An Inside Look at Keller v. U.S. :IRC sec. 2036 and Valuation Discounts

The National Association of Certified Valuators and Analysts

Careful Estate Planning Overcomes IRS Objections Even After Sudden Death

***Keller v. United States*resulted in a huge family limited partnership (FLP) win—$125 million—in Fifth Circuit Court. In this article, learn what the lead attorneys at the Dallas-based law firm of Meadows, Collier, Reed, Cousins, Crouch, and Ungerman have to say about FLP planning and their victory as well as what every financial advisor can learn from this monumental taxpayer victory.**

In *Keller v. United States*, 697 F.3d 238 (5th Cir. 2012), *aff'd*, 104 AFTR 2d 2009-6015 (S.D. Tex. 2009), the Fifth Circuit affirmed the district court's holding that the estate was entitled to a refund of more than a $125 million. The refund was in large part due to applying discounts in valuing interests in a family limited partnership (FLP) that the district court determined had been validly formed prior to the decedent's death. The district court also held that the estate was entitled to claim a deduction for interest on a transaction that had been retroactively characterized as a loan from the FLP to the estate for the payment of the estate taxes and other estate obligations.

Mrs. Williams, the decedent in *Keller*, was by all accounts a prudent, frugal steward of her family fortune. She preserved her estate by living in a modest home, driving a modest car, and incurring annual living expenses of approximately $60,000. She was very involved in the management of her family fortune and dedicated to its safeguard and preservation.

In 1998, Mrs. Williams and her husband decided to form a family trust, which held approximately $300 million in cash, certificates of deposit, and bonds. Upon her husband's death, the family trust divided into two trusts. Trust A held Mrs. William's separate property and her share of the couple's community property. Trust M held Mr. Williams' separate property and his share of the community property. Mrs. Williams, as the surviving spouse, was trustee of both trusts.

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Following the death of her husband, Mrs. Williams began to explore forming FLPs to provide ease of administration, management, and asset protection for her estate. Of particular concern to Mrs. Williams as she worked to protect the family’s interests was the risk of losing control of significant family assets through divorces.

In September of 1999, she met with her advisors to discuss the formation of an investment partnership that would hold approximately $250 million in community property bonds. Trust A and Trust M would be the limited partners, and a newly formed corporation would be the 0.1 percent general partner. Mrs. Williams was to be the initial shareholder of the general partner, but would immediately sell her shares, 50 percent to her daughter and 25 percent to each of her two grandsons from a deceased daughter.

Following the 1999 meeting, revisions were made to the partnership agreement; however, the structure, purpose, and intended contributions remained the same. Significantly, Mrs. Williams maintained her resolve that the $250 million of community property bonds were to be partnership property and rebuffed suggestions to add more.

In March of 2000, Mrs. Williams was diagnosed with cancer. Her physicians, however, did not believe that her death was imminent. On May 9, 2000, Mrs. Williams’ advisors finalized the formation documents for the FLP. At the time, Mrs. Williams was in the hospital for a routine procedure relating to her cancer. She reviewed the final partnership agreement while in the hospital and signed it multiple times in more than one capacity. In addition, she also signed the formation documents for the corporate general partner. Over the next few days, her advisors applied for tax identification numbers, filed the FLP and corporate constitutive documents with the Secretary of State, and cut a check for $300,000 from one of the family trust accounts to fund the corporate general partner. Her advisors planned for Mrs. Williams to sign the check when she came home from the hospital, but Mrs. Williams unexpectedly died on May 15, 2000.

In addition, Schedule A of the FLP agreement had not been completed. Although the ownership percentages were included for the partners, the dollar amounts for the initial capital contributions were left blank. Mrs. Williams’ advisors had not had an opportunity to obtain a firm market value of the community property bonds in order to include a dollar amount at the time Mrs. Williams signed the partnership agreement. The initial contributions were not discernible from anything located within the partnership agreement or in any of the other documents that Mrs. Williams signed prior to her death.

After Mrs. Williams’ death, her advisors believed that the FLP had not been funded and ceased all activities relating to the partnership. As a result, they did not consider the value of the limited partnership interests, but, rather, the underlying assets transferred to the FLP when determining Mrs. Williams’ gross estate for estate tax purposes. The estate filed a six-month extension request and paid federal estate tax in excess of $147 million. Approximately 12 months after Mrs. Williams’ death and three months after paying the taxes, the advisors reconsidered their position and took steps to formally transfer legal title to the community property bonds to the FLP and fund the general partner. In addition, the advisors accounted for the estate’s use of part of the FLP assets as a $114 million loan from the FLP to the estate. When the estate tax return was filed towards the end of the six-month extension, no discounts were taken, but the related issues and the intention to file a future refund claim were disclosed.

In November of 2001, the estate filed a claim for refund. The basis of the refund claim was that the value of the gross estate was substantially overstated since the original estate tax return failed to include the appropriate discounts attributable to the FLP interest. In addition, the estate claimed it was entitled to a deduction for interest accrued on its restructured loan from the FLP. When the IRS failed to act on the

estate's refund request, the estate brought a refund suit in federal district court.

