature of the transfer to the Turner FLP and the operation of such entity.

(g) The Court also addressed the form of the assets transferred to the partnerships, which was predominantly marketable securities. The Court recognized that a nontax benefit for establishing the partnerships is questionable if the partnerships hold an untraded portfolio of securities with no ongoing business operations. The Court distinguished the facts in Thompson from the facts in Church, Stone and Kimbell.

(h) The Court concluded that the transfers to the partnerships did not constitute “bona fide sales” to qualify for the exception under Section 2036, although for a different reason than suggested by the Commissioner. The Commissioner argued there was no bona fide sale because a bona fide sale requires an arm’s length bargain, and there can be no such bargain when one party stands on both sides of the transaction (i.e., as transferor and as limited partner). However, the Court stated that neither the Code nor the Treasury Regulations define a “bona fide” sale to include an “arm’s length transaction” between unrelated parties. The Court recognized, however, that “mischief that may arise

in the family estate planning context” and that such mischief can be monitored by heightened scrutiny of intra-family transfers and does not require prohibition to all family limited partnerships.

(i) Although an “arm’s length transaction” is not a requirement, the transfer must be made in good faith. The Court addressed the fact that a good faith transfer to a partnership must have a benefit other than the estate tax benefits. Regardless of whether all of the partnership formalities are followed, the transaction cannot be entered solely for the purpose of saving estate taxes with no business purpose.

(j) In short, because the partnerships did not conduct any legitimate business operations nor provide the decedent with any nontax benefits, the exception to Section 2036 could not be met and inclusion in the gross estate under such Section was required.

(k) Judge Greenberg’s concurring opinion, as joined by Judge Rosenn.

(i) Judge Greenberg had some additional thoughts with respect to the issue of whether the transfers qualified as transfers for the “adequate and full consideration in money or money’s worth” exception. In this case, because the transfers were not for money, the exception could only apply if the transfers were for property that can be regarded as being for “money’s worth.” Judge Greenberg opined that the conclusion is clear that if a discount is justified, in a valuation sense, the decedent could not have receive adequate and full consideration for his transfers in terms of “money’s worth.”

(ii) Judge Greenberg also addressed the estate’s argument, which is not addressed in the majority opinion, that the decedent did not make a gift for gift tax purposes upon the formation of the partnerships and, therefore, there must have been full consideration for his transfers for purposes of Section 2036. The Judge agreed that there were no gifts made upon formation of the partnerships, but concluded that the estate’s argument that the gift tax and estate tax are in *pari materia* is immaterial to a determination, as such relationship did not change the fact that decedent retained the right to enjoyment of the property and did not receive adequate and full consideration for it in money’s worth.

(iii) Judge Greenberg also stated that the logic of the case should not be applied too broadly. He imagined many partnerships existed where the partner died after contributing assets to the partnership and, therefore, made a transfer that could be included under Section 2036(a). He stressed that the Court cannot hold in all circumstances that Section 2036(a) could apply requiring the valuation of the decedent’s interest at death be made by looking at the assets within the partnership, rather than his or her respective interest, thus disregarding the partnership’s existence

for estate tax valuation purposes. Judge Greenberg does not want the court's reasoning in Thompson to apply routinely in commercial circumstances, although he does not think it would be.

E. Estate of Strangi v. Commissioner, T.C. Memo 2003-145.

1. Procedural Posture.

(a) On January 17, 1996, a Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, was filed on behalf of decedent's estate. The value of decedent's partnership interest was reported as \$6,560,730 and a value of \$25,551 was reported for decedent's stock in the general partner of the partnership.

(b) In a statutory notice dated December 1, 1998, the IRS determined a deficiency in federal estate tax and, alternatively, a deficiency in federal gift tax, resulting from an increase in the value of decedent's interest in the partnership to \$10,947,343 (a deficiency in the amount of \$4,386,613) and an increase in the value of decedent's interest in the general partner of the partnership to \$53,560 (a deficiency in the amount of \$29,009).

(c) Strangi's first appearance before the Tax Court was in response to the above deficiencies. Prior to trial, the IRS, by motion, attempted to add Section 2036 to their list of legal theories which would deny the discount. The Tax Court denied the motion on the ground of untimeliness and ruled in favor of the taxpayer on all the other issues. See Estate of Strangi v. Commissioner, 115 T.C. 478 (2000). The Tax Court holding with respect to the issues other than 2036 are not addressed herein; they were all favorable with respect to the taxpayer.

(i) The IRS appealed to the Court of Appeals for the Fifth Circuit. The Court of Appeals affirmed on all issues other than the question of whether the IRS was timely with respect to raising the Section 2036 argument. The Fifth Circuit reversed the Tax Court's denial of leave to amend and remanded with either of two (2) instructions, the pertinent of which was that the Tax Court reverse its denial of the IRS's motion, permit an amendment to answer and consider the 2036 issue. See Gulig v. Commissioner, 293 F.3d 279 (5th Cir. 2002), aff'g in part and rev'g in part Strangi v. Commissioner, 115 T.C. 478 (2000).

(ii) On July 15, 2005 the Fifth Circuit affirmed the Tax Court decision under Section 2036(a) that the decedent retained enjoyment of the assets transferred to SFLP and that such assets were properly included in the decedent's estate. Strangi v. Commissioner, 417 F.3d 468 (5th Cir. 2005). The Fifth Circuit decision is discussed below.

2. Formation Facts.

(a) On July 19, 1988, Albert Strangi (“decendent”) executed an extremely broad durable power of attorney in favor of Michael J. Gulig, his son-in-law.

(b) In May of 1993, decendent had surgery that removed a cancerous mass from his back. In the summer of 1993, decendent was diagnosed with supranuclear palsy, a brain disorder that would gradually reduce his ability to speak, walk and swallow. In September of 1993, decendent had prostate surgery. After such time, decendent’s son-in-law took over the management of decendent’s affairs pursuant to the durable power of attorney.

(c) On August 12, 1994, decendent’s son-in-law, acting as decendent’s agent through the durable power of attorney, formed the Strangi Family Limited Partnership (“SFLP”) and its corporate general partner, Stranco, Inc. (“Stranco”). Decendent’s son-in-law was a practicing attorney who had done a substantial amount of estate planning. Decendent’s son-in-law had attended a seminar given by the Fortress Financial Group, Inc. the day before he formed the entities. Indeed, all documents relating to the formation of the entities were furnished by Fortress.

(d) Decendent purchased 47% of the shares of the corporate general partner for cash; decendent’s four children purchased the remaining 53% of the shares of the corporate general partner for cash. The corporate general partner contributed the cash to the limited partnership in exchange for a 1% general partnership interest. 98% of decendent’s property, the majority of which was cash and securities, was contributed to the partnership in exchange for a 99% limited partnership interest. Decendent also contributed his personal residence, accrued interest and dividends, insurance policies, an annuity, receivables and partnership interests to the partnership. One of decendent’s children loaned her three siblings the money to purchase the shares in the corporate general partner.

(e) Each of the four (4) children gifted a .25% interest in Stranco to a public charity, which became a 1% shareholder in the corporation.

(f) Decendent and his four (4) children served as the board of directors of the corporate general partner. One of the children was the president. Pursuant to a management agreement, the corporate general partner employed decendent’s son-in-law to manage the affairs of SFLP and Stranco.

(g) Decendent died of cancer on October 14, 1994 at the age of 81; it is unclear whether he was terminal at the time the partnership was established. However, in August of 1994, decendent’s son-in-law believed decendent had about 12 to 18 months to live and decendent’s spouse expected decendent to survive for a period of 2 years. Additionally, from September of 1993 until his death on October 14, 1994, decendent required 24-hour home health care.

3. Operational Facts.

(a) Stranco never had formal meetings.

(b) After decedent died, various distributions were made from SFLP to decedent's children (totaling \$2,662,000) and corresponding and proportionate distributions were made to Stranco. Distributions to the children were characterized as distributions to the estate (as the children were beneficiaries of the estate).

(c) After decedent died, SFLP also paid for decedent's funeral expenses, estate administration expenses, related debts of the decedent, and a specific bequest in decedent's will to decedent's sister.

(d) SFLP paid for the back surgery of decedent's housekeeper who injured her back while working for decedent.

(e) In July of 1995, a distribution of \$3,187,000 was made from SFLP to the decedent's estate to satisfy decedent's federal and state estate taxes. SFLP also advanced funds to decedent's estate to post bonds with the IRS and the state of Texas in connection with the review of decedent's estate tax returns.

(f) SFLP accrued rent on the residence occupied by decedent and reported the rental income on its 1994 income tax return. The accrued amount was paid in 1997.

(g) The primary account held by SFLP was divided into four (4) separate accounts for decedent's children. Each child then had control over a proportionate share of the partnership's assets.

(h) SFLP extended lines of credit to decedent's children.

4. Section 2036(a)(1) applied for the following reasons.

(a) The partnership agreement provided the corporate general partner with the sole discretion to determine when distributions from the partnership would be made. The shareholders of the general partner, pursuant to the executed management agreement, provided decedent's son-in-law with the authority to make such distributions and act on behalf of the partnership and corporation.

(b) The court determined that the property must be included in decedent's estate under Section 2036(a)(1) based solely on the "right to income criterion without looking for an implied benefit to satisfy the "possession" or "enjoyment" criteria of the Section. There were no restrictions evident in the governing entity documents which would have prevented the decedent, through his son-in-law pursuant to the durable power of attorney, from receiving income from the partnership and corporation.

(c) The court also determined that an implied agreement existed whereby decedent retained possession and enjoyment of the assets transferred to the partnership. The reasoning of prior caselaw such as Reichardt, Thompson and Schauerhamer were found to control here. The Tax Court concluded that the decedent “fundamentally” retained the same relationship to his assets before and after the establishment of the partnership.

(d) The court acknowledged that, in contrast to prior cases, the participants proceeded such that “the proverbial ‘i’s were dotted and the ‘t’s were crossed.” However, such measures only gave SFLP and Stranco sufficient substance to be recognized as legal entities in the context of valuation. They do not preclude implicit retention by decedent of economic benefit from the transferred property for purposes of Section 2036(a)(1).

(e) The decedent transferred approximately 98% of his assets, including his personal residence, to the partnership. The court weighed the decedent’s “liquefied” assets versus “liquefiable” assets in determining that an implied understanding existed whereby the partnership and corporation would be a primary source of financial support for decedent. The court found it unreasonable to expect the decedent to rely on the sale of assets for his daily living needs.

(f) The court also stated that a feature “highly probative” under Section 2036(a)(1) was the fact that the decedent’s personal residence was owned by the partnership. Although the decedent continued to reside in the residence, the estate argued that the partnership charged decedent rent to occupy such home and that the rental income was reported on the partnership’s 1994 income tax return. However, the “accrued rent” was recorded on the partnership’s books, but was not actually paid until January of 1997. The court reasoned that decedent continued to retain possession and enjoyment of the residence because a residential lessor dealing at arm’s length would not allow a two year accrual of a rental obligation.

(g) The court was not persuaded by the argument that distributions from the partnership to decedent or his estate was followed by a pro-rata distribution to the general partner. Specifically, the partnership’s payment for the back surgery of decedent’s housekeeper and the partnership’s distribution for the payment of funeral expenses, estate administration and related debts were accompanied by an accounting on the partnership’s books and records as advances to partners, and later closed as distributions, with pro-rata distributions to the general partner. The court recognized the pro-rata distributions as “tokens in nature” and “accounting manipulations.” Such distributions were “insufficient to negate the probability that the decedent retained economic enjoyment of his assets.” The distributions to the general partner were not found to prevent decedent from receiving the benefit of partnership assets. The accounting adjustments did not change the fact that the implicit agreement existed whereby the decedent would receive assets from the partnership as necessary.

(h) The court referred to the testamentary aspects of the partnership and recognized that the partnership had a greater resemblance to a “one man estate plan” rather than an arms length business transaction. The transaction was deemed unilateral in formation in that the decedent’s son-in-law was the only individual who established the entities with little input from family members. The fact that the decedent contributed the majority of his assets and that he was advanced in age and in deteriorating health, supported a finding that the plan was testamentary in nature rather than a business enterprise.

(i) The court recognized that other than a formal title change, there was no other change with respect to the decedent’s relationship to his assets. Decedent’s son-in-law, pursuant to power of attorney, managed decedent’s assets before and after the partnership was formed. Although decedent’s children were shareholders of the corporate general partner, they received no meaningful economic stake in the property during decedent lifetime and made no inquiry into the distribution of assets from the partnership to the decedent or his estate.

5. Section 2036(a)(2) applied for the following reasons.

(a) The Arguments posed by the decedent’s estate and the IRS focused on Byrum. The court addresses these arguments as an alternative to their conclusions concerning Section 2036(a)(1) and “with particular consideration of the facts of this case.” In Byrum, the Supreme Court held that the independent trustee of the irrevocable trust “did not have an unconstrained de facto power to regulate the flow of dividends to the trust, much less the ‘right’ to designate who was to enjoy the income from trust property.”

(b) The court agreed with the arguments raised by the IRS on the 2036(a)(2) issue. Decedent retained a right to designate who enjoyed the property and income from the partnership and the general partner. The partnership agreement named the corporation as the general partner; the management agreement gave decedent’s son-in-law the right to direct distributions. In Byrum, the Supreme Court held that a “power to terminate the trust and thereby designate the beneficiaries at a time selected by the settlor would implicate Section 2036(a)(2).” In this case, pursuant to the partnership agreement, the partnership would be dissolved and terminated upon a unanimous vote of the limited partners and the unanimous consent of the general partner. The general partner’s shareholders agreement provided that a dissolution of the partnership would require the affirmative vote of all shareholders. If dissolution occurred, liquidation of partnership assets would be accomplished pursuant to the partnership agreement at the direction of the managing general partner (decedent’s son-in-law). Based upon the above, the court reasoned that the decedent, with the other shareholders, can act to revoke the partnership and accelerate present enjoyment of the partnership assets. Because the decedent was the 99% limited partner, the majority of the partnership assets would be re-distributed to himself.

(c) Decedent had the right, in conjunction with other directors of the general partner, to declare dividends. The bylaws of the general partner authorize the board of directors, by majority vote at a meeting with a quorum present (a quorum consisting of three (3) members), to declare dividends. Because the general partner had five (5) directors, decedent, through his son-in-law pursuant to the durable power of attorney, and one other director could potentially act to declare a dividend.

(d) The court was also not persuaded by the estate's assertion that the decedent was subject to several impediments so that he could not exercise the power that would warrant inclusion under Section 2036(a)(2). The court concluded that such constraints were illusory. For example, in Byrum, there was an independent trustee; in this case, all decisions were made by Mr. Gulig. In addition, in Byrum, the corporation was subject to economic and business realities which were not present in the case of Stranco and SFLP, which held only monetary or investment assets. Moreover, the fiduciary duties in Byrum applied to a significant number of unrelated parties and had their genesis in operating businesses that would lend meaning to the standard of acting in the best interests of the entity. In this case, Mr. Gulig stood in a confidential relationship, and owed fiduciary duties, to decedent personally as his attorney in fact; to the extent that Stranco or SFLP's interest might diverge from those of decedent, Mr. Gulig would not disregard his preexisting obligation to decedent.

(e) Regarding fiduciary obligations of Stranco and its directors, these intra-family fiduciary duties within an investment vehicle are not the equivalent in nature to the obligations created in Byrum.

(f) Regarding the public charity which owned 1% of Stranco, the court viewed such ownership as "window dressing." The court stated that the charity would not exercise any meaningful oversight.

6. Existence of Consideration Argument.

(a) The applicability of Section 2036(a) may be avoided pursuant to the "bona fide sale for adequate and full consideration in money or money's worth" exception. This exception is afforded if two requirements are met: (1) there is a bona fide sale, meaning an arms length transaction; and (2) adequate and full consideration exists. The court held that neither requirement was satisfied.

(b) Because the decedent, through his son-in-law, stood on both sides of the transaction, no arms length transaction existed.

(c) No full and adequate consideration existed where there has been a mere "recycling" of value through the partnership structure.

7. Amounts Includible in Decedent's Estate.

(a) Because the court held the decedent retained an interest includible under Section 2036, the question is the value of what is includible.

(b) Section 20.2036-1(a) of the Treasury Regulations promulgated under the Code provides that "if the decedent retained or reserved an interest or right with respect to a part only of the property transferred by him, the amount to be included in his gross estate under Section 2036 is only a corresponding proportion." Caselaw and other authority indicates that the full value of transferred property is included unless there is a specific portion of the contributed assets that the retained interest could not reach.

(c) In this case, no part of the transferred property was exempt from the rights or enjoyment retained by the decedent. No distinction was made among the assets contributed to the partnership. There was no evidence that the son-in-law looked to certain assets when deciding whether distributions should be made.

(d) The court held that the full value of the assets transferred to the partnership were included in decedent's estate under Section 2036.

8. The taxpayer appealed the Tax Court's decision to the Fifth Circuit Court of Appeals.

9. Strangi v. Commissioner, 417 F.3d 468 (5th Cir. 2005).

(a) On July 15, 2005, the Fifth Circuit affirmed the Tax Court decision under Section 2036(a) that the decedent retained enjoyment of the assets transferred to SFLP and that such assets were properly included in the decedent's estate.

(b) The Fifth Circuit, citing Byrum, 408 U.S. 125, 145, 150 (1972), stated that a transferor retains "possession or enjoyment" of property, within the meaning of Section 2036(a)(1), if he retains a "substantial present economic benefit" from the property, as opposed to a speculative contingent benefit which may or may not be realized." The Court concluded that the benefits retained by Mr. Strangi – periodic payments made prior to his death, the continued use of his home which was transferred to SFLP, and the post-death payments of various debts and expenses, were clearly "substantial" and "present," as opposed to "speculative" or "contingent."

(c) Furthermore, in a footnote, the Fifth Circuit stated that "[t]he controlling question . . . is not whether Strangi actually kept any particular asset in his possession, but whether he received a general assurance that the assets would be available to meet his personal needs."

(d) The taxpayer argued that the Tax Court erred in concluding that Mr. Strangi retained possession or enjoyment of the assets transferred to SFLP

and that such assets were includible under Section 2036(a). The Fifth Circuit narrowed the question to whether the record supported the Tax Court's conclusion that Mr. Strangi and the other shareholders of Stranco (Strangi children) had an implicit agreement by which Mr. Strangi would retain enjoyment of the property transferred to SFLP.

(e) The Fifth Circuit noted that the Tax Court's finding of fact would only be reversed if it was "left with the definite and firm conviction that a mistake has been made." Under the circumstances, the Fifth Circuit held that the Tax Court did not err in holding that an implicit agreement existed whereby Mr. Strangi would retain enjoyment of the SFLP assets includible in his gross estate under Section 2036(a)(1). The following evidentiary factors were addressed:

(i) The Court addressed the disbursement of funds from SFLP to Mr. Strangi or his estate. Although the taxpayer argued that only two (2) payments totaling \$14,000 should be considered because they were the payments made during Mr. Strangi's lifetime, the Court responded that the taxpayer missed the point. "Possession or enjoyment" of the assets included the assurance that they would be available to pay expenses and debts associated with the decedent and estate administration. The Court recognized that SFLP distributed over \$100,000 from 1994 to 1996 for funeral expenses, estate administration expenses, specific bequests and the satisfaction of Mr. Strangi's personal debts. Repeated distributions of this nature were strong circumstantial evidence that an implied agreement existed between Mr. Strangi and his children that Mr. Strangi would retain access to SFLP assets.

(ii) The fact that Mr. Strangi retained physical possession of the residence was addressed. The taxpayer argued that although he retained possession, SFLP charged Mr. Strangi rent to reside in the residence. The Tax Court recognized that although the rent charged was recorded in SFLP books and records in 1994, the actual payment of the rent did not occur until 1997. The Fifth Circuit recognized that the Tax Court did not err in considering the retained interest of the residence as evidence of the implied agreement. Even if the belated rent payment was an attempt to recast the proper use of the residence (i.e., possession for rent), the deferral of the payment, in itself, provided a substantial benefit to Mr. Strangi.

(iii) Both the Commissioner and the Tax Court addressed Mr. Strangi's lack of liquid assets after the transfer to SFLP. Mr. Strangi transferred 98% of his assets to SFLP and after such transfer, had only \$762 in liquid assets. The Estate argued that Mr. Strangi had over \$187,000 in assets that could be liquefied to meet expenses for the rest of Mr. Strangi's life. However, the Court found this to be dubious and noted the Tax Court's finding that Mr. Strangi averaged nearly \$17,000 in

monthly expenses over the two month period between the creation of SFLP and his death.

(f) The Estate argued that even if Section 2036(a)(1) applied, the assets transferred to SFLP should be excluded under the bona fide sale exception. The Fifth Circuit disagreed recognizing that two requirements are required to be satisfied under such exception: (1) a “bona fide sale” and (2) “adequate and full consideration.”

(g) The Court held that adequate and full consideration existed using the three prong test enunciated in Kimbell (see pages 58 and 59 of this outline), provided that the formalities of the partnership were respected. The IRS conceded that there was adequate and full consideration.

(h) With respect to whether there was a “bona fide sale,” the Court stated that such a determination is an “objective” inquiry. The Court determined that the proper approach to this prong was also set forth in Kimbell, where it was determined that a sale was bona fide if it serves a “substantial business or other nontax” purpose. It recognized that the finder of fact is charged with making an objective determination as to what, if any, nontax business purposes the transfer was reasonably likely to serve at inception. The Fifth Circuit reviewed the Tax Court determination only for clear error and determined that the Tax Court did not clearly err in finding that Mr. Strangi’s transfer of assets to SFLP lacked a substantial nontax purpose.

(i) Specifically, the Estate raised the following five (5) “nontax” reasons for Mr. Strangi’s transfer of assets to SFLP: (1) deterring potential tort litigation by Mr. Strangi’s former housekeeper; (2) deterring a potential will contest; (3) persuading a corporate executor to decline to serve; (4) creating a joint investment vehicle for the partners; and (5) permitting centralized, active management of working interests owned by Mr. Strangi. These issues were discussed by the Fifth Circuit as follows:

(i) Mr. Strangi’s housekeeper was injured on the job and the Estate argued that SFLP was formed partly out of concern that she may sue for damages. However, the record showed that Mr. Strangi and the housekeeper were very close, Mr. Strangi paid her medical bills after the injury and there was no evidence that Mr. Strangi caused the injury. Thus, the Tax Court did not clearly err in the finding that the transfer of assets into SFLP did not deter a potential tort claim.

(ii) Regarding the contention that the creation of SFLP would deter a potential will contest by the children of Mrs. Strangi (from her prior marriage), the Tax Court concluded that these claims were stale when SFLP was formed. The conclusion that a claim would not be filed or successful was not clearly erroneous.

(iii) The Estate argued that the creation of SFLP would deter the appointment of the corporate Co-Executor of the estate and the fiduciary fees associated with the appointment. The Tax Court was unpersuaded by this argument and could not equate the Estate's claim of "business purpose" with executor fees. This appears to be the only time the Court uses the term "business purpose" rather than "nontax purpose." Thus, it does not appear to be imputing a "business purpose" test.

(iv) The Estate contended that SFLP functioned as a joint investment vehicle for its partners. Addressing the de minimis contribution of the Strangi children to SFLP, this argument was rejected by the Tax Court and for purposes of the bona fide sale requirement. Even if the children contributed their respective proportionate amounts to SFLP, it did not conduct any active business or make any investments after formation. In response, the Estate cited Kimbell which addressed the fact that there was no principle in partnership law which required a minority partner to own a minimum percentage interest for a transfer to be bona fide. However, it was noted that a finding that the partnership served as a joint investment vehicle was questionable where a partnership made no actual investments and there were minimal minority contributions. It was not clear error for the Tax Court to reject this argument.

(v) Again referring to Kimbell, the Estate asserted that SFLP's real property and interests in real estate partnerships (the "working assets") comprised an approximately equal proportion of the transfer in this case. The Court recognized that although Mr. Strangi may have transferred a substantial percentage of assets that might have been actively managed under SFLP, the Tax court concluded that no such management took place. Thus, the Court could not say that the Tax Court clearly erred in rejecting this argument.

(j) Because the Court held that transfer of assets to SFLP lacked a substantial nontax purpose and that the bona fide sale exception did not apply, the assets were included in Mr. Strangi's estate under Section 2036(a)(1). Thus, the Court did not address Commissioner's alternative argument under Section 2036(a)(2).

F. Estate of Abraham v. Commissioner, T.C. Memo 2004-39.

1. Formation Facts.

(a) Decedent and her husband, Nicholas Abraham, Sr., had four (4) children. Mr. Abraham, Sr. died on June 5, 1991 and left significant assets to decedent. Mr. Abraham, Sr.'s will was contested and the family entered into an agreement to compromise his will, which the probate court accepted.

(b) On March 10, 1993, decedent was placed under a guardianship. On June 22, 1993, Donna Cawley, decedent's daughter, and Ira A. Nagel were appointed permanent guardians of the property and estate of decedent.

(c) On or about November 3, 1993, Ms. Cawley and Mr. Nagel petitioned the probate court for authority to make gifts of decedent's assets as a means to reduce decedent's estate for federal estate tax purposes. The court granted such petition.

(d) On June 13, 1994, decedent's children and their counsel, as well as the decedent's guardians, agreed to a stipulation and agreement for entry of a decree to petition to establish an estate plan for the decedent (the "decree").

(e) Based upon the above referenced decree, decedent's Walpole and Smithfield properties (properties transferred to decedent upon the death of her husband) were to be contributed to a family limited partnership of which the decedent was the general partner and a limited partner. Richard Abraham, decedent's son, was to become a 30% limited partner in the partnership in exchange for the settlement of his claims against the decedent's estate. With respect to this partnership, the decree stated that Richard Abraham would receive income from the partnership as the management fee and/or gifts of decedent after deducting partnership expenses and amounts needed for decedent's support.

(f) Decedent was to be the general partner and a limited partner of two (2) other partnerships. Each daughter of decedent, Donna Cawley and Diana Slater, would be a limited partner of a partnership in exchange for her payment of \$160,000. Each of these partnerships would own a 50% interest in the Tyngsboro property (such property was also transferred to decedent upon the death of her husband). Similar to the discussion in (e) above, the decree also provided a similar income distribution provision with respect to the daughters.

(g) The partnerships established would share equally in the costs and expenses related to the "Ozdemir suit," the Bloom potential action and the support of the decedent insofar as the funds generated by decedent's properties not transferred to the partnerships were insufficient for her maintenance as determined by the limited Guardian ad litem.

(h) In October, 1995, the three (3) partnerships discussed above were formed. The names of the entities were as follows. RMA Smithfield/Walpole Family Limited Partnership ("RMA FLP"), the DAS Tyngsboro Family Limited Partnership ("DAS FLP") and DAC Tyngsboro Family Limited Partnership ("DAC FLP"). On October 6, 1995, the Smithfield property was deeded to RMA FLP.

(i) Pursuant to the partnership agreements, the stated purpose of the partnerships was to "acquire, own, hold, sell, invest, reinvest and otherwise deal with the property and any investments." Additionally, "all income, deductions,

profits, losses and credits shall be allocated among the partners in proportion to their respective Percentage Interests.”

(j) RMA Smithfield/Walpole Management Company, Inc. (“RMA, Inc.”) was formed to serve as the corporate general partner of RMA FLP. DAS Tyngsboro Management Company, Inc. (“DAS, Inc.”) was formed to serve as the corporate general partner of DAS FLP. DAC Tyngsboro Management Company, Inc. (“DAC, Inc.”) was formed to serve as the corporate general partner of DAC FLP. David Goldman, Esq. was appointed president of DAC, Inc. and DAS, Inc.; Mr. Goldman was also the appointed limited guardian ad litem for the decedent regarding her partnership interests in the partnerships. With respect to RMA, Inc., Harold Rubin was named as its president. The appointed president of the entity was in control of the respective partnership and acted in a fiduciary capacity for decedent and had complete discretion to determine how much money decedent needed for her maintenance.

(k) Decedent, through her legal representatives, formed three (3) separate revocable trusts to own her stock in the corporate general partners, discussed above.

(l) Regarding DAS and DAC FLPs, decedent held a 98% interest as limited partner, DAS, Inc. and DAC, Inc., respectively, held a 1% interest as general partner, and Ms. Slater and Ms. Cauley, respectively, held a 1% interest as limited partner. Regarding RMA FLP, decedent held a 99% interest as limited partner and RMA, Inc. held the remaining 1% interest as general partner. On December 26, 1995, Richard Abraham was given the 30% interest in RMA FLP, discussed above, in exchange for the settlement of his claims against decedent’s estate.

(m) In October, 1995, Ms. Cawley transferred \$160,000 to decedent’s checking account to purchase an interest in DAC FLP. In exchange for the \$151,000 of the \$160,000 contributed, Ms. Cawley received a 26.057% interest in the partnership as limited partner. Similarly, Ms. Slater transferred \$160,000 to decedent’s checking account in exchange for a 27.783% limited partnership interest in DAS FLP.

(n) On March 25, 1996, Ms. Cawley wrote a \$30,000 check to DAC FLP and a \$40,000 check to DAS FLP from an account that was jointly held between Ms. Cawley and Ms. Slater. In exchange, Ms. Cawley received an additional 5.178% limited partnership interest in DAC FLP and Ms. Slater received an additional 6.904% limited partnership interest in DAS FLP.

(o) On March 1 and April 4, 1997, Ms. Cawley wrote two checks to DAC FLP, each for \$25,000, and received an additional 8.64% interest in the partnership as limited partner.

(p) Similarly, on March 5 and April 8, 1997, Ms. Slater wrote two checks to DAS FLP, each for \$25,000, and received an additional 8.63% interest in the partnership as limited partner.

(q) In each of 1995, 1996 and 1997, decedent, through the guardian, gifted 1.726% in the DAS FLP to Ms. Slater, her husband and their children. Similarly, in 1995, 1996 and 1997, gifts of 1.803% in the RMA FLP were made to Richard Abraham and his family.

2. Operational Facts.

(a) Each month between the establishment of the partnerships and Mrs. Abraham's death, her guardian would prepare an analysis of Mrs. Abraham's expenses and, after determining the monthly "shortfall," would write a letter demanding payment from the partnerships regarding such amount. Checks were written from the partnerships to the guardian in that regard.

(b) On a monthly basis, each of Ms. Cawley, Ms. Slater and Mr. Abraham received their percentage ownership share (including the shares gifted to their families) of the income from the partnerships.

(c) Pursuant to early accounting records, the payments from the partnerships to satisfy the "shortfall" in Mrs. Abraham's expenses were not treated formally on the books as partnership expenses. Net income of the partnerships was computed by deducting expenses such as administration fees and insurance from gross partnership income.

3. The Tax Court held that Section 2036 applied because the decedent continued to enjoy the right to support and maintenance from the income from the partnerships, regardless of the form of her transfers. According to the decree, income generated by the partnerships was directed first to the decedent as necessary for her support and maintenance. The limited partners would only receive their proportionate share of the partnership income, if any, after the decedent's needs were addressed.

4. Estate of Abraham v. Commissioner, 408 F.3d 26 (1st Cir. 2005).

(a) On appeal, the First Circuit Court of Appeals affirmed the Tax Court decision. The First Circuit recognized that the Estate's biggest hurdle was that it did not prove that Ms. Cawley and Ms. Slater paid adequate consideration for the interests in the partnerships. No admissible evidence was presented concerning the validity of the discounts applied to the partnership interests because the valuation letters relied on by the Estate were excluded from evidence.

(b) The Estate argued that the Tax Court used the wrong test to determine what constituted adequate consideration. The Estate argued that whether full and adequate consideration was paid for the partnership interests should be measured by the value of the remainder interest at the time of the transfers and not the fee simple value of the partnership percentages at the time of

the transfer. The cases presented by the Estate provided for a decedent's sale of remainder interests in property and the courts in those cases held that "adequate and full consideration" for purposes of Section 2036 should be measured by what the decedent sold (remainder interest) and not the fee value of the property as a whole. The First Circuit stated that the cases presented by the Estate were inapplicable because no evidence in the record suggested that the parties contemplated the transfers as "sales" by Mrs. Abraham of remainder interests in the partnerships. The First Circuit stated that the Estate's current argument conflicted with its position at trial, where it argued that Ms. Cawley and Ms. Slater purchased present fee interests in the partnerships.

(c) The Estate argued that the Tax Court erred in holding that Mrs. Abraham retained the right to the income for her personal needs. Specifically, the Estate argued that (1) Mrs. Abraham did not retain a legally enforceable "right" within Section 2036; and (2) there was no agreement that Mrs. Abraham would retain access to the income from the partnerships to the extent necessary for her support. With respect to the first argument, the First Circuit disposed of such argument. The Court stated that the Tax Court did not find that Mrs. Abraham retained a legally enforceable "right" to the income of the partnerships. Thus, the argument that the Tax Court decision is in conflict with vested property interests was irrelevant.

(d) The First Circuit confirmed that the Tax Court finding that the decedent was entitled to any and all funds generated from the partnership for her support was not clearly erroneous. Based upon the evidence, it was clear that Mrs. Abraham's guardian ad litem had the discretion and the approval of the family to use the partnership income for Mrs. Abraham's support. This would include the invasion of the other partners' shares of the partnership in the event that Mrs. Abraham's needs exceeded her share of the partnership income. The evidence supported the finding that the guardian ad litem failed to segregate the personal funds of Mrs. Abraham from the funds in her revocable trust and commingled all monies in the bank accounts for the partnerships. This commingling was indicative of Mrs. Abraham's retained interest over the partnership income.

(e) The Estate's final argument on appeal was that the Tax Court erred by including 100% of the partnerships in Mrs. Abraham's gross estate under Section 2036 because such Section only covered the interests that Mrs. Abraham transferred to her children, not the interests she held at death. Section 2033 of the Code addressed the interests retained by Mrs. Abraham at death, but the Estate argued that because the Tax Court did not address Section 2033, it should be reversed with respect to those interests. The First Circuit rejected the Estate's arguments. Section 2036 was invoked to recapture in the gross estate partnership interests that were allegedly "transferred." Regarding the Section 2033 argument, such Section was never an issue at trial because the Estate never disputed that the interests held by Mrs. Abraham were included in her gross estate (such interests were also included on Mrs. Abraham's initial estate tax return). It was assumed

by all parties that the only dispute rested with the interests transferred to the children.

G. Estate of Hillgren v. Commissioner, T.C. Memo 2004-46.

1. Formation Facts.

(a) Decedent and her brother, Mark Hillgren (“Hillgren”), formed the Lea K. Hillgren Partnership (“LKHP”) on January 1, 1997. The same attorney represented decedent and Hillgren in the formation of LKHP.

(b) Decedent held a 99.95% capital interest and a 75% profit interest in LKHP and gave Hillgren a .05% capital interest and 25% profit interest in LKHP.

(c) Decedent contributed seven (7) properties to LKHP; Hillgren did not contribute property to LKHP. However, the properties were not deeded to LKHP. The partnership agreement specifically provided that title to any property contributed by a limited partner to the partnership would remain in the name of the limited partner for the benefit of the partnership. The leases with respect to such properties were not formally assigned to LKHP.

(d) On May 27, 1997, decedent executed seven (7) quitclaim deeds transferring her interest in the LKHP properties to her amended trust; such deeds were not recorded. She also assigned her partnership interest to the amended trust on that date.

(e) On May 13, 1999, almost two (2) years after decedent’s death, a certificate of limited partnership was filed for LKHP with the California Secretary of State.

2. Operational Facts.

(a) The partnership agreement provided that Hillgren could conduct partnership business without disclosing the existence of the partnership.

(b) The partnership agreement provided that the general partner is not required to open an account in the name of the partnership, but could maintain the existing bank account that was used by Sea Shell (another entity owned by the decedent) and the decedent’s amended trust. No account was established in the name of the partnership.

(c) LKHP’s financial statement dated June 5, 1997 and its general ledger included decedent’s residence, the mortgage on such residence and the mortgage and property tax payments made on the residence. Decedent’s residence and expenses attributable thereto were removed from the ledger by journal entry by an adjustment dated January 1, 1997. Such adjustment was not posted until after decedent’s death. The balance sheets, ledgers and check

registers that represented the financial information of LKHP were maintained under the name of Sea Shell.

(d) Leases were executed on the LKHP properties in the name of Sea Shell. All contracts entered into for maintenance and improvement of the LKHP properties, as well as bills received, were in names other than LKHP.

(e) After the formation of LKHP, Nordica, a general partnership owned by decedent and Hillgren, refinanced its properties. During the loan application process, it was represented to a mortgage broker and lender that the decedent owned and controlled all of the LKHP properties. It was not disclosed to the lender or mortgage broker that the properties were owned by LKHP or that they were restricted by a business loan agreement entered into by decedent and Hillgren.

(f) No minutes were taken regarding meetings of the partners of LKHP.

(g) The partnership agreement provided for distributions of cash at the sole discretion of Hillgren, as the general partner. From January 1, 1997 through June 5, 1997, decedent received distributions totaling \$99,363 and Hillgren received nothing. The distributions directed to decedent were made specifically for her living expenses, and she was dependent on the cash flow of the partnership to cover her personal expenses.

(h) LKHP paid the costs of decedent's estate as necessary for the payment of estate taxes to the IRS and the state of California.

(i) MSL Properties, Inc., a property management company, managed the properties transferred to LKHP prior to such transfer and continued to manage such properties after the transfer. Management books with respect to the management of such properties remained the same before and after the transfer of the properties to LKHP.

(j) Income tax returns filed on behalf of LKHP for 1997, 1998 and 1999 were problematic and required amendments. Distributions were not properly allocated to the partners in accordance with their partnership percentages. Proper returns were filed, with the correct allocation of the profits interest, for 2000 and 2001.

3. Section 2036 applied for the following reasons.

(a) There was no language in the partnership agreement which stated the purpose of forming the partnership. Although the estate contended that the partnership was established to protect the decedent's assets from an impending marriage, the assets were never retitled to LKHP. Based upon the operations, it appeared that LKHP was intended to be invisible.

(b) The Court was not persuaded that decedent and Hillgren acted at arm's length. The same attorney represented decedent and Hillgren in the transaction. The same management company managed the assets before and after the transfer to LKHP. Hillgren stood on all sides of the transaction: he was Co-Trustee of decedent's trust, general partner of the partnership, vice president of Sea Shell, etc. Accordingly, documents were never signed with a consistent signature. Hillgren signed documents in his capacity as all of the above.

(c) Decedent's interest in the properties transferred to LKHP did not change. Legal title of the properties did not change. Again, the same management company managed the properties before and after the transfer and the tenants renting such properties had no knowledge of the change of ownership. Representations were made to third parties that decedent owned and remained in control of the properties.

(d) The Court noted that decedent continued to use Sea Shell's bank account for the partnership.

(e) The Court noted that distributions were made to the decedent and not to Hillgren, which promoted a finding that the intent was to use the partnership assets to support the decedent.

(f) Regarding the formality of the partnership formation, the certificate of limited partnership was not filed with the state until examination commenced with respect to the decedent's federal estate tax return. In addition, inconsistent positions were taken with respect to Hillgren's interest in the partnership on both the partnership income tax returns and the decedent's federal estate tax return.

(g) The Court viewed the partnership as a testamentary vehicle to dispose of the decedent's assets. Prior to decedent's death by suicide, decedent attempted suicide and was on various medications and under the care of a psychiatrist, and suffered from severe pain due to degenerative disc disease. LKHP was formed after decedent's first suicide attempt. The Court could not accept the estate's argument that decedent was in excellent health.

H. Estate of Bongard v. Commissioner, 124 T.C. No. 8 (2005).

1. Formation Facts.

(a) Wayne C. Bongard created an irrevocable trust, the Wayne C. Bongard Irrevocable Stock Accumulation Trust ("ISA Trust") in 1980 and funded it with stock in his closely-held company, Empak, Inc. ("Empak"). The initial Trustees of the ISA Trust were Mr. Bongard's son and an employee of Empak, Mr. Welter (subsequently, Mr. Welter was the sole Trustee). Between 1991 and 1994, ISA Trust made distributions of Empak stock to its beneficiaries. Empak immediately redeemed the stock from the trust beneficiaries for cash.

(b) Mr. Bongard formed WCB Holdings, LLC (“the LLC”) in December, 1996 (it was formed earlier in the year, but not capitalized until December). The LLC had Class A and Class B units; only the Class A units had voting rights. Mr. Bongard and the ISA Trust transferred Empak stock to the LLC.

(c) Also in December, 1996, Mr. Bongard formed a family limited partnership, Bongard Family Limited Partnership (“BFLP”), and transferred his Class B units in the LLC to BFLP. The ISA Trust was the 1% general partner of BFLP. In exchange for its partnership interest, the ISA Trust transferred some of its Class B units in the LLC to BFLP.

(d) Mr. Bongard signed a letter explaining the reasons for forming BFLP and the LLC. Such letter discussed that the entities provided, among other things, a method for giving assets to family members without deterring them from working hard and becoming educated, protection of his estate from frivolous lawsuits and creditors, greater flexibility than trusts, a means to limit expenses if any lawsuits should arise, tutelage with respect to managing the family assets and tax benefits with respect to transfer taxes.

(e) Mr. Bongard also created (in the same month as the LLC and partnership formation) the Wayne C. Bongard Children’s Trust and the Wayne C. Bongard Grandchildren’s Trust. He transferred Class A units in the LLC to these trusts so that he held a minority position in the LLC.

2. Operational Facts.

(a) In December, 1997, Mr. Bongard gifted a 7.72% limited partnership interest in the partnership to his wife, Cynthia Bongard. The gift was not reported on Mr. Bongard’s 1997 gift tax return, as the gift qualified for the unlimited gift tax marital deduction.

(b) In November, 1998, Mr. Bongard died. On the federal estate tax return, alternate valuation was elected. A notice of deficiency was issued that determined a tax deficiency of \$52,878,785. The IRS argued that the shares of Empak stock Mr. Bongard transferred to the LLC were includible in his gross estate because he retained interests in the transferred property under Sections 2035(a) and 2036(a) and/or (b) of the Code.

3. Section 2036 applied for the following reasons.

(a) The Estate argued that Mr. Bongard’s transfer of Empak stock to the LLC and his transfer of Class B membership interests in the LLC to BFLP (1) did not constitute “transfers” under Section 2036; (2) satisfied the bona fide sale exception under Section 2036; and (3) did not include the retention of Section 2036 interests.

(b) The Court determined that a lifetime transfer was made. The term “transfer” was broadly defined and any act, including Mr. Bongard’s transfer of his Empak shares to the LLC and the membership interests in the LLC to BFLP, would be included in the broad interpretation of the term.

(c) With respect to the bona fide sale exception, the Court referred to Estate of Harrison v. Commissioner, T.C. Memo 1987-9, Harper, Thompson, Strangi, Stone and Hillgren. The Court addressed a “simplified” bona fide sale exception stating that the exception would be met where the “record establishes the existence of a *legitimate and significant nontax reason* for creating the partnership and the transferors received partnership interests *proportionate* to the value of the property transferred.” The objective evidence must indicate that the nontax reason was a significant factor that motivated the partnership’s creation. The significant purpose must be an “actual motivation,” not a “theoretical justification.”

(d) The Court addressed Kimbell, and recognized that the bona fide sale exception was separated into two (2) prongs: (1) whether the transaction qualified as a bona fide sale; and (2) whether the decedent received full and adequate consideration. In examining the adequate and full consideration language (the “proportionality” prong), the Court set forth an objective inquiry and stated that the proper question in examining the adequate and full consideration prong was whether the sale depleted the gross estate.

(e) The Court held the bona fide sale exception applied to Mr. Bongard’s transfer of Empak stock to the LLC because he possessed a legitimate and significant nontax reason for the transfer and because he received LLC interests proportionate to the value of the property transferred. Specifically, in reaching such conclusion, the Court focused on the fact that the LLC was formed as a holding company for the Empak stock to facilitate liquidity and attract outside investment. This supported the conclusion that the legitimate and significant nontax reason existed. Because the exception applied to the LLC transfer, Sections 2036(a)(1) and (2) were not addressed.

(f) The bona fide sale exception was held not to apply to Mr. Bongard’s transfer of Class B membership interests in the LLC to BFLP. The Court addressed the letter executed by Mr. Bongard which summarized his reasons for forming BFLP and dismissed the nontax reasons discussed therein as not satisfying the legitimate and significant nontax reason test.

(i) Although using BFLP as part of a future gifting program could be an acceptable nontax reason for creating the entity, the Court pointed out that Mr. Bongard only made one small gift of limited partnership interests to his spouse, but no other gifts of limited partnership interests.

(ii) Under Minnesota law, each spouse was required to own at least \$1.2 million in assets to have a valid postmarital agreement. One of the reasons to establish BFLP was for Mr. Bongard to satisfy this requirement. However, the formation of the LLC allowed Mr. Bongard to make gifts without disrupting the company. Also, he only transferred a small amount of limited partnership interests to his spouse; such did not justify his transfer of all Class B membership interests to BFLP.

(iii) The creditor protection purpose referenced in Mr. Bongard's letter was rejected because no additional protection was afforded by BFLP with respect to the Empak shares. Protection was already afforded by Mr. Bongard's initial transfer to the LLC.

(iv) Mr. Bongard's letter addressed that BFLP would provide tutelage to his children regarding the management of family assets. However, the Court noted that the interests were never diversified and BFLP did not perform any management function. The "recycling" argument discussed in Harper applied.

(g) The Court determined that Section 2036(a)(1) applied because an implied agreement existed which allowed Mr. Bongard to retain enjoyment of the assets transferred to BFLP. Mr. Bongard was the CEO of Empak and could control any redemption over the entity shares. Thus, he controlled whether BFLP could transform the Class B membership interests in the LLC into liquid assets.

