RECENT DEVELOPMENTS IN THE FEDERAL ESTATE, GIFT AND
GENERATION–SKIPPING TRANSFER TAX AREAS
(CASE LAW DEVELOPMENTS)

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Thomas R. Pulsifer
Morris, Nichols, Arsht & Tunnell
1201 North Market Street
Wilmington, Delaware 19801
Tel: (302) 575-7226
Fax: (302) 425-4682
tpulsifer@mnat.com
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Introduction
This outline provides a brief overview of selected significant case law developments in the federal estate, gift and generation–skipping transfer tax areas occurring since the due date for written materials presented at last year’s Delaware Tax Institute (October 22, 2004) through the due date for written materials presented at this year’s Delaware Tax Institute (November 4, 2005). As has generally been the situation for a number of years, the case law developments this year primarily involve family limited partnerships and other substantially similar entities such as family limited liability companies and family business trusts (now known in Delaware as “statutory trusts”). These various entities are, for convenience, sometimes hereinafter collectively referred to as “family limited partnerships.” In view of the importance and prevalence of the family limited partnership cases, this outline is divided into two sections. The first section discusses selected family limited partnership cases. The second section discusses other case law developments.

Family Limited Partnership Cases

A. Estate of Bongard v. Commissioner, 124 T.C. 95 (March 15, 2005; amended May 24, 2005)

Overview
Assuming the Tax Court’s decision in Estate of Bongard is not reversed on appeal, the case may ultimately become the seminal decision concerning the family limited partnership estate inclusion issue. The case is a decision of the full Tax Court (except that for some reason Judge Cohen did not participate) and may fairly be viewed as the Tax Court’s
attempt to establish a definitive test for the federal estate tax treatment of interests in family limited partnerships retained by decedents.

One unfortunate aspect of the many recent decisions concerning the estate tax treatment of family limited partnerships is that the cases are difficult (some might say impossible) to reconcile. This often and probably unavoidably is the situation with decisions entered by the various District and Circuit Courts on many topics. For example, consider the Circuit Court opinions on the deductibility of investment advisor fees discussed below in the Estate of Rudkin synopsis. However, judicial inconsistency within a single court, such as the Tax Court, is a phenomenon that courts obviously strive to avoid.

The full Tax Court decision in Bongard appears to be that Court’s laudatory attempt to articulate a single and relatively succinct court-wide test for determining whether assets contributed by a decedent to a family limited partnership are includable in the decedent’s gross estate for federal estate tax purposes.

In Bongard, the Tax Court laid down a relatively simple (albeit essentially brand new) test for estate inclusion and then, by way of demonstration, twice applied the test (once leading to estate exclusion and once to estate inclusion) within the case. The case therefore both unveiled the Tax Court’s test and provided two applications of the test as illustrations of how the test will work in actual operation. Subsequent case law, such as the Schutt and Korby decisions described immediately below, undoubtedly will provide a more complete explication for taxpayers and their advisors of the import of the new test.

Facts

In 1980, the decedent, Wayne Bongard, formed a corporation called “Empak” (an acronym for “electronic materials packaging”). Empak designed and manufactured plastic
products used in the semiconductor and data storage industries. Aside from one brief period not relevant here, Mr. Bongard was the sole member of Empak’s Board of Directors from the mid-1980’s until his death on November 16, 1998.

Mr. Bongard owned all of Empak’s outstanding stock from the time of Empak’s incorporation until 1986. In 1986, Mr. Bongard created a trust referred to in the case as an “irrevocable stock accumulation trust” (the “ISA Trust”) for the benefit of his four children and his wife’s child by a prior marriage. Mr. Bongard funded the ISA Trust with 15% of Empak’s outstanding stock, leaving him as the owner of 85% of the company’s stock.

By 1995, Mr. Bongard began to plan for a public or private offering of Empak stock. Mr. Bongard’s counsel for business matters, Mr. Boyle, advised Mr. Bongard that all of the Empak stock owned by Mr. Bongard and the ISA Trust ought to be contributed to a single holding company as this would facilitate the contemplated Empak stock offering.

In 1996, Mr. Boyle advised Mr. Bongard’s estate planning attorney, Mr. Fullmer, that Mr. Bongard intended to contribute all of his Empak stock to a holding company in anticipation of an Empak stock offering. In late 1996, both Mr. Bongard and the ISA Trust contributed all of their Empak stock to a holding company, known as WCB Holdings and organized as a limited liability company, in exchange for LLC units proportionate to the Empak stock contributions.

The next day, in reliance upon Mr. Fullmer’s advice, Mr. Bongard contributed all of his WCB Holdings Class B LLC units to Bongard Family Limited Partnership (“BFLP”) in exchange for a 99% limited partnership interest. ISA Trust contributed some of its WCB Holdings Class B LLC units to BFLP in exchange for a 1% general partnership interest.
In March, 1997, Empak’s 51% owned subsidiary, Empak International, was merged into Empak. Empak International’s 49% minority shareholders, Marubeni Corp. (“MC”) and MC’s subsidiary, Marubeni America Corp., received 10% of Empak’s stock leaving WCB Holdings as Empak’s 90% owner. MC is a Japanese trading entity with over 700 subsidiaries and is listed on numerous international stock exchanges.

