

Business Purpose, Bona Fide Sale, and Family Limited Partnerships

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In "Business Purpose and Economic Substance in FLPs," Tax Notes, Jan. 1, 2001, p. 85, we wrote that while a family limited partnership (FLP) without a business purpose "may be ignored by the IRS for income tax purposes, . . . that lack of business purpose will not prevent an FLP from being given effect for transfer tax purposes and thus producing valuation discounts." That comment was based on *Estate of Albert Strangi v. Commissioner*, 115 T.C. 478, Doc 2000-31014, 2000 TNT 232-12 (2000).¹ The first Strangi decision was hardly clear-cut, including an opinion, a concurring opinion, and three dissenting opinions. Now the Tax Court has compounded the confusion with another family limited partnership opinion, *Estate of Wayne C. Bongard v. Commissioner*, 124 T.C. No. 8, Doc 2005-5359, 2005 TNT 50-11 (2005), in which the majority concludes -- contrary to Strangi I -- that for estate tax purposes, there must be a legitimate and significant nontax reason for creating the family limited partnership. In addition to a majority opinion, the Bongard case had three other opinions -- one judge who concurred with only the result and not the reasoning (joined by another judge) and two judges who each wrote their own separate opinions concurring in part but dissenting in part, with still two other judges agreeing with one of those latter separate opinions.

Strangi I Reprise

What is needed for an FLP to be effective for transfer tax discount purposes? That is a practical question to which practitioners need answers. Even those who do not actually create FLPs are faced with advising clients on their likely effectiveness -- or lack thereof. In Strangi I (the original 2000 opinion), the FLP "was validly formed under State law" and actually took title to the Strangi assets. That was the crucial point in determining that it was valid for transfer tax purposes. While rejecting the business purposes that the estate alleged motivated formation of the FLP, Judge Mary Ann Cohen, writing for the majority, concluded that business purpose was not necessary for transfer tax effectiveness. She also accepted that the Strangi FLP had enough economic substance to carry the valuation day. The opinion stated, "Regardless of subjective intentions, the partnership had sufficient substance to be recognized for tax purposes. Its existence would not be disregarded by potential purchasers of decedent's assets, and we do not disregard it in this case."

In his separate opinion concurring in the result, Tax Court Judge Thomas B. Wells took issue with the language used by the majority. His view was that:

the majority's stated reasons for holding that the partnership had substance misapplies the economic substance doctrine. . . . Rather than holding that the economic substance doctrine is satisfied in the instant case, the Court should conclude that the economic substance doctrine does not apply to disregard a validly formed entity where the issue is the value for Federal gift and estate tax purposes of the interest transferred in that entity.

The Strangi I Dissenters

¹Subsequently that decision was affirmed and reversed under the name of *Rosalie Gulig v. Commissioner*, 293 F.3d 279, Doc 2002-14498, 2002 TNT 118-10 (5th Cir. 2002) and then decided by the Tax Court on remand as *Estate of Strangi v. Commissioner*, T.C. Memo 2003-145, Doc 2003-12584, 2003 TNT 98-16. An appeal on that latter decision is still pending in the Fifth Circuit as this is written. In its affirmation of *Strangi I*, the appeals court explained, "We review the question of whether SFLP has a business purpose and economic substance, such that it should not be disregarded for tax purposes, for clear error. . . . Under this standard of review, we agree with the tax court that the partnership has enough economic substance for SFLP to be recognized for federal estate tax purposes."

However, Tax Court Judge Carolyn Miller Parr went further and dissented. "The facts clearly demonstrate that the paper arrangement, the written partnership agreement, had no relationship to the reality of decedent's ownership and control of the assets contributed to the partnership," she said. "If a hypothetical third party had offered to purchase the assets held by the partnership for the full fair market value of those assets, there is little doubt that decedent could have had the assets distributed to himself to complete the sale." Judge Parr complained that the majority "values decedent's partnership interest as if the restrictions in the written partnership agreement were actually binding on the partners," and further explained that if the partnership had to be recognized for estate tax purposes, she "would value the interest under the agreement that existed in fact, rather than under the written partnership agreement that had no relationship to the reality of decedent's ownership and control of the assets contributed to the partnership."

