

Client Advisory

March 2005

Estate of Bongard v. Comm’r, 124 T.C. No. 6141-03

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Family Limited Partnerships have become a valuable estate planning tool. The IRS has attacked Family Limited Partnerships using a number of different approaches. Recently, the IRS has had some success with an attack based on Internal Revenue Code Section 2036.

One way to avoid that attack is to qualify for an exception to Section 2036 that applies to bona fide sales for full and adequate consideration. On Tuesday, the Tax Court issued its ruling in Estate of Bongard v. Comm’r which indicates its opinion as to when that exception applies.

Set forth below is our summary of that case.

Facts

Decedent founded a company. He and the company’s board of directors determined that it was best to pool the family’s stock in a family holding company (“WCB Holdings”) to position the company for a liquidity event. As a result of that decision, decedent and an irrevocable trust for decedent’s children (“ISA Trust” – with decedent’s attorney and an employee of decedent’s company as trustees) formed WCB Holdings. In exchange, Class A and Class B membership units were issued.

The Class A units had the voting rights and certain favorable economic rights in the holding company. Decedent received 86.39% of Class A and Class B units, and the ISA Trust received 13.61% of Class A and Class B units. Decedent was elected the “manager” of WCB Holdings; however, the manager could make decisions regarding distributions and accounting matters, as well as issuance of more units, borrowings over \$25,000, sale of the family company shares of more than \$10,000 over any 12-month period, or capital expenditures over \$10,000 as only with the consent of a majority of the holders of Class A units.

Years later, decedent and ISA Trust formed an FLP. Each transferred Class B units in WCB Holdings to the FLP, and each received an interest proportionate to their respective contribution (decedent, who did not transfer all of his Class B units in WCB Holdings to the FLP, received 99%, and ISA Trust received 1%). In a letter written by decedent to his children, he recited the reasons for forming the FLP: to give assets to family members without deterring them from working hard and pursuing their educations, to protect assets from creditors, to provide more flexibility than a trust, to limit expenses if lawsuits arise, to teach how to manage the family assets, and to accomplish transfer tax benefits.

A few years after the FLP was created, decedent gave 7.72% of his interest in FLP to his wife as part of a post-nuptial agreement. Decedent, a healthy individual, unexpectedly died.

Parties' Positions

The IRS attempts to apply Section 2036 of the Internal Revenue Code to both decedent's transfer to WCB Holdings and to the FLP, in order to eliminate discounts taken on his estate tax return relative to his interests in those entities.

The taxpayer argued, first, that there had been no "transfer" to which Section 2036 of the Internal Revenue Code applied. Second, the taxpayer argued that the "bona fide sale for full and adequate consideration" exception to Section 2036 of the Internal Revenue Code applied to defeat the IRS argument. Third, the taxpayer argued that no "retained interest" existed to cause Section 2036 to apply.

Conclusions

The Tax Court concluded that both the transfer of family company stock to WCB Holdings and of WCB Holdings units to the FLP are "transfers" for purposes of Section 2036 of the Internal Revenue Code.

The "bona fide sale for full and adequate consideration" exception was found to apply to the transfer from decedent to WCB Holdings. As a result, the assets of WCB Holdings were not taxed at decedent's death; only his interests in that entity. The discount for his interest in WCB Holdings was allowed.

The "bona fide sale for full and adequate consideration" exception was found not to apply to the transfer of WCB Holdings interests to the FLP. As a result, Section 2036 of the Internal Revenue Code applied to those transfers. Relying on the implied agreement provisions of Treasury Regulations Section 20.2036-1(a), the assets of the FLP were included as part of decedent's estate. The discount was denied.

Analysis

The Tax Court reviewed all of the recent cases regarding the bona fide sale for full and adequate consideration exception to Section 2036 of the Internal Revenue Code. It, like the *Kimbell* court, broke the exception into two pieces: the "bona fide" piece and the "full and adequate consideration" piece. The court then stated it would apply the following standard to determine whether the exception applied: **the record must establish the existence of legitimate and significant non-tax reasons for creating the FLP, and the transferors must receive partnership interests proportionate to the value of the property transferred to the FLP.**

As to the "full and adequate consideration" piece, this test indicates that the Tax Court takes virtually the same position as *Kimbell*. Apparently, so long as the percentage interest received in the FLP corresponds to the percentage value of property contributed (and, presumably, distribution and liquidation rights fall along the same lines), this prong of the test is met.

The court rejected the argument that because decedent failed to receive back from the FLP a "control premium," it suggested that he had not received full and adequate consideration. However, the court did say that these facts indicating the receipt of an entity interest with "dissipated value" triggers "heightened scrutiny into the substance of the transaction and whether there was a true business purpose" (citing *Thompson/Turner*).

In the case before it, the Tax Court found "legitimate and significant non-tax reasons" existed with respect to the formation of WCB Holdings. The court found that positioning the family company to facilitate a liquidity event was such a purpose; potential investors were more easily attracted and the market for the shares of the underlying family company was increased. Since the units in WCB Holdings were issued in proportion to the contributions of family business stock contributed to it by decedent

and ISA Trust, the bona fide sale for full and adequate consideration exception to Section 2036 of the Internal Revenue Code was deemed to apply.