As was mentioned above, Mr. Bongard died on November 16, 1998. He was then 58 years old, appeared to be in good health and died unexpectedly.

**The Service’s Position**

It goes almost without saying, at this point in the evolution of the family limited partnership jurisprudence, that the Internal Revenue Service (the “Service”) was of the view that the ratable portion of the Empak stock that Mr. Bongard would have received upon a complete liquidation of both BFLP and WCB Holdings was includable in Mr. Bongard’s gross estate pursuant to Internal Revenue Code (“Code”) Sections 2036(a)(1) and 2036(a)(2).

**The Court’s Opinion**

The Court began its analysis with a lengthy reprise of the recent hallmark decisions concerning family limited partnerships. The Court implied that cases such as Harrison, Harper, Thompson, Strangi, Stone, Kimbell and many others form a seamless web of authority rather than the hopelessly confusing jumble that many tax advisors perceive. However that may be, despite its lip service to these precedents, the Court essentially jettisoned the entire lot and embarked upon a new course of its own.

The new test, which was to some degree anticipated by the Court’s memorandum opinion in Stone, provides that a taxpayer who conveys assets to a family limited partnership has made a bona fide sale for adequate and full consideration if the record in the case establishes the
existence of a legitimate and significant nontax reason for creating the family limited partnership and the taxpayer received partnership interest proportionate to the value of the property contributed to the partnership.

By its express terms, Code Section 2036 is inapplicable to any transfer that constitutes a bona fide sale for an adequate and full consideration. Accordingly, Code Section 2036 can have no application in such cases even if the taxpayer retains, directly or indirectly, use or enjoyment of the property contributed to the partnership or the right, alone or with others, to designate the persons who will possess or enjoy the contributed property or the income from that property.

Therefore, in the absence of some other basis for estate inclusion found in some other Code Section, a finding by the Court that there was a legitimate and significant nontax reason for creating the partnership is essentially case dispositive. The only remaining issue, of course, being the magnitude of the discount available to the taxpayer’s estate with respect to the partnership interests included in the estate.

The Court expounded upon this new test in only two particulars.

First, the Court stated that a significant purpose must be an actual motivation, not a theoretical justification. Although it is not possible to determine precisely what the Court had in mind by the statement, probably cases in which the taxpayer cites, as the only reasons for creating the partnership, the usual list of makeweight justifications common to virtually all family limited partnerships (such as asset consolidation, common management, creditor protection and so forth), the Court will conclude that contributions to the family limited partnership were not bona fide sales. On the other hand, if the taxpayer has credible and unique
or unusual reasons for creating the partnership, it appears that the Court will view the contributions to the partnership as bona fide sales.

Secondly, the Court indicated generally that the sale will be a sale for adequate and full consideration, as required by the Code, if (i) the assets contributed to the partnership are properly credited to the respective capital accounts of the contributing partners; and (ii) distributions from the partnership are debited from the distributee’s capital account. Importantly, the Court rejected the theory espoused by some courts that a sale is never for adequate and full consideration if the taxpayer’s gross estate is depleted by reason of the sale. The Court also indicated that if a taxpayer (such as Mr. Bongard) were to contribute stock representing a controlling interest in a corporation and did not retain effective control over the partnership (or alternatively receive an appropriate control premium in the form of additional interests in the partnership and a larger capital account), the sale might not be for adequate and full consideration.

Having promulgated the foregoing new test, the Court then proceeded to apply the test twice. First, to determine whether Mr. Bongard’s contribution of Empak stock to WCB Holdings was done for legitimate and significant nontax reasons and then to determine whether the contribution of Mr. Bongard’s WBC Holdings membership interests to BFLP was done for legitimate and significant nontax reasons.

The Court first considered the transfer of Empak stock to WCB Holdings. The Court, upon recitation of the relevant facts and due considerations of those facts, concluded that positioning Empak for a public or private stock offering (referred to by the Court as a “liquidity event”) was a legitimate and significant nontax reason that motivated Mr. Bongard and the ISA Trust to create WCB Holdings. The Court then held (as seems to follow almost ineluctably from
the way the Court sets out the bona fide sale and adequate consideration test) that the Empak stock contribution to WCB Holdings was a bona fide sale for adequate consideration, meaning Code Section 2036 could not cause the Empak stock to be includable in Mr. Bongard’s estate.

Next, the Court turned to the transfer of Mr. Bongard’s WCB Holdings membership interests to BFLP. This transfer was not necessary to position Empak for the anticipated stock offering. The creation and funding of BFLP was done at Mr. Fullmer’s recommendation in his capacity as Mr. Bongard’s estate planning counsel. Mr. Fullmer testified that BFLP was intended to provide another layer of creditor protection and facilitated Mr. Bongard’s post-marital agreement. The Court described these rationales for the creation of BFLP as unpersuasive. Other similar reasons for the formation of BFLP proffered by Mr. Bongard’s estate, such as that BFLP was intended to facilitate Mr. Bongard’s ability to make future gifts, met with a similar reaction from the Court. The Court also noted that estate tax savings played an important role in motivating the transfer to BFLP and concluded that there was no legitimate and significant nontax reason for the creation of BFLP. Accordingly, the transfer to BFLP was not a bona fide sale.