(h) Judge Chiechi's dissenting opinion should be noted as it is directly attacked the Section 2036(a)(1) majority analysis with respect to the BFLP determination. It was cited that Mr. Bongard did not need the membership interests in the LLC to maintain his lifestyle. Distributions from BFLP were not made to Mr. Bongard at any time and there was no indication that distributions would ever have been made to him. The majority's conclusion assumed Mr. Bongard's control over the cash flow to BFLP (based upon his control over when Empak stock is redeemed and when LLC interests owned by BFLP are redeemed). The dissenting opinion recognized that control over cash flow to BFLP should not logically lead to a conclusion that an implied understanding existed as to how the cash would be used once in the entity.

I. Estate of Bigelow v. Commissioner, T.C. Memo 2005-65.

1. Formation Facts.

(a) Virginia A. Bigelow transferred her 98.2857% interest in her residence to her revocable trust (the "Bigelow Trust") in 1991. Mrs. Bigelow was the Grantor of such trust and she and her son, Franklin T. Bigelow, Jr. ("Franklin"), were the Co-Trustees.

(b) In 1992, Mrs. Bigelow suffered a stroke and was hospitalized. After entering rehabilitation for six (6) weeks, she moved to an assisted living facility.

(c) At the end of December, 1992, Mrs. Bigelow withdrew a 1.5% interest in the property from the Bigelow Trust and gave each of her daughters a .75% interest.

(d) In January, 1993, the Trustees of the Bigelow Trust and the Bigelow children entered into an exchange and leaseback agreement with Peter and Margaret Seaman. Pursuant to the terms of the agreement, the Bigelows agreed to transfer the residence owned by the Bigelow Trust to the Seamans in exchange for \$125,000 and the property owned by the Seamans. It was contemplated that the Seamans would build a new house on the property transferred to them by the Bigelows. As part of the agreement, the Bigelows agreed to lease the property transferred by the Seamans back to them until the new house was completed.

(e) The Bigelow Trust obtained a \$350,000 loan from Great Western bank to pay off loans that had been secured by the residence. Mrs. Bigelow and Franklin personally guaranteed the notes.

(f) In December, 1994, the Trustees of the Bigelow Trust and the Bigelow children executed a limited partnership agreement to form Spindrift Associates, Ltd, a California limited partnership ("Spindrift"). The purpose of Spindrift was limited under the partnership agreement; it provided that the sole purpose was to engage in the business of owning and operating residential real property. The partnership agreement allowed Spindrift to issue units with different rights and preferences. Specifically, each unit represented a contribution of cash or property of \$100. "A units" were issued to limited partners in exchange for cash or checks and "B units" were issued to limited partners in exchange for contributions of property. The Bigelow Trust was the sole general partner and a limited partner. The Bigelow children were limited partners. In December, 1994, the Bigelow Trust contributed \$500 to Spindrift in exchange for a 1% interest as general partner and the Bigelow Trust and the Bigelow children contributed \$100 in exchange for one A unit.

(g) In December, 1994, the Bigelow Trust transferred the property it received from the Seaman agreement, but not the debt secured by the property, to Spindrift in exchange for 14,500 B units. Mrs. Bigelow, as grantor and beneficiary of the Bigelow Trust, agreed to hold Spindrift harmless for the loan and line of credit. The Spindrift agreement required the capital account of the Bigelow Trust to be reduced to the extent that Spindrift funds were used to pay any of the principal of the loan or line of credit.

(h) In February, 1995 (after the Seamans moved out), the property was leased from Spindrift pursuant to a 24 month lease. In September, 1997, Spindrift

agreed to sell the property and the proceeds of the sale were distributed to the partners in December, 1997.

2. Operational Facts.

(a) Rental receipts received were deposited into the Spindrifft bank accounts and the property expenses were paid from those accounts. Spindrifft also made the payments on the loan (Mrs. Bigelow was supposed to make these payments). Spindrifft did not adjust the capital account of the Bigelow Trust for payment of principal as required under the terms of the Spindrifft agreement. The Bigelow Trust made the payments on the line of credit. For the two (2) year period ending on Mrs. Bigelow's death, Franklin transferred funds between Spindrifft and Mrs. Bigelow forty (40) times.

(b) In December of 1994 and 1995, Franklin, under Mrs. Bigelow's durable power of attorney, transferred limited partnership interests in Spindrifft from the Bigelow Trust to the Bigelow children.

(c) Mrs. Bigelow died in August, 1997. At such time, the Bigelow Trust owned a 1% general partnership interest and a 45% limited partnership interest in Spindrifft. By December, 1998, Spindrifft was terminated, final distributions were made to the partners and the appropriate dissolution documents were recorded in the state of California.

(d) When the gift tax returns and estate tax return for Mrs. Bigelow were filed, a 31% marketability discount was applied to the gifts of the limited partnership interests and the estate claimed a 37% marketability discount on the value of the limited partnership interests for estate tax purposes.

3. Section 2036 applied for the following reasons.

(a) The Court determined that Section 2036(a)(1) applied because there was an implied agreement for Mrs. Bigelow to retain the enjoyment of the property that was contributed to Spindrifft. Spindrifft made the monthly payments on the loan that was owed by the Bigelow Trust and Spindrifft made cash distributions to provide cash flow for monthly expenses. The Court stated that Mrs. Bigelow's use of Spindrifft income to replace the income lost by the transfer of the rental property to the partnership supports the implied agreement theory. In addition, Mrs. Bigelow retained the economic benefit of ownership of the property transferred from the Seamans, which was subsequently contributed to the partnership; the Court reasoned that the property continued to secure the decedent's legal obligation to pay the loan and line of credit which were secured by the property. The opinion includes a detailed analysis of Mrs. Bigelow's income and expenses.

(b) The Court addressed whether the bona fide sale for full consideration exception applied and, (1) citing Thompson (see Article III., Section D. of this outline), recognized that the transfer to Spindrifft must have

been made in good faith, and (2) citing Bongard (see Article III., Section H. of this outline), that the transfer must be made for a legitimate nontax purpose. In determining that the transfer was not made in good faith and that there was no nontax benefit to Mrs. Bigelow, the following reasons were addressed.

(i) The transfer of the property to Spindrift by Mrs. Bigelow rendered her unable to meet her financial obligations. In addition, Mrs. Bigelow continued to make substantial gifts during her lifetime, despite the fact that funds were not available for the payment of living expenses.

(ii) The provisions governing the formalities of the transaction were not respected (i.e. K-1s were not properly reflective of capital accounts, partnership capital or capital accounts were not maintained, balance sheets improperly showed the loan as a partnership liability although it was a liability of the Bigelow Trust).

(iii) In order for the transaction to be bona fide, the transfer must provide “some benefit other than estate tax savings.” No nontax benefit existed here “because management of the assets did not change as a result of the transfer and there was no pooling of assets.”

(c) The Court distinguished the Kimbell case as follows: (1) the Bigelow Trust did not relinquish its interest in the property because it continued to secure Mrs. Bigelow’s personal obligations; (2) because the Bigelow Trust did not benefit from the creation of Spindrift, the partnership interest received was not equal in value to the property transferred; (3) in Kimbell, an LLC was the general partner and shielded the decedent from liability; (4) Mrs. Kimbell retained assets outside of the partnership for her support; and (5) Mrs. Kimbell did not transfer assets between the entity and her revocable trust.

(d) Based upon the foregoing, the Court determined that the value of the rental property contributed to the partnership was included in Mrs. Bigelow’s gross estate.

4. The 9th Circuit affirmed the Tax Court holding discussed above.

J. Estate of Korby v. Commissioner, T.C. Memo 2005 – 102 and T.C. Memo 2005-103.

These companion cases, initially decided before the Tax Court on May 10, 2005, are virtually identical except that in the first case, additional arguments under Sections 2056 and 6651 of the Code were addressed; in the second case, an additional argument pertaining to the inclusion of assets transferred to a family trust under the terms of the revocable trust was addressed. These additional arguments are not relevant for purposes of this outline; thus, they are not addressed herein. The issues, law and analysis pertaining to Section 2036 in the first case are included herein.

1. Formation Facts.

(a) Austin and Edna Korby had four (4) sons, Austin Dennis Korby, Jr. ("Dennis"), Gary Alan Korby, Donald Wayne Korby and Steven Glen Korby.

(b) Mr. and Mrs. Korby both died in 1998; beginning in 1993, both were diagnosed with a series of ailments which contributed to their ultimate demises.

(c) In 1993, Mr. Korby and Dennis sought the advice of an estate planning attorney. The Korbys created a revocable trust of which Mr. Korby and Dennis were the Trustees (the "Korby Trust"). Between 1993 and 1995, the Korbys transferred assets to the Korby Trust, including a 2% general partnership interest in Korby Properties, a limited partnership ("KPLP").

(d) On March 26, 1994, KPLP was formed in Minnesota. Mr. and Mrs. Korby and each of their sons signed the limited partnership agreement as limited partners on March 26, 1994. The Korby Trust was the sole general partner of KPLP.

(e) KPLP was not funded and did not commence business until spring of 1995. In 1995, the Korby Trust transferred a money market account with \$37,841 to KPLP in exchange for the 2% general partnership interest. The Korbys also transferred the following to KPLP: (1) stocks valued at \$1,330,442; (2) state and municipal bonds valued at \$449,378; and (3) U.S. savings bonds worth \$71,043. 90% of these assets transferred were held by Mr. and Mrs. Korby, as joint tenants. The remaining transferred assets were held by Mr. Korby, individually, or in joint tenancy between Mr. Korby and the sons. In exchange for the assets transferred, Mr. and Mrs. Korby received a 98% limited partnership interest in KPLP.

2. Operational Facts.

(a) In 1995, Mr. and Mrs. Korby gave 24.5% limited partnership interests to irrevocable trusts created for each of the Korby children. Such gifts were reported on their 1995 federal gift tax returns with a value of \$521,870. A 43.61% discount was applied to transferred interests because such interests were minority interests and lacked management control.

(b) After 1995, KPLP maintained five (5) investment accounts and a checking account. Dividends from the investment accounts were deposited into the checking account. The checking account was used to pay KPLP expenses. Mr. Korby and Dennis were the only signatories on the checking account.

(c) In 1995, Mr. Korby purchased an annuity from LifeUSA Insurance Co. and named himself the annuitant and KPLP as the owner.

(d) In 1995, the Korbys transferred their residence to the Korby Trust. KPLP and the living trust paid many of the Korbys' household expenses between 1995 and 1998. The Korby Trust made payments for Mrs. Korby's nursing home, to drug and miscellaneous stores and the IRS, and cash payments to Mr. Korby. In order to make these payments, the Korby Trust received a distribution from KPLP and the Korbys' Social Security. KPLP also paid utility bills for the residence, property taxes and insurance, and deducted a percentage of such payments as "business expenses."

(e) In June, 1998, KPLP redeemed a U.S. savings bond that was initially contributed to the entity by Mr. and Mrs. Korby. The U.S. Treasury issued KPLP two (2) checks. One check was endorsed to National Western Life Insurance Co. to purchase an annuity of which Dennis was the annuitant and the Korby children were the owners and beneficiaries. The other check was deposited into the Korby Trust. KPLP did not report this amount on its 1998 return as a distribution or guaranteed payment to the Korby Trust.

(f) After the estate tax return for Mrs. Korby was filed, a notice of deficiency was issued stating that the full value of the assets held by KPLP were includable in Mrs. Korby's gross estate under Sections 2036 and 2038 of the Code.

3. The Tax Court determined that Section 2036 applied for the following reasons.

(a) The Court determined that an implied agreement existed between Mr. Korby, on his behalf and on behalf of Mrs. Korby, and the Korby children that the assets transferred to KPLP would be available for Mr. and Mrs. Korby if they needed income.

(b) Based upon the health of the Korbys and increasing medical and living expenses, it was clear that the costs of such expenses would exceed the amount they received from Social Security.

(c) Mrs. Korby's estate argued that the cash payments made from KPLP to the Korby Trust and the payments of the Korbys' home expenses were management fees paid for Mr. Korby's services as a money manager for the KPLP assets. This argument was rejected. The amounts received were consumed by Mr. and Mrs. Korby for their expenses; Dennis, who was the Co-Trustee of the Korby Trust, general partner of KPLP, did not receive any of such amount. As Co-Trustee, he would be entitled to one-half (1/2) of such "management fee." Furthermore, no management contract was executed and the fee timing and amounts were not consistent from year to year. In addition, while the "management fees" to the Korby Trust totaled over \$120,000 over the years at issue, the limited partners, who owned 98% of KPLP, received only one distribution for \$12,061 in 1998. The Court also reviewed an expert report submitted by Mrs. Korby's estate to validate the management fee. Upon review,

the Court determined that the amount of work and time committed by Mr. Korby to the management of KPLP assets was minimal.

(d) Concluding that an implied agreement existed that the assets transferred to KPLP would be available for the Korbys, the Court then addressed the issue of whether the bona fide sale exception applied (so that Section 2036 would be inapplicable).

(e) The Court referred to Bongard which held that the bona fide sale exception is met when the record establishes the existence of a legitimate and significant nontax reason for the transfer and the transferors received partnership interests proportionate to the value of the property transferred. The objective evidence must indicate that the nontax reason was a significant factor that motivated the partnership's creation. A significant purpose must be an actual motivation, not a theoretical justification.

(f) The Court noted that the facts and circumstances must be examined in order to determine whether the bona fide sale exception has been met. Looking to the previous partnership cases, the factors referred to by the Court were (1) whether the taxpayer stood on both sides of the transaction; (2) the taxpayer's financial dependence on partnership distributions; (3) commingling partner and partnership funds; and (4) taxpayer's failure to transfer property to the partnership.

(g) It was determined that Mr. Korby stood on all sides of the partnership transaction. He and his estate lawyer formed KPLP without the involvement of the sons, who were 24.5% owners of KPLP through the trusts and who signed the partnership agreement. Mr. Korby determined the assets to be contributed to KPLP. The Korby children did not have any understanding of the partnership from a funding or operational perspective.

(h) The determination that the fees from KPLP from the Korby Trust were not management fees support a conclusion against the bona fide sale exception.

(i) The argument made by Mrs. Korby's estate to support a finding that KPLP was formed for nontax reasons was not supported. Specifically, the estate argued that the creation of KPLP was bona fide because it was created to protect the family from commercial and personal injury liability resulting from their bridge-building business, as well as liability arising from divorce. Although the estate pointed to the provision in the KPLP agreement that prevented a partner from unilaterally forcing a distribution and restricted a transfer of limited partnership interests, the Court held that the estate did not show that the terms of the partnership agreement would prevent a creditor of a partner from obtaining the partnership interest in an involuntary transfer. Thus, the limited protection and other evidence supported a conclusion that creditor protection was not a significant reason for forming the partnership.

4. The 8th Circuit affirmed the Tax Court holding discussed above, concluding that there was no clear error in the Tax Court's findings.

K. Estate of Disbrow v. Commissioner, T.C. Memo 2006-34.

1. Formation Facts.

(a) At her husband's death in 1993, Lorraine Disbrow became the sole owner of a residence that she shared with her husband, which she used as her primary residence until she died.

(b) From 1993 until her death, Mrs. Disbrow's was in poor health and mentally unstable.

(c) When Mrs. Disbrow was living at the residence (there were periods of time that she was hospitalized, in rehabilitation or staying with her son), she generally was restricted to the first floor because she could not use stairs by herself. While one or more of Mrs. Disbrow's children frequently visited or stayed with her, she generally lived at the residence by herself.

(d) After her husband's death, Mrs. Disbrow hired the attorney whom she retained to probate her husband's Will to advise her on estate planning matters. The attorney recommended that she transfer her residence to a family general partnership. The attorney advised Mrs. Disbrow that this would enable her to give all of her interest in the partnership to her family, continue to live at the residence as a tenant of the partnership and prevent the residence from being subject to estate tax.

(e) On December 10, 1993, Mrs. Disbrow (at almost age 72), together with her children and children-in-law, executed a general partnership agreement forming Funny Hats. As stated in the partnership agreement, Mrs. Disbrow received a 28.125% partnership interest, and everyone else received a 7.1875% partnership interest (except for one single son who received a 14.375% partnership interest).

(f) On the same date that the partnership agreement was executed, Mrs. Disbrow contributed the residence to Funny Hats for no consideration. Neither her children nor her children in-law contributed any asset to the partnership upon its formation.

(g) On January 1, 1994, Mrs. Disbrow gave her entire partnership interest to her children and children-in-law. Thereafter, each of them owned a 10% partnership interest in Funny Hats (except for her son who owned a 20% partnership interest).

(h) The partnership agreement of Funny Hats stated that it was "created to establish and conduct the business of real estate ownership and management" and that its place of business was the address of the residence. The

partnership conducted no business and was not operated with an intent to make a profit.

(i) The only assets of Funny Hats were the residence and a checking account, which was primarily funded with transfers from Mrs. Disbrow.

2. Operational Facts.

(a) From January 1, 1994 through December 31, 2000, Mrs. Disbrow rented the residence from the partnership pursuant to one-year lease agreements. Mrs. Disbrow's attorney prepared the lease agreements on standard forms and certain pre-typed provisions were crossed out (e.g., "Tenant may not alter, decorate, change or add to the Premises;" "Tenant may not sublet all or part of the Premises, or assign this Lease or permit any other person to use the Premises").

(b) Each of the lease agreements stated what rent was to be paid, when it was to be paid, and what would happen if it was not paid. None of the lease agreements restricted Mrs. Disbrow's use of the residence.

(c) Mrs. Disbrow, when she was not a partner in Funny Hats, wrote on her personal bank account a number of checks that were payable to Funny Hats, which she then endorsed and deposited in the partnership's checking account. A majority of those checks were for rent.

(d) Mrs. Disbrow paid (directly or indirectly) most of the expenses connected with the residence. Because the partners of Funny Hats did not want to incur out-of-pocket costs relating to the residence, they asked Mrs. Disbrow to pay "rent" greater than that stated in the lease agreements to the extent that the stated rent was insufficient to pay expenses connected with the residence.

(e) Mrs. Disbrow did not regularly pay her rent as required by the lease agreements, did not always pay the amount of rent that was stated in the lease agreements, and often paid her rent later than the time required by the lease agreements. Funny Hats never mailed Mrs. Disbrow a notice demanding that she pay her rent, nor did Funny Hats ever send to Mrs. Disbrow a notice of eviction.

(f) There were no lease agreements with anyone other than Mrs. Disbrow with respect to the residence, and no individual had a right superior to that of Mrs. Disbrow to use the residence from January 1, 1994, through her death. Mrs. Disbrow permitted family members and friends to visit and stay at the residence rent free during various times from January 1, 1994, through her death.

(g) When Mrs. Disbrow died on February 9, 2000, the fair market value of the residence was \$400,000. On November 30, 2000, Funny Hats sold the residence to Mrs. Disbrow's son for \$ 350,000 at his request and did not attempt to obtain a second bid for the residence or otherwise sell it in the market.

(h) In May 2001, Mrs. Disbrow's Executor filed a Federal estate tax return. The return reported in part that the decedent's estate owed Funny Hats \$8,500 for the "Balance of annual rent due pursuant to lease agreement" and that decedent's estate incurred a \$6,000 expense for the "Clean out and removal of property re: Decedent's home." The IRS issued a notice of deficiency.

3. Section 2036 applied for the following reasons.

(a) The Court determined that, after transferring the residence to Funny Hats, decedent retained lifetime possession and enjoyment of the residence pursuant to her express and implied understandings and agreements with her children.

(b) The Court first reviewed the lease agreements. The Court found that the lease agreements gave the decedent the same rights in the residence that she had enjoyed before transferring the residence to Funny Hats. In particular, the lease agreements:

(i) Contained no relevant limitation on the decedent's use of the property;

(ii) Gave the decedent the right to "peaceably and quietly have, hold and enjoy" the residence for the term of the lease;

(iii) Allowed the decedent to alter, decorate, change or add to the residence; and

(iv) Gave the decedent the right to sublet all or a part of the residence, to assign the lease and to permit any other person to use the residence.

(c) The Court then determined that there was an implied agreement between the decedent and Funny Hats as to her continued possession and enjoyment of the residence and that the annual lease agreements were nothing more than a "subterfuge to disguise the testamentary nature of the transfer." It reached this conclusion because:

(i) Funny Hats was not a business operated for profit. During the decedent's life, Funny Hats operated solely as a conduit for the payment of expenses related to the residence and operated for the most part only to the extent that the decedent furnished it with funds. Funny Hats used those funds to pay indirectly the same types of expenses that the decedent had paid directly before she transferred the residence to the partnership. Shortly after the decedent died, Funny Hats sold the residence and then liquidated.

(ii) The decedent's relationship to the residence following its transfer to Funny Hats was not treated by either decedent or Funny Hats as

that of a tenant to leased property. Decedent was frequently delinquent in paying, or failed to pay, rent. Funny Hats never sent the decedent a late notice, accelerated her installment payments, made a written demand for payment, sought her eviction, or asked her to post a security deposit. The decedent also directly paid the taxes on and insurance for the residence.

(iii) The decedent transferred the residence to Funny Hats when she was almost 72 years old and in poor health. Following the transfer, decedent continued to live at the residence until she died, and Funny Hats never rented, or sought to rent, the residence after decedent died. Instead, Funny Hats sold the residence to her son shortly after decedent's death, without attempting to sell the residence in the market for a higher price.

(iv) As admitted at trial by a partner of Funny Hats, the children and children-in-law wanted decedent to continue to use and possess the residence as she had before its transfer and wanted decedent to live at the residence for as long as she could. Although Mrs. Disbow's estate argued that Funny Hats could have evicted decedent from the residence at the end of a year by not renewing her lease for the next year, little weight was given this argument. The partners of Funny Hats were all members of decedent's immediate family, and the record gave the Court no reason to find that they would have evicted decedent from the residence.

(v) The decedent transferred the residence to Funny Hats on the advice of counsel to minimize the tax on her estate. The Court opined that the decedent appeared to have understood that transferring the residence to Funny Hats and executing the lease agreements with Funny Hats was merely a mechanism for removing the residence from her gross estate while allowing her to retain beneficial ownership of the residence. The Court noted that as the beneficial owner of the residence, but not as a partner of Funny Hats, decedent frequently wrote checks to Funny Hats and personally cashed those checks to generate funds that were used to maintain the residence.

(d) The Court also concluded that the decedent did not pay full rental value for possession and enjoyment of the residence. Mrs. Disbow's estate argued that the decedent shared the residence with others and that she was required to pay only a portion of the fair rental value of the residence. The Court, however, found no credible evidence establishing that someone other than decedent used the residence. There was no agreement (other than the lease agreements) that governed the use of the residence, and the lease agreements contained no provision permitting any other individual to use any part of the residence. There were also inconsistencies between the estate's claim of decedent's shared usage and the manner in which Funny Hats and decedent's estate reported the rental for Federal tax purposes. On its partnership returns, Funny Hats reported its rental of the residence to decedent as that of the entire residence in that Funny Hats deducted 100% of its related expenses and claimed

depreciation on the entire house. The decedent's estate tax return reported that decedent's estate was entitled to deduct a \$6,000 expense for cleaning out "Decedent's home."

L. Estate of Rosen v. Commissioner, T.C. Memo 2006-115.

1. Formation Facts.

(a) On June 18, 1974, Mrs. Rosen formed a revocable trust known as the Lillie Sachar Rosen Investment Trust ("Lillie Investment Trust"). Mrs. Rosen was the Trustee and Settlor, and her two children were named as successor Trustees. During her life, Mrs. Rosen was the beneficiary of the trust, and the Trustees were permitted to make gifts to Mrs. Rosen's descendants. At her death, after payment of certain expenses and cash legacies, the trust assets passed to Mrs. Rosen's children.

(b) In April 1994, Mrs. Rosen signed a "springing" power of attorney designating her daughter as her attorney-in-fact. The power of attorney specifically authorized Mrs. Rosen's daughter, as her attorney-in-fact, to make gifts.

(c) In or about 1994, Mrs. Rosen began suffering from dementia and Alzheimer's disease, and on July 25, 1994, Mrs. Rosen's children determined that their mother was unable to manage her affairs. They then became successor Trustees of the Lillie Investment Trust pursuant to its terms.

(d) In 1994, Mrs. Rosen's son-in-law, who was an attorney, attended a seminar on family limited partnerships and concluded from this seminar that his mother-in-law should transfer her assets to a family limited partnership in order to reduce the value of her estate for estate tax purposes. Mrs. Rosen's son-in-law contacted her estate planning attorney ("Feldman") and discussed this matter with him.

(e) Thereafter, Feldman structured and formed the Lillie Rosen Family Limited Partnership ("LRFLP"). Feldman determined who would be the initial general and limited partners of the LRFLP, the amount that each initial partner would contribute and which assets Mrs. Rosen would and would not contribute to the partnership.

(f) Although Feldman discussed the structure and formation of the LRFLP with Mrs. Rosen's son-in-law, neither of Mrs. Rosen's children participated in these discussions. Feldman also never met with or spoke to Mrs. Rosen about the formation of the LRFLP (at the relevant time underlying the formation of the LRFLP, Feldman did not know whether Mrs. Rosen was competent, but he did know that her health was not good).

(g) The partnership agreement for the LRFLP was signed on July 31, 1996. Mrs. Rosen's children signed as the general partners (her son signing in his

individual capacity and her daughter signing in her capacity as Trustee of a trust she created) and as the limited partners in their capacities as co-Trustees of the Lillie Investment Trust.

(h) As general partners, Mrs. Rosen's son and the trust created by Mrs. Rosen's daughter each received a .5% general partnership interest, and the Lillie Investment Trust received a 99% limited partnership interest.

(i) Upon signing the LRFLP agreement, Mrs. Rosen's children (and Feldman) were unaware of the dollar amount of any partner's capital contribution. In or about October 1996, Feldman calculated what capital contributions should be made and informed Mrs. Rosen's daughter of the amount that each partner should contribute. In accordance with Feldman's calculations, each general partner contributed approximately \$12,000 (for a .5% general partnership interest) and the Lillie Investment Trust contributed approximately \$2.4 million (for a 99% limited partnership interest).

(j) On October 11, 1996, Mrs. Rosen's daughter, as co-Trustee of the Lillie Investment Trust, directed the transfer of cash and marketable securities in exchange for the 99% limited partnership interest.

(k) On October 24 and 30, 1996, Mrs. Rosen's children each contributed \$12,145 in exchange for a .5% general partnership interest. (It was noted that Mrs. Rosen's daughter, as her mother's attorney-in-fact, gave herself, her brother and their spouses cash gifts in that same year – her brother receiving \$10,000 approximately two months after the capital contributions.)

(l) Between October 1996 and January 2000, Mrs. Rosen's daughter, as her mother's attorney-in-fact, gave Mrs. Rosen's descendants (including spouses of some descendants) a total of approximately 65% of the limited partnership interest in the LRFLP.

(m) When Mrs. Rosen died in July 2000, the Lillie Investment Trust held approximately 35% of the limited partnership interest in the LRFLP.

(n) After Mrs. Rosen died, the LRFLP redeemed the Lillie Investment Trust's limited partnership interest. As a result, the trust was able to pay Mrs. Rosen's debts, funeral expenses, legal fees, bequests and estate taxes.

2. Operational Facts.

(a) The LRFLP conducted no business activity and its income tax returns reported no trade or business income.

(b) No books were maintained as to any activity of the LRFLP, and the primary records that were kept by or for the partnership were the brokerage account records, the checkbook (and related canceled checks) and the bank and

brokerage account statements bearing the name of the partnership. No formal or documented meetings were held between the general partners.

(c) There was no material change in the manner in which the cash and securities contributed by the Lillie Investment Trust was managed. Although the amounts invested in equity versus debt changed somewhat from year to year, the investment strategy of the general partners followed that of Mrs. Rosen when she had managed her investments.

(d) After the transfer of Mrs. Rosen's assets to the LRFLP, her retained assets were insufficient to pay her living expenses and the cost of her formal gift-giving program that she had begun in 1979.

(e) From 1996 through 2000, Mrs. Rosen's daughter withdrew funds from the LRFLP to pay Mrs. Rosen's living expenses and to satisfy her obligations under her gift-giving plan. With one exception, these withdrawals were treated as loans from the partnership to Mrs. Rosen. None of the other partners of the LRFLP ever received from the partnership a loan, a distribution or a payment of a personal obligation.

(f) Two demand notes were prepared in connection with the partnership funds used on behalf of Mrs. Rosen (with interest due at the applicable Federal blended annual rate). The general partners never demanded from Mrs. Rosen any repayment of either note. In addition, there was no security or collateral for any repayment of the funds reflected in either note.

(g) During her life, Mrs. Rosen never repaid any of the principal or interest reflected in the promissory notes. Mrs. Rosen also did not have the ability to repay the amount of the notes unless she sold her interest in the partnership. (After her death, Mrs. Rosen's limited partnership interest in the LRFLP was redeemed, and her estate paid all amounts shown as due, plus interest.)

3. Section 2036 applied for the following reasons.

(a) The Court first addressed whether the bona fide sale exception to Section 2036(a) applied. As in Korby, the Court cited Bongard, which held that the bona fide sale exception is met when the record establishes the existence of a legitimate and significant nontax reason for the transfer and the transferor receives partnership interests proportionate to the value of the property transferred. The Court concluded that the first prong of this test was not met. (The Court did not consider the second prong.)

(b) The Court held that the LRFLP was formed only for purposes of avoiding transfer taxes and stated that in order to qualify as a "legitimate and significant nontax reason" (to qualify for the bona fide sale exception), the reason to form the partnership must be "an important one that actually motivated the formation of that partnership from a business point of view... The reason must be

an actual motivation, not a theoretical justification, for a limited partnership's formation." The Court's conclusion was based on the following:

(i) The LRFLP was not engaged in a valid, functioning business operation and it served no legitimate or significant nontax purpose. While the LRFLP did have some economic activity consisting of its receipt of dividend and interest income, its sale of a small portion of its portfolio, and its reinvestment of the proceeds of matured bonds, was not significant enough to characterize the LRFLP as a legitimate business operation.

(ii) The LRFLP did not maintain the books of account required by the partnership agreement, comply with all of the other terms of the partnership agreement (e.g., no capital contributions were made by any of the partners at the signing of the LRFLP agreement), hold formal or documented meetings between the general partners, or operate the way that a bona fide partnership would have operated (e.g., while the LRFLP agreement was signed on July 31, 1996, and a certificate of limited partnership was filed 5 days later, the amount of each partner's contribution to the capital of the LRFLP was not set until October 11, 1996, at the earliest).

(iii) The partners of the LRFLP did not negotiate or set any of the terms of the LRFLP, and the decedent's daughter (as decedent's attorney-in-fact, co-trustee of the Lillie Investment Trust, and general partner of the LRFLP) stood on all sides of the transaction.

(iv) While the LRFLP agreement was signed on July 31, 1996, decedent did not make her initial contribution until October 11, 1996, and decedent's children did not make their initial contributions until October 24 and 30, 1996. The reported contributions of assets by decedent's children also were de minimis in relation to the assets contributed by decedent. (The Court went on to note that because of the cash gifts that decedent made to her children, the decedent arguably funded the LRFLP all by herself.)

(v) The decedent, acting through her daughter (her attorney-in-fact and co-trustee of the Lillie Investment Trust) transferred substantially all of decedent's assets to the LRFLP. The management of the transferred assets was the same both before and after the transfer, and no meaningful change occurred in decedent's relationship to her assets after the transfer.

(vi) After the transfer of the assets to the LRFLP, the decedent was unable to meet her financial obligations without using funds of the LRFLP, and the funds that were withdrawn from the LRFLP were used for decedent's benefit.

(vii) The assets that were contributed to the LRFLP consisted solely of marketable securities and cash, which, for the most part, were not traded by the LRFLP.

(viii) The decedent was 88 years old and in failing health when the LRFLP was formed.

(c) The following nontax reasons for creation of the LRFLP were disregarded by the Court:

(i) To create centralized management. The Court concluded that the decedent had centralized management through the Lillie Investment Trust. The Lillie Investment Trust held almost all of decedent's assets and allowed her (or a successor trustee) to manage and control her assets in full.

(ii) To limit decedent's liability. The Court was not persuaded that the LRFLP was likely to provide more meaningful creditor protection than the Lillie Investment Trust would have provided. The Court first noted that there was no evidence that the LRFLP was formed with any such intent. The Court then stated that the decedent's creditors should be able to foreclose on substantially all of decedent's assets transferred to the LRFLP (as could be done in connection with the Lillie Investment Trust).

(iii) To facilitate decedent's gift giving and to preserve the value of her gifts. According to the Court, this is not a significant nontax purpose that could characterize the transfer of decedent's assets to the LRFLP as a bona fide sale.

(d) The Court also determined that the decedent had retained the lifetime possession and enjoyment of the assets transferred to the LRFLP (the Section 2036(a)(1) prong) because:

(i) The LRFLP was not a business operated for profit. Instead, it was a testamentary device whose goal was to reduce the estate tax value of the decedent's estate. Before the transfer of decedent's assets to the LRFLP, decedent directly paid her expenses and fulfilled her plan of gift giving. After the transfer, the LRFLP used the assets received from decedent to pay indirectly the same types of expenses and conduct the same gift giving.

(ii) The decedent's relationship to her assets did not change following their transfer to the LRFLP and was not treated differently by either decedent's daughter (as decedent's attorney-in-fact) or the general partners of the LRFLP. Decedent transferred substantially all of her assets to the LRFLP, leaving her few liquid assets on which to live. The funds of the LRFLP were used to pay decedent's living expenses, to make gifts to her descendants, and, after her death, to pay the bequests under the Lillie

Investment Trust and the expenses of her estate.

(iii) The decedent's assets were transferred to the LRFLP on the advice of counsel in order to minimize the tax on the passage of her estate to her descendants. Decedent transferred her assets to the LRFLP when she was 88 years old and in poor health, and the only other partners of the LRFLP were decedent's children. Decedent's children did not prevent decedent from continuing to enjoy her transferred assets.

(iv) The distributions from the LRFLP to the decedent were not bona fide loans. Although there were two promissory notes issued, each was a demand note with no fixed maturity date, no written repayment schedule, no provision requiring periodic payments of principal or interest, no stated collateral, and no repayments by decedent during her lifetime. Other indicia that otherwise would create a true debtor-creditor relationship was also absent. The court discussed each one of the aforementioned factors in great detail.

M. Estate of Erickson v. Commissioner, T.C. Memo 2007-107.

1. Formation Facts.

(a) Arthur Erickson died in May, 1984, leaving his assets to his wife, Hilde Erickson. Pursuant to the terms of his Last Will and Testament, a credit shelter trust was established for Mrs. Erickson's benefit during her lifetime. Upon her death, any remaining assets owned by the credit shelter trust would be distributed to the Ericksons' daughters. Mrs. Erickson and Karen Lange, one of the Ericksons' daughters, were the Trustees of the credit shelter trust.

(b) Mrs. Erickson executed a durable power of attorney in 1994 in favor of Karen, with her other daughter, Sigrid Knuti, as the successor. The power of attorney allowed Karen to make gifts to herself.

(c) In 1998 or 1999, Karen began handling Mrs. Erickson's finances and personal affairs when she became unable to do so.

(d) Mrs. Erickson was diagnosed with Alzheimer's disease in March, 1999 and, when her health continued to decline, she was moved into a supervised living facility. In 2000 and 2001, Mrs. Erickson also experienced serious physical problems such as fracturing her hip which required hip replacement surgery and fracturing her collarbone. The Erickson family expected her to live another year or two after the hip surgery.

(e) After Mrs. Erickson's Alzheimer's disease diagnosis, the family requested that Merrill Lynch Financial Foundation prepare a financial report for Mrs. Erickson including planning alternatives and recommendations. The report indicated that Mrs. Erickson wanted to maintain a \$100,600 budget and minimize estate shrinkage. As it was determined that the approximate estate taxes that

would be owed upon Mrs. Erickson's death would be in excess of \$500,000, the report advised consultation with tax and estate planning professionals.

(f) Karen had initial discussions regarding the formation of a family limited partnership in 2001 when she and her husband were discussing their own estate planning but postponed in depth discussion of the plan with her sister, Sigrid, until Sigrid returned from Russia for their mother's hip surgery. When Sigrid returned, she and Karen met with an attorney regarding the partnership plan. Karen discussed the proposed plan with Mrs. Erickson as a concept, but did not discuss the financial aspects of the transaction.

(g) In May, 2001, the limited partnership agreement was signed. Karen signed the agreement in multiple capacities: individual, as Co-Trustee of the credit shelter trust established for her mother under her father's Will, and as agent under the durable power of attorney for Mrs. Erickson. Karen and Sigrid were general partners and limited partners. Mrs. Erickson, Chad Lange (Mrs. Erickson's son-in-law) and the credit shelter trust were the limited partners.

(h) Regarding the funding of the partnership, Mrs. Erickson would contribute marketable securities plus a Florida condominium in exchange for an 86.25% limited partnership interest. The approximate fair market value of these contributed assets was \$2.1 million. Karen would contribute two partial interests in a Colorado investment condominium she and Chad owned in exchange for a general partnership interest and a limited partnership interest representing 1.4% of the partnership. Sigrid would contribute two partial interests in a Colorado investment condominium she owned in exchange for a general partnership interest and a limited partnership interest representing 2.8% of the partnership. Chad would contribute a partial interest in the Colorado condominium he and Karen owned in exchange for a 1.4% limited partnership interest. The credit shelter trust would contribute a Florida condominium in exchange for an 8.2% limited partnership interest.

(i) Although the partnership agreement contemplated that the above contributions to the partnership would be accomplished concurrently with the signing of the agreement, no transfers were made at such time. Instead, Karen handled the entity administrative matters, such as obtaining the certificate of limited partnership and a taxpayer identification number. It is worth noting that the address listed on the certificate for service of process had no mail delivery.

(j) The funding of the partnership did not begin until two months after the partnership agreement was executed. In September, 2001, the transferring was still being effectuated.

(k) On September 27, 2001, Mrs. Erickson was admitted to the hospital with pneumonia and a decreased level of consciousness. When the condition did not appear to improve, the family decided to forego additional

medical treatment in lieu of care to keep Mrs. Erickson comfortable, in accordance with her wishes.

(l) On September 28, 2001, Karen was scrambling to make the asset transfers to the partnership. On the same day, Karen, pursuant to the durable power of attorney for Mrs. Erickson, finalized gifts to Mrs. Erickson's grandchildren by giving limited partnership interests in the partnership to three trusts for the grandchildren's benefit thereby reducing Mrs. Erickson's limited partnership percentage from 86.25% to 24.18%.

(m) Mrs. Erickson died on September 30, 2001.

2. Operational Facts.

(a) The partnership continued to operate after Mrs. Erickson's death.

(b) The Florida and Colorado condominiums owned by the partnership were managed by the same onsite management companies before and after they were contributed to the partnership.

(c) The marketable securities transferred to the partnership were managed by the same investment advisors before and after they were contributed to the partnership.

(d) The partnership made 2 loans to its partners. \$140,000 was loaned to Sigrid to enable her to purchase a Florida condominium. The partnership did not take a security interest in the condominium but accepted Sigrid's partnership interest as collateral. The partnership reduced the initial interest rate on her loan and Sigrid, acting as general partner of the partnership, approved the original loan to herself and the subsequent rate reduction. A loan of \$70,000 was also made to Chad. Both loans were timely repaid.

(e) Karen was the personal representative of Mrs. Erickson's estate. Because the estate did not have the liquidity to pay the estate taxes owed, Karen sold Mrs. Erickson's residence to the partnership for cash. In addition, the partnership gave the estate cash and characterized the disbursement as a redemption of a portion of Mrs. Erickson's limited partnership interests.

3. Section 2036 applied for the following reasons.

(a) The Court recognized the delay in funding of the partnership indicated the formalities of the partnership were not respected. Specifically, the partnership agreement contemplated concurrent funding with its execution but the actual funding did not occur at that time and transfers were still being effectuated two days before Mrs. Erickson's death.

(b) The partnership had a separate account, but the partners did not alter the relationship to their assets until it was clear Mrs. Erickson's death was imminent.

(c) With respect to Mrs. Erickson's estate tax liability, the partnership distribution to the estate made it clear that partnership funds were still available to Mrs. Erickson as needed. Also, when the distribution to the estate was made, the other partners did not receive a distribution with respect to their partnership percentages.

(d) The partnership had little practical effect during Mrs. Erickson's lifetime because it was not funded until just before her death. It was technically a vehicle for her to provide for her heirs.

(e) The above facts, when taken together, indicated that an implied agreement existed among the parties that Mrs. Erickson would retain the right to possess or enjoy the assets she transferred to the partnership.

(f) The Court also determined that the bona fide sale exception of Section 2036 did not apply. Such exception would apply if the record showed that the partnership was formed for a legitimate and significant nontax reason and that each transferor received a partnership interest proportionate to the fair market value of the property transferred. In this case, the formation of the partnership was not motivated by a legitimate and significant nontax purpose because Mrs. Erickson stood on both sides of the transaction, she was financially dependent on distributions from the partnership, the partners commingled partnership funds with their own and there was a failure to transfer funds to the partnership.

(g) The Court did not find the estate's arguments that a nontax reason existed for forming the partnership compelling.

(i) The estate argued the partnership allowed for centralized management of family assets. This argument was rejected because Karen had management control over Mrs. Erickson's assets before the partnership was formed. There was no additional layer of centralized management afforded.

(ii) The argument that the partnership afforded greater creditor protection was rejected.

(iii) The estate argued that the partnership facilitated Mrs. Erickson's schedule of gift giving to family members. However, the Court recognized that a gift giving plan was not a significant nontax purpose for the entity formation.

(iv) The Court recognized that the partnership was mainly a collection of passive assets (marketable securities and rental properties) that remained in the same management and location as they were in pre-contribution.

(h) The Court recognized that the partnership was formed unilaterally with Karen in control. Sigrid admitted at trial that she did not understand the transaction and there was no evidence that Mrs. Erickson understood the transaction. In addition, the same attorney represented all parties in the transaction.

(i) The Court addressed the age (she was in her 80's) and health of Mrs. Erickson at the time of the transaction as an indication that the transfers were made to avoid estate tax.

N. Estate of Gore v. Commissioner, T.C. Memo 2007-169.

1. Formation Facts.

(a) Sidney Gore died in January, 1995, survived by his wife, Sylvia Gore.

(b) Mr. Gore established a revocable trust during his lifetime so that upon his death, a credit shelter trust and marital trust would be established for Mrs. Gore, if she survived him. Mrs. Gore established a revocable trust on the same date with the same provisions (obviously providing for Mr. Gore, if he survived her).

(c) On the day before Mr. Gore died, he met with his accountant and discussed his concerns about preserving his wealth for Mrs. Gore and future generations.

(d) After Mr. Gore's death, the accountant proposed the idea of the family limited partnership to the Gore children and later, Mrs. Gore. The Gore children engaged an attorney in that regard.

(e) On December 19, 1996, the Gore children executed the certificate of limited partnership for GFLP in Oklahoma. The Gore children were the general partners of the partnership; Mrs. Gore did not participate in the formation of the partnership.

(f) The limited partnership agreement for the partnership was executed on December 26, 1996. The Gore children were listed as general partners on the agreement but no limited partners were listed. The partnership agreement provided that the partnership was formed for investment purposes and that profits and losses would be allocated in proportion to the partners capital accounts. Schedule A of the agreement stated that each of the Gore children had contributed \$500 each for a general partnership unit. However, neither child made any contributions to the partnership when the agreement was executed.

(g) On December 23, 1996, Mrs. Gore executed a durable power of attorney in favor of her daughter, Pamela Powell. On January 3, 1997, Mrs. Gore resigned as Trustee of her revocable trust and Ms. Powell became the successor

Trustee. On January 8, 1997, Mrs. Gore executed an amendment to her revocable trust and other estate planning documents.

(h) The document of interest that Mrs. Gore executed on January 8, 1997 was an "Exercise of Power and Irrevocable Assignment" whereby Mrs. Gore purported to transfer all assets from the marital trust established under her husband's trust for her benefit to the partnership and make \$100,000 gifts to the irrevocable trusts she executed on the same date for each of her children.

(i) The assignment discussed above did not identify or describe any specific assets to which it was to apply and it was unlikely that Mrs. Gore knew the assets owned by her husband's trust.

(j) Prior to her death, Mrs. Gore did not transfer title to any assets in the marital trust to fund the \$100,000 bequests to the children's trusts.

(k) After January 8, 1997, Mrs. Gore did not execute any other documents confirming any transfer of assets pursuant to the assignment, reflecting any gifts of partnership interests or documenting any sale or transfer of assets to the partnership.

(l) With the exception of a bank account, no assets were transferred to the Partnership prior to Mrs. Gore's death.

(m) Mrs. Gore suffered from Parkinson's disease and had been admitted to the hospital for disorientation and decreased levels of consciousness on several occasions after Mr. Gore's death.

2. Operational Facts.

(a) From its formation in December, 1996, through and including the date of Mrs. Gore's death on June 12, 1997, the partnership did not operate a business or engage in any business or investment activity.

(b) During that time, the partnership did not hold legal title to any marital trust assets other than a bank account opened in February, 1997.

(c) During 1997, Ms. Powell deposited some but not all of the dividends paid on the marital trust stocks for the first six months of 1997 into the partnership account. None of the dividend checks issued with respect to marital trust assets were made payable to the partnership.

