Note: The following represents a combined summary of two Tax Court Memorandums since the two memorandums were simultaneously issued (for husband and wife).

Estate of Edna Korby, et al., v. Commissioner, T.C. Memo 2005-102, May 10, 2005,
and
Estate of Austin Korby, et al., v. Commissioner, T.C. Memo 2005-103, May 10, 2005.

The Facts: Edna and Austin Korby were married in 1948 and had four sons. In 1993, at age 69, Edna was diagnosed with severe Alzheimer's dementia. She resided in a nursing home from 1993 until her death on July 3, 1998. Prior to 1993, Austin suffered a stroke and had been diagnosed with Type II diabetes, hypertension and cardiac arrhythmias. During 1993, Austin was diagnosed with atrial fibrillation with slow ventricular response. He was moved to a nursing home in 1998 and died on December 2, 1998, from coronary artery disease, diabetes and pneumonia.

In 1993, Austin and Dennis (one of their four sons) met with an estate planning attorney. A Living Trust, with Austin and Edna as co-trustmakers was established on June 2, 1993. Austin and Dennis were the only trustees of the Living Trust from its inception until Austin's death (his wife Edna was never a Trustee of the Living Trust). The Living Trust gave Austin and Edna the authority to control and direct payments from the Living Trust, add or remove Living Trust property, and amend or revoke the Living Trust. The Korby's transferred into the Living Trust a money market account, a house, a vacant lot, a checking account, a savings account, household furnishings and items, a 1% general partner interest in Crane Properties, a limited partnership ("Crane Properties"), a 2% general partner equity interest in KPLP (see below) and the Korby's monthly social security checks.

KPLP was formed on March 26, 1994. Austin, Edna and each of their four sons signed the KPLP limited partnership agreement as limited partners on such date. The Living Trust was the sole general partner of KPLP from its formation until after Austin's death. KPLP's agreement provided for management fees to be paid to the General Partner. The fees paid were decided by the General Partner and were to "be measured by the time required to manage and administer the partnership, by the value of property under the general partner(s) administration, and by the responsibilities the general partner(s) assume in discharging of the duties of office." The Korby's did not fund KPLP until 1995 wherein they transferred stocks and bonds worth an additional $1,850,000 in exchange for a 98% Limited Partner equity interest. Austin and Edna then transferred a 24.5% Limited Partner equity interest to irrevocable trusts created for each of their four sons. Of the total assets transferred, 58.46% of KPLP's assets were transferred by Austin, 38.26% were transferred by Edna, 1.28% was transferred by their four children, and 2% was transferred by the Living Trust. After the transfers, Austin and Edna did not have any bank accounts open in their own names. Gift tax returns were filed in 1995 reporting the gifts as split gifts—the four sons each received half of the 24.5% equity interest(s) from Austin and half from Edna. A 43.61% discount was applied to the KPLP

Limited Partner equity interests transferred. From 1995 to 1998, KPLP and the Living Trust paid many of the Korbys' household expenses. The Living Trust also made payments to Edna's nursing home, various miscellaneous stores, the IRS, and occasional cash payments to Austin. The Living Trust funds came from either funds transferred to it by KPLP or the Korbys' monthly social security checks.

The IRS issued a notice of deficiency to the Estates indicating that the full values of the assets held by KPLP were includable in the gross estate under Sections 2036 and 2038. The IRS also determined that the value of the property held by Living Trust was includable in the gross estate under Sections 2036 and 2038, rather than as jointly owned property. The total deficiency in estate tax for Edna totaled $1,104,635, while the total deficiency in estate tax for Austin totaled $1,070,482.

The Arguments: The Estate argued that Section 2036 did not apply to the assets transferred to KPLP because Austin and Edna retained no right to income from, corpus of, or power of appointment over the transferred assets, KPLP received the assets in a bona fide sale for adequate and full consideration in money or money's worth, and Austin and Edna did not retain ownership or control over the assets alone. The Estate argued that the cash payments that KPLP made to the Living Trust and payments of the Korbys' home expenses were actually management fees paid for Austin's services as a money manager for KPLP's assets. The IRS argued that Austin and Edna retained, by express and implied agreement, until they died, the enjoyment of the assets (via income) they transferred to KPLP.

The Findings: The Court did not believe that the payments to the Living Trust were management fees. Furthermore, the Court agreed with the IRS that an implied agreement existed between Austin, on his own behalf and on behalf of Edna, and the four Korby sons that after the assets were transferred to KPLP, income from the assets would continue to be available to Austin and Edna for as long as they needed income. Reasons for this determination are as follows:

1. The only assets retained by Austin and Edna after the 1995 transfer, in their names or the name of their living trust, were their house, a vacant lot, bank accounts with a total balance of $7,428, a 1% GP interest in Crane Properties, a 2% GP interest in KPLP, and the right to receive social security income.

2. Austin and Edna's reported medical expenses of over $37,000 were approximately double their social security income in each of the four years before they died.

3. KPLP distributed between 26.7% and 50.1% of its income to the Living Trust between 1996 and 1998 (even though the Living Trust only owned 2%). Furthermore, the payments from KPLP to the Living Trust totaled at least 52.6% of the Korby's income in each of the four years before their death.

4. The purported management fees paid by KPLP were used entirely by Austin and Edna and not by Dennis, who was co-trustee of the General Partner and was entitled to half of any management fees.

5. No management contract was executed, and the management fees were not based on any regular or prescribed method of payment (but instead paid at varying times and amounts, as Austin requested them).

6. The amount of time that Austin committed to managing KPLP's assets, under Austin's own plan to avoid recognition of capital gain, was minimal (KPLP held approximately 60 investments but Austin made only 6 sales or purchases of investments between 1995 and 1998).

7. Management fees paid by KPLP to the Living Trust totaled over $120,000 from 1995 to 1998, while the limited partners (who owned 98% of KPLP) received only one distribution totaling $12,061, for taxes in 1998.

In regards to the bona fide sale exception under Section 2036, the Court further concluded that this exception was not met for the following reasons:

1. Austin alone decided which of his and Edna's assets would be contributed to KPLP, the terms of the KPLP agreement, the determination of management fees for the General Partner, and whether the Limited Partners would receive any distributions.

2. Testimony from Dennis (the co-trustee) indicated that he was unfamiliar with the terms of the KPLP agreement and how management fees were to be determined.

3. Testimony from Gary (another of the sons) indicated that he was not represented in the formation of KPLP and did not even know how he acquired his interest in KPLP.

4. The Korbys' use of KPLP income for basic living expenses is inconsistent with the finding of a bona fide transfer.

Thus, the Court determined that 58.46% of KPLP's asset value should be included in Austin's gross estate and 38.26% of KPLP's asset value should be included in Edna's gross estate. Furthermore, the 2% GP interest owned by KPLP is included in Austin's gross estate as living trust property.

<u>Parting Thoughts:</u>

The Korbys' committed several of the "deadly sins" that have been in many recent cases in which the assets were pulled back into the Estate via Section 2036 (*Estate of Bigelow v. Commissioner, Estate of Hillgren v. Commissioner, Estate of Thompson v. Commissioner, Estate of Harper v. Commissioner*). Individuals who transfer assets to a FLP need to be sure to retain sufficient assets and income to pay for living expenses. Furthermore, individuals also need to make sure that a significant nontax reason has been identified for establishment of the FLP.