The Court then turned its attention to the traditional Code Section 2036 estate inclusion analysis and concluded that the WCB Holdings membership interests contributed by Mr. Bongard to BFLP were includable in Mr. Bongard’s gross estate pursuant to Code Section 2036(a)(1). The Court concluded, with little analysis and virtually no supporting facts, that Mr. Bongard had an implied agreement permitting him to retain the enjoyment of the WCB Holdings membership interests contributed to BFLP. In support of its conclusion, the Court reasoned that Mr. Bongard “controlled” whether BFLP could transform its sole asset (the WCB Holdings membership units) into a liquid asset because Mr. Bongard, as CEO and the sole member of
Empak’s board of directors, could determine when Empak redeemed its stock. The Court further explained that Mr. Bongard, by not redeeming the WCB membership units held by BFLP, ensured that BFLP would not engage in asset management but rather would remain an inactive holding company.

As the dissent pointed out, the Court’s reasoning confounds the Code Section 2036(a) retained “enjoyment” criterion with control. It has never been the law that control over investment decisions is sufficient for estate inclusion under Code Section 2036. Judge Chiechi’s dissenting opinion, in particular, skewered the majority for its “factually, logically, and legally flawed” rationale on this point. Judge Chiechi easily and persuasively demonstrated that the term “enjoyment” in Code Section 2036 means a “substantial present economic benefit” not the mere ability to control investment decisions. Furthermore, with respect to the facts of the case, she noted the absurdity of the majority’s unsupported conclusion that Mr. Bongard’s position as the sole director of Empak gave him unrestrained power to redeem Empak stock at his whim. Judge Chiechi noted that MC (a major Japanese corporation), directly and through a wholly-owned subsidiary, owned 10% of Empak’s stock. Mr. Bongard obviously had fiduciary duties to MC and MC unquestionably would have standing to challenge redemptions that were not made in Empak’s interest.

The ease with which Judge Chiechi demonstrated the errors in the majority opinion concerning the application of Code Section 2036(a)(1) seems to suggest that the majority now favors an approach to family limited partnerships that entirely disregards tradition Code Section 2036 jurisprudence and the well-established meaning of the Code Section itself. It appears that, under the Court’s approach, the cases may turn entirely upon whether the family limited partnership was formed for a legitimate and significant nontax reason. If so, the bona
fide sale exception applies and Code Section 2036 is inapplicable. If not, the Court invariably will discover some rationale, however weak, for estate inclusion under Code Section 2036.

B. Estate of Schutt v. Commissioner, T.C. Memo 2005-126 (May 26, 2005)

Overview

Apart from the Bongard decision itself, the Tax Court’s memorandum opinion in Estate of Schutt is probably the most instructive example of how the Court will apply the Bongard test in actual operation. The case was decided by Judge Wherry who voted with the majority in Bongard. The case reinforces the often repeated lesson (this time in a positive fashion) that careful planning and good lawyering are critically important to the successful employment of family limited partnerships as an estate planning tool.

Facts

Mr. Schutt resided in Delaware at the time of his death on April 21, 1999. Mr. Schutt’s father-in-law was Eugene duPont (“Mr. duPont”). Historically, a significant portion of the Schutt family’s wealth and income was derived from DuPont Company stock and Phillips Petroleum Company stock initially obtained from Mr. duPont. In the mid-1980’s, the Schutt family’s holdings in Phillips Petroleum stock were sold, due to dissatisfaction with the management of that company, and were replaced with stock in Exxon Corporation.

Both Mr. duPont and Mr. Schutt subscribed to a buy and hold investment philosophy. This philosophy emphasized the acquisition of stock in quality companies that would provide both income and value appreciation, which would then be held for the long term. In particular, Mr. Schutt stressed maintaining the family’s large holdings in DuPont and Exxon.
Mr. Schutt served as investment advisor for various family trusts (the “Trusts”) holding substantial positions in DuPont and Exxon. He also personally held substantial DuPont and Exxon positions through a revocable trust. As investment advisor for the Trusts, Mr. Schutt was empowered to prevent the Trusts from selling assets. However, by their terms, the various Trusts were destined to terminate upon events such as the death of Mr. Schutt’s children and the date upon which his youngest grandchild turned 40. Upon the termination of the Trusts, the Trust assets were to be distributed outright to Trust beneficiaries meaning Mr. Schutt no longer would be in a position to effect his buy and hold investment philosophy with respect to the distributed assets. The Court stated that it was clear from the structures of the Trusts that outright distributions occurring upon the termination of the Trusts created the single largest risk to the perpetuation of Mr. Schutt’s buy and hold philosophy.

Against this backdrop, Mr. Schutt met with two of his principal advisors, Mr. Dinneen and Mr. Sweeney, to begin discussions concerning the transfer of assets from his revocable trust to another investment vehicle. Mr. Dinneen was in charge of accounting and tax work for Mr. Schutt’s family office. Mr. Sweeney was Mr. Schutt’s attorney on tax and estate planning matters.

