FAMILY LIMITED PARTNERSHIPS IN ESTATE PLANNING – IS *ESTATE OF POWELL* THE END OR THE BEGINNING OF AGGRESSIVE TAX PLANNING?

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In a recent Tax Court decision, *Estate of Powell v. Commr.*, the majority opinion of the Tax Court made two notable decisions that may affect the future use of family partnerships in estate planning:

- It extended the application of Code §2036(a)(2) to a decedent who owned only a limited partnership interest; and
- It applied Code §2043(a) for the first time to limit the Code §2036 inclusion to the amount by which a gross estate is depleted, *i.e.*, the discount applied to the value of property transferred to the partnership, plus (or minus) any change in the value of the transferred assets between the date of the transfer and the date of death.

Instead of following the standard I.R.S. approach[1] for cases where Code §2036(a) was applied, which was never contested, the court adopted a new, untested theory–one that could potentially create "problems that we do not yet know about." This uncommon approach and the potential implications are discussed in detail in the following article.

THE FACTS

- On August 8, 2008, the decedent's son, Mr. Powell, acting on her behalf as the trustee of a revocable trust, transferred approximately $10 million in cash and securities from the trust to NHP Enterprises LP ("NHP"), a family limited partnership formed by Mr. Powell, a general partner, two days earlier. In exchange for the transferred cash and securities, the decedent received a 99% limited partnership interest in NHP. Her two sons transferred unsecured promissory notes in exchange for a shared 1% general partner interest.
- The value of the limited partnership interest was based on a Duff & Phelps appraisal, which applied a 25% discount for lack of control and lack of marketability.
- NHP's limited partnership agreement gave Mr. Powell, as general partner, the sole discretion to determine the amount and timing of partnership distributions. The partnership agreement allowed for the dissolution of the partnership with the written consent of all partners.
- On August 8, 2008, the same day the $10 million was transferred to NHL,

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[1] Under this approach, the value of the assets transferred during life are included in the value of the gross estate, in lieu of the value of the property received in return.

Mr. Powell, purportedly acting on behalf of the decedent under a power of attorney, assigned the decedent's 99% limited partnership interest in NHP to a charitable lead annuity trust ("C.L.A.T."). The terms of the C.L.A.T. provided an annuity to a nonprofit corporation for the rest of the decedent's life. Upon the decedent's death, the remaining assets in the C.L.A.T. were to be divided equally between two trusts for the benefit of Mr. Powell and his brother.

"The court concluded that the value of the property would have been included in the decedent's estate under Code §2035, provided she did not transfer the property and Code §2036 applied."

- The power of attorney granted Mr. Powell broad authority to deal in all property, real and personal, which the principal may own. With respect to gifts, the power of attorney authorized Mr. Powell to make gifts to the full extent of the Federal annual gift tax exclusion under the Code.
- At the time of the transfers, the decedent was hospitalized in an intensive care unit and was described by two doctors as incapacitated and unable to act on her own behalf.
- The decedent died seven days after the $10 million transfer to NHP.
- The I.R.S. claimed there was no reason for creating the partnership other than a tax reason, and the estate did not challenge this claim.

The I.R.S. claimed that the $10 million contributed to NHP was includible in the decedent's estate, without a discount, under either Code §2036(a)(1) (retained enjoyment or right to income), Code §2036(a)(2) (retained right, alone or in conjunction with any person, to designate who could enjoy the property or its income), or Code §2038 (power to alter, amend, revoke, or terminate the transfer at the time of death).[2] Additionally, the I.R.S. claimed that the transfer to the C.L.A.T is disregarded under Code §2035(a) (transfer of property by gift within three years of death, if such property would have otherwise been included in the estate under Code §§2036-2038 or 2042).

The estate, completely ignoring Code §2035(a), did not challenge the I.R.S.'s argument that the decedent may have retained certain rights. Rather, the estate argued that notwithstanding any retained right in the partnership interest, the value of the assets contributed to NHP should not be included in the decedent's gross estate because the decedent did not hold her interest in NHP upon her death. Thus, according to the estate, even if the decedent's interest in NHP gave her the right to designate the beneficiaries of the property that she transferred to the partnership, Code §2036(a)(2) does not apply.

With respect to the estate's claim, the court concluded that, under California law, the power of attorney did not allow the son to gift the 99% limited partnership interest to the C.L.A.T., deeming the transfer void. Nevertheless, since the validity of the transfer was a matter of state law, the court analyzed whether (if the gift was valid) the value of the cash and securities should be included in the decedent's estate from a tax law perspective.

Notwithstanding the question of whether the transfer to the C.L.A.T. was valid under state law, the court concluded that the value of the property would have been included in the decedent's estate under Code §2035, provided she did not transfer the property and Code §2036 applied, because the gift was made within three years

[2] Because Code §2036(a)(2) applied, the majority opinion did not consider Code §§2036(a)(1) or 2038.

of the decedent's death. Thus, the court rejected the estate's claim and turned its analysis to the I.R.S. arguments.

