Estate Planning / Trust and Estate Litigation Newsletter

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Protecting and Preserving Wealth for Future Generations

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The Ink Was Not Yet Dry on the *Estate of Bongard* Case When the IRS Scored Another FLP Victory with *Estate of Bigelow* Case

In April we discussed the IRS victory in *Estate of Bongard*, 124 T.C. 8 (March 15, 2005). *Bongard* was followed shortly thereafter with another IRS victory dealing with family limited partnerships in *Estate of Bigelow*, T.C. Memo 2005-65 (March 30, 2005).

In *Biglelow*, the taxpayer created a revocable living trust and transferred her residence into it in 1991. The taxpayer's son was her agent under a durable power of attorney as well as a co-trustee under the trust. In 1992, the taxpayer suffered a stroke and she moved out of the house. She made some gifts of a partial interest in the former residence to her daughters. In 1993, the trust exchange the former residence for other rental real estate and borrowed $350,000 secured by the new property to pay off loans that had been secured by the former residence. Later in 1993, the trust obtained a line of credit for $100,000 against the rental real estate. Some of the $100,000 line of credit was used to make gifts to children and grandchildren.

In December 2004, the trust contributed the rental real property (but not the loans that were secured by the real property – the trust remained liable for the loans). The trust received the bulk of the limited partnership units in exchange for the property.

Before contributing the rental real estate to the FLP, the taxpayer had a positive cash flow of approximately $1,000 monthly. After transferring the rental real estate to the FLP and retaining liability on the loans, the taxpayer's cash flow went negative at approximately $1,200 per month (the negative cash flow grew to approximately $2,700 per month three years later).

The FLP made the payments on the loans (the liability for which remained with the taxpayer) and also paid some of the taxpayer's living expenses. The taxpayer's son, as agent under her durable power of attorney, made more than forty transfers between the partnership and the revocable living trust during the next two years. In December of 1994 and 1995, the son, as agent under the durable power of attorney, made gifts of fractional interests in the family limited partnership to himself, his siblings and the taxpayer's grandchildren.

The taxpayer died in 1997. At the time, her revocable trust retained a 1% general partnership interest and a 45% limited partnership interest. The limited partnership was terminated approximately one year after the taxpayer's death. The estate claimed a 31% marketability discount on the gifts of the LP interests (the gift tax returns were not filed until after the taxpayer's death) and a 37% marketability discount on the FLP units remaining in her estate after her death.

The IRS challenged the discounts under the retained control and enjoyment provisions under IRC § 2036(a). The court held that there was no legitimate non-tax business purpose for transferring the rental real estate to the family limited partnership.

The court also noted the following lapses in the formalities of the partnership:

1. The partnership did not maintain partnership not partner's capital accounts;
2. The balance sheet improperly showed $350,000 of liability for the mortgages taken out by the trust;
3. The 1065 K-1's did not properly reflect the partner's capital accounts;
4. The partnership made payments on the $350,000 of loans but did not adjust the trust's capital account as required under the partnership agreement; and
5. The taxpayer's capital account never reflected the value of the trust's contribution of the rental real estate.

The court held that the revocable trust did not part with its interest in the rental real property because the property continued to secure the obligations of the taxpayer. It also found that the taxpayer retained enjoyment of the rental real estate when the rent derived from the property was used to make payments on the loans. The court further held that there was no potential for a non-tax benefit to the trust because management of the assets did not change as a result of the transfer to the partnership and there was no "pooling of assets". Unlike the *Kimbell* case, there was no significant protection from creditors since the taxpayer's revocable trust remained as the general partner of the partnership. Since there was no transfer for adequate consideration and there was a retention of control and benefits, IRC § 2036(a) brought the property bank into the taxpayer's estate without any discount.

As with many of the previous IRS victories using IRC § 2036, the taxpayer's failure to respect the formalities of the partnership she created and her need to access partnership assets to maintain her lifestyle doomed this transaction from its beginning.

Can We Be of Assistance to You?

Dennis M. Sandoval, A Professional Law Corporation, specializes in estate planning (including probate administration and trust / will contests), asset protection planning, elder law (including qualifying for Medi-Cal coverage, conservatorships, and creation of Special Needs Trusts for disabled beneficiaries) and tax controversy work (including federal and state tax audits, appeals and litigation). All of your referrals will be handled promptly and professionally.

Mr. Sandoval is available to speak to your group or organization. Call (951) 734-9728 to schedule him to speak on any topic relating to estate planning, elder law, asset protection or taxes.

Upcoming Seminar for the General Public			
Subject Matter	**Dates**	**Time**	**Location**
Planning for a Lifetime Partnership Under the California Domestic Partner Rights and Responsibilities Act	June 11	1 pm - 3 pm:	Janet Goeske Senior Center 5257 Sierra Street Riverside

Upcoming Seminars / Classes for Professionals			
The Mechanics of Drafting First Party and Third Party Special Needs Trusts in California	6/18/2005	9 am - noon	UNEX 3 hrs. Attorney CLE
Basics of Conservatorships in California	5/26/2005	Noon – 1 pm	Kaiser Hospital Riverside, California
Maintaining and Maximizing Government Benefits for Special Needs Beneficiaries: The Basics of Administering a Special Needs Trust	6/18/2005	1 pm – 4 pm	UNEX 3 hrs. Attorney CLE
Retirement Plan Distribution Rules: A Magical Mystery Tour; Federal Estate Tax Repeal Update and recent Tax Developments	9/29 - 10/2/2005	TBD	National Academy of Elder Law Attorneys Sheraton New Orleans New Orleans
Topics to be Determined	10/6 – 10/10/2005	TBD	American Academy of Estate Planning Attorneys Catamaran Hotel San Diego