TAX COURT CASE UPDATE

FCG Valuation Case E-Flash

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Citation:

Estate of Samuel P. Black, Jr., Deceased v. Commissioner, 133 T.C. No. 15, December 14, 2009.

Comments:

While the ruling is lengthy, the following summary captures the salient points of the case. A close reading of the case indicates that effective estate planning significantly reduced the decedent's estate tax liability. Key points in the ruling included:

- Transfers of closely-held stock from the gross estate to an FLP were for full and adequate consideration and therefore not includable in the gross estate.
- Passive entities can be created for legitimate and significant nontax reasons (including preventing the sale of assets by grandsons who lacked ambition and preventing distribution to a spouse in an anticipated divorce proceeding).
- Date of death of surviving spouse was reasonable date for funding of QTIP trust given that the death of Mr. and Mrs. Black were close together and the estates were so intertwined.
- Interest on a loan to pay estate tax and associated fees were not deductible.
- Significant portions of the estate's attorney and executor fees were disallowed for one estate but allowed in the other.

Details:

Samuel P. Black, Jr. engaged in sophisticated estate planning between 1988 and his death in November 2001. He created an FLP (Black Interests Limited Partnership, "BILP") and several trusts as part of his estate planning.

Upon creation of BILP on October 12, 1993, the decedent, as trustee of two of the trusts (Grandson Trusts), contributed nonvoting Class A shares of stock in a closely-held company ("Erie") on behalf of the trusts in exchange for limited partnership interests. Mr. Black also contributed all of his Class A nonvoting shares and almost all of his Class B voting stock of Erie in exchange for a large limited partnership interest and a 1.0 percent general partnership interest in BILP. The decedent's son also contributed most of his Class B nonvoting stock of Erie to BILP in exchange for a significant limited partnership and 0.5 percent general partnership interest.

According to the partnership agreement, BILP was formed in part to consolidate assets owned by the family of Mr. Black, to avoid division of certain properties, and to prevent family members from transferring interests in BILP without first offering them to other family members. The partnership agreement required written consent of the partnership and all of the other partners to transfer an interest to unrelated entities or people. Additionally, the partnership agreement granted rights of first refusal to BILP and its partners to purchase any interest subject to disposition, including via death or divorce of a partner.

Mr. Black served as managing partner until October 1998, at which time he ceded his general partnership interest and responsibilities to his son. Between the time of formation and his death, Mr. Black gifted almost 7 percent of the limited partnership interests to his family members (including the Grandson Trusts) and charities. In August 2001, the decedent transferred his remaining 77.0876 percent limited partnership interest to a revocable trust.

The revocable trust required the formation of a marital trust for the benefit of the decedent's wife (Mrs. Black), should she survive him. The marital trust was to dissolve upon Mrs. Black's death. The fact that the Blacks died within six months of each other prevented the calculation of Mr. Black's bequest to the marital trust, and the marital trust was not funded as of Mrs. Black's death. Son, as executor of both estates and trustee of the revocable trust, intended to fund the marital trust with the large limited partnership interest in BILP owned by the revocable trust.

The decedent's estate reported and paid a federal estate tax liability of $1.7 million during September 2002 out of the estate's liquid assets. Mrs. Black's estate lacked the liquidity to pay estimated taxes due to the transfer of a large block of illiquid BILP limited partnership interests. The son, as executor of Mrs. Black's estate, attempted to borrow money from several commercial lending institutions in order to satisfy the tax liability. However, the terms required were unacceptable to him. He then tried borrowing money from Erie but Erie refused. The son's legal and financial advisors then suggested that Erie participate in a secondary offering of Erie stock from Black LP. Erie agreed as long as BILP agreed to pay Erie's expenses associated with the secondary offering. On January 29, 2003, BILP sold three million shares (just over one-third of the Erie shares owned by BILP).

On February 25, 2003, BILP loaned $71 million in total to Mrs. Black's estate and to the revocable trust, subject to an agreement signed by the son as representative for both entities. Terms of the note required 6 percent simple interest, with all principal and interest due and payable not before November 30, 2007. The note did not allow for prepayment of principal or interest. Calculated interest for the note was determined to be just over $20 million, which was deducted in full from Mrs. Black's estate tax return. Included in the $71 million disbursed by the estate were costs to reimburse Erie for its participation in the secondary offering, a $20 million bequest to a local college, $1,155,000 in legal fees, and the exact same amount in executor fees.

Discussion:

Mr. Black's Estate:

IRC §2036(a) requires estates to include assets from the value of the gross estates except in certain instances ("except in the case of a bona fide sale for an adequate and full consideration in money or money's worth"). In particular, §2036(a)(1) includes in gross estates "the possession or enjoyment of, or the right to the income from, the property" which the decedent (in general) enjoyed even if a transfer of the property had taken place.