The district court agreed with the estate and held that the evidence clearly established that Mrs. Williams intended the community property bonds to be partnership property, despite the fact that legal title to the bonds were not formally transferred to the FLP. The court relied on well-established principles of Texas law that provide that the intent of an owner to make an asset partnership property causes the asset to be the property of the partnership. This is the case regardless of whether legal or record title to the property has been transferred. Accordingly, the district court held that the failure of Mrs. Williams' advisors to finalize the FLP documentation immediately following her death did nothing to alter the legal effect of her intent that the community property bonds were FLP assets. Therefore, the court concluded that that the estate was required to only include the discounted value of the partnership interests, as opposed to the value of the community property bonds, in its federal estate tax return.

The court rejected the government's argument that the FLP was a mere recycling of wealth and held that Mrs. Williams' transfer of the community property bonds to the FLP constituted a bona fide sale. The district court found that the primary purpose of the FLP's formation was to protect family assets from depletion by ex-spouses through divorce proceedings. This purpose was accomplished by altering the legal relationship between Mrs. Williams and her heirs through the formation of the FLP. As a result, the court determined that there was a non-tax business purpose for undertaking the formation of the FLP.

Furthermore, the district court held that Mrs. Williams had a binding oral agreement to sell her stock in the corporate general partner to her daughter and two grandsons. Therefore, since contractual obligations generally survive the death of a party and bind an estate, the district court found that Mrs. Williams' estate was obligated to assign the stock to her daughter and two grandsons. As a result of this binding agreement, Mrs. Williams did not control the FLP.

The district court then held that the estate's expert, Mr. Robert F. Reilly of Willamette Management Associates, used the correct standard in determining the fair market value of Mrs. Williams' interest at the date of her death. The court rejected the government's expert since he violated several tenets of the fair market value standard, including considering the true identities of the buyer and seller, speculating as to events occurring after the valuation date, and aggregating the interests of different owners. Moreover, the district court found the most appropriate valuation method in the case was the Asset-Based Approach employed by Mr. Reilly. As a result, the court accepted Mr. Reilly's 47.5 percent combined discount for lack of marketability and control.

The court also held that the estate was entitled to an estate tax deduction for interest on the loan from the FLP. The loan resulted from the estate's advisors use of FLP assets to pay a portion of the estate taxes and other estate obligations before realizing that the FLP was funded. Since the FLP was funded prior to Mrs. Williams' death, the district court held that the loan was necessary because there was in fact a liquidity problem for the estate. Therefore, the court held that the estate incurred deductible interest expense on the borrowings for federal estate tax purposes.

The government appealed. Rather than attacking the district court's findings on Mrs. Williams' intent and valuation conclusions, however, the government challenged the legal conclusions of the district court.

The Fifth Circuit noted that a decedent's partnership interest is not usually valued at the pro rata share of the property owned by the partnership. An estate is entitled to a discount on the value of that interest to reflect restriction on the interest's transferability and other burdens on the partnership interest. As a result, in this case, the Fifth Circuit noted that a substantial valuation discount hinged on whether the community property bonds were transferred effectively to the FLP. The Fifth Circuit determined that Texas state partnership law controlled and reiterated the district court's conclusion that the intent of an owner to make an asset partnership property causes the asset to be the property of the partnership, even though the facts of this case were distinguishable from the prior case law, which involved property acquired or used by an already-

formed partnership. The Fifth Circuit concluded that the prior precedent would also apply to property intended to be partnership property on formation of a partnership.

With regard to the retroactively structured loan, the government challenged the loan on two grounds. First, the government challenged the initial transfer of the community property bonds to the FLP. This argument was moot as a result of the Fifth Circuit's holding that the transfer was valid. Second, the government claimed that the loan could have just as easily been retroactively characterized as a distribution, rendering it not "actually and necessarily incurred" within the meaning of the Internal Revenue Code and regulations thereunder.

The government relied on the *Estate of Black*, 133 T.C. 340 (2009), in support of its position that the loan should be treated as a distribution. In *Black*, the Tax Court denied a deduction for interest on a loan between a FLP and a decedent's estate when the FLPs only meaningful asset was stock in a corporation. The Tax Court's holding was premised on the fact that it would be impossible for the Black estate to repay the loan without eventually being required to sell Black LP's stock or its partnership interest, and thus its financing structure was merely an "indirect use" of that stock to generate a tax deduction. The court in *Black* further determined that the transaction could just as easily been structured as a distribution or partial redemption.

The Fifth Circuit, however, found the indirect use distinction was inapplicable to the FLP. In this case, the estate had a number of different options to repay the loan. The estate's assets included over $110 million in ranch and mineral holdings from which the estate could repay the loan. In addition, the estate's refund amounted to a substantial fraction of the value of the loan. Therefore, the Fifth Circuit held that the loan did not constitute an "indirect use" of the community property bonds. As a result, the Fifth Circuit did not question the business judgment of the executors in structuring the transaction as a loan.

The moral of this case is that planning pays and that state law determines the nature of property or an interest in property, while federal tax law determines the tax affect of such characterization. The reduction in the estate's federal estate tax liability was a direct result of the inclusion of the discounted value of the assets in Mrs. Williams' estate and the deduction for the additional administrative expenses. At the end of the day, Mrs. Williams' prudent foresight in considering the use of a FLP to preserve her estate for the next generations saved her beneficiaries millions of dollars. Her intent was also sufficient to overcome what appeared to be an incomplete funding of the FLP, and her oral agreement to sell her shares in the general partner was binding on her estate.

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