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TURNER II AND FAMILY PARTNERSHIPS: AVOIDING PROBLEMS AND SECURING OPPORTUNITY

BY JONATHAN G. BLATTMACHR, MITCHELL M. GANS, AND DIANA S.C. ZEYDEL

Where a married couple control a family limited partnership and one spouse dies, many issues may arise concerning what assets—the partnership interest itself, or the underlying assets of the partnership—are included in the gross estate, and how that may affect the marital deduction. Nevertheless, married couples have unique opportunities to avoid Section 2036(a) and to achieve an enhanced income tax basis.

In *Estate of Turner*, 138 TC No. 14 (“*Turner II*”), the Tax Court refused to change the conclusion it reached in *Estate of Turner*, TCM 2011-209 (“*Turner I*”), that the underlying assets that the decedent had contributed to a partnership were included in his federal gross estate, even with respect to partnership interests he had transferred by gift to persons other than his wife prior to his death. More important, perhaps, it also held that no marital deduction would be permitted for the value of the partnership interests that were the subject of those lifetime gifts. The court indicated that there could be a further reason for at least a partial disallowance of the marital deduction where the underlying assets of a partnership are included in the estate and are worth more than the partnership interests that the decedent owned at death.

Turner II raises significant issues for practitioners representing a married person who holds a substantial partnership interest at death and who wishes a portion of the estate to qualify for the estate tax marital deduction to avoid the imposition of estate tax on his or her death.

We will explore below some of the consequences of having the underlying assets of a partnership included in the estate of a married deceased partner where the estate tax value of those assets

exceeds the FMV of the partnership interest owned by the decedent at death that otherwise would be included in his or her estate. We will offer suggestions for avoiding such a situation and other potential solutions to the adverse consequences that otherwise might arise from such a circumstance.¹ We also will demonstrate that, despite the potential problems that *Turner II* may raise for a married person who creates a limited partnership, such a married person may be in a more advantageous position to secure valuation discounts from partnerships than is a single person.

BACKGROUND

The estate, gift, and generation-skipping transfer taxes are imposed, in general, on the FMV of the property transferred.²

The nature of property ownership is changed when an asset is contributed to another entity (such as a partnership or corporation). For example, if stock traded on an exchange is contributed to a partnership, what the owner of the stock then owns is a partnership interest rather than the stock. The partnership interest will not be valued in accordance with the valuation rule for stock traded on an exchange but will be valued in accordance with the rule of determining FMV by the “willing buy-

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er/willing seller" method in the Regulations.³

As a consequence, the value of the partnership interest almost certainly will be different than the value of the underlying partnership assets. Very often, the value of the interests in the partnership will be lower than the value of the partnership's underlying assets because the partnership interests are less marketable than its underlying assets. Also, if the partnership interests transferred do not reflect control of the partnership, the value of the interests also will be diminished as compared to the partnership's underlying assets because lack of control means no power to liquidate the entity and sell the assets it owns. In short, changing the nature of what is owned changes, and in many cases reduces, the value of what is owned after the change.

Under Section 2036(a), property transferred prior to death is included in the gross estate of the transferor if the transferor retained (1) the right to 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 are to possess or enjoy the property or the income therefrom, unless the property had been transferred in a bona fide sale for full and adequate consideration in money or money's worth. In applying Section 2036 in the partnership context, the courts

have held that an estate seeking to invoke the bona fide sale exception must demonstrate a significant and legitimate non-tax reason for the formation of the partnership.⁴

In many cases, the decedent's estate and the IRS have disagreed as to whether the underlying assets of the partnership are included in the estate of the partner who formed it.⁵ In some cases, the Service has prevailed; in others, the taxpayer. Although it is beyond the scope of this article to discuss those cases in detail, we note that it is often difficult to reconcile these cases.⁶

Turner involved the inclusion of the underlying assets of a partnership where those assets exceeded the FMV of the partnership interest.

The motivation of the Service is to collect more estate tax and the motivation of the taxpayer is to pay less tax. The key is that the lower the value of assets included in the decedent's estate, the less tax is paid. Because almost always the FMV of a partnership interest is lower than the FMV of the underlying assets associated with that interest, the IRS seeks to have those assets, rather

than just the partnership interest, included in the gross estate. The taxpayer seeks the opposite result.

Whenever the estate tax value of the underlying assets of the partnership that are included in the gross estate of a married decedent under Section 2036 is greater than the value of the partnership interest owned by the decedent at death, a mismatch may result: the FMV of the assets available for distribution in satisfaction of the marital deduction share may be less than the value of what is included in the deceased partner's gross estate and what may in turn be distributed to the surviving spouse or a trust under the protection of the estate tax marital deduction.⁷

A precursor to *Turner II*: *Chenoweth*. In *Estate of Chenoweth*, 88 TC 1577 (1987), the decedent had owned all of the company's outstanding stock. In his will, he bequeathed 51% of the stock to his wife. The IRS argued that the marital deduction should not exceed 51% of the value of the company determined on a pro rata basis. The estate argued that, because the 51% interest represented control, the marital deduction should be increased to reflect this.

The Tax Court agreed with the estate. The court held that, in computing the marital deduction, the estate could take into account the enhanced value of the 51% interest

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¹ For an excellent discussion of some of these issues in a pre-Turner article, see Matz, "Special Concerns in FLP Planning Where Both Spouses Are Living," 34 Estate Planning No. 1 (January 2007), page 16.

² See, e.g., Regs. 20.2031(b)-1 and 25.2512-1, which define FMV as the price at which the property would change hands between a willing buyer and willing seller, neither of whom is acting under a compulsion and both of whom have knowledge of relevant facts affecting the property's value. In some situations, however, artificial valuation rules are used, even though they may not reflect the price at which the property would change hands between a willing buyer and willing seller. For example, under Reg. 20.2031-2(b)(1), the value of a publicly traded stock is deemed, as a general rule, to have an FMV equal to the mean of the high and the low quoted selling prices on the transfer date. That mean value is used rather than the closing price even if the stock is transferred after the market closes. See, e.g., Holman, 130 TC 170 (2008), *aff'd* 601 F.3d 763, 105 AFTR2d

2010-1802 (CA-8, 2010). Also, valuation of noncommercial annuities, life estates, unitrust interests, and successor interests is based on actuarial factors that may not reflect actual FMV. See, e.g., Reg. 20.2031-7, as well as Section 7520 and the Regulations thereunder. See also Section 2032A, relating to the estate tax valuation of real property used in certain farms and other closely held businesses at death.

³ *Id.* Nevertheless, because the value of a partnership interest may reflect the underlying value of its assets, those assets may be valued in accordance with the normal estate and gift tax valuation of such property. See, e.g., Holman, *id.*

⁴ See, e.g., *Estate of Bongard*, 124 TC 95 (2005).

⁵ *Estate of Strangi*, 417 F.3d 468, 96 AFTR2d 2005-6895 (CA-5, 2005).