APPLICABILITY OF CODE §2036(A)(2) TO A MERE LIMITED PARTNERSHIP INTEREST

Unlike Code §2036(a)(1), which may be applied in cases of an express or implied understanding concerning the assets transferred rather than a legally enforceable right, Code §2036(a)(2) requires the presence of a "right" in order to include the transferred property in the gross estate of a decedent.

Normally, in the context of limited partnerships, such legal rights are held by the general partner, and indeed, the court has applied Code §2036(a)(2) before in such circumstances.[3] However, in *Powell* the decedent merely held a limited partnership interest, which does not embody such rights, and nevertheless, the court applied Code §2036(a)(2). This is the first time the Code section has been applied in this way.

It did so by adopting a theory introduced by the Tax Court 14 years ago in *Estate of Strangi*, whereby the limitation imposed by the "fiduciary duties" of a manager (duties which caused the Supreme Court to reject the application of Code §2036(a)(2) in *Byrum*) are simply "illusory." Under this theory, the decedent is treated as holding, through an agent, the rights of a general partner.[4]

In *Byrum*, the Supreme Court rejected the I.R.S. argument that through the ability to vote on the transferred shares, the decedent could affect the corporations' dividend policy and thus retained the right to "designate the persons who shall possess or enjoy the property or the income thereform" under Code §2036(a)(2). The Court's reasoning rested, *inter alia*, on its opinion that the controlling shareholder of each corporation owed fiduciary duties to the minority shareholders that impacted the controlling shareholders' decisions with respect to the corporations' dividend policies.

In *Strangi*, the Tax Court distinguished the case from *Byrum* on several counts, including the fact that, unlike the corporations transferred in *Byrum*, the limited partnership in *Strangi* consisted of only family members and did not conduct any business. The court in *Strangi* noted that the son-in-law who served as the manager of the partnership (and thus controlled partnership distributions) was also the decedent's attorney-in-fact under a power of attorney and therefore owed a personal duty to the decedent. The court thus reasoned that in exercising his duties to the partnership, the son-in-law would not disregard his "preexisting obligation to decedent." Additionally, because the decedent owned 99% of the partnership, any fiduciary duties that limited the son-in-law's authority to make distributions and manage the partnership were, in the eyes of the court, duties he essentially owed to himself and

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[3] The few cases where Code §2036(a)(2) was applied before involved decedents who either held a general partnership interest directly, or held an interest in a corporate general partner; See for example *Estate of Clyde W. Turner, Sr. v. Commr.*, T.C. Memo 2011 – 209 and *Estate of Strangi v. Commr.*, T.C. Memo. 2003-145.

[4] *Estate of Strangi v. Commr.* T.C. Memo. 2003-145; *U.S. v. Byrum*, 408 U.S. 125 (1972).

thus "illusory" in nature. The court concluded that "intrafamily fiduciary duties within an investment vehicle simply are not equivalent in nature to the obligations created by the *U.S. v. Byrum*."

In *Powell*, the court concluded that the decedent's ability to dissolve the family limited partnership with the cooperation of her sons carried with it the ability to direct the disposition of the partnership's assets. And while this ability was viewed by the court as insufficient to apply Code §2036(a)(2), the court found that the *Powell* case could be distinguished from *Byrum* on the same grounds as the *Strangi* case. In *Powell*, the decedent's son was her attorney-in-fact and thus owed the decedent personal duties, which he assumed either before he created the partnership or at about the same time. Thus, under the illusory fiduciary duties theory, the agent is viewed as a manager who will not exercise his or her responsibility as a general partner in a way that would prejudice the decedent's interests. Additionally, when the decedent owns 99% of the partnership, the fiduciary duties that limit the general partner's discretion in determining partnership distributions are owed almost exclusively to the decedent. Thus, any fiduciary duties held by the general partner (the decedent's attorney-in-fact) were illusory and did not prevent his authority over distributions from being a right that, if retained by the decedent at her death, is described in Code §2036(a)(2).

The concurring opinion, with which six other judges agree, upheld the court's application of Code §2036(a)(2) under these circumstances. It describes the facts as aggressive deathbed tax planning where the attorney-in-fact was essentially negotiating with himself and where the decedent clearly had retained the proverbial "string" that pulled the $10 million in cash and securities back into her estate. Notwithstanding the concurring opinion's agreement with the application of Code §2036(a)(2), the concurring opinion did raise a different theory on which it would have based the inclusion of the assets in the decedent's estate under Code §2033. Under this theory, the NHP partnership was invalid; therefore, the assets purportedly transferred to NHP were in fact owned by the decedent when she died.

THE LIMITATION UNDER CODE §2043(A) AND THE RISK OF DOUBLE INCLUSION

Code §2043(a) applies when property is transferred *inter vivos* for less than full consideration and the property is to be pulled back into the gross estate under certain Code provisions. The provision, initially included in the Revenue Act of 1926, is intended to limit inclusion under certain provisions in order to prevent double taxation of the same economic interest. Code §2043(a) has never been applied by the Tax Court.[5] However, in *Powell*, the majority opinion chose to "fill that lacuna" and proceeded to analyze the section without any of the parties to the case advancing an argument based on such section.

