ESTATE TAX MEMORANDUM

TO: CPAs, Clients & Associates
FROM: David L. Silverman, Esq.
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DATE: April 7, 2010
RE: The IRC § 2036 Trap in Planning With FLPs & Grantor Trusts

The IRS has advanced many theories to challenge the gift and estate tax savings occasioned by the use of family entities and grantor trusts in estate planning. Until recently, most IRS arguments had been rather unsuccessful. However, the IRS discovered a potent weapon in IRC § 2036(a), which provides that the value of the gross estate includes the value of all property to the extent the decedent has made a transfer but has retained (i) the possession or enjoyment of, or the right to income from, the property, or (ii) 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.

The IRS has been successful in arguing that IRC § 2036(a) requires the inclusion in the decedent’s estate of (i) partnership assets if the decedent continued to derive benefits from the partnership, or of (ii) trust assets, if the decedent continued to receive distributions, disguised in the form of a note, from assets sold to a “defective” grantor trust. The IRS has been most successful

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where the transactions with not imbued with a sufficient quantum of non-tax objectives, or the economics of the transaction were questionable, most often because the grantor had not left himself with sufficient assets to live according to his accustomed standard without receiving partnership (or trust) distributions.

Gifts of partnership interests shift wealth and future appreciation, and are effective in transferring management and control of family businesses to younger generations. Various discounts, which reflect the lack of control and the lack of transferability of the transferred interests, as well as built-in capital gains tax liability, have enabled the estate planners to leverage both the $1 million gift tax exemption and the $2 million lifetime exemption. The largest discounts, which may exceed 50 percent, arise with respect to family entities owning real estate.

Sales to “defective” grantor trusts are useful where the size of the estate exceeds the $2 million lifetime exemption. Assets (which could include partnership interests) are sold by the grantor to the trust in exchange for a promissory note. The sale accomplishes the following: (i) the asset, as well as future appreciation, is shifted out of the estate; (ii) “leakage” back into the estate is minimized by reason of the low interest rate of the note; (iii) the obligation to pay trust income tax remains that of the grantor, thereby enabling trust assets to grow without diminution for income taxes — accomplishing a gift-tax free payment of the trust’s income tax liability by the grantor (hence, the term “defective”); and (iv) asset protection against potential creditors of the grantor and trust beneficiaries.

If discounted partnership assets are sold to the trust, the sale price — and consequently the principal amount of the note as well as interest payments — can be reduced. The reduction in purchase price will further enhance the estate planning attributes of the transaction by stemming “leakage” back into the grantor’s estate.

To illustrate, assume FLP owns appreciating real estate worth $1 million. Father sells a 50 percent limited partnership interest to family trust in exchange for a 15-year interest only, balloon principal, promissory note. The note bears interest at the AFR of 6 percent, pursuant to IRC § 1274(b). Upon the advice of appraiser, father takes a 50 percent discount for the real estate within
the FLP. Although 50 percent of the value of the real estate is $500,000, the discounted value is $250,000. Thus, the principal amount of the note is $250,000. The note requires interest in year one of $15,000, which is 6 percent of $250,000.

If the property produces annual income of 10 percent, the value of the underlying assets in the partnership interest purchased by the family trust would increase by $50,000 in year one. Since the trust is obligated to make only a $15,000 interest payment, $35,000 in growth is shifted out of the estate. Moreover, the income tax liability of the family trust — perhaps $20,000 — will be paid by father, since the trust is a wholly grantor trust with respect to father. (Although an early ruling viewed the payment by father of the income tax liability of the trust as a taxable gift to trust beneficiaries, that argument was abandoned.)

**Trend of Recent Cases**

In Estate of Stone, 86 T.C.M. (CCH) 551 (2003), the IRS argued that Stone had retained possession or enjoyment of the property that had been transferred to separate FLPs owned by Stone’s children. In rejecting the application of IRC § 2036, the Tax Court found the partnerships were the result of arm’s-length negotiations in which each child was represented by independent counsel. The transfers were motivated primarily by “investment and business concerns” and a desire to avoid litigation.

Similarly, in Estate of Kimbell, Mrs. Kimbell held most of her assets in a living trust, of which she and her son were trustees. In exchange for trust assets, the trust received a 99 percent limited partnership interest. The district court held the partnership should be ignored under IRC § 2036(a). The Fifth Circuit reversed, holding that a “bona fide sale for adequate and full consideration” precluded the application of IRC § 2036. 371 F.3d 257 (5th Cir. 2004), rev’g 244 F.Supp. 700 (N.D. Tex. 2003). “[O]bjective facts” supported the conclusion that the transfer to the partnership was a bona fide sale. Credible non-tax reasons for the partnership formation included (i) creditor protection, which could not have been accomplished with a trust; (ii) the preservation
of property as separate property for descendants, and (iii) the availability of a dispute resolution mechanism for the children.