⁶ Compare, e.g., *Estate of Schutt*, TCM 2005-126, and *Estate of Mirowski*, TCM 2008-74, with *Estate of Bongard*, *supra* note 4, and *Estate of Strangi*, *supra* note 5.

⁷ As indicated in the text accompanying note 6, *supra*, this article does not discuss all issues relating to estate taxation with respect to partnerships formed by one person or members of one family. Nonetheless, it seems appropriate to note that the IRS treats the contribution of assets to a partnership as a transfer for purposes of Section 2036(a). Whether the transfer is regarded as "bona fide" depends, it seems, at least in part on motive, which is tested based on whether there is a significant and legitimate non-tax reason for the formation of the partnership. (Tax in this context appears to be estate tax, although that is not certain; if it is, however, it seems the taxpayer may establish the transfer as bona fide if, for example, the partnership is formed to reduce overall income taxation on the family. Cf. Section 704(e).) The significance of the bona fide test is that, even if the transfer is for full and adequate consideration in money or money's worth, Section 2036(a) may apply if the transfer is not found to be bona fide within the meaning of the section. See *Estate of Liljestrand*, TCM 2011-259.

attributable to the control element. While in *Chenoweth* the element of control could be used to increase the marital deduction, the principle established by the court can be used to reduce the deduction. If, for example, the decedent in *Chenoweth* had bequeathed 49% of his stock to his wife, the value of the interest passing to the wife for marital deduction purposes would be reduced under the *Chenoweth* holding to reflect a minority discount (as well as a marketability discount).⁸

ENTER TURNER II

As mentioned above, in *Turner I* the Tax Court held that the underlying assets Clyde Turner had contributed to the partnership that he had formed with his wife were included in his gross estate for federal estate tax purposes under Sections 2036(a)(1) and 2036(a)(2), although the court's reasoning in applying those sections is not entirely clear.⁹

As mentioned above, it often is difficult to reconcile the various decisions on whether the underlying partnership assets will be included in the gross estate of the deceased partner. Apparently, the taxpayer in *Turner I* felt so strongly that it should have prevailed that it sought reconsideration by the Tax Court. The court in *Turner II* found that the

estate had not demonstrated any manifest error of fact made in *Turner I* and, therefore, denied the taxpayer's motion not to apply Section 2036(a) and thereby, in effect, affirmed its original decision.

In *Turner*, the decedent, pursuant to his will, had bequeathed his estate by a disposition called an "optimum" marital deduction provision. Such a disposition essentially directs that all property pass in a form qualifying for the estate tax marital deduction except for any unused estate tax exemption.¹⁰ The structure is intended, by using the unused estate tax exemption and the marital deduction, to avoid the imposition of any federal estate tax when the married person dies and to avoid having the unused estate tax exemption amount of the spouse dying first, unlike the marital deduction amount, be included in the gross estate of the surviving spouse on his or her later death.

That seems to be what Turner intended. His estate, in its request for reconsideration of *Turner I*, contended that no estate tax should be payable because Turner had so structured his will. According to the court, "[t]he estate argues that even if section 2036 applies, the will requires the estate to increase the value of the marital gift." The court rejected that contention essentially because the partnership interests that were given away before death could

not be transferred to the surviving spouse and would not be included in the gross estate at her death (or subject to consumption by her during her remaining lifetime or could be made the subject of gifts by her).

The Tax Court referred to a situation where assets are included in the decedent's gross estate but which cannot pass to the surviving spouse (because they have passed to someone else) as a type of "mismatch" because the optimum marital deduction cannot include such assets—essentially, a "not available for the spouse" mismatch. It seems, however, that the estate may have made the argument that such assets should be allowed to qualify for the estate tax marital deduction on account of another or, perhaps, what may be viewed as a more fundamental type of "mismatch" that the IRS had not apparently made in *Turner I*—a "valuation" mismatch.

THE VALUATION MISMATCH

As mentioned above, when the underlying assets of a partnership are included in the gross estate of a partner, it is likely the value of the gross estate will be larger than if instead the partnership interest had been included. As the Tax Court observed in *Turner II*, "[t]his produces a mismatch between values for the gross

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⁸ See TAM 9050004, TAM 9403005, and Estate of Disanto, TCM 1999-421. See generally Matz, *supra* note 1.

⁹ For example, although acknowledging that, under Byrum, 408 U.S. 125, 30 AFTR2d 72-5811 (1972), a transferor's retention of the right to manage transferred assets does not necessarily require inclusion under Section 2036(a)(2), the *Turner I* court appears to apply the section differently. The court held as follows:

"[The decedent] was, for all intents and purposes, the sole general partner of Turner & Co., [footnote omitted] and the partnership agreement gave him broad authority not only to manage partnership property, but also to amend the partnership agreement at any time without the consent of the limited partners. As a general partner, [the decedent] had the sole and absolute discretion to make pro rata distributions of partnership income (in addition to distributions to pay Federal and State tax liabilities) and to make distributions in kind. Moreover, [the decedent] had the authority to amend the partnership agreement at any time without the consent of the limited partners. Finally, even after the gifts

of limited partnership interests to their children and grandchildren, [the decedent and his wife] owned more than 50 percent of the limited partnership interests in Turner & Co. and could make any decision requiring a majority vote of the limited partners."

In a footnote to the statement that the decedent was for all intents and purposes the sole general partner, the court opined: "Even if we were to treat [the decedent's wife] as a coequal general partner of Turner & Co., we would reach the same conclusion because sec. 2036(a)(2) applies where the transferor's right to designate who shall possess or enjoy property and the income therefrom is held 'alone or in conjunction with any person.'" It is unclear whether the application of Section 2036(a)(2) was based solely on the additional factors present in *Turner* that were not present in *Byrum*, or if fewer than all those factors still would have caused the section to apply, in the view of the Tax Court. On account of *Byrum*, the IRS in Rev. Rul. 81-15, 1981-1 CB 457, revoked Rev. Rul. 67-54, 1964-1 CB 269, in which it had held that all stock transferred during lifetime was included in the transferor's gross estate under Sec-

tion 2036(a)(2) because he retained all voting stock in the corporation and he thereby had retained the right to control income (by controlling dividends) and because he could control whether the gift stock could be sold. The Service concluded in Rev. Rul. 81-15 that such stock was not included in the decedent's estate pursuant to that section.

Also, certain of the statements made by the Tax Court in *Turner I*, quoted above, do not appear to be accurate: the decedent alone did not seem to have the sole and absolute discretion to make distributions of partnership income, but only in conjunction with his wife who was also a general partner.

¹⁰ For the structure and common language to effect such a disposition, see, generally, Blattmachr and Lustgarten, "The New Estate Tax Marital Deduction: Many Questions and Some Answers," 121 *Trusts & Estates* 18 (January 1982); Blattmachr, Hastings, and Blattmachr, "The Tripartite Will: A New Form of Marital Deduction," 127 *Trusts & Estates* 47 (April 1988); and Gans and Blattmachr, "Quadpartite Will: Decoupling and the Next Generation of Instruments," 32 *Estate Planning* No. 4 (April 2005), page 3.

estate inclusion and the marital deduction calculation.” In other words, more is included in the gross estate than is available for the funding of the marital deduction share.

