IRC 2036 – The Tax Court Yet Again

Take-Away: IRC 2036 is a trap that awaits many transferors who intend to play the valuation-discount-game with the transfer of readily marketable assets to an illiquid family limited partnership or LLC in exchange for an unmarketable interest. This is even more likely to spring that trap when this sophisticated transfer planning is engaged in by the transferor's agent who acts under a durable power of attorney, which seems to be a 'red flag' for the Tax Court these days.

Background: Periodically the U.S. Tax Court will decide a case based on IRC 2036(a) which them comes as a surprise to the decedent's estate. IRC 2036 is one of the *string* provisions of the Tax Code. The value of a decedent's gross estate generally includes the fair market value of all property that the decedent owned on death, *or that is otherwise included in the gross estate under the Code.* [IRC 3031, 2033-2046; Regulation 1.20.2031-1.] IRC 2036 is an *otherwise included string* section of the Tax Code.

IRC 2036: If a decedent made a lifetime transfer of property other than a bona fide sale for adequate and full consideration, and he/she retained specific rights or interest in the property that were not relinquished until his/her death, the full value of the transferred property is generally included in the decedent's gross estate. [IRC 2036(a).] Accordingly, the purpose of IRC 2036(a) is to include in the decedent's gross estate lifetime transfers that were testamentary in nature.

Requirements: There are three requirements for property to be included in the decedent's estate under IRC 2036(a):

(i) the decedent must have made a lifetime transfer of the property;

(ii) the decedent must have retained an interest or right specified in IRC 3026(a)(1) or (2) in the transferred property that he/she did not relinquish until death; and

(iii) the transfer must not have been a bona fide sale for adequate and full consideration.

Estate of Bongard, 124 Tax Court, 112. This IRC 2036 *trap* was once again sprung in a Tax Court decision in late September, and once again, the transferor's agent's role, acting under a durable power of attorney, was part of the problem.

Estate of Fields v. Commissioner, -Tax Court (September 26, 2024)

Facts: The facts reported by the Court were voluminous, so I'll try to provide the key facts. In essence, assets were transferred on behalf of Ms. Fields who had owned a Texas oil business after her husband's death. Her nephew, using a durable power of attorney and acting on Mrs. Field's behalf, transferred her assets to a family limited partnership about a month before Ms. Field's death. About $17 million in assets were transferred to the limited partnership by her agent, who relied on a 15% discount for lack of control and a 25% discount for lack of marketability associated with the limited partnership interest that she received. Ms. Field's limited partnership interest was 99.9941%. Assets transferred to the limited partnership interest by Ms. Fields (or her agent under the durable power of attorney) included $10 million in marketable securities, $5.3 million in closely held bank stock, and a tree farm valued at $1.1 million. Ms. Fields' estate reported the value of Ms. Fields' limited partnership interest at $10.8 million on the estate's federal estate tax return. An IRS audit of the estate tax return found a deficiency; the IRS claimed that the value of Ms. Fields' limited partnership interest was worth $15.388 million; no value was assigned by the estate to the assets that were held by the limited partnership, only her limited partnership interest was reported on the Form 706 Estate Tax Return. A penalty was also asserted by the IRS for underpayment of tax attributable to negligence or a disregard of the rules (but the IRS later abandoned one of its claims that a penalty applied. It continued to assert a gross understatement penalty.)

Dispute: The issue before the Tax Court was whether the transferred assets should be included in Ms. Fields' gross estate at their fair market value, if she retained possession or enjoyment of, or the right to income from, the transferred property held in the limited partnership. [IRC 2036(a)(1).]

Tax Court: The Court found that Ms. Fields, through her agent who controlled the general partnership interest, retained possession or enjoyment of the transferred assets since she (through her agent) retained a substantial present economic benefit from the property that was transferred. Specifically, it found there was an express or implied agreement among the partners by which Ms. Fields retained possession or enjoyment at the time of the transfer. This is the result, whether or not that agreement is legally enforceable; IRC 2036(a) will apply to cause estate inclusion.

