T.C. Memo. 2011-259, Docket No. 29397-08

Estate of Liljestrand v. Commissioner

by
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OVERVIEW

In yet another bad facts case (from the taxpayer's perspective), the value of assets contributed to an FLP were includable in the Decedent's estate under IRC § 2036(a). In particular, the Decedent failed to provide a non-tax reason for the FLP's formation, ignored partnership formalities, commingled funds, did not maintain sufficient assets outside the FLP for personal use, and made disproportionate distributions of Partnership assets to himself.

THE FACTS

Paul H. Liljestrand ("Dr. Liljestrand" or the "Decedent") formed Paul H. Liljestrand Partners Limited Partnership ("PLP" or the "Partnership") on May 30, 1997. The Decedent, through a trust, transferred more than $5.9 million of real estate to PLP in December 1997. Of particular note:

- Dr. Liljestrand was both trustee and beneficiary of the trust, and he had access to all trust income and corpus during his life.
- The mortgage associated with one property was not transferred to PLP.
- Leases associated with the transferred properties were not transferred to the Partnership.

The Decedent – through his trust – received a 99.98-percent interest in the Partnership (all of the general partner units, all of the Class A limited partner units, and 5,545 out of 5,546 Class B limited partner units), while his son, Robert, received one Class B limited partnership unit. No record of Robert's contribution of capital to PLP was found.

Class A limited partners were granted a preferred return. Interestingly, the preferred return – along with the total number of PLP partnership units, the number of partnership units each partner would receive, and the required contribution of each partner – was left blank on the Partnership Agreement when it was initially signed by the Partners.

Dr. Liljestrand formed the Partnership on the advice of his attorney, who believed the entity was the only way for Dr. Liljestrand to protect against the restrictions of two Hawaii statutes (one permits certain property owners to seek partition; the other allows beneficiaries of trusts to void the actions of interested trustees). The Decedent further wished to gift interests of PLP to his four children, although only Robert was involved with the formation or running of the Partnership. Finally, Dr. Liljestrand wished to ensure Robert's continued management of the real estate properties owned by the Decedent through his trust.

During 1998, the Decedent's trust gifted Class B units to four irrevocable trusts for the benefit of the Decedent's children. The children's trusts each received an additional 33 Class B units during 1999. Although gift tax returns were required, none were filed until after Dr. Liljestrand's death in 2004.

No bank account was opened for PLP until August 1999, even though the Partnership was formed in 1997. Additionally, Dr. Liljestrand reported PLP's income and expenses on his personal tax return. As a result, there was significant commingling of trust and Partnership funds. The Decedent's accountant (rather than Dr. Liljestrand or Robert) noticed that PLP had no employer identification number or a separate bank account. Instead of amending the Decedent's 1997 and 1998 tax returns, the Decedent's advisors agreed to treat the Partnership as having begun on January 1, 1999, even though property titles were transferred in December 1997.

Although Dr. Liljestrand maintained some assets outside of PLP, the retained assets were insufficient to maintain the Decedent's lifestyle. As a result, Dr. Liljestrand received disproportionate distributions and the Partnership frequently paid personal expenses directly. Included in the personal expenses paid by PLP were Dr. Liljestrand's housekeeping staff, personal assistant, grandchildren's tuition, personal line of credit, and personal mortgage. Additionally, the Decedent's children used PLP's funds to pay personal expenses but did not execute promissory notes for repayment of the purported loans.

Further, the preferred return portion of the Partnership Agreement was filled in at some point and allowed for a 14-percent return. Based on a $310,000 value for the preferred Class A limited partner units (a value deter-

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E-FLASH TAKEAWAY

Among the many reasons the taxpayer failed to prevail was his reluctance to rely on a business appraisal prepared by an independent business appraiser. Instead, he chose to rely on his own estimate of fair market value to establish the rate of return on his Class A limited partnership units. The court viewed his actions as self serving and not what would transpire in an arm's-length transaction.

mined by the Decedent and not by an independent outside expert), the $43,400 annual preferred return was almost exactly the amount of income generated by the Partnership's property, which inferred the two were driven by the Decedent's personal income requirements and not an arm's-length marketplace.

When she began separately tracking business activities in 1999 (again, two years after the Partnership was formed), PLP's accountant set up capital accounts for each partner. However, according to the statement of partners' capital, there was only $24,203 of capital as of December 31, 1999, even though more than $5.9 million of real property had been contributed.

After Dr. Liljestrand's death, the Partnership's accountant was informed that disproportionate distributions and personal expense payments were being accounted for incorrectly. The distributions and expenses should have been treated as receivables for the Partnership rather than draws against capital accounts. However, there was no evidence any of the partners made any attempt to pay the allegedly borrowed amounts.

After Dr. Liljestrand passed away in 2004, his estate filed an estate tax return. To pay the federal and state tax obligations of $2.37 million and $130,000, respectively, his estate refinanced property owned by PLP and used the proceeds from the refinancing to fund the tax liabilities.

The IRS determined a federal estate tax deficiency of $2.57 million in August 2008 and included in its notice of deficiency the assets transferred to PLP.

DISCUSSION

Although the estate attempted to shift the burden of proof to the IRS under § 7491, the Tax Court decided that its ruling would be based on the preponderance of evidence. Therefore, the court did not address the burden of proof argument.