EXAMPLE: The decedent, who has used her entire estate tax exemption before death, leaves her estate to her husband. The only asset she owns at death is an interest in a partnership she created during lifetime. Her partnership interest is worth \$10x when she dies, but the underlying assets of the partnership are then worth \$16x. Those assets are included in her gross estate. The most her husband can receive from her is an interest worth \$10x (as of her date of death), but \$16x is included in her gross estate and, assuming no other deductions such as for debts or the costs of administering her estate,¹¹ her taxable estate will be \$6x (\$16x gross estate minus \$10x marital deduction).

That type of mismatch could have been raised in *Turner I* but apparently was not. The Tax Court stated in *Turner II* that “[the IRS] allowed an increased marital deduction that [was] calculated on the basis of the value of assets transferred in exchange for the partnership interests that [the decedent] held at death, rather than on the basis of the discounted values of the general and limited partnership interests that [the decedent] owned at death, to the extent that they passed to [his wife].”

Perhaps that allowance by the Service was inadvertent. Certainly,

the IRS previously had raised the issue in court in other cases. The Tax Court noted that the issue was raised in *Estate of Black*, 133 TC 340 (2009), and *Estate of Shurtz*, TCM 2010-21, but stated it did not have to address the issue because it found in those cases that the underlying assets of the partnership were not included in the decedent’s gross estate.¹² Nevertheless, if a court does find them included in the gross estate of a married person and if the IRS raises the valuation mismatch as a ground to limit the marital deduction, the question is, how will the courts rule? The action of the IRS in *Turner I* may indicate the Service will not contend there is a valuation mismatch.

Inadvertence may not be the reason the IRS did not raise the valuation mismatch in *Turner*, however. It may be that the Service concluded that the wife could unilaterally terminate the partnership (essentially as a general partner) under the terms of the partnership agreement. That is, to the extent *Turner*’s wife inherited partnership interests from him she could access the proportionate underlying assets, assuming she could do so under the terms of the partnership agreement. Of course, even if she had a unilateral right to terminate the partnership, she could not access the underlying partnership assets attributable to the partnership interests her husband had given away to others during his lifetime.

Based on the reasoning the Tax Court used in *Turner II* to not allow

the marital deduction for partnership units that could not pass to the surviving spouse, it may well be that no marital deduction will be allowed by a court for the excess of the estate tax value of the underlying assets of the partnership included in the gross estate over the value of the partnership interests the decedent could pass to the surviving spouse, at least where the surviving spouse may not unilaterally access the partnership assets attributable to the partnership interest the survivor acquires from the first spouse to die.

TWO OTHER VALUATION MISMATCH ISSUES

There are two other issues that the IRS does not seem to have raised. The first is one of “double” estate tax inclusion. Clearly, the partnership interest the decedent owned at death is included in the gross estate under Section 2033. If the underlying assets of the partnership are also included in the gross estate, pursuant to Section 2036(a) or otherwise, it might seem there is double inclusion: the partnership interest and its underlying assets. The result may seem absurd but it seems potentially supported by the technical provisions of the Code. It seems likely that the IRS (and the courts) would accept that the partnership interest is not included in the gross estate when its underlying assets are included.¹³ Such a result, however, raises the second issue.

This second issue is the require-

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¹¹ Assets included in the gross estate that are deducted under Section 2053 as debts against the decedent or for the cost of administering the estate, whether or not deducted for estate tax purposes under Section 2053, do not qualify for the marital deduction because they cannot pass to or for the surviving spouse.

¹² Citing the two cases referred to in the text, the court stated: “In some cases the Internal Revenue Service has taken the position that even when section 2036(a) applies, the marital deduction is measured by the value of what actually passes to the surviving spouse, which is a discounted partnership interest, and not by the value of the underlying assets.”

¹³ See *Estate of Malkin*, TCM 2009-212, fn. 23 (finding Section 2036 applicable and rejecting Section 2033 with respect to the partnership

interest in order to avoid double-counting the same assets). The IRS has recognized the inappropriateness of double inclusion in other contexts. See, e.g., Reg. 20.2036-1(c)(1)(i) (providing that, in the case of a GRAT, any annuity payable to the decedent’s estate should not be included under Section 2033 in order to avoid the double inclusion that otherwise would result given the inclusion under Section 2036); Rev. Rul. 84-25, 1984-1 CB 191 (holding that inclusion in the gross estate under Section 2033 made it appropriate to remove the item from adjusted taxable gifts). Although questions have been raised about the possible application of Section 2043 in this context—which could produce additional estate tax where the underlying assets appreciate between the time of their transfer to the partnership and the date of death—the

Tax Court has thus far been unwilling to invoke this section in the partnership context. See *Harper*, TCM 2002-121 (“Furthermore, although section 2043 can entitle taxpayers to an offset for partial consideration in cases where a transfer is otherwise subject to section 2036, this section, too, is inapplicable where, as here, there has been only a recycling of value and not a transfer for consideration”). In short, inclusion of partnership assets under Section 2036 could produce the following alternative outcomes: (1) inclusion of the underlying assets and no inclusion of the partnership units; (2) inclusion of the underlying assets and inclusion of the partnership units as well; or (3) inclusion of the assets and the units with an offset permitted under Section 2043 in order to ameliorate the double inclusion.

ment that the marital deduction is allowed only for property passing from the decedent and that no marital deduction is permitted for assets not included in the decedent's gross estate.¹⁴ Certainly, in a case such as *Turner*, the partnership interest passes to the surviving spouse but the underlying assets of the partnership do not.¹⁵ Therefore, if it is concluded that the partnership interest is not included in the deceased spouse's gross estate because the underlying partnership assets are so included, it seems, based on a literal reading of the Code, that the partnership interest, even if passing to the surviving spouse in a form qualifying for the marital deduction, cannot qualify for the estate tax marital deduction.

If that is the case, the valuation mismatch issue raised by the Service in *Estate of Black* and *Estate of Shurtz* and mentioned by the Tax Court in *Turner II* never needs to be addressed. And, of course, even if the courts would limit the marital deduction to the value of the partnership interests passing to the surviving spouse, where the underlying partnership assets are included in the gross estate of the deceased spouse and have an estate tax value in excess of the value of the partnership interest, the result of not allowing any marital deduction for the

partnership interest is an even worse result for the taxpayer.¹⁶

Again, however, it does not seem that the IRS has raised this second issue. Assuming it does not (or the courts reject it), we are led back to the mismatch between the value of the partnership's assets and the value of the partnership interest transferred to or for the surviving spouse and how the courts will resolve that question.¹⁷

THE COURT'S REASONING APPLIED TO THE VALUATION MISMATCH

In not allowing any marital deduction with respect to the gifts of the partnership interests and their associated underlying assets transferred to others that could not, therefore, pass to the surviving spouse, the Tax Court provided detailed reasoning for its conclusion.

