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Not as Sure As Death and Taxes

Exclusion of lifetime asset transfers from a decedent's gross estate has become dramatically more difficult.

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EVERYONE KNOWS the old adage about death and taxes—unavoidable, inevitable, universal—but when has that ever stopped a good estate plan? What can stop a good estate plan is the reality that not everything is as sure as death and taxes.

Tax laws, and their interpretation by the courts, are subject to change. Their application can, and often does, evolve over time. What was once an acceptable exception—and a perfectly good estate planning tool—can become so restricted and limited over time as to be rendered nearly unusable. A good illustration of this is the court's increased scrutiny of lifetime asset transfers and their interaction with Internal Revenue Code §2036, especially of the decedent's residence.

IRC Section 2036

Estate taxes are imposed on the "privilege of transfer" and are levied against a decedent's gross estate—the total value of the assets transferred.[1] The gross estate will include the value of any assets owned by the decedent and transferred at death, as well as lifetime transfers that allowed the transferor to retain a life estate, control, or "beneficial enjoyment" during his or her lifetime.

IRC §2036, which deals with such lifetime transfers and their inclusion in the gross estate, provides that:

"(a) General rule. The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—

(1) the possession or enjoyment of, or the right to the income from, the property, or

(2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom."[2]

Thus, §2036 covers two types of lifetime transfers (and calls for their inclusion in the gross estate so as to be taxed): (1) those where the transferor retains a life estate in the transferred asset, along with all the rights of property ownership; and (2) those where the transferor does not retain all the incidents of ownership but does retain beneficial possession or enjoyment.[3]

Possession and enjoyment has been defined as lifetime use of the property or right of income.[4] Possession and enjoyment are considered retained where there is "an express or implied understanding to that effect among the parties."[5] Where such a transfer is made, the burden is on the estate to disprove the presumption that there was such an implied agreement.[6]

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In the past, the formal creation of a partnership, and relinquishment of control and possession of an asset transferred thereto, was enough to exclude the transferred asset from inclusion in the transferor's gross estate for estate tax purposes.[7] Family limited partnerships have been a popular way to transfer property without triggering estate taxes.

In the past, as long as the family recognized the transfer as real and acted accordingly, the courts would do the same. Only when the transfer was not respected—such as where the transferor commingled his assets with partnership assets, and/or lived at the transferred property rent-free;[8] where partnership income was commingled with the transferor's personal funds or retained solely by the transferor;[9] where the transferor conveyed all his property without retaining sufficient funds to live on;[10] or other extreme abuses—did the courts rule in the IRS's favor.

Where the decedent's residence was transferred, whether to a partnership or to an individual, the creation of a lease agreement requiring the decedent to pay rent in order to occupy the

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residence allowed for exclusion of the residence from the gross estate.[11]

In *Estate of Roemer*, T.C. Memo 1983-509 (1983), the court went even further. After the decedent transferred her residence to her daughter, the decedent paid no rent, but still considered her daughter her "landlord." The *Estate of Roemer* court found that the decedent's relationship towards the property had so changed that even the fact that she resided there rent free was not enough to show a retained interest. Likewise, in *Stephenson v. United States*, 15 A.F.T.R. 2d 1408 (1965), the court found that the mere fact that the decedent continued to live in the house after the transfer was insufficient to allow an inference of an agreement to that effect.

The Times Have Changed

This is no longer the case. As recent case law shows, the presumption that such transfers are a testamentary device designed to avoid inclusion of the transferred assets in the gross estate of the transferor is just too strong for most families to overcome.

For example, in March 2005, the U.S. Tax Court decided two landmark cases dealing specifically with family limited partnerships: *Estate of Bigelow v. Comm'r*, T.C. Memo 2005-65 (2005), and *Estate of Bongard v. Comm'r*, 124 T.C. 95 (2005). In both cases, the decedent retained a partnership interest in a family limited partnership, and retained control over, or the right to receive economic benefits from, the assets transferred.

For example, in *Estate of Bigelow*, where the decedent transferred her assets without retaining sufficient funds to maintain herself, and the family failed to respect partnership formalities, the court found that there was an implied agreement that the decedent would continue to enjoy the economic benefits from the property transferred and would retain all the income from said property. See also *Estate of Strangi v. Comm'r*, T.C. Memo. 2003-145 (2003), wherein the court noted that the decedent made no actual, regular rent payments, retained insufficient funds to pay living expenses, and that after she died, partnership funds were used to pay funeral expenses, estate administration expenses and to pay personal debts of the decedent.

In the recent decision of *Disbrow v. Comm'r*, T.C. Memo. 2006-34 (2006), the court continued this pattern of severely limiting asset exclusion where lifetime transfers are made—especially where it appears that at least some level of possession and enjoyment is retained. Specifically, the court found that the value of the decedent's residence was includable in the estate even though:

- the transfer was made six years before the transferor's death;
- the residence was transferred to a family general partnership in which the decedent had no partnership interest; and
- the decedent retained sufficient funds to support herself after the residence was transferred.