SECTION 2036(a) – *Bona fide* sales

§ 2036(a) does not apply if the transfer meets the *bona fide* sale exception; that is, the transfer must be an arm's-length transaction, for full and adequate consideration. Accordingly, the *bona fide* sale portion of the requirement was considered by the court.

NON-TAX REASONS FOR PARTNERSHIP FORMATION

The Estate

The estate argued that PLP had been formed for several non-tax reasons (as outlined in the Court Analysis below).

Court Analysis

The tax court considered the estate's reasons for forming the Partnership:

A) Ensure Robert would continue to manage the real estate

The court determined that Robert's role as manager was not a central reason for the formation of the Partnership.

Robert's roles as trustee of the trust and manager of the real estate created a conflict of interest that could potentially allow a beneficiary of the trust (i.e., one of Dr. Liljestrand's other children) to invoke a state statute voiding his actions as trustee. The estate argued that resolving this conflict was a primary reason for the formation of PLP.

The court disagreed, determining that the formation of the Partnership merely changed the assets in the trust but did not change Robert's roles. After the formation of PLP, Robert was still trustee of the trust and manager of the property. Because the conflict still existed, the court determined Robert's continued management of the property was not a non-tax reason for the formation of PLP.

B) Ensure real estate was not subject to partition

The court decided that a partitioning action was not a significant non-tax reason for the formation of the Partnership.

In particular, the court noted most of the real estate in question was outside of Hawaii and thus not subject to the state's partitioning law. Because the Decedent's attorney made no effort to research partitioning laws in the states in which the real estate sets, the court determined a partitioning action was not a primary reason for the Partnership's formation.

The court further noted that the trusts to which the LP interests were gifted (and those which would be created upon the Decedent's death for the benefit of his children) would never allow his children to be joint tenants nor tenants in common.

Finally, no partitioning action was considered on the date of Dr. Liljestrand's death nor had partitioning come up before his death. Although the estate attempted to rely on precedent set in *Estate of Shurtz v. Commissioner,* T.C. Memo 2010-21 (see FCG *E-Flash* 12-2), the court determined *Shurtz* was inapplicable. More specifically, the litigation environment in Hawaii was different than that of Mississippi. Furthermore, the estate's attorney had never been involved in a partitioning action and had never advised other clients to form an FLP to avoid a partitioning action.

C) Protection from creditors

Although the estate claimed creditor protection was a reason for the Partnership's formation, it provided no evidence any of the partners were worried about creditor claims. The court faulted the estate for failing to name a single creditor and for failing to determine how the protections provided by the formation of a partnership were different from a trust. Accordingly, the court found creditor protection was not a significant non-tax reason for PLP's formation.

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The court also determined there were factors indicating the transfers were not *bona fide* sales.

DISREGARD OF PARTNERSHIP FORMALITIES

The court faulted the Partnership for failing to open a bank account during its first two years of existence and for commingling funds. PLP held only one partnership meeting, failed to keep meeting minutes, and had no other formal meetings between partners. The partners used Partnership funds for personal expenses, made disproportionate distributions to Dr. Liljestrand, and failed to execute loan documents with partners for purported loans. More emphatically, the final two characteristics violated the Partnership Agreement, which required pro rata distributions.

STANDING ON BOTH SIDES OF THE TRANSACTION

Dr. Liljestrand contributed all of the capital to the Partnership, received 5,545 out of 5,546 units of Class B limited partnership interests, all of the Class A limited partner units, and all of the general partner interests. While Robert did receive a limited partner interest, he failed to receive outside counsel independent of his father. Further, the Decedent did not consult with three of his children – although he indicated he wanted them to be partners – before forming the Partnership. As a result, the court determined the transfers were not arm's-length.

As a result of the preceding, the court determined that the transfers of assets to the Partnership failed the *bona fide* sale prong of the *bona fide* sale exception.

The court further determined that the transactions were not for full and adequate consideration. In particular, the interests credited to the partners were not proportionate to capital contributed because Robert never proved he contributed capital. It also faulted the Partnership for a valuation of its interests with a value much greater than the value of the assets contributed and then ignoring that value (as determined by an outside, independent appraiser) and determining a value (in a manner not reflected in the court record) much less than the value of the property contributed. Additionally, the court found that the assets contributed by each partner were not properly credited to their capital accounts.

Finally, the court determined that Dr. Liljestrand retained possession of, enjoyment of, or the right to income from the property he transferred to PLP. The court noted that the Decedent failed to maintain enough assets outside the Partnership to maintain his lifestyle. PLP's payment of many of Dr. Liljestrand's personal expenses (including his estate tax obligations), the Decedent's commingling of trust and Partnership funds, and PLP providing Dr. Liljestrand with disproportionate distributions were the major determinative factors for the court.

The court ultimately decided that the Decedent's motivation for forming PLP was primarily testamentary and that his relationship with the assets did not change as a result of the Partnership's formation. As a result, the assets were includable in his estate under § 2036(a).

CONCLUSION

Poor estate planning advice coupled with inattention to partnership formalities doomed the use of the FLP as an estate planning vehicle in the present case. Because the Decedent's relationship with the assets did not change as a result of PLP's formation and because the partners failed to follow through with partnership formalities, the Partnership's assets were includable in Dr. Liljestrand's estate. ꩜