First, the court noted that only property passing to the surviving spouse (or otherwise in a form qualifying for the marital deduction, such as a marital deduction trust) may qualify for the marital deduction. The partnership interests given during lifetime to others could not pass to *Turner's* wife, and therefore could not qualify for the marital deduction.¹⁸

Second, the Tax Court noted that the marital deduction is not a true deduction in the sense that it "per-

manently" avoids estate taxation of the property. Rather, the marital deduction may merely postpone the estate taxation of the property until the surviving spouse later dies.¹⁹ The court observed that, if the marital deduction were permitted for the partnership interests given to others during lifetime, no estate taxation of the property would occur when the survivor later dies.²⁰ It concluded that allowing a marital deduction for the partnership interests held by others and that could not pass to the surviving spouse would "thereby frustrat[e] the purpose and the policy underlying the marital deduction."

The value of the partnership interest almost certainly will be different than the value of the underlying partnership assets.

How does the Tax Court's reasoning suggest it would resolve the valuation mismatch? The underlying partnership assets do not and cannot pass to the surviving spouse (or a marital deduction trust for his or her benefit) and, unless the partnership is liquidated before the surviving spouse dies, would not be in-

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¹⁴ Section 2056(a) provides, in part, "the value of the taxable estate shall, except as limited by subsection (b), be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate." (Emphasis added.) The Tax Court in *Turner II* does not raise this (that is, that only assets included in the gross estate may qualify for the marital deduction) as another reason not to permit the marital deduction for the partnership interests *Turner* transferred to persons other than his wife during his lifetime.

¹⁵ If the surviving spouse (or the marital deduction trust) held the unilateral right to withdraw the assets from the partnership, then perhaps the underlying assets might be seen as indeed passing to the spouse (or the trust). If so, it might be appropriate to grant the surviving spouse that right. Of course, if the surviving spouse holds the unilateral right at death, no discounts in valuation would seem to be allowed with respect to the part-

nership interest included in his or her estate at death. Cf. *Estate of Jones*, 116 TC 121 (2001), and see Reg. 25.2704-1(f), Example 5 ("Because of a general partner's right to dissolve the partnership, a limited partnership interest has a greater fair market value when held in conjunction with a general partnership interest than when held alone"). As indicated earlier, Mrs. *Turner* may have held that right under the *Turner* partnership agreement.

¹⁶ The partnership interest, even if not qualifying at all for the estate tax marital deduction, would be included in the gross estate of the surviving spouse (or subject to consumption by the survivor, or will be the subject of a lifetime gift by him or her). In that case, the partnership interest would be subject, in effect, to a double tax.

¹⁷ The Tax Court in *Turner II* commented that "we leave this mismatch problem for another day."

¹⁸ This "passing" requirement is set forth in Reg. 20.2056(c)-2(a). As indicated above, the Tax Court did not wrestle with the issue that the partnership units given away by *Turner* prior to his death were not included in his gross estate and that only property included

in the gross estate may qualify, under Section 2056(a), for the estate tax marital deduction. Hence, it seems the court is perpetuating the fiction that, if those partnership interests given away during lifetime could be transferred to the decedent's spouse, their value would qualify for the marital deduction.

¹⁹ The court acknowledged that the surviving spouse might consume the property prior to death or make a gift of the property during lifetime, which would avoid its inclusion in the gross estate of the surviving spouse.

²⁰ Although not mentioned by the Tax Court, its characterization of the marital deduction as being merely a tax postponement mechanism seems to be reinforced by Section 2056A, which postpones the collection of the estate tax imposed when a married person dies to the extent his or her gross estate passes into a qualified domestic trust (QDOT) for his or her spouse who is not a U.S. citizen. No estate tax marital deduction is allowed for transfers to a decedent's surviving spouse who is not a U.S. citizen (and who does not become one as set forth in Section 2056A(b)(12)), unless transferred to a QDOT described in Section 2056A; see Section 2056(d).

cluded in his or her gross estate. Rather, only the decedent's partnership interest bequeathed to the surviving spouse would pass to the survivor and be included in his or her gross estate at death. Since the court in *Turner II* reasoned that no marital deduction could be allowed for assets that could not pass to the surviving spouse, the court might reach a similar conclusion because the underlying partnership assets could not pass to the survivor.

Suppose, however, that the surviving spouse held a unilateral right to liquidate the partnership. In that event, perhaps, the surviving spouse should be viewed as receiving the underlying assets of the partnership. Of course, if the survivor continued to hold that liquidation power until his or her death, likely little or no discount in valuation of the partnership interest inherited from the first spouse to die would be permitted in the estate of the survivor.²¹ Of course, if the decedent had a liquidation power at death, whether or not conferred on the surviving spouse, likely little or no discount in valuation of the partnership interest inherited from the first spouse to die would be allowed at the death of the surviving spouse.

Therefore, although it is not certain, it appears there is a substantial chance that the courts will allow the marital deduction only for the FMV of the partnership interest transferred to the surviving spouse or in another marital-deduction-qualifying form. It seems prudent for tax counselors to consider this possibility in advising married individuals. The balance of this article will discuss steps that may be considered to avoid that potential problem.

AVOIDING SECTION 2036(a) IN GENERAL

Ideally, from the perspective of a taxpayer who is seeking to reduce estate taxes by having the FMV of partnership interests included in his or her estate rather than the underlying partnership assets that have a higher value, the possibility that the

partnership's underlying assets will be included in the married partner's gross estate should be avoided.²² That avoidance probably may be achieved using the following pattern to form and administer the partnership.

There seem to be at least two ways in which Section 2036(a) may be avoided. The first is to cause the entity to be formed in a manner so that transfers to it fall under the "bona fide sale for an adequate and full consideration" exception to the section. Case law has established that the exception consists of two parts, both of which must be met for it to apply:

1. The transfer must be for full and adequate consideration in money or money's worth, and
2. The transfer must be "bona fide."

The courts seem to have concluded that the transfer will be deemed to have been for full and adequate consideration in money or money's worth if the transferor receives back a proportionate interest in the income and equity of the entity (e.g., the amount contributed by a partner is fully reflected in the partner's capital account and represents a proportionate part of all contributions to the partnership, and distributions are made in accordance with the partners' interests). See, e.g., *Estate of Bongard*, 124 TC 95 (2005), and *Estate of Strangi*, 417 F.3d 468, 96 AFTR2d 2005-6895 (CA-5, 2005).

The courts also appear to have concluded that a transfer will be regarded as "bona fide" if there is a significant and legitimate non-estate tax reason for the formation of the entity. The Fifth Circuit in its famous decision in *Strangi* in 2005 suggested that there will be a finding of a sig-

nificant and legitimate non-tax reason only if, measured from a purely objective standard, the formation was likely to achieve the non-tax purpose.

It seems that a legitimate concern about a real threat of a creditor may be such a reason; see, e.g., *Estate of Hilgren*, TCM 2004-46. A need to provide management for a business or investment may be sufficient; see, e.g., *Kimbell*, 371 F.3d 257, 93 AFTR2d 2004-2400 (CA-5, 2004). A wish to avoid diversification of certain public stock holdings may be a sufficient reason; see, e.g., *Estate of Schutt*, TCM 2005-126.