Over the next fifteen months, a process of meetings, discussions and research, extensively documented in letters, memoranda and notes, took place and culminated in the formation of two Delaware business trusts, known as Schutt I and Schutt II. Schutt I was funded entirely with DuPont stock and Schutt II was funded entirely with Exxon stock. The Trusts collectively obtained an approximately 55% interest in Schutt I in exchange for their collective contribution to Schutt I of DuPont stock representing approximately 55% of all of Schutt I’s DuPont stock. Mr. Schutt’s revocable trust obtained an approximately 45% interest in Schutt I in
exchange for a contribution to Schutt I of the remaining DuPont stock owned by Schutt I. Similarly, the Trusts collectively obtained an approximately 53% interest in Schutt II in exchange for Exxon stock and Mr. Schutt obtained the remaining 47% interest in Schutt II in exchange for a proportionate contribution of Exxon stock.

Pursuant to the terms of the Trust Agreements for Schutt I and Schutt II, Mr. Schutt controlled the investment of the assets of both business trusts. Both business trusts had a stated term ending December 31, 2048 and could not be dissolved prior to that date except with the consent of all unit holders. No unit holder could transfer an interest in either business trust or withdraw from the trust without the consent of all unit holders.

The record revealed, and Mr. Schutt’s estate acknowledged, that Mr. Schutt and his advisors were aware that, for gift and estate tax purposes, Mr. Schutt’s interests in Schutt I and Schutt II might, due to marketability and minority interest discounts, have a value less than the value of the DuPont and Exxon stock contributed by him to the business trusts.

The record, however, also revealed, and the estate persuasively argued, that Mr. Schutt’s focus, during the fifteen months over which the formation of the business trusts took place, was upon achieving his desire to assure that the DuPont and Exxon stock contributed by the Trusts to Schutt I and Schutt II would remain subject to Mr. Schutt’s buy and hold investment philosophy, during the remainder of his lifetime (and possibly beyond), even if one or more of the Trusts were to terminate by its terms prior to December 31, 2048.

**The Service’s Position**

Oddly, the Service initially argued only that the discounts applied in valuing Mr. Schutt’s interests in Schutt I and Schutt II were excessive. Predictably, the Service eventually took the position that the DuPont and Exxon stock contributed to Schutt I and
Schutt II by Mr. Schutt were includable in his gross estate pursuant to Section 2036. For good measure, the Service also argued for inclusion pursuant to Code Section 2038. The parties stipulated to a 32.5% valuation discount for both Schutt I and Schutt II in the event the Court found that the underlying DuPont and Exxon stock was not includable in Mr. Schutt’s estate.

The Court’s Opinion

Interestingly, perhaps in a bow to Judge Chiechi’s powerful and persuasive dissent in Bongard, Judge Wherry began his analysis by noting that the term “enjoyment” as used in Code Section 2036(a)(1) connotes economic benefit. He cited Treasury Regulations and case law for this proposition but did not mention that the majority opinion in Bongard (in which he joined) seems to hold that control over the investment of assets suffices for inclusion under Section 2036(a)(1).

In any case, the Court then noted that neither Section 2036 nor Section 2038 can apply to property transferred by a decedent during lifetime in a bona fide sale for an adequate and full consideration in money or money’s worth.

The Court then stated, citing Bongard as authority, that in the context of family limited partnerships, the bona fide sole test is met where the record establishes the existence of a legitimate and significant nontax reason for creating the family limited partnership and the transferor receives partnership interests proportionate to the value of the transferred property. The Court further stated that the objective evidence must indicate that the nontax reason was a significant factor that motivated the partnership’s creation. The Court noted also that the Bongard test is similar to the test employed by the Third Circuit in the Thompson case. The Schutt decision would be appealable to the Third Circuit.
The estate argued that Schutt I and Schutt II were formed “primarily” to put into place an entity to perpetuate Mr. Schutt’s buy and hold investment philosophy. The Court, in keeping with the **Bongard** test, did not hold the estate to a primary purpose test but rather concluded that the totality of the record in the case, when viewed as a whole, supported the estate’s position that a “significant” motive for the creation of Schutt I and Schutt II was to perpetuate Mr. Schutt’s buy and hold investment philosophy.

In this regard, the Court noted that representatives of the trustee for the Trusts (the trustee was Wilmington Trust Company) testified that the trustee likely would not have contributed Trust assets to Schutt I and Schutt II without Mr. Schutt’s willingness to contribute substantial stock of his own to both business trusts. In effect, Mr. Schutt used his own assets to enhance his ability to perpetuate his investment philosophy with respect to the stock held in the Trusts.

Although the Court did not make special note of the point, it is interesting that Mr. Schutt insisted that the business trusts be structured so that he would have control over investments in the Trusts. Wilmington Trust Company, as trustee for the Trusts ultimately agreed to this so long as Wilmington Trust Company had some input. Mr. Schutt and his advisors must have known that this arrangement might possible have an adverse effect on the magnitude of the minority interest discounts available to Mr. Schutt with respect to his interests in Schutt I and Schutt II. If tax savings were Mr. Schutt’s only concern and perpetuating his investment philosophy were not a significant reason for creating the business trusts, presumably the business trusts would have been designed to vest at least some degree of investment control in the trustee of the Trusts.
Having concluded that a significant motive for the creation of Schutt I and Schutt II was to perpetuate Mr. Schutt’s investment philosophy, the Court easily and quickly dismissed the Service’s other arguments and concluded that the bona fide sale exception to the application of Code Sections 2036 and 2038 applied in the unique circumstances of the case.