(d) On June 6, 1997, accounts were still titled in Mrs. Gore's name, not the partnership, and Ms. Powell deposited interest paid from such accounts to the partnership.

(e) Deposits of interest pertaining to marital trust assets continued to be deposited to Mrs. Gore's account, although such assets were allegedly transferred to the partnership.

(f) In October, 1997, which was more than nine months after the partnership was formed and four months after Mrs. Gore died, the accountant created partnership accounting records to document the funding of the partnership and amounts paid to Mrs. Gore for her expenses from the partnership offset by amounts allegedly owed to her by the partnership.

(g) After Mrs. Gore's death, Ms. Powell continued to use the partnership account to pay Mr. and Mrs. Gore's personal expenses.

3. Section 2036 applied for the following reasons.

(a) Mrs. Gore did not part with possession or enjoyment of the property purportedly transferred to the partnership.

(b) At the time of Mrs. Gore's death, the partnership did not hold any of the marital trust assets.

(c) From inception, the partnership did not engage in any business or investment activity.

(d) Accounting records pertaining to the partnership were created after Mrs. Gore's death, long after the partnership was formed.

(e) Mrs. Gore, individually, or through Ms. Powell, as attorney-in-fact, continued to receive all of the income from the partnership transferred to the partnership, directed its deposit and benefited from its use without restriction.

(f) Ms. Powell continued using marital trust assets transferred to the partnership for Mrs. Gore's benefit.

(g) Mrs. Gore maintained the same relationship to her assets before and after the transfers.

(h) The transfer did not qualify for the bona fide sale exception. The transfer was not an arm's length transaction because Mrs. Gore technically acquired her interest from herself. She stood on both sides of the transaction and the partnership was formed without any bargaining or negotiating.

(i) The Court also recognized the transfer was not made for full and adequate consideration because Mrs. Gore used the partnership as a vehicle for changing the form in which she held her interest in the marital trust. The transfer represented a mere "recycling of value."

O. Estate of Rector v. Commissioner, T.C. Memo 2007-367.

1. Formation Facts.

(a) On October 29, 1991, Concetta Rector, at age 85, created a revocable trust naming herself and her son John Rector, as co-Trustees, and transferred assets from a trust established for her benefit upon her husband's prior death to such trust.

(b) In October, 1998, Mrs. Rector, at age 92, moved to a nursing home.

(c) John Rector discussed the possibility of his mother's formation of a family limited partnership with his estate planning attorney; such attorney also prepared an amendment to Mrs. Rector's revocable trust.

(d) The attorney advised John Rector that the partnership would (i) provide Mrs. Rector with a gifting mechanism to transfer limited partnership interests to her descendants, (ii) provide creditor protection and (iii) reduce Mrs. Rector's estate because the value of the partnership interests would be discounted for lack of control and marketability.

(e) On September 3, 1998, John Rector met with the attorney and two of his colleagues to discuss the formation of the partnership for Mrs. Rector. Subsequently, John Rector met with Mrs. Rector and her other son Frederic Rector to discuss the partnership and they decided to proceed with formation; there were not any negotiations over the terms of the partnership agreement. It was determined that Mrs. Rector would be the sole contributor to the partnership and that she would contribute all the assets under her revocable trust to the partnership.

(f) Mrs. Rector and her sons each discussed the terms of the partnership agreement with the attorney; each party did not obtain separate counsel to represent him or her in that regard.

(g) The partnership agreement was executed on December 17, 1998 and Mrs. Rector, individually, was named as the 2% general partner of the partnership and her revocable trust was named as the 98% limited partnership of the partnership.

(h) On March 9, 1999, Mrs. Rector contributed cash and marketable securities with values of \$174,259.38 and \$8,635,082.77, respectively, to the partnership. After the transfer, Mrs. Rector's revocable trust owned the 98% limited partnership interest in the partnership, but no other assets. In addition, Mrs. Rector was the beneficiary of another trust (Trust B) established upon her husband's prior death; such trust owned assets with an approximate value of \$2.5 million. The terms of Trust B provided that Mrs. Rector was required to receive income from the trust on a monthly basis and principal as the Trustee deems

necessary for her “care and comfortable support in her accustomed manner of living.” It was determined that Mrs. Rector’s income entitlement from Trust B for 1999 was \$47,439.12.

(i) In March, 1999, Mrs. Rector gifted 11.11% limited partnership interests to each of her sons. On January 2, 2001, Mrs. Rector assigned her individual 2% general partnership interests in the partnership to her revocable trust. On January 4, 2002, Mrs. Rector gifted additional 2.754% limited partnership interests to each of her sons.

(j) Mrs. Rector died on January 11, 2002.

2. Operational Facts.

(a) The partnership operated without a business plan or investment strategy and it did not trade or acquire investments.

(b) The partnership did not issue financial statements, balance sheets or income statements.

(c) Formal meetings amongst the partners were not held.

(d) The functions of the partnership were to pay Mrs. Rector’s personal expenses, make partnership distributions and own investment accounts.

(e) Capital accounts for the partners were not maintained.

(f) Mrs. Rector continued to receive her monthly income distributions from Trust B, but such amounts received were not sufficient to satisfy her living expenses. Checks were written from the partnership to cover the insufficiency.

(g) In April, 2000, the partnership transferred \$348,100 to Mrs. Rector’s revocable trust. After such transfer, a check in the same amount was issued to the Internal Revenue Service for payment of Mrs. Rector’s 1999 federal gift tax liability.

(h) After Mrs. Rector’s death, the partnership drew on a line of credit (opened prior to death) to pay the Federal and California estate tax liabilities.

3. Section 2036 applied for the following reasons.

(a) The partnership was formed as a testamentary substitute to transfer assets to Mrs. Rector’s descendants.

(b) An implied understanding existed between Mrs. Rector and her sons that she would retain the right to income and enjoyment of the property transferred to the partnership. Assets were not retained outside of the partnership

to satisfy her living expenses; monthly distributions from Trust B were not sufficient.

(c) Mrs. Rector, as the initial individual general partner, and as the co-Trustee of her revocable trust, the subsequent general partner, had the right to direct partnership distributions. She also had the right to revoke the trust. Thus, she at all times retained a majority interest in the partnership and power as general partner.

(d) The transfer of Mrs. Rector's assets to the partnership did not satisfy the bona fide sale for adequate and full consideration exception to Section 2036. The Court focused on the pre-Bongard position that the exception does not apply when there is a mere recycling of assets and no change in the pool of assets transferred or a likelihood of profit. Citing Bongard and Bigelow, without such a change in asset composition, the Court determined that the receipt of the partnership interests was not enough to satisfy receipt of full and adequate consideration.

(e) Similar to Erickson, where the payment of estate taxes using partnership assets was a considered factor in determining estate tax inclusion under Section 2036, the Tax Court in Rector also stated that the use of partnership assets (through the credit line) to satisfy Mrs. Rector's estate tax liability shows an implied agreement between Mrs. Rector and her sons that she would retain enjoyment of the partnership assets during her lifetime, and even after her death, warranting inclusion under Section 2036.

(f) Mrs. Rector did not transfer the assets to the partnership in good faith, meaning for a legitimate and significant nontax business purpose. No arms length transaction existed, as Mrs. Rector transferred all of her assets to the partnership and she was the sole contributor. Separate attorneys were not engaged for each of Mrs. Rector and her sons with respect to the transaction and partnership agreement negotiation. The funding of the partnership did not occur until 3 months after formation. The significant nontax business purpose did not exist at the partnership's inception; the Tax Court recognized that the goal of gift giving as set forth by the estate is a testamentary purpose, not a nontax business purpose. No evidence existed that the assets required special management so the estate's argument that the partnership allowed for efficiency with respect to asset management does not support the nontax business purpose. Lastly, the creditor protection argument failed, as there was no evidence that Mrs. Rector had creditor issues.

(g) Based upon the foregoing, and considering Mrs. Rector's age at the time of formation and the fact that only cash and marketable securities were transferred to the partnership, the Tax Court determined that the formation of the partnership was consistent with an estate plan rather than an investment in a legitimate business.

P. Estate of Hurford v. Commissioner, T.C. Memo 2008-278.

1. Formation Facts.

(a) Funding of HI-1.

(i) During the lifetime of Gary and Thelma Hurford, their attorney assisted them with the preparation and implementation of their estate plan, which included wills which took a conservative approach to planning with the basic bypass trust and marital trust to be established upon the death of the first spouse. Upon Mr. Hurford's death, his gross estate was approximately \$14 million. Mrs. Hurford was the Executor of her husband's estate and the Trustee of the trusts established under his will.

(ii) During the administration of Mr. Hurford's estate, the attorney also assisted Mrs. Hurford with respect to her estate plan. The attorney recommended gifting \$225,000 to each of her children to utilize her lifetime gift tax exemption. These gifts were made in February, 2000.

(iii) The attorney also recommended that Mrs. Hurford create two family limited partnerships. The first partnership would be established to own her farm and ranch properties and the second partnership would be established to own her financial assets.

(iv) At the beginning of 2000, Mrs. Hurford was diagnosed with stage 3 cancer.

(v) At the end of 2000, Mrs. Hurford's attorney began the implementation of the two partnerships. This plan was subsequently halted when the Hurford family hired a new estate planning attorney, Joe Garza.

(vi) Mr. Garza proposed the formation of three family limited partnerships. The first partnership would own the cash, stocks and bonds that were owned by the Family Trust and Marital Trusts established for the benefit of Mrs. Hurford under Mr. Hurford's will (this partnership would be known as HI-1). The second partnership would own the Hunt Oil phantom stock owned by such trusts (this partnership would be known as HI-2). The third partnership would own the farm and ranch properties owned by these trusts (this partnership would be known as HI-3). After the funding of the partnerships, Mr. Garza advised Mrs. Hurford to sell her interest and the estate's interest in each partnership to the children through a private annuity agreement.

(vii) On February 24, 2000, Mr. Garza proceeded with the formation of three limited liability companies ("LLCs") to serve as the general partners of the partnerships. Each of Mrs. Hurford and her three

children received a one-fourth interest in each LLC. Although entity certificates, regulations, employment agreements and minutes of the organizational meetings for the LLCs were prepared, they were never executed.

(viii) On the same date, Mr. Garza filed the formation documents for the partnerships.

(ix) Mrs. Hurford began the funding of HI-1 with her individual stock and cash assets, and the stock and cash owned by the Marital Trust and Family Trust. The letter to effectuate the transfers was drafted by Mr. Garza, but was not dated, and was not tailored to the Hurford's specific situation. In other words, it was a generic "form" letter Mr. Garza used to fund family limited partnerships.

(x) Chase opened three accounts for HI-1, using the same names as the old existing accounts except that each was preceded by the designation HI-1. Over the next three months, assets were transferred from Mrs. Hurford, individually, to the HI-1 account. The accounts being transferred were held at Chase.

(xi) In November or December, 2000, Mrs. Hurford authorized Chase to transfer over \$1 million from Mr. Hurford's estate account to HI-1. Chase initially transferred these assets to a new account named "Thelma G. Hurford, Executrix of the Estate of Gary T. Hurford, Deceased #1" and in February, 2001, the assets were transferred to HI-1.

(xii) On December 28, 2000, Mrs. Hurford authorized Chase to liquidate her IRA and transfer the funds to HI-1.

(xiii) In February, 2001, Chase moved most of the assets from the Family Trust and Marital Trust and Mr. Hurford's estate to HI-1.

(xiv) There was no evidence that any of the children made a capital contribution to HI-1.

(b) Funding of HI-2.

(i) Mr. Garza prepared another "form" letter for Mrs. Hurford to transfer the Hunt Oil phantom stock to HI-2. In response to the receipt of the letter on March 24, 2000, Hunt's transfer agent for the stock, president and general counsel, Richard Massman, sent Mrs. Hurford a list of documents that he needed to effectuate the transfer. Other than forwarding the letters testamentary in May, 2000, there was no further communication with Mr. Massman until October 20, 2000. On January 15, 2001, Mr. Massman responded in writing that HI-2 was the owner of the Hunt Oil phantom stock, but the internal records indicated that the

transfer occurred on March 22, 2000, the day Mrs. Hurford sent the initial letter to effectuate the transfer.

(ii) There was no evidence that any of the children made a capital contribution to HI-2.

(c) Funding of HI-3.

(i) HI-3 was created to receive the real property owned by Mrs. Hurford, individually, the Marital Trust and the Family Trust. Although there were eleven parcels of property, Mr. Garza prepared twenty deeds for signature. It was unclear as to why twenty deeds were prepared. In addition, the correct name of HI-3 was not reflected on the deeds and no deeds were prepared to effectuate the transfer of the property situated in both Ellis and Dallas Counties. The initial deeds prepared were recorded on March 23, 2000 and the last “forgotten” deed was prepared on April 10, 2002.

(ii) There was no evidence that any of the children made a capital contribution to HI-3.

2. Operational Facts.

(a) HI-1.

(i) In the year prior to Mrs. Hurford’s death, she remained the sole signatory on many of the HI-1 accounts and continued to transfer assets to these accounts even after they had supposedly been used to pay for the private annuity.

(ii) The Hurford children claimed they tried to remove Mrs. Hurford’s name from the HI-1 accounts but were unsuccessful.

(iii) All of the transfers to HI-1 were not deposits. For example, on April 14, 2000, days after she started the transfer of assets to the HI-1 accounts, Mrs. Hurford had Chase transfer cash from the partnership to her individual checking account. Mrs. Hurford’s daughter explained that these transfers were signed by her mother because Chase was confused about who had authority to transact on the accounts and that Mrs. Hurford needed money to make an estimated tax payment.

(b) HI-2. There were no operational facts with respect to HI-2.

(c) HI-3.

(i) Mrs. Hurford, individually, maintained the insurance policy on the farm and ranch properties after the transfer of such properties to HI-3.

(ii) Mrs. Hurford and her daughter remained on the Bank of America farm account until December, 2000, when the account name was finally changed to reflect the partnership (although the name on the account was not the actual name of HI-3).

3. The Private Annuity Agreement. Two of the Hurford children entered into a private annuity with Mrs. Hurford on April 5, 2000, just over two weeks from the date of the partnerships formation, but prior to the funding of the partnerships. Through this agreement, Mrs. Hurford purported to sell the children a 96.25% interest in HI-1, HI-2 and HI-3 for a fixed annual income for the rest of her life. David, the last of the Hurford children, was not a party to the private annuity agreement.

4. Mrs. Hurford's estate and gift tax returns' audit.

(a) Mrs. Hurford died on February 19, 2001.

(b) On November 18, 2004, Mrs. Hurford's estate received two notices of deficiency. One for her estate tax return and the other for her 2000 gift tax return.

(c) The main issue for the Court to determine was whether Mrs. Hurford's transfers to the partnership and the subsequent private-annuity transaction were valid under Sections 2035, 2036 and 2038 of the Code.

5. Section 2036 applied for the following reasons.

(a) The Court determined that the private annuity agreement was not a bona fide transfer supported by adequate and full consideration but was a disguised gift or a sham transaction. The agreement transferred Mrs. Hurford's interest only to Michael and Michelle, two of the Hurford children. Mrs. Hurford intended to limit David's (her son) control over the property she was giving to her children but the intent was not to disinherit him. Mr. Garza assumed that Michael and Michelle would ignore the agreement to carry out their mother's true intentions. Thus, the Court determined that the private annuity was nothing more than a will substitute to leave Mrs. Hurford's estate equally to her children.

(b) The Court also looked at what Mrs. Hurford transferred. In April, 2000, she transferred all of her interests in each partnership to two of her children, including the marketable securities and cash in HI-1. In May, 2000, Mrs. Hurford received her first payment under the private annuity agreement, \$40,000 of the cash and \$40,000 of the securities that she just transferred to the children. In every subsequent month, she received another \$80,000 of cash and securities that she initially transferred. The Hurford children never used their own assets (or even the income from the partnerships) to make these payments. The Hurford children held these assets in the same form they were in before the private annuity and then transferred bits and pieces back to her, planning to divide the balance for

all of the Hurford children after Mrs. Hurford's death. Again, this fact made the private annuity look like a will substitute.

(c) The Court addressed Bongard, stating that the transaction did not need to be amongst strangers to be bona fide but there would need to be objective proof the transaction would not be materially different if the parties involved were negotiating at arms' length. This finding was unsupportable here. The interests in Mr. Hurford's estate were transferred to the partnerships by initially transferring the Marital and Family Trust assets to herself, individually, without any formalities, and the completion of the transfer to the children were effectuated without putting anything in writing.

(d) The Court looked at whether Mrs. Hurford received adequate and full consideration when she transferred her assets for the private annuity. The focus was whether she received an amount that was roughly equivalent to what she gave up. The Court recognized that Mr. Garza conjured the discounts applicable to the partnerships without substantiation. However, even if the discounts were supportable, the interests sold in the private annuity were undervalued.

(e) Based upon the foregoing, the Court determined that the bona fide sale exception of Section 2036 was not satisfied and addressed the issue of whether Mrs. Hurford kept possession or "enjoyment" of the property after the private annuity agreement to warrant inclusion of the property in Mrs. Hurford's estate under Section 2036(a)(1).

(f) The Court determined that Mrs. Hurford retained an interest in the assets transferred to her children through the private annuity under Sections 2036 and 2038 of the Code. Although Mrs. Hurford's relationship to the assets changed after the private annuity (she did not need use of the partnership's assets after she began receiving the annuity payments), her children were paying her with the assets she sold to them, meaning, that she retained a present economic benefit from her assets after she "sold" them. Mrs. Hurford continued to make deposits into the partnership accounts, shifted assets between accounts and continued to treat them as if they were her own rather than transferring them to her children.

(g) After the private annuity agreement, Mrs. Hurford never resigned as president of the LLCs and remained a party to the farm leases. She retained signatory authority over assets in HI-1's Chase accounts and exercised such authority after the annuity agreement by withdrawing funds to pay her income taxes.

(h) The Court addressed the format of the private annuity agreement. Although David was excluded from the agreement, the intent was for him not to have any managerial rights, but there was no intent to exclude him as a beneficiary of the assets. Thus, the implied agreement between the family was to

exclude David on paper but not in the execution of the agreement. The Court recognized this as Mrs. Hurford's exercise of a "right, either alone or in conjunction with any other person, to designate the persons who shall possess or enjoy the property," under Section 2036(a)(2) of the Code.

(i) The Court also focused on whether the exchange of property for the partnership interests were bona fide and for full consideration. It was clear that one of the main goals in creating the partnerships was to receive valuation discounts. Although the partnership agreements listed ten reasons promoting the formation of the partnerships, the Court recognized the list was not enough. Citing Bongard and Thompson, the Court noted that Mrs. Hurford's nontax reason for forming the partnerships has to be a significant factor motivating creation of the partnerships and not merely a theoretical justification.

(j) The Hurfords claim that the main nontax purposes for the formation of the partnerships were asset protection and asset management. Specifically, they claimed that the assets needed protection from the liabilities associated with the farm and ranch properties and from creditors. With respect to asset management, they claimed that the partnerships would consolidate the management of the cash and securities held by Mrs. Hurford, the Marital Trust and the Family Trust.

(k) The Court determined that forming the partnerships did not provide them with any greater protection than they had while held by the Family or Marital Trusts, or in Mrs. Hurford's individual name. In addition, the Court was not convinced that giving each child a small ownership interest in the partnerships reduced the risk of a creditor's reaching the assets. Lastly, since the partners' relationship to the assets did not change after formation of the partnerships, the argument that there was any advantage in consolidated management was unsupported. Thus, the Court determined that asset management and asset protection were not significant non-tax purposes in this case.

(l) The Court discussed the Hurfords' disregard for partnership formalities. Specifically, it addressed Mrs. Hurford's request for partnership distributions to make income tax payments, commingling of personal and partnership funds and the delay in funding the partnerships.

(m) The Court also recognized that the partnerships were not functioning businesses nor did they have meaningful economic activity. Regarding HI-1, the Hurfords did not even have a minimal involvement in deciding which securities HI-1 should own, or even whether it should buy or sell. Chase was responsible for all investment decisions. Regarding HI-2, the Hurfords had even less of an involvement. The only choice they had with respect to the Hunt Oil phantom stock was to hold it or cash out. With respect to HI-3, it did hold real estate, but the partnership was not actively managing any of the farms or

ranches. No evidence existed that the partners met to discuss family business or investment strategy, or discuss partnerships' profits or losses.

(n) Even if the transfers of the assets to the partnerships were bona fide, they were not for adequate and full consideration. This Court focused on the Bongard test and whether all partners received interests proportionate to the fair market value of the assets they each transferred, and whether partnership legal formalities were respected. The value of Mrs. Hurford's interest in each partnership was worth less than the assets she contributed. For the three partnerships, Mr. and Mrs. Hurford's estates received a 48% interest and the three children and LLC each received a 1% interest *gratis*.

(o) There was no pooling of assets or the creation of a new enterprise. Mr. and Mrs. Hurford's estates contributed everything to the partnership and there was no contribution from the Hurford children in money, property or services. In addition, the gifts of the partnership interests were not reported as gifts. The crediting of the partners' capital accounts was entirely fictional. The only purpose supportable in creating the partnership was the availability of the discounts.

Q. Estate of Miller v. Commissioner, T.C. Memo 2009-119.

1. Family Background.

(a) Valeria Miller, the decedent ("Mrs. Miller"), was married to Virgil Miller ("Mr. Miller"). They had four children together.

(b) On October 29, 1991, Mr. Miller created a revocable trust which established a marital trust for Mrs. Miller (the "QTIP Trust") upon his death.

(c) Mr. Miller predeceased Mrs. Miller. His gross estate was valued at \$7,667,939, the majority of which was held in the name of his revocable trust. His estate elected to treat the property owned by the QTIP Trust as qualified terminable interest property under Section 2056(b)(7) of the Code.

(d) Assets owned by Mr. Miller's revocable trust that were not part of the QTIP Trust, with an approximate value of \$3.6 million, were distributed to Mrs. Miller's revocable trust.

2. Formation Facts.

(a) After Mr. Miller's death, Mrs. Miller, at the age of 86, formed a family limited partnership under the laws of the state of Indiana called V/V Miller Family Limited Partnership ("MFLP"). The date of formation was November 21, 2001.

(b) As of December 31, 2001, MFLP was not funded, but the fair market value of a limited partnership interest was appraised for gift tax purposes

using statements detailing the assets that were going to be transferred to MFLP. The appraisal indicated that MFLP was comprised of \$4,336,380 in marketable equity securities, a margin account payable of \$499,573 and a net asset value of \$3,836,807. A 35% lack of marketability discount was applied to MFLP's net asset value to determine a partnership per unit value of \$2,264.73.

(d) Mrs. Miller's estate planning advisor prepared the MFLP agreement. Mrs. Miller's son, Virgil, signed the agreement as general partner, and Mrs. Miller, as Trustee of her revocable trust, and Mrs. Miller's other three children, signed the agreement as limited partners. The agreement was executed in the middle of February, 2002. In early March, 2002, partnership certificates were sent to Virgil, as general partner. Virgil executed the agreements and dated them November 27, 2001.

(e) MFLP issued 1,000 partnership units. Mrs. Miller's revocable trust owned 920 units. Each of Donald, Gordon and Marcia, three of the Miller children, received 20 limited partnership units. Mrs. Miller's son, Virgil, received 10 units as general partner and 10 units as limited partner. Each of the Miller children received their units from Mrs. Miller; such transfers were gifts from Mrs. Miller to the children.

(f) Mrs. Miller began the funding of MFLP in April, 2002. The transfer of assets from Mrs. Miller's Fidelity and Merrill Lynch accounts to the MFLP account comprised about 77% of Mrs. Miller's net assets. Additional funding was commenced in 2003.

(g) Mrs. Miller's revocable trust accounts at Merrill Lynch and Fidelity often made purchases on margin. In order to satisfy the trust's margin accounts, MFLP sold some of the securities purchased on margin and transferred proceeds back to Mrs. Miller's revocable trust accounts.

(h) In April and May of 2003, Mrs. Miller's health deteriorated, ranging from a broken hip to congestive heart failure to a brain injury. Mrs. Miller died on May 28, 2003. When her estate tax return was filed, her gross estate included 920 limited partnership interests in MFLP with a discounted value of \$2,589,118.

3. Operational Facts.

(a) Virgil owned VGM Enterprises and was its only employee. MFLP paid VGM Enterprises (basically, Virgil) a monthly fee to manage the partnership's securities.

(b) Mrs. Miller wanted MFLP assets to be managed in accordance with her husband's investment strategy he employed during his lifetime. While the assets were owned by Mrs. Miller's revocable trust, there was little activity with respect to trading. There was an increase in trading activity once these assets were transferred to MFLP.

(c) Virgil, as general partner, kept his siblings informed about MFLP's status and provided them with financial advice.

(d) Mrs. Miller's will devised her estate to her living trust. On January 29, 2004, MFLP made a pro-rata cash distribution to its partners. As limited partner, Mrs. Miller's living trust received \$1.1 million of the distribution. A portion of that amount was used to pay the Federal and state estate tax liabilities owed with respect to her estate.

4. Section 2036 does not apply with respect to Mrs. Miller's 2002 contributions to MFLP for the following reasons.

(a) Because Mrs. Miller had legitimate and substantial nontax business reasons for forming MFLP, the Court recognized that her 2002 transfers to MFLP satisfied the bona fide sale for adequate and full consideration exception under Section 2036.

(b) Mrs. Miller formed MFLP to ensure the assets continued to be managed in accordance with her husband's investment strategy. Virgil, as general partner, spent a good portion of time each week managing MFLP's assets; such management included monitoring and trading MFLP assets. Thus, MFLP did not hold investments passively, solely for the collection of dividends and interest.

(c) The Court recognized that it was not a requirement for MFLP's activities to rise to the level of a "business" in order for the bona fide exception to apply. The goal of continuing her husband's investment philosophy could not have been met if Mrs. Miller did not form MFLP.

(d) The argument focusing around Mrs. Miller's age and the formation of the MFLP was misplaced. At the time of the April, 2002 transfers to MFLP, Mrs. Miller was generally in good health and neither she nor her family anticipated a significant decline in her health in the near future.

(e) Mrs. Miller retained sufficient assets outside of MFLP after the April, 2002 transfers to MFLP for her everyday living expenses.

5. Section 2036 applies with respect to Mrs. Miller's 2003 contributions to MFLP for the following reasons.

(a) In contrast to the 2002 transfers, the Court determined that there was no legitimate and substantial nontax business reason for the May, 2003 transfers to MFLP and that such transfers were driven by Virgil's desire to reduce the value of Mrs. Miller's estate. Thus, the transfers could not qualify as a bona fide sale for adequate and full consideration.

(b) There was a significant decline in Mrs. Miller's health prior to the 2003 transfers, including a broken hip, pacemaker implantation surgery and congestive heart failure.

(c) The Court determined that Mrs. Miller retained the possession or enjoyment of the right to the income from the property transferred in 2003 to MFLP warranting inclusion under Section 2036. When the decision was made to effectuate the 2003 transfers, Virgil knew the MFLP funds would be needed to satisfy Mrs. Miller's estate tax liabilities. Thus, after the transfer, sufficient assets were not retained outside of MFLP.

R. Estate of Malkin v. Commissioner, T.C. Memo 2009-212.

1. Robert D. Malkin Family Limited Partnership ("MFLP").

(a) In 1998, Mr. Malkin created MFLP. Mr. Malkin was the general partner and a limited partner of MFLP. Two trusts for the benefit of his children were established in June, 1998, and were the other limited partners. Mr. Malkin's attorneys were designated as the Trustees of the trusts.

(b) In August, 1998, Mr. Malkin gifted \$500,000 to each trust and an unidentified source transferred \$25,000 to each trust.

(c) On August 31, 1998, MFLP's certificate of limited partnership was filed in Mississippi. Mr. Malkin transferred 365,371 shares in D & PL stock (this was stock in Delta & Pine Land Co., the company of which he served as the chairman and chief executive officer) to MFLP in exchange for a 1% general partnership interest and 98.494% limited partnership interest. Each trust transferred \$25,000 to MFLP in exchange for a .253% limited partnership interest. On the same day, Mr. Malkin sold a 44.297% limited partnership interest in MFLP to each trust in exchange for \$442,424 in cash and a self-canceling installment note ("SCIN") with a principal amount of \$3,981,816.

(d) In August, 1999 and 2000, it appeared that Mr. Malkin made gifts of cash to each of his children. Upon receipt, each child loaned the amounts to his or her respective trusts. In turn, these amounts were used to make the interest payments owed to Mr. Malkin from the SCINs.

(e) Mr. Malkin was diagnosed with pancreatic cancer in May, 1999.

(f) On September 24, 1999, Mr. Malkin, as general partner of MFLP, pledged the majority of MFLP assets to secure his personal debt to Bank of America. On December 7, 1999, Mr. Malkin executed a personal guaranty to use his "personal assets" to repay his debt, plus interest. The guaranty stated that Mr. Malkin would pay MFLP a fee of \$32,587, which is .75% of the \$4,345,000 required as security for his debt. Mr. Malkin refinanced his personal debt with Morgan Guaranty Trust Co. of New York so that in April and June, 2000, all of the D & PL stock owned by

MFLP was pledged to Morgan Guaranty to secure his personal debt. Mr. Malkin again paid a .75% fee to MFLP.

2. Cotton Row Family Limited Partnership ("CRFLP").

(a) Several months after Mr. Malkin was diagnosed with pancreatic cancer, he created another partnership to own the membership interests in various limited liability companies (referred to as Malkin I, Malkin II, Malkin III and Malkin IV and Malkin V) which he owned with his son and the two additional trusts (not the same trusts established for MFLP) for his children that would be limited partners in the partnership.

(b) In November, 1999, CRFLP's certificate of limited partnership was filed in Mississippi. On February 29, 2000, Mr. Malkin transferred a 30% membership interest in Malkin I, a 50% membership interest in Malkin II, a 99% membership interest in Malkin IV and a 50% membership interest in Malkin V to CRFLP in exchange for all of the partnership interests. Mr. Malkin contracted to sell a 44.5% limited partnership interest to each trust in exchange for cash in the amount of \$40,050 and a promissory note for \$260,450.

(c) On March 1, 2000, Mr. Malkin executed two additional trusts for the benefit of his children. Mr. Malkin's attorneys were designated as the Trustees of these trusts.

(d) A week after the sale of the limited partnership interests to the trusts, Mr. Malkin transferred \$40,525 to each trust and signed the promissory notes regarding the sale of the limited partnership interests to the trusts.

(e) In November, 2000, Mr. Malkin transferred 80,000 D & PL shares to CRFLP. Prior to the transfer, Mr. Malkin had pledged the shares as collateral for a personal loan from Morgan Guaranty, and the shares remained as collateral after the transfer.

(f) Mr. Malkin died prior to the first anniversary date of the promissory notes so no interest was paid with respect to the sale of his limited partnership interests to the trusts.

3. Transfers Made by Mr. Malkin.

(a) In November, 1998, Mr. Malkin paid a \$64,760 debt of Malkin I. At the time of payment, Mr. Malkin was a 30% owner of Malkin I and his son was the 70% owner.

(b) In May, 2000, Mr. Malkin paid a \$3,878,409 debt of Malkin I and a \$370,061 debt of Malkin IV. In September, 2000, he paid \$177,795 to Malkin IV related to a capital call.

(c) In June and November, 2000, Mr. Malkin transferred amounts to his children in exchange for promissory notes.

4. Section 2036 applied for the following reasons.

(a) The Court did not find that there was an express or implied agreement whereby Mr. Malkin would retain the present economic benefit of the membership interests in the Malkin limited liability companies transferred to CRFLP. However, the same did not hold true for the D & PL stock that was transferred to CRFLP and MFLP. Mr. Malkin applied all of the D & PL stock transferred to the partnerships toward the discharge of his legal obligations.

(b) With respect to the 365,371 D & PL shares owned by MFLP, there was no evidence that the decision of Mr. Malkin and his attorneys to pledge the shares to secure the personal debts of Mr. Malkin was a business decision made at arm's length. First, there was no evidence to show the .75% fees that were paid were reasonable. Second, no explanation was provided to show that the decision to allow Mr. Malkin to pledge the D & PL stock to secure his personal debt was in the best interests of MFLP. Thus, no business purpose existed. In addition, the Court found that no business purpose existed for having CRFLP hold the 80,000 D & PL shares pledged to secure Mr. Malkin's personal debt.

(c) The Court also determined that Mr. Malkin's transfers of D & PL stock to the partnerships did not fall within the Section 2036(a) exception for "bona fide" sales for "adequate and full consideration in money or money's worth." With respect to the D & PL stock, Mr. Malkin had no legitimate and significant nontax reason for creating the partnerships. The Court recognized that Mr. Malkin was the only transferor of stock to the partnerships. His son also owned stock in D & PL. If Mr. Malkin wanted to prevent the sale of stock owned by his family, he would have requested that his son contribute his own D & PL stock to the partnerships. Mr. Malkin already controlled the stock; he did not need the partnerships in that regard.

(d) The argument that Mr. Malkin created the partnerships to centralize the management of the family's wealth fell short. All of the assets held by the partnerships were contributed by Mr. Malkin. Thus, there was no pooled family wealth to manage.

(e) The Court held that Mr. Malkin's transfers of D & PL stock to the partnerships achieved nothing more than testamentary objectives and tax benefits and, thus, did not qualify for the bona fide sale exception.

S. Estate of Jorgensen v. Commissioner, T.C. Memo 2009-66.

1. Formation Facts.

(a) Ms. Jorgensen and her husband, Colonel Jorgensen, met with their estate planning attorney and decided to form a family limited partnership. They had several meetings to discuss the entity structure.

(b) On May 15, 1995, the Jorgensens and their children, Jerry Lou and Gerald, signed the Jorgensen Management Association (JMA-I) partnership agreement. The Certificate of Limited Partnership for JMA-I was filed in Virginia on May 19, 1995. Jerry Lou and Gerald were not involved in the initial meetings to discuss the partnership.

(c) On June 30, 1995, the Jorgensens each contributed marketable securities valued at \$227,664 to JMA-I in exchange for a 50% limited partnership interest. Their children and grandchildren were also limited partners and received such interests by way of gift. Colonel Jorgensen, Gerald and Jerry Lou were the general partners but only Colonel Jorgensen made decisions with respect to JMA-I.

(d) Colonel Jorgensen died on November 12, 1996.

(e) The estate planning attorney recommended that Colonel Jorgensen's estate claim a 35% discount with respect to his interest in JMA-I. This interest passed to Colonel Jorgensen's family trust. The attorney also recommended that Ms. Jorgensen make additional contributions to JMA-I consisting of her accounts and Colonel Jorgensen's estate account in an effort to secure additional discounts with respect to Ms. Jorgensen's limited partnership interest upon her death.

(f) There was no meeting between the attorney and Ms. Jorgensen with respect to the additional contributions. All planning was discussed amongst the attorney and the Jorgensen children (and Jerry Lou's husband). As a result of these discussions, a letter was written to Ms. Jorgensen on May 19, 1997 regarding the potential formation of JMA-II. The letter expressed the intent to organize the Jorgensen assets into groups: high basis assets would be held in JMA-II and the low basis assets would be held in JMA-I.

(g) The Certificate of Limited Partnership for JMA-II was filed in Virginia on July 1, 1997.

(h) With respect to the funding of JMA-II, on July 28, 1997, Ms. Jorgensen contributed \$1,861,116 in marketable securities to JMA-II in exchange for a limited partnership interest. In August, 1997, she contributed \$22,019 to JMA-II consisting of marketable securities, money market funds and cash. She also contributed, as the executrix of her husband's estate, \$718,530 in marketable securities, money market funds and cash from his brokerage account. A portion

of this amount was attributable to Ms. Jorgensen, as it was part of the marital bequest from her husband upon his death. Based upon the foregoing, Ms. Jorgensen held a 79.6947% limited partnership interest and Colonel Jorgensen's estate held a 20.3053% limited partnership interest. Similar to JMA-I, the Jorgensen children and grandchildren were limited partners, but did not contribute to JMA-II. Jerald and Jerry Lou were the general partners of JMA-II.

(i) The children and grandchildren received their limited partnership interests by gift from Ms. Jorgensen, the value of which exceeded the then annual exclusion gift per beneficiary of \$10,000. No gift tax returns were filed to report the gifts.

2. Operational Facts.

(a) JMA-I and JMA-II held passive investments only. Jerry Lou maintained the checking accounts for the entities but they were never reconciled nor double checked by Gerald, the other general partner.

(b) The entities did not maintain formal books or records.

(c) Gerald had discussions with the attorney regarding the possibility of accessing partnership assets for his personal use. There was discussion that a loan could be made from the partnership, but Gerald was surprised that the terms would require a repayment of the loan with interest. In July, 1999, Gerald borrowed \$125,000 from JMA-II to purchase a home. His first interest payment on the loan in the amount of \$7,625 was made on July 25, 2001 and the second payment was made on August 7, 2002. Jerry Lou believed that if the loan was not repaid, it would be taken out of Gerald's partnership interest.

(d) The partnership agreements stated that withdrawals could only be made by the general partners. However, Ms. Jorgensen was authorized to write checks on the JMA-II checking account and she did write checks, including checks from JMA-I account. In 1998, she signed checks from the JMA-I account, including cash gifts to family members. On April 28, 1999, Ms. Jorgensen deposited \$30,000 into the JMA-II account to repay the amounts she had withdrawn from JMA-I for family gift giving. There is no information as to why the amounts were not reimbursed to JMA-I.

(e) On January 10, 1999, Ms. Jorgensen wrote a check from JMA-I in the amount of \$48,500 to Jerry Lou to equalize a previous gift made to Gerald. On April 28, 1999, this amount that was withdrawn from JMA-I was reimbursed by Ms. Jorgensen to JMA-II. Again, there is no information as to why the amount was not reimbursed to JMA-I.

(f) Ms. Jorgensen used the JMA-I account to pay her 1998 income taxes.

(g) Ms. Jorgensen paid \$6,447 of the administration expenses for Colonel Jorgensen's estate from JMA-II's account, including expenses for the estate's income tax return and legal services relating to the filing of its estate tax return.

(h) In 1998 and 1999, Ms. Jorgensen paid accounting fees, registered agent fees and annual state registration fees pertaining to the partnerships. She also paid attorneys fees relating to the attorney's conversations with an appraiser regarding the partnership as well as the promissory note regarding the loan to Gerald. The attorney did not separate his billing for the entities and Ms. Jorgensen, individually.

(i) After Ms. Jorgensen's death, JMA-II paid the Federal and California estate tax liability owed with respect to her estate.

3. Section 2036 applied for the following reasons.

(a) The Court recognized that the transfers to the partnerships did not qualify for the bona fide sale exception under Section 2036. No legitimate and nontax reason existed for transferring the property to the partnerships. The Court was mindful that "efficient management" may count as a credible nontax purpose, but only where the entity required active management. Under these facts, the partnerships held only passive assets. The partnerships were not necessary to help Ms. Jorgensen manage her assets because her revocable trust assisted with that function.

(b) There was no indication that the formation of the partnerships was an effort to promote family unity and teach the Jorgensen children about the investment of family assets. The children did not participate in the activities of JMA-I while Colonel Jorgensen was living, although they were general partners.

(c) The Court was not persuaded by the argument that the partnerships were formed to perpetuate Colonel Jorgensen's investment philosophy premised on buying and holding stocks with an eye toward long-term growth and capital preservation. This was not a legitimate or significant nontax reason for transferring the bulk of one's assets to a partnership.

(d) The Court was not persuaded by the argument that the partnerships were formed in an effort to pool family assets.

(e) The Estate argued that the partnerships were formed because the Jorgensens intended to make gifts to their children and grandchildren and because they had spendthrift concerns. The Court recognized that if the Jorgensens had a concern that Gerald was a "free spender" who "never saved a dime," they would not have made him a general partner in the partnerships. The argument that the partnerships protected the family's assets from creditors fell short, as there was no evidence that Ms. Jorgensen or any other partner was likely to be liable in contract or tort for any reason.

(f) The Court recognized that the partnerships were not necessary to provide equally for the Jorgensen children and grandchildren. While Ms. Jorgensen did provide for her children equally by giving them limited partnership interests, she could have provided for them by giving securities directly. Using the partnerships facilitated annual exclusion gift giving, but this was not a significant and legitimate nontax reason for transferring the assets to a limited partnership.

(g) The Court determined that Ms. Jorgensen did not have a legitimate and significant nontax reason for transferring her assets to JMA-I and JMA-II. Of most significance was that the transactions were not at arm's length and that the partnerships held a largely untraded portfolio of marketable securities. The Jorgensens contributed equal amounts to JMA-I, but Ms. Jorgensen had no involvement in the decision or the transfer. During the meetings between Colonel Jorgensen and his attorney, neither Ms. Jorgensen nor any of the family members were consulted. Ms. Jorgensen formed and funded JMA-II through her revocable trust and in her role as executrix of her husband's estate. However, the decision to form and fund was made by her children with the attorney's guidance. Ms. Jorgensen, although in different roles, stood on both sides of the transaction so the transfer of assets to JMA-II was not at arm's length.

(h) The Court recognized that Ms. Jorgensen retained the use, benefit and enjoyment of the assets she transferred to the partnerships. Although Ms. Jorgensen retained sufficient assets outside the partnership for her day-to-day expenses, she did not have sufficient funds to satisfy her desire to make cash gifts. Thus, Ms. Jorgensen used partnership assets to make significant cash gifts to her family members. Distributions were made from JMA-II to pay the estate taxes and legal fees owed upon Ms. Jorgensen's death. The use of a significant portion of partnership assets to discharge obligations of a taxpayer's estate is evidence of a retained interest in the assets transferred to the partnership.

(i) In support of the decision that Ms. Jorgensen retained the use, benefit and enjoyment of the assets she transferred to the partnership, the Court also addressed that Gerald and Jerry Lou, as the general partners of the partnership and Co-Trustees of Ms. Jorgensen's revocable trust, had a fiduciary obligation to administer the trust assets, including the JMA-I and JMA-II partnership interests, solely for Ms. Jorgensen's benefit. In addition, as general partners, they had the express authority to administer the partnership assets at their discretion.

IV. THE "TAXPAYER FRIENDLY" CASES.

A. Church v. U.S., 2000 USTC (CCH) ¶ 60, 369 (W.D. Tex. 2000), affirmed No. 00-50386, July 18, 2001 (5th Cir. 2001).

1. Formation Facts.

(a) Decedent and her children entered the Agreement of Stumberg Ranch Partners, Ltd. on October 22, 1993, governed by the laws of Texas.

(b) Purpose of the partnership was to provide centralized management of their interests in W.R. Stumberg Ranch to preserve such ranch for future generations, in addition to asset protection from creditors in the event of tort claims.

(c) Decedent and her children were limited partners of the partnership. Stumberg Ranch, L.C. was the general partner of the partnership with each of decedent's children owning a 50% interest to reflect their management positions with respect to the ranch.

(d) Stumberg Ranch, L.C. was not yet formed when the partnership agreement was executed on October 22, 1993.

(e) Each limited partner contributed his or her undivided interest in the ranch to the partnership. Decedent also contributed approximately \$1 million in securities that she inherited from her mother and her husband to the partnership.

(f) The limited partners owned 57% of the ranch while members of another family owned the remaining 43%. Regarding the 57%, decedent owned 62%, individually, 2% as a trustee, and her children each owned 18%.

(g) The limited partners conveyed their interests in the ranch to the partnership on October 22, 1993. In addition, decedent's son, pursuant to a durable power of attorney, transferred decedent's securities to the partnership on the same date.

(h) Decedent died suddenly on October 24, 1993, two (2) days after the assets were contributed to the partnership. At the time of her death, decedent had breast cancer which was initially diagnosed in July 1990. However, decedent was in clinical remission during the last six months of her life. Thus, her sudden death of cardiopulmonary collapse was considered unrelated to the cancer.

(i) Although the partnership was technically formed on October 22, 1993 with the execution of the partnership agreement, the full organization of the partnership was not established until after the death of decedent.

(j) Certificate of Limited Partnership was filed on October 26, 1993. Although the Certificate stated that it was signed and executed on July 1, 1993, the Court found this to be a clerical error. The Court believed the Certificate of Limited Partnership was likely signed on October 22, 1993, the date the Partnership Agreement was signed. However, the mistake was likely due to the fact that the Partnership Agreement, although executed on October 22, 1993, had

an effective date of July 1, 1993. Regardless, the Court held that the date the Certificate of Limited Partnership was executed was immaterial.

(k) The corporate general partner was organized in March of 1994 and decedent's PaineWebber account, consisting of her marketable securities, was transferred to the partnership account in the same month.

2. Operational Facts.

(a) Partnership Agreement allocated profit or loss to the partners in proportion to their partnership percentages and contributions.

3. Section 2036 did not apply for the following reasons.

(a) The Court held that the purpose of the partnership was to preserve the family ranching enterprise for present and future generations.

(b) No express or implied agreement existed whereby decedent retained use, possession, or enjoyment of the partnership's property.

B. Estate of Stone v. Commissioner, T.C. Memo 2003-309.

1. Background.

(a) E.E. Stone, III and Allene W. Stone had four (4) children, Eugene Earle Stone, IV, C. Rivers Stone, Rosalie Stone Morris and Mary Stone Fraser.

(b) In 1933, the Stones founded several successful ventures in the apparel industry. The ventures became known as Stone Manufacturing Co. focusing on sports apparel.

(c) In 1939, Mr. Stone purchased the "Cherrydale" property in South Carolina to relocate the manufacturing facilities of Stone Manufacturing Co. to such property.

(d) In 1950, the Stone family resided in a house located on the Cherrydale property.

