

## News Analysis: Business Purpose for Family Limited Partnerships?

by Lee A. Sheppard

In news analysis, Lee A. Sheppard discusses the Estate of Strangi decisions, family limited partnerships, and business purpose.

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The housing bubble may be about to burst, taking consumer spending down with it. Consumer spending has been sustained by explicit borrowing against houses and by the confidence engendered by high prices. A dampening of consumption may be good news for readers who don't want their wives and daughters to turn themselves out like some bizarre combination of rich hippie and Japanese teenager.

It may be hotter than hell outside, but it's fall in the stores. And for readers who thought the wife's new peasant skirt looked like she'd removed the dust ruffle from the bed, there's more of the same in the new fall fashions. There's embroidered velvet. There's suede. There's oversized necklaces. There are granny furs that cute little baby lambs had to die for. There's decorated hose. There's more gothic black than your correspondent wears. And all of that is to be combined with beat-up jeans that look like they protested the Vietnam war.



But most women won't be wearing that stuff. Instead, they will be coveting heavy, ugly, overdecorated handbags that cost as much as automobiles. Indeed, the "It Bag" is a car-like status symbol in that everyone knows exactly how much each one costs. That plum-colored quilted monstrosity that Uma Thurman is holding in the latest Louis Vuitton ad? Your wife wants one. (And make sure to keep your mouth shut about Uma Thurman.) Some women will be teetering around on platform shoes. (Japan has reported road accidents caused by teenage girls driving while wearing seven-inch platform shoes.)

No, designers have not taken LSD or leave of their senses. Instead they have soberly recognized that handbags carry the enterprise because they are a high-margin indulgence that does not require youth or thinness to enjoy. Moreover, other status symbols have gone downmarket. There are cheap mink coats from South Korea and glassy diamonds that two decades ago would have been drill bits. Last year, we correctly predicted the election result on the basis of women's fashions. If the rich hippie look is a political bellwether, watch for tree-hugging, antiwar, feel-good politics to rise again.

A similar recognition of reality is taking place in the confines of the U.S. Senate. Despite the protests of Senate Majority Leader William H. Frist, R-Tenn., who has challenged his colleagues to vote to repeal the hated "death tax," there is a recognition that the estate tax is not going away and that it should be fixed. Some Republicans, like Sen. Jon Kyl of Arizona, are arguing for fixing the estate tax. Indeed, if the Senate majority leader had control over his troops, he wouldn't have to be writing whiny opinion pieces for *The Wall Street Journal* editorial page, which conservatives use to communicate with each other. Frist's urgency also has to do with the House already having voted for repeal. (For coverage, see *Doc 2005-16147* [PDF], *2005 TNT 144-2* )

The sensible compromise, which this magazine predicted when the estate tax was formally repealed in 2001, would be to adjust the exemption and credit amounts so that well-off people who somehow consider themselves middle class do not owe estate tax. In financier- speak, we're talking about the core affluent (the unified credit already covers the mass affluent). Indeed, that is the deal that is taking shape in the Senate. When the exemption from tax hits \$3.5 million in 2009 -- marital deductions and other features allow tax- free transfer of roughly twice that amount -- very few American households will owe transfer tax. Kyl has proposed an \$8 million exemption and a 15 percent top rate for the estate tax, linked to the capital gains rate. Senate Finance Committee ranking minority member Max Baucus, D-Mont., has yet to make a counteroffer, despite having made an agreement in principle to make a deal. (*Doc 2005- 14884* [PDF], *2005 TNT 133-1* )

Presumably these developments will reduce demand for family limited partnerships, a tax plan mostly sold to mass affluent and core affluent owners of portfolios and houses. But fear of the "death tax" does appear to overwhelm knowledge of its provisions. It can be fairly said that Republicans would not have an issue that would resonate with average voters if the latter were well apprised of their precise chances of incurring the "death tax." Like designer handbags, which are sold on the basis of social insecurity, estate- tax-avoidance plans are sold on the basis of wealth insecurity. In either case, the customer is a mark.