It also seems that in making the objective determination the courts will look at facts after formation of the enterprise—for example, a claim that the parties pooled their assets to change investments probably will not be upheld if no sales and reinvestments of the contributions are made. Similarly, having the entity make large distributions to the partners may be used as evidence that the recited reason is not true. Also, failure to pool business assets may be used as evidence of a lack of a bona fide reason for the formation of the enterprise. See, e.g., *Turner (Estate of Thompson)*, 382 F.3d 367, 94 AFTR2d 2004-5764 (CA-3, 2004).²³

In any event, it seems appropriate to make a contemporaneous record of the legitimate and significant non-tax reasons for the formation of the entity and have the operation of the entity made consistent with those reasons if it is desirable to fall under the bona fide sale exception. As *Turner II* illustrates, however, there is no assurance that Section 2036(a) will not be found to apply.

An alternative way to avoid the application of Section 2036(a) is to

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²¹ See *Estate of Jones* and Reg. 25.2704-1(f), Example 5, both *supra* note 15. Of course, even if the surviving spouse holds a unilateral liquidation right as of the death of the first spouse to die, the survivor could rid himself or herself of that right by the time of his or her death.

²² Even for an unmarried person, that result likely is desirable. Some, but not all, of the structures suggested in this article for a married person to avoid Section 2036 may be used for a single individual. Moreover, these

suggested structures usually can be used for other entities such as LLCs and corporations. The marital deduction mismatch problems mentioned in *Turner II* can be avoided by having the partnership created only by the spouse who will survive (something often difficult to forecast) or waiting until after the first spouse dies, which may cause complications on account of changes in the law or otherwise.

²³ This 2004 decision is not related to *Turner I* or *Turner II*.

avoid a finding that the transferor retained the right to income or the right to control the beneficial enjoyment of the transferred property or its income. Because a transferor may be found to have retained the right to income through an implied, non-legally enforceable understanding, it may be difficult to prove a lack of a retained right if significant distributions are made to the transferor from the entity. A statement in the last decision in *Estate of Strangi* may suggest that pro rata distributions to the partners will not be used as evidence of such an understanding if there are other partners whose interests are significant. But the meaning and scope of the statement is uncertain.

What does seem more certain is that the failure of the transferor to maintain adequate assets to maintain a reasonable lifestyle for life will be used as evidence of an implied understanding (as it may show the transferor knew that he or she would need distributions from the entity). Cf. *Estate of Stone*, TCM 2003-309. Perhaps the strongest proof will be the fact that no distributions are made. (If a need for additional funds arises, the transferor could sell partnership units.) Nevertheless, the courts still may find that Section 2036(a) applies. The court in *Estate of Bongard* applied Section 2036(a) (1) even though no distribution had been made.

Pre-Death Sale

If the transferor of the assets to the partnership sells his or her interest in it prior to death, Section 2036(a) cannot apply—assuming the sale is respected as arm's length and for full and adequate consideration.²⁴ A sale, however, may cause gain to be recognized unless it is made to the transferor's spouse or to an entity that is disregarded for federal income tax purposes. It has long been the Service's position that a grantor trust is such a disregarded entity.²⁵ Hence, a sale of the partnership interest to a trust that is a grantor trust with respect to the seller does not generate taxable income; that is also true if it is a grantor trust with respect to the seller's spouse.²⁶ Even if the partnership interest is sold on an installment basis, there should be no gain on a sale to a trust that is a grantor trust with respect to the seller or the seller's spouse,²⁷ but the interest paid or accrued on the indebtedness thereby created would be taxable if the installment sale were to a grantor trust with respect to the seller's spouse.²⁸

If, however, the sale of the partnership interest is made within three years of death and if the decedent on formation of the partnership is treated as having retained the right to income or right to control the beneficial enjoyment of the partnership property (as was found in *Turner I*), Section 2035 might be applied. If the

partnership interest is sold for its full FMV, Section 2035 may not apply as it contains an exception for a transfer made for full consideration.²⁹

In any event, it probably would be best to try to avoid an inference of a retained right to income. Most case law suggests that, if the transferor never received any income or use of the property, then Section 2036(a) (1) should not apply.³⁰ As mentioned above, however, one partnership case—*Estate of Bongard*—found the section to apply even though the decedent never received a distribution.³¹

Accordingly, a sale to a grantor trust may be considered if there is a significant risk that the partnership's underlying assets would be included in the transferor's gross estate at death. If a non-controlling interest in the partnership is sold, it should be valued with appropriate lack of control and lack of marketability discounts.³² Provided the sale is for full value, no portion of the partnership or its underlying assets should be included in the transferor's gross estate at death, at least if the interest is sold more than three years prior to death.³³ The consideration received will be included in the seller's gross estate unless consumed or given away prior to death. Nevertheless, any appreciation in the partnership interest sold (and in the underlying partnership assets) occurring between the time of the sale and the

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²⁴ There is no gift tax counterpart to Section 2036. Thus, if a partner gives or sells limited (non-controlling) partnership interests, the value of the transferred interest should be determined without regard to whether the transferor has any control over the entity or is entitled to the income from the transferred assets. Cf. Rev. Rul. 93-12, 1993-1 CB 202.

²⁵ Rev. Rul. 85-13, 1985-1 CB 184.

²⁶ See Section 1041. In Ltr. Rul. 200120007, the IRS ruled that the protection of Section 1041 applies in the case of a sale between the husband and wife's grantor trusts. See also Dana, "Till Death Do Us Part: The Riddle of Note Basis in a Sale to a Spouse's Grantor Trust," 114 JTAX 340 (June 2011).

²⁷ See generally Blattmachr and Zeydel, "GRATs vs. Installment Sales to IDGTs: Which Is the Panacea or Are They Both Pandemics?," 41 U. Miami Philip E. Heckerling Inst. on Est. Plan. Chapter 1 (2007).

²⁸ See Seymour, 109 TC 279 (1997); Armacost, TCM 1998-150; Cipriano, TCM 2001-157, *aff'd*

55 Fed. Appx. 104, 91 AFTR2d 2003-608 (Table) (CA-3, 2003). Any interest due from a grantor trust with respect to the seller will not be included in gross income; see Rev. Rul. 85-13, *supra* note 25.

²⁹ Although one case may suggest otherwise; see Allen, 293 F.2d 916, 8 AFTR2d 6055 (CA-10, 1961).

³⁰ See the discussion in Stephens, Maxfield, Lind, Calfee, and Smith, *Federal Estate and Gift Taxation*, Eighth Edition (Thomson Reuters/WG&L, 2002), ¶ 4.08[4][c].

³¹ Also, in at least one partnership case, the court found distributions that were carried as loans were, in fact, distributions from the partnership. Under the circumstances, Section 2036(a)(1) applied. *Estate of Rosen*, TCM 2006-115.

³² The taxpayer also should sell off the controlling interest as well to avoid or at least reduce the risk of any continuing application of Section 2036(a)(2).

