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Rector v. Commissioner, TC Memo 2007-367, December 13, 2007

The Facts: Mrs. Rector and her late husband, Jack Rector, formed their original trust in 1975. After Mr. Rector's death in 1978, Mrs. Rector, with the help of her son, John Rector (who served as her investment counselor) split the trust into Trust A and Trust B. Trust A contained Mrs. Rector's share of her community property from her marriage, her separate property and one half of her late husband's estate. Mrs. Rector was entitled to the income and principal of Trust A and had a power of appointment with respect to its remainder. Trust B contained the remainder of Mrs. Rector's late husband's assets. Mrs. Rector's interest in Trust B was a life estate consisting of distributions of monthly income. In October of 1991, Mrs. Rector created the Concetta H. Rector Revocable Living Trust (1991 Revocable Trust) and transferred the assets of Trust A into it. Mrs. Rector was entitled to all income and principle from the 1991 revocable trust and she had the power to revoke it as if it had never been created.

Mrs. Rector's son, John, discussed forming a FLP with his brother, Frederick and Mrs. Rector and in 1998 to save Federal Estate tax, among other reasons. Mrs. Rector and her sons formed the RLP without any negotiation over the Partnership terms. It was intended that Mrs. Rector fund the formation of the of the Partnership by contributing all assets she held in the 1991 revocable trust, for Mrs. Rector to give limited partnership interests in RLP to each son and for Mrs. Rector to value the gifts at significantly less than the proportionate value of RLP's assets. Neither Mrs. Rector nor her sons had separate council in the formation of the Partnership.

The Partnership was executed in December of 1998. Mrs. Rector was a 2% general partner in RLP and the 1991 revocable trust was a 98% limited partner. Approximately 3 months after the formation of the Partnership, Mrs. Rector funded the Partnership by transferring from the 1991 revocable trust $174,259.38 in cash and $8,635,082.77 in marketable securities. At the time of the transfer, Trust B was worth approximately $2.5 million dollars.

RLP operated without a business plan or an investment strategy and it did not trade or acquire investments. The Partnership did not issue balance sheets, income statements or other financial statements, and its partners did not hold formal meetings. Statements of activity and capital accounts were not regularly maintained. RLP's function was to own investment accounts to make distributions to partners and to pay Mrs. Rector's personal

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expenses. RLP maintained monthly investment account activity statements, including distributions and a hand written check register for payments.

During 1999, 2000 and 2001 RLP's total distributions to its partners exceeded its annual income by $491,480. Of the total distributions, 86% to 90% were made to Mrs. Rector during 1999 and 2000.

Prior to the formation of RLP, Mrs. Rector received income from Trust B and the 1991 revocable trust. After the formation, Mrs. Rector continued to receive the same monthly income from Trust B, which was her only significant source of income besides the distributions she received from RLP. Mrs. Rector's living expenses were nearly three times her monthly income in the years 1999-2001. During the years 1999-2002, RLP transferred funds for or paid Mrs. Rector's additional expenses including living expenses and tax liabilities.

<u>The Arguments:</u>

The respondent argued that the value of Mrs. Rector's total assets, including property transferred to the Rector Limited Partnership (RLP), be included in Mrs. Rector's estate because Mrs. Rector retained possession or enjoyment of, or the right to the income from the transferred property for purposes of Section 2036 (a)(1).

The estate argued that Mrs. Rector's transferred assets should not be included in her total estate because she did not retain possession or enjoyment of, and the right to the income from the transferred assets and alternatively she transferred the assets to RLP in a bona fide sale for adequate and full consideration.

<u>The Findings:</u>

The Court found that the transfer of assets to the RLP was not a bona fide sale because, (1) the formation of RLP entailed no change in the underlying pool of assets or the likelihood of profit, (2) Mrs. Rector's transfer must have been made in good faith, meaning the transfer was made for a legitimate, non-tax purpose. Good faith transactions between family members are highly scrutinized and the formation of RLP contrasts greatly with actions of unrelated parties. Mrs. Rector and her sons did not negotiate the terms of the agreement and they did not retain separate counsel. RLP was formed with Mrs. Rector and her revocable trust as the only partners and was not funded until

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approximately three months after its formation. The Court also noted that the agreement contemplated that more than one partner would contribute property, however, Mrs. Rector and her sons had never intended that anyone other than Mrs. Rector would actually contribute property, and (3) RLP had no investment strategy and did not engage in business transactions.

In addition, the Court found that RLP was formed to facilitate the transfer of Mrs. Rector's property to her sons and grandchildren primarily as a testamentary substitute with the aim of lowering the value of her gross estate by applying discounts for lack of control and marketability. Furthermore, the Court found that RLP did not have a specific non-tax purpose to justify that it was a legitimate business. The Estate claimed that the business purposes were to (1) benefit from estate tax savings, (2) give away partnership interests, (3) provide for creditor protection and (4) diversify assets. The Court disagreed stating that (1) the goal of gift-giving is a testamentary purpose and is not a significant nontax business purpose, (2) RLP had no active management to help assert their claim of efficient asset management, (3) creditor protection was not a valid purpose because there was never a concern about the liabilities of Mrs. Rector and she or her trust continued as the General Partner of RLP and (4) asset diversification was not deemed as a valid defense because the assets post transfer were basically identical to the assets pre-transfer and that RLP had no business plan or investment strategy.

Finally, Mrs. Rector funded RLP with substantially all of her wealth which left her with insufficient funds to cover her own living expenses. The Court found that Mrs. Rector did continue to enjoy economic benefit from her transferred assets in that she wrote many checks for personal expenses on the RLP account that were never reimbursed, and that she derived economic benefit from using RLP's assets to pay her living expenses, to meet her tax obligations and to make gifts to her family and subsequently the transferred funds should be included in the gross estate.

Parting Thoughts:

Another textbook case of what not to do when setting up an FLP. If the formalities of the FLP are not followed and the decedent transfers virtually all assets to an FLP, the courts are likely to disregard the FLP and disallow the discounts. However, if the FLP follows good business practices, there are sufficient assets outside the FLP, there is management and business purpose demonstrated through investment diversification and other characteristics of a business entity, then it is very probable that an FLP discount will be permitted.