(e) From 1994 until the date of Mr. and Ms. Stone's deaths, Mr. Stone lived in North Carolina on their "Cedar Mountain" property and Ms. Stone lived in their Cypress villa on Hilton Head, South Carolina.

(f) In 1995, the Cherrydale residence was renovated to house out of town business visitors coming to the Stone Manufacturing Co.

(g) In 1976, Mr. Stone formed Stones, Inc. as a holding company of Stone Manufacturing Co. Mr. Stone owned 100% of such holding company.

From 1976 to April 1997, Mr. Stone owned a preferred stock interest in Stones, Inc.

(h) On December 30, 1976, Mr. Stone gifted 2,250 shares (50%) of the common stock of Stones, Inc. to two (2) trusts. One trust was established for the benefit of the Stone children and one trust was established for the benefit of the Stone grandchildren. C. Rivers Stone and John J. Brausch, a senior executive officer at Stone Manufacturing Co., were Co-Trustees of the trusts.

(i) Litigation among the children subsequently ensued with respect to the trusts. The details of such litigation will not be discussed herein. Throughout the course of the litigation, the children also had concerns regarding their parents' assets, which presented grounds for additional litigation among the children. Specifically, their concerns related to (1) the management of assets during their parents' lives (at the end of 1995, the Stones no longer were interested or actively involved in managing their assets) and after they died; (2) certain charitable gifts Mr. Stone had made; (3) Ms. Stone's living arrangements; and (4) the use of Ms. Stone's credit cards.

2. Formation Facts.

(a) At least as early as 1994, C. Rivers Stone was a member of three (3) separate organizations: the Young Presidents Organization, the World Presidents Organization and the Chief Executive Organization. At such organizations' meetings, members discussed various problems they encountered and ways to alleviate such problems.

(b) In 1995, certain members of the organizations that were friends of C. Rivers Stone suggested that the Stone children utilize family limited partnerships ("FLPs") as a way to resolve the litigation among the children and the children's concerns regarding their parents assets.

(c) The Stone family, once informed about the FLPs, was interested in exploring whether it was a viable option. Mr. and Ms. Stone wanted to bring an end to the litigation amongst the children and wanted to avoid disputes among the children regarding the ultimate division of their assets after their demises. They wanted to know whether their concerns could be resolved by:

(i) Actively involving each of the children in the management of certain of their parents assets during their parents lives by giving each child the opportunity, through ownership of a general partnership interest in a different FLP, to manage such assets in which such child was interested.

(ii) Actively involving all children in the management of certain of their parents other assets during their parents lives by giving them the opportunity, through ownership of general partnership interests in a fifth FLP, to manage assets in which they were all interested.

(d) In the summer of 1994, Mr. Stone spoke to Mr. Merline, an attorney, about the drafting of a will. Ms. Stone retained her own counsel.

(e) During the last six (6) months of 1995, Mr. Stone and Mr. Merline discussed the use of FLPs. Mr. Merline discussed the potential transfer tax benefits of FLPs with Mr. Stone, and also explained that any assets transferred to the FLPs would no longer be available for Mr. and Ms. Stone's unfettered, personal use. He emphasized that assets transferred to the FLPs would belong to such FLPs and would be subject to FLP agreements.

(f) A later amendment to the plan of settlement for the children's ensuing litigation included a provision for the establishment of five (5) FLPs. Technically, the amendment to the settlement agreement provided that the parties use their reasonable best efforts to encourage E.E. Stone, III and Allene W. Stone to establish the five (5) FLPs. Intense negotiations between the children began regarding the particular assets that each child wanted their parents to transfer to an FLP, in which such child and the parents would hold an FLP interest.

(g) Around April of 1996, Mr. and Ms. Stone proceeded with the formation of the FLPs and Mr. Merline drafted the FLP agreements and circulated such drafts among the Stones, their children and their respective attorneys. Changes were suggested and made. For example, one change provided that anyone who obtained a power of attorney on behalf of Mr. Stone could not use such power to vote any general partnership interest that Mr. Stone was to receive.

(h) On May 9, 1996, Mr. Stone and Eugene Earle Stone, IV, as general partners and limited partners, and Ms. Stone, as limited partner, executed the Eugene E. Stone, III Limited Partnership (ES3LP) Agreement.

(i) On May 9, 1996, Mr. Stone and Eugene Earle Stone, IV, as general partners and limited partners, and Anne M. Stone (the spouse of Eugene Earle Stone, IV), as general partner, executed the E.E. Stone, IV, Limited Partnership (ES4LP) Agreement.

(j) On May 9, 1996, Mr. Stone, C. Rivers Stone and Charles River Stone, Jr. (son of C. Rivers Stone), as general partners and limited partners, and Frances O. Stone (daughter of C. Rivers Stone), as limited partner, executed the C. Rivers Stone Limited Partnership (CRSLP) Agreement.

(k) On May 9, 1996, Mr. Stone and Ms. Morris, as general partners and limited partners, Mr. Morris, as general partner, Charles H. Morris, Jr. (son of Ms. Morris) and Ms. Morris, as custodian for Rosalie S. Morris, II (daughter of Ms. Morris), as limited partners, executed the Rosalie Stone Morris Limited Partnership (RSMLP) Agreement.

(l) On May 9, 1996, Mr. Stone, Ms. Fraser, Wyman Fraser Davis (daughter of Ms. Fraser) and Laura Lawton Fraser Arnal (daughter of Ms. Fraser),

as general partners and limited partners, executed the Mary Stone Fraser Limited Partnership (MSFLP) Agreement.

(m) Each of the FLP agreements contained similar provisions. The purposes of the FLPs as set forth in the agreements were to consolidate the management of the Stone property. There was also specific reference to the litigation and the intention of creating the FLPs to avoid litigation and further dispute between the Stone family members. In addition, the FLP agreements stated that distributions to partners may be made only if the financial condition of the FLP permitted distributions. Furthermore, unless otherwise agreed by all the partners in writing, distributions were required to be made to each of the partners in accordance with their proportionate share of the FLP.

(n) Mr. and Ms. Stone retained accountants to advise them with respect to the monthly cash flow they would need to maintain their standard of living as they did not intend to transfer all of their assets to the FLPs. The "prefunding process" was commenced (i.e., obtaining appraisals of assets, negotiations, etc.) to determine which of the Stone assets would be transferred to which FLP.

(o) On October, 15, 1996, certificates of limited partnership were filed for the FLPs with the Secretary of State of South Carolina.

(p) On January 31, 1997, Mr. Stone was diagnosed with cancer of the gallbladder. It was anticipated that he would live a period of months. Prior to the date of diagnosis, Mr. Stone was in good health, did not have any known serious health problems and was active and alert.

(q) By late March 1997, Mr. and Ms. Stone were satisfied with the assets the accountants advised them to retain, versus what they should transfer to the FLPs, and were ready to fund the FLPs. Eugene Earle Stone, IV had an interest in Stones, Inc.; \$1 million of Stones, Inc. stock and other property was transferred to ES4LP. C. Rivers Stone had an interest in Mr. Stone's Piney Mountain property; various parcels of such property and other property were transferred to CRSLP. Ms. Morris had an interest in managing certain of her parents' stock and securities, including at least some of Mr. Stone's preferred stock in Stone's, Inc.; various stock and securities and some preferred stock in Stones, Inc. were transferred to RSMLP. Ms. Fraser had an interest in the Cedar Mountain property; such property and other property was transferred to MSFLP. All of the children had an interest in the Cherrydale residence; such property and other property was transferred to ES3LP.

(r) On April 4, 1997, the ES3LP partnership agreement was amended to include C. Rivers Stone, Ms. Morris and Ms. Fraser as general partners.

(s) The settlement agreement between the children was amended in 1997 to be consistent with the plan of establishing and funding the FLPs. The

details of the 1997 amendment are extensive and beyond the scope of this excerpt. However, it should be noted that provisions were added to the settlement agreement to resolve the possibility that Mr. and Ms. Stone might need financial assistance during their lives. In the unlikely event that the assets held by ES3LP and the assets owned by Mr. and Ms. Stone were insufficient to enable them to maintain their accustomed standards of living, the children, as a group, would share equally in their maintenance through distributions of equal amounts from ES4LP, CRSLP, RSMLP and MSFLP.

(t) On April 5, 1997, Mr. Stone executed a Last Will and Testament. Such Will provided that debts and expenses of his estate be paid from ES3LP and, to the extent such funds were unavailable, such expenses would be charged equally against the FLPs established for the Stone children. Specific bequests of FLP interests held by Mr. Stone were also addressed in his will. Specifically, any interests held by Mr. Stone in ES3LP upon his death would be distributed to a trust for the benefit of Ms. Stone, if she is then living, otherwise to the children. Any interests held by Mr. Stone in CRSLP would be distributed to C. Rivers Stone, if then living, otherwise to his estate. Any interests held by Mr. Stone in ES4LP would be distributed to E.E. Stone, IV, if then living, otherwise to his estate. Any interests held by Mr. Stone in MSFLP would be distributed to Mary Fraser, if then living, otherwise to her estate. Any interests held by Mr. Stone in RSMLP would be distributed to Rosalie Morris, if then living, otherwise to her estate.

(u) On May 3, 1997, Ms. Stone executed a Last Will and Testament. Pursuant to the terms of her Will, upon her death, if Mr. Stone was then living, any interests held by Ms. Stone in ES3LP would be held in trust. If Mr. Stone was not then living, such FLP units would be distributed to her children.

(v) On June 14, 1997, Ms. Stone executed a codicil to her Will to mimic the provisions in Mr. Stone's Will with respect to the payment of taxes and the specific bequests; provided, however, that any interest in ES3LP owned by Ms. Stone upon her death would be distributed to her children (rather than to Mr. Stone, if then living).

(w) On April 8, 1997, Mr. Stone gave his children interests in various parcels of property; such gifts were reported on Mr. Stone's 1997 Form 709, United States Gift (& Generation-Skipping Transfer) Tax Return.

(x) In April, 1997, the partners of ES3LP made bona fide, arms length transfers to such FLP. Specifically, Mr. Stone transferred his interest in the Cherrydale residence and certain other property in exchange for both general and limited partnership interests, and the children transferred to ES3LP their respective interests in the Cherrydale residence in exchange for their general partnership interests. Neither Mr. Stone nor Ms. Stone intended to continue to reside in the Cherrydale residence. If they desired to do so, none of the partners

would have objected, provided, however, that they would need to utilize personal funds to pay appropriate rent to ES3LP.

(y) Similar transfers were made to the other FLPs in exchange for FLP interests in accordance with the child's interest in respective assets as discussed above in Paragraph Q of this Section.

(z) Mr. and Ms. Stone retained sufficient assets outside of the FLPs.

3. Operational Facts.

(a) After the partners of ES3LP transferred the assets to the FLP in exchange for the FLP interests, the children actively managed the assets of ES3LP, as Mr. and Ms. Stone intended. After the partners of ES4LP transferred the assets to the FLP in exchange for the FLP interests, Eugene Earle Stone, IV actively managed the assets of ES4LP, as Mr. and Ms. Stone intended. After the partners of CRSLP transferred the assets to the FLP in exchange for the FLP interests, C. Rivers Stone actively managed the assets of CRSLP, as Mr. and Ms. Stone intended. After the partners of RSMLP transferred the assets to the FLP in exchange for the FLP interests, Ms. Morris actively managed the assets of RSMLP, as Mr. and Ms. Stone intended. After the partners of MSFLP transferred the assets to the FLP in exchange for the FLP interests, Ms. Fraser actively managed the assets of MSFLP, as Mr. and Ms. Stone intended.

(b) During 1998, after renovation of the Cherrydale residence was complete, ES3LP rented it to, and received rental income from, Stone Manufacturing Co, which used the residence to house a management team that it decided to retain to assist the Stone Manufacturing Co.

(c) ES3LP partnership returns filed for 1998 and 1999 reflected that ES3LP made investment decisions to sell assets, including stock that it purchased on May 7, 1997 and sold two (2) years later for a substantial gain. ES4LP partnership returns filed for 1997 and 1999 also reflected that it sold certain stock for substantial gains.

(d) Each FLP hired advisors and accountants who were separate and distinct from the other FLPs. Thus, none of the advisors and/or accountants for the entities were the same.

(e) At no time did Mr. or Ms. Stone or the partners of the FLPs commingle the assets of any of the FLPs with non-entity assets.

(f) After funding the FLPs, the Stone family realized that there was an inadvertent, improper valuation of certain assets. Such valuation errors resulted in each of the children's having received a total FLP interest in each such FLP in which such child had a FLP interest that was larger than intended. To rectify these valuation errors, Mr. Stone made a gift to each of the children of the unintended excessive FLP interest.

(g) Upon Mr. Stone's death on June 5, 1997, the trust established for the benefit of Ms. Stone under Mr. Stone's Will was established. Mr. Stone's interest in ES3LP was distributed to such trust. The appropriate amendments to the certificates of limited partnership for the FLPs were filed to remove Mr. Stone as general partner.

(h) After Mr. Stone's death, all of the respective partners of the FLPs (other than ES4LP) agreed to make a distribution from each FLP (other than ES4LP) in order to pay the portion of the federal estate tax and any applicable state tax with respect to Mr. Stone's estate that was attributable to the inclusion in that estate of the total FLP interest in each FLP held by Mr. Stone on his date of death. The FLPs partnership returns reflected such distributions.

(i) On October 16, 1998, Ms. Stone died.

4. Section 2036 did not apply for the following reasons.

(a) The Court stated that the IRS' reliance on Harper and the other Section 2036 cases was misplaced. The transfer of assets to the FLPs by Mr. and Ms. Stone, and the transfer of assets by the other partners, were bona fide, arms length transfers.

(b) Each member of the Stone family was represented by independent counsel and had input as to the structure and funding of each FLP. All parties understood that Mr. Stone and Ms. Stone would not be bound by any agreements that the children reached through their own negotiations and that Mr. Stone and Ms. Stone would make the ultimate decision with respect to the assets transferred to the FLPs.

(c) Mr. Stone and Ms. Stone agreed to form the FLPs, but they retained assets outside of the FLP structure to enable them to maintain their accustomed standard of living.

(d) Mr. Stone and Ms. Stone did not automatically accept the children's recommendations with respect to changes to the FLP agreements. Mr. Stone and Mr. Merline discussed each of the proposed changes in detail prior to accepting or rejecting them.

(e) The transfers to the FLPs did not constitute gifts to the other partners of the FLPs. Such transfers were motivated primarily by investment and business concerns relating to the management of certain of the respective assets of Mr. and Ms. Stone and the resolution of the litigation amongst the children.

(f) Mr. Stone and Ms. Stone did more than merely "change the form in which he [and she] held his [and her] beneficial interest in the contributed property."

(g) The FLPs had economic substance and operated as joint enterprises for profit through which the children actively participated in the management and development of the respective assets, as intended by Mr. and Ms. Stone.

(h) The transfers to the FLPs did not constitute “circuitous ‘recycling’ of value.”

(i) The transfer of assets by Mr. Stone and Ms. Stone to the FLPs was for adequate and full consideration in money or money’s worth.

C. Kimbell v. U.S., 371 F.3d 257 (5th Cir. 2004).

1. Formation Facts.

(a) R.A. Kimbell Management Co., LLC, a Texas limited liability company, was established on January 7, 1998. Decedent’s revocable trust contributed \$20,000 to the LLC in exchange for a 50% membership interest. Decedent’s son and daughter-in-law each contributed \$10,000 to the LLC in exchange for a 25% membership interest. Decedent’s son was the manager.

(b) R.A. Kimbell Property Co., Ltd., a Texas limited partnership, was established on January 29, 1998 (two months prior to decedent’s death). Decedent’s revocable trust was the 99% limited partner and the LLC was the 1% general partner. The trust contributed 99% of the capital to the partnership and the limited liability company contributed 1% of the capital. Specifically, the trust contributed \$2.5 million in cash, oil and gas working interests, securities, notes and other assets, and the LLC contributed \$25,000 in cash. At inception, approximately 15% of the assets of the partnership were oil and gas working (11%) and royalty (4%) interests.

(c) Mrs. Kimbell retained over \$450,000 in assets outside of the LLC and the partnership for her personal expenses.

(d) The partnership had a term of 40 years at which time decedent would have been 136 years old.

(e) The partnership agreement stated that “[t]he General Partner will not owe a fiduciary duty to the Partnership or to any Partner.”

2. Operational Facts – there were none!

3. The District Court held that Section 2036 applied for the following reasons.

(a) The Court recognized that only a mere paper transaction had transpired. Because decedent’s son was the managing member of the LLC, the general partner of the partnership, and the Co-Trustee of decedent’s revocable

trust, no meaningful changes had occurred after the assets were contributed to the partnership.

(b) The Court relied on the “recycling of assets” argument which provided that only a change in the form of the retention of the beneficial interest had occurred, rather than a change in the underlying pool of assets or prospect for profit.

(c) Based upon the terms of the Partnership Agreement, the Court held an implied agreement existed whereby decedent would retain the benefit of the property transferred to the partnership. The decedent’s revocable trust was a 99% limited partner of the partnership and the LLC was the 1% general partner of the partnership. Decedent technically owned 99.5% of the Partnership (99% limited partnership interest plus a .5% partnership interest based upon her 50% ownership of the LLC). The Partnership Agreement specifically provided that the general partner may be removed upon the consent of 70% of the limited partners. Furthermore, the Partnership Agreement provided that if a general partner is unable to serve for any reason, a Majority in Interest (as defined in the Partnership Agreement) of the limited partners may elect one or more general partners from among the limited partners or any persons not already limited partners. Lastly, any distributions from the partnership would be made solely at the discretion of the general partner. Decedent’s revocable trust, as the 99% limited partner, had the sole authority pursuant to the Partnership Agreement to remove the general partner and appoint a subsequent general partner, which would include an appointment of decedent as general partner. By retaining the authority to remove and appoint the general partner, decedent retained the right to benefit from the partnership income or to designate who would benefit from such income. In essence, the Court reasoned that decedent could remove the general partner, appoint herself as general partner and re-distribute the assets back to herself.

4. The taxpayer appealed the judgment of the District Court denying the Estate’s request for a refund of estate tax and interest paid to the Fifth Circuit Court of Appeals.

5. The Fifth Circuit Court of Appeals Reverses the District Court’s Decision!

(a) The Fifth Circuit stated that the District Court erred in making its determination. The Fifth Circuit relied primarily on Wheeler v. United States, 116 F.3d 749 (5th Cir. 1997), which was the only case addressing the exception for a bona fide sale for full and adequate consideration in the applicable circuit and addressed the issue as an objective inquiry. Pursuant to Wheeler, adequate and full consideration under Section 2036 “requires only that the sale not deplete the gross estate.” As a rule, unless a transfer that depletes the entire gross estate is coupled with a transfer that augments the gross estate, there is no “adequate and full consideration” for purposes of the estate or gift tax. In other words, the assets the estate receives must be roughly equivalent to the assets it gave up.

(b) Since Wheeler, a taxpayer's testamentary or tax savings motive for a transfer alone does not trigger Section 2036(a) recapture if objective facts demonstrate that the transfer was made for full and adequate consideration.

(c) Wheeler also addressed whether a sale is "bona fide" for purposes of Section 2036; the examination is whether the sale was a bona fide sale or a disguised gift or sham transaction. Although transactions between family members are subject to a higher standard of scrutiny, the Court should inquire beyond the form of the transaction (i.e., the fact that family members are involved) to determine whether the substance of the transaction justifies the tax treatment requested. The statute does not impose an additional requirement when determining whether the bona fide sale requirement is met under Section 2036 solely because the parties involved with the transaction are related.

(d) The Court cited and discussed both Church and Stone, both of which involved a transfer qualifying as a bona fide sale for purposes of Section 2036.

(e) The Fifth Circuit stated that the focus on whether a transfer to a partnership is for adequate and full consideration is (1) whether the interests credited to each of the partners was proportionate to the fair market value of the assets each partner contributed to the partnership; (2) whether the assets contributed by each partner to the partnership were properly credited to the respective capital accounts of the partners; and (3) whether on termination or dissolution of the partnership the partners were entitled to distributions from the partnership in amounts equal to their respective capital accounts. The Fifth Circuit answered each of these questions in the affirmative stating that (1) Mrs. Kimbell received a partnership interest that was proportionate to the assets contributed to the partnership; (2) Mrs. Kimbell's partnership account was credited with the assets she contributed; and (3) the partnership agreement required distributions to the partners in accordance with their partnership percentages upon dissolution of the partnership.

(f) Regarding the question of whether there was a bona fide sale, the Fifth Circuit determined that the District Court ignored record evidence in support of the taxpayer's position that the transaction was entered into for substantial business and other nontax reasons.

(g) The Fifth Circuit relied on the following facts to determine that the transfer to the partnership was a bona fide sale: (1) Mrs. Kimbell retained sufficient assets outside of the partnership for personal expenses and did not commingle partnership assets with personal assets; (2) formalities with respect to the formation of the partnership were adhered to and the assets contributed to the partnership were retitled accordingly; (3) the assets contributed to the partnership included working interests in oil and gas properties which require active management; and (4) several credible nontax reasons for the formation of the

partnership were presented that could not be accomplished through Mrs. Kimbell's trust.

(h) The second exception to avoid inclusion under Section 2036 is that the transferor did not retain an interest in the asset transferred. Because the Fifth Circuit determined that the transfer qualified under the bona fide sale exception, it was not obligated to address the retained interest exception with respect to the partnership. However, such exception was examined in reference to Mrs. Kimbell's transfer to the limited liability company. The Fifth Circuit held that the district court's application of Section 2036 to the LLC transfer was erroneous. Even if the bona fide sale exception was not met, Mrs. Kimbell did not retain control over the assets transferred to the limited liability company to subject the transfer to Section 2036 because Mrs. Kimbell held a fifty percent (50%) interest in the limited liability company, which was not controlling, and her son managed such entity. Thus, she did not retain the right to enjoy or designate who would enjoy the limited liability company property.

D. Estate of Schutt v. Commissioner, T.C. Memo 2005-126.

1. Formation Facts.

(a) Charles Porter Schutt was married to Phyllis duPont (Mrs. Schutt), the daughter of Eugene E. DuPont (Mr. DuPont). Mr. and Mrs. Schutt had four (4) children.

(b) Various trusts had been established in the past pertaining to the DuPont/Schutt families. Specifically, Trust 3044 was established in 1940 by Mr. DuPont for the benefit of the DuPont descendants. Trust 2064 was established in 1936 by Mr. DuPont for the benefit of Schutt descendants. Trust 11258-3 was established by Mrs. Schutt in 1976 for the benefit of Mr. Schutt and the Schutt descendants. Wilmington Trust Company ("WTC") was the Trustee of the aforementioned trusts. Mr. Schutt executed a revocable trust in 1976. Mr. Schutt, Henry I. Brown, III and Charles P. Schutt, Jr. were the Co-Trustees.

(c) During 1996 or 1997, Mr. Schutt and his advisors discussed various issues pertaining to asset planning and family assets. Specifically, the issues addressed were (1) Mr. Schutt's concerns regarding family sales of stock positions and the perpetuation of his philosophy regarding the maintenance of family assets; he had a very strong "buy and hold" investment policy; (2) Mr. Schutt's desire to create a vehicle through which he could make annual exclusion gifts; and (3) the applicability of valuation discounts.

(d) After extensive negotiations and concessions, including correspondence documenting the purposes of restructuring the family trusts, in 1998, Schutt, I, Business Trust (SI) and Schutt, II, Business Trust (SII), both Delaware business trusts, were formed. WTC, as the Trustee of 2064, 3044 and

11258-3, and Mr. Schutt, Henry I. Brown, III and Charles P. Schutt, Jr., as Co-Trustees of Mr. Schutt's revocable trust, executed the trust agreements.

(e) The purpose of SI and SII was to have one vehicle for all of the trust assets of which Mr. Schutt was an investment advisor or director, including a portion of Mr. Schutt's personal portfolio owned by his revocable trust. This would effectuate a plan of consistency and coordination with respect to investment policy.

2. Operational Facts.

(a) After the funding of SI and SII, the net cash flow of each trust was distributed pro rata on a quarterly basis pursuant to the terms of the trusts. Annual tax returns were prepared on behalf of SI and SII reporting the appropriate pro rata distributions. Until Mr. Schutt's death in 1999, SI and SII did not acquire any other assets, nor did it sell any of the stock it received at the time of initial funding. At no time were Mr. Schutt's personal assets commingled with SI and SII assets.

(b) Mr. Schutt died on April 21, 1999, approximately one year after SI and SII were formed. Mr. Schutt's estate tax return was filed and alternate valuation was elected. Discounts were applied in valuing the interests in SI and SII. In the notice of deficiency, the IRS asserted that the discounts applied were excessive and that the full fair market value of the assets contributed by Mr. Schutt's revocable trust to SI and SII should be included in his gross estate under Sections 2036 and 2038.

3. Section 2036 did not apply for the following reasons.

(a) The Court determined that Mr. Schutt's transfers to SI and SII constituted bona fide sales for adequate and full consideration and were excepted from inclusion under Sections 2036 and 2038. Emphasis was placed on Mr. Schutt's motives in the creation of SI and SII. Specifically, the Court addressed (1) Mr. Schutt's motive to perpetuate his family investment policies through the creation of SI and SII; (2) the fact that the underlying motive to establish SI and SII was more than merely testamentary; and (3) the fact that WTC took an active role with respect to the establishment of the trusts and their implementation. It was addressed that SI and SII had a meaningful economic impact on the rights of the beneficiaries under the 2064, 3044 and 11258-3 trusts.

(b) Mr. Schutt was recognized as having a legitimate desire with respect to the holding and perpetuation of family stock (his investment philosophy) and such was deemed a legitimate and significant nontax purpose in creating SI and SII.

(c) The Court addressed the adequate and full consideration issue and noted that contributors other than Mr. Schutt were responsible for the addition of

more than one-half (½) of the assets to SI and SII. The contribution to SI and SII was more than just a mere recycling of Mr. Schutt's assets.

(d) In making such determination, the Court equated the bona fide sale analysis in Turner (which was a Third Circuit Court of Appeals case; the circuit to which this case is appealable), which recognized that the bona fide sale prong would be met where the transfer was made in good faith, such that the transferor is provided some potential for benefit other than the potential estate tax savings, with the Tax Court's finding in Bongard, which recognized the bona fide sale standard for an arm's length transfer that shows a legitimate and significant nontax purpose for the entity.

E. Estate of Mirowski v. Commissioner, T.C. Memo 2008-74.

1. Family Background Facts.

(a) The background of the Mirowski family is remarkable and warrants recognition. As such, the details are outlined below.

(b) Anna Mirowski ("Mrs. Mirowski") met her husband, Mieczyslaw Mirowski ("Dr. Mirowski"), in France, where she was raised. Dr. Mirowski moved to France from Poland after Germany invaded Poland and his family was lost in the Holocaust.

(c) Dr. Mirowski attended medical school in France and continued his training and specialization in cardiology after Dr. Mirowski and Mrs. Mirowski moved to Israel.

(d) Dr. Mirowski developed a close relationship with Dr. Harry Heller, chief of medicine at the hospital where Dr. Mirowski trained in Israel.

(e) Dr. Heller suffered from ventricular fibrillation. The only treatment available for the condition at the time was electric shock administered by a defibrillator that was only located in the hospital because of its size. Dr. Heller died from an episode of ventricular fibrillation when he was not at the hospital to receive the treatment.

(f) After the death of his friend and mentor, Dr. Mirowski focused his medical career on the development of an implantable defibrillator in order to prevent individuals who were not able to receive the treatment at the hospital from dying and allow those who did not want to spend their life continuously in the hospital receiving treatment a feasible treatment alternative to what was currently available.

(g) In 1968, the Mirowskis emigrated to the United States so that Dr. Mirowski could continue developing his defibrillator, and over the following ten years, the automatic implantable cardioverter defibrillator (ICD) was created to

monitor and correct abnormal heart rhythms. The first successful ICD was implanted in a human in 1980.

(h) Dr. Mirowski held various patents relating to the ICD and entered into an exclusive license agreement where he received approximately 73% of the patent royalties. The royalties Dr. Mirowski received during his lifetime were modest.

(i) The Mirowski family vacationed annually at Rehoboth Beach, in Delaware, with their three daughters. The vacation tradition continued after their daughters married and had families of their own. During this time that the family was together, they discussed family business and investment with their accountants and attorneys.

(j) Dr. Mirowski died on March 26, 1990. Pursuant to the terms of his will, the ICD patents, his interest under the ICD license agreement and the balance of his assets, except for \$600,000, passed to Mrs. Mirowski.

(k) After Dr. Mirowski's death, Mrs. Mirowski continued to make gifts to family members and friends, outright and in trust, as discussed below, and paid the related gift tax. In addition, in an effort to keep her husband's memory and his passion for his career alive, Mrs. Mirowski made charitable donations to various hospitals and she established a charitable foundation known as Mirowski Family Foundation, Inc. in 1997.

(l) On February 27, 1982, Mrs. Mirowski created an irrevocable trust for each of her daughters, Ginat Mirowski ("Ginat"), Ariella Rosengard ("Ariella") and Doris Frydman ("Doris"), and each daughter was a co-Trustee of each trust. The terms of each trust provided for mandatory income to be distributed to the respective daughter during her lifetime and discretionary principal distributions to the daughter for her health, education, maintenance and support needs. Upon the daughter's death, the balance of her trust would be held in trust for the daughter's descendants or distributed outright, depending on the issue's age.

(m) Mrs. Mirowski funded each of the daughter's trusts with a portion of her interest under the ICD license agreement. After the trusts were funded, each trust owned a 7.2616% interest in the royalties under the ICD license agreement and Mrs. Mirowski retained a 51.09% interest in the royalties under the agreement. The initial coinventor of the ICD continued to hold approximately 27% interest in the royalties under the ICD license agreement.

2. Investment Facts.

(a) After Dr. Mirowski's death, sales of ICDs increased significantly. The royalties received under the ICD license agreement by Mrs. Mirowski and her daughters trusts increased from thousands of dollars a year to millions of dollars a year.

(b) After Dr. Mirowski's death, Mrs. Mirowski became responsible for managing her own financial affairs and was considered a highly conservative investor in that regard. Ariella and Ginat assisted their mother with her bookkeeping and provided advice regarding her investments, but the children did not make financial decisions for Mrs. Mirowski.

(c) Once the royalties began increasing, the spreadsheet Mrs. Mirowski was using to manage her investments and financial accounts was no longer effective because she had over 84 accounts in ten different financial institutions.

(d) In February, 1998, Mrs. Mirowski met with William Lewin of Goldman, Sachs, & Co. at the request of her daughter Ginat, who also held an investment account with Mr. Lewin. Because of the success of the account Ginat and her husband held at Goldman, Mrs. Mirowski realized that her investment portfolio would perform better if she were to diversify the portfolio and consolidate the investments at one place. The account at Goldman was opened in December, 1998, approximately ten months after the initial meeting with Lewin. In addition, Mrs. Mirowski continued to maintain investments at her other financial institutions.

(e) Beginning in January, 1999, Mrs. Mirowski deposited cash and marketable securities into her new Goldman Sachs account. The composition of the initial assets was changed once in the account, at Mrs. Mirowski's direction, in order to diversify the portfolio.

(f) After the Goldman Sachs account was opened, Mrs. Mirowski met with Goldman advisors a few times a month to discuss investment strategy and receive an update regarding her account. Mrs. Mirowski took a very active role in her account and made every decision pertaining to the purchase of securities within her account.

(g) In 2001, Mrs. Mirowski consolidated all of her investments into the Goldman Sachs account.

3. LLC Formation Facts and Additional Facts Involving Mrs. Mirowski.

(a) In 1999, Mrs. Mirowski's daughter Doris had surgery to treat her chronic epilepsy. This life event caused Mrs. Mirowski to focus on ways to provide financially for her daughters and grandchildren, while allowing her daughters to work together in a way other than as Trustees of their existing irrevocable trusts.

(b) In May, 2000, Mrs. Mirowski had a meeting with U.S. Trust representatives at the residence of her daughter Ariella to discuss the concept of a limited liability company ("LLC").

(c) After the meeting with U.S. Trust, Mrs. Mirowski spoke to her attorney, Sidney Silver, about the LLC. On August 31, 2000, Mr. Silver sent a letter to Mrs. Mirowski enclosing the draft Articles of Organization and Operating Agreement for Mirowski Family Ventures, LLC. Copies of these documents were also sent to the Mirowski daughters. The letter enclosing the documents referenced the fact that the documents were prepared in accordance with Mr. Silver's recent telephone conversations with Gunat and Ariella.

(d) Because Mrs. Mirowski discussed important decisions with her family, a meeting was planned with Mr. Silver in August, 2001, to discuss the LLC. This was the next time the family planned on being together.

(e) In January, 2001, Mrs. Mirowski travelled to France to visit her sister who was hit by a car. During the trip, Mrs. Mirowski developed a blister on her foot as a result of the shoes she wore. The blister, coupled with her diabetes, caused her to develop a foot ulcer. When she returned to the United States, she received treatment for the condition. If she received proper treatment for the foot ulcer resulting from diabetes, her doctors expected her to recover from it.

(f) On March 3, 2001, Mrs. Mirowski signed an agreement for residency at North Oaks retirement community in Baltimore County, Maryland. It was intended that this would be her primary residence.

(g) On March 13, 2001, Mrs. Mirowski underwent surgery on her foot.

(h) On July 22, 2001, Mrs. Mirowski signed an agreement for residency at Waverly Heights continuing care retirement community, in Gladwne, Pennsylvania. She committed over \$500,000 for her occupancy at North Oaks and Waverly Heights. A small studio was purchased at Waverly Heights because a larger unit she intended to acquire was not yet available.

(i) Between March and August 2001, Mrs. Mirowski continued treatment for her foot ulcer; various types of medical treatment alternatives were suggested by her physician, including amputation.

(j) In August, 2001, Mrs. Mirowski's daughters and families took their annual vacation in Rehoboth Beach and conducted their family meeting. Mr. Silver was at the meeting, but Mrs. Mirowski was not. The discussion focused around (1) the formation of the LLC and how it would function, (2) Mrs. Mirowski's plans to make gifts of LLC interests to her daughters' trusts, and (3) the daughters' role in the LLC. Although Mrs. Mirowski was not present at the meeting, her health was stable.

(k) After the August 14, 2001 meeting, on August 22, 2001, Mr. Silver finalized the documents to form the LLC. Although Mrs. Mirowski knew the LLC would provide her with tax benefits, the legitimate and nontax purposes for forming the LLC and transferring the bulk of her assets to it were more significant to her. The following legitimate and nontax purposes were expressed: (1) joint

management of the family's assets by her daughters and later her grandchildren; this purpose was rooted in her early years where her family worked together in the family business and retained a closeness and involvement that Mrs. Mirowski continued to respect, (2) maintenance of the assets in a single pool of assets to allow for particular investment opportunities, (3) providing equally for each of the Mirowski descendants, and (4) additional protection from potential creditors for the interests in the family's assets that she intended for her descendants.

(l) Mrs. Mirowski executed the LLC Articles of Organization and Operating Agreement on August 27, 2001 and the articles were filed in Maryland on August 30, 2001.

(m) On August 31, 2001, Mrs. Mirowski was admitted to Johns Hopkins Hospital for further treatment for her foot ulcer.

(n) On September 1, 2001, Mrs. Mirowski made a bona fide, arm's length transfer of her assets to the LLC. Specifically, the ICD patents and her 51.09% interest under the ICD patents license agreement were transferred to the LLC in exchange for a 100% membership interest in the LLC.

(o) On September 5, 2001, Mrs. Mirowski made another transfer to the LLC of property consisting of marketable securities from her Goldman Sachs account with a value of \$60,578,298.

(p) On September 6 and 7, 2001, Mrs. Mirowski transferred an additional \$1,525,008.08 in cash and marketable securities to the LLC from her Goldman Sachs account.

(q) On September 7, 2001, Mrs. Mirowski gifted a 16% membership interest in the LLC to each of her daughter's trusts. It was known that gift tax would result from these gifts.

3. Pertinent Provisions of LLC Operating Agreement.

(a) Pursuant to Sections I and 3.6 of the Operating Agreement, Mrs. Mirowski's capital account was to be credited with her contributions of property to the LLC and her capital account was to be maintained after such contribution. After Mrs. Mirowski's gift of the membership interests in the LLC to the daughters' trusts, the capital accounts were to be adjusted to the extent the capital was attributed to such trusts.

(b) Section 3.4 of the Operating Agreement provided that no interest holder was to have the right to receive the return of any capital contribution except as otherwise provided in the Agreement. The Agreement only provided for a return of capital contribution in the event of liquidation and dissolution of the entity.

(c) Section 4.1.1 of the Operating Agreement provided that upon liquidation of the entity, the assets were required to be distributed to interest holders in accordance with their current capital accounts.

(d) Section 5.1.1 of the Operating Agreement provided for Manager management of the LLC and that Mrs. Mirowski was the initial Manager. Her powers as Manager were subject to the provisions in the Agreement, in addition to Maryland law (i.e., fiduciary duty to the other members of the LLC).

(e) Pursuant to Sections 5.1.2.3, 5.1.3.1 and 5.1.3.2 of the Operating Agreement, although Mrs. Mirowski was a 52% member of the LLC after the gift of the interests to her daughters' trusts and the Manager, she could not sell or dispose of the LLC assets, other than in the normal course of entity operation, without the approval of the LLC members.

(f) Section 7.1.1 of the Operating Agreement provided that Mrs. Mirowski could not liquidate and dissolve the LLC without the consent of all LLC members.

(g) Sections 5.1.3.1 and 5.1.3.4 of the Operating Agreement provided that Mrs. Mirowski could not admit additional members to the LLC without the consent of the other LLC members.

(h) Section 4.1.1 of the Operating Agreement provided that profit or loss would be allocated to the members in accordance with their percentage interests in the LLC.

(i) Section 4.1.2 of the Operating Agreement provided that distributions of the LLC cash flow for a taxable year was required to be made to the members in accordance with their percentage interests within 75 days of the close of the taxable year.

(j) Sections 4.2.1 and 4.2.2 of the Operating Agreement provided that profit or loss from a capital transaction was to be credited to the members of the LLC in accordance with their capital accounts.

(k) Section 4.2.3 of the Operating Agreement provided for "Capital Proceeds" to be distributed to LLC members in accordance with their capital accounts after expenses, debts and liabilities with respect to the capital transaction are satisfied, and amounts are set aside at the Manager's discretion for the LLCs liabilities or obligations.

(l) Section 4.5.1 of the Operating Agreement provided that except as otherwise provided in the Operating Agreement, the majority interest of the Members determined the timing and amount of LLC distributions.

(m) Section 7.1.2 of the Operating Agreement provided that an involuntary withdrawal of an LLC member (including the death of the member),

would cause the LLC to dissolve unless the remaining members were unanimous that the LLC business should continue in accordance with the terms of the Operating Agreement.

4. Operational Facts.

(a) Mrs. Mirowski and her family knew that she retained substantial personal assets outside of the LLC as follows: her residence valued at \$799,000, cash and cash equivalents of approximately \$3,308,000, personal property consisting primarily of fine art valued at approximately \$1,892,000, a loan of \$305,640 due from North Oaks, a right to receive a refund of \$203,301 that she paid as an occupancy rights fee to Waverly Heights, a promissory note of Ginat and her husband with a balance of \$136,499.99 plus interest in the amount of \$205.96, a promissory note of Rosengard and her husband with a balance of \$460,111.73, plus interest in the amount of \$922.26, and a promissory note of Doris Frydman and her husband that had an outstanding balance of \$500,000, plus interest in the amount of \$915.67. In addition, Mrs. Mirowski was the beneficiary under a trust established under Dr. Mirowski's will that had a value of \$620,000.

(b) It was also anticipated that Mrs. Mirowski would receive, as a member of the LLC, millions of dollars a year attributable to royalty payments under the ICD patents license agreement.

(c) Mrs. Mirowski's daughters believed that she could borrow against her LLC interest in order to pay the substantial gift tax liability attributable to the gifts of the membership interests to the daughters' trusts. There was no agreement or understanding that LLC assets would be distributed to satisfy the gift tax liability.

(d) Mrs. Mirowski's personal assets were never commingled with the LLC assets. At no time was there an agreement between Mrs. Mirowski and her daughters that assets would be distributed from the LLC in order to satisfy Mrs. Mirowski's financial obligations. In addition, there was no agreement that Mrs. Mirowski would have access to the LLC assets at her own discretion or retain the right to enjoyment of the assets or the right to determine who could enjoy the assets.

(e) Mrs. Mirowski retained sufficient assets outside of the LLC to meet her living expenses. However, sufficient assets were not retained to satisfy the gift tax liability associated with Mrs. Mirowski's gifts of her membership interests to the daughters' trusts.

(f) Mrs. Mirowski died on September 11, 2001 after unexpected complications from her foot ulcer leading to sepsis.

(g) After Mrs. Mirowski's death, on September 16, 2001, the Personal Representatives of her estate and the other members of the LLC (i.e., the daughters' trusts) executed a memorandum pertaining to the LLC's operating

agreement acknowledging receipt of the membership interest in the LLC. On the same date, the members of the LLC also held a special meeting electing officers for the LLC and discussing the LLC account opened at Goldman Sachs.

(h) Pursuant to the terms of Mrs. Mirowski's will, her 52% membership interest in the LLC would be distributed equally to the daughters' trusts.

(i) The daughters' trusts, as the members of the LLC, decided not to receive distributions of all of the LLC's cash flow, as defined in the LLC Operating Agreement, but rather to retain the cash flow beyond that required by the members for taxes and expenses in the LLC for reinvestment.

(j) The LLC, before and after Mrs. Mirowski's death, was a valid functioning investment operation managing the business relating to the ICD patents and license agreement, including related litigation. The daughters, as the Trustees of the trusts and as officers, worked together to manage the LLC assets and to address the ICD patents and license agreements. Specifically, they held meetings (either all in person or via telephone conference) with representatives of Goldman Sachs approximately three to four times a year to review the performance of LLC assets and discuss future investment changes.

(k) In 2002, the LLC made distributions totaling \$36,415,810 to Mrs. Mirowski's estate for the payment of Federal and state transfer taxes, legal fees and other estate obligations. No distributions were made to the daughters' trusts.

(l) For the years 1991 through 2001, Mrs. Mirowski filed Federal gift tax returns to reflect the substantial gifts made in such years. The aggregate value of such gifts was \$24,715,921. Her estate filed the 2001 Federal gift tax return to report the gift of the membership interests in the LLC to the daughters' trusts; the 2001 gift tax reported on such return was \$9,729,280 which resulted in a credit to Mrs. Mirowski's estate of \$2,021,343.

(m) Mrs. Mirowski's Federal estate tax return showed an estate tax liability of \$14,119,83.13. The estate tax owed was paid with funds it received from the LLC distribution.

5. Section 2036 did not apply for the following reasons.

(a) The Tax Court, citing Bongard and Stone, recognized that the "bona fide sale for an adequate and full consideration in money or money's worth" exception to the application of Section 2036(a) of the Code is satisfied where the record establishes a legitimate and significant nontax reason for creating the entity and the transferor receives entity interests proportionate to the value of the property transferred.

(b) Relying on the testimonies of Mrs. Mirowski's daughters, the Tax Court determined the following legitimate and nontax reasons for forming and

transferring assets to the LLC: (1) joint management of the family's assets by her daughters and ultimately, the grandchildren, (2) maintenance of the bulk of the family's assets in a single pool of assets to allow specific investment opportunity, and (3) providing equal distribution of assets to her descendants.

(c) The Tax Court disagreed with the Commissioner's argument that Mrs. Mirowski failed to retain sufficient assets outside of the LLC. Mrs. Mirowski's only anticipated significant financial obligation when she formed and funded the LLC was the gift tax she would be liable for upon the gift of the membership interests in the LLCs to the daughters' trusts. There was never an express or unwritten agreement that LLC assets would be distributed to Mrs. Mirowski to satisfy these taxes. In addition, as Mrs. Mirowski's condition worsened unexpectedly just prior to her death, none of Mrs. Mirowski, her family and her doctors expected her to die from the condition and there was no discussion of tax liabilities that would be incurred only as a result of her death.

(d) The Tax Court disagreed with the Commissioner's argument that the LLC lacked any valid functioning business operation. The Tax Court determined that at all relevant times, including after Mrs. Mirowski's death, the LLC was managing the business matters relating to the ICD patents and license agreement, including the related litigation.

(e) The Tax Court disagreed with the Commissioner's contention that Mrs. Mirowski delayed forming and funding the LLC until shortly before her death when her health began to fail. As previously mentioned, there was no expectation by Mrs. Mirowski, her family and her doctors that her condition would lead to her demise, nor were there discussion amongst the family members regarding tax liabilities that would arise solely as a result of Mrs. Mirowski's death.

(f) The Commissioner's argument that Mrs. Mirowski stood on both sides of the transaction was rejected by the Tax Court. Such argument ignored the fact that Mrs. Mirowski fully funded the LLC, which was initially a single member LLC. Each of the daughter's trusts received a membership interest in the LLC by gift from Mrs. Mirowski.

(g) The Commissioner also focused on the fact that the LLC distributed \$36,415,810 to Mrs. Mirowski's estate after she died for the payment of transfer taxes, legal fees and other estate obligations. The Tax Court again reiterated the fact that there was no expectation that Mrs. Mirowski would die from her condition nor was there any discussion between the family of anticipated taxes and other obligations that would arise solely from Mrs. Mirowski's death.