So what does the Fifth Circuit's affirmation of the family limited partnership case *Estate of Strangi v. Commissioner*, Dkt. No. 03-60992 (July 15, 2005), *Doc 2005-15234* [PDF], *2005 TNT 137-12* , tell us? Well, estate planners breathed a sigh of relief that the IRS once again did not get a per se rule that these hokey deals do not work. The IRS likewise breathed a sigh of relief that the apparent damage done by *Kimbell v. United States*, 371 F.3d 257 (5th Cir. 2004), *Doc 2004-10976* [PDF], *2004 TNT 100-9* , in which the Fifth Circuit rejected the recycling theory, was limited.

In so limiting *Kimbell*, the Fifth Circuit opened the door to using business-purpose case law to effectively disregard a family limited

partnership. Four months earlier, in *Estate of Bongard v. Commissioner*, 124 T.C. No. 8, *Doc 2005-5359* [PDF], 2005 TNT 50-11 [PDF], a reviewed decision, the Tax Court made an even stronger statement about the application of the business purpose doctrine to the creation of family limited partnerships, while it bucked the *Kimbell* holding on what constitutes adequate consideration for the bona-fide-sale exception to section 2036(a). *Bongard* can be appealed to the Eighth Circuit, which is likely given that the tax deficiency is larger than most taxable estates.

So where are we now? It will be much more difficult, if not impossible, for the family limited partnership doing nothing but holding the portfolio assets of some core affluent decedent to be justified by a made-up business purpose. The business purpose inquiry comes late, after the inquiry whether the decedent retained possession and enjoyment of the transferred assets (or controlled their disposition), but the point is that it comes eventually. Estate planners have lost their bid to keep business purpose out of the evaluation of the paper transactions they create.

### Bad Facts

A year ago, we said that the *Strangi* facts were so bad that if the government couldn't win this case, it couldn't win any family limited partnership cases. Estate planners agree, arguing that family limited partnerships achieve the desired result if they are done right, and this wasn't.

The *Strangi* family limited partnership was created by the decedent's son-in-law, an estate planning lawyer, using form agreements from an estate planning boutique. Because the son-in-law was already managing the decedent's assets under a power of attorney, management of the assets underwent no practical change.

The decedent had transferred 98 percent of his assets in exchange for a 99 percent limited partnership interest. The 1 percent general interest was held by a family corporation of which the decedent was a 47 percent shareholder. His children owned the rest of the shares. A 1 percent interest in the corporation was given to a charity. The partnership held mostly cash and securities and insurance policies, but also some commercial real estate. As is typical of family limited partnership agreements, partnership distributions were entirely within the discretion of the general partner, the family corporation, which was run by the son-in-law.

The decedent was old, incapacitated, and terminally ill when the partnership was created, and he died two months later. Partnership assets were used to pay his personal living expenses, his funeral expenses, and the administrative expenses and state and federal transfer taxes of his estate. The partnership even posted bond for the estate tax dispute. The decedent and two of his daughters lived rent-free in three residences owned by the partnership. One of the decedent's daughters and two sons borrowed large amounts of cash from the partnership, both before and after his death; neither principal nor interest was ever paid. The partnership's only employee was the decedent's maid. No partnership meetings were ever held. But the books were meticulous; the partnership accrued and paid tax on interest and rent it never collected.

A year after the decedent's death, the partnership made distributions of almost half of the value of its assets to his children, including the residences occupied by the daughters. At that time the partnership's brokerage account was divided into smaller accounts so that each of the decedent's five children could separately manage his or her share of the assets. The estate asked for a roughly 40 percent valuation discount. During the short period between the creation of the partnership and the decedent's death, the partnership assets had appreciated by roughly 20 percent.

There are several *Strangi* decisions. The Fifth Circuit has just affirmed what has come to be known as *Strangi II*, T.C. Memo. 2003-145, *Doc 2003-12584* [PDF], 2003 TNT 98-16 [PDF], in which Tax Court Judge Mary Ann Cohen sustained the government's section 2036(a) argument that the decedent retained possession and enjoyment of the property so that it should be included in his estate. (For discussion of the strange *Strangi* saga, see *Doc 2004-11325* [PDF], 2004 TNT 105-2 [PDF].)