³³ If the partnership interest is sold for less than a full and adequate consideration in money

or money's worth, the seller may be treated as making a gift to the extent the FMV of the partnership interest sold exceeds the consideration received. See Section 2512(b). That also might cause the partnership interest sold (or its underlying assets) to be included in the decedent's gross estate, offset pursuant to Section 2043 only by the amount the purchaser paid to the seller. Some recent cases suggest that a taxpayer may be able to avoid making a gift in a sale by using a "defined value formula." See generally Hood, "Wandry v. Commissioner: A Significant Taxpayer Win in Another Defined Value Case," Steve Leimberg's Estate Planning Email Newsletter—Archive Message #1941 (3/17/12); Katzenstein and Bowman, "Tax Court Provides Road Map for Successful Defined Value Clause Planning," Steve Leimberg's Estate Planning Email Newsletter—Archive Message #1946 (4/9/12); Akers, "Wandry: First Case to Address and Respect Simple Formula Transfer," Steve Leimberg's Estate Planning Email Newsletter—Archive Message #1945 (4/9/12).

transferor's death also may avoid estate taxation when the transferor dies.

Of course, that means the partnership units sold will not receive an automatic change in basis under Section 1014(a) at the transferor's death (unless pursuant to Section 2035 or otherwise they are included in the transferor's gross estate).³⁴ That factor also should be considered in determining if a sale is appropriate. Additional factors may be considered if the transferor is married and would be using an optimum marital deduction at death.

Gift to the Spouse

To attempt to avoid the valuation mismatch discussed above, consideration may be given to having a married person make a gift of the partnership interest prior to death, perhaps to his or her spouse or a marital deduction trust.³⁵ As long as the transferor's spouse is a U.S. citizen, the gift should qualify for the gift tax marital deduction. Although that will cause the partnership interest to be included in the gross estate of the transferor's spouse (unless consumed or given away before death), Section 2036(a) cannot apply to that spouse's estate because he or she was not the transferor of the partnership's assets.³⁶ Hence, discounts in valuation likely will apply.

Suppose the transferor survives his or her spouse and that spouse bequeaths the partnership interest

back to the transferor spouse under the protection of the estate tax marital deduction. The partnership interest then will be in the gross estate of the transferor (unless, again, consumed or given away before death), but, it seems, the underlying partnership assets should not be. In Rev. Rul. 84-179, 1984-2 CB 195, the IRS embraced the decision in *Estate of Skifter*, 468 F.2d 699, 30 AFTR2d 72-5920 (CA-2, 1972). In doing so, the Service appeared to accept the *Skifter* notion that a testamentary transfer back to the transferor spouse at the death of the transferee spouse can be viewed as unrelated to the initial transfer, thus eliminating the application of Section 2036 at the later death of the transferor spouse.³⁷

Income tax basis of such a gift also should be considered. One of the "prices" of having a partnership interest transferred at death and not having the higher value of the underlying partnership assets included in the gross estate of the decedent is the limitation of the automatic change in basis under Section 1014(a) to the estate tax value of the limited partnership interest. Where the estate tax rate is higher than the capital gains tax rate, the result may be viewed as worthwhile. If, however, the decedent is married and is transferring the partnership interest to or for his or her spouse under the protection of the estate tax marital deduction, then estate tax will be postponed until the surviv-

ing spouse dies, which may mean that the lower capital gains tax may apply earlier in time than the avoidance of higher estate tax.³⁸

If the transferor spouse gives the partnership interest to (or for) his or her spouse during lifetime, the income tax basis of the partnership interest in the hands of the transferor's spouse will be the income tax basis of the transferor.³⁹ Assuming the transferor's spouse retains the partnership interest until death, its basis then will be equal to its estate tax value (assuming, which appears to be the case, that the underlying assets of the partnership are not included in the gross estate of the transferor's spouse).⁴⁰ The key question then in determining what the basis of the partnership interest will be is what its estate tax value will be.

The estate tax value depends, at least in part, on whether the spouse of the transferor holds the unilateral power to liquidate that partnership as of death. If the transferor's spouse holds that power, there likely will be little or no discount available in determining the value of partnership units held by the transferor's spouse. This means that the value of the partnership will equal the value of its underlying assets, which in turn means the income tax basis will be equal to that value.⁴¹ If so, and the partnership interest is subject to estate tax when the transferor's spouse dies, that tax essentially will be im-

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³⁴ As discussed in Blattmachr, Gans, and Jacobson, "Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death," 97 JTAX 149 (September 2002), the result may be different if the sale is to a grantor trust.

³⁵ A qualified terminable interest property trust described in Section 2523(f) may be a preferred choice as it may cut off the application of Section 2036 with respect to the interest given away before death. See Reg. 25.2523(f)-1(f), Example 11.

³⁶ The income tax basis of the partnership interest on the death of the transferor's spouse will equal its estate tax value in the spouse's estate, which, as indicated, likely will be lower than the FMV of the partnership's underlying assets.

³⁷ An inter vivos transfer by the transferee spouse back to the transferor spouse might well be viewed differently. Indeed, the Tax

Court alluded to the possibility of a different outcome in the inter vivos context. See *Estate of Skifter*, 56 TC 1190 (1972), fn. 5.

³⁸ In *Turner*, because the underlying assets of the partnership were included in the husband's gross estate, their estate tax value presumably became their basis pursuant to Section 1014(a). As emphasized earlier in this article, Mrs. Turner did not "inherit" these assets from her husband; rather, she inherited his partnership interest (although not the interests he gave away to others before he died). The basis of the partnership units inherited by Mrs. Turner is uncertain—if the partnership interest was not included in her husband's gross estate because the underlying partnership assets were included, there may or may not be an automatic change in basis pursuant to Section 1014. As discussed in Blattmachr, Gans, and Jacobson, *supra* note 34, Section 1014 applies not just to assets included in the decedent's gross

estate for federal estate tax purposes but also to property received from a decedent, including by inheritance. The automatic change in basis to estate tax value applies under Section 1014(a) to "property in the hands of a person acquiring the property from a decedent," and Section 1014(b) provides, in part, that "the following property shall be considered to have been acquired from or to have passed from the decedent: (1) Property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent." (Emphasis added.) But see CCA 200937028.

³⁹ Section 1015(a).

⁴⁰ Recall that Section 2036(a) cannot apply to the transferor's spouse because that spouse did not transfer the assets to the partnership.

⁴¹ See *Estate of Jones* and Reg. 25.2704-1(f), Example 5, both *supra* note 15. *Cf.* *Estate of Newhouse*, 94 TC 193, *nonacq.* in result.

posed on the FMV of the partnership's underlying assets.⁴²

To avoid having estate tax imposed on the value of the partnership's underlying assets, the transferor's spouse could transfer the controlling interest (e.g., the general partnership interest) prior to death. Because the transferor's spouse did not form the partnership, neither Section 2036(a) nor Section 2035(a) (the transfer-within-three-years-of-death rule) can apply. If the underlying assets are worth more at the death of the transferor's spouse than the basis of the partnership interest given to the transferor's spouse, it may be appropriate to hold the limited and controlling partnership interests until the transferor's spouse dies to obtain a higher basis pursuant to Section 1014(a) rather than having the surviving spouse give them away before death.