(h) The Commissioner argued that the bona fide sale for an adequate and full consideration in money or money's worth exception under Section 2036 of the Code did not apply to Mrs. Mirowski's transfers to the LLC because it was always contemplated that the forming and funding of the LLC would precede gifts

of membership interests to the daughters' trusts so, in substance, Mrs. Mirowski only really received a 52% LLC interest in exchange for 100% of the assets she transferred. Thus, the Commissioner's argument was that Mrs. Mirowski did not receive adequate and full consideration in the form of a proportionate LLC interest compared with what was transferred. The Tax Court rejected this argument and recognized that Mrs. Mirowski made two separate transfers at issue here; the initial transfer of assets to the LLC and the subsequent transfer of the membership interests to the daughters' trusts. Mrs. Mirowski received 100% of the membership interests in the LLC when she funded the LLC (i.e., an interest proportionate to what she transferred) and she received nothing in exchange when she gifted membership interests in the LLC to her daughters' trusts. Mrs. Mirowski's capital account was properly credited upon the funding of the LLC and, in accordance with the LLC's Operating Agreement, she would be entitled to a distribution of property from the LLC in accordance with her capital account in the event of liquidation and dissolution.

(i) Based upon the foregoing, the Tax Court determined that the bona fide sale for an adequate and full consideration in money or money's worth exception applied to Mrs. Mirowski's transfer of assets to the LLC so that Section 2036(a) of the Code did not apply with respect to such transfers.

(j) Mrs. Mirowski's estate and the Tax Court found that Mrs. Mirowski's transfers of membership interests in the LLC to her daughters' trusts were transfers of property under Section 2036(a) of the Code and that such transfers did qualify for the bona fide sale for full consideration in money or money's worth exception under Section 2036(a) of the Code.

(k) The Commissioner argued that at the time of Mrs. Mirowski's gifts of the membership interests in the LLC to the daughters' trusts and at the time of her death, she retained the right to the possession or enjoyment of, or the right to the income from, the interests transferred to the daughters' trusts. This argument was based upon Section 4.5.1 of the LLC operating agreement which provided that Mrs. Mirowski's authority as manager of the LLC included the authority to decide the timing and amounts of distributions from the LLC. Section 4.5.1 of the LLC Operating Agreement provided that "except as otherwise provided in the agreement, the timing and amount of all distributions shall be determined by the members holding a majority of the percentages then outstanding." Thus, the authority given to Mrs. Mirowski under that Section was in her capacity as member of the LLC who owned a majority of the outstanding percentage interests in the LLC, not as Manager. In addition, Mrs. Mirowski, as a majority percentage member of the LLC, would not have the authority with respect to the determination of the timing and amount of distributions where such were "otherwise provided" in the Operating Agreement. Specifically, under Section 4.1 of the Operating Agreement, Mrs. Mirowski had no authority (either as Manager or majority percentage member) to determine the distribution of the LLC's cash flow or the allocation of LLC profit or loss from the ordinary course of LLC operations. Pursuant to Section 4.2 of the Operating Agreement, she also

had no authority (in either capacity, majority member or Manager) to determine the distribution of capital proceeds or the allocation of profit or loss from a capital transaction. Based upon the foregoing, Section 4.5.1 of the LLC Operating Agreement did not give Mrs. Mirowski, either as Manager or majority member, the authority to determine the timing and amount of distributions as suggested by the Commissioner.

(l) The Tax Court recognized that Mrs. Mirowski's authority as Manager of the LLC was subject to other provisions of the LLC's Operating Agreement, including Section 4.1 (regarding distribution of cash flow and allocation of profit or loss from transactions other than capital transactions), Section 4.2 (regarding distribution of capital proceeds and allocation of profit or loss from capital transactions), Section 4.4 (regarding distribution of LLC assets upon liquidation and dissolution), Section 5.1.3 (regarding extraordinary transactions), Section 7.1 (regarding events resulting in entity dissolution) and Section 7.2 (regarding procedure for entity winding up and dissolution). In addition, the Operating Agreement also recognized that Mrs. Mirowski, as Manager, was also bound by Maryland law, including a fiduciary duty to the other members of the LLC. The Tax Court determined that the authority as Manager granted to Mrs. Mirowski under the Operating Agreement did not warrant a finding that there was an express agreement that she retained an interest under Section 2036(a)(1) of the Code with respect to the interests transferred to the daughters' trusts.

(m) The Tax Court stated that the decision of the LLC members to distribute over \$36 million from the LLC to Mrs. Mirowski's estate for the payment of transfer taxes, legal fees and other estate obligations, was not determinative in this case of whether at the time of her gifts to the daughters' trusts and upon her death there was an implied agreement to retain an interest under Section 2036(a)(1) of the Code.

F. Keller v. U.S., Civil Action No. V-02-62 (S.D. Tex. August 20, 2009).

1. Background Facts.

(a) On June 26, 1998, Maude Williams and her husband, Roger Williams, both 88 years of age, executed a revocable trust which provided for the formation of a "Family Trust" to hold approximately \$300 million in assets of their separate and community property.

(b) Upon the death of the first spouse, the Family Trust divided into two shares, Share M and Share A. Share M would include the first-to-die spouse's separate property and one-half of the community property. Share A would hold the balance of the Family Trust assets. Each of Share M and Share A were held in trust (i.e., Trust M and Trust A), of which the surviving spouse would be the Trustee. The surviving spouse also had the right not to fund, in whole or in part, Trust A, and the right to disclaim his or her interest, in whole or

in part, in Trust M. Upon the death of the surviving spouse, Trust A and Trust M would divide into separate trusts for the Williamses' grandchildren.

(c) Mr. Williams passed away on January 5, 1999 and the Family Trust was divided into Trust A and Trust M in accordance with the above provisions.

2. Formation Facts.

(a) Ms. Williams began discussions with her advisors regarding options for the protection and disposition of some of the assets held in Trust A and Trust M after her death. Her advisors were her accountants, Rayford L. "Bo" Keller and his son, Lane Keller, and Ms. Williams' grandson, Michael Anderson. The discussions focused around the formation of several limited partnerships to hold the separate class of assets.

(b) At the beginning of 2000, Ms. Williams formed a family limited partnership with a limited liability company as its general partner (to be created at the time the partnership was formed). The LLC (of which Ms. Williams was the initial sole member) was the .01% general partner and each of Trust A and Trust M was a 49.95% limited partner.

(c) Ms. Williams was diagnosed with cancer in March, 2000. While in the hospital in May, 2009, she executed the partnership agreement for the partnership.

(d) Although the partnership agreement referenced that each partner shall contribute to the partnership as its initial capital contribution, the property addressed in a Schedule attached to the agreement, the Schedule did not list any information as the values of what was being contributed. The Schedule did reference the percentage interests of each partner of the partnership.

(e) On May 10, 2000, Mr. Keller applied for taxpayer identification numbers for the entities and began arranging for the opening of accounts for the partnership and LLC. A \$300,000 check was written, but not signed, that would be used to fund the LLC general partner from either the Trust M or Trust A account.

(f) On May 11, 2000, the formation documents were filed in the state of Texas with respect to the LLC and partnership.

(g) Ms. Williams died in May 15, 2000, six days after signing the partnership agreement and four days after filing the entity documents with the state of Texas. At the time of her death, the entities (1) did not have taxpayer identification numbers (2) did not have accounts and (3) did not have assets (note that the \$300,000 check was not signed for the contribution to the LLC).

(h) On February 12, 2001, Ms. Williams estate tax liability was satisfied in the amount of \$147,800,245. Because it was believed that the partnership was not properly formed and funded upon Ms. Williams death, the estate tax return did not disclose the partnership or report any discounts with respect to it.

(i) On May 17, 2001, Mr. Keller attended an estate planning seminar which discussed Church (see discussion of Church at Paragraph A. of Section IV of this outline), and he discovered that the partnership was in fact formed successfully at the time of Ms. Williams death. As a result, Mr. Keller and the other Williams advisors proceeded with funding the partnership in accordance with the initial plan.

(j) On November 15, 2001, Ms. Williams estate filed a Claim for Refund in the amount of \$40,455,332, plus interest. When no response was received by the Government within the requested six month time frame, the estate filed its complaint.

3. Operational Facts. There were none.

4. Section 2036 did not apply for the following reasons.

(a) Although the partnership formalities were not accomplished prior to Ms. Williams death, the Court determined that the intent for the partnership to be funded existed. Relying on Texas law, the Court recognized that the intent of the owner to make an asset partnership property will cause the asset to be partnership property. The Court stated that the observance of the partnership formalities was not necessary to evidence the intent of Ms. Williams to fund it.

(b) The Court addressed the unsigned \$300,000 check that was to fund the LLC general partner. It recognized that Ms. Williams intended the funding of the LLC with this amount and also intended for the interests in the general partner to be sold to her children.

(c) Ms. Williams intent was a key consideration by the Court; the Court found her intent to form and fund the Partnership evident based upon the extensive recordkeeping of her advisors throughout the planning process.

(d) The Court determined that the bona fide sale exception applied and that the partnership met the significant and legitimate nontax business purpose requirement to avoid the applicability of Section 2036. The primary purpose of the partnership was to consolidate and protect family assets for management purposes while establishing a vehicle to pass these assets easily to family members. Significant factors supporting the Court's decisions were as follows:

(i) Ms. Williams desire to protect family assets from potential creditors, specifically, ex-spouses. The record shows that Ms. Williams

had a significant and valid concern for the family interests when her daughter went through a lengthy and expensive divorce;

(ii) The extensive discussions and planning amongst Ms. Williams and her advisors which represent that the partnership was formed in good faith;

(iii) It was anticipated that Ms. Williams would have more than sufficient assets outside of the partnership structure; and

(iv) The partnership agreement was validly executed.

(e) Since the Court determined that the partnership was valid and that Section 2036 did not apply, the question turned to one of valuation of the 49.95% limited partnership interests held by Trust M and Trust A.

(f) The Court relied on the “asset-based” valuation of the estate’s expert and agreed with such expert that the value of the limited partnership interests owned by Trust A and Trust A was \$68,439,000, which represents an overall discount for lack of marketability and control of approximately 47.51%. Thus, the estate tax liability was reduced by over \$40 million!

G. Estate of Murphy v. U.S., U.S. Dist. Ct. W.D. Ark. El Dorado Division, Case No. 07-CV-1013 (October 2, 2009).

1. Formation Facts.

(a) Mr. Murphy was the CEO and Chairman of the Board of Murphy Oil Corporation, a publicly traded company. He also owned 3% of the stock of Deltic Timber Corporation and a .37% interest in a bank. Mr. Murphy was involved in the management of all three companies (collectively referred to as the “Company”).

(b) On February 19, 1998, Mr. Murphy contributed his interests in the Company, with an approximate value of \$89 million, to a family limited partnership, in exchange for a 96.75% limited partnership interest. A 1% limited partnership interest was allocated to a college as a charitable bequest. A limited liability company was a 2.25% general partner with its membership interests owned 49% by Mr. Murphy and 51% by two of his children.

(c) The partnership was formed after several planning meetings between Mr. Murphy and his children. One of his children was represented by independent counsel.

(d) The main purpose of the partnership was to provide centralized management of family assets so it could be turned over to the next generation. Mr. Murphy and his children shared the same “buy and hold” philosophy with respect to business and investing.

2. Operational Facts.

(a) Mr. Murphy's children were actively involved with the management of the partnership.

(b) The partners of the partnership met six to eight times a year to discuss partnership business.

(c) Two distributions from the partnership were made pro-rata to the partners during Mr. Murphy's lifetime. The first distribution was made to the partners for purposes of their federal income taxes attributable to the partnership ownership. The second distribution was made to Mr. Murphy in stock of a company owned by the partnership; such distribution reduced his percentage interest and capital account accordingly.

(d) Up until his death, Mr. Murphy gifted limited partnership interests to his family members and their spouses for purposes of utilizing his annual exclusion gifting.

(e) Upon Mr. Murphy's death, his estate did not have sufficient funds to satisfy the estate taxes that were owed. In that regard, the estate borrowed funds from the partnership for such purpose.

3. The estate tax return and Notice of Deficiency.

(a) Upon Mr. Murphy's death, his 95.25365% limited partnership interests in the partnership were reported on his estate tax return. The interest was valued at \$74,082,000 and a 41% discount was applied.

(b) The IRS issued a Notice of Deficiency for \$34 million, alleging that the estate undervalued the assets and that the partnership assets were included in Mr. Murphy's estate under Section 2036. The estate borrowed money to satisfy the deficiency and filed a Claim for Refund.

4. Section 2036 did *not* apply for the following reasons.

(a) The Court determined that Section 2036 did not apply because the bona fide sale exception was satisfied. Specifically, the Court addressed the legitimate nontax purpose of pooling assets consistent with the family's investment strategy. Relying on Shutt, the Court recognized that the buy and hold investment strategy was a legitimate nontax purpose for the formation of the partnership and also focused on the active management of the children with respect to the investments.

(b) Mr. Murphy retained more than sufficient assets outside of the partnership for his everyday living expenses.

(c) Mr. Murphy respected the formalities of the entities and successfully separated entity from personal assets.

(d) Mr. Murphy did not stand on both sides of the transaction with respect to the entity formation. The children were engaged with their father with respect to discussions about the formation of the partnership and its funding and one of the children retained separate counsel.

(e) In valuing the 95.25365% limited partnership interests owned by Mr. Murphy at the time of his death, the Court determined the value of the Company, considering Rule 144 and blockage discounts, holding a 41% overall discount should apply (12.5% lack of control discount and 32.5% lack of marketability discount).

(f) Mr. Murphy also owned a 49% membership interest in the limited liability company general partner of the partnership. The Court applied an overall 52% discount to the interest, based upon two levels. The first level of discount determined a 20% lack of control/marketability discount for the LLC's 2.28113% general partnership interest and the second level of discount determined a 32.5% lack of marketability discount and 11.1% lack of control discount for the 49% membership interest owned by the estate in the general partner LLC.

V. THE “SERVICE’S BEST FRIEND” – BYRUM.

A. United States v. Byrum, 408 U.S. 125 (1972).

1. Facts.

(a) Decedent (Mr. Byrum) transferred shares of stock in three (3) closely held corporations to an irrevocable trust. Prior to the transfer, he owned at least 71% of the outstanding stock of each corporation. Decedent’s children or more remote descendants were the beneficiaries of the trust. The other shareholders in each corporation were unrelated to the decedent.

(b) A corporate trustee was required pursuant to the terms of the trust; Huntington National Bank was named by decedent as such trustee.

(c) The trustee maintained broad and detailed powers with respect to the control of the trust property and such powers were exercisable in the trustee’s sole discretion.

(d) Decedent reserved certain rights with respect to the trust property. Specifically, decedent retained the right (i) to vote the shares of unlisted stock held by the trust; (ii) to disapprove the sale or transfer of any trust assets, including the shares of stock transferred to the trust; (iii) to approve investments and reinvestments; and (iv) to remove the trustee and appoint another corporate trustee in its place and stead.

(e) Trustee was authorized to pay income and principal, at its sole discretion, from the trust to or for the benefit of the beneficiaries for health, education, care, maintenance and support until the youngest child attained the age of twenty-one (21) years.

(f) Upon the youngest child's attaining the age of twenty-one (21) years, the trust was required to be divided into separate trusts for each child and held for such child until the child attained the age of thirty-five (35) years. During the time such child's share was held in trust, the trustee had the discretion to pay income and principal from the trust to the beneficiary for emergency or other "worthy need."

(g) Upon decedent's death, he owned less than 50% of the common stock in two (2) of the corporations and 59% in the third corporation. Because the trust had retained the shares decedent transferred to it, decedent had the right to vote not less than 71% of the common stock in each of the corporations.

2. Commissioner's 2036(a)(2) arguments.

(a) The stock transferred into the trust should be included in the decedent's gross estate because of the rights he retained in the trust agreement.

(b) Decedent's right to vote the transferred shares and to veto any sale thereof by the trustee, coupled with the ownership of his other shares, enabled him to retain the "enjoyment of . . . the property" and also allowed him to determine the income flow to the trust and thereby "designate the persons who shall . . . enjoy . . . the income."

3. Section 2036 did *not* apply for the following reasons.

(a) The Government claimed that the decedent retained the right to designate the persons who shall enjoy the income from the property transferred to the trust under Section 2036(a)(2) because the decedent, by retaining the voting control over the corporations, was in a position to select the corporate directors. It was argued that this allowed decedent control over the corporate dividend policy. Decedent could increase, decrease or stop dividends completely; thus, he could regulate the flow of income to the trust and thereby shift or defer the beneficial enjoyment of trust income between the present beneficiaries and the remaindermen. The Government argued that such retained power was akin to a grantor-trustee's power to accumulate income in a trust. The Court rejected this argument, as trust property is not necessarily included in a grantor's estate solely because such grantor retained the power to manage the trust assets.

(b) The Court recognized that the grantor of a trust may retain broad powers of management without adverse estate tax consequences and that such concept has been relied upon in the drafting of hundreds of trusts. Modifying this principle could have a seriously adverse impact upon settlors who happen to be "controlling" stockholders of a closely held corporation.

(c) The Court determined that the decedent retained no “right” in the trust instrument to designate the enjoyment of trust property under Section 2036(a)(2). The Court construed the term “right” as an ascertainable and legally enforceable power. The only right retained by the decedent was the power to use his majority position and influence over the corporate directors to regulate the dividend flow to the trust. Such “right” was neither ascertainable nor legally enforceable.

(d) The Court recognized that the decedent retained the legal right to vote shares in the corporations held by the trust and to veto investments and reinvestments. However, it was the corporate trustee, not the decedent, who had the sole right to distribute or withhold income and designate which beneficiaries enjoyed such income. The decedent’s power to regulate the dividend flow was not specified by the trust instrument, but was granted to him because he could elect a majority of the directors of the corporations. Decedent’s power to elect directors did not compel them to pay dividends.

(e) The Court also addressed the importance of the concept of “fiduciary duty.” A majority shareholder has a fiduciary duty not to misuse his power by promoting his personal interests at the expense of corporate interests. In addition, the directors have a duty to preserve the interests of the corporation. Although the decedent may have had influence over the corporate directors, their responsibilities were to all stockholders (there were additional stockholders who were unrelated to the decedent) and were legally enforceable, separate from any needs of decedent and the trust.

(f) The Court noted that the Government’s assertion regarding decedent’s power to increase or decrease corporate dividends fails to consider the realities of corporate life. The Court assumed that the corporations controlled by the decedent were nothing more than typical small businesses. Thus, based upon market variables (i.e., bad years, product obsolescence, new competition, litigation, Government regulations, etc.), there is no assurance that such small entities would have income available for dividend distribution. The decedent’s power to control the flow of dividends to the trust was subject to market variables outside of decedent’s control.

(g) Even when there are corporate earnings available for distribution as a dividend, it is the corporate board who has sole legal power to declare such dividends. In making such a decision, the board must consider various factors (i.e., stockholder expectations, corporate needs, nature of the corporation’s business and access to capital markets, etc.).

(h) Decedent was also inhibited by a fiduciary duty from abusing his position as majority shareholder for personal or family advantage to the detriment of the corporation or other stockholder. In this case, there were a substantial number of unrelated minority stockholders. Thus, if decedent violated his

fiduciary duties, the minority shareholders would probably initiate a cause of action against him.

VI. DETERMINING THE DISCOUNT ADJUSTMENTS.

A. Lappo v. Commissioner, T.C. Memo 2003-258.

1. Facts.

(a) On October 20, 1995, Mrs. Lappo and her daughter formed the Lappo Family Limited Partnership (the "Lappo Partnership") pursuant to Georgia law.

(b) On April 19, 1996, the Lappo Partnership was funded by Mrs. Lappo and her daughter with a marketable securities portfolio and Michigan real estate. Mrs. Lappo owned a 1% general partnership interest and a 98.7% limited partnership interest and her daughter owned a .2% general partnership interest and a .1% limited partnership interest. The allocation of the partnership interests was based on the market value of the assets contributed as of December 31, 1995. As of such date, the appraised market value of the real estate was \$1,860,000 and the appraised market value of the marketable securities was \$1,318,609.

(c) On April 19, 1996, Mrs. Lappo transferred 69.4815368% limited partnership interests to a trust of which her daughter was the Trustee and her four grandchildren, individually.

(d) On July 2, 1996, Mrs. Lappo gifted her remaining 29.2184632% limited partnership interests to her daughter, individually.

(e) On April 11, 1997, Mrs. Lappo filed a Federal gift tax return to report her April 19, 1996 gifts of limited partnership interests. Such interests were valued at \$1,040,000. \$153,000 of gift tax liability was remitted with the return. On February 6, 1998, Mrs. Lappo filed an amended Federal gift tax return to report the gift of limited partnership interests to her daughter; such gift was omitted from the initially filed 1996 Federal gift tax return. The gift of the limited partnership interest to Mrs. Lappo's daughter was filed at \$423,871 and gift taxes in the amount of \$177,265 were remitted with the amended return.

(f) On June 19, 2001, the notice of deficiency issued by the IRS sought to increase the value of the gift of the limited partnership interests reported on the initial 1996 Federal gift tax return from \$1,040,000 to \$3,137,287.

2. Opinion.

(a) The dispute between Mrs. Lappo and the IRS focused on the fair market value of the limited partnership interests transferred. Specifically, the

disagreement focused on the size of the applicable minority interest and marketability discounts.

(b) Mrs. Lappo's expert concluded that a 7.5% minority interest discount was appropriate with respect to the marketable securities component of the partnership interests. With respect to the real estate component, he concluded that a 35% minority interest discount should apply to the April 19, 1996 gifts and a 30% minority interest discount should apply to the July 2, 1996 gift.

(c) The IRS expert concluded that the partnership interests should be valued to reflect an 8.5% minority interest discount and an 8.3% marketability discount.

(d) The Court concluded that an overall minority interest discount of 15% was appropriate in determining the fair market value of each gift partnership interest.

(e) The expert for the IRS and Mrs. Lappo's expert agreed that private placements of publicly traded stock are the starting point for determining the lack of marketability discount. However, they disagree on the private placements to be considered, what is measured by those comparisons and the inferences to be drawn from the specific characteristics of the Lappo Partnership.

(f) The Court preferred the approach of the IRS expert, which focused on the Bajaj study. Such study analyzed discounts observed in private placements of registered shares as well as private placements of unregistered (restricted) shares. However, the Court determined that the conclusions of the Bajaj study (a 7.2% discount) could not be validated without the benefit of other empirical studies and that the 7.2% discount was not a persuasive starting point for determining the marketability discount.

(g) The Court instead looked to the raw data from the Bajaj study and that the average discount with respect to its sample of private placements is 22.21%. In concluding the 21% marketability discount, before adjustments to incorporate characteristics specific to the Lappo Partnership, the court addressed the Hertz & Smith study, cited in the Bajaj study, as averaged with the sample of private placements (the 22.21%).

(h) The Court also determined that a 3% upward adjustment in the marketability discount rate was appropriate to incorporate characteristics specific to the Lappo Partnership. In that regard, the Court held that a discount for lack of marketability of 24% was appropriate.

B. Peracchio v. Commissioner, T.C. Memo 2003-280.

1. Facts.

(a) On November 25, 1997, Mr. and Mrs. Peracchio created the

Peracchio Family Trust of which Mr. Peracchio was the Settlor and Mrs. Peracchio was the Trustee (the "Family Trust"). On the same day, Mr. Peracchio, the Family Trust and Mr. Peracchio's son executed a limited partnership agreement for Peracchio Investors, LP.

(b) Also on November 25, 1997, Mr. Peracchio contributed cash and securities with a value of \$2,013,765 to the partnership in exchange for a .5% general partnership interest and a 99.4% limited partnership interest. Mr. Peracchio's son contributed \$1,000 to the partnership in exchange for a .05% general partnership interest. The Family Trust contributed \$1,000 to the partnership in exchange for a .05% limited partnership interest.

(c) On the same date of the creation of the Family Trust, signing of the limited partnership agreement and funding of the partnership, Mr. Peracchio gifted .45% of his partnership interests to his son, to be held in the capacity as general partner. In addition, Mr. Peracchio gifted 45.47% of his partnership interests to the Family Trust, as limited partner. He also sold 53.48% of his limited partnership interests to the Family Trust in exchange for a promissory note in the amount of \$646,764. After these transfers, Mr. Peracchio held a .05% general partnership interest and .45% limited partnership interest, his son held a .5% general partnership interest and the Family Trust held a 99% limited partnership interest in the partnership.

(d) Mr. Peracchio filed a Federal gift tax return to report the gifts of the partnership interests to his son and the Family Trust. A combined 40% discount for lack of control and lack of marketability was applied to the value of the partnership interests.

(e) The Internal Revenue Service issued a notice of deficiency with respect to the value of the reported gifts.

2. Opinion.

(a) With respect to the minority interest discount, the Court followed the approach of McCord. Specifically, the minority interest discount factor was determined for each type of investment held by the partnership based on discounts observed in shares of closed end funds holding similar assets. The discounts were determined by calculating the weighted average of the factors, based on the partnership's relative holdings of each asset type. This approach was followed by both the expert for Mr. Peracchio and the expert for the Internal Revenue Service.

(b) The Court also recognized the experts division of the assets of the partnership into five basic categories: cash and money market funds, U.S. Government bond funds, municipal bonds, domestic equities and foreign equities. After review of each of the categories, the Court determined a 6.02% minority interest discount applied.

(c) With respect to the marketability discount, the Court determined that 25% was appropriate for determining the fair market value of the transferred interests. The Court rejects the reliance by Mr. Peracchio's expert on Mandelbaum v. Commissioner, T.C. Memo 1995-255, which "established a benchmark lack of marketability discount range of 35% to 45%," stating that reliance on that range was solely for the purpose of the Mandelbaum case. If such expert believed the range of discounts applied to the facts at hand, he did not present any evidence in support of such view. The Court stated that it would be hard to justify the applicability of Mandelbaum to these facts; the entity in Mandelbaum was an established operating company, which was completely different from the partnership in this case.

(d) The Court also took issue with the argument set forth by the other expert for Mr. Peracchio. Such expert relied on restricted stock studies which centered around a 30% marketability discount for transfers of restricted stock and concluded that a 40% discount was applicable to the value of the limited partnership interests. However, the Court recognized that the expert did not effectively relate the data from those studies to the transferred interests.

(e) The Court also took issue with the argument set forth by the expert for the Internal Revenue Service stating that he did not offer a satisfactory alternative to the inadequate analyses of Mr. Peracchio's experts. Such expert concluded that it was reasonable to assume that a negotiation between buyer and seller would initially focus on a discount for lack of marketability in the range of 5% to 25% and then determined that a 15% discount was appropriate. The Court was not impressed by his arbitrary selection of the midpoint 15% range of discount with no analysis.

(f) The Court determined the overall discount to be approximately 29.5%.

C. Estate of Kelley v. Commissioner, T.C. Memo 2005-235.

1. Facts.

(a) Webster E. Kelley formed a Texas limited partnership and a limited liability company with his daughter and her husband (the "Loudens"). The name of the partnership was Kelley-Louden, Ltd. ("KLLP") and the name of the limited liability company was Kelley-Louden Business Properties, LLC ("KLBP, LLC").

(b) Between June 6 and September 11, 1999, Mr. Kelley contributed cash and CDs in the amount of \$1,101,475 to KLLP. On September 13, 1999, the Loudens contributed \$50,000 cash to KLLP.

(c) At the time of Mr. Kelley's death on December 8, 1999, he owned a 94.83% interest in KLLP and a 33.33% interest in KLBP, LLC. For Federal estate tax purposes, these interests were valued by appraisal; a 53.5% discount was supported.

(d) The Internal Revenue Service issued a notice of deficiency claiming the discounts claimed by Mr. Kelley's estate were too high and that a lower 25.2% discount was appropriate.

2. Opinion.

(a) The Court was not persuaded with the recommendation of a 38% marketability discount by the appraiser employed by Mr. Kelley's estate. Such appraiser relied on restricted stock studies which examined mostly operating companies and the Court recognized fundamental differences between an investment company holding easily valued and liquid assets (such as the cash and CDs held by KLLP) and operating companies. The Court also recognized that the appraiser did not analyze the data from these studies as they related to the transferred interests. Thus, the marketability discount of 38% could not be supported.

(b) Similarly, the court was not persuaded with the 15% marketability discount suggested by the Internal Revenue Service. The Court agreed with the use of the Bajaj study as an appropriate tool in determining the marketability discount, as this appraiser relied upon, but the appraiser's conclusion was not accurate because the study does not solely focus on the marketability discount but is also influenced by additional factors depending on the fraction of total shares offered in the placement, business risk, financial distress of the firm and total proceeds from the placement.

(c) Based upon the foregoing, the Court relied on its own analysis and assumptions focusing on the analyses set forth in McCord and Lappo to conclude that a combined discount of 32.24% was appropriate with respect to the limited partnership interests owned by Mr. Kelley in KLLP. To determine the lack of control discount, the court considered the arithmetic mean of all the closed-end funds. In determining the lack of marketability discount, the Court relied on the private placement approach.

D. Succession of Charles T. McCord, v. Commissioner, 461 F.3d 614 (5th Cir. 2006).

1. Background Facts.

(a) On June 30, 1995, Charles and Mary McCord, their sons and an existing partnership formed by the sons (known as McCord Bros.), established MIL, a Texas limited partnership. Each of Mr. and Mrs. McCord contributed \$10,000 to MIL in exchange for one-half of the Class A limited partnership interests and each contributed identical assets equal in value to \$6,147,192 in exchange for Class B limited partnership interests in MIL. Each son contributed

\$40,000 in exchange for a one-fourth general partnership interest in MIL. McCord Bros. contributed interests in similar business and investment assets valued at \$2,478,000 in exchange for the remaining Class B limited partnership interests in MIL.

(b) MIL's partnership agreement was amended and restated with an effective date of November 1, 1995.

(c) Twenty days later, Mr. and Mrs. McCord, as the owners of all Class A limited partnership interests in MIL, donated their Class A interests to The Southfield School Foundation, a tax exempt organization under Section 501(c)(3) of the Code. After the transfer, Mr. and Mrs. McCord were left with their Class B limited partnership interests in MIL.

(d) On January 12, 1996, Mr. and Mrs. McCord disposed of their remaining Class B limited partnership interests in MIL to non-exempt donees and charitable-deduction gifts to exempt donees.

(e) The issue was the value of the Class B limited partnership interests in MIL transferred by Mr. and Mrs. McCord pursuant to the January 12, 1996 transfers. The gifts were not made by a disposition of percentage interests in MIL, but, rather, in dollar amounts of the net fair market value of MIL pursuant to a sequentially structured "defined value clause."

(f) Because the interests donated by Mr. and Mrs. McCord to the recipients were expressed in dollars, "fair market value" was defined in the agreement evidencing the assignment of the interests in terms of the applicable "willing buyer/willing-seller" test specified in the Treasury Regulations.

(g) The appraisal of the partnership interests as of January 12, 1996, the date of the gifts, was completed on February 28, 1996. Based upon that appraisal, all donees entered into a Confirmation Agreement to translate the dollar value of each gift made pursuant to the assignment agreement's defined value formula into percentages of interests in MIL.

(h) In 1997, Mr. and Mrs. McCord filed federal gift tax returns to report the 1996 gifts of the limited partnership interests, the value of which was determined by the appraisal.

(i) The Internal Revenue Service issued deficiency notices proposing to increase the values of the gifts.

(j) Mr. and Mrs. McCord filed a petition in the Tax Court contesting the deficiency notices. The issues raised by the Internal Revenue Service at trial were (1) the values of Mr. and Mrs. McCords' interests in MIL given under the dollar-value formula clause to the donees and (2) the propriety of discounting the gross fair market value of the gifts to the non-exempt donees on the basis of the actuarially determined negative present value of these donees' assumed liability

for additional estate taxes of Mr. or Mrs. McCord should one of them die within three years following the gifts. At trial, the Internal Revenue Service's arguments were grounded in the equitable doctrines of form-over-substance and violation-of-public policy. However, Judge Foley, of the Tax Court, held that the Internal Revenue Service failed to meet its burden of proof and could not prevail.

(k) The Tax court addressed whether the gifted interests were assignee interests or limited partnership interests and held that they were in fact assignee interests. Relying on the Kerr case, the Tax Court determined that the overall discount applicable to the assignee interest was 32%, not the 41% the taxpayers applied to the gifts. However, the Tax Court recognized the discount would only be 29% if the interest was determined to be a limited partnership interest.

(l) At issue in the Tax Court was also the value of the gifts. The Tax Court was not satisfied with the expert opinions provided by William Frazier of Howard Frazier Barker Elliot, Inc., for the taxpayers, or Dr. Bajaj, for the Internal Revenue Service.

(m) With respect to the minority interest, the Tax Court applied an average discount of the sample funds under consideration (as opposed to the higher or lower than average minority interest discount for the partnership's bond portfolio supported by the experts). Both Mr. Frazier and Dr. Bajaj used closed end mutual funds which generally trade at discounts to determine the minority interest discount, but disagreed with the funds used in their data set and the factors to be used in determining the discount.

(n) The Tax Court recognized that the minority interest discount is a discount applied to the control value. The discount is based upon the interest's lack of certain features inherent in control value, such as control over distributions and/or liquidation, or control over which entity assets to retain or sell. In other words, the basis for the discount looks to the control over entity activities, subject to a fiduciary duty to the partners. The Tax Court believed the determination for the lack of control discount cannot be based solely on asset categories. In fact, the Tax Court recognized that the differentiation in the discounts based solely upon asset categories belonged in the lack of marketability discount, not the minority interest discount.

(o) The Tax Court concluded that since the bond portfolio included 75% Louisiana bonds, the data set should include only single-state bond funds.

(p) Mr. Bajaj also looked to real estate investment trusts (REITs) to determine the discount. Mr. Frazier rejected the use of REITs, arguing that "they are primarily priced on a current yield basis because REITs are required by law to annually pay out a large portion of earnings to shareholders." The Tax Court rejected Mr. Frazier's rebuttal since the investment funds he used in his equity and bond portfolio analyses are also required to distribute all of their income each year to retain their tax status as a Section 852 regulated investment company. Dr.

Bajaj stated that the difference between the NAV and trading price for a REIT is composed of a positive amount for the liquidity premium and a negative amount for the minority discount. Thus, the Tax Court adjusted Mr. Bajaj's figures to arrive at a 22% liquidity premium with a 1.3% discount to NAV for a 23.3% lack of control discount.

(q) With respect to the lack of marketability discount, Mr. Frazier supported the taxpayer's discount using four restricted stock studies, but also suggested that the IPO studies would reach the same result with respect to the claimed 35% discount. Thus, the Tax Court rejected the restricted stock analysis of Mr. Frazier. The Court also rejected the analysis provided by Dr. Bajaj, but utilized the data from his private placement study. It believed that assessment and monitoring costs are high in unregistered private placements and a sample consisting solely of such placements would be skewed. The Tax Court also recognized that this study was the only one that covered the period 1990 to 1995 which immediately preceded the valuation date. The Court looked to the middle group of placements in this study with an average discount of 20.36%.

(r) Based upon the foregoing, the overall discount was determined to be 32%.

(s) Two years after trial, an order was entered by the Acting Chief Judge of the Tax Court resulting in a proceeding resembling an en banc rehearing. The matter was reassigned to Judge James Halpern who filed an opinion on behalf of the Majority, joined by seven other Tax Court judges, including the Acting Chief Judge. This opinion opposed the original Tax Court opinion and held in favor of the Internal Revenue Service. However, the reversal was based upon a rejection of the concept of a postponed determination of the taxable value of a completed gift. Mr. and Mrs. McCord filed a notice of appeal.

2. Opinion.

(a) The main issue was the use of the dollar-formula, or "defined value," clause specified in the assignment agreement to quantify the gifts to the various donees in dollars, rather than percentages.

(b) The Court recognized that the Majority used the after-the-fact Confirmation Agreement to change the assignment agreement's dollar-value gifts into percentage interests in MIL. The Majority should have stopped with the plain wording of the assignment agreement. By using the post-gift Confirmation Agreement to equate the dollars into percentages, the Majority violated the firmly established rule that a gift is valued as of the date that it is complete.

(c) The Court agreed with Judge Foley's disagreement with the Majority for basing its holding on an interpretation of the assignment agreement and an application of the Confirmation Agreement that the Commissioner never raised. The Majority made a contractual interpretation of the assignment

agreement that rested in part that it uses the term “fair market value” without including the modifying language “as finally determined for tax purposes.” The Majority also rejected the dollar formula of the defined valued clause in the assignment agreement.

(d) The Court agreed with Judge Foley that the gift was complete on January 12, 1996 and that the courts and parties were governed by Section 2512(a) of the Code. The Majority asserted without authority that the charitable deduction could not be determined unless the gifted interest was expressed in terms of a percentage or fraction. This Court, in addition to Judge Foley, was convinced that regardless of how the transfer of the gift was described, it has an ascertainable value as of the date of such gift.

E. Astleford v. Commissioner, T.C. Memo 2008-128.

1. Facts.

(a) The Petitioner, Jane Z. Astleford (“Mrs. Astleford”), and her husband, M.G. Astleford (“MG”), jointly owned many real estate interests through trusts and partnerships.

(b) In 1970, MG and Richard Burger formed Pine Bend Development Co. (“Pine Bend”), a Minnesota general partnership, of which each of them was a 50% partner. Pine Bend purchased agricultural property in Rosemount, Minnesota (the “Rosemount Property”) and leased it for farm and commercial use.

(c) On or about February 20, 1992, MG and Mrs. Astleford created revocable trusts and transferred their real estate interests to the trusts.

(d) MG died on April 1, 1995 and all of the real estate interests he owned directly or indirectly through partnerships and his revocable trust were distributed to a marital trust established under his Last Will and Testament for the benefit of Mrs. Astleford.

(e) On August 1, 1996, Mrs. Astleford created the Astleford Family Limited Partnership (“AFLP”), a Minnesota limited partnership. It was intended that AFLP would be a vehicle for Mrs. Astleford to consolidate all of the real estate investments and to facilitate gifting to her children. On the same date, Mrs. Astleford transferred her ownership interest in an elder care assisted living facility to AFLP with a value of \$870,904 and also transferred a 30% limited partnership interest in AFLP to each of her three children, so that she retained a 10% interest in AFLP, as general partner.

(f) The limited partnership agreement of AFLP provided for the following: (1) that net cash flow was required to be distributed annually to the partners, (2) that limited partners could not vote on matters pertaining to AFLP management, (3) additional partners could not be admitted to AFLP without the

consent of Mrs. Astleford as general partner, (4) a limited partner could not sell or transfer his or her partnership interest without the general partner's consent, and (5) real property owned by AFLP could not be partitioned without the general partner's consent.

(g) On December 1, 1997, Mrs. Astleford made an additional capital contribution to AFLP of her 50% interest in Pine Bend and her ownership interests in fourteen other real estate properties. The children, as limited partners, did not make any subsequent capital contributions to AFLP. Thus, as of result of Mrs. Astelford's capital contribution, the percentage of Mrs. Astleford's general partnership interest increased and the percentage of limited partnership interests owned by the children simultaneously decreased. On the same date, Mrs. Astleford gifted additional partnership interests to her children so that her general partnership interest and the children's limited partnership interests were reduced and increased, respectively, so that Mrs. Astleford again owned a 10% general partnership interest and each child owned a 30% limited partnership interest.

(h) Mrs. Astleford's 1996 and 1997 Federal gift tax returns that were filed to report her gift of the partnership interests to her children were audited. The Internal Revenue Service decreased the lack of control and lack of marketability discounts that were applied to the valuation of the limited partnership interests.

2. Opinion.

(a) With respect to the Rosemount Property, the 50% Pine Bend interest and the various other real estate properties were contributed to AFLP. At issue was the following: (1) the value of the Rosemount Property, (2) whether the 50% Pine Bend Interest should be valued as a general partnership interest or an assignee interest, and (3) the applicable discounts for the 50% Pine Bend interest owned by AFLP and the limited partnership interests in AFLP Mrs. Astleford gifted to her children.

(b) With respect to the Rosemount Property, the petitioner's expert determined that such property was extraordinarily large and unique, warranting the application of the market data approach in the valuation, with a downward adjustment for an absorption discount. In the analysis, the petitioner's expert compared the Rosemount Property to eighteen separate farm properties that were previously sold. Because of the size of the Rosemount Property, the petitioner's expert determined that a sale of the property would flood the market with farmland thus causing a reduction in the price per acre if such property was sold and that it would likely sell over a four year period with appreciation at the rate of seven percent each year. Based upon the foregoing, a 25% present value discount was applied.

(c) In comparison, the respondent's expert reviewed the sale of one hundred twenty-five Minnesota properties and personally reviewed twelve of

them. He determined that two of the properties were comparable to the Rosemount Property and made adjustments to them based upon date of sale, but applied no other adjustments and/or discounts. The respondent's expert also believed that since Pine Bend purchased the property in a single transaction, the entire property could likely be sold in a single year without an absorption discount. Alternatively, even if the absorption discount was applied, the IRS expert argued that the 25% discount applied by the petitioner was excessive.

(d) The Tax Court determined that it was likely that the Rosemount Property would not sell in a single year, as suggested by the respondent's expert. The present value discount is a function of the project's riskiness. Thus, because the situation was not land development but a sale of the land over a 4 year period, the 25% present value discount applied by the petitioner was determined to be unreasonably high, as it relied on statistics relating to real estate developers who expected greater returns given greater risks.

(e) The Tax Court reduced the present value discount from 25% to 10%. Over 75% of the Rosemount Property was leased to farmers so a purchaser could expect a flow of income because of the property rent. Given the low level of risk involved, the Tax Court recognized that a rate of return that likely would induce a purchase of the Rosemount Property would be more similar to the return equity farmers were actually earning.

(f) Regarding the Pine Bend interest, the Tax Court determined that such interest should be treated as a general partnership interest, not as an assignee interest. Mrs. Astleford was the general partner of AFLP and was in the same management position with respect to the Pine Bend interest whether she was viewed as having transferred an assignee interest in Pine Bend (i.e., retaining the management right to Pine Bend) or as having transferred those management rights to AFLP by a transfer of a Pine Bend general partnership interest (so that she reacquired the management rights as AFLP's general partner). Regardless, after December 1, 1997, Mrs. Astleford retained the management control with respect to the Pine Bend general partnership interest.

(g) In addition, an AFLP partnership resolution executed on November 2, 1997 recognized Mrs. Astleford's transfer of Pine Bend as a transfer of all of her rights and interests which suggests a transfer of a general partnership interest, not the transfer of an assignee interest.

(h) At issue was also the appropriate lack of control and lack of marketability discounts that should be applied to the 50% Pine Bend general partnership interest transferred by Mrs. Astleford to AFLP and to Mrs. Astleford's gifts of limited partnership interests in AFLP to her children.

(i) In order to determine the applicable discounts, the petitioner's expert relied on comparability data from sales of registered real estate limited partnerships ("RELPs"). The respondent's expert relied on comparability data

from sales of publicly traded real estate investment trusts (“REITs”). The Tax Court determined that the analysis involving RELPs was applicable; comparing the size, marketability, management, distribution requirements and taxation of RELPs and REITs warranted justification that AFLP and Pine Bend were more closely related to RELPs.

(j) The Tax Court concluded that a combined discount of 30% for lack of control and lack of marketability was appropriate for the 50% Pine Bend interest.

(k) With respect to the discounts applied to the gift of the limited partnership interests to the children, the Tax Court determined that the RELP comparables petitioner’s experts used were too dissimilar to AFLP to warrant the reliance placed on them. The lack of control discounts applied to the gifts of the limited partnership interests of 45% for the 1996 gifts and 40% for the 1997 gifts were determined to be excessive. In an effort to avoid further review of the RELP data to locate additional comparables, the Tax Court used the REIT data relied on by the respondent’s expert, with adjustments. Thus, the Tax Court determined the lack of control discount with respect to the 1996 gifts was 16.17% and the lack of control discount with respect to the 1997 gifts was 17.47%.

(l) Regarding the lack of marketability discount applicable to the 1996 gifts, petitioner’s expert estimated a 15% discount and the respondent’s expert estimated a 21.23% discount. The Tax Court saw no reason not to apply the respondent’s higher marketability discount with respect to the 1996 gifts. The Tax Court applied a 22% lack of marketability discount to the 1997 gifts; such discount was advocated by both sides.

(m) In conclusion, based upon the foregoing, the Tax Court determined the overall discount applicable to the 1996 gifts was approximately 34% and the overall discount applicable to the 1997 gifts was approximately 36%.

VII. INDIRECT GIFTS/STEP TRANSACTION.

A. Shepherd v. Commissioner, 115 T.C. 376, 283 F.3d 1258 (11th Cir. 2002).

1. Facts.

(a) On August 1, 1991, J.C. Shepherd executed the Shepherd Family Partnership Agreement (“SFP”), a general partnership under Alabama law. On the same day, Mr. Shepherd and his wife executed two deeds to transfer a 50% interest in two separate properties to SFP. The deeds were recorded on August 30, 1991.

(b) The Shepherd children, John and William, executed the partnership agreement for SFP the next day. Mr. Shepherd was a 50% managing partner and each of John and William were 25% partners.

(c) On September 9, 1991, Mr. Shepherd transferred stock in three banks to SFP.

(d) On Mr. Shepherd's 1991 Federal gift tax return, he reported gifts to John and William of interests in the leased land and the bank stock. The leased land was valued at \$400,000 on the return and the bank stock was valued at \$932,219, applying a 15% minority interest discount, for a discounted value of \$792,386. There was no gift tax due on the return.