Judge Robert P. Ruwe also dissented. He emphasized that "tax savings was the only motivating factor for transferring property to the partnership" and objected to the fact that "the majority validates this scheme by valuing decedent's 99 percent partnership interest at 31 percent below the value of the property that decedent transferred to the partnership." Judge Ruwe would have agreed with the IRS's alternative argument, rejected by the majority, that if any discount was to be allowed, the difference between the value of the property going into the FLP and the value of the partnership interest received "should be considered to be a gift."

Estate of Bongard

Tax Court Judge Joseph Robert Goeke, who wrote the majority opinion in Bongard, was not even on the Tax Court bench when Strangi I was handed down in 2000. Therefore he was in an especially good position to take a fresh look at the role of business purpose and the questions of substance versus form and tax avoidance. He explained that according to a December 28, 1996, letter to Bongard's children signed by Wayne C. Bongard and drafted by John Fullmer, his estate planning attorney, Bongard Family Limited Partnership (BFLP) was ostensibly created as part of an overall plan to provide:

among other things, a method for giving assets to decedent's family members without deterring them from working hard and becoming educated, protection of his estate from frivolous lawsuits and creditors, greater flexibility than trusts, a means to limit expenses if any lawsuits should arise, tutelage with respect to managing the family's assets, and tax benefits with respect to transfer taxes.

On December 29, 1996, Bongard contributed to the partnership all of his nonvoting membership units in WCB Holdings, the LLC that held stock in Empak, a business that Bongard had founded. He received a 99 percent limited partnership interest in BFLP. ISA Trust, an irrevocable stock accumulation trust that Bongard had established 10 years earlier for the benefit of his children and his wife's daughter from her first marriage, contributed its nonvoting membership units in the WCB Holdings and received a 1 percent general partnership interest in exchange. Mark Bongard, son of Wayne C. Bongard, was one of the three trustees of ISA Trust, the other two being attorney Fullmer and James A. Bernards, an outside accounting consultant who was one of Bongard's closest advisers (and who was later to serve as his personal representative after his death).

Two years later, on November 16, 1998, Wayne C. Bongard died unexpectedly while on a business/hunting trip to Austria. He was 58 at the time and had appeared to be in good health. Judge Goeke noted that:

from its inception until decedent's death, BFLP did not perform any activities, never acted to diversify its assets, or make any distributions. The WCB Holdings membership units in BFLP were nonvoting, and decedent determined whether the Empak shares held by WCB Holdings would be redeemed. WCB Holdings did not redeem any of its . . . membership units held by BFLP before decedent's death.

The estate tax return reported a tax due of \$17,004,363. The IRS's 90-day letter determined a deficiency of \$52,878,785. Later, after the case was docketed with the Tax Court, the IRS amended its answer to the estate's petition to increase the value of the underlying Empak stock. Judge Goeke observed that "using this value, respondent's counsel estimated the revised adjustment to decedent's gross estate could be as high as \$160 million."

The Bona Fide Sale Exception

A primary concern facing tax practitioners is that assets that have been transferred to an FLP might get pulled back into the taxable estate under section 2036. Section 2036(a)(1) includes in the estate transfers of property where the decedent retained the "possession or the enjoyment of, or the right to the income from," the transferred property. Section 2036(a)(2) "claws back" into the estate any property transferred during the lifetime over which the decedent has retained "the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom." The only assets in BFLP were the membership units in WCB Holdings, and the assets of WCB Holdings consisted of Empak stock. As noted in the quote above from Judge Goeke, "decedent determined whether the Empak shares held by WCB Holdings would be redeemed," so that BFLP could not actually do anything except passively hold its assets until that redemption occurred.

However, section 2036 would not apply if the transfer of the WCB Holdings membership units to BFLP was "a bona fide sale for an adequate and full consideration in money or money's worth." The estate argued that it was a bona fide sale. The partnership agreement provided that BFLP was established to "acquire, own and sell from time to time stocks (including closely held stocks), bonds, options, mutual funds and other securities." Attorney Fullmer testified that "BFLP was established to provide another layer of credit protection for decedent." Both accounting adviser Bernards and Fullmer testified that BFLP was established, in part, to make gifts.

