IRC 2036- "...and Hogs Get Slaughtered"

Take-Away: Often 'aggressive' (*hog*-like) estate planning occurs when an individual is either diagnosed with a terminal illness or Alzheimer's. By then, it is probably too late to engage in such aggressive planning. If such planning is done nonetheless, often by the ill individual's attorney-in-fact, you can probably expect the IRS to assert that IRC 2036 applied to the lifetime transfers, which not only results in the value of the transferred assets being included in the transferor's taxable estate (note, IRC requires the *value,* not the assets themselves, to be included in the deceased transferor's gross estate) and possibly add-on an additional 20% accuracy-related penalty if aggressive valuation discounts were the basis of the planning.

IRC 2036: We have regularly covered IRC 2036 (a *string* provision of the Tax Code) in the past, but it never hurts to review the rule, and more importantly the scope of the rule that focuses on *retained* rights. IRC 2036(a) applies if: (i) the decedent made a lifetime transfer of property; (ii) the decedent retained an interest or right specified in subsections (1) or (2) in the transferred property that he/she did not relinquish until his/her death; and (iii) the transfer by the decedent was not a bona fide sale for adequate and full consideration. Subsection (1) covers a transfer where the transferor retained the right to income or enjoyment of the transferred property. Subsection (2), which has gained a lot of attention by the IRS in recent years, covers the situation where the transferor in conjunction with another to designate the persons who shall possess or enjoy the property or the income from the property.

A recent Tax Court decision provides a good example of aggressive, aka greedy, end-of-life planning that backfired in a dramatic way.

Estate of Anne Milner Fields v. Commissioner, Tax Court Memo, 2024-90 (2024)

Facts: Anne, age 91, was diagnosed with Alzheimer's. Anne had experienced a slip and fall, a broken hip, was the victim of elder abuse who had lost $20,000 in that scheme. Anne had named Mr. Milner (Milner) as her springing durable power of attorney agent, and he was named as the Personal Representative of Anne's estate under a Will that she had executed

about 6 years earlier. Milner was the residuary beneficiary of Anne's estate, after 11 bequests that amounted to over $2,500,000. When Anne's health began to seriously deteriorate, within days of her heart attack and placement in hospice Milner, acting as her agent met with an estate planning attorney. Milner first formed an LLC to which Milner was the sole member; Milner transferred $1,000 to the LLC. Milner then using Anne's durable power of attorney formed a limited partnership. Milner's LLC was the general partner with a .0059% partnership interest. Anne was the 99.9941% limited partner. Milner then, using the durable power of attorney, transferred Anne's assets to the limited partnership. Milner then asked the estate planning attorney for a recommendation for an appraisal of the limited partnership and Anne's interest in the limited partnership. The estate planning attorney referred Milner to an appraisal firm where his father worked. The attorney even consulted with the appraisal firm while the limited partnership was being formed, to ask if additional provisions might be added to the limited partnership agreement to enhance the likelihood of valuation discounts associated with Anne's 99% limited partnership interest. A few days later (like within 5 weeks when this process started) , Anne died. Anne's interest in the limited partnership was valued by an appraiser who applied a 15% value discount for lack of control and a 25% value discount for lack of marketability. As such, Anne's limited partnership interest was valued at $10.8 million with these discounts. The IRS issued a Notice of Deficiency after Anne's estate tax return was filed (in 2017) and claimed an estate tax underpayment penalty attributable to negligence or disregard of rules or regulations under IRC 6662(a) and (b)(1) of 20%.

Tax Court: The Court found that the transfer of Anne's assets to the limited partnership were not bona fide sales, and that she retained applicable rights and interests with respect to the transferred assets up until the time of her death. Despite Milner's arguments, the Court found that there was no nontax motive behind the limited partnership planning, and that due to the facts outlined above, the limited partnership transaction was conducted solely to reduce estate taxes (which would shrink Milner's residuary interest in Anne's estate.)

IRC 2036(a)(1): The Court found that Milner's general partnership interest (0.0059%) while allegedly in control of the partnership 'was merely token in nature. It found that Milner, the sole manager of the LLC and thus the sole member of the limited partnership, as Anne's fiduciary, caused Anne to effectively have the right to virtually all the income from the assets transferred to the limited partnership. The Court observed that no actual or planned distributions of income are necessary for IRC 2036(a)(1) to apply; only having the ability to

make such distributions to the transferor is sufficient for 2036 to apply. In support of its conclusion, the Court also focused on the fact that Anne's assets that were not transferred to the limited partnership were inadequate to pay her living expenses, the bequests under her Will, and any estate tax liability, such that there must have been an **implicit agreement** between Anne and Milner that the LLC which he controlled would make transfers of assets from the limited partnership to satisfy Anne's bequests, estate tax liability, and her estate administration expenses. ***"The use of a significant portion of partnership assets to discharge obligations of a decedent's estate is evidence of a retained interest in the assets transferred to the partnership."***