C. Estate of Edna Korby, T.C. Memo 2005-102 (May 10, 2005); Estate of Austin Korby, T.C. Memo 2005-103 (May 10, 2005)

Overview

The two Korby cases involve a husband and a wife who died with a few months of each other. Both Korbys retained interests in a family limited partnership at the time of their deaths and the Service argued in both cases for estate inclusion of the decedent’s proportionate share of the underlying partnership assets pursuant to Code Sections 2036 and 2038. In both cases, notwithstanding the new Bongard bona fide sale test, the estates lost due to the same sort of bad facts that have resulted in estate inclusion in so many other similar cases.

Facts

The decedents, Edna and Austin Korby, created a family limited partnership and contributed virtually all of their income-producing assets to the partnership. Their only remaining source of income was their Social Security payments. Their annual medical expenses were approximately double their Social Security income.

The Korbys gifted a 98% limited partnership interest (at a substantially discounted value) in equal shares to their four children. The Korbys retained a 2% general partnership interest.

Over the ensuing four years until Mr. and Mrs. Korby died in 1998, the partnership paid many of their living expenses. The estate argued that these payments (totaling
over $120,000) were management fees paid by the partnership to its general partner for services performed in managing the partnership assets. However, the partnership assets, which were stocks and bonds, were not actively managed and the Korbyss did not report the payments as self-employment income. Furthermore, during the years in which these payments were made, the limited partners (holding a 98% interest) received only a single distribution totaling $12,061.

**The Service’s Position**

A recitation of the facts is sufficient to apprise the reader of the Service’s position. The Service noted that the Korbyss had failed to retain sufficient income-producing assets to allow them to pay their anticipatable expenses. According to the Service, this arrangement, coupled with the large non-pro rata payments made for the benefit of the Korbyss from the partnership, demonstrated the existence of an implied agreement that the income from the partnership assets would continue to be available to the Korbyss.

**The Court’s Opinion**

The Tax Court agreed with the Service’s position that the evidence established the existence of an implied agreement permitting the Korbyss to retain the income from the partnership assets. Upon reaching this conclusion (which seems almost to be compelled by the facts), the Court turned to the Bongard test. The Court first noted that if the Korbyss had a legitimate and significant nontax reason for transferring assets to the partnership, the transfer would be a bona fide sale under the Bongard test and there could be no estate inclusion under Code Section 2036 or Section 2038 even though the Korbyss had retained an implied right to the income from the assets transferred to the partnership.

However, apparently the only nontax reason for the formation of the partnership (particularly when one considers that the Korbyss were the general partners) posited by the estates
was that old shibboleth “creditor protection.” Not surprisingly in the circumstances, the Court found that the limited creditor protection provided by the partnership and the other evidence in the record led the Court to believe that creditor protection was not a significant reason for formation of the partnership.

D. **Strangi v. Commissioner, 417 F.3d 468 (5th Cir. July 25, 2005)**

**Overview**

The Fifth Circuit’s most recent Strangi opinion is the fourth reported decision concerning Albert Strangi’s estate. Briefly, the Strangi saga to date has evolved as follows: (i) the Tax Court initially rejected a hodgepodge of governmental attacks upon Mr. Strangi’s family limited partnership (such as that the partnership should be disregarded because it lacked a business purpose and economic substance; gift on formation; excessive discounts; and that the partnership was a restriction on sale that should be disregarded under Code Section 2703(a)(2)) and denied the Service’s motion to add belatedly a Section 2036 argument; (ii) the Fifth Circuit affirmed the Tax Court’s substantive decision on appeal but remanded with instructions that the Tax Court either consider the Section 2036 argument or set forth its reasoning for denying the Service’s request to add the Section 2036 argument; (iii) on remand, the Tax Court chose to consider the Section 2036 argument and held (probably correctly) that the partnership assets were includible in Mr. Strangi’s estate under Section 2036(a)(1) and further held (almost certainly incorrectly) that inclusion was also required under Code Section 2036(a)(2); and (iv) on appeal the Fifth Circuit affirmed the Tax Court’s Section 2036(a)(1) holding but refused to address the Section 2036(a)(2) holding as unnecessary to the resolution of the case.
**Facts**

Strangi is another case involving very bad facts from the taxpayer’s point of view. Mr. Strangi was terminally ill at the time his family limited partnership was formed and he died two months later. Mr. Strangi’s son-in-law, acting as attorney-in-fact under a general power of attorney, formed the partnership and contributed 98% of Mr. Strangi’s assets including his home to the partnership in exchange for a 99% limited partnership interest and contributed just under $50,000 of Mr. Strangi’s remaining assets to a corporation in exchange for 47% of the corporation’s stock. The corporation served as 1% general partner of the partnership. Mr. Strangi’s children owned the rest of the corporation’s stock. The partnership made two payments to Mr. Strangi of $8,000 and $6,000 to “meet his needs and expenses” and upon his death paid the expenses of his estate including funeral expenses, administration expenses, a specific bequest under his Will and his estate taxes. Mr. Strangi continued to live in the house contributed to the partnership for the remaining two months of his life but did not pay rent (although rent was accrued on the partnership books).