Of course, this would make sense only if the transferor spouse survives and can inherit the partnership units with a basis determined under Section 1014(a). Although there may be a positive impact on basis, it may come at the cost of exposing to estate taxation any appreciation on the assets occurring during the balance of the lifetime of the transferee spouse. The estate tax on that appreciation may be greater than the capital gains avoided by the step-up in basis that would occur under Section 1014(a) by having the transferor's spouse hold it until death.⁴³

If the transferor's spouse dies before the transferor and bequeaths the partnership interest at death back to

the transferor spouse under the protection of the estate tax marital deduction or transfers the interest back to (or for) the transferor under the protection of the gift tax marital deduction prior to death, then the partnership interest will be included in the gross estate of the transferor (unless consumed or given away prior to death). As discussed above, it seems unlikely that the underlying assets of the partnership would be included in the transferor's gross estate if the partnership interest is reacquired by the transferor as a result of his or her spouse's death. The exclusion of the underlying assets from the transferor's gross estate may not be as certain if the partnership interest is transferred back to the transferor by his or her spouse as a lifetime gift.⁴⁴ If the underlying assets of the partnership are not included in the transferor's gross estate, the basis of the partnership interest held by the transferor at death, which he or she had reacquired from his or her spouse, would equal its estate tax value in the transferor's gross estate (as opposed to the value of the partnership's underlying assets).⁴⁵

Sale to the Spouse

A married transferor also may consider selling the taxpayer's partnership interest prior to death to his or her spouse (or a marital deduction trust for his or her benefit). Such a sale is not income taxable.⁴⁶ Such a sale, if for full and adequate consideration in money or money's worth, may avoid the potential application of Section 2036.

Section 2036(a) applies only if the decedent had the right to income or to control who receives the income at death. A right to receive or control income prior to death would not matter except that, as discussed above, a transfer of a Section 2036(a) interest prior to but within three years of death may trigger the application of Section 2035, essentially causing the same result as if the interest had not been transferred before death. A sale may cause gain to be recognized unless it is made to the transferor's spouse or to an entity that is disregarded for federal income tax purposes. It has long been the position of the Service that a grantor trust is such a disregarded entity.⁴⁷ Hence, a sale of the partnership interest to a trust that is a grantor trust with respect to the seller does not generate income; that is also true if it is a grantor trust with respect to the seller's spouse.⁴⁸

Even if the partnership interest is sold on an installment basis, there should be no gain on a sale to a trust that is a grantor trust with respect to the seller or the seller's spouse,⁴⁹ but the interest paid or accrued on the indebtedness thereby created would be taxable if the installment sale were to a grantor trust with respect to the seller's spouse.⁵⁰

As indicated above, however, if the sale of the partnership interest is made within three years of death and if the decedent on formation of the partnership is treated as having retained the right to income or right to control the beneficial enjoyment of the partnership property (as was found in *Turner I*), Section 2035

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⁴² The reason estate tax would be imposed on the FMV of the underlying assets of the partnership is not because Section 2036(a) applies (it cannot apply because the spouse of the transferor was not the transferor of the assets to the partnership) but rather because no (or little) discount will be permitted where the transferor's spouse held the unilateral right to liquidate the partnership as of his or her death.

⁴³ For example, assume the estate tax value and, as a result, the basis of the partnership interest inherited by the surviving spouse is \$1 million with discounts but would be \$1.5 million without discounts. This means that "forfeiting" the discounts at the death of the first spouse to die could save \$100,000 of capital gains tax if the effective rate of that

tax were 20% (that is, 20% of the \$500,000 "increase" in basis). But the estate tax, at a rate of 35%, on the additional \$500,000 of value would be \$175,000.

⁴⁴ See the discussion in the text accompanying note 37, *supra*, of Rev. Rul. 84-179, 1984-2 CB 195.

⁴⁵ The automatic change of basis does not apply to all assets included in the decedent's gross estate. For example, the basis of the right to income in respect of a decedent (IRD) (the treatment of which is set forth, in part, in Section 691) is not automatically changed; see Section 1014(c). In general, one "looks through" a partnership to see if it contains what would be IRD, in which event the change of basis under Section 1014(a) is denied to that extent.

⁴⁶ Section 1041(a). As a general rule, a sale to a taxpayer's spouse does not result in income tax even of "negative basis" property. *Id.* Unlike a sale to a spouse, a gift to the spouse of negative basis property may trigger recognition of gain. See generally Blattmachr, Gans, and Jacobson, *supra* note 34. A trust a taxpayer creates for his or her spouse typically will be a grantor trust with respect to the taxpayer under Sections 676 and 677. The IRS has ruled that sales to grantor trusts are not income recognition events. Rev. Rul. 85-13, *supra* note 25.

⁴⁷ Rev. Rul. 85-13, *supra* note 25.

⁴⁸ See note 26, *supra*.

⁴⁹ See note 27, *supra*.

⁵⁰ See note 28, *supra*.

might be applied. If the partnership interest is sold for its full FMV, Section 2035 may not apply as it contains an exception for a transfer made for such full consideration.⁵¹ A gift to the transferor's spouse will not avoid Section 2035 if the transferor had retained an interest or power described in Section 2036(a).

MORE EFFICIENT WAYS FOR A MARRIED PERSON TO AVOID 2036(a)

Other techniques to avoid the consequences of Section 2036 exist, and may prove to be more practical to achieve.

Contribution to the Other Spouse's Partnership

A way that may be even more efficient than giving the partnership units to the spouse of the taxpayer who formed the partnership may be for one spouse to form the partnership with a small amount of property and then have the other spouse make a significant contribution to that partnership. The contribution to such a partnership that the spouse has formed should qualify for the gift tax marital deduction if that spouse is a U.S. citizen.⁵²

Except for the initial (small) contribution by the spouse who formed the partnership, none of the property transferred to the partnership by the other spouse can be included in the gross estate of the spouse who formed the partnership because, for purposes of Section 2036, the spouse forming the partnership was not the transferor of the assets contributed to the partnership by the other spouse. That means the spouse forming the partnership may retain an income interest and a controlling interest without triggering Section 2036 (other than with respect to the small contribution that spouse made to the partnership). Moreover, Section 2035 cannot apply with respect to the contribution the one spouse made to the partnership formed by the other because the contributing spouse did not retain an income interest in or control over those partnership assets.

Accordingly, this seems a better route for a married couple to follow in forming a partnership where they are seeking discounts in valuation. It also means no gift need be made during lifetime of the partnership interest retained by the spouse who formed it (and to which the other spouse made significant contributions) to avoid having the underlying partnership assets included in the gross estate of the spouse who formed it. That, in turn, means an automatic change in basis will occur when the spouse who formed the partnership with a small contribution dies, rather than a carryover basis in the event of a lifetime gift.⁵³

As discussed above, even if the partnership interest given to the transferor's spouse or the partnership interest in the partnership formed by one spouse to which the other made a significant contribution is bequeathed to the surviving spouse (the one who either formed the partnership that was given to the other spouse or who made a significant contribution to the partnership formed by the deceased spouse), Section 2036(a) should not apply with respect to the estate of the surviving spouse.