IRC 2036(a)(2): The Court also found that Anne had retained applicable rights under IRC 2026(a)(2) because Anne, in conjunction with Milner, could dissolved the limited partnership which required the affirmative vote of all partners, and thus she was ***"able to designate the persons who shall possess or enjoy the property or the income from the transferred property.…[T]here was essentially no pooling of assets in the partnership, which accordingly functioned not as a joint investment vehicle by rather a vehicle to reduce estate tax."*** Because Milner was Anne's durable power of attorney agent, his fiduciary duties were held to require him to act in concert with Anne when it came to decisions about the limited partnership. This is consistent with an earlier Tax Court decision, *Estate of Powell v. Commissioner, 148 Tax Court 18 (May 18, 2017)* where the agent under a durable power of attorney was considered to not act independently when it comes to the principal having control over the entity the agent formed on behalf of the principal.

Bona Fide Sale: Nor did the Court find that Anne's transfer of assets to the limited partnership was a bona fide sale of her assets. The Court found Milner's arguments that there was a nontax purpose for the transfer of Anne's assets to the limited partnership were only a "theoretical justification." Rather, the Court pointed to some troublesome facts including: (i) Anne was not personally involved in any of the partnership planning; (ii) The assets transferred to the limited partnership did not require active management; (iii) the claim that the partnership was needed to forestall any future elder abuse was disregarded because that abuse had occurred many years earlier; (iii) no major changes in the amount or composition of Anne's assets resulted leading up to the formation of the limited partnership; and (iv) Anne contributed virtually all of her assets to the limited partnership, such that there was "no potential for intangibles stemming from a pooling of assets for a joint enterprise."

Underpayment Penalty: The Tax Court also found that the assessment of penalties against the estate was appropriate. The Court found that there was no evidence that Milner personally considered, researched, or understood the application of Section 2036 for the estate tax liability. It further noted that such a large reduction in the value of an asset from discounts take would strike a reasonable person as 'too good to be true' if it was merely due to the inconsequential interposition of a limited partner interest between Ms. Fields and her assets on the eve of her death."

Observations: Death-bed planning is always going to attract the attention of the IRS, especially when large valuation discounts are asserted by the decedent's estate. With *Fields* Milner was intent on estate planning for Anne that would enhance Milner's own inheritance, more than helping Anne due to her incapacity. If this type of death-bed planning is considered when an individual nears death, some 'lessons learned' from *Fields* might be the following:

Note the Risk of Penalty: If valuation discounts are to be exploited, explain to the client, the client's family, and the person who holds the individual's durable power of attorney that there are several risks associated with the use of fractional interests in entities (for which value discounts might be claimed) and that there is also exposure to the 20% penalty for negligence or disregarding rules and regulations normally found with this aggressive type of planning.

Avoid Common Control: Do not have the same person control the general partner (or LLC manager) and act as attorney-in-fact for the individual whose planning is being pursued. Control by others will be more easily imputed to the individual whose assets are transferred to the entity.

Don't Be Too Greedy with Transferred Assets: You need to leave sufficient assets in the name of the individual, outside of the entity that is being formed, to pay the individual's living expenses, administration costs, personal debts, specific distributions, funeral expenses, specific bequests, etc. If insufficient assets are retained outside of the entity that is formed and funded, the IRS will claim there was an implied agreement to access the assets transferred to the entity.

Show a Pooling of Assets: Sufficient assets need to be contributed to the entity from the 'other' person(s), such that the entity can be genuinely considered to be a legitimate joint investment vehicle, as opposed to appearing on its face to be simply a vehicle to reduce estate taxes.

Keep the Agents Away: Do not allow the person who holds the individual's durable power of attorney, and thus in a fiduciary role, from participating in the decisions that are related to the entity's dissolution or liquidation or become involved in any distributions that are related to the entity's dissolution or liquidation.

Conclusion: We often learn the most from the mistake made by others. The very aggressive planning done in *Fields* within a few weeks of Ms. Fields' death to claim very large valuation discounts using a limited partnership 'wrapper' is a good reminder that all too often creating valuation discounts on paper, is usually 'too good to be true.' When you consider that this type of aggressive estate planning, often motivated by greed of the heirs, can lead to a 20% penalty in addition to the higher federal estate tax liability, think twice before going 'hog wild.'

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