The IRS responded that BFLP was "simply a paper transaction designed to facilitate the distribution of family wealth both before and after death while leaving decedent's lifetime control of Empak unimpaired." The IRS argued that Bongard's relationship to the assets put into BFLP remained the same before and after that contribution. As CEO and the sole member of Empak's board of directors, Bongard could determine when and if dividends would be paid or stock redeemed. While the December 1996 letter to Bongard's children recited that tutelage with respect to management of the family assets was one of the objectives of the family partnership, the reality was that until Bongard's death, BFLP never engaged in any investment transactions or decisions and had neither an investment plan nor a diversification strategy. Bongard made no gifts of his BFLP interests to his children.

Judge Goeke concluded that:

The record does not support that the nontax reasons for BFLP's existence were significant motivating factors. The formation of WCB Holdings eliminated direct stock ownership in Empak and allowed decedent to make gifts without diversifying the direct ownership of Empak. Messrs. Fullmer and Bernards testified that an impetus for forming BFLP was to continue decedent's gift giving. Decedent, in fact, made numerous gifts after the formation of BFLP, but not of his BFLP interest. All of the gifts decedent made were of WCB Holdings class A membership units, except for the 7.72 percent limited partnership interest he gave to Cynthia Bongard [his wife] in 1997. At the time of BFLP's formation and at the time of his death, any additional gifts decedent had contemplated were speculative and indefinite at best. There was no immediate or definite plan for such gifts. Such intent is not sufficient to establish that the transfer of membership units to BFLP was motivated by a significant nontax reason. . . .

As a practical matter, decedent did not receive any benefit beyond transfer tax savings from placing his WCB Holding class B membership units in BFLP. . . . Under these facts, decedent's transfer of WCB Holdings class B membership units to BFLP did not satisfy the bona fide sale exception.

That was enough for Judge Goeke to determine that the underlying WCB Holdings class B membership units transferred to BFLP were the assets to be included in the estate under section 2036(a)(1), thus effectively eliminating any discount otherwise obtainable from use of the family limited partnership. By so deciding, the court made it "unnecessary to determine whether the terms of the BFLP agreement provided decedent explicit rights to control the property" sufficient to result in its inclusion under section 2036(a)(2).²

Receiving 100 Cents on the Dollar

Judge David Laro concurred in only the Bongard result. He disagreed with the reasoning of the majority when they said that "where the record establishes the existence of a legitimate and significant nontax reason for creating a family limited partnership, . . . the adequate and full consideration exception is met if the transferors received partnership interests proportionate to the value of the property transferred." After reviewing several other valuation discount cases, he focused on the decision in *Kimbell v. United States*, 371 F.3d 257, Doc 2004-10976, 2004 TNT 100-9 (5th Cir. 2004). The Kimbell opinion, he said:

stated that valuation principles should not be equated with the test of "adequate and full consideration" because business or other financial considerations may not enter into a transferor's decision to receive an interest in a limited partnership that may not be immediately sold for 100 cents on the dollar. While I do not disagree that these considerations may cause a transferor to accept such an interest in a partnership, the issue as I see it is whether the inability to realize the 100 cents is attributable to (1) an actual difference in value between the transferred and received properties or (2) the presence of one or more intangible

²The IRS and the estate had stipulated that discounts would apply in valuing the decedent's membership units in WCB Holdings LLC. Those included a 13 percent lack-of-control discount, a 17.5 percent lack-of-marketability discount, and, for the nonvoting class B units, a 5 percent lack-of-voting-rights discount. If BFLP had been allowed to stand, discounts attributable to it would have been in addition to the stipulated discounts.

assets the sales price of which is subject to dispute. Under the case law referenced above, the adequate and full consideration exception does not apply where a difference in value between transferred and received properties causes a depletion in the transferor's gross estate. Nor does *Kimbell v. United States*, *supra*, hold otherwise.