**The Service’s Position**

The Service argued that the Tax Court’s holding ought to be affirmed as to both Section 2036(a)(1) and 2036(a)(2).

**The Court’s Opinion**

The Fifth Circuit affirmed the Tax Court holding that the estate was required under Code Section 2036(a)(1) to include in Mr. Strangi’s gross estate the property contributed by him to the family limited partnership. The Court noted that Mr. Strangi retained insufficient assets to pay his expenses including post-mortem expenses. The Court may have deemed it necessary in this case to focus on post-mortem expenses given that Mr. Strangi was known to be
terminally ill at the time the partnership was created. The Court stated that in cases where the evidence demonstrated that a decedent had received a general assurance that assets contributed to a partnership would be available to meet the decedent’s personal needs, the assets were includable in the decedent’s estate pursuant to Code Section 2036(a)(1). The Court found that the evidence supported such a conclusion in this case. Or rather, more precisely, the Court held that it was required to affirm the Tax Court’s findings on the issue because the Tax Court’s findings on these factual questions were not clearly erroneous.

The Court also used the Strangi case as an opportunity to refine its bona fide sale test to bring the Fifth Circuit test closely into line with the Bongard test. Indeed, the test appears to be substantively identical to the Bongard test. In Kimbell v. United States, 371 F.3d 257 (5th Cir. 2004), the Court seemed to say that the existence of a substantial business or nontax purpose for creating a family limited partnership was one factor to consider in determining whether the transfer of assets to the partnership constituted a bona fide sale. However, in the Strangi case, the Court declared that “the proper approach was set forth in Kimbell, in which we held that a sale is bona fide if, as an objective matter, it serves a substantial business or other nontax purpose.” Although it may not be entirely clear that this actually was what the Court said in Kimbell, it plainly is what the Court was saying in the most recent iteration of the Strangi case and the test appears to be substantially identical to the Tax Court’s holding in Bongard. Interestingly, it is not at all clear that the Fifth Circuit agreed with the Tax Court’s conclusion that there was no substantial nontax reason for the formation of Mr. Strangi’s partnership. Rather the Court held only that the Tax Court did not clearly err in reaching that conclusion. Accordingly, because this was a factual determination, the Court affirmed the Tax Court without revealing its own view on the factual issue.
E. Estate of Abraham v. Commissioner, 408 F.3d 26 (1st Cir. May 25, 2005)

Overview

The Abraham case demonstrates (unfortunately) that the Bongard test will produce an incorrect result in some cases. In Abraham, there was a court order (entered by a Massachusetts probate court which also appointed a guardian for Ms. Abraham and approved the creation and funding of her family limited partnerships) providing that the three family limited partnerships formed by Ms. Abraham “share equally [in] the support of Ida Abraham insofar as the funds generated by Ida Abraham’s properties maintained by her do not provide sufficient funds for her adequate health, safety, welfare and comfort as determined by [her] guardian.” It is hard to imagine a more plain instance of a taxpayer retaining the enjoyment of property ostensibly contributed to a partnership or a more classic circumstance in which the partnership assets ought to be included in the estate of the contributor. Nevertheless, it also is clear that the three partnerships were formed for a legitimate and significant nontax reason. Namely, to settle crippling litigation among Ms. Abraham’s children who had been fighting among themselves for control of her assets ever since Ms. Abraham became mentally incapacitated by Alzheimer’s Disease. It appears that if the Bongard test were applied in Abraham, the partnership assets would have not been includable in Ms. Abraham’s estate. In any event, the case was briefed and argued before the Bongard decision and the estate did not even argue that the transfers by Ms. Abraham to the partnerships constituted bona fide sales.
F. Estate of Bigelow v. Commissioner, T.C. Memo 2005-65 (March 30, 2005)

Overview

Bigelow is a family limited partnership case involving an attempt to make lifetime gifts of limited partnership interests at discounted values and then to claim a discount for the remaining partnership interests owned by the decedent at the time of her death. The case, although decided before Bongard, seems to apply the Bongard test. The bad facts lead almost inevitably to estate inclusion under Code Section 2036(a)(1) and again leave the reader wondering why and how so many of these cases end up in litigation.

In 1991, Ms. Bigelow transferred her house to her revocable trust. In 1992, she suffered a stroke and moved out of the house. In 1993, the revocable trust exchanged the house for rental property, and borrowed $350,000 secured by the new rental property to pay off prior loans that had been secured by the house. Later that year, the revocable trust obtained a $100,000 line of credit secured by the rental property, and the revocable trust drew down the $100,000 over the next year and made gifts of some of that amount to Ms. Bigelow’s children and grandchildren.

In December of 1994, the revocable trust contributed the rental property to a family limited partnership. The $450,000 of liability secured by the rental property, however, remained as a liability of the revocable trust and was not assumed by the partnership. The revocable trust was the partnership’s sole general partner and initially owned most of the limited partner units. Ms. Bigelow’s children each contributed $100 for a very small limited partnership interest. After the creation of the family limited partnership, Ms. Bigelow was left with insufficient assets to pay her living expenses or to satisfy her liability under the $450,000 loan.
The partnership made the principal and interest payments on the loan, even though the loan was not a partnership debt. The partnership also paid some of Ms. Bigelow’s living expenses.