The court found that the residence was part of the gross estate because, although lease agreements were signed and in place, they were not enforced. Decedent payed rent inconsistently, and what rent she did pay was below fair market rental value. Moreover, the inconsistent payments were not treated as a default by the partnership.

The court found that decedent's relationship to the property had not been affected by the transfer, and that, at the time the transfer was made, there existed an implicit understanding that decedent could and would occupy the residence as she always had.

Tips for the Practitioner

The strict interpretation of §2036, evidenced by the cases cited above, begs the two questions: Is the creation of a family limited partnership still a practical estate planning tool, and can the decedent's residence be excluded from the gross estate if transferred?

The estate planning attorney faced with a lifetime transfer of assets implicating §2036 should realize that the presumption arises that such a transfer is testamentary and designed to avoid estate taxes. In that instance, the prudent attorney should ask the following questions:

- Is the family partnership formed with all the usual formalities required of any other partnership? Has there been negotiation in arriving at the terms? Have the parties dealt at arms length? Remember, "intrafamily transactions are subject to a higher level of scrutiny."[12]
- Does the family partnership have a clearly stated and valid business purpose? Keep in mind that the purpose behind the transfer cannot be to simply remove the asset from the transferor's gross estate or anything that relates to this goal.
- Does the family partnership carry out the stated purpose?
- Is the transfer of assets made in return for consideration? Generally, "a decedent's gross estate does not include property transferred pursuant to a bona fide sale for adequate and full consideration."[13]
- Have the assets been appraised or have their values been haphazardly arrived at?
- Has the possibility of commingling the transferor's funds with partnership funds been avoided?
- Is the family partnership run like a business—does it make a profit?
- After the transfer is made, does the transferor retain the ability to control, use, enjoy the transferred asset or revoke the transfer itself? Is all the income made by the partnership retained by the transferor?
- Note that the transferor should not also be a partner. Who manages the partnership and its interest—does the transferor make all the decisions, reap all the benefits, incur all the risks?
- Is the transferor of advanced age or in poor health at the time the transfer is made?
- Does the transferor retain sole possession or use of the transferred asset?
- Does the transfer give the appearance of a testamentary device?
- Does the transferor have other, sufficient assets with which to support him or herself?
- Is the partnership discontinued after the death of the transferor?
- Is it possible to not transfer the decedent's residence? If the residence absolutely has to be transferred, will the transferor pay fair market rent in accordance with a strictly enforced lease agreement?

Although this list of questions is not exclusive, if the answer is no to any of the above, the presumption that the transfer is essentially testamentary may not be overridden. Moreover, it becomes even more problematic if the asset transferred is the transferor's home, and additional questions arise:

- Will the transferor continue to live there, and if so, will he or she do so pursuant to a formal lease agreement?
- Will the transferor-tenant be required to pay a security deposit? Who will pay for the utilities, homeowner's insurance and the like?
- Who will maintain the property and decide how it will be maintained?
- Will the transferor-tenant pay fair market rental value and do so consistently?
- Does the rental payment result in a profit to the transferee-landlord or does it simply cancel out mortgage payments or the cost of property maintenance?
- Will the lease terms be strictly enforced, including those regarding default and eviction?
- Finally, will the family involved be able to treat the lease as an arms length transaction? Will they be able to raise the rent, send default notices if the rent is overdue and even evict the transferor-tenant if necessary?

This last consideration is what makes this kind of asset transfer untenable in the majority of estate planning situations whether or not a family limited partnership is involved.

In a close family relationship, love, respect, sympathy and sacrifice are unavoidable and inevitable—like death and taxes. The detachment necessary to overcome the presumption that the transfer had a testamentary purpose is just not always feasible.

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1. See, Jesse Dukeminier, Stanley M. Johanson, "Wills, Trusts and Estates," 980 (6th ed., 2000).
2. 26 U.S.C.S. §2036 (2006).
3. See also §2038 dealing with lifetime transfers where the transferor retains the right to change or revoke the transfer.
4. See *United States v. Byrum*, 408 U.S.125, 147 (1972).
5. See *Rapelje v. Comm'r*, 73 T.C. 82, 86 (1979); and *Comm'r v. Estate of Church*, 335 U.S. 632, 645-46 (1949) (where the court found that "the settlor must be left with no present legal title in the property, no possible reversionary interest in that title, and no right to possess or enjoy the property then or thereafter. In other words such a transfer must be immediate and out and out, and must be unaffected by whether the grantor lives or dies.").
6. See *Maxwell v. Comm'r*, 3 F. 3d 591 (2d Cir. 1993).
7. See *Church v. United States*, 85 A.F.T.R. 2d 2000-804; *Estate of Harrison v. Comm'r*, T.C. Memo 1987-8.
8. See *Estate of Reichardt v. Comm'r*, 114 T.S. 144 (2000).
9. See *Estate of Schauerhamer v. Comm'r*, T.C. Memo. 1997-242.
10. See *Estate of Thompson v. Comm'r*, T.C. Memo. 2002-246.
11. See *Estate of Barlow*, 55 T.C. 666 (1963).
12. *Estate of Bongard*, supra, at *19.
13. *Estate of Bigelow*, supra.

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