The estate of Mr. Black argued that the formation of BILP was for legitimate non-tax reasons, including, but not limited to:

- Long-term management and protection of the family's Erie stock holdings.
- Pooling the family's Erie stock holdings to allow the stock to vote as one block, thereby capitalizing on the block's swing vote characteristics.
- To protect the Erie stock from creditors and divorce.

Further, the estate cited accomplishment of the goals of the partnership in its argument. Additionally, the estate maintained that the transfer was for full and adequate consideration.

The IRS rejected the estate's arguments and asserted that the formation of BILP was not necessary to further the family's goals. The IRS did not believe that full and adequate consideration was paid and that Mr. Black maintained an interest in the transferred Erie stock, thereby contending that the stock should be included in his gross estate.

Mrs. Black's Estate:

Although disadvantageous to the estate in terms of tax payments, Mrs. Black's son selected her date of death as the date of funding for the marital trust. In so arguing, the estate believed that was the earliest possible date at which the value of Mr. Black's estate value could be calculated and the amount passed to Mrs. Black could be determined.

The IRS held no position on the estate's date determination, stating that §20.2044-1(e) provides no clarity to the funding date of a QTIP trust when the surviving spouse dies before the trust is funded.

The estate argued that the interest on the $71 million loan was tax deductible. The estate believed that the son exercised reasonable business judgment in executing the loan rather than causing a distribution or forcing redemption from BILP. Additionally, the loan was bona fide because there was a note, security, interest charges, a repayment schedule, actual repayment of the loan, and a relationship between the borrower and lender that created a reasonable expectation or enforceable obligation to repay the note.

Additionally, the estate claimed deductions of almost $1 million to BILP to reimburse the partnership for monies it paid to Erie for the secondary offering. The estate also claimed $1.155 million in legal fees and $1.155 million in executor fees.

The IRS rejected the estate's arguments. Its position on loan deductibility was:

- The loan was created for the tax deductibility of the interest.

- The son was in a position to distribute enough Erie stock from BILP to cover the liability.

- The son was in a position to redeem at least a portion of Mrs. Black's BILP interest.

- The only way for BILP to repay the loan was to redeem Erie stock, which made the loan pointless.

Further, the IRS sought to deny the full amount of reimbursement to BILP and any portion over $500,000 in legal and executor fees.

Conclusion:

Mr. Black's Estate:

The Court ruled that the formation of BILP was for legitimate non-tax reasons. The Tax Court found that Mr. Black had legitimate concerns about:

- His grandsons selling their Erie stock upon termination of their trusts and the resulting dilution of Erie stock.

- His son's marriage and dilution of Erie stock should the stock become marital property.

As a result of the preceding, The Court found that Mr. Black's transfer of Erie stock to the partnership was a bona fide sale. Because the IRS acknowledged that the partners of BILP received partnership interests in proportion to the fair market value of the assets contributed, the full and adequate consideration prong of §20.2043-1(a)'s definition of bona fide sale was met. Accordingly, only the fair market value of Mr. Black's limited partnership interests in BILP (not the value of the Erie stock the decedent transferred to the partnership) was includable in his estate under §2036(a).

Significantly, the Tax Court found in this case, as in *Estate of Schutt v. Commissioner*, "that a family limited partnership that does not conduct an active trade or business may nonetheless be formed for a legitimate and significant nontax reason."

Mrs. Black's Estate:

The Court found that the value of the marital trust likely could not have been knowable as of the date of Mr. Black's death in December 2001, as the trust would be funded with partnership interests. As evidence, The Court cited the date of valuation of the decedent's interest in BILP (September 2002), more than three months after Mrs. Black's death in May 2002. Accordingly, her date of death was the latest reasonable date on which to consider the trust funded.

Turning to the loan to pay Mrs. Black's estate taxes and administration fees, The Court sided with the IRS in ruling that the loan interest was not a deductible expense. The ruling was determined primarily because the partnership lacked sufficient income and distributions to partners to repay the loan without the sale of Erie stock at the loan's maturity date. If the sale of Erie stock was necessary and enforceable at the maturity date, it was necessary and enforceable at the date of death, making the loan unnecessary.

Finally, The Court determined that only 49 percent of the secondary offering by BILP was used on behalf of Mrs. Black's estate. Accordingly, only 49 percent of the fee could be deducted. The Court also held that because the executor for both Mr. and Mrs. Black was working on both estates simultaneously and because the estates were so intertwined, deductibility of executor

fees should be split between the estates. Similarly, The Court permitted deductibility of only one-half of the legal fees as only one-half of the work performed benefitted Mrs. Black's estate.