Section 2036 may apply even in cases where no abuse has occurred. In Estate of Abraham v. Com’r, 87 T.C.M. 975 (2004), a guardian ad litem, with court approval, established an estate plan for Mrs. Abraham. The partnership agreement created pursuant to the estate plan required the partnership to “share equally any and all costs and expenses [related to] . . . the support of Ida Abraham.” Since Mrs. Abraham had been been given the legal right to continue to benefit from partnership assets, inclusion in her estate was “required.” The First Circuit affirmed. 408 F.3d 26 (2005).

Some cases seemed destined to fall prey to IRC § 2036. The Eighth Circuit recently affirmed a Tax Court decision in Estate of Korby, 98 AFTR 2d ¶ 2006-5897, aff’g T.C. Memo, 2005-103. After attending an estate planning seminar in 1993, the Korbys created FLPs into which they transferred marketable securities. A gift tax return claimed a 43.61 percent discount. The Korbys died within five months of each other in 1998. The Tax Court, finding an implied agreement that the Korbys would continue to receive distributions “as long as they needed income,” held that partnership assets were includible under IRC § 2036. The lack of a written management contract and Korby’s failure to report self-employment income were cited by the court in rejecting the management-fee claim.

Estate of Bongard, 124 T.C. No. 8 (2005), reviewed by the entire court, demonstrated that significant non-tax reasons alone will not defeat the application of IRC § 2036. The court found “legitimate and significant non-tax reason[s]” for the creation of the FLP and acknowledged that “legitimate non-tax purposes are often inextricably interwoven with testamentary objectives.” Nevertheless, since Bongard retained the practical control over the entities formed as CEO, the entire value of the partnership holdings were includible in his estate under IRC § 2036(a)(1).

In Estate of Discrow, 91 TCM 794 (2006), the decedent transferred her New York residence to a general partnership of which she, her children and her spouse, were partners. Within 30 days, she gifted her entire interest in the partnership (which owned no other assets) to the children.
Pursuant to an implied understanding, she continued to live in the residence pursuant to below-market lease agreements until her death. The residence was included in her estate under IRC § 2036(a)(1).

In Estate of Rosen, 91 TCM 1220 (2006), Rosen created an FLP to which he contributed liquid assets worth $2.4 million. The partnership was created after the decedent’s son-in-law attended an estate planning seminar. The court found the primary reason for creating the FLP was to avoid taxes and that no legitimate or significant non-tax reasons were present. There was an implied understanding that Rosen would receive partnership distributions. Since Rosen continued to “possess and enjoy the transferred assets until her death,” the entire value of the FLP was included pursuant to IRC § 2036(a)(1).

Tax Court’s holding in Rosen that partnership distributions constituted a retained interest, rather than loans (as the estate argued) makes the case relevant in the context of asset sales to grantor trusts. The IRS may attempt to recharacterize the note received from the trust as a retained equity interest in trust assets, resulting in inclusion in the grantor’s estate of all trust assets. It is therefore critical that the note be respected as debt.

Debt Versus Equity Distinction

The starting point for determining whether a note constitutes true debt or a disguised retained equity interest is Fidelity-Philadelphia Trust Co. v. Smith, 356 U.S. 274 (1958). The Supreme Court held that where a decedent transfers property in exchange for the transferee’s promise to make periodic payments to the transferor, those payments are not chargeable to the transferred property but rather constitute a personal obligation of the transferee. Accordingly, the property is not includible in the transferor’s estate under IRC § 2036(a)(1).

Miller v. Com’r, 71 T.C.M. 1674 (1996), aff’d, 113 F.3d 1241 (9th Cir. 1997) distinguished Fidelity-Philadelphia, and held that the “mere promise” to pay a sum of money in the future accompanied by an “implied understanding” that the promise would not be enforced is not evidence
of a loan. Whether a “real expectation of repayment” exists depends upon factors such as whether (i) a promissory note existed; (ii) interest was charged; (iii) any security or collateral was advanced; (iv) a fixed maturity date was present; (v) a demand for repayment was made; (vi) any actual payment was made; and (vii) the transferee had the ability to repay.

The prominence of non-tax factors in transfers to family partnerships and “defective” grantor trusts appears to be a prerequisite to establishing the legitimacy of those transfers for gift and estate tax purposes. However, as Bongard clearly demonstrates, non-tax factors alone are insufficient to prevent the inclusion of partnership or trust assets pursuant to IRC § 2036, even if the general partner or trustee has respected fiduciary obligations.

Inclusion may be nearly unavoidable if (i) the decedent continued to control partnership property or could benefit from partnership or trust distributions pursuant to an express or even an implied agreement or (ii) the other partners’ or beneficiaries’ contributions were more imaginary than real. The situation is even more precarious since even where the decedent had been punctilious, IRC § 2036 has defeated many plans which seemed sound on their face.