(e) The Notice of Deficiency issued by the IRS stated that the fair market value of the 50% interest in the leased land gifted by Mr. Shepherd to each of his sons was \$639,300, which determined a gift tax deficiency in the amount of \$168,577.

2. Opinion.

(a) The parties agreed that SFP was a valid partnership on August 2, 1991, after all parties signed the partnership agreement. However, they disagreed about the effect of Mr. Shepherd's executing the deeds to transfer the land on August 1, 1991 to a "nonexistent" partnership.

(b) The Court agreed with Mr. Shepherd that any gift to his sons was not completed before August 2, 1991. However, the Court did not agree that the gifts to the Shepherd children of the interests in the leased land represented gifts of minority partnership interests because the creation of the entity preceded the completion of Mr. Shepherd's gift to SFP.

(c) Mr. Shepherd did not make direct gifts of the leased land and bank stock to his children. He deeded the land and transferred the bank stock to SFP. Thus, the children acquired their interests in these assets by virtue of their status as partners in the partnership.

(d) The Court held that Mr. Shepherd's transfers to SFP represented indirect gifts to each of his sons of undivided 25% interests in the leased land and the bank stock. In this case, Mr. Shepherd's contributions to SFP were allocated to his and his sons' capital accounts according to their respective shares in SFP. SFP's partnership agreement provided that each son was entitled to receive distributions of any part of his capital account with prior consent of the partners and was entitled to sell his partnership interest after granting a right of first refusal to the other partners to purchase the interest at fair market value. Upon the dissolution of the partnership, each son was entitled to receive payment of the balance of his capital account.

(e) The Court aggregated Mr. Shepherd's two same day transfers to SFP of undivided 50% interests in the leased land to reflect the economic substance of his conveyance of his entire interest. The Court did not aggregate the separate, indirect gifts to the sons.

(f) With respect to valuation, the Court determined that a 15% discount for an undivided fractional interest in the leased land was fair and reasonable and a 15% minority interest discount for the gifts to the Shepherd sons of undivided interests in the bank stock was reasonable.

B. Senda v. Commissioner, T.C. Memo 2004-160, aff'd 433 F.3d 1044 (8th Cir. 2006).

1. Facts.

(a) After attending a tax seminar that discussed the benefits of a family limited partnership, Mark and Michele Senda formed, but did not fund, a family limited partnership on December 30, 1996 under Illinois law.

(b) In 1998, Mr. Senda met with his attorney to further discuss the advantages of a family limited partnership as a vehicle to hold investments and as a means to make gifts to family members.

(c) On or about April 1, 1998, the Sendas executed the partnership agreement for the Mark W. Senda Family Limited Partnership ("SFLP I"). The Certificate of Limited Partnership was filed for SFLP I with the state of Missouri on June 3, 1998. Pursuant to the partnership agreement for SFLP I, Mark Senda's revocable trust was a 10% general partner of SFLP I and an 89.8397% limited partner, Michele Senda was a .1303% limited partner and each of three trusts for the Senda children, of which Mr. Senda was the Trustee, were .010% limited partners of SFLP I.

(d) Although trusts for the Senda children were designated as limited partners of SFLP I, such trusts were not established at that time. The children reported income/losses from SFLP I on their individual tax returns.

(e) On December 28, 1998, the Sendas contributed 28,500 shares of MCI WorldCom stock from their joint account to SFLP I. The children purportedly contributed oral accounts receivable to SFLP I. However, the accounts receivable were not reduced to writing, had no terms of repayment nor were they paid.

(f) Also on December 28, 1998, Mr. Senda gifted a 29.94657% limited partnership interest in SFLP I to each of the Senda children (or to the so called trusts for their benefit). Ms. Senda gave each child (or trust for a child) a .0434% limited partnership interest in SFLP I. No documentation regarding ownership evidenced these transfers until several years thereafter.

(g) SFLP I formalities were not met, as addressed in the partnership agreement. Specifically, there were no meetings of the partners as required under the partnership agreement, nor were there annual financial statements prepared.

(h) In 1999, Mr. Senda formed a second family limited partnership, Senda & Associates, L.P (“SFLP II”). The Certificate of Limited Partnership was filed in Missouri on December 2, 1999.

(i) On December 4, 1999, the Trustee signed the irrevocable trusts for the children in his capacity as Trustee, but the Sendas, as the Grantors of the trusts, did not execute the trusts until the beginning of May, 2000. Although Citicorp Trust South Dakota was also listed as Trustee of the trusts, a representative of the company did not sign the trusts.

(j) On December 17, 1999, the Sendas signed the partnership agreement for SFLP II. Mark’s revocable trust was the 1% general partner and 97.97% limited partner of SFLP II, Michele Senda was a 1% limited partner and each of the trusts for the Senda children were .01% limited partners.

(k) Similar to the funding of SFLP I, on December 20, 1999, the Sendas contributed 18,477 shares of MCI WorldCom stock from their joint account to SFLP II. The trusts for the children purportedly contributed oral accounts receivable to SFLP II. However, the accounts receivable were not reduced to writing, had no terms of repayment nor were they paid.

(l) Also on December 20, 1999, Mr. Senda gifted a 17.9% limited partnership interest in SFLP II to each child’s trust. The certificates of ownership for these transfers were not signed until a few weeks later.

(m) On January 31, 2000, Mr. Senda gifted an additional 4.5% limited partnership interest in SFLP II to each child’s trust.

(n) Although the partnership agreement for SFLP II provided that the general partner shall keep the financial statements for the partnership for the most recent three year period, no statements were prepared. Mr. Senda did maintain brokerage account statements and partnership tax returns.

(o) All legal fees and entity filing costs for both SFLP I and SFLP II were paid by Mr. Senda; such costs were not reimbursed to him by the entities.

(p) On the gift tax returns filed by the Sendas for 1998, 1999 and 2000, they reported split gifts of limited partnership interests to the children valued at \$462,379, \$183,792 and \$14,307.71, respectively. Lack of marketability and minority interest discounts were applied to determine the value. The Notice of Deficiency issued by the IRS recalculated the value of the limited partnership interests transferred to \$1,798,647, \$791,826 and \$164,103, for the years 1998, 1999 and 2000, respectively, denying any marketability and minority interest discounts that were initially applied.

2. Opinion.

(a) The Court determined that the Sendas transfer of stock was similar to the transfer in Shepherd (discussed in Paragraph A of this Section). In both cases, the value of the children's partnership interests was enhanced by the contributions to the partnership by the parents.

(b) The testimony indicated that the Sendas were more concerned with ensuring that the beneficial ownership of the stock was transferred to their children in a tax-advantaged form than they were with respecting the formalities of the entities. The Court recognized that no books or records had been maintained and that tax returns, although prepared, were prepared months after the transfer of partnership interests. Thus, the records did not affirmatively indicate whether the Sendas transferred the limited partnership interests to the children before or after they contributed the stock to the entities. Similarly, the same difficulty arose with respect to the transfer documentation, as the certificates of ownership reflecting the transfers of the partnership interests were not prepared until weeks after such transfers were effectuated.

(c) No reliable evidence was presented to support a determination that the stock was contributed to the partnerships before the limited partnership interests were transferred to the children. At best, the transactions were integrated and, in effect, simultaneous.

(d) The Court held that the value of the limited partnership interests transferred to the children was enhanced upon the contributions of the stock to the partnerships by the Sendas. Thus, the transfers of the stock were indirect gifts to the children. The gift tax should be determined on the value of the stock, rather than on the value of the limited partnership interests transferred.

C. Holman v. Commissioner, 130 T.C. No. 12 (2008).

1. Facts.

(a) Thomas H. Holman, Jr. ("Tom") was employed by Dell Computer Corp and received substantial stock options, some of which he exercised. Tom and his wife, Kim Holman ("Kim"), purchased additional shares of Dell stock.

(b) Beginning in 1996, Tom and Kim made annual exclusion gifts of Dell stock to three custodianship accounts under the Texas Uniform Transfer to Minors Act, one for each of their three children. Tom was the initial custodian on the account, but he later resigned and was replaced by his mother. In 1999, their fourth child was born and a custodianship account was established for her under the Minnesota Uniform Transfers to Minors Act. Tom's mother was the custodian on the account.

(c) At the end of 1997, Tom, Kim and their children moved to Minnesota and they met with a business and estate planning attorney to discuss

their estate planning; such discussions spanned over a two year period. Their estate planning goals focused on the transfer of wealth to their children so that the children would learn to be responsible with respect to the wealth they received.

(d) Tom and Kim discussed the formation of a family limited partnership with their attorney. The discussions focused on the formation of the partnership, the contribution of property to the partnership, the possibility of making gifts of limited partnership interests to or for the benefit of the Holman children and the potential valuation discounts that could apply upon the gift of limited partnership interests, as opposed to a direct gift of the underlying assets.

(e) Tom's reasons for forming the family limited partnership were: (1) long term growth of assets; (2) asset preservation; (3) asset protection; and (4) education.

(f) In November, 1999, Tom and Kim executed an irrevocable trust (the "Irrevocable Trust") of which the Holman children were the beneficiaries. Tom and Kim were the grantors of the trust, and Tom's mother was the Trustee. The Irrevocable Trust had an effective date of September 10, 1999. Before the Irrevocable Trust was effective, Tom opened an account at Morgan Stanley Dean Witter and transferred 100 shares of Dell stock and \$10,000 to such account.

(g) The estate planning attorney drafted the partnership agreement for the Holman Limited Partnership, a Minnesota limited partnership. Tom and Kim were the general and limited partners of the partnership and Tom's mother, as the custodian of each of the custodianship accounts for the Holman children and as the Trustee of the Irrevocable Trust, was the limited partner. Tom reviewed the limited partnership agreement and proposed changes with his attorney with respect to the draft agreement prepared to ensure that his partnership goals, discussed above, were reflected in the final agreement. The final partnership agreement was executed on November 2, 1999.

(h) The funding of the partnership also occurred on November 2, 1999. Tom's mother, as the Trustee of the Irrevocable Trust, transferred 100 shares of Dell stock from the Irrevocable Trust to the partnership account. Tom transferred 70,000 shares of Dell stock owned one-half by him and one-half by Kim to the partnership account. Based upon these contributions, the following initial partnership interests were received: Tom .89% general partner and 49.04% limited partner, Kim .89% general partner and 49.04% limited partner, Irrevocable Trust .14% limited partner.

(i) The certificate of limited partnership for the partnership was filed on November 3, 1999.

(j) On November 8, 1999 (six days after the partnership was funded), Tom and Kim each gifted limited partnership interests in the partnership to one of the children's custodianship accounts and the Irrevocable Trust (and the capital

accounts and percentage interests for the partners were adjusted accordingly). They filed gift tax returns to report the gifts of the limited partnership interests. The limited partnership interests reflected on the return were appraised by an independent appraiser and a 49.25% discount was applied to the partnership's net asset value in reaching the valuation of the limited partnership interests.

(k) A second stage of partnership funding occurred on December 13, 1999. 10,030 shares of Dell stock were transferred to the partnership from three of the custodianship accounts for the children and 30 shares of Dell stock were transferred to the partnership from the last custodianship account. The capital accounts and percentage interests for the partners in the partnership were adjusted accordingly.

(l) On January 4, 2000, Tom and Kim gifted additional limited partnership interests to the custodianship accounts for the children (and the capital accounts and percentage interests for the partners were adjusted accordingly). They filed gift tax returns to report the gifts of the limited partnership interests. The limited partnership interests reflected on the return were again appraised by an independent appraiser and a 49.25% discount was applied to the partnership's net asset value in reaching the valuation of the limited partnership interests.

(m) A third stage of partnership funding occurred on January 5, 2001. Tom and Kim transferred 10,880 shares of Dell stock to the partnership. The capital accounts and percentage interests for the partners in the partnership were adjusted accordingly.

(n) On February 2, 2001, Tom and Kim gifted additional limited partnership interests to the custodianship accounts for the children (again there were adjustments to the partners capital accounts and percentage interests). They filed gift tax returns to report the gifts of the limited partnership interests. The limited partnership interests transferred by each of Tom and Kim were valued at \$40,000, based upon the number of limited partnership interests transferred using values based upon previously prepared independent appraisals.

(o) With respect to the operations of the partnership, at no time did the partnership have a business plan. There were no employees and no telephone listings in any directory. The sole partnership asset at all times was the shares of Dell stock; Tom had no immediate plan for the partnership other than it being a vehicle for holding such stock. No annual statements were prepared for the partnership and no income tax returns were filed (because there was no income to report). The gifts of the limited partnership interests that were effectuated in 1999, 2000 and 2001 were contemplated by Tom when the partnership was formed.

2. Opinion.

(a) The Tax Court addressed the argument of whether the 1999 gift of limited partnership interests should be viewed as an indirect gift of the shares to the donees under the step transaction doctrine. In short, the Court disregarded this argument holding that it would not treat the formation and funding of the partnership and subsequent gifts of limited partnership interests as occurring simultaneously under the step transaction doctrine.

(b) The Tax Court addressed Section 2703 of the Code. The general rule under Section 2703(a) is that, for purposes of the gift tax, the value of any property transferred by gift is determined without regard to any right or restriction relating to the property. Section 2703(b) provides that Section 2703(a) does not apply to disregard a restriction if the restriction meets each of the following three requirements: (1) it is a bona fide business arrangement; (2) it is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth; and (3) its terms are comparable to similar arrangements entered into by persons in an arm's length transaction.

(c) With respect to the first requirement, no definition of the phrase "bona fide business arrangement" is provided under Section 2703, but it has been determined that the subject of the restrictive agreement does not need to involve an actively managed business. Under these facts, there is no closely held business. From the time the partnership was formed through the time of the gift of the limited partnership interests, the partnership carried on little activity other than holding the Dell stock. The Court recognized the sections of the partnership agreement pertaining to the requirements and manner of the transfer of limited partnership interests, viewed in light of Tom and Kim's testimony at trial as to their reasons to form the partnership, to conclude that the restrictions set forth in the partnership agreement pertaining to transferability do not serve a bona fide business purpose. The Tax Court also addressed the section of the partnership agreement which set forth Tom and Kim's stated purpose for the formation as a means for the family to gain knowledge of, manage and preserve family assets. Tom discussed his understanding of the meaning of this purpose at trial and the Court determined that their reason for making asset preservation a purpose of the partnership was to protect family assets from dissipation by the children. The Court found that the sections of the partnership pertaining to transferability were drafted in accordance with these goals and did not constitute a bona fide business purpose.

(d) With respect to the second requirement, the restriction cannot be a device to transfer property to family members for less than full and adequate consideration in money or money's worth. The question posed by the Tax Court was whether the transferability restrictions under the partnership agreement, which restrict the Holman children's rights to enjoy the limited partnership interests, constituted such a device.

(e) The Tax Court determined that the provisions in the limited partnership agreement restricting transferability was a device to transfer the limited partnership interests to the Holman children for less than full and adequate consideration. The provisions served the purpose of discouraging the children from disposing of the wealth that their parents transferred to them via gift because if the child attempted to make a transfer that was not permitted under the partnership agreement provisions, the general partners (Tom and Kim) could redistribute an amount that is equal to the difference in the fair market value of the limited partnership interests and the interests proportionate share of the partnership's NAV to the other partners so as to increase the other partners partnership interests. The Court recognized Tom's goal of asset preservation when forming the partnership and that he understood the redistributive nature of the partnership interests as a result of a child's attempt at an impermissible transfer contained in the partnership agreement.

(f) With respect to the third requirement, the restriction must be comparable to similar arrangements entered into by persons in an arm's length transaction. Expert witnesses were called by the parties on both sides at trial to address this issue. The Court did not make a determination with respect to this issue because the restriction did not satisfy the bona fide business arrangement requirement and because the restriction was a device to transfer property to family members for less than full consideration. Thus, the general rule of Section 2703(a) applied to disregard the restrictions under the partnership agreement for valuation purposes.

(g) Based upon the foregoing, the valuation of the gifts was then addressed in detail, based upon the appraisers' expert opinions and analyses, and appropriate discounts were considered. The Tax Court conclusions were significantly closer to the IRS's position, allowing overall discounts of 22.4%, 25% and 16.25% in 1999, 2000 and 2001, respectively.

D. Gross v. Commissioner, T.C. Memo 2008-221.

1. Facts.

(a) After the death of her husband, Bianca Gross recognized the importance of involving her daughters in the management of her investment portfolio.

(b) Mrs. Gross believed a family limited partnership would encourage her daughters to work together to learn about family assets while allowing Mrs. Gross to maintain control over the partnership assets (because she was the general partner).

(c) On July 15, 1998, after numerous discussions between Mrs. Gross and her daughters, the terms of the partnership agreement for Dimar Holdings LP ("Dimar") was agreed upon. The certificate of limited partnership was also filed

in New York on such date. It was agreed that each of the daughters would contribute \$10 cash to Dimar and that Mrs. Gross would contribute \$100 cash and her marketable securities to Dimar. Mrs. Gross was the general partner of Dimar and owned the majority of the limited partnership interests.

(d) With respect to the funding of Dimar, on July 31, 1998, the daughters contributed their \$10 in cash to Dimar. Mrs. Gross contributed cash in the amount of \$100 to Dimar on November 16, 1998. Between October, 1998 and December 4, 1998, Mrs. Gross transferred marketable securities with an approximate value of \$2.1 million to Dimar.

(e) On or about December 15, 1998, Mrs. Gross transferred a 22.25% limited partnership interest in Dimar to each of her daughters. The partnership agreement for Dimar was also executed on such date.

(f) Mrs. Gross filed a 1998 Federal gift tax return to report the gift of the 22.25% limited partnership interests in Dimar to her daughters; each of such gifts was valued at \$312,500 after a 35% discount was applied to account for lack of marketability, lack of control and minority interest.

(g) A notice of deficiency was issued by the IRS increasing the value of the gifts of the limited partnership interests reported on Mrs. Gross' 1998 Federal gift tax return, arguing that Mrs. Gross made indirect gifts to each of her daughters of marketable securities rather than a gift of limited partnership interests.

2. Opinion.

(a) The Court examined New York's partnership law. In New York, in order to form a limited partnership, the general partners must execute a certificate of limited partnership and such certificate must be filed with the department of state. The limited partnership is deemed formed at the time of the filing of the certificate of limited partnership or any time within sixty days from the date of filing specified in the certificate. New York also has a publication requirement that must be satisfied within 120 days after the filing of the certificate of limited partnership. If the requirements necessary to form a limited partnership are not satisfied, the parties seeking to form the partnership may be deemed to have formed a general partnership if their conduct indicates that they have agreed on the essential terms and conditions of the partnership arrangement.

(b) Looking at the testimony surrounding the discussions between Mrs. Gross and her daughters regarding the partnership arrangement, the sequence of Dimar's funding and the recordkeeping that was done, the Court agreed with Mrs. Gross that there was sufficient evidence to conclude she and her daughters agreed to form a partnership.

(c) Relying on Holman, the Court determined that Mrs. Gross did not make indirect gifts to her daughters under the step transaction doctrine. In

Holman, the taxpayers made a series of gifts of limited partnership interests six days after forming and funding the partnership. The Holman Court held in favor of the taxpayer concluding that the taxpayers bore a real economic risk of a change in value of the partnership for the six days that separated their transfer of the shares to the partnership and the gift. Thus, the formation and funding of the partnership and the transfer of the partnership interests just a few days later were not deemed to occur simultaneously. The Court applied the Holman analysis to the facts of this case where eleven days passed between Mrs. Gross' transfer of the marketable securities to Dimar and her gift of limited partnership interests. Mrs. Gross also bore a real economic risk of a change in the value of the partnership for the eleven days between funding and partnership interest transfer due to the fact that the marketable securities transferred were heavily traded, relatively volatile common stocks.

E. Heckerman et ux v. U.S., No. 2:08-cv-00211.

1. Facts.

(a) In 2001, David Heckerman sought the advice of his financial advisors with respect to passing assets to his children in a manner that would teach them the value of a dollar.

(b) The overall plan that was discussed was to establish and fund a limited liability company whereby membership interests in the LLC could be transferred to trusts for the benefit of the Heckerman children at a discounted value.

(c) On November 28, 2001, Mr. and Mrs. Heckerman established trusts for their children, of which their siblings were the Trustees. On the same day, they established three LLCs: Heckerman Investments LLC, Heckerman Real Estate LLC and Heckerman Family LLC (Heckerman Family LLC was an umbrella LLC that solely owned Heckerman Investments LLC and Heckerman Real Estate LLC). The Certificates of Formation were issued by the State of Washington with respect to the LLCs on December 21, 2001.

(d) On December 28, 2001, the Heckermans transferred ownership of their \$2.05 million California beach house to Heckerman Family LLC and from such LLC to Heckerman Real Estate LLC.

(e) On January 11, 2002, the Heckermans transferred \$2.85 million in mutual funds to Heckerman Investments LLC.

(f) Also on January 11, 2002, the Heckermans transferred 1,217.65 membership interests in Heckerman Family LLC to each of the children's trusts. While all documentation evidencing the transfer, including the appraisal of the membership interests conducted by Private Valuations, Inc., recognized an effective date of January 11, 2002, the Heckermans, at trial, contended that their

gifts of the LLC interests were subsequent to the January 11, 2002 funding of Heckerman Investments LLC.

(g) On October 9, 2003, the Heckermans filed gift tax returns which reported the gifts of the LLC interests. The returns indicated a 58% discount for lack of marketability and that no gift tax was owed.

(h) In 2005, the gift tax returns were audited and the IRS determined that the property value of each gift was \$1,001,512 and not \$511,000, as reflected on the 2003 filed returns. The IRS stated that the transfer of \$2.85 million to Heckerman Investments LLC on January 11, 2002 was an indirect gift to the children's trusts and part of an integrated transaction intended to pass cash to the Heckerman children.

2. Opinion.

(a) The Court recognized that it was undisputed that the Heckermans transferred the cash to Heckerman Investments LLC on January 11, 2002. At issue was whether the Heckermans could demonstrate that they gifted the membership interests in Heckerman Family LLC to the children's trusts subsequent to that date. The Court recognized that all transfer documentation, the business valuation and the gift tax returns evidenced the transfer date as January 11, 2002 and there was nothing in the record to show that the Heckermans objected at any time to the use of such date.

(b) The Court also recognized that the "step transaction" doctrine applied and that the initial transfer of the \$2.85 million to Heckerman Investments LLC and the gifting of the membership interests in Heckerman Family LLC to the trusts was an integrated transaction in which the Heckermans indirectly gifted the cash to the children's trusts. The Court cited Judge Zilly's discussion in Linton (see discussion of Linton at Paragraph D. of Section VII of this outline) which recognized that "no specific standard has been universally applied in assessing whether a number of separate steps or activities should be viewed as comprising one transaction; however, courts have generally used one of three alternative tests: (i) the 'binding commitment' test; (2) the 'end result' test; and (iii) the 'interdependence' test. It was determined that both the end result test and the interdependence test were met.

(c) The end result test addressed whether there were a series of formally separate steps that were prearranged at the outset to reach a final result. Under these facts, the Court recognized that the Heckermans clearly had a subjective intent to convey property to their children while minimizing their tax liability (Mr. Heckerman testified that he and his wife wanted to fund the LLCs in such a way to avoid gift tax).

(d) The interdependence test focused on the relationship between the steps and whether any one step would have been taken except in contemplation of

the other acts. The Court recognized that such test was met because they would not have transferred the cash into Heckerman Investments LLC if the potential discount was not available on the transfer of membership interests as applicable to the gift tax liability.

(e) The Court determined that the Heckermans reliance on Holman and Gross was unfounded. In those cases, the Court did not apply the step transaction doctrine. However, in those cases, days had passed between the transfer of the assets and the gifting of the entity interests and the courts found that during that time, the taxpayers bore a real economic risk that the value of the partnership interests could change. This case was distinguishable because the Heckermans (1) did not make affirmative decisions to delay the gifts for some period of time after funding and (2) have not established that they bore any real economic risk that the LLC interests would change in value between any alleged time between the funding and the gift.

F. Linton v. U.S., U.S. Dist. Ct. W.D. Washington, Cause No. C08-227Z (July 1, 2009).

1. Facts.

(a) In November, 2002, William Linton formed WLFB Investments, LLC (“WLFB LLC”) and he was its sole initial member.

(b) On January 22, 2003, Mr. Linton gave his wife 50% of his percentage interests in WLFB LLC. On the same day, Mr. Linton contributed undeveloped real property and securities, municipal bonds and cash to WLFB LLC.

(c) Also on January 22, 2003, the Lintons executed four trusts for the benefit of their children and documentation evidencing gifts of 11.5% membership interests in WLFB LLC to the trusts. These documents were not dated at the time of execution.

(d) The attorney who prepared the documents filled in the missing dates when he prepared the minute book for WLFB LLC a few months later. Although he dated the documents January 22, 2003, he believed he made a mistake as the intended creation of the trusts and the transfers of membership interests in WLFB LLC was to be January 31, 2003.

(e) The representation by the attorney with respect to the intended dates for the trusts and transfer documentation was consistent with the testimony of another advisor to the Lintons. The advisor testified that the intended order the transaction was to form WLFB LLC, transfer the assets to it and then determine the amount of any gifts of membership interests the Lintons wanted to make for the benefit of their children.

(f) Pursuant to the terms of the operating agreement of WLFB LLC, there were restrictions on the transfer of percentage interests to non-family members and limitations on the involvement of members in the day to day operations of WLFB LLC; the Lintons, as the Managers, had the sole power to act on behalf of the entity.

(g) In computing their 2003 gift taxes, the Lintons applied a 47% discount for lack of control and marketability. On their gift tax returns, Mr. Linton reported his gift of membership interests with a value of \$725,548 and Mrs. Linton reported her gift of membership interests with a value of \$724,000. The IRS audited the returns and increased the values for gift tax purposes to \$1,587,988 and \$1,520,440, respectively.

(h) The Lintons paid the additional gift taxes assessed, plus interest, and initiated an action to seek a refund of such additional amounts paid.

2. Opinion.

(a) The Court recognized that the documents to fund WLFB LLC, create the trusts and transfer the membership interests were signed (and dated) on the same day so the sequence of events asserted by the Lintons and the supporting documentation they presented could not be supported.

(b) The Lintons sought to reform the trusts and the documentation transferring the membership interests in WLFB LLC to reflect the date January 31, 2003. The Court determined that they did not present any evidence to justify the reformation. The evidence presented only proved that the Lintons did not date the trusts or gifting documentation and that the provided dates were inserted by the attorney. The evidence established only a scrivener's error with respect to the date but not with the written terms of the documents.

(c) The Court also determined that the step transaction doctrine applied so that the gifts of the membership interests in WLFB LLC were indirect gifts to the trusts for the Linton children. In making this determination, courts have addressed three separate tests (such as also addressed in Heckerman): (1) the binding commitment test, (2) the end result test and (3) the interdependence test. Under the binding commitment test, a series of transactions is collapsed if at the time the first step of the transaction is taken there is a binding commitment to enter a later step. Under the end result test, the question is whether the series of formally separate steps are pre-arranged parts of a single transaction intended from the beginning to reach the end result. Lastly, under the interdependence test, the relationship between the steps is analyzed to determine whether any one step would have been taken except in contemplation of the other steps.

(d) Based upon each of the above referenced tests, there was no question that the step transaction doctrine applied. The binding commitment test was met because the Lintons executed trusts and documentation to effectuate the

gifts of the membership interests at the same time they took the steps to fund WLFB LLC. The end results test was met because the Lintons had a subjective intent to convey as much property to their children with minimal gift tax implications and sought the assistance of their attorney and advisor, in that regard. The interdependence test is met because the evidence demonstrated that the Lintons would not have contemplated one or more of the steps absent their contemplation of the other acts. Without the potential to gift the membership interests in WLFB LLC with a significant discount, the Lintons would not have funded the entity.

G. Pierre v. Commissioner, 133 T.C. No. 2 (2009).

1. Facts.

(a) On July 13, 2000, Suzanne Pierre formed Pierre Family, LLC (“Pierre LLC”) in New York and was its sole member.

(b) On July 24, 2000, Ms. Pierre created the Jacques Despretz 2000 Trust and the Kati Despretz 2000 Trust for the benefit of her son and granddaughter, respectively.

(c) On September 15, 2000, Ms. Pierre transferred \$4.25 million in cash and marketable securities to Pierre LLC.

(d) On September 27, 2000, twelve days after the funding of Pierre LLC, Ms. Pierre transferred her entire interest in the entity to the trusts in a part gift/part sale transaction. The value of the membership interests was determined by independent appraisal; a 30% discount was applied. However, Ms. Pierre recognized that because of an error in valuing the underlying entity assets, a discount of 36.55% was used in valuing the membership interests for gift tax purposes.

(e) Ms. Pierre filed a 2000 gift tax return to report the gift of a 9.5% membership interest in Pierre LLC to each trust. The value of each gift was \$256,168. On audit, the IRS determined that Ms. Pierre’s gift transfers of the 9.5% membership interest in Pierre LLC to the trusts were gifts of proportionate shares of Pierre LLC assets valued at \$403,750, not as transfers of membership interests in Pierre LLC.

2. Opinion.

(a) The concern is whether a transfer of a membership interest in an entity that is treated as a disregarded entity for income tax purposes is valued as a transfer of a proportionate share of the underlying assets owned by the entity, or rather a transfer of the membership interests in the entity, subject to valuation discounts for lack of control and marketability.

(b) The Court referred to the “historical gift tax regime” and based upon such regime, Ms. Pierre’s gift tax liability was determined by the value of the transferred membership interests in Pierre LLC, not by a hypothetical transfer of the underlying entity assets. The “check-the-box” regulations does not alter the historical gift tax regime warranting disregarding a single member LLC, validly formed under state law, in deciding how to value a donor’s transfer of a membership interest in the LLC under the Federal gift tax regime.

(c) In addition, the Court notes that Congress has not acted to eliminate entity related discounts for LLCs or other entities generally, or for single member LLCs specifically.

(d) The Court determined that the transfer of the membership interests by Ms. Pierre to the trusts should be treated as transfers of membership interests in the entity, and not as transfers of a proportionate share of the underlying assets.

VIII. THE FUTURE OF VALUATION DISCOUNTS.

A. As of the date these materials are being written, the Federal estate tax is scheduled to disappear on January 1, 2010 and reappear on January 1, 2011, the House of Representatives and the Senate have introduced numerous bills addressing Federal estate tax reform. In addition, the Treasury has recently released General Explanations of the Administration’s Fiscal Year 2010 Revenue Proposals (the “Greenbook”) which reflect revenue proposals from the Obama administration. There is focus within the proposed legislation regarding the elimination of the use of discounts in a closely-held company in circumstances where the assets owned by the company are not used in an active trade or business or where there is an active business, but family-controlled.

B. Restrictions on the liquidation of any entity often times serve as a basis for the applicability of a marketability discount of an entity interest. However, when the entity is family-controlled, it is questionable whether the restrictions are included in the entity’s agreement solely for the purposes of achieving a tax benefit without a proper reflection of economic value in the hands of the transferee.

C. Section 2704(b) of the Code addresses this concern. It provides that certain “applicable restrictions” which limit the ability of the entity to liquidate are disregarded for valuation purposes if the transfer is of an interest in an entity to or for the benefit of a member of the transferor’s family.

D. Judicial decisions and the modification of state statutes have made Section 2704(b) of the Code inapplicable in many situations. Basically the decisions and statutes have recharacterized restrictions so that they no longer fall within the definition of an “applicable restriction.”

E. As referenced in the Greenbook, Section 2704(b) of the Code would be modified to create a category of “disregarded restrictions” that would be ignored when valuing an interest in a family-controlled entity transferred to a family member, if, after the transfer, the restriction would lapse or may be removed by the transferor and/or the transferors family. In determining

value, the disregarded restrictions would be substituted with certain assumptions specified in the regulations (such assumptions are not addressed in the proposal). Regulatory authority would also be granted, including the ability to create safe harbors to permit the governing documents of a family-controlled entity to avoid Section 2704(b) if certain standards are met.

F. Examples of disregarded restrictions would include the following:

1. Limitations on a holder's right to liquidate such holder's interest in the family-controlled entity that are more restrictive than a standard to be specified in the regulations.

2. Limitations on a transferee's ability to be admitted as a full partner or holder of an equity interest in the entity.

G. The intent of the proposal is to restrict the use of family limited partnerships and limited liability companies to create valuation discounts (specifically, lack of marketability discounts). A more stringent Section 2704(b) to establish the class of disregarded restrictions that would be ignored for valuation purposes would subject taxpayers to a greater limit on such discounts arising from liquidation restrictions when transferring interests in family-controlled entities.

H. Because this proposal targets only marketability discounts arising from liquidation restrictions, it has been argued that a broader approach would be preferable. As an example, if an entity whose interests are nonmarketable holds marketable assets, a marketability discount for an entity interest in this type of entity may result in the undervaluing of the interest if the owner has a controlling interest and can access the assets. Some alternative proposals have sought to curb this by imposing "look through" rules under which a marketability discount generally is denied to the extent an entity holds marketable assets.

I. The proposal's focus is on marketability discounts, so it does not address minority discounts that do not accurately reflect the economics of a transfer. Some other proposals have sought to address certain excessive minority discounts more directly through the aggregation of interests when determining whether the transferred interest should receive such a discount. The aggregation analysis was addressed in 2005 by a proposal by the staff of the Joint Committee on Taxation. Under the basic aggregation rule of the staff proposal, the value for transfer tax purposes of an asset transferred by a donor generally is a pro-rata share of the fair market value of the entire interest in the asset owned by the transferor immediately before the transfer. This rule is similar to the 1984 proposal made by the Treasury Department as part of a report on tax reform Department of the Treasury, *Tax Reform for Fairness, Simplicity, and Economic Growth, vol. 2, General Explanation of the Treasury Department Proposals* (November 1984). The 1984 proposal, however, based the value of the transferred property on the transferor's highest level of ownership after considering prior gifts (i.e., a "tracing" of ownership), which could prove difficult from an administrative perspective. Under a separate aggregation rule included in the proposal, if an individual did not own a controlling interest in an asset before the transfer, but in the hands of the transferee, the transferred asset is part of a controlling interest, the transfer tax value of the interest is a pro-rata share of the fair market value of the entire interest in the asset owned by the transferee after accounting for the gift or bequest.

J. Other proposals have addressed minority interest discounts through rules that attribute ownership among family members. For example, under the Certain Estate Tax Relief Act of 2009, a minority interest discount would be denied in connection with the transfer of an interest where the transferee and members of his or her family together have control over the entity. Although the Administration's budget proposal considers family relationships in determining whether a liquidation restriction is removed for purposes of Section 2704(b), a family attribution rule is not addressed in the minority interest context.

IX. IRS APPEALS SETTLEMENT GUIDELINES FOR FLPs.

A. The IRS has issued appeals settlement guidelines ("ASG" document) for FLPs and family limited liability companies. These guidelines are effective as of October 20, 2006.

B. The ASG document focuses on four issues:

1. Whether the fair market value of transfers of FLP or corporation interests, by death or gift, is properly discounted from the pro rata value of the underlying assets.

2. Whether the fair market value at date of death of Code Sections 2036 or 2038 transfers should be included in the gross estate.

3. Whether there is an indirect gift of the underlying assets, rather than the family limited partnership interests, where the transfers of assets to the family limited partnership (the funding) occurred either before, at the same time, or after the gifts of the limited partnership interests.

4. Whether an accuracy-related penalty under Code Section 6662 is applicable to any portion of the deficiency.

C. Discussion of first issue: Whether the fair market value of transfers of FLP or corporation interests, by death or gift, is properly discounted from the pro rata value of the underlying assets.

1. The taxpayer position is that the fair market value of the transfers of the interests is substantially less than the underlying pro rata value of the assets owned by the FLP because of the illiquid nature of such assets.

2. The IRS position is that under certain circumstances, there should be minimal or no discounts from the pro rata value of the assets owned by the FLP.

3. The ASG document recognizes that the Tax Court has become increasingly sophisticated in its analysis and valuation of passive asset FLP interests based upon its decisions in McCord, Lappo and Peracchio. Each case involving a discount of the FLP interests is fact specific and should be individually assessed to determine the appropriate discounts. Appeals Officers are advised that they should carefully review the taxpayer's appraisal for comparability. Additional factors discussed were not disclosed in the ASG document.

D. Discussion of second issue: Whether the fair market value at date of death of Code Sections 2036 or 2038 transfers should be included in the gross estate.

1. The taxpayer position is that the transfer of property to an FLP is a bona fide sale for full and adequate consideration and Code Sections 2036 and 2038 should not apply.

2. The IRS position is that the FLP property is includible in the decedent's gross estate under Code Sections 2036 and 2038 where the facts and circumstances indicate that the decedent retained a sufficient interest in the transferred property.

3. The ASG document recognizes that in analyzing the hazards of litigation, Appeals Officers should consider a list of nonexclusive factors. Such factors are not disclosed in the ASG document.

E. Discussion of third issue: Whether there is an indirect gift of the underlying assets, rather than the family limited partnership interests, where the transfers of assets to the family limited partnership (the funding) occurred either before, at the same time, or after the gifts of the limited partnership interests.

1. The taxpayer position is that transfers of assets to the FLP after the transfer of the limited partnership interests in the FLP are actually transfers of partnership interests (and not the underlying FLP assets).

2. The IRS position is that the transfer of assets to the FLP after the transfer of the limited partnership interests in the FLP are indirect gifts of the underlying FLP assets.

3. The ASG document recognizes that under current caselaw, specifically Shepherd and Senda v. Commissioner, T.C. Memo 2004-160, aff'd 433 F.3d 1044 (8th Cir. 2006), the transfer of assets to the FLP after the transfer of the limited partnership interests in the FLP are treated as indirect gifts subject to gift tax. The ASG document does not disclose what Appeals Officers should do in cases where the facts are similar to Shepherd and Senda.

F. Discussion of fourth issue: Whether an accuracy-related penalty under Code Section 6662 is applicable to any portion of the deficiency.

1. The taxpayer position is that no accuracy-related penalty should apply due to the reasonable cause exceptions provided for in the law and regulations.

2. The IRS position is that the penalty should apply in certain FLP cases where the valuation discounts claimed are egregious, or evidence of negligence exists.

3. Code Section 6662 imposes an accuracy-related penalty of 20% of the underpayment of tax attributable to, among other things, negligence or disregard of rules or regulations and any substantial valuation understatement.

4. The ASG document recognizes that the question of whether accuracy-related penalties or the reasonable cause exception applies to cases involving FLPs must be determined on a case by case basis depending on the specific facts and circumstances. In the case of an FLP, the taxpayer will often have relied on the advice of his or her advisors with respect to the FLP formation and funding. The question in these cases is whether the taxpayer's reliance on such advisors was reasonable and in good faith. All relevant facts, including the nature of the transaction, complexity of the tax issues, competence and independence of the tax advisor and the sophistication of the taxpayer are considered to determine whether the taxpayer was reasonable and acted in good faith.

5. The ASG document also recognizes that the application of penalties must be considered on their own merits and that it not appropriate to trade any amount of penalty for the taxpayer's concession of the issue. In addition, if there is no appraisal or an unreasonable reliance on an appraisal that takes an egregious discount, the Code Section 6662 penalty will likely apply.

X. GIFT AND ESTATE TAX RETURNS.

A. With respect to the reporting of lifetime gifts on a Federal Gift Tax Return, Form 709, if the value of the gift reported on Schedule A of the return reflects a discount for lack of marketability and/or a minority interest, the appropriate box must be checked under Schedule A of the return. In addition, if the box is checked, an explanation giving the factual basis for the claimed discount and the amount of discounts taken must be provided.

B. The following changes were made to the 2006 and 2007 Form Federal Estate Tax Return, Form 706, with respect to the reporting of entity interests owned by the decedent upon his or her death:

1. Interests in family limited partnerships, limited liability corporations and fractional interests in real estate have been added to the list of interests owned by a decedent at the time of death listed on line 10(a) of Part 4 of the return. In addition, line 10(b) of Part 4 requires the disclosure of whether the interests owned by the decedent discussed in line 10(a) were discounted. Specifically, if the reported interest was discounted, Schedule F of the Federal estate tax return needs to be reviewed for the proper reporting of the total accumulated or effective discounts taken on Schedules A, F or G. If line 10(b) of Part 4 was answered yes, for any interest in miscellaneous property not reportable under any other schedule owned by the decedent, a statement must be attached which lists the item number from Schedule F and identifies the total accumulated discount taken on the interest. Further, line 10(b) of Part 4 was answered yes, for any transfers described in (1) through (5) on pages 14 and 15 of the Federal estate tax return instructions (i.e., transfers includible under Sections 2035, 2036, 2037 or 2038 of the Code), a statement must be attached to Schedule G which lists the item number from that Schedule and identifies the total accumulated discount taken on the transfer.

2. Line 12(e) of Part 4 of the Federal estate tax return was expanded to address whether the decedent transferred or sold interests in a partnership, limited

liability company or closely held corporation to a trust that was (i) created by the decedent during his or her lifetime; or (ii) not created by the decedent but of which the decedent possessed any power, beneficial interest or trusteeship. In that regard, any gift and/or sale of entity interests by a decedent to an intentionally defective grantor trust would be recognized.

C. Individuals will often gift and/or sell their limited partnership interests in a family limited partnership to an intentionally defective grantor trust. Question: how does the IRS become privy to these types of transactions? Consider the following:

1. If the individual gifts his or her limited partnership interests in the family limited partnership, such gift is typically disclosed on the individual's gift tax return, with the value of the gift reported in accordance with Paragraph A. above. In addition, an appraisal that satisfies the gift tax adequate disclosure requirements would be filed with the return to substantiate the valuation so that the statute of limitations with respect to an audit of the return may commence.

2. If the individual sells his or her limited partnership interests in a family limited partnership, the sales transaction should also be reported on the individual's gift tax return in order to commence the statute of limitations period.

3. As part of the sale, the purchaser of the limited partnership interests (i.e. an intentionally defective grantor trust) typically will execute a promissory note. Pursuant to the terms of this promissory note, the purchaser will typically pay interest to the seller for a term of years, with the balance of the principal due to the seller upon the expiration of the term of the note. Thus, the promissory note is considered an asset of the seller of the partnership interests. If the seller dies during the term of the promissory note, such note is included in the seller's gross estate for Federal estate tax purposes and reported on his or her Federal estate tax return. Thus, the IRS may be alerted to the transaction upon review of such individual's Federal estate tax return.

4. Line 12(e) of Part 4 of the Federal estate tax return was expanded to address whether the decedent transferred or sold interests in a partnership, limited liability company or closely held corporation to a trust. In that regard, any gift and/or sale of entity interests to an intentionally defective grantor trust would be recognized.

XI. FIDUCIARY DUTY TO ESTABLISH FLP?

A. In the Matter of Janice Galloway Trust, Second Judicial District Court, County of Ramsey, Minnesota, Court File No. C5-04-200042.

1. In 1988, Herbert Galloway created a revocable trust. Pursuant to the terms of the trust, upon his death, the trust was required to be divided into a credit shelter trust, a GST exempt marital trust and a GST non-exempt marital trust. U.S. Bank was appointed to serve as the Trustees of these trusts that would be established upon Mr. Galloway's death.

2. Mr. Galloway died in 1994, survived by his wife, Janice, two children and five grandchildren.

3. The marital trusts established for Janice's benefit consisted solely of marketable securities.

4. Janice also established a revocable trust, remarried in 1998 and died in 2001.

5. At the time of Janice's death, the value of the assets in the GST non-exempt marital trust was approximately \$17,500,000.

6. Upon Janice's death, the Galloway's children contacted an attorney to object to the fees charged by the estate planning attorney administering the estates of their parents. One of the issues raised was the failure of U.S. Bank to transfer the marketable securities held in the marital trusts to a family limited partnership as a vehicle to reduce estate taxes that would be owed in Janice's estate upon her death.

7. When U.S. Bank requested court approval of fees, the Galloway children objected and sought to have U.S. Bank pay a surcharge to the trusts as compensation for breach of trust, including the failure to establish a family limited partnership.

8. The issue pertaining to the formation of the partnership was the only issue that went to trial.

9. The Court held in favor of U.S. Bank establishing that there was no fiduciary duty for the bank to establish the family limited partnership. The following conclusions were reached: (i) the formation of the partnership was permissible, not mandatory; (ii) as a partnership is a complex, aggressive technique, there is no duty to establish it; (iii) tax minimization was not the main purpose for the trust; and (iv) marital trusts were not typically involved with a family limited partnership.

XII. H.R. 436: CERTAIN ESTATE TAX RELIEF ACT OF 2009.

A. Section 4 of the 2009 Act addresses valuation rules for certain transfers of non-business assets and the limitations on minority discounts. Specifically, Section 4(a) of the 2009 Act adds 2031(d) to the Code, the language of which is as follows:

“(d) Valuation Rules for Certain Transfers of Nonbusiness Assets – For purposes of this chapter and Chapter 12 –

(1) IN GENERAL – In the case of the transfer of any interest in an entity other than an interest which is actively traded (within the meaning of section 1092) –

(A) the value of any nonbusiness assets held by the entity shall be determined as if the transferor had transferred such assets directly to the

transferee (and no valuation discount shall be allowed with respect to such nonbusiness assets), and

(B) the nonbusiness assets shall not be taken into account in determining the value of the interest in the entity.”

B. If there is a transfer of an interest in an entity, which is not “actively traded,” the value of the “nonbusiness assets” held by the entity shall be determined as if the transfer was made directly from the transferor. In other words, the nonbusiness assets owned by the entity are treated as a direct gift to the transferor and are not considered for purposes of valuing the entity. Most importantly, the marketability and minority interest discounts would not be available for the “nonbusiness assets.”