At the time of Ms. Bigelow’s death, the revocable trust owned a 1% general partnership interest and a 45% limited partnership interest in the partnership. The remaining limited partnership interests had been gifted to Ms. Bigelow’s children and grandchildren at discounted values.

The Service argued that the partnership assets were includable in Ms. Bigelow’s estate under Code Sections 2036(a)(1), 2036(a)(2) and 2038.

The Tax Court held that Section 2036(a)(1) applied because there was an implied agreement that Ms. Bigelow would retain the income from and the enjoyment of the rental property contributed to the partnership. The Court noted that the partnership made the payments on debt owed by Ms. Bigelow and the partnership made distributions to fund Ms. Bigelow’s living expenses. No distributions were made to any other partner.

The Court further held that the bona fide sale exception to Code Section 2036 did not apply because the transfers to the partnership were not in good faith and were not made for legitimate nontax purposes. For good measure, the Court also found that the Bigelows had not complied with the terms of the partnership agreement.

The estate argued that the nontax purposes for creating the partnership were creditor protection, continuity of management, and gifting efficiency. In response, the Court found that the partnership provided no creditor protection because Ms. Bigelow’s revocable trust was the sole general partner and the general partner was not protected from liability associated with the rental property. The Court also noted that the partnership provided no continuity of
management of the partnership assets beyond what could have been obtained simply by leaving the partnership property in the revocable trust. Finally, the Court held that gifting efficiency was not a sufficient nontax reason for formation of the partnership because a transfer made solely to reduce taxes and to facilitate gift giving is not considered in this context to be made in good faith or for a bona fide purpose.

G. **Estate of Kelley v. Commissioner, T.C. Memo 2005-235** (October 11, 2005)

**Overview**

The **Estate of Kelley** case is a puzzlement. **Kelley** is the sort of case in which the Service always argues for estate inclusion under Code Section 2036(a)(1). Moreover, the facts in relevant part seem virtually indistinguishable from the facts in **Strangi** (because Mr. Kelley owned an interest in the general partner) meaning the Service should also have argued for inclusion under Code Section 2036(a)(2). Furthermore, the notice of deficiency asserted that Sections 2036, 2038 and 2703 were applicable. Yet all of these estate inclusion arguments were conceded at trial. The case therefore involved only the question of the magnitude of the discount available to the estate in valuing Mr. Kelley’s family limited partnership interests.

Mr. Kelley created a family limited partnership three months before he died. At the time of his death, Mr. Kelley owned a 94.83% limited partnership interest in the partnership and he owned 1/3\textsuperscript{rd} of the limited liability company that served as the partnership’s sole general partnership. Mr. Kelley’s children owned the remaining limited partnership interests and the remaining interests in the limited liability company.

The partnership’s assets consisted entirely of cash and certificates of deposit. The estate claimed a 55.15% discount (although the Court seems erroneously to have calculated the
discount at 53.5%). The Service argued for a 25.2% discount. Both numbers seem high for a family limited partnership holding nothing but cash and cash equivalents. In any case, the Court concluded that a 32.25% discount was appropriate. The opinion includes an excellent explanation of how discounts should be computed in such cases and likely will be helpful, in the future, to appraisers valuing limited partnership interests for gift and estate tax purposes.

Other Cases

A. Estate of Noble v. Commissioner, T.C. Memo 2005-2 (January 6, 2005)  

Overview

The Noble case is of some special interest because it addresses the question of whether events occurring after the date of death may be taken into account in determining the date of death value of an asset.

Ms. Noble owned closely held bank stock at the time of her death. The estate valued the stock at $903,988 based upon book value reduced by a 45% minority interest discount. About 14 months after Ms. Noble’s death, the estate sold the stock for $1,100,000. The Court held that the most accurate method of determining the fair market value of closely held stock is through arm’s-length sales of the stock near the valuation date. The Court disregarded two small sales occurring shortly before death because the sellers were not knowledgeable and the stock involved was de minimis. However, the actual sale of the stock being appraised, occurring within 14 months of the valuation date, was viewed by the Court as essentially dispositive of the issue. The Court used the post-death sale price of $1,100,000, reduced by a 3% adjustment for inflation, to determine the date of death value of $1,067,000.
B. **Rudkin Testamentary Trust v. Commissioner, 124 T.C. 304 (June 27, 2005)**

**Overview**

Rudkin is the latest installment in the endless stream of cases concerning whether investment advisor fees incurred by a trust are fully deductible as trust administration expenses described in Code Section 67(e)(1) or are miscellaneous itemized deductions that may be deducted only to the extent that they exceed 2% of the trust’s adjusted gross income in accordance with Code Section 67(a).

Rudkin is an opinion of the full Tax Court in which 17 judges joined. The Court held that a trust’s investment advisor fees are subject to the Code Section 67(a) 2% floor. The case is consistent with the Tax Court’s earlier opinion on the issue in O’Neill v. Commissioner, 98 T.C. 227 (1992) and with the Circuit Court opinions in Mellon Bank v. United States, 265 F.3d 1275 (Fed. Cir. 2001) and Scott v. United States, 328 F.3d 132 (4th Cir. 2003). The Sixth Circuit reached the opposite conclusion on the appeal of the Tax Court’s O’Neill decision in O’Neill v. Commissioner, 994 F.2d 302 (6th Cir. 1993). The Rudkin case is appealable to the Second Circuit, meaning that Court likely will be the next to weigh in on the issue.