Bequest to the Other Spouse at Death

There seems to be yet another potential manner in which the spouses might form and administer a partnership, although it involves the risk of forecasting which spouse will die first.

For example, assume it is anticipated that the husband will die first. He forms the partnership, retaining

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It seems appropriate to make a contemporaneous record of the legitimate and significant non-tax reasons for the formation of the entity and to have the operation of the entity made consistent with those reasons, if it is desirable to fall under the bona fide sale exception.

all interests including the controlling (e.g., general partnership) interest. He dies first. Because he would have had the ability to liquidate the partnership as of his death, no (or little) discount will apply in determining the estate tax value of the partnership interest in his estate, and the basis of the partnership interest will likely equal the value of the underlying assets.

The partnership could then make a Section 754 election, which allows the basis of the partnership's underlying assets to be adjusted to their full FMV as reflected by the estate tax value of the partnership interest in the husband's gross estate. The election may be important if the assets of the partnership are appreciated. After inheriting the partnership interest from her husband, the wife could give away the controlling interest to ensure that the partnership interest in her estate would not be valued on a liquidation basis. If she owns partnership interests when she dies and they are discounted because she cannot effect a liquidation (be-

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⁵¹ But see note 29, *supra*.

⁵² Reg. 25.2511-1(h)(1) provides that a gift to a corporation is to be treated as a proportionate gift to the shareholders, i.e., without taking any discount into account. This rule also applies to a gift to a partnership. See Shepherd, 283 F.3d 1258, 89 AFTR2d 2002-1251 (CA-11, 2002), *aff'd* 115 TC 376 (2000) ("And gifts to a partnership, like gifts to a corporation, are deemed to be indirect gifts to the stakeholders 'to the extent of their proportionate interests' in the entity. See [Reg.] 25.2511-1(h)(1)".) In terms of the marital deduction where a gift is made to an entity, the Service applies the same analysis, permitting a deduction equal to the amount of the gift—

again, without taking discounts into account. See Rev. Rul. 71-443, 1971-2 CB 337 (applying the Regulation and concluding that the marital deduction is equal to the amount of the gift).

⁵³ As indicated in Blattmachr, Gans, and Jacobson, *supra* note 34, one way the basis of the partnership assets could be determined pursuant to Section 1014(a) at the death of the spouse is for the spouse to buy the assets for cash (or other high-basis assets) before death. Such a purchase should not trigger gain recognition if the partnership is disregarded for federal income tax purposes pursuant to Reg. 301.7701-3. See also Rev. Rul. 2004-77, 2004-2 CB 119.

cause she gave away the controlling interest before death), the partnership presumably would have to reduce basis in accordance with the Section 754 election.

Avoiding the 754 Election When the Survivor Dies

There is another step that the wife could consider taking to avoid having the basis of the partnership's assets decreased on account of the Section 754 election that would occur on her death. She could give away her entire partnership interest before death.⁵⁴ No adjustment in basis on account of a Section 754 election is made on account of a transfer by gift (although the adjustment will occur on sale if the election has previously been made), so the gift would not affect the basis of the partnership's assets.⁵⁵

The basis of the partnership interest transferred by gift would carry over to the spouse's donee, potentially adjusted for gift tax payable, although if the FMV of the gift is lower than the wife's basis in the partnership interests (as it likely would be, because the partnership interest probably was not discounted in the husband's estate but her gift of a non-controlling interest likely would be), the basis of the property in the hands of the donee will be the property's gift tax value for purposes of loss but the wife's (carry over) basis for purposes of gain.⁵⁶

If the wife would incur gift tax by making a gift of the non-controlling interest in the partnership and does not wish to pay gift tax, she could sell the non-controlling interest in the partnership. As mentioned above, the sale of that interest to a grantor trust with respect to the wife would not trigger income tax recognition (al-

though as mentioned above there may well be no inherent gain) and, except to the extent the interest is sold for less than full and adequate consideration in money's worth, no gift would be deemed made.

Because the gift tax value of the non-controlling partnership interest probably cannot be determined with certainty, the risk of a gift by the sale is present. As indicated earlier, a sale of a defined value formula interest in the non-controlling interest would prevent any gift from being made if the formula is respected for gift tax purposes.⁵⁷ Of course, if the defined value formula price is less than the value of the entire non-controlling partnership interest, the wife would own some portion of that interest at death. Nevertheless, unlike a retention by the spouse who formed the partnership, which could trigger Section 2036(a) causing the underlying assets to be included in the gross estate of the transferor spouse, the underlying assets cannot be included in the gross estate of the surviving spouse because that spouse was not the transferor of the assets in the partnership.

Although some partnership interests may be treated as retained (because, under the defined value formula sale, they were not all sold for full value) and would be included in the surviving spouse's gross estate, that retained interest likely would be valued with a discount. While the Section 754 election would have to be respected, it would apply only with respect to the interest so included in the gross estate of the surviving spouse.

Basis of Assets Held in a Non-Included Grantor Trust at Death of the Grantor

The sale strategy discussed above

begs the question of what the basis would be, on the wife's death, of the partnership interests then held by the grantor trust to which she sold them. As discussed in an article cited earlier,⁵⁸ the law does not appear to be well developed as to what is the basis of property held in a grantor trust that is not included in the grantor's gross estate if grantor trust status terminates by reason of the grantor's death. Although the IRS has informally agreed that no gain would be deemed to occur on death,⁵⁹ it has informally disagreed with the conclusion that basis of the assets held by the grantor trust most likely would be determined under Section 1014(a).⁶⁰

If the Service is correct that the basis of the assets in the grantor trust is not determined by Section 1014(a), then basis would have to be determined either by Section 1015 (basis of gift property) or Section 1012 (basis determined by purchase price). As the article observes, it is difficult to conclude that Section 1012(a) applies. The IRS has officially ruled that a sale to a grantor trust is not treated as a sale for income tax purposes and, as the article discusses, other authority (including Supreme Court decisions) is inconsistent with treating death as an income tax realization event. Nonetheless, if Section 1012(a) applies, a determination would have to be made as to what the purchase price is and it would require a Section 754 basis change (because the election had been made when the first spouse died), which may result in a lower basis of the partnership assets than their basis before the death of the wife.

IF ESTATE TAX INCLUSION NONETHELESS OCCURS

Despite the care with which a partnership may be formed by a married person and regardless of how it is administered, it may be that its underlying assets are included in the gross estate of the spouse who transferred them to the partnership. As indicated by *Turner II*, if that is pos-

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⁵⁴ She likely should transfer the non-controlling interest separately from the controlling interest. See Rev. Rul. 93-12, *supra* note 24.
⁵⁵