C. Proposed Section 2031(d)(2) provides a definition of “nonbusiness asset.” For purposes of the Section, the term “nonbusiness asset” means “any asset which is not used in the active conduct of one or more trades or businesses.”

D. Unless an exception is met, a passive asset would not necessarily be considered as a nonbusiness asset (meaning that the marketability and minority interest discounts would apply) unless the asset was property described in paragraph (1) or (4) of Section 1221(a) or was a hedge with respect to such property, or the asset was real property used in the active conduct of one or more real property trades or businesses in which the transferor materially participates and with respect to which the transferor meets the requirements of Section 469(c)(7)(B)(ii). In other words, this suggests that real estate in which the transferor materially participates will receive a marketability discount and that a transfer of a real estate partnership interest without material participation would not receive a minority interest or lack of marketability discount.

E. The exception referenced in D. above is with respect to any asset (including a passive asset) which is held as a part of the reasonably required capital needs of a trade or business. Such asset would be treated as used in the active conduct of a trade or business and would be eligible for a minority interest and marketability discount.

F. “Passive assets” are defined by the Section as follows:

1. Cash or cash equivalents.
2. Except to the extent provided by the Secretary, stock in a corporate or any other equity, profits, or capital interest in any entity,
3. Evidence of indebtedness, option forward or futures contract, notional principal contract, or derivative,
4. asset described in clause (iii), (iv) or (v) of Section 351(e)(1)(B) of the Code,
5. annuity,

6. real property used in one or more real property trades or businesses (defined in Section 469(c)(7)(C)),
7. asset (other than a patent, trademark, or copyright) which produces royalty income,
8. commodity,
9. collectible (within the meaning of Section 401(m)), or
10. any other asset specified in regulations prescribed by the Secretary.

G. Section 4(e) of the 2009 Act disallows any minority discount on “any interest in an entity” that a family controls (as defined in Section 2032A(e)(2) of the Code). This Section will have a sweeping impact on family business interests, as they will be unable to receive a minority interest discount.

XIII. CHECKLISTS TO AVOID SECTION 2036.

A. Practitioner’s “Formation” Checklist.

1. General Issues.

(a) For existing clients, establish the partnership while clients are healthy or before client’s disease becomes “terminal.” Clients with history of cancer or other health issues may become terminal; thus, even if the partnership is not used at a later date in conjunction with wealth transfer planning, at least the foundation for FLP planning has been established.

(b) To the extent possible, avoid the use of durable powers attorney and revocable trusts (when the grantor is incapacitated and he or she is not serving as the trustee of his or her revocable trust, respectively) to form and fund the partnership (and related entities, such as a corporate general partner).

(c) Use an entity, such as a corporation, limited liability company or irrevocable trust, rather than one or more individuals, to serve as the general partner(s) of the partnership.¹

(d) The partnership and corporate general partner are separate entities. Engagement letters should be prepared for each entity and each entity should be billed separately.

(e) Signatures on all formation documents should be properly executed. Officers of the corporation should sign as such (i.e., John Smith, President, Client Holdings, Inc.). When the president of the corporation executes

¹For purposes of this checklist, it is assumed that a corporation will serve as the general partner.

a document on behalf of the partnership (acting on behalf of the corporate general partner), the president should sign in such capacity (i.e., John Smith, President, Client Holdings, Inc., General Partner, Client Holdings Limited Partnership). Trustees should also sign in their fiduciary capacity.

(f) The term of the partnership should be realistic (i.e., one which the partners will survive). Under most states' limited partnership acts, it is no longer necessary to have a term.

(g) The appropriate entity should reimburse the individual or entity who advanced the filing fees to form the entity.

(h) If it is contemplated that limited partnership units will be gifted or sold, a sufficient amount of time should lapse between the initial funding of the entities and the transfer (via gift or sale) of limited partnership units.

(i) An initial meeting of the shareholders of the corporation and partners of the partnership should be held; minutes should be taken. Investment and distribution plans for the first year of operations should be discussed. The investment objectives of the partnership should be addressed. For example, if a municipal bond portfolio is contributed to the partnership and the partnership's objective is long term growth, the portfolio will need to be changed.

(j) A schedule of meetings for the first year of operations, if any, should be communicated to the partners of the partnership and shareholders of the corporation.

(k) The corporation and the partnership should enter into a written management agreement. A management fee should be agreed upon.

(l) The corporation should enter into an written employment contract with the president and any employees.

(m) Ensure that there is a provision in the partnership agreement regarding the general partner's affirmative fiduciary duty to the limited partners.

(n) Restrict the limited partners' right to remove the general partner.

(o) Separate accounts should be established in the name of the partnership and the general partner. Account applications should be properly executed by the proper parties. The president of the corporation is generally the individual who should open the accounts in the name of the corporate general partner and the partnership. When a limited liability company is the general partner of the partnership, the manager of the limited liability company (or the member of the limited liability company, if such company does not have a manager) would be the proper person to open an account for such an entity.

(p) The anticipated initial partners of the partnership should negotiate the terms of the partnership agreement.

2. Taxes/Accounting/Books and Records.

(a) When a corporation is used as the corporate general partner, the corporation should elect to be treated as an “S” corporation for federal income tax purposes. The president of the corporation, as well as the shareholders, must sign IRS Form 2553 to make the election. The president should sign the form in his representative capacity; the shareholders should sign in their individual capacities.

(b) A certified public accountant should be engaged at the inception of the partnership and formation of the corporate general partner. Engagement letters should be addressed to both the partnership and the corporation which define the scope of each representation, including the fees that will be charged.

(c) The partnership (and corporation, if necessary) should consider hiring a bookkeeper. An employment contract should be prepared outlining the duties of the bookkeeper and the associated fees.

(d) Capital accounts should be established for each partner.

3. Contributions.

(a) If children will be shareholders of the corporation, they should contribute their own assets to the corporation. If a child cannot independently afford to contribute assets to the corporation, he or she should execute a promissory note payable to the corporation. Alternatively, the parent can gift the anticipated contribution to the child. However, such a gift should occur well in advance of the funding of the corporation and should not be for the exact amount of the anticipated contribution.

(b) The partners of the partnership should contribute assets to the partnership with a value equal to their initial percentage ownership interests in the partnership.

(c) The shareholders of the corporation should contribute assets to the corporation with a value equal to their initial percentage ownership interests in the corporation.

(d) With respect to the general partner’s contribution, assets should first be contributed to the entity, and then from the entity to the partnership. Two separate transactions should occur; property should not be contributed directly to the partnership.

(e) The general partner should maintain separate assets, independent of its interest in the partnership. For example, cash should be contributed to the entity in order to pay ongoing expenses, such as accounting and annual filing fees.

(f) No partner should contribute the majority of his or her assets to the partnership. The Fifth Circuit in Strangi held that the retention of the enjoyment over the assets included the assurance that they will be available to pay various debts and expenses upon death. Thus, when determining the assets to be contributed to the partnership, not only should the partner consider the assets necessary to satisfy current and anticipated living expenses, but he should retain assets outside of the partnership structure for expenses associated with a potential estate administration and post-mortem payment of personal debts and other expenses.

(g) Personal use assets, such as a home or artwork, should never be contributed to the partnership.

(h) When rental property is contributed to the partnership, leases should be revised accordingly. Tenants need to be advised to send rent checks directly to the partnership.

(i) If insured property is contributed to the partnership (i.e., commercial or residential rental property), the insurance policies should be revised to reflect the partnership as the owner of the real property.

(j) If real property is contributed to the partnership, maintenance (and other) contracts should be revised to reflect the partnership as the proper party to the contract. Vendors should also be advised of the change in ownership of the property.

(k) If possible, the “younger generation” partners should make more than an “insignificant” contribution to the partnership.

B. Client’s “Operational” Checklist.

1. General Issues.

(a) The President of the corporation, the general partner of the partnership, should execute all documents relating to transactions involving the partnership; the President of the corporation should execute all documents relating to transactions involving the corporate general partner. When the President signs any document relating to a corporate transaction, he/she should sign “[name of President], President, [name of corporation], Inc.” When the President signs any document relating to a partnership transaction, he/she should sign “[name of President], President, [name of corporation], Inc., general partner, [name of partnership], LP.”

(b) Conduct annual meetings on behalf of the corporation pursuant to its bylaws to elect corporate officers and discuss corporate transactions. Such annual meetings should be documented in corporate minutes prepared and signed by the corporation's Secretary; such minutes should be sent to the partners of the partnership if partnership business is discussed.

(c) Conduct annual meetings on behalf of the partnership to discuss partnership business, including the investment plan for the succeeding year. The partners and the partnership's advisors (i.e., accountant, attorney and investment advisors) should participate in these meetings. The investment policy of the partnership should be carefully examined. Remember, the partner who contributed the majority of the assets probably has a different investment objective than the partnership. Regarding cash distributions, it may be prudent to memorialize objective standards for distributions of cash that are tied to the partnership's investment performance. Such standards should not, in any circumstances, be based on a partner's need for funds to maintain his or her lifestyle.

(d) Ensure that each entity remains active in its state of formation. Such active status should be maintained by timely payment of registered agent fees and satisfaction of any state tax requirements (i.e., payment of franchise tax, filing of annual reports, etc.) on a timely basis.

(e) Ensure that the corporation (as general partner) provides the appropriate financial information relating to the partnership to the limited partners, such as a balance sheet for the partnership (as of December 31st of each year), an annual profit and loss statement, copies of federal and state tax returns, etc., as may be reasonably necessary for the limited partners to be advised of the financial status and results of the partnership's operations. While limited partners may have reduced decision making capacity with regard to the partnership and may not participate in the daily management of the partnership, they are generally entitled to be apprized of the partnership's operations.

(f) Partners of the partnership and shareholders of the corporation should retain a portion of their assets outside of the partnership (i.e., in their revocable trusts and/or individual accounts). Such isolated assets should be used for their daily maintenance, expenses, gift giving, etc.

(g) Ensure that the partnership and the corporation are respected as business entities. If the partnership and/or the corporation engage in business transactions, all parties (family members included) to such transactions are required to abide by the terms of the transaction terms as evidenced in contracts, notes, etc. For example, payments of interest and/or principal on a note should be paid when due and, if not so paid, the appropriate interest and/or penalties should be calculated and collected.

(h) If a serious illness occurs after the partnership is operating, do not contribute additional assets to the partnership immediately after the diagnosis.

(i) If mistakes are made, they need to be rectified as soon as they are uncovered. Adjusting entries may need to be made to the partnership's books and transactions may need to be reversed.

2. Partnership Assets and Income Must Be Segregated.

(a) Ensure that separate account(s) are continuously maintained in the name of the partnership and the corporation and that the assets in such accounts remain separate from non-entity accounts (such as personal or trust accounts), and from the account(s) in the name of the other entity.

(b) Income relating to the partnership's operations should be deposited into partnership accounts only. It should never be contributed into a partner's personal account.

(c) Ensure that personal obligations and expenses incurred by shareholders and/or partners are satisfied from such shareholder's or partner's personal, non-entity accounts, never from entity accounts.

(d) If the corporation and/or the partnership employs a bookkeeper, the bookkeeper's fees should be allocated between the entities accordingly. If one or more of the shareholders or partners also utilizes the bookkeeper for personal matters, fees for such services should be paid from a personal account of the shareholder or partner.

(e) If the corporation and/or the partnership is required to pay any annual property taxes (i.e., real estate or intangibles tax), ensure that the proper entity pays the tax. Entity taxes should never be paid by any of the shareholders or partners.

(f) If a shareholder of the corporation or partner of the partnership uses any partnership property for any purpose, such individual should pay fair market value rent for such use and a lease should be executed between the parties.

(g) Each partner's estimated and actual tax payments should be made by the partner, individually; the partnership should never make a partner's estimated or actual tax payment on behalf of the partner.

(h) If the partnership loans money to a partner, the note should be structured in an "arm's length" transaction. Interest must be charged and paid. If a payment is not made, remedies upon default must be pursued.

(i) If limited partnership interests will be transferred (by gift, sale or otherwise) and an appraisal is necessary, the appropriate party should pay for the appraisal. For example, a donor would pay for the appraisal if limited partnership

units will be gifted; the estate would pay for the appraisal if limited partnership units are being valued for federal estate tax purposes. In these cases, the partnership would not pay for the appraisal.

3. Taxes/Accounting/Books and Records.

(a) Separate capital accounts should be maintained for each partner of the partnership. The partner's accountant should be able to assist him or her with the maintenance of such accounts.

(b) Maintain accurate records of partnership transactions as they occur and prepare an annual account of all partnership transactions for the given year to be maintained with the partnership's records. Such annual accounting should be forwarded to all partners of the partnership.

(c) Engage an accountant to prepare the appropriate tax returns for the partnership (Form 1065) and the corporation (Form 1120S) which need to be filed annually. These returns are informational type returns that are required to be filed accurately and timely. Income will flow through to the partners and shareholders of the partnership and corporation, respectively. The entities will not pay any tax. The accountant should also determine whether any state income or intangibles tax returns need to be filed.

4. Distributions.

(a) When the partnership makes any distributions, ensure that they are made to the partners in accordance with their respective partnership percentages and in compliance with the partnership agreement. If additional assets are contributed to the partnership, they should be made by the partners in accordance with their respective partnership percentages at the time of the additional contribution.

(b) If it is contemplated that distributions from the partnership on a regular basis, such distributions should not be tied to a partner's personal expenses or recurring obligations, including already existing patterns of gift giving.

(c) Gifts of cash to partners (i.e., \$11,000 annual exclusion gifts) should not be made immediately after distributions are made from the partnership.

5. Death of a Partner.

(a) Upon a partner's death, if a partnership interest is included in a partner's gross estate (for federal estate tax purposes) and estate tax is due, the partner's estate should make the estate tax payment, including an estimated tax payment. The partnership should not make the payment on behalf of the estate. The partnership should make a distribution to the estate (and other partners according to partnership percentages) in advance of the due date which is not the

exact amount of the amount that will be paid. Alternatively, the partnership can loan money to the estate; if a loan is made, it should be documented and interest should be paid.

(b) Upon a partner's death, partnership assets should not be used to satisfy any bequests, specific or otherwise. Rather, the partnership should make a distribution to the estate (and other partners according to partnership percentages) or the estate should distribute partnership interests when appropriate. Distributions should not be made to the beneficiaries of the estate.

(c) The partnership should continue its operations after a partner's death.

C. Bona Fide Sale for Adequate and Full Consideration Checklist.

1. All nontax reasons to establish the partnership should be documented in the partnership agreement and in external documents, and should be implemented. There must be at least one "legitimate and significant nontax reason" to establish the partnership. Strangi required a "substantial business or other nontax purpose," which altered the standard in Kimbell (which used "and" instead of "or"). Also, Kimbell discussed the business and nontax purpose as "factors" to consider; Strangi recognized the requirement for a "substantial business or nontax purpose." Specifically, investment management, educating younger family members, creating a vehicle for gifting programs, creditor protection and pooling investment assets appear to be viable "nontax" purposes. Again, the mere addressing of the nontax reasons would not be sufficient; they must be implemented to avoid Section 2036. Examples:

(a) Gifting Programs – Gifts need to be actually made.

(b) Educating Younger Family Members – Meetings should take place with such younger family members and educational programs should be designed and implemented.

(c) Creditor Protection – Partnership formalities must be followed in order to avoid a creditor's "pierce the veil" argument. It appears that the "creditor protection" purpose will work better when real estate is contributed to the partnership, as opposed to marketable securities. When practical, each piece of real estate should be held in a separate entity (i.e., an LLC of which the partnership is a member) and should never be held in the same entity as other assets (such as marketable securities) unless the partnership owns the real estate through an entity.

2. Ensure the partnership functions as an investment vehicle for its partners when asset management is one of the reasons to form the partnership. Regarding implementation, regular meetings should take place with general (and limited) partners and investment advisors. Thus, the partnership should make actual investments and the composition and management of the assets contributed to the partnership should change

after they are contributed. Consider transferring assets to the partnership that require active management.

3. Perhaps the best argument to fall within the “bona fide sale for adequate and full consideration” exception is for the partnership to be involved in an active business.

4. When creditor protection is one of the reasons to form the partnership, “exposed” assets should be contributed to the partnership, separate and apart from “non-exposed” assets.

5. The partners must contribute assets to the partnership in accordance with their partnership percentages. Capital accounts of the partners must be credited with the fair market value of the assets contributed by each partner. Each partner’s capital account must be debited by the fair market value of property distributed to that partner.

6. Upon the termination or dissolution of the partnership, the partners should receive liquidating distributions from the partnership in amounts equal to the balance of their respective capital accounts.

7. A sufficient amount of assets must be retained outside of the partnership for personal expenses. When considering the amount of assets to retain outside of the partnership, the amount of anticipated, normal expenses that will be incurred on an annual basis, in addition to potential expenses for estate and other administration expenses and debts of a decedent, need to be considered. Assets should be retained outside of the partnership to satisfy such expenses. An analysis should be prepared which illustrates that the income generated by the assets outside of the partnership will be sufficient to meet the anticipated annual expenses. Alternatively, the analysis could demonstrate that the “liquid assets” outside of the partnership will be sufficient to satisfy the recurring expenses that will be incurred over the taxpayer’s life expectancy (using one of the Internal Revenue Service’s life expectancy tables) and the estimated expenses, debts and taxes that will need to be satisfied upon the taxpayer’s death.

8. Avoid commingling of personal and partnership assets.

9. Adhere to the formalities regarding the formation of the partnership. Assets to be contributed to the partnership should be retitled accordingly. There must be a “legal transfer” of assets to the partnership i.e., deeds, assignments, stock transfers, etc.

D. Checklist to Avoid Section 2036(a)(2).

1. While the service’s “business purpose” argument has generally been unsuccessful in family limited partnership cases, partnerships which are not engaged in an active business may want to consider investing in a business in order to impose fiduciary duties and business realities that may not otherwise exist.

2. The general partner’s fiduciary duty owed all limited partners should be affirmatively stated in the partnership agreement and should never be negated.

3. An individual who is named as an attorney-in-fact in a durable power of attorney or successor trustee in a trust should not be an officer of the corporate general partner and should not have a controlling interest in the corporate general partner in any capacity.

4. If possible, more than an insignificant amount of limited partnership units should be transferred to unrelated parties. For example, a gift of limited partnership units could be made to one or more charities or to an unrelated individual in lieu of a bequest that would otherwise be made at death.

5. The client should consider transferring all interests in the limited partnership during life, including any interests indirectly held (i.e., through a corporate general partner).

(a) At a minimum, controlling interests should be transferred.

(b) Gifts should be made sooner rather than later, as such gifts would be subject to Section 2035's three year rule.

(c) At a minimum, the \$1 million gift tax exemption should be used. After the exemption is used, GRATs and CLATs (especially in a low interest rate environment), for example, should be utilized, as well as GRITs (when using a family limited partnership to transfer wealth to family members who are not a client's lineal descendants).

(d) It is probably not wise for a client to pay gift tax in light of decreased transfer tax rates and the possibility of estate tax repeal.

(e) A good alternative to paying gift tax is to make an "incomplete" gift to a gifting trust (i.e., the client could retain a testamentary limited power of appointment).

(f) Alternatively, limited partnership units could be sold for a note or a non-appreciating asset. The purchaser could be an individual or an irrevocable trust. If a trust is used, consider a traditional gifting trust (grantor or non-grantor and properly seeded), or GRAT (owning assets other than limited partnership units), for example. Note that the Service may challenge the "sale to defective grantor trust" technique. When limited partnership units are sold, pay careful attention to the sales price to ensure that the sale is made for full and adequate consideration.

(g) Married couples (with good marriages!) may have more options than single individuals. In general, transfers of limited partnership units between spouses (via gift or sale) will not have any adverse income or gift tax consequences. See IRC §§1041, 2523. However, the step transaction doctrine must be avoided, especially in light of Brown v. United States, 329 F.3d 664 (9th Cir. 2003).

6. The general partner should not have the unlimited and absolute discretion to make distributions to the limited partners.

(a) It may be wise to prohibit distributions altogether, although this may not be practical.

(b) Alternatively, the partnership agreement could provide that distributions will only be made upon the attainment of predetermined thresholds. For example, x% of cash would be distributed if the partnership earned y% of income. Such a provision could affect the discount, depending on the likelihood of attaining the thresholds.

(c) Alternatively, the partnership agreement could create a committee to determine when distributions will be made. The major contributor to the partnership (i.e., the client) would not serve on the committee. Moreover, it may be prudent to include “outside” members on the committee (i.e., the partnership’s accountant, attorney and investment advisor(s)), similar to an independent trustee.

7. The partnership agreement should include a provision which precludes the major contributor (the client) from participating in any decisions with respect to distributions to the partners or any other major decisions that could affect the timing of distributions.

XIV. EXHIBITS.

- A. Exhibit I is a compilation of IRS questions used in Section 2036 audits.
- B. Exhibit II is the Appeals Settlement Guidelines for FLPs.
- C. Exhibit III is H.R. 436 – Certain Estate Tax Relief Act of 2009.

ADVISOR TOOLS

Listening for charitable opportunities

Helping your clients achieve their **charitable goals**.



Philanthropy is a very personal decision. A professional advisor can help clients realize their charitable objectives by listening for charitable giving opportunities, explaining options, and suggesting solutions. Significant giving opportunities often arise when clients are making major business, personal, and financial decisions. Our staff can work with you and your client to recommend the best charitable solution. Following are some typical scenarios:

Year-end tax planning. Your client just earned a large bonus and wants to give a portion back to the community, but has no time to decide on the most deserving charities. Recommend establishing a Donor Advised Fund through their community foundation for an immediate tax deduction, and the ability to stay involved in recommending uses for the gift for years to come.

Preserving an estate. Estate planning identifies significant taxes going to the IRS, but your client wants to direct dollars for local benefit. The community foundation can work with you and your client to reduce his/her taxable estate through a charitable bequest or other planned gift. Your client's gift will create a legacy of caring in the community that stays true to his/her charitable intent forever.

(CONTINUED ON REVERSE)

Planning charitable giving

Many clients want their professional advisors to help them plan charitable giving. Your community foundation can work with you to answer these questions and help each client fulfill his/her charitable goals.

- What are your client's personal motivations for charitable giving?
- What are your client's charitable interests in the community?
- What are your client's priorities when focusing on a few areas may make the greatest impact?
- What level of involvement does your client want to have in identifying charitable uses for his/her gift?
- What type of giving instrument best fits your client's financial situation and tax status?

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We work with advisors to enhance the services clients seek from you and your firm — always respecting and working within the relationships you have developed and lead with your clients.

Why should you talk to your clients about charitable giving?

Some advisors are reluctant to begin a charitable giving conversation with their client, and may be concerned about appearing to make a values judgment, especially if the client has not expressed charitable intentions.

However, by not broaching the subject of charitable giving, a significant opportunity may be lost for your client and the community. In fact, many individuals expect their professional advisors to bring up the subject if appropriate... and assume charitable giving is not an option if the subject is not raised.

Retiring in comfort. Your client is concerned about running out of money during his/her lifetime, but has always been charitable. Recommend establishing a life income gift (such as a charitable remainder trust) at their community foundation that pays income potentially for life. Upon your client's death, the gift can be distributed by the community foundation in accordance with his/her charitable interests.

Establishing a private foundation. Your client is thinking about establishing a private foundation, but is looking for a simpler, more cost-efficient alternative. The community foundation can help you and your client analyze the pros and cons of creating a Donor Advised Fund, a supporting organization, or a private foundation.

Closely held stock. Your client's personal net worth is primarily tied up in a closely held company, but it's important for him/her to give back to the community. Recommend establishing a Donor Advised Fund or planned gift; your client is eligible for a tax deduction measured by the fair market value of appreciated stock (less any planned gift value).

Sale or disposition of highly appreciated stock. Your client has appreciated stock and wants to use a portion of the gains for charitable giving, but the identified charities are too small to accept direct stock gifts. Suggest establishing a fund at a community foundation with a gift of appreciated stock. Your client receives a tax deduction on the full market value, while avoiding the capital gains tax that would otherwise arise from sale of the stock. Your client can even be involved in recommending uses for the gift, including the organizations and programs he/she cares about most.

Sale of a business. Your client owns highly appreciated stock in a company that is about to be acquired. The community foundation can work with you to suggest several ways to structure a charitable gift (including the use of planned giving techniques) to help your client reduce capital gains tax and maximize impact to the community.

Strategic giving. Your client is passionate about helping meet a specific community need and wants to make a meaningful gift. You and your client can work with our grantmaking experts to understand community needs and programs and then direct gift dollars to make the greatest impact.

Substantial IRA/401(k) assets. Your client wants to leave his/her estate to community and family, and has substantial assets in retirement accounts. The community foundation can help you and your client evaluate the most beneficial asset distribution to minimize taxes, giving more to his/her heirs and preserving charitable intent.

There's so much more we'd like you to know. Your community foundation can help you help your clients achieve their charitable giving goals. We welcome the opportunity to work with you.

EXHIBIT I*

*Special gratitude is extended to Barry Nelson, Esq. for his permission to include the materials following this page. Mr. Nelson assisted in the compilation of the questions in connection with his membership on the Business Planning Committee of the American College of Trust and Estate Counsel.

INFORMATION REQUESTED ON AUDIT

1. Copies of donor's Federal and state Income Tax Returns (1040) for the year before, the year of and the year after the gift referenced in this audit letter (or in the case of an estate, for the year of the decedent's death and the two preceding years).
2. Copies of all 709's filed with appraisals, acts of donation and other supporting documentation. This includes 709's filed by the donor's spouse.
3. Copies of all partnership returns filed from the time the entity was created until the partnership return for the tax period of the transfer or ending immediately after the decedent's death.
4. If any assets subject to any of the gifts have been sold or agreements to sell have been entered into subsequent to the date of donation please provide complete details, including contracts, deeds and closing statements.
5. A list of donations of any kind, other than customary holiday and birthday gifts of small value [in some cases, they want all gifts including holiday and birthday], made during the donor's lifetime regardless of whether a Gift Tax Return Form 709 was filed.
6. For an estate, explain how the estate obtained the funds used to pay the debts, expenses and taxes it has paid to date, and how it plans to obtain funds for future such payments.
7. If the object of any of the above donations was an interest in any closely held corporation, partnership, limited liability company or other business organization, we need the following:
 - a. All documents relating to the creation of the entity (including bills) from any attorney, accountant or firm involved in recommending the creation of the entity or in drafting the necessary documents. Copies of all contemporaneous correspondence between the original partners/members (and/or their respective representatives) prior to, and through, the date the entity was established. If a claim is made that any of these documents are privileged, identify each privileged document by date, source, audience, and reason for the privilege.
 - b. Articles of organization and operating agreement (or certificate of partnership and partnership agreement), with any amendments.
 - c. Articles of incorporation of the general partner, if the general partner is a corporation.
 - d. All documents that were prepared to meet state law requirements for the formation and operation of the entity (i.e., certificate of limited partnership which has the filing date stamp on it and all amendments thereto; stamped copies of annual reports; supplemental affidavits on capital contributions, etc.).

- e. All financial statements prepared and/or filed since inception.
- f. All of the entity's bank and other records (i.e., general ledger, cash receipts and disbursements journals, check registers, etc.) which reflect the amount and nature of all deposits and distributions, including distributions to owner/members, for the period since the entity was formed to the current period.
- g. Minutes of all meetings; if none, indicate the dates of all meetings and the business discussed.
- h. Evidence showing how the value of each entity asset was arrived at as of the date:
 - (i) It was contributed to the entity.
 - (ii) Of each gift of an interest in the entity.
 - (iii) Of the death of the donor.
 - (iv) Provide all appraisals and supporting work papers.
- i. Evidence as to how the entity was valued as a whole as well as fractional interests. Provide all appraisals and supporting work papers if not already furnished.
- j. Evidence to substantiate all initial and subsequent capital contributions and the source of all contributions by owners other than the donor, and a copy of all "capital account records" maintained in conformance with the partnership or operating agreement.
- k. For any entity asset that has been sold or offered for sale since the formation of the entity, provide evidence which documents the sale or attempted sale (i.e., sales agreement, listing agreement, escrow statement, etc.).
- l. For each entity asset, explain/provide:
 - (i) Evidence that the entity owns the asset (i.e., deeds, bills of sale, other title changes, account statements and the date the transfer of the asset to the entity was complete).
 - (ii) When the contributor acquired the asset.
 - (iii) How the asset was used by the contributor after its acquisition, and how the entity has used the asset since its contribution (i.e., held for rent; personal residence, investment, etc.).
 - (iv) Who managed the asset prior to and after its contribution; explain in detail what management consisted of and how it changed after the entity was formed.

- m. A detailed narrative explanation of all the business activity conducted in connection with the entity's assets, including a year-by-year detailed schedule of all gross income receipts, with related expenses and services provided by the entity in earning the receipts.
- n. Brokerage statements or other information reflecting the ownership and activity of the assets contributed to the entity for the period beginning one year prior to the formation of the entity and continuing through the current date, and copies of any other tax returns and financial statements which reflect the activity of the entity's assets, if different from the foregoing.
- o. For each gift or transfer of an interest, provide:
 - (i) Evidence that the interest was legally transferred under state law and under the terms of any agreement among the owner/members.
 - (ii) Any assignment of any interest along with the terms of the assignment.
 - (iii) The amount and source of any consideration paid along with an explanation as to how the amount was arrived at.
- p. Provide the following with respect to the donor, all other original members and any recipients of gifts or transfers of interests:
 - (i) Date of birth.
 - (ii) Education, occupation, and their residence address.
 - (iii) Experience and expertise in dealing with entities, real estate, financial affairs and investments; provide tangible evidence thereof.
 - (iv) Extent of the donor's investments as of the date of the formation of the entity, including a summary of assets that were not contributed to the entity; provide tangible evidence thereof.
 - (v) Any personal financial statements and credit applications which were prepared in connection with loan applications after the entity was created.
- q. Indicate whether the entity is currently in existence, and, if so, provide the current ownership interests.
- r. Provide a summary of any other transfers of business interests not reflected in the gift tax returns filed.
- s. A statement describing the donor's state of health at the time of the formation of the entity and for the six month period prior thereto, including a description of any serious illnesses. Please also provide the names, addresses and telephone numbers of all doctors who would have knowledge of the donor's state of health

during this period to the present date and provide these doctors with authorization to respond to the Service's future requests for information, including a copy of the medical records, if necessary.

- t. A copy of the donor's will, revocable trust, and any executed power of attorney, if not submitted with the return.
- u. A statement indicating the identity of the parties recommending the use of the entity, when the recommendations were made, and the reasons set forth in support of using such an entity. Provide a copy of any/all notes and correspondence.
- v. A detailed narrative explanation of the reasons and reasoning for creation of the entity.
- w. Names, addresses, and current telephone numbers of the representatives of the donor/estate, all donees/beneficiaries, all partners or members, accountants/bookkeepers, and brokers/investment advisors.

INTERNAL REVENUE SERVICE'S INTERVIEW QUESTIONS

LLC/PARTNERSHIP FORMATION ATTORNEY/CPA INTERVIEW QUESTIONS

INDIVIDUALS PRESENT:

_____, Estate Tax Attorney;

Questions were asked by Estate Tax Attorney and answers were given by _____ unless otherwise specified.

All references to "LLC/Partnership" are to the _____

All references to Decedent are to _____

A. Please do not speculate as to any answer; provide answers only if you have personal knowledge of the answer.

1. Is there any medical or other reason that would affect your ability to understand and answer questions today?
2. When did you become the Decedent's attorney?
3. What work have you performed for the Decedent in general in the past?
4. How did the Decedent become your client for purposes of forming the LLC/Partnership?
5. What file(s) do you maintain on the LLC/Partnership or the Decedent's estate planning?
6. Describe each document in your files on the LLC/Partnership.

B. The following questions pertain to the time period beginning when you had first contact with the Decedent or anyone on the Decedent's behalf in connection with the decision to form the LLC/Partnership and ending with the execution of the LLC/Partnership operating agreement.

1. Who was involved in the decision to form the LLC/Partnership?
2. Indicate approximately how many meetings were held during the decision making process.
3. What were the dates, locations, and approximate duration of each of these meetings?

4. Who attended each meeting?
5. Did you take any notes at these meetings?
6. What documents did you hand out at the meetings?
7. Were there any discussions over the telephone about the formation?
8. How many telephone conversations did you have during the decision making process?
9. With whom did you talk during these telephone conversations?
10. Did you take any notes of the telephone calls?
11. Approximately how many emails, letters or other correspondence did you send and receive?
12. Did you prepare or have the Decedent, or anyone on his/her behalf, complete questionnaires about the Decedent's estate planning desires?
13. Who exactly was your client for purposes of forming the LLC/Partnership?
14. Was each member represented by her own counsel?
15. Did you prepare any fee, retainer or similar agreements?
16. Did you prepare any waiver of conflict of interest or similar document for the members retaining you jointly?
17. Did you issue billing statements describing the services you rendered?
18. Is every meeting and telephone conversation described in your bills?
19. Do you maintain any documents describing the services you have rendered other than the bills you have issued, such as pre-bills or other summaries of services rendered?
20. Did you prepare any computations of tax savings for the meetings with the Decedent or his family?
21. Did you discuss the tax benefits to be derived from the formation of the LLC/Partnership with the Decedent?
22. Were any flow charts, graphs or similar documents presented to the Decedent?
23. What reasons did the Decedent give you for the formation of the LLC/Partnership?

24. Who was present when the Decedent gave you the reasons for forming the LLC/Partnership?
25. Who else would have personal knowledge of the Decedent's reasons and motivations for forming the LLC/Partnership?
26. Do you know of any document (e.g., letters, notes of meetings, etc.) that exists which may corroborate the Decedent's reasons and motivations for forming the LLC/Partnership?
27. Follow-up questions on reasons Decedent gave for formation of LLC/Partnership?

**ESTATE'S PERSONAL REPRESENTATIVE AND/OR FAMILY MEMBER
INTERVIEW QUESTIONS**

A. INTRODUCTION

1. Would you please state your occupations; and, if you are retired, then your former occupations.
2. What special experience, training or expertise do you have in investing in stocks, bonds, mutual funds?
3. Did you discuss with your attorney or with anyone else before these interviews the questions that would likely be asked of you today? If so, what were the discussions?

B. CREATION OF THE LLC/PARTNERSHIP

1. Who suggested the use of the LLC/Partnership?
2. To whom did the attorney or CPA or anyone from his office suggest the use of the LLC/Partnership?
3. When did the attorney or CPA or anyone from his office first suggest the use of the LLC/Partnership?
4. What other estate planning techniques did the attorney or CPA or anyone from his office discuss other than the LLC/Partnership?
5. Why did the Decedent want to form and use the LLC/Partnership if you know?
6. What discussions did you have with your parent or others concerning their need for estate planning? What was the need and what advice did you or your parent obtain?
7. Who else has personal knowledge of the Decedent's reasons and motivations for the formation and use of the LLC/Partnership?
8. Do you know of any document that corroborates the reasons the Decedent had for the formation of the LLC/Partnership?
9. How many meetings were there with the attorney or CPA or anyone from his office to form the LLC/Partnership?
10. How many meetings with the attorney or CPA or anyone from his office to form the LLC/Partnership did you attend?
11. Who was present at each meeting you attended to form the LLC/Partnership?

12. Who was present at each meeting to form the LLC/Partnership that you did not attend?
13. Did you take any notes at the meetings you attended to form the LLC/Partnership?
14. Do you have your notes available to provide to the Service?
15. Did you ask any questions at any of the meetings you attended to form the LLC/Partnership?
16. What questions did you ask?
17. Did the Decedent take any notes at any of the meetings you attended to form the LLC/Partnership?
18. Are the Decedent's notes available?
19. Did the Decedent ask any questions at any of the meetings you attended to form the LLC/Partnership?
20. (If yes) What questions did the Decedent ask?
21. Did the attorney or CPA or anyone from his office send you any letters, emails, or other correspondence about the formation of the LLC/Partnership?
22. Did you send the attorney or CPA or anyone from his office any letters, emails, or other correspondence about the formation of the LLC/Partnership?
23. Do you have the letters, emails or other correspondence the attorney or CPA or anyone from his office sent you or you sent the attorney or CPA or anyone from his office about the formation of the LLC/Partnership?
24. Did the attorney or CPA or anyone from his office send the Decedent any letters, emails, or other correspondence about the formation of the LLC/Partnership?
25. Did the Decedent send the attorney or CPA or anyone from his office any letters, emails, or other correspondence about the formation of the LLC/Partnership?
26. Do you have the letters, emails or other correspondence the attorney or CPA or anyone from his office sent the Decedent or the Decedent sent the attorney or CPA or anyone from his office about the formation of the LLC/Partnership?

27. Did you see any calculations or projections of the tax benefits to be achieved by forming the LLC/Partnership?
28. Describe all of the reasons the decedent had for forming the LLC/Partnership.
29. Do you know of any document that corroborates or describes the reasons the decedent had for forming the LLC/Partnership?
30. What was the Decedent's age at the time the LLC/Partnership was formed?
31. What was the Decedent's state of health before, and at the time, the LLC/Partnership was formed?
32. What was the state of the Decedent's mental competence before, and at the time the LLC/Partnership was formed?

C. LLC/PARTNERSHIP AGREEMENT.

1. Were any of the terms of the LLC/Partnership agreement negotiated among the members?

D. FUNDING OF THE LLC/PARTNERSHIP.

1. Who decided which assets were to be contributed to the LLC/Partnership?
2. Who made the decisions to sell the LLC/Partnership Interests to the Trust and why? Have the notes been paid off? If so, where did the money come from?
3. Your parent transferred about \$_____ Million. Who managed these investments before the LLC/Partnership was formed? What was your involvement with their brokerage accounts?
4. Who opened the bank account?

E. OPERATION OF THE LLC/PARTNERSHIP.

1. Explain how the LLC/Partnership's assets were managed after their contribution to the LLC, including all individuals involved and the amount of time devoted.
2. The Plans of Operation all state that the plan was to invest for long term appreciation, but the value of the brokerage account stayed the same for years after the LLC/Partnership was formed. Can you provide some examples of activities that you or your parent carried on with the

investments after the LLC/Partnership was formed that were different than before?

F. Re: the LLC/Partnership's marketable securities:

1. Explain who made the decision to buy, sell or hold each security.
2. Who managed the investments before the LLC/Partnership was formed? What was your involvement with the investments?
3. Can you provide some examples of activities you or the Decedent carried on with the LLC/Partnership's investments after the LLC/Partnership was formed that were different than before?
 - (a) Explain who made the decision to buy, sell or hold each security.
 - (b) Who managed the investments before the LLC/Partnership was formed? What was your involvement with the investments?
 - (c) Can you provide some examples of activities you or the Decedent carried on with the LLC/Partnership's investments after the LLC/Partnership was formed that were different than before?
4. Re: the LLC/Partnership's real estate:
 - (a) Who deposited the rents?
 - (b) Who paid the expenses?
 - (c) Who negotiated the leases?
 - (d) Did the LLC/Partnership ever file suit or otherwise engage in litigation?
 - (e) Did the LLC/Partnership purchase, convey, lease, or otherwise acquire property?
 - (f) Did the LLC/Partnership sell, convey, lease, mortgage, or otherwise encumber or dispose of any property?
5. Did the LLC/Partnership vote or deal in the shares or other interests of other entities?
6. Did the LLC/Partnership borrow money or otherwise incur debts?
7. Did the LLC/Partnership lend money and receive a security interest in property as security for repayment?

8. Has the LLC/Partnership had employees or agents? If so, describe the duties, terms of employment, dates of employment and compensation for each such employee or agent.
9. The LLC/Partnership's income tax return shows distributions. What percentages were used to compute the distributions?
10. Who made the decisions on the timing and amounts of the distributions?

EXHIBIT II

**APPEALS COORDINATED ISSUE
SETTLEMENT GUIDELINES**

ISSUE: Discounts for Family Limited Partnerships
COORDINATOR: Mary Lou Edelstein
TELEPHONE: (305) 982-5276
UIL NO: 2031.01-00
FACTUAL/LEGAL ISSUE: Legal and Factual

APPROVED:

/s/ Cynthia A. Vassilowitch

October 18, 2006

Director, Technical Guidance

DATE

/s/ Diane S. Ryan

October 20, 2006

Director, Technical Services

DATE

EFFECTIVE DATE: October 20, 2006

APPEALS SETTLEMENT GUIDELINES

FAMILY LIMITED PARTNERSHIPS AND FAMILY LIMITED LIABILITY CORPORATIONS

UIL 2031.01-00

Issues

1. Whether the fair market value of transfers of family limited partnership or corporation interests, by death or gift, is properly discounted from the pro rata value of the underlying assets.
2. Whether the fair market value at date of death of I.R.C. §§ 2036 or 2038 transfers should be included in the gross estate.
3. Whether there is an indirect gift of the underlying assets, rather than the family limited partnership interests, where the transfers of assets to the family limited partnership (funding) occurred either before, at the same time, or after the gifts of the limited partnership interests were made to family members.
4. Whether an accuracy-related penalty under I.R.C. § 6662 is applicable to any portion of the deficiency.

Background

Family limited partnerships and family corporations have long been used in the conduct of active businesses, primarily to provide a vehicle for family involvement in the enterprise and for succession planning. In the early 1990's, however, estate planners began using family limited partnerships and family limited liability corporations to hold and transfer passive assets such as stock portfolios, mutual funds, bond portfolios, cash, and similar passive assets that are easily liquidated. The alleged "business" purpose for forming family partnerships or corporations with passive assets was to engage a younger generation in investment decision making.

The IRS initially focused on the question of whether the family limited partnership was valid for tax purposes. Substance over form, step-transaction analysis, and lack of business purpose theories were used by the IRS to essentially set aside the transaction for estate and gift tax purposes and include the full value of the assets in determining estate or gift tax liabilities. These arguments are not always successful in litigation. As a result of some well-articulated court decisions, there is now a set of recognized criteria that estate planners can use in establishing family limited partnerships and family limited liability corporations that head off such challenges. The IRS still raises the issue of legitimacy, however, when these criteria have not been followed.

In cases where the IRS cannot successfully argue to set aside the family limited partnership's existence for tax purposes, the focus shifts to determining the correct valuation of its assets. The amount of discount to be applied to the fair market value of the assets is often a source of dispute, with taxpayers arguing that lack of marketability and minority interest factors should result in deep discounts that significantly reduce the tax base.

Thus, the IRS generally considers two basic issues with family limited partnerships: the validity issue (often known as the IRC § 2036 and § 2038 issue) and the valuation issue. The issue of indirect-type gifts, where the transfers of family limited partnership interests are made before, at the same time as funding, or shortly thereafter, is also raised where facts and circumstances support it.

The above should not be taken to preclude Compliance raising other arguments or legal theories that might apply to cases involving family limited partnerships or family limited liability corporations. Each case is factually unique, and interpretation of the law in this area continues to evolve. At the time of this writing Compliance has not published a coordinated issue paper.

The IRS has pursued coordination of family limited partnership issues at both the Compliance and Appeals levels in response to abusive practices. Recently, taxpayers have been forming family limited partnerships and taking excessive discounts from the net asset value of the partnership. More often than not, these cases undervalue passive and/or liquid assets. In addition, there have been cases where the partnership formalities were not followed or where the donor/decedent used the family limited partnership to pay personal expenses. These practices are often tax-avoidance in nature, and therefore looked upon as tax shelters.

When the practices described above clearly violate the intent of the tax law and undermine voluntary compliance, they are considered abusive. The negative impact on our tax system is manifested most immediately in estate and gift tax reporting for transactions involving family limited partnerships. But there is a carryover impact on income taxes as well. Liquidations of, or distributions from, family limited partnerships and limited liability corporations generally result in a recognizable gain subject to income tax. Frequently, however, taxpayers use the *undiscounted* value of the partnership interest to compute the gain, thus improperly understating the reportable income tax on the transaction.

Although related to the valuation issue discussed below, the income tax implications will not be addressed in this document.

Issue 1

Whether the fair market value of transfers of family limited partnership or family limited liability corporation interests by death or gift is properly discounted from the pro rata value of the underlying assets.

Compliance Position

The Government's position is that under certain circumstances, there should be minimal discounts or no discounts from the pro rata value of the underlying asset value of the entity. This position is based upon current case law, reliance on current studies that support minimal discounts for minority interest and lack of marketability, and certain alternative methods of valuation.

Taxpayer's Position

Because of the illiquid nature of the assets involved, taxpayers claim that the fair market value of the transfers are substantially less than the underlying pro rata value of the assets held by the entity. Discounts for minority interest, lack of marketability, and possibly portfolio composition are used by taxpayers to reduce the value of the assets transferred. In addition, the methods of valuation used by the appraiser valuing the entity may contribute to reductions from the underlying pro rata value of the assets.

Discussion

For estate and gift tax purposes, § 2031 of the Internal Revenue Code provides the general rule that transfers from family limited partnerships and family limited liability corporations are valued at their fair market value. Fair market value is generally defined as the value at which a willing buyer would purchase, and a willing seller would sell, neither being under any compulsion to buy or to sell and both having reasonable knowledge of all relevant facts.

Treas. Reg. § 20.2031-1(b) further expands the definition of fair market value:

The fair market value of a particular item of property includible in the decedent's gross estate is not to be determined by a forced sale price. Nor is the fair market value of an item of property to be determined by the sale price of the item in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate.

With respect to family limited partnerships and family limited liability corporations, an appraisal is usually obtained from a qualified appraiser who determines the fair market value of the interest at some value less than the pro rata value of the underlying assets, either because of the method of valuation used, or because of discounts for lack of marketability and minority interest.