In order to prevent "double taxation of the same economic interest" – which in the

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[5] According to the Tax Court in *Powell*, there was only one prior case where Code §2043(a) was considered in the context of a family limited partnership. See *Estate of Harper v. Commr.*, T.C. Memo 2002-121. In *Harper*, the court did not apply Code §2043(a) to limit the inclusion under Code §2036(a) due to the court's decision that the partnership interest received was to be ignored and not be treated as consideration.

eyes of the court is widely recognized as an illogic result, albeit one, in their opinion, without legal grounds – the majority concluded that when Code §2036(a) is read together with Code §2043(a), it only requires the amount of any depletion in gross estate (in this case, the discount allowed in valuing the limited partnership interest issued in consideration for the transferred property) to be included back in the gross estate. Code §2036(a), read together with Code §2043(a), does not require that the gross estate include the full value of the assets transferred to the partnership, as if they were never transferred and a partnership interest was never received as consideration. Under the court's analysis, the value of the interest in the limited partnership received need not be pulled back into the gross estate under Code §2036(a) because it will be included in the gross estate under the general rule of Code §2033, or be subject to gift tax if gifted *inter vivos* after the formation of the limited partnership.

While the purpose of this analysis was "to explain why double inclusion in a decedent's estate is not only illogical, it is not allowed," it only does so if the assets have not appreciated in value between the time of transfer and the time of death. If the assets appreciate, "duplicative transfer tax" would apply, resulting in more tax owed than if no transfer ever occured; likewise, if the assets depreciated in value, "duplicative reduction in transfer tax" would occur.[6] The majority opinion acknowledged this in a footnote but did not specifically mention if the court would refuse to tax the same appreciation twice. This analysis, in the words of the concurring opinion, was "a solution in search of a problem."

The concurring opinion expressed concern that by adopting this new, untested theory the court is inviting overly aggressive tax planning in search of the possibility of a "duplicative reduction in transfer tax." Further, the concurring opinion found that there was no double inclusion problem to be solved. It viewed the newly formed partnership, if at all valid, as an empty box into which the allegedly transferred property was notionally placed. Thus, the partnership interest had no value apart from the property allegedly contributed and no double inclusion arose from an inclusion of the full $10 million under Code §2036(a).

THE BONA FIDE EXCLUSION AND THE RECYCLING OF VALUE THEORY

The Tax Court's analysis highlights the importance of the "*bona fide* sale" exception to Code §2036(a), especially for taxpayers whose transferred assets may appreciate over time and until their deaths. The analysis references the two-prong interpretation of the *bona fide* sale exception, as established by the Tax Court and other courts. Meeting this exception requires an estate to establish both: (i) a nontax *bona fide* reason for creating the partnership and (ii) the existence of full and adequate consideration (*i.e.*, receiving partnership interests that are proportionate to the value of the property transferred). The court discussed this exception as it justified the application of Code §2043(a) to family limited partnerships notwithstanding the "recycling of value" theory raised by the court in *Estate of Harper*,[7] eliminating

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6 This is because Code §2036 includes the date-of-death value in the value of the gross estate, while Code §2043 reduces the inclusion by the date-of-transfer value.

7 *Estate of Harper v. Commr.* T.C. Memo. 2002-121.

the need to consider the effect of Code §2043.

In *Harper*, the court concluded that the partnership interest received did not qualify as consideration for purposes of either Code §§2036(a) or 2043(a) because the formation of the partnership did not involve genuine pooling of assets and was nothing more than a circuitous recycling of value that does not rise to the level of a payment of consideration.

"The majority opinion not only extended the application of Code §2036(a)(2) to a limited partner but adopted at the center of its analysis a theory under Code §2043(a) that was never before discussed by the courts."

In *Powell*, the court concluded that the extent of the pooling of assets is more relevant to the first prong of the *bona fide* exception (the nontax reason for the transaction) than to the adequacy of the consideration prong. Therefore, the proportion of partnership assets contributed does not affect the treatment of the family limited partnership interest issued in return as "consideration" for the transferred property for purposes of Code §§2036(a) and 2043(a). The court further mentioned that application of discounts when valuing an interest in a family limited partnership does not prevent the partnership's formation from qualifying for the *bona fide* sale exception, if the partnership was created for a legitimate nontax reason. Otherwise, the *bona fide* exception would not apply and, according to the majority's opinion, the net effect of Code §2036(a) as limited by Code §2043(a) would be the inclusion of the discount in the gross estate.

CONCLUSION

While the fact that the taxpayer lost is not actually surprising considering the bad facts – which can best be described as aggressive deathbed tax planning – the ruling is mostly surprising in that the majority opinion not only extended the application of Code §2036(a)(2) to a limited partner but adopted at the center of its analysis a theory under Code §2043(a) that was never before discussed by the courts, was not raised by either of the parties, and "was not necessary" for the result. According to the concurring opinion, the ruling has opened the door to the risk of "creating problems that we do not yet know about." One such problem could be that the Code §2043(a) theory, which limits the Code §2036 inclusion, seemingly validates a discount for lack of marketability, even under bad facts such as these.

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