**Overview**

By a series of transfers occurring over three years, Mr. Tehan conveyed title to his residence in equal shares to his eight children. However, before beginning the partial transfers of interests in the residence to his children, Mr. Tehan entered into a written agreement with the children providing that Mr. Tehan would have the sole and exclusive right to the use and occupancy of the residence for such period of time as he desired. The agreement further
provided that Mr. Tehan was not liable for rent but would be responsible for mortgage payments (although the residence was not subject to a mortgage), condominium assessments, real estate taxes and insurance premiums for the residence and all costs and expenses of maintenance and repair of the residence. Mr. Tehan continued to reside in the residence until his death.

The Tax Court predictably held that the residence was includible in Mr. Tehan’s estate pursuant to Code Section 2036(a)(1) because Mr. Tehan had retained the possession and enjoyment of the residence for his life pursuant to an express agreement. The Court noted that there is an exception, recognized by the Court in *Barlow v. Commissioner*, 55 T.C. 666 (1971), to the general rule of estate inclusion under Code Section 2036(a)(1) in cases where the transferor retains only the right to lease the transferred property at a fair market rental. However, the Court found that exception inapplicable because Mr. Tehan was not liable for the payment of rent.

It is interesting to note that, from a transfer tax planning point of view, Mr. Tehan would have been better off had he paid a fair market rental both because he would have avoided the application of Code Section 2036(a)(1) and because he would have further depleted his potentially taxable estate for the benefit of his children. Moreover, had he placed the residence in a grantor trust (designed so that contributions to the trust qualified as completed gifts), the rental payments would not have been subject to income taxation.


**Overview**

Mr. Jelke owned a 6.44% interest in a closely held corporation at the time of his death. The corporation’s assets consisted primarily of marketable securities. The corporation was a C corporation for federal income tax purposes and the corporation had a built-in capital
gain tax liability of about $51,000,000 that would have been incurred if the corporation had sold all of its assets at the time of Mr. Jelke’s death.

The primary issue before the Court (in addition to determining appropriate marketability and minority interest discounts in valuing the stock for estate tax purposes) was the proper treatment of the built-in gain in valuing the decedent’s stock. The estate argued that the entire built-in gain should be subtracted from the value of the corporation’s assets before applying minority interest and lack of marketability discounts. This was the approach adopted by the Fifth Circuit in Estate of Dunn v. Commissioner, 301 F.3d 339 (5th Cir. 2002).

The Tax Court, however, noted that the Jelke case was not appealable to the Fifth Circuit and therefore the Tax Court was not bound by the Dunn decision. Furthermore, the Tax Court attempted somewhat unpersuasively to distinguish Dunn on the ground that in Dunn the decedent was a majority stockholder while in Jelke the decedent was a minority stockholder. The Court did not explain why this should matter, except to note that in Dunn, the Fifth Circuit stated that if it were valuing a minority interest, a “business-as-usual assumption or earnings-based approach” might be more appropriate. However, that comment by the Fifth Circuit probably was intended to address only the question of whether an earnings-based valuation methodology or an asset-based valuation methodology should be employed in valuing the stock. In both Dunn and Jelke as asset-based valuation methodology was employed. The Fifth Circuit opinion seems plainly to hold that in cases where an asset-based valuation methodology is employed, the full value of the corporation’s built-in capital gain should be deducted from the value of the corporation’s assets in arriving at net asset value.

In any event, the Tax Court concluded that in the Jelke case the proper treatment of the built-in capital gain would be to assume that the corporation’s marketable securities
portfolio would be turned over ratably over a sixteen-year period. Therefore, the $51,000,000 liability would be incurred ratably over sixteen years. The sixteen-year turnover period was based upon the Court’s examination of the corporation’s past trading practices. Furthermore, the Court held that the deferred tax liability ought to be discounted at the rate of 13.2% per year for purposes of determining the present value of the deferred built-in gain tax liability as of the date of Mr. Jelke’s death. The Court used the 13.2% rate because that was the average annual rate at which large-cap stocks grew during the period from 1926 through the last full year prior to Mr. Jelke’s death.

The apparent error in the Court’s analysis is that if one assumes a 13.2% discount rate for purposes of computing the present value of a future debt, it is fundamental to assume also that assets will grow at the same rate. If so, the built-in gain liability would grow at the same 13.2% rate (because the corporation’s stock portfolio will grow at that rate) as is used for discounting purposes. If this entirely reasonable assumption is made, the present value of the built-in gain tax liability necessarily is $51,000,000.

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**Circular 230 Disclosure Statement**

IRS regulations provide that taxpayers may not rely upon written advice to promote third-party transactions or avoid federal tax penalties unless the advice is provided in the form of a “covered opinion” (essentially a formal tax opinion letter which satisfies numerous regulatory requirements and is based upon an independent fact inquiry). This outline is not a covered opinion within the meaning of the regulations.