In the first *Strangi* case, the IRS unsuccessfully argued that the partnership, whose provisions the alleged partners willfully ignored, should be disregarded. The Tax Court majority, setting aside common sense, decided to give credence to the partnership on the dubious ground that its existence would not be disregarded by potential purchasers of the decedent's assets.

The estate in any family limited partnership case is arguing that because the partnership changed the *legal* relationship of the parties, it somehow changed the *value* of the contributed assets to the decedent's estate. That is nonsense. It is basically an argument that the nuisance factor of the existence of a partnership between the decedent and the natural objects of his bounty would significantly affect the price that a willing and informed buyer would pay for what are in most cases liquid, readily priced, publicly traded assets.

Nonetheless, the *Strangi I* court had methodically dismissed the alleged business purposes for forming the partnership. There were no creditors to be protected from, and no joint investment management was achieved. Why is it courts even entertain the idea that a partnership would offer any protection from creditors? The bankruptcy code takes a dim view of that idea. The only creditor the decedent was trying to protect his assets from was the tax collector.

So in *Strangi II*, after an appeal to request leave to plead a new ground, the IRS went another route to disregarding the existence of the partnership, invoking section 2036(a). Application of section 2036(a) basically says that partnership provisions that are

being ignored should not figure in the valuation of assets to be included in the decedent's estate.

Section 2036(a) provides:

The value of the gross estate shall include the value of all property to the extent of any interest therein which the decedent has at any time made a transfer (except in the case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death

(1) the possession or enjoyment of, or the right to the income from, the property, or

(2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

In *Strangi II*, Judge Cohen used the same facts that could have justified disregard of the partnership to find an implied agreement for retained possession or enjoyment under section 2036(a). She noted that the partnership's massive distributions were rationalized by accounting entries, but not repayments. She noted that the person with ultimate power over partnership distribution decisions was acting in the stead of the decedent. She concluded, "The crucial characteristic is that virtually nothing beyond formal title changed in decedent's relationship to his assets."

Judge Cohen tried to finesse her questionable prior recognition of the partnership by arguing that it had enough substance for recognition -- its books were kept in order -- but not enough for section 2036(a). Judge Cohen had a set of bad facts before her. She was loath to deny the existence of a meticulously documented partnership, for whatever reason. But then given a statute as guideline, which said that all of those same bad facts matter for what property should come into the estate, the judge saw the way to deny a valuation discount. *Kimbell*, which was decided on cross-motions for summary judgment, presented facts similar to *Strangi*. The Kimbell family limited partnership was created two months before the decedent's death at age 96. The decedent contributed 99 percent of the capital of the partnership in exchange for a limited partnership interest. A limited liability company half owned by the decedent and half owned by her son and daughter-in-law was the 1 percent general partner. The partnership assets were oil and gas rights, securities, and cash. The decedent retained sufficient assets to live on. The decedent's son managed the partnership; he was already managing the decedent's contributed property, which was held by a trust. Although distributions were in the sole discretion of the general partner, the decedent could remove the general partner.

The estate claimed a 49 percent valuation discount, invoking the bona-fide-sale exception to section 2036(a). The district court could not find any consideration for the purported sale, and it upheld the IRS's theory that the transfer was a mere recycling of the decedent's asset to an alternative testamentary vehicle. The Fifth Circuit reversed, on the theory that there has been adequate consideration for purposes of the bona-fide-sale exception to section 2036(a) as long as the gross estate has not been depleted. The court concentrated on the terms of the partnership agreement and the proper documentation without noticing that nothing had changed in the handling of the decedent's passive assets. Hokey though that was, the record contained no showing of personal use of partnership property. Both of those cases took place in Texas, where apparently every rich person has an oil well in the backyard, or owns a working interest -- a riskier limited-partnership-type interest -- in an oil well somewhere. The *Strangi* and *Kimbell* estates were mostly, but not wholly, composed of portfolio assets. The presence of working interests in oil wells allowed the *Kimbell* estate to mount a colorable argument that some business management of estate assets was necessary and could be provided by the family limited partnership. So the Fifth Circuit in *Kimbell* bought the line that the estate's working interests needed management, even though the decedent's son was already providing the necessary services.

