Estate of Lillie Rosen v. Internal Revenue Service, 2006 T.C. Memo LEXIS 116 (June 1, 2006)

The Facts: Ms. Rosen's son-in-law consulted the family attorney regarding family limited partnerships (FLP). The attorney advised him that "simply changing the form in which the decedent's assets were held from a trust to a limited partnership would generate significant tax savings. Based on his general understanding of FLP's and discussions with the son-in-law, the family attorney (without meeting with any additional family members), determined which family members would become general and limited partners, the percentage amount each would contribute, and which assets would fund the FLP. Ms. Rosen, who suffered from dementia, was never consulted regarding the formation of an FLP when the documents were completed in 1996.

Only one family member signed the FLP documents in the presence of an attorney. Although the documents required capital contributions at the time of execution, not one of the family members knew the dollar amount of their capital calls until several months after the formation. The stated purpose of the FLP was the "business of making, protecting, enhancing, and otherwise investing…in any type of security," which amounted to $2.4 million in cash and marketable securities in a Merrill Lynch account, transferred from the family trust to the FLP, with the trust becoming the 99% limited partner. After the opening of the Merrill Lynch account in the name of the FLP, "there was no material change in the manner in which the …assets were managed."

The FLP paid for Ms. Rosen's living expenses and continued to fund gift-giving programs to Ms. Rosen's family members. The withdrawals by Ms. Rosen from the Merrill Lynch account were characterized as "loans" supported by two demand notes. None of the other partners took similar loans. In fact, one of the notes was prepared after Ms. Rosen's death in 2000 and back-dated to the day she passed away. By the date of Ms. Rosen's death, the FLP had given away 64% of the limited partnership interests. The trust's interest in the FLP was redeemed to pay Ms. Rosen's legal fees, funeral expenses and other bequests.

The Arguments:

The IRS argued to return all of the FLP's assets back in to the gross estate of Ms. Rosen, pursuant to Section 2036(a)(1), for tax purposes.

The estate claimed exemption arguing the same provision, that the transfers were a "bona fide sale for full and adequate consideration" and Ms. Rosen did not retain full possession and enjoyment of the assets. The estate also argued that Section 2035(a) limited the estate because the decedent had given away a 48.5% limited partnership interest more than three years before her death, from 1996-1998.

The Court stated, “to state the obvious, the 1998 gifts were not more than three years before the decedents death in 2000.” In addition, citing case law of the Estate of Thomson (2004), Estate of Abraham (2004), Estate of Strangi (2005) and Estate of Bongard (2005), the Court explained that to fall within the 2036(a)(1) exception for a bona fide transfer, the FLP must have:

1. Served a legitimate, non-tax purpose; and
2. Bestowed on each transferor a partnership interest proportionate to the fair market value of the transferred property.

Due to its findings on the first point, the Court did not discuss the second.

<u>The Findings:</u>

Judge Laro indicated that the Rosen FLP “conducted no business activity and had no business purpose for its existence other than the avoidance of Federal estate (and gift) tax.” A legitimate, significant non-tax reason is one that actually motivated the formation of [the] partnership from a business point of view and a “theoretical justification” won’t suffice.

The Court supported its findings with the following facts;

1. It conducted minimal and mostly passive investment activity.
2. It failed to follow “commonplace” business procedures such as maintaining books of account, making proper capital calls, holding formal partnership meetings, etc.
3. None of the FLP partners negotiated its original terms, and the decedents daughter stood “on all sides of the transaction” as general partner, trustee of the largest limited partner interest, and decedent’s attorney-in-fact.
4. Compared to the decedent’s contributions, the children’s contributions were “de minimus,” and given her contemporaneous gifts to the children, decedent arguably funded the FLP on her own.
5. The management of the assets was the same before and after the transfer.
6. During the first four years of the FLP, decedent gave away almost 65% of her limited partnership interest.
7. After forming the FLP, decedent was unable to meet her personal living expenses and gift giving program, which required withdrawal of FLP funds, which also went to meet her death expenses.
8. The assets of the FLP consisted solely of marketable securities and cash.
9. Decedent was 88 years old and in failing health when the FLP was formed.
10. The FLP provided no more meaningful protection from her creditors than the former family trust.
11. Decedent enjoyed the FLP assets and their income during her lifetime, receiving distributions when and as she needed them, which was the same arrangement that she had enjoyed when they were held in the trust.

<u>Parting Thoughts:</u>

I found this one actually humorous to read as it could be used as a perfect case of “what not to do” regarding FLP formation for estate planning purposes.