New York Law Journal
Trusts&Estates
WWW.NYLJ.COM
An ALM Publication
VOLUME 257—NO. 10
TUESDAY, JANUARY 17, 2017

Letting Go: Common Gift and Estate Tax Triggers

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It is the season of giving which ultimately fuels the season of estate and gift tax audits.

Many of the questions raised in an audit can be anticipated by prior cases, such as: review of the decedent's background, lifestyle, gifts and assets (*Estate of Harper*, TC Memo 2002-121); information about the donor's heath, intent and entity operation (*Estate of Rosen*, TC Memo 2006-115); the order in which transactions occurred (*Estate of Shepard*, 115 TC 376 (2000), aff'd 283 F3d 1258 (11th Cir. 2002)); and information about meetings with the client(s) and the reason for the entity, the manner in which business responsibilities were assumed, and the documentation of legitimate non-tax reasons (*Estate of Rosen*, TC Memo 2006-115). One of the common gift or estate tax audit triggers occurs when a family limited partnership (FLP) or a limited liability company (LLC) is involved. This is because these entities are utilized by donors who may not completely understand the risks associated with planning with these entities or who demand continued control. The result is that the Internal Revenue Service may claim the estate retained certain enumerated rights over the entity, and pursuant to §2036 of the Internal Revenue Code, the full value of the transferred asset should be included in the estate at the date of death value, not at a discounted value.

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That is why *Estate of Purdue v. Commissioner*, TC Memo 2015-249, stood out—because it bucked the typical scenario. In this case, the decedent and her husband in August 2000 formed a family limited liability partnership (PFLLC) to hold their marketable securities and their interests in a commercial building to centralize management and take advantage of valuation discounts. As set forth in the memorandum prepared by their attorney, the purposes of the FLP was (1) to consolidate their assets, (2) avoid fractionalization of their interests, (3) keep the ownership in the family, (4) protect assets, (5) provide flexibility and (6) promote education of and communication among the family with respect to financial matters.

The day after the FLP was formed, the family, including all five children received a draft Purdue Family Limited Liability Company operating agreement from this same attorney noting the tax savings the FLP could provide as well as four non-tax

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business reasons for the formation of the FLP. In November 2000 the FLP was funded. In the same month, the decedent and her husband also formed a family trust, the beneficiaries of which were their descendants and the spouses of their descendants. The trust provided for Crummey withdrawal rights and on Dec. 28, 2000, the decedent and her husband funded the trust with cash from two separate bank accounts, which was partially distributed to their children on Dec. 29, 2000 and completely distributed during 2001.

From 2001 until the death of the decedent, the children held annual meetings in their capacities as trustees and beneficiaries of the trusts, personal representatives and beneficiaries of their parents' estates, attorneys-in-fact for the parents and as members of the FLP. They discussed accounts and assets, heard presentations and received estate tax planning updates and advice. In addition, beginning in 2001, in order to address their concerns about the fractionalization of the investment structure, the family hired an investment firm who provided guidance regarding the FLP and their investments.

Also, prior to forming the FLP and the family trust, the decedent and her husband made annual gifts to their children and grandchildren. This pattern of gifting continued where from 2002 to 2007 the decedent made annual exclusion gifts of her FLP interests to the beneficiaries of the family trust with additional gifts at the end of the year if there were additional births or marriages. The value of the gifts was based on valuation summaries prepared by their attorney and each year waivers of their withdrawal rights were distributed and signed by the beneficiaries of the family trust.

During this period of planning, the decedent was in excellent health until her death in 2007, other than an injury sustained in 1984 from which she never fully recovered her ability to walk safely. Her husband, who died unexpectedly in 2001, was also considered to be in good health although later it was determined that he had Alzheimer's disease. Finally, because of family disputes and the structuring of the ownership of assets, one of the decedent's children was able to block the liquidation of assets/distributions so that the estate tax liability could be paid. Therefore, some of the beneficiaries loaned money to the estate to pay the estate tax liability and the estate in turn took any interest paid on the loan as a deduction on the estate tax return.

> 'Purdue' provides a clear roadmap of how to **successfully divest oneself of the risks** associated with key audit triggers.

The issues highlighted in this case—§2036(a), annual exclusions and the deductibility of loan interest to pay estate tax—frequently arise in estate and gift tax audits although not usually in one single case. The first issue refuted was the IRS claim that the contributions of assets to the LLC was a transfer with a retained interest includible in the decedent's estate under §2036.