### Disappearing Value

Such is the reluctance of the rich in the sunbelt to give the govment its due that the Fifth Circuit essentially retried the *Strangi* case. One thing is certain about family limited partnerships: In court, their proponents get vastly more process than is due. People of lesser means routinely go to jail with far less due process than millionaires get for their transfer tax bills.

The Fifth Circuit looked at the extensive record of personal use of partnership assets and concluded that the use was "substantial and present," as opposed to "speculative and contingent," under *United States v. Byrum*, 408 U.S. 125 (1972). The court agreed with the Tax Court that there was an implied agreement at the time of the transfer to allow the substantial and present use of transferred assets under reg. section 20.2036-1(a). That regulation states in pertinent part:

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.

The estate objected that most of the payments were made after the decedent's death, and the court responded that beyond-the-grave control over the monies evinced an implied agreement for possession and enjoyment. The Fifth Circuit also noted the decedent's continued rent-free occupancy of one of the transferred houses and the inadequacy of his retained assets to support his living expenses.




The Strangi estate argued the bona-fide-sale exception to section 2036(a) as interpreted in *Kimbell*, which saw it vigorously rearguing its nonsensical nontax purposes for the creation of the partnership as showing the bona fide nature of the sale.

That statutory phrase is "a bona fide sale for an adequate and full consideration in money or money's worth." The court separated it into two elements -- adequacy of consideration and genuineness of sale. That separation, which should not be allowed, permits taxpayers to have their nonsensical transfers to paper partnerships respected on the ground that the paper exchanged for valuable assets represents a proportionate interest in the partnership holding them. That is what *Kimbell* held.

The IRS inexplicably conceded the adequacy of the consideration. It probably had no other choice, given the Fifth Circuit's endorsement of the depletion argument in *Kimbell*. The court restated that rationale thus: "Where assets are transferred into a partnership in exchange for a proportional interest therein, the 'adequate and full consideration' requirement will generally be satisfied, so long as the formalities of the partnership entity are respected." In *Strangi*, however, the partnership agreement was not respected, so the IRS should not have made the concession.

The Fifth Circuit in *Kimbell* eliminated the requirement that value equal to the assets transferred show up in the decedent's estate. For this court, it was good enough that "roughly equivalent" -- that is, heavily discounted -- value show up in the estate. That is not what adequate consideration means. The court basically read the adequate consideration requirement out of the law. Perhaps the IRS decided that there was no use picking a fight about a requirement that the court did not believe exists.

Estates in family limited partnership cases try to avoid section 2036(a) by invoking the bona-fide-sale exception, while simultaneously claiming that the transfer of assets to a partnership reduces their value in the estate. Looked at from the perspective of having one's cake, the Fifth Circuit's idea that there has been no depletion of the estate on one of the family limited partnership transfers appears strained, to say the least. Other courts have tried to address the question while trying to explain *Kimbell*.

Rejected in *Kimbell*, the government's recycling theory has been endorsed by the Third Circuit in *Turner v. Commissioner*, 382 F.3d 367 (3rd Cir. 2004), *Doc 2004- 17577* [PDF], 2004 TNT 171-8 , affirming *Estate of Thompson v. Commissioner*, T.C. Memo. 2002-246, *Doc 2002-22023* [PDF], 2002 TNT 188-7 . The Third Circuit concluded that heightened scrutiny was appropriate when simultaneous claims of bona fide sale and valuation discount are being made. No previous court has been able to answer the question how there can be a sale for "adequate consideration in money or money's worth" when value disappears. (For discussion, see *Doc 2004-19377* [PDF], 2004 TNT 193-10 .)