In *Knicht v. Commissioner*, 115 T.C. 506 (2000), although the IRS raised the legitimacy of the family limited partnership for tax purposes, the Tax Court found that under Texas law the partnership had properly been created and was recognizable for federal gift tax purposes. The family limited partnership had been funded primarily with cash, municipal bonds, and real property. However, the Court allowed only a 15% overall discount for lack of marketability and minority interest from the underlying value of the property.

The Tax Court has been using a more sophisticated approach in recent cases, such as *McCord v. Commissioner*, 120 T.C. 358 (2003); *Lappo v. Commissioner*, T.C. Memo. 2003-258; *Peracchio v. Commissioner*, T.C. Memo. 2003-280; and *Estate of Webster E. Kelley v. Commissioner*, T. C. Memo. 2005-235.

In each of these cases, the appraiser started with the net asset value of the partnership, then analyzed the makeup of the portfolio and divided it into cash, equities, bonds, and real estate, or other types of assets.

For each element of the portfolio, the appraiser looked to comparable funds for an average discount from net asset value. Generally, the appropriate discount was smaller commensurate with the risk of the investment. That is, foreign equities should be expected to have a higher net asset value discount than domestic bonds because foreign equities have an inherently higher risk.

In *McCord v. Commissioner*, the Tax Court extensively analyzed the testimony and opinions of both the Government's and the taxpayer's appraisers to arrive at a discount of 15% for minority interest and 20% for lack of marketability interest for the transferred interests.

The taxpayers had formed a family limited partnership with 2 classes of limited partner's interests; Class A partners were the taxpayers, and Class B partners were the taxpayers, their children, and the children's partnership. The general partners were the children.

In 1996, the taxpayers assigned their Class A interests to charity and their Class B interests to the children, the children's trust, and two charities; the assignments were made according to a formula that allocated the interests based on a set dollar amount.

The taxpayer's appraiser had opined that a 22% minority interest discount and a 35% lack of marketability discount were applicable; while the Government's appraiser opined that an 8.34% minority interest discount and a 7% lack of marketability discount were applicable.

In making its determination on the discounts, the Court considered the discount from the net asset value of samples of comparable funds. The Court considered the following factors in assessing the comparability of the funds:

- The quality of the equities in the sample funds;
- Age of the funds;
- Whether unrealized capital gains are present in the funds;
- The type and quality of management for the sample funds; and
- Whether the funds are scheduled for liquidation or conversion.

The Court accepted the Government appraiser's findings on the appropriate minority discount for the liquid assets, and allowed 10%. With respect to the lack of marketability discount, the Court reviewed the traditional IPO (Initial Public Offering) and restricted stock studies, rejecting the IPO studies on the testimony of the Government's appraiser in favor of the restricted stock studies; ultimately a 20% lack of marketability discount was allowed by the Court.

In *Lappo v. Commissioner*, the Tax Court, after considering the testimony of both taxpayer's and Government's expert witnesses, allowed an overall 15% minority interest discount and an overall 24% marketability discount in determining the fair market value of transfers of a family limited partnership with both active and passive assets.

In *Lappo*, both parties agreed that the marketable securities portion of the family limited partnership should be valued using the net asset value of the partnership. The petitioner's expert used a minority interest discount of 7.5%, while the respondent's expert used a minority interest discount of 8.5%. Since the difference between the experts was not significant, the Tax Court adopted the 8.5% minority interest discount for the marketable securities.

In valuing the real estate component of the portfolio, both appraisers started with REITS and real estate companies as comparable companies for determining minority interest discounts; respondent's expert used 52 comparables, while petitioner's expert used 7 comparables. Some of the factors considered by the Court are as follows:

- Size of the guideline group and comparability of the companies (the Court rejected the taxpayer's group of 7 comparable sales as too small using respondent's expert's sample instead);
- The liquidity component of the discount (the Bajaj study found the liquidity component of the discount was 7.5%).

The Court ultimately allowed a 19% minority interest discount for the real estate portion of the portfolio.

The Court also reviewed recent studies in determining the lack of marketability discount applicable; noting that these studies found 14.09%, 17.6%, and 13.5% discounts for

lack of marketability, respectively. The Court allowed a lack of marketability discount of 24%.

In *Peracchio v. Commissioner*, the Tax Court valued two transferred limited partnership interests: a 45.47% interest transferred to a family trust, and a 53.48% interest sold to the trust in exchange for a promissory note in the amount of \$646,764.

At trial the issue was the fair market value of the family limited partnership interests. Relying on an appraisal, the taxpayer took a 40% discount, while the Government, based upon an appraisal, took a 4.4% lack of control and a 15% lack of marketability discount.

Both appraisers started with fair market value, dividing the family limited partnership's passive assets into categories: cash, U.S Government bonds, state/local bonds, domestic equities, and foreign equities. Each category was assigned a minority interest discount based upon comparable closed end investment funds classified by Lipper Analytical Services.

After analyzing both appraisers' samples, the Tax Court assigned appropriate minority interest discounts as follows:

Cash and money market funds	2.0%
U. S. Government bond funds	6.9%
State and local bonds	3.5%
National municipal bond funds	3.4%
Domestic equities	9.6%
Foreign equities	13.8%

After applying the minority interest discounts to the asset categories, the average minority discount was 6.02%.

With respect to the marketability discount, the Tax Court analyzed the various restricted stock studies, expressing dissatisfaction with both appraisers' analyses, and allowed a final discount of 25%. The total discount allowed by the Tax Court was 29%.

In summary, the discounts allowed by the Tax Court in the above three cases are set forth below:

Case Name	Lack of Control or Minority Interest Discount	Lack of Marketability Discount	Combined Discount
<i>McCord</i>	10%	20%	32%
<i>Lappo</i>	8.5%	24%	27%
<i>Peracchio</i>	6.02%	25%	29%

In the recently decided case, *Estate of Webster E. Kelley v. Commissioner*, the Tax Court allowed a 12% minority discount and a 23% marketability discount for a family limited partnership that consisted solely of cash and certificates of deposit. In allowing this large discount, the Tax Court relied upon appraisals by both the petitioner and respondent that used general equity closed-end funds as comparables. The use of general equity funds as comparable to cash by both the petitioner and the respondent could be criticized, since cash is a more liquid investment than securities. This case was an anomaly for various reasons and should not be considered valuable guidance.

Cases in this area are fact specific. Consequently, each case needs to be individually assessed to determine the appropriate discounts.

Issue 2

Whether the fair market value at date of death of I.R.C. §§ 2036 or 2038 transfers should be included in the gross estate.

Compliance Position

The Government's position is that, where the facts and circumstances indicate the decedent retained a sufficient interest in the transferred property, the property is includible under §§ 2036 or 2038.

Taxpayer's Position

The taxpayer's position is that the transfer of property to a family limited partnership is a bona fide sale for full and adequate consideration, and so is an exception to I.R.C. §§ 2036 and 2038, or, in the alternative, that §§ 2036 and 2038 do not apply to the transaction.

Discussion

I.R.C. § 2036 provides the general rule that the value of the gross estate includes the value of all property to the extent of any interest therein of which the decedent has made a transfer, except in case of a bona fide sale for adequate and full consideration in money or money's worth, under which he has retained for his life (1) the possession or enjoyment of or the right to income from the property, or (2) the right, either alone or in conjunction with another person, to designate the persons who shall possess or enjoy the property or the income there from.

I.R.C. § 2038 provides the general rule that 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 case of a bona fide sale for an adequate and full consideration in money or money's worth), ... where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power by the decedent alone or by the decedent in conjunction with any other person ...to alter, amend, revoke or terminate.

There are numerous cases where the Court has applied the provisions of § 2036(a) to the transfer: *Estate of Schauerhamer*, T. C. Memo. 1997-242; *Estate of Reichardt*, 114 T.C. 144 (2000); *Estate of Harper*, T.C. Memo. 2002-121; *Estate of Abraham*, T.C. Memo. 2004-39, *aff'd* 408 F.3d 26 (1st Cir. 2005); *Estate of Hillgren*, 87 T.C.M. 1008 (2004); *Estate of Thompson*, T.C. Memo. 2002-246, *aff'd* *Turner v. Commissioner*, 382 F.3rd 367 (3rd Cir. 2004); *Estate of Stranqi v. Commissioner*, 115 T.C. 478 (2002), *aff'd in part rev'd in part* *Gulig v. Commissioner*, 293 F.3d 279 (5th Cir. 2002), *rehearing denied* *Gulig v. Commissioner*, 48 Fed. Appx. 108 (2002), *on remand at judgment entered* *Estate of Stranqi v. Commissioner*, T.C. Memo. 2003-145, *aff'd* *Stranqi v. Commissioner*, 417 F.3d 468 (5th Cir. 2005), *review or rehearing granted* 429 F.3d 1154 (5th Cir. 2005); *Estate of Kimbell*, 371 F.3d 257 (5th Cir. 2004); *Estate of Bongard*, 124 T.C. No. 8 (2005); *Estate of Bigelow*, T.C. Memo. 2005-65; the companion *Korby* cases, T. C. Memo. 2005-102 and 103; and *Estate of Schutt*, T.C. Memo. 2005-126.

In the earliest case, *Estate of Schauerhamer*, the decedent deposited income from partnership assets into her personal bank account and failed to keep any partnership books and records. The Tax Court held that the amount of the partnership transfer was includible in her estate under § 2036(a).

Similarly, in *Estate of Reichardt*, the donor commingled personal funds and continued to use the personal residence, which he had contributed to the partnership, without paying rent. The donor also continued to manage the assets in the same way as he did before the transfer, with sole authority to sign partnership checks and documents. The Tax Court held that the assets transferred were includible in his estate under § 2036(a).

In *Estate of Harper*, the taxpayer commingled personal funds, delayed in transferring funds to the partnership, and made disproportionate distributions to the donor. The Tax Court held that the amount of the transfers was includible in the estate under § 2036(a).

In *Estate of Abraham*, the Tax Court held that transfers of real property to three family limited partnerships were includible under § 2036, because there was an agreement among the siblings that the decedent's need for support would come first from the family limited partnerships. The children so testified in Court and the agreements worked out with the approval of the Probate Court during decedent's guardianship so provided.

Next, in *Estate of Lea Hillgren*, the decedent created a family limited partnership with her brother five months before she committed suicide. The assets were subject to a

business loan arrangement, under which the decedent's brother retained a 25% interest in the partnership, plus a 29-year right to determine whether any of the properties could be sold. Although the Tax Court accepted the business loan agreement as a factor in reducing the value of the real properties, it held that, under § 2036, the properties were brought back into the decedent's estate.

During the five-month period the family limited partnership was in existence, the decedent continued to operate the properties as if they were owned by her sole proprietorship, Shell Properties; continued the Shell Properties bank account to deposit partnership income; and continued to execute leases and contracts in the name of Sea Shell. The Tax Court held, on these facts, that the family limited partnership should be disregarded for estate tax purposes.

In a more recent case, *Estate of Thompson*, the Court held that the transfer was includible under § 2036(a) because the decedent contributed almost all his property to the family limited partnership, and the partnership continued to distribute funds to Mr. Thompson after formation to enable him to continue his lifestyle, including the making of annual exclusion gifts. One of the family limited partnerships loaned money to family members, who made interest payments late or not at all, and who had their loans reamortized.

The Tax Court concluded Mr. Thompson had an implied agreement to receive the income from the partnership as long as he lived, even though he lived only two years after formation of the partnership.

Estate of Thompson was recently affirmed on appeal in the Third Circuit, *Turner v. Commissioner*, 382 F.3rd 367 (3rd Cir. 9-1-2004). The Third Circuit stated that a diminution of value did not automatically rule out an "adequate and full consideration" exception for purposes of § 2036, but that in family limited partnerships there was a "heightened scrutiny" of the actual substance of the transaction. The Third Circuit held that there was no adequate and full consideration exception under these facts, where the donor transferred marketable securities to two family limited partnerships, which did not operate legitimate businesses.

The Third Circuit acknowledged there was some economic activity in the Turner partnership; however, these transactions did not rise to the level of legitimate business operations. The "Lewisville properties" business activity was overwhelmed by the testamentary nature of the transfers and subsequent operation of the partnership.

Two cases, *Strangi* and *Kimbell*, have ignited a storm of controversy in the estate planning community.

At his death, Mr. Strangi owned a 99% interest in a family limited partnership, SFLP, which had been formed two months before death, and a 47% interest in Stranco, a family corporation which owned a 1% general partnership interest in SFLP. In the initial

opinion, the Tax Court refused to consider the § 2036 argument, because it was not raised timely. However, the Court indicated in dicta that § 2036 might apply where the decedent owned a general partnership interest sufficient to terminate the family limited partnership.

On appeal, the Fifth Circuit determined that the respondent's § 2036 argument was timely raised, and remanded the case for consideration of the argument. **Gulig v. Commissioner, 293 F.3rd 279, 2002-USTC Para 60,441 (5th Cir. 2002).**

On remand, Judge Cohen held that the respondent showed by a preponderance of the evidence that Mr. Strangi retained the right to the income from, and the economic enjoyment of the mostly passive assets transferred to SFLP. Respondent had the burden of proof since the statutory notice failed to raise the § 2036 issue. The reasons enumerated by Judge Cohen were:

- Mr. Strangi transferred 98% of his assets to the family limited partnership;
- Mr. Strangi continued to live in the residence after he contributed it to the partnership;
- The pro rata distributions to Stranco were de minimis;
- The partnership expended funds in response to a need from Mr. Strangi or his estate, such as paying for funeral expenses, nursing care, estate taxes, and for back surgery for a nursing aide; and
- Mr. Strangi retained the income through his Power of Attorney, Mr. Gulig.

Further, after holding that § 2036(a)(1) applied to the transaction, Judge Cohen also held that § 2036(a)(2) applied to the transaction, as well.

Section 2036(a)(2) provides inclusion in the estate of any transfer for which the decedent retained during life 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.

Since Mr. Strangi retained the right to revoke the partnership agreement and accelerate the present enjoyment of the assets, the decedent retained a right to designate the persons that would enjoy the property, thus causing inclusion under 2036(a)(2).

The Tax Court distinguished the holding in **U.S. v. Byrum, 408 U.S. 125 (1972), rehearing denied 409 U.S. 898 (1972)**, where the Supreme Court held that management powers subject to the business world were not within the contemplation of § 2036(a)(2), since here, the decedent's powers went beyond mere management, since there were no operating businesses, no independent trustees, and no fiduciary duties to third parties.

In summary, the facts in **Strangi** that led to an application of § 2036 were:

- A majority of the decedent's assets were transferred to the family limited partnership;
- The decedent continued to occupy the transferred residence;
- Personal and entity assets were commingled;
- There were disproportionate distributions of partnership assets for personal purposes of the decedent; and
- The family limited partnership had testamentary characteristics.

However, in another hotly debated decision, *Kimbell v. Commissioner*, an appeal of a Texas District Court granting a motion for summary judgment in favor of the respondent, the Fifth Circuit held that Mrs. Kimbell's transfer of assets to a family limited partnership was not includible under § 2036(a), because the evidence showed that the "bona fide sale for adequate and full consideration" exception to § 2036(a) applied.

Mrs. Kimbell had formed a family limited partnership in January 1998, with \$2.5 million in assets, transferring a 99% limited partnership interest to her revocable trust, and a 1% general partnership interest to a corporation, which was held 25% by decedent's son, 25% by decedent's daughter-in-law, and 50% by the trust. Decedent, who retained \$450,000 outside the partnership, thus owned 99.5% of the family limited partnership. Mrs. Kimbell died two months later, at age 96.

In upholding the respondent's motion for summary judgment, the Northern District of Texas found, as a matter of law, that § 2036 applied to the transfer (even though there was no gift), and a transfer of assets for a limited partnership interest is not a bona fide sale.

On appeal, the Fifth Circuit reversed the District Court. In making its determination, the Court relied upon the following:

- Whether the interest credited to each of the partners was proportionate to the fair market value of the assets each partner contributed to the partnership;
- Whether the assets contributed by each partner to the partnership were properly contributed to the respective capital accounts of the partnership; and
- Whether on termination or dissolution of the partnership the partners were entitled to distributions from the partnership in amounts equal to their respective capital accounts.

The Fifth Circuit held that these tests were met under the uncontroverted facts, citing the following:

- Mrs. Kimbell retained sufficient assets outside the partnership for her own purposes;

- The partnership formalities were satisfied and the assets contributed to the partnership were actually assigned to the partnership; and
- The assets contributed to the partnership included working oil and gas interests.

In two very recent Tax Court decisions, the Court articulated another test for the existence of the “bona fide sale” exception to § 2036: the business purpose test; that is, whether the transfer of the property was made for a legitimate nontax purpose. This test was first enunciated in *Bongard, 124 T.C. No. 8 (2005)* and again addressed in *Bigelow, T. C. Memo. 2005-65*.

In *Bongard*, the taxpayer created an irrevocable trust (called the “ISA Trust”), funded with shares of stock in his closely held corporation, Empak, in 1980. On December 28, 1996, the taxpayer formed WCB Holdings, and he and the ISA Trust transferred their Empak stock to WCB in exchange for Class A governance (voting) units, Class A financial units, Class B governance units, and Class B financial units. The transfer was proportionate to their stock ownership.

On December 29, 1996, the taxpayer and ISA Trust created the Bongard Family Limited Partnership. Mr. Bongard transferred all his WCB Class B governance and financial units to the Bongard Family Limited Partnership (“BFLP”) in exchange for a 99% limited partnership interest. ISA Trust transferred Class B WCB units in exchange for a 1% general partnership interest. The exchange was proportionate to the partners’ interests.

On December 10, 1997, the taxpayer gave his wife a 7.72% interest in BFLP. On November 16, 1998, Mr. Bongard died suddenly at the age of 58.

The Government argued the Empak stock transferred to WCB was includible in the gross estate under §§ 2035, 2036(a), and 2036(b). The taxpayer argued the transfer was not includible under the bona fide sale exception to § 2036.

The Court held the first transfer of Empak to WCB met the bona fide sale exception, but the second transfer of WCB to BFLP did not. The Court stated that part of the “bona fide sale” test was whether there was a bona fide nontax reason for creating the family limited partnership. Although the taxpayer argued several nontax reasons for forming BFLP, such as creditor protection, ease of giving, and opportunity to give children investment experience, the Court did not accept those reasons. The Tax Court emphasized that BFLP never diversified its assets during decedent’s life, never had an investment plan, and never functioned as a business enterprise or otherwise had any meaningful economic activity.

There were several dissents; most notably arguing that the “bona fide nontax reason” test should not be a part of the bona fide sale exception to § 2036; however, it appears that the Tax Court has accepted the existence of this test in *Bigelow*, decided in March, 2005.

In *Bigelow*, the decedent owned property which she transferred to a family limited partnership at the age of 85, after she suffered a stroke and moved to an assisted living residence. She did not retain enough assets to pay for her living expenses, and, in fact, her son, who was executor and attorney in fact, made 40 transfers between the partnership and her trust to pay for living expenses. The Court found that there was an implied agreement for use of the assets during the decedent's lifetime, and included the assets in the estate under § 2036.

In deciding whether the transfer of the decedent's property to the family limited partnership was a bona fide sale, the Court held, citing *Bongard*, that the sale must be made for a legitimate nontax purpose. The Court found that the transaction was not made in good faith, and so the bona fide sale exception did not apply.

In the *Korby* cases, the Tax Court held that there was an implied agreement for the family limited partnership to support the decedents during their lifetime, where the decedent's living trust (the general partner of the family limited partnership), paid nursing home expenses, claiming they were management expenses.

In the *Schutt* case, the primary issue was whether the fair market value of stock the decedent had contributed through a revocable trust into two business trusts was includable in his gross estate. The Tax Court found for the petitioners in this case, determining that the transfers to the business trusts were bona fide sales for adequate and full consideration for purposes of §§ 2036(a) and 2038. Petitioners had contended in this case, that the predominant motive for the creation of the business trusts was to perpetuate the decedent's buy and hold investment philosophy rather than estate tax savings.

Issue 3

Whether there is an indirect gift of the underlying assets, rather than the family limited partnership interests, where the transfers of assets to the family limited partnership (funding) occurred either before, at the same time, or after the gifts of the limited partnership interests were made to family members.

Compliance Position

Under current case law, transfers of assets to a family limited partnership after transfers of limited partnership interests were made to family members are indirect gifts and subject to the gift tax provisions of the Internal Revenue Code.

Taxpayer's Position

Transfers of assets to a family limited partnership after transfers of the limited partnership interests themselves are actually transfers of partnerships interests.

Discussion

In the case of *Shepherd v. Commissioner*, 115 T.C. 376 (2000), *aff'd* 283 F.3d 1258 (11th Cir. 2002), *rehearing, en banc, denied* 2002 U.S. App. LEXIS 14147 (2002), the Eleventh Circuit upheld a Tax Court decision holding that Mr. Shepherd made an indirect gift to his children where he created a family limited partnership on August 1, 1991, transferring two 25% interests in same to his two children. Thereafter, on August 30, 1991, the taxpayer conveyed by recorded deed a fee simple interest in timberland, and on September 9, 1991, the taxpayer conveyed bank stock to the partnership. The Tax Court determined that the actual gift was a gift of land, and valued the gift as such, without discounting the transfer as a partnership interest.

This same result was reached in *Senda v. Commissioner*, T.C. Memo. 2004-160, *aff'd* 2006 U.S. App. LEXIS 254 (8th Cir. 2006), where the taxpayer formed a family limited partnership in 1996, but did not fund it until 1998. The children's transfers were purportedly held for them in trust, but there was no written trust agreement. Further, the certificates of limited partnership reflecting the transfers were not prepared and signed until several years after the transfer.

Quoting *Shepherd*, where the contributions were allocated pro rata to the noncontributing partners, the Tax Court held that the gifts were indirect transfers, since it was unclear whether the taxpayer's contributions of stock to the family limited partnership were ever reflected in their capital accounts. The Court noted that the funding and gifting were integrated and in effect simultaneous. The Circuit Court agreed that these were integrated steps of a single transaction (the step-transaction doctrine).

Issue 4

Whether an accuracy-related penalty under I.R.C. § 6662 is applicable to any portion of the deficiency.

I.R.C. § 6662 imposes an accuracy-related penalty of 20% of the underpayment of tax attributable to, among other things: (1) negligence or disregard of rules or regulations and (2) any substantial valuation understatement. A penalty of 40% applies if the underpayment is attributable to a gross valuation understatement. Treas. Reg. § 1.6662-2(c) provides that there is no stacking of the accuracy related penalty components. Thus, the maximum accuracy-related penalty imposed on any portion of an underpayment is 20% (40% in the case of a gross valuation understatement), even if that portion of the underpayment is attributable to more than one type of misconduct

(e.g., negligence and substantial valuation understatement). See *DHL Corp. v. Commissioner*, T.C. Memo. 1998-461. *aff'd in part and rev'd on other grounds, remanded*, 285 F.3d 1210 (9th Cir. 2002) (either the 40 percent accuracy-related penalty attributable to a gross valuation misstatement under section 6662(h) or the 20 percent accuracy-related penalty attributable to negligence is applicable). The accuracy-related penalty provided by section 6662 does not apply to any portion of an underpayment on which a penalty is imposed for fraud under section 6663. I.R.C. § 6662(b).

The penalty applies only when a tax return is filed. I.R.C. § 6664 (b). There is an exception to the imposition of accuracy related penalties where there was reasonable cause for, and the taxpayer acted in good faith with respect to, such understatement. I.R.C. § 6664 (c)(1).

Compliance Position

In certain family limited partnership cases where the valuation discounts claimed are egregious, Compliance may argue that a penalty applies pursuant to § 6662(g) or § 6662(h)(2)(C). If there is evidence of negligence, Compliance also may conclude that a penalty applies, pursuant to § 6662(c).

If multiple provisions of § 6662 are raised, normally Compliance lists substantial or gross valuation understatement as its primary position and negligence as its alternative position.

Taxpayer's Position

Taxpayers typically argue that no accuracy related penalty applies due to the reasonable cause exceptions provided for in the law and regulations.

Discussion

Whether accuracy related penalties apply to cases involving family limited partnerships must be determined on a case-by-case basis depending on the specific facts and circumstances of the taxpayer. The application of any penalty must be based upon a comparison of the facts developed with the legal standard for the application of the penalty. Compliance should accordingly ensure that the scope of their factual development encompasses those matters relevant to any penalties proposed.

Negligence

I.R.C. § 6662(c) provides for a 20% penalty for negligence when the taxpayer fails to make a reasonable attempt to comply with the provisions of the Internal Revenue Code or to exercise ordinary and reasonable care in the preparation of a tax return.

See I.R.C. § 6662(c) and Treas. Reg. § 1.6662-3(b)(1). Negligence also includes the failure to do what a reasonable and ordinarily prudent person would do under the same circumstances. See *Marcello v. Commissioner*, 380 F.2d 499, 506 (5th Cir. 1967), *aff'g*, 43 T.C. 168 (1964); *Neely v. Commissioner*, 85 T.C. 934, 947 (1985). Treas. Reg. § 1.6662-3(b)(1)(ii) provides that negligence is strongly indicated where a taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit, or exclusion on a return that would seem to a reasonable and prudent person to be "too good to be true" under the circumstances.

A return position that has a reasonable basis is not attributable to negligence. Treas. Reg. § 1.6662-3(c). A reasonable basis is a relatively high standard of tax reporting, one significantly higher than not frivolous or not patently improper. Thus, the reasonable basis standard is not satisfied by a return position that is merely arguable or colorable. Conversely, under Treas. Reg. § 1.6662-3(b)(3), a return position is reasonable where it is based on one or more of the authorities listed in Treas. Reg. § 1.6662-4(d)(3)(iii), taking into account the relevance and persuasiveness of the authorities and subsequent developments, even if the position does not satisfy the substantial authority standard defined in Treas. Reg. § 1.6662-4(d)(2).

The phrase "disregard of rules and regulations" includes any careless, reckless, or intentional disregard of rules and regulations. The term "rules and regulations" includes the provisions of the Internal Revenue Code and revenue rulings or notices issued by the IRS and published in the Internal Revenue Bulletin. Treas. Reg. § 1.6662-3(b)(2). A disregard of rules or regulations is "careless" if the taxpayer does not exercise reasonable diligence in determining the correctness of a position taken on its return that is contrary to the rule or regulation. A disregard is "reckless" if the taxpayer makes little or no effort to determine whether a rule or regulation exists, under circumstances demonstrating a substantial deviation from the standard of conduct observed by a reasonable person. Additionally, disregard of the rules and regulations is "intentional" where the taxpayer has knowledge of the rule or regulation that it disregards. Treas. Reg. § 1.6662-3(b)(2).

The accuracy-related penalty for disregard of rules and regulations will not be imposed on any portion of underpayment due to a position contrary to rules and regulations if: (1) the position is disclosed on a properly completed Form 8275 or Form 8275-R (the latter is used for a position contrary to regulations); and (2), in the case of a position contrary to a regulation, the position represents a good faith challenge to the validity of a regulation. This adequate disclosure exception applies only if the taxpayer has a reasonable basis for the position and keeps adequate records to substantiate items correctly. See Rev. Proc. 2002-66, 2002-2 C.B. 724.

Substantial or Gross Estate or Gift Tax Valuation Understatement

I.R.C. § 6662(g) provides for a penalty equal to 20% of the underpayment of estate or gift tax attributable to a substantial valuation understatement.¹ There is a substantial estate or gift tax understatement if the value of any property claimed on the return of tax imposed by Subtitle B is 50% or less of the amount determined to be the correct amount of such valuation. I.R.C. § 6662(g)(1). I.R.C. § 6662(h)(2)(C) provides for a penalty equal to 40% of the underpayment of estate or gift tax attributable to a gross valuation understatement. There is a gross valuation misstatement if the value of any property claimed on a return is 25% or less of the amount determined to be the correct amount of such valuation. In both instances, the portion of the underpayment attributable to the valuation understatement must exceed \$5,000.

The determination of whether the percentage and dollar thresholds for a substantial or gross valuation misstatement have been reached is made on a property by property basis. The understatement percentage is calculated by dividing the value of the property reported on the return by the corrected value of the property. See I.R.M. 20.1.5.11.2. Treas. Reg. § 1.6664-3 describes the ordering rules for determining the underpayment on which the penalty is imposed.

The Reasonable Cause Exception

The accuracy-related penalty does not apply to any portion of an underpayment with respect to which it is shown that there was reasonable cause and that the taxpayer acted in good faith. I.R.C. § 6664(c)(1). The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. Treas. Reg. § 1.6664-4(b)(1) and (f)(1). Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability. See Treas. Reg. § 1.6664-4(b).

In the case of a family limited partnership, the taxpayer will often have relied upon the advice of an attorney, accountant, appraiser, or a combination thereof, for assistance in establishing and funding the family limited partnership. Accordingly, in the majority of cases, the relevant inquiry for the imposition of any accuracy related penalty is whether the taxpayer's reliance was reasonable and in good faith.

All relevant facts, including the nature of the transaction or investment, the complexity of the tax issues, issues of independence of a tax advisor, the competence of a tax advisor, the sophistication of the taxpayer, and the quality of an opinion, must be developed to determine whether the taxpayer was reasonable and acted in good faith. Circumstances that may suggest reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of the facts, including the

¹ For purposes of I.R.C. § 6662, the term "underpayment" is generally the amount by which the taxpayer's correct tax is greater than the tax reported on the return. I.R.C. § 6664(a).

experience, knowledge, sophistication, and education of the taxpayer. The taxpayer's mental and physical condition, as well as sophistication with respect to the tax laws, at the time the return was filed, is relevant in deciding whether the taxpayer acted with reasonable cause. See Kees v. Commissioner, *T.C. Memo. 1999-41*. If the taxpayer is misguided, unsophisticated in tax law, and acts in good faith, a penalty is not warranted. See Collins v. Commissioner, *857 F.2d 1383, 1386 (9th Cir. 1988)*.

In order for reliance on a tax advisor to constitute reasonable cause, the taxpayer must have acted in good faith and made full disclosure of all relevant facts to the advisor. In Long Term Capital Holdings v. United States, *330 F. Supp.2d 122, 199 (D. Conn. 2004)*, *aff'd 2005 U.S. App. LEXIS 20988 (2005)*, the Court relied upon the following points in making its determination that it did not rely in good faith upon its professional opinions:

- There was no corroborative evidence to support the existence, timing, and nature of the advice;
- The written advice was not received timely, before the tax return was filed;
- There were no substantive citations to relevant legal authority;
- The opinion did not contain reasonable legal assumptions; and
- The clarity, specificity, and legal depth of the analysis were lacking.

In one of the most comprehensive analysis of reasonable cause and reliance on a tax advisor, Neonatology Associates P.A. v. Commissioner, *115 T.C. 43, 99 (2000)*, *motion granted 293 F.3d 128 (3d Cir. 2002)*, *aff'd, 299 F.3d 221 (3d Cir. 2002)*, the Tax Court articulated a three-prong test to establish a reasonable cause defense: (1) the adviser was a competent professional who had sufficient expertise to justify reliance; (2) the taxpayer gave to the adviser the necessary and accurate information; and (3) the taxpayer actually relied in good faith on the adviser's judgment.

While case law involving the reliance of a tax advisor in the estate and gift context is rather limited, in Estate of Monroe v. Commissioner, *104 T.C. 352 (1995)* *rev'd in part remanded in part 124 F.3d 699 (5th Cir. 1997)*, the Tax Court held reliance on a qualified adviser did not constitute reasonable cause where the estate failed to advise the accountants of certain cash gifts to beneficiaries that equaled renounced bequests. See also Estate of Sylvia Goldman, *71 T.C. Memo. 1996-29* (I.R.C. § 6662 penalty upheld where it was not shown that the accountant was furnished with all the information necessary to prepare an accurate return). In contrast, in Streber v. Commissioner, *138 F.3d 216 (5th Cir. 1998)*, *citing Reser v. Commissioner*, *112 F.3d 1258, 1251 (5th Cir 1995)*, the Fifth Circuit reversed the Tax Court and held that two daughters reasonably relied upon the advice of a tax professional in connection with a transfer by their father of two \$2,000,000 promissory notes in 1981, which were paid off in 1985. The daughters did not report capital gain on the transaction, arguing that they consulted an "advisor" who advised that the notes were neither

income nor a gift. At the time of the transaction, the daughters were teenagers, and their lack of sophistication appears to have been a factor.

Factors to be considered in determining reasonable cause and good faith with respect to an appraisal include: (1) the methodology and assumptions underlying the appraisal; (2) the appraised value; (3) the circumstances under which the appraisal was attained; and (4) the appraiser's relationship to the taxpayer. Treas. Reg. § 1.16664-4(b)(1). In *Estate of Schauerhamer*, 73 T.C.Memo. 2855 (1997), the Court held that the taxpayer reasonably relied upon the appraiser, although there was no significant discussion of the details of the appraisal or the methods used by the appraiser. The complete failure to have an appraisal evidences a lack of reasonable cause and good faith. See *Estate of H.A. True, Jr., Deceased, H.A. True, III, Personal Representative, and Jean D. True et. al. v. Commissioner*, T.C. Memo. 2001-167, (Tax Court upheld the penalty on the understatement of tax attributable to substantially and grossly undervalued assets because the executors did not engage the services of an appraiser).

SETTLEMENT GUIDELINES

General Comments – Duty of Consistency

In a recent case, *Janis v. Commissioner*, T.C. Memo. 2004-117, the taxpayer used the undiscounted basis for determining cost of goods sold in an art inventory, even though a heavily discounted basis was used when valuing the art inventory for estate tax purposes. The Tax Court held that, under a duty of consistency, the taxpayer was required to use the same basis for estate and income tax reporting purposes. The three tests of the taxpayer's duty of consistency were: (1) the taxpayer made a representation of fact or reported an item for tax purposes in one tax year; (2) the Commissioner acquiesced in or relied on that fact for that year; and (3) the taxpayer desires to change the representation previously made in a later tax year after the earlier year has been closed by the statute of limitations.

Settlement Guidelines for Issue 1

With the three decisions of *McCord*, *Lappo*, and *Peracchio*, it is obvious that the Tax Court has become increasingly sophisticated in its analysis and valuation of passive asset family limited partnership interests.

The Appeals Officer should carefully review the taxpayer's appraisal for comparability and such factors as (among others):

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While these factors will vary with the risk inherent in the type of investment and overall market forces,

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For those family limited partnerships consisting mostly of cash or cash equivalents,

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While this is contra to the recent Tax Court decision of Estate of Webster E. Kelley v. Commissioner, (where the Court allowed a minority interest discount of 12% and a marketability discount of 23% on a family limited partnership funded with cash and certificates of deposit), that case can be strongly criticized because both sides used closed-end securities funds as comparable to cash. Money Market funds would be a more appropriate comparable. As previously stated, this case is an anomaly for several reasons both factually and administrative, and should not be considered in determining the minority and marketability interest discounts applicable for similarly funded family limited partnerships.

With respect to the lack of marketability discount, the studies relied upon by the appraiser should be carefully considered, especially with regard to how current the data is used in the report.

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Settlement Guidelines for Issue 4

The IRS has adopted a policy with respect to penalties that applies to all functions. Penalties must be considered on their own merits. It is never appropriate to "trade" any amount of an appropriate penalty for a concession by the taxpayer of the underlying issue.

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Based upon the reasoning in the court cases cited above, the absence of an appraisal, or an unreasonable reliance on an appraisal that takes an egregious discount, the taxpayer may be subject to a penalty under § 6662,

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The Appeals Officer, in making a hazards of litigation determination of the penalty, should carefully evaluate the taxpayer's reliance on the professional appraisal for:

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The application of the § 6662 penalty may be seen in the following examples. For purposes of these examples, it is assumed that the family limited partnership is recognized as a valid partnership and is not deemed to be a sham.

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Example #1: The taxpayers, husband and wife, form a family limited partnership and transfer miscellaneous assets into a family limited partnership. Pursuant to certain tax advice from their estate planning attorney, the taxpayers make certain gift transfers to their children. All the formalities of a partnership are observed. An appraisal is conducted by a member of the taxpayers' family, and without citing any methodology, the appraiser provides his opinion that the family limited partnership interests should be discounted by _____ because of a lack of marketability and minority interest. An appraiser for the Government is retained, who opines that the applicable discount should be

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Example #2: The taxpayers, husband and wife, contribute cash and certificates of deposit to a family limited partnership classified as an investment company. Pursuant to advice from a certified public accountant, certain gift transfers are made to the taxpayers' grandchildren. All the formalities of a partnership are observed. An

independent appraiser is retained and, using an IPO approach which compares the private-market price of shares sold before a company goes public with the public-market price obtained in the initial public offering of the shares, the appraiser concludes that a lack of marketability discount of _____ applies. An appraiser for the Government, using a restricted stock approach which compares the private-market price of restricted shares of public companies with their coeval public-market price, concludes that a lack of marketability discount applies.

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Example #3: Pursuant to advice from their tax attorney, the taxpayers, husband and wife, form a family limited partnership consisting of 100 units of ownership and convey real property and financial assets to the partnership. The partnership makes certain financial investments, including significant investments in bonds and treasury notes. All of the formalities of a partnership are observed. An independent appraiser is retained. Using well-recognized methodology, the appraiser discounts the value of the gifts based on (1) a portfolio discount which

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EXHIBIT III

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Certain Estate Tax Relief Act of 2009 (Introduced in House)

HR 436 IH

111th CONGRESS

1st Session

H. R. 436

To amend the Internal Revenue Code of 1986 to repeal the new carryover basis rules in order to prevent tax increases and the imposition of compliance burdens on many more estates than would benefit from repeal, to retain the estate tax with a \$3,500,000 exemption, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

January 9, 2009

Mr. POMEROY introduced the following bill; which was referred to the Committee on Ways and Means

A BILL

To amend the Internal Revenue Code of 1986 to repeal the new carryover basis rules in order to prevent tax increases and the imposition of compliance burdens on many more estates than would benefit from repeal, to retain the estate tax with a \$3,500,000 exemption, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the 'Certain Estate Tax Relief Act of 2009'.

SEC. 2. RETENTION OF ESTATE TAX; REPEAL OF CARRYOVER BASIS.

(a) In General- Subtitles A and E of title V of the Economic Growth and Tax Relief Reconciliation Act of 2001, and the amendments made by such subtitles, are hereby repealed; and the Internal Revenue Code of 1986 shall be applied as if such subtitles, and amendments, had never been enacted.

(b) Sunset Not To Apply- Section 901 of the Economic Growth and Tax Relief Reconciliation Act of 2001 shall not apply to title V of such Act.

(c) Conforming Amendments- Subsections (d) and (e) of section 511 of the Economic Growth and Tax Relief Reconciliation Act of 2001, and the amendments made by such subsections, are hereby repealed; and the Internal Revenue Code of 1986 shall be applied as if such subsections, and amendments, had never been enacted.

SEC. 3. MODIFICATIONS TO ESTATE TAX.

(a) \$3,500,000 Exclusion Equivalent of Unified Credit- Subsection (c) of section 2010 of the Internal Revenue Code of 1986 (relating to applicable credit amount) is amended by striking all that follows 'the applicable exclusion amount' and inserting '. For purposes of the preceding sentence, the applicable exclusion amount is \$3,500,000.'

(b) Freeze Maximum Estate Tax Rate at 45 Percent; Restoration of Phaseout of Graduated Rates and Unified Credit-

(1) Paragraph (1) of section 2001(c) of such Code is amended by striking the last 2 items in the table and inserting the following new item:

 `Over \$1,500,000 \$555,800, plus 45 percent of the excess of such amount over

(2) Paragraph (2) of section 2001(c) of such Code is amended to read as follows:

`(2) PHASEOUT OF GRADUATED RATES AND UNIFIED CREDIT- The tentative tax determined under paragraph (1) shall be increased by an amount equal to 5 percent of so much of the amount (with respect to which the tentative tax is to be computed) as exceeds \$10,000,000. The amount of the increase under the preceding sentence shall not exceed the sum of the applicable credit amount under section 2010(c) and \$119,200.'

(c) Effective Date- The amendments made by this section shall apply to estates of decedents dying, and gifts made, after December 31, 2009.

SEC. 4. VALUATION RULES FOR CERTAIN TRANSFERS OF NONBUSINESS ASSETS; LIMITATION ON MINORITY DISCOUNTS.

(a) In General- Section 2031 of the Internal Revenue Code of 1986 (relating to definition of gross estate) is amended by redesignating subsection (d) as subsection (f) and by inserting after subsection (c) the following new subsections:

`(d) Valuation Rules for Certain Transfers of Nonbusiness Assets- For purposes of this chapter and chapter 12--

`(1) IN GENERAL- In the case of the transfer of any interest in an entity other than an interest which is actively traded (within the meaning of section 1092)--

`(A) the value of any nonbusiness assets held by the entity shall be determined as if the transferor had transferred such assets directly to the transferee (and no valuation discount shall be allowed with respect to such nonbusiness assets), and

`(B) the nonbusiness assets shall not be taken into account in determining the value of the interest in the entity.

`(2) NONBUSINESS ASSETS- For purposes of this subsection--

`(A) IN GENERAL- The term `nonbusiness asset' means any asset which is not used in the active conduct of 1 or more trades or businesses.

`(B) EXCEPTION FOR CERTAIN PASSIVE ASSETS- Except as provided in subparagraph (C), a passive asset shall not be treated for purposes of subparagraph (A) as used in the active conduct of a trade or business unless--

`(i) the asset is property described in paragraph (1) or (4) of section 1221(a) or is a hedge with respect to such property, or

`(ii) the asset is real property used in the active conduct of 1 or more real property trades or businesses (within the meaning of section 469(c)(7)(C)) in which the transferor materially participates and with respect to which the transferor meets the requirements of section 469(c)(7)(B)(ii).

For purposes of clause (ii), material participation shall be determined under the rules of section 469(h), except that section 469(h)(3) shall be applied without regard to the limitation to farming activity.

`(C) EXCEPTION FOR WORKING CAPITAL- Any asset (including a passive

asset) which is held as a part of the reasonably required working capital needs of a trade or business shall be treated as used in the active conduct of a trade or business.

`(3) PASSIVE ASSET- For purposes of this subsection, the term `passive asset' means any--

`(A) cash or cash equivalents,

`(B) except to the extent provided by the Secretary, stock in a corporation or any other equity, profits, or capital interest in any entity,

`(C) evidence of indebtedness, option, forward or futures contract, notional principal contract, or derivative,

`(D) asset described in clause (iii), (iv), or (v) of section 351(e)(1)(B),

`(E) annuity,

`(F) real property used in 1 or more real property trades or businesses (as defined in section 469(c)(7)(C)),

`(G) asset (other than a patent, trademark, or copyright) which produces royalty income,

`(H) commodity,

`(I) collectible (within the meaning of section 401(m)), or

`(J) any other asset specified in regulations prescribed by the Secretary.

`(4) LOOK-THRU RULES-

`(A) IN GENERAL- If a nonbusiness asset of an entity consists of a 10-percent interest in any other entity, this subsection shall be applied by disregarding the 10-percent interest and by treating the entity as holding directly its ratable share of the assets of the other entity. This subparagraph shall be applied successively to any 10-percent interest of such other entity in any other entity.

`(B) 10-percent INTEREST- The term `10-percent interest' means--

`(i) in the case of an interest in a corporation, ownership of at least 10 percent (by vote or value) of the stock in such corporation,

`(ii) in the case of an interest in a partnership, ownership of at least 10 percent of the capital or profits interest in the partnership, and

` (iii) in any other case, ownership of at least 10 percent of the beneficial interests in the entity.

` (5) COORDINATION WITH SUBSECTION (b)- Subsection (b) shall apply after the application of this subsection.

` (e) Limitation on Minority Discounts- For purposes of this chapter and chapter 12, in the case of the transfer of any interest in an entity other than an interest which is actively traded (within the meaning of section 1092), no discount shall be allowed by reason of the fact that the transferee does not have control of such entity if the transferee and members of the family (as defined in section 2032A(e) (2)) of the transferee have control of such entity.'

(b) Effective Date- The amendments made by this section shall apply to transfers after the date of the enactment of this Act.

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Flexible charitable vehicles. Effective financial solutions.

A professional advisor's perspective.



Throughout his years as an attorney specializing in estate planning, Chris Christ has had the opportunity to introduce many people to their community foundation as a vehicle for philanthropy. "The community foundation is more global than a single-purpose charity," says Chris. "It's a neutral party, an impartial organization, established to improve and enrich the quality of life in the community."

Flexible giving. When donors establish a fund through their community foundation, they open the door to a very broad range of charitable options. The community foundation can manage virtually any type of gift for any charitable purpose, offering everyone the opportunity to make a lasting contribution that directly benefits their community.

"Clients who voice interest in giving through a charitable trust or a private foundation accomplish many of the same objectives by using their community foundation as a vehicle," Chris explains. "Clients get the advantage of good counsel regarding local needs and community resources. They can direct funds into their own areas of interest, and make recommendations for grants to charitable agencies of their choice."

One of the advantages of the community foundation is that it "offers the donor much more flexibility in the use of their charitable dollars than a direct gift to a charity," Chris says. "Many charitable organizations encourage planned giving, but that organization is the sole beneficiary of the gift. With their community foundation, on the other hand, donors can name multiple beneficiaries."

(CONTINUED ON REVERSE)

A valuable resource

One of the advantages community foundations offer advisors is statewide access to technical resources and experienced planned giving professionals.

"Community foundations can provide information on specific types of charitable gifts, such as charitable remainder trusts," says Chris Christ. "There are some subtleties within each instrument, and being able to work with their legal counsel has been very helpful."

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