Section 2036(a) generally provides that if there is an inter vivos transfer made for something other than a bona fide sale for adequate and full consideration and the decedent retains certain enumerated rights or interests in the property which are not relinquished until death, the full value of the transferred property is included in the value of the decedent's gross estate.[1] A bona fide sale requires a legitimate and significant non-tax reason for creating the entity. The estate, who had the burden of proof and never argued that the burden shifted to the government, stressed the seven non-tax motives for the transfer outlined in the decedent's attorney's memorandum the day after the formation of the FLP (TC Memo 2015-249 at p. 15-17). The court in *Purdue*, however, focused on the change in management of the assets after the FLP was formed, specifically that there was a single advisor involved in the management, that the children made the decisions jointly and that the decedent and her husband were not involved once the transfer occurred. To the court, this was a legitimate non-tax motive for the transfer of property. And although, as the IRS argued, the decedent and her husband stood on both sides of the transaction, the court reasoned

that "an arm's length transaction occurs when mutual legitimate and significant non-tax reasons exist for the transaction and the transaction is carried out in a way in which unrelated parties to a business transaction would deal with each other." (Id. at 20 (citing *Estate of Bongard v. Commissioner*, 124 TC 95 at 123)). The court was clear that this was not a mere change in form, as argued by the IRS, because if "a decedent employ[s] his capital to achieve a legitimate non-tax purpose, the court cannot conclude that he merely recycled his shareholdings." (Id. at 22 (citing *Estate of Schutt v. Commissioner*, TC Memo. 2005-126). The remaining factors (the financial independence of the transferors, the lack of commingling, timely transfers, the entity maintained annual records and the transferors were in good health) all were decided in favor of the Estate.

The next issue refuted was the IRS claim that the annual gifts were not present interest gifts that qualified for the annual exclusion. To qualify as a present interest gift, a gift must give the donee "[a]n unrestricted right to the immediate use, possession or enjoyment of property or of income from the property." When the gift is of LLC or limited partnership interests, as in *Purdue*, the donees must "obtain use, possession or enjoyment (1) of the limited partnership interests or (2) of the income from those interests within the meaning of Section 2503(b)." The difficulty that the estate had in *Purdue* was that the donees membership interests in the LLC were limited because no one interest could be transferred without unanimous consent of the other members and so there was not the receipt of "unrestricted and non-contingent rights to the immediate use, possession or enjoyment of the PFLLC interests themselves." However, utilizing the three prong test set out in *Calder v. Commissioner*, 85 TC 713, 727-28 (1985), the court reasoned that the present interest requirement was met (TC Memo 2015-249 at pg. 26-27) since the LLC held income-producing real estate and dividend-paying marketable securities, the LLC made distributions to the trust and the trust made distributions to the beneficiaries over eight years of approximately $2 million, and the rent was readily ascertainable.

The third issue refuted was the claim by the IRS that the interest expense deducted as an administration expense under §2053 was not actually and necessarily incurred in the administration of the estate. For interest to be deductible, "the loan obligation must be bona fide and actually and necessarily incurred in the administration of the decedent's estate and essential to the proper settlement of the estate." Since one of the decedent's daughters created a deadlock by not voting for the liquidation of assets/distributions so that the estate tax liability could be paid, the loan was necessary. Therefore, the deduction of the interest expense on the loan was permitted.

Purdue provides a clear roadmap of how to successfully divest oneself of the risks associated with key audit triggers. Careful planning, working with trusted advisors whose advice is followed, and having the ability to cede control to the successor generation ensured that the issues raised by the auditors were resolved in favor of the Estate. The Purdue family began their estate plan almost 12 years prior to the audit and five years prior to the actual creation of the family LLC or family trust. Yet it was not the facts alone that made their plan a success but rather the years of administration that followed. Succession planning is difficult for myriad reasons but those difficulties can be minimized when a plan is instituted based on a knowledge of known audit triggers and an ability to let go.

1. Section 2036(a) is applicable when (1) an inter vivos transfer was made, (2) that was not a bone fide sale for full and adequate consideration, (3) decedent retained an interested or right enumerated under Section 2036(a)(1) or (2) or (b) in the transferred property that was not relinquished prior to death.

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