In *Bongard*, the Tax Court majority took a much more restrictive view of the term "adequate and full consideration." (*Bongard* facts are discussed later in this article.) There has to be a nontax purpose to justify the argument that a proportionate partnership interest constitutes full value. The Tax Court, in a majority opinion written by Judge Robert Goeke, characterized the rule of law as follows:

In the context of family limited partnerships, the bona fide sale for adequate and full consideration exception is met where the record establishes the existence of a legitimate and significant nontax reason for creating the family limited partnership, 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. (Citations omitted.)

Judge David Laro, concurring in the result, disagreed with the majority's strict interpretation of adequate and full consideration. He asked for a disjunctive test: Either the transfer had a business purpose or the transferor received full value. He read the business-purpose test and *Kimbell* as allowing for intangibles that might obtain from the change of form, so that consideration need not be dollar-for-dollar. In short, business people are allowed to make real commercial deals with future yet-to-be-realized consideration.

Judge Laro also explored the question whether claimed valuation discounts should be taken into account in determining adequacy of consideration, as the *Turner* court concluded they should be. He would ask whether any difference between the value transferred and the value received was attributable to actual differences or the presence of hard-to-value intangibles. If the difference is due to the latter, according to Judge Laro, then adequate and full consideration need not be dollar-for-dollar. But there can be no adequate and full consideration if the estate was depleted by the transfer.

Judge James Halpern, concurring in part and dissenting in part, argued that the majority was putting the cart before the horse by letting the bona-fide-sale exception govern the analysis. The inquiry should start by asking whether the decedent retained lifetime

possession and enjoyment of the property. Only after that question is answered in the affirmative should the bona-fide-sale exception come into play.

In applying the bona-fide-sale exception, Judge Halpern would ask whether the transfer was made in the ordinary course of business according to reg. section 25.2512-8. That regulation states that a gift can be deemed made when there is inadequate consideration for the transfer. It excludes from gift classification transfers made in the ordinary course of business; that is, "a transaction which is bona fide, at arm's length, and free from any donative intent." Basically, it lets business people make their own business decisions and deems those transfers to have been made for adequate and full consideration. Judge Halpern's interpretation reads the estate and gift taxes provisions *in pari materia*, as they are meant to be construed. (For discussion, see [Doc 2004-14031 \[PDF\]](#), [2004 TNT 149-45](#).)

Otherwise, if the transfer was not made in the ordinary course of business, Judge Halpern would ask whether the transfer was made for full value. His full value test would be the same as the majority's -- 100 cents on the dollar. But he would test for full value without asking about the decedent's purpose for the transfer, aside from donative intent, and without asking about the proportionality of the partnership interest received. Proportionality is irrelevant, in his view, especially in the presence of donative intent.

"By the explicit terms of section 25.2512-8, the resulting inquiry is limited to an economic calculus, and there is no room for any inquiry as to the transferor's (decedent's) state of mind," Judge Halpern wrote. "Once it is determined that the transfer in question was not made in the ordinary course of business, intent is no longer relevant to the determination of whether the transfer was for full consideration."

Judge Halpern also addressed the difficult question of disappearing value, which both the Tax Court majority and the Fifth Circuit in *Strangi* ignored. How can an estate simultaneously argue that full value was received on a transfer of assets to a family limited partnership, but that those same assets are worth less than fair market value because they are in that partnership?

Readers will recall that the judges who decided *Turner* debated whether, if the estate's claim of valuation discount were to be believed, the difference between the fair market value of the transferred property and the discounted value of the partnership interest received in exchange for it should be considered a taxable gift by the decedent to the other partners. The *Turner* majority decided that adequate and full consideration had not been transferred, and left it there. The IRS resisted the idea of a gift of the disappearing value, arguing that the transfer itself was incomplete -- a valid but separate point. Judge Greenberg, who concurred in *Turner*, agreed with the IRS.

