John G. Mack, ASA, CBA
Mack Business Appraisals, LLC
26956 N. 90th Lane
Peoria, Arizona 85383
(888) 789-2401 (toll free) (623) 340-6770 (direct) (623) 476-5405 (fax)
john@mackbusinessappraisals.com
www.mackbusinessappraisals.com

Keller V. U.S. Civil Action No. V-02-62 (S.D. Tex., August 20, 2009)

The Facts:

Mrs. Maude O'Connor Williams and Mr. Roger P. Williams had established a Family Trust which would hold a pool of approximately $300 million in cash, certificates of deposit and bonds in June of 1998. The Family Trust was to terminate upon the death of either spouse and was to be distributed to two additional trusts, Trust M (a QTIP trust) and Trust A (which would hold Mrs. Williams' separate property and one half the community property). Mr. Williams passed away in January of 1999.

Throughout her lifetime, Mrs. Williams was a very shrewd businesswoman and a frugal heiress. Mrs. Williams also became increasingly concerned about protecting the family's considerable interests from loss of control of significant family assets through divorces as one of her daughters had endured a long and expensive divorce.

Mrs. Williams had long turned to their accountants, Rayford and Lane Keller, for advice and sought their advice on further protecting her assets. Messrs. Keller discussed with Mrs. Williams creating a series of family limited partnerships for the different classes of assets she owned. During the summer of 1999, a number of meetings were held between Mrs. Williams and the Kellers. Mrs. Williams was very interested in establishing an Investment Partnership to own her community property and bonds. The plan included both Trust A and the QTIP trust (Trust M) to contribute bonds in return for limited partnership interests. Mrs. Williams would be the general partner through a wholly owned LLC. Mrs. Williams would then sell her interests in the LLC to one of her daughters and two of her grandchildren. In September of 1999, the Kellers prepared a spreadsheet detailing the funding of the Partnership which was discussed with Mrs. Williams, who gave her verbal permission to begin formation of the partnership.

Drafts of the partnership agreement were prepared by a well-known Dallas attorney prior to the end of 1999. Draft copies of the agreement were discussed in length and amended several times by Mrs. Williams, the Kellers and their attorney. In January of 2000, Lane Keller established a flowchart and notes discussing the funding plan for the partnership. Mr. Keller attempted to convince Mrs. Williams on several occasions to contribute more assets to the partnership (as Mrs. Williams retained more than $110 million of assets outside the partnership), but she refused.

On May 9, 2000, the final draft of the partnership agreement was discussed with Mrs. Williams who signed the documents creating the partnership and the LLC. The agreement stated that each partner would contribute assets as described on Schedule A of the agreement. Schedule A was left with blank spaces to be filled in when the amounts were finalized because the accountant did not have a firm value of the bonds or the interest accrued on the bonds as of that date. On May 10, the Kellers took steps to request tax ID numbers and began to establish new accounts for the partnership assets for as soon as the tax ID numbers were available. The Kellers also cut a check for $300,000 to be contributed by Mrs. Williams. The Kellers planned to complete the funding after the tax ID numbers were received and the accounts could be opened. Furthermore, the partnership certificate of limited partnership and LLC articles of organization were filed with the Secretary of State. However, before the funding could occur, Mrs. Williams passed away on May 15, 2000. After her passing, all activity regarding the partnership was put on hold and no assets were transferred and the Schedule A remained blank.

In February of 2001, the estate filed an extension request for filing the estate tax return along with a check in the amount of $147,800,245, which was drawn from accounts relating to the Family Trust and made payable to the United States Treasury.

In May of 2001, Mr. Lane Keller heard a discussion of the Church (Elsie J. Church, Deceased v. U.S.) case which had recognized a partnership that was similarly not formerly funded at the time of the decedent's death. After hearing this, Mr. Keller quickly moved forward with formally funding the partnership. Then, in August of 2001, the estate filed an estate tax return reporting approximately $143 million of estate tax (which reported the interests in the partnership owned by the QTIP Trust and Trust A but claiming no discounts). Three months later, a Claim for Refund was filed by the estate requesting a refund of approximately $40 million (which was the reduced value of the partnership interests held by the two trusts as a result of a combined discount of 47.5% for lack of control and lack of marketability).

The estate (and the Family Trust) borrowed $114 million from the partnership to pay federal estate taxes, state inheritance taxes and other debts and obligations arising from the partnership, after funding the partnership, "with an eye towards preserving the liquidity of Mrs. Williams' estate." The $114 million debt was evidenced by a 9-year note with annual interest payments based on a 5.07% rate. The principal is due at the end of 9 years. The estate had paid about $30 million of interest payments to the partnership by the time of trial, and the partners had reported and paid income taxes on this flow-through interest income from the partnership.

The Arguments and Findings:

The Court concluded that the assets should be considered partnership property before her death because: (1) Mrs. Williams had expressed the clear intent to fund the partnership with the identified assets at the time she signed the partnership agreement; and (2) the partnership was a valid Texas partnership before her death.

The Court also determined that Sections 2036 and 2038 did not apply to the assets contributed to the partnership in the estate because the transfers to the partnership satisfied the bona fide sale for full consideration exception. Facts considered by the Court that satisfied the bona fide sales exception were (1) there was a legitimate business purpose for the partnership (protecting family assets from divorce proceedings and facilitating the administration of family assets); (2) Mrs. Williams retained significant assets (over $110 million) outside the partnership for her use; (3) partnership interests were properly credited to each of the partners capital accounts in proportion to the fair market value of the assets each partner contributed to the partnership; and (4) the partners were entitled to distributions from the partnership in accordance with their percentage interests in the event of termination and dissolution.

The taxpayer's valuation expert's value was accepted, representing a 47.5% discount on the 99.9% interest in the partnership held by the two trusts. The IRS's expert's opinion was rejected because it violated several of the tenets of the hypothetical willing buyer-willing seller valuation principle, including considering the true identities of the buyer and seller, speculating as to future events, and aggregating the interests of the various owners. The Court also held that the $30 million in interest payments the estate made to the partnership in connection with the $114 million loan to pay estate taxes and other debts was deductible because the interest expense was actually and necessarily incurred in the administration of the estate.

Parting Thoughts:

This case was a significant victory for the taxpayer. A few items to note really stood out to me upon reading this agreement. First, the accountants' very careful planning and documentation of their various meetings and planning discussions were critical elements in convincing the court of the decedent's expressed intent to fund the partnership. Furthermore, the professionalism and ethical behavior of the accountants (as evidenced by their careful handling of all matters before and after Mrs. Williams death) were also instrumental in convincing the court that they were trying to do the right thing. Second, this case gave a surprising amount of weight to asset protection/divorce protection as a business purpose of the partnership (which may be the result of discussion regarding a lengthy and expensive divorce previously experienced by one of Mrs. Williams' daughters). Finally, a 47.5% discount for a limited partnership holding bonds and cash seems to be a high discount as compared to discounts allowed in prior case law. However, the taxpayer's appraiser valued the limited partner equity interests owned by the two trusts as "assignee interests", and there is no discussion regarding how much of the discount is attributable to the fact that the interest was valued as an assignee interest as opposed to a full limited partnership interest.