The Tax Court reached a different conclusion based on its analysis of the non-tax reasons for forming the FLP. The court looked at and rejected each reason advanced by the taxpayer.

Although one of the reasons for forming the FLP was to give assets to family members without deterring them from working hard and pursuing their educations, the only gift of FLP interest that was made was to decedent's wife as part of a post-nuptial arrangement. The court felt that was not the type of "gift" referenced in decedent's letter describing the purposes of the FLP. Further, though decedent made many other gifts after the FLP was created, he did not make any gifts of FLP interests. The court concluded this purpose was not a "legitimate and significant" non-tax purpose for establishing the FLP.

Another stated purpose of the FLP was to protect assets from creditors and to limit expenses if lawsuits were to arise. The court noted that creditor protection was already provided by WCB Holdings and that the FLP didn't provide any additional protection. This may be true as to the risk to decedent as to suit from WCB Holdings' creditors, but not as to the ability of decedent to use a "charging order" that is issued in a partnership context to protect the assets of the FLP from decedent's creditors. Nevertheless, the court was not persuaded that this was a "legitimate and significant" non-tax reason for establishing the FLP.

Decedent created trusts for grandchildren shortly after he created the FLP. The court found this fact to mean that decedent didn't find trusts to be too inflexible, as he continued to create them after creating the allegedly "more" flexible FLP. Again, this purpose was not found to be a "legitimate and significant" non-tax reason for establishing the FLP.

Finally, the stated purpose of teaching family members how to manage assets could not be accomplished through the FLP, as it did not perform a management function for the assets it received. The FLP never engaged in any business transactions after creation; it simply held the units in WCB Holdings. This purpose could not be found to be a "legitimate and significant" non-tax reason for establishing the FLP.

Having failed to find any legitimate and significant non-tax reasons for establishing the FLP, the Tax Court concluded that the exception to Section 2036 of the Internal Revenue Code did not apply. Absent the exception, the court set out to determine if decedent had maintained an interest in the assets of the FLP as required to cause Section 2036 of the Internal Revenue Code to include the assets of the FLP in decedent's taxable estate without discount.

First, the court found that decedent did not make the mistake made by the taxpayer in *Strangi* or in *Thompson/Turner*; he had left enough assets outside the FLP to maintain his lifestyle. As a result, the arguments in those cases were not available for the court to find an "implied agreement" under Treasury Regulations Section 20.2036-1(a).

However, the court did find that decedent, through his control of the underlying family business (by serving as sole member of the Board and by voting to liquidate some of the company shares from time-to-time), had the ability to determine what the assets of the FLP were (i.e., either stock or cash). In each case of a liquidation, the court noted that decedent chose not to participate – in effect limiting the FLP to its ownership of Class B units.

The court recognized the corporate formalities in establishing the FLP were followed and that the general partner of the FLP owed fiduciary responsibilities to the partners. Nevertheless, it concluded that the extent of decedent's control was enough to cause Internal Revenue Code Section 2036 to apply.

Observations

A number of Tax Court judges found problems with the majority's decision. Some found fault with the new "legitimate and significant non-tax purposes" test, indicating that they did not see this requirement in Section 2036 of the Internal Revenue Code. One judge indicated that the appeal from this case would go to the Eighth Circuit, where a "business purpose/economic substance test" was applied.

Another judge sought to apply an "ordinary course of business" test as set forth in Treasury Regulations Section 25.2512-8 to determine if the transaction was "bona fide". He felt that this would virtually eliminate the availability of the exception for family transactions.

Another judge believed that the implied agreement was too tentative to apply Section 2036 of the Internal Revenue Code even if the exception was found not to apply.

For future planning, if the exception to Section 2036 of the Internal Revenue Code is to apply, it becomes even more important to have true, "legitimate and significant" non-tax reasons for establishing the FLP. The creditor protection reason would seem to have benefit, so long as the assets being transferred to the FLP don't already provide for same. Transfers of rental real estate would seem to be classic examples of assets that would allow for this purpose to be given weight.

The court might also allow weight for teaching other family members how to manage the assets, so long as those other family members are actually involved in management after the transfer. If, for example, the children are the general partners (or owners of a general partner entity) of the FLP, management would have shifted from parents to children, and this factor becomes more legitimate and significant.

It was interesting that the court might have supported as a purpose an ability to make gifts of assets to family members by allowing the partnership interest to "wrap" a number of different assets so that they could be given more simply. Of course, if this purpose is to be given importance, the taxpayer should actually make gifts of FLP interests.

The *Kimbell* case includes a good list of business purposes to seek to establish in order for the exception to Section 2036 of the Internal Revenue Code to apply.

It makes sense to set forth the business purposes in the FLP agreement, and also to cause communications regarding the formation of the FLP to include lengthy discussions of these non-tax reasons. Though transfer tax benefits can be discussed, the focus of communications should be non-tax reasons.

We Can Help

As always, we stand ready and able to assist you with these matters at any time. Please do not hesitate to query any of us using the below contact information:

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