Judge Halpern would not ignore the disappearing value. "I believe that a transfer to a family-owned entity may constitute a taxable gift, even if the size of the entity interest received by each transferor is deemed proportional to the value of the property contributed by that transferor," he wrote. "It is precisely that debasement in value that [the transferor] sought to achieve as his means of generating the transfer tax saving, and it is appropriate that that be the measure of his gift." In his view, the desire to reduce estate tax was evidence of donative intent, and that the disappearing value could be reclaimed once the decedent died and the intervening entities were unwound.

What would account for the disappearing value or, more politely, the intangibles to be achieved by the change in form? Would a credible nontax reason for the formation of the partnership support the existence of those intangibles?

### **What Business Purpose?**

The Fifth Circuit next turned to the bona fide nature of the partnership transfer. Noting that "bona fide" means "in good faith," the court endeavored to keep the criteria objective, in keeping with congressional intent to remove subjective inquiries from estate planning. So relying on *Kimbell*, the court held that "a sale is bona fide if, as an objective matter, it serves a 'substantial business [or] other non-tax' purpose."

The court's trip through the alleged nontax purposes was nonetheless amusing. The decedent's maid was gonna sue for injuries sustained in taking care of him. Nope, he paid her medical expenses and salary while she was incapacitated. The decedent's second wife's children from a prior marriage were gonna contest his will. Nope, any claims they had were already stale. The pricey bank had to be discouraged from serving as executor of his will. Banks usually decline to serve when asked. The family needed a joint investment vehicle. Nope, the children's contributions were de minimis.

The commercial real estate assets needed management. Here the court differentiated *Kimbell* on the basis of its undeveloped factual record, given that it was decided on cross-motions for summary judgment. The court noted that the government had failed to challenge the Kimbell estate's assertion that there had been significant active management of the working interests. The fully developed *Strangi* record, however, showed that the partnership conducted no active business. Even though the transferred assets *might have been* actively managed, the court emphasized, "no such management ever took place." Hence active management was "objectively unlikely" as of the date of the creation of the partnership.

Although the Fifth Circuit's holding that a sale is only bona fide if it serves a business purpose is a reiteration of *Kimbell*, which

was wrongly decided on the basis of a motion for summary judgment, it is very important. The holding means that the government can get a judge to disregard a family limited partnership using the bona-fide-sale exception to section 2036(a), rather than the direct route of using the business purpose of the partnership law. Indeed, the indirect route through section 2036(a) allows the IRS to bring in business-purpose-of-the-partnership precedent. The Fifth Circuit did just that in testing the adequacy of the alleged business purposes.


The Fifth Circuit cited *Merryman v. Commissioner*, 873 F.2d 879 (5th Cir. 1989), for the need to use objective criteria to determine the parties' business purpose in setting up a partnership.

In *Merryman*, a corporation, its shareholders, and key employees formed a general partnership, the principal effect of which was to pass through to the individual partners the accrued interest deductions, investment tax credits, and depreciation deductions attributable to an oil drilling business that was being conducted and managed by the corporate general partner.

The government prevailed in its argument that the partnership should be disregarded for tax purposes. The court focused on the formation and role of the partnership and asked what the business purpose for that was, concluding that its only purpose was to create tax benefits for its partners. The partnership functioned as an instrument through which the corporation could retain control of the oil rig while passing the tax advantages on to the partners, the court found, noting the circular flow of funds.

There is precedent for the Fifth Circuit's reference to business-purpose/economic substance case law to interpret the bona-fide-sale exception in the Third Circuit's decision in *Turner*. Citing *Gregory v. Helvering*, 293 U.S. 465, 469 (1935), Chief Judge Scirica wrote in *Turner*:

A "good faith" transfer to a family limited partnership must provide the transferor some potential for benefit other than the potential *estate* tax advantages that might result from holding assets in the partnership form. Even when all the "i's are dotted and t's are crossed," a transaction motivated solely by tax planning and with "no business or corporate purpose . . . is nothing more than a contrivance."