Economic Reality: The manager/general partner (her agent) only contributed $1,000 to the limited partnership, which the Court found to be *de minimis. "That interest was hardly more than a token in nature."*

Agent's Control Imputed to the Principal: The general partner with absolute discretion to make proportionate distributions from the partnership was effectively controlled by Ms. Fields' agent under her durable power of attorney.

"Therefore, at all times, Ms. Fields effectively held the right to virtually all the income from her transferred assets, and the AM Fields (the general partner) partnership agreement constituted an express agreement to that effect... Although Ms. Fields did not actually receive any income from distributions from AM Fields during life, we have clarified before that IRC 2036(a)(1) does not require that the transferor pull the 'string' or even intend to pull the 'string' on the transferred property; it only requires that the string exist."

Implied Agreement: The Court noted that after the transfer to the limited partnership, Ms. Fields retained in her name alone about $2.15 million of assets, in the face of a substantial estate tax liability that was expected. Based on these facts the Court found an implied agreement that the manager of the general partner, who was also Ms. Fields' agent, would make distributions from the partnership to satisfy Ms. Fields' expenses, debts, and bequests if and when necessary.

IRC 2036(a)(2): The Court even found that Ms. Fields also retained the right, either alone or in conjunction with another person, to designate the persons who shall possess or enjoy the transferred property or the income from it. Under the partnership agreement Ms. Fields had the right, along with her agent, the general partner, to dissolve the partnership, upon which dissolution the general partner (her agent) would be obligated to liquidate all partnership property, pay off all partnership debts, and distribute cash to Ms. Fields. Therefore, in *conjunction with* her agent, the general partner, Ms. Fields had the right at any time to acquire outright all income from the transferred assets to the limited partnership.

Not a Bona Fide Sale: A bona fide sale is an exception to the application of IRC 2036(a). Whether a lifetime transfer is a bona fide sale is a question of motive, and whether a transfer is adequate and full consideration is a question of value. While Ms. Fields received adequate and full consideration, in the form of her limited partnership interest, the Court found that it was not a bona fide sale. It reached this conclusion because the transfer was *not objectively likely to serve a substantial nontax purpose,* which is the 'test' the Tax Court uses to determine motive.

Ms. Fields estate identified 4 different nontax purposes: (i) protect her from further instances of financial elder abuse; (ii) create a succession of management of assets; (iii) to resolve the problem of banks refusing to honor Ms. Fields' durable power of attorney; and (iv) the partnership allowed for the consolidation and streamlined management of her assets. All of these 'excuses' were rejected by the Court based on the underlying facts, in particular the reality that none of the assets that Ms. Fields transferred to the limited partnership required active management by the general partner, not to mention that the transfers to the partnership depleted Ms. Fields' assets to the extent that her estate could neither pay bequests under her Will nor the expected federal estate tax liability.

Penalty: Despite the IRS dropping some penalties at the audit stage of the proceedings, the Court did find that Ms. Fields' estate did not show that it relied in good faith on an advisor's judgment, so that a 20% accuracy related penalty applied for the estate's negligence or its disregard of rules under IRC 6662(a)(c).

Observation: *Fields* is probably one of those 'bad facts make bad law' decisions. A mad scramble occurred once Ms. Fields health turned bad to fund a limited partnership with most of her assets (assets that arguably did not need any structured or active management) while her agent acquired a controlling interest in the limited partnership, less than 1% general partnership interest, with a contribution of only $1,000. A death-bed depletion of wealth occurred attempting to exploit valuation discounts associated with an unmarketable limited partnership interest, which was indirectly controlled by the limited partner's agent who owed her some fiduciary duties under Texas law. This is the second time in 3 years that the IRS, and the Tax Court, focused on the fact that the other person who was legally in control of the general partnership, was also an agent under a durable power of attorney who owed a fiduciary duty to the limited partner, leading to the *in conjunction with* trap under IRC 2036(a)(2.)

Conclusion: If an individual engages in sophisticated estate planning with limited partnership and/or LLC, where *another* is in control of the entity, it is imperative to avoid family members or those who owe fiduciary duties to the transferor, since that seems to be the weak factual link that the IRS and the Tax Court will exploit to find estate inclusion and also by which it will ignore the bona fide sale exception to the application of IRC 2036(a).

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