That nontax reasons may have motivated the transfer to the family limited partnership would not carry that much weight for Judge Laro, nor for Judge Marvel, who agreed with his comments. Those judges would have applied the traditional business purpose test of *Gregory v. Helvering*, 293 U.S. 465 (1935), despite all of its problems and ambiguities. "In fact," wrote Judge Laro, "as I read the relevant text underlying the adequate and full consideration exception, that text speaks only to a 'sale' of property and makes no specific statement as to the purchaser of that property."

Judge Halpern went further, both concurring in part and dissenting in part, but specifically noting that he did not agree with all of Judge Laro's views even though he, too, felt the majority was wrong in their interpretation of the bona fide sales exception. Judge Halpern approached the question of whether the property transferred by a decedent was nevertheless includable in that decedent's estate by:

first, determining whether the decedent retained lifetime possession, enjoyment, income, or control of transferred property. Only after answering that question in the affirmative would I proceed to determine whether the bona fide sale exception applies to the transfer.

[In considering the bona fide sale exception] I would first determine whether the transfer was made in the ordinary course of business, as that term is used in section 25.2512-8 Gift Tax Regs. If not, I would determine whether the transfer was made for full value (i.e., whether the value of the transferred property at most equaled the cash value of the consideration received therefor). If not, then I would find that the value of the transferred property was included in the value of the gross estate pursuant to section 2036. Motive would only play the limited role I have outlined above (i.e., determining donative intent for purposes of the ordinary-course-of-business test).

Judge Halpern would essentially apply the same test to determining whether transfers to the partnership constituted gifts in the first place. "I believe," he said, "that a transfer to a family-owned entity may constitute a taxable gift, even if the size of the entity interest received by each transferor is deemed proportional to the value of the property contributed by that transferor."

Conclusion

The owner in fee simple of a single piece of property has a title to it that is worth what the property as a whole is worth. When that property is transferred to 15 different owners as tenants in common, each ownership interest has a fair market value that is less than 1/15 of the fair market value of the whole. The whole is not equal to the sum of the parts, whatever mathematicians may say or common sense dictate. If a decedent who owned that single piece of property conveyed it to 15 different heirs as tenants in common, that there is a disparity between the value of the 100 percent of the property and the lesser total of the value of the 15 1/15 separate tenancy in common interests disturbs no one. The estate tax is imposed on the value of the 100 percent because that is what the decedent possessed on the date of death. That the heirs

received an aggregate of value worth less is of no concern to the tax collector.

The problem with the family limited partnership "device" arises when what is essentially a testamentary disposition masquerades itself as a lifetime transfer. Tax practitioners who become enamored of the device forget that courts will struggle to find reasons to set aside devices and reach results that seem equitable. That seems to be the struggle in which the family limited partnership strategy finds itself entangled. We agree with Judge Laro that the Bongard majority reached the right result as to the BFLP assets.

The debate over the family limited partnership strategy has not ended, of course. In the midst of that battle of paper and words, tax practitioners must deal with clients every day. We cannot wait until a "final" solution has been reached. The Bongard family limited partnership failed, we believe, mainly because nothing was ever done with it. It was like the situation we sometimes encounter in which the decedent intended to avoid probate by using a revocable trust. It can happen that the trust was created, but none of the major assets the taxpayer owned at the date of death had ever been transferred to the trust. His advisers created a vehicle for Wayne Bongard, but Mr. Bongard never implemented the strategy of which BFLP's creation was the first step. He made no gifts of limited partnership interests except that one small amount to his wife. Given the marital deduction, that gift probably had no transfer tax implications. He died before the assets could be converted into cash or its equivalent by the general partner and therefore before the partnership could move into more active investments.

The family limited partnership does offer great opportunities for preventing family net worth from splintering, including some degree of asset protection. In the process, it also offers the opportunity of transfer tax discounts. If the discounts are all that is being sought, however, and it appears that the decedent merely moved the assets into the partnership and nothing more, little is apt to be accomplished taxwise. There is a message in all this: Practitioners need to review not only the basic estate planning strategy but also periodically review its implementation. The tax devil often lurks in the details. And that is not true of FLPs alone.