The Tax Court has just made a stronger statement that there must be a significant nontax purpose for the creation of a family limited partnership in *Bongard*, a reviewed decision that featured four opinions. In so doing, the court supplanted the recycling theory it had adopted in *Estate of Harper v. Commissioner*, T.C. Memo. 2002-121, *Doc 2002-11394* [PDF], 2002 TNT 95-11 , which had been rejected in *Kimbell*. The court recited that it was applying the heightened scrutiny to intrafamily transactions that the Fifth Circuit called for (but did not apply) in *Kimbell*.

Bongard contributed the shares of Empak, the data storage corporation that he founded and completely controlled, to a limited liability holding company run by his son as appointed manager. A day later, he contributed his 88 percent nonvoting equity interest in the LLC to a family limited partnership in exchange for a 99 percent limited interest. His previously formed irrevocable trust contributed its voting and nonvoting equity interests in the LLC to the partnership in exchange for a 1 percent general interest. (His son and his lawyers were the trustees.) The decedent retained 86 percent of the voting interests in the LLC; the remaining 14 percent voting interest was part of the contribution by the trust to the partnership.

The decedent gave a 7 percent limited partnership interest to his second wife as part of a postnuptial agreement. He did not give any partnership interests to his children, though he did give trusts for their benefit some voting and nonvoting interests in the LLC. Empak redeemed some shares, and the LLC some units, and the children got some cash. After all the gifts, the decedent retained a 48 percent voting interest in the LLC. Two years after the formation of the partnership, the otherwise healthy Bongard died while on a hunting trip at age 58. The partnership had done precisely nothing during the two years of its existence.

The only thing in the decedent's favor was a letter to his children reciting that he'd created the partnership with the aim of making them responsible and self-sufficient. The IRS argued that the transfer was a paper transaction without substance, while the estate argued for the bona-fide-sale exception to section 2036(a). The government noted the decedent's complete control over whether Empak paid dividends or redeemed shares. The government argued that there could not be an arm's-length transaction between related parties. The government fought about the adequacy of consideration in not just the transfer to the partnership but also in the transfer to the LLC, arguing that the decedent should have received a control premium.

The court could not find any concrete intent to make further gifts in the creation of the partnership. The idea that the decedent might have made gifts of partnership interests to his children was merely speculative. There were also assertions about protection from creditors, flexibility, and management of the assets, all of which the majority summarily rejected. The court found that the decedent simply used the partnership to hold title to nonvoting LLC interests and prevented it from managing its assets.

The majority enumerated the factors that would point to the absence of a "legitimate and significant" nontax reason for creation of the partnership. The factors include: the decedent standing on both sides of the transaction; the decedent depending on distributions from the partnership to pay for living expenses; the partners treating partnership assets as their own; and any failure to transfer property to the partnership.

Sounds like a reasonable list. The trouble was, according to the four judges who dissented, that none of those bad facts was present in Bongard's case. He had plenty to live on, he made the transfer, and there were no partnership distributions. (Those factors were present in *Estate of Korby*, T.C. Memo. 2005-102 and 103, *Doc 2005-10180* [PDF], 2005 TNT 90-13 [PDF], *Doc 2005-10206* [PDF], 2005 TNT 90-14 [PDF].)

The dissenters, in an opinion by Judge Carolyn Chiechi, further objected that even though the decedent completely controlled Empak, he did not have complete control of the LLC, which could have redeemed the nonvoting interests held by the partnership. Plus there were fiduciary duties of the decedent to Empak and the general partner to the LLC that the majority ignored. As if anyone was going to sue to enforce them -- the majority found the fiduciary duty argument mooted by the lack of activity in the partnership.

The *Bongard* majority could find no nontax reason for the transfer of LLC interests to the partnership. The court thought that the initial creation of the LLC, which was created at the same time as the partnership, had a legitimate nontax purpose of raising capital. The majority concluded that the transfer to the partnership flunked the bona-fide-sale exception because of the lack of a significant nontax purpose. Then the court inferred that the decedent retained possession and enjoyment of the transferred LLC interests; that is, the court put the bona-fide-sale inquiry first. The court included the LLC interests in the estate at their full fair market value under section 2036, except for LLC interests attributable to the wife's partnership interest, which it included under section 2035 as a contemplation-of-death transfer.

Judge Halpern, who is no fan of the business-purpose doctrine, accused the majority of importing "an inappropriate motive test." He would substitute an ordinary course of business inquiry for the majority's nontax purpose inquiry. Judge Laro quibbled that the majority should have asked for a "business" purpose rather than a "legitimate and significant non-tax" purpose. (We use the terms interchangeably.) Judges Halpern and Laro were both getting at the idea that the transfer itself needed to be businesslike. The majority put the onus on the partnership creation, while Judges Halpern and Laro looked at the transfer transaction. It's all the same thing, however, when the partnership is created by the transfer.

### Return to Senda

But sometimes it isn't. The Eighth Circuit is currently busy with *Senda v. Commissioner*, T.C. Memo. 2004-160, *Doc 2004-14321* [PDF], 2004 TNT 134-11 [PDF], a gift tax case in which partnership formalities were ignored. Most practitioners would dismiss this case as yet another case of really bad facts. It is significant because it shows that taxpayers and their planners can no longer get away with open disregard for form. As we've said in other tax shelter contexts, we can't stop you from making these arrangements, but at a minimum, get the form right. You can't ask a court to respect the form if you don't.

The Sendas, a couple who were in the process of setting up a family limited partnership, didn't even bother to do that. The Sendas became suddenly rich as the result of the WorldCom-MCI acquisition of his employer. They set up a family limited partnership and filed a certificate for it, listing their minor children as beneficial owners of tiny interests held in trust. Trouble was the described trust hadn't been formed yet. Six months later, WorldCom-MCI shares were contributed to the partnership. On the same day, the Sendas gave partnership interests to their children. Their accountant had to scramble to allocate partnership interests to the children. A year later, a second partnership agreement was prepared to reflect the formation of the children's trust, but it was not properly executed. Another share transfer and gifts of partnership interests were made. No other partnership formalities were adhered to; the partnerships had no books other than brokerage statements and tax returns.

The Sendas were reduced to arguing that at the time of formation of both partnerships, the children had orally agreed to contribute undocumented accounts receivable in exchange for their partnership interests. The purported receivables remained unpaid at the time of the trial. The IRS argued that although the partnerships were properly formed under state law, the transitory allocations to the children meant they were merely vehicles to pass share ownership to the children, so it should be ignored in valuing the gifts. Tax Court Judge Cohen had no trouble giving the deal the boot, finding no evidence that the shares were contributed to the partnerships before partnership interests were given to the children. The decision is, incredibly, being appealed. (For the briefs, see *Doc 2005-12107* [PDF], 2005 TNT 107-47 [PDF], *Doc 2005-12493* [PDF], 2005 TNT 111-46 [PDF].)

The estate planners who optimistically told the general-interest newspapers that the Fifth Circuit's *Strangi II* says that family limited partnerships can achieve the desired result if done correctly are wrong. Planners want to think that the business purpose for the transfer can be minimal and built into the deal by careful lawyering. (For examples of that argument, see *Doc 2005-5964* [PDF], 2005 TNT 56-33 [PDF], *Doc 2005-7352* [PDF], 2005 TNT 74-58 [PDF].) That complacent thinking is wrong. It is no longer enough to dot the i's and cross the t's and prevent the family from making personal use of partnership assets.

The Fifth Circuit says that a family limited partnership transfer will not be respected as a bona fide sale if there is no business purpose. There never is a business purpose for the creation of family limited partnerships, for the simple reason that the core affluent class of people who create them mostly don't own businesses to which a credible business purpose can attach. If they did own a business, they would already have a more watertight estate plan, like an estate freeze or a buy-sell agreement, to achieve the desired valuation discount. Bongard had a real business, but his cold, dead hand prevented anyone else from acting on it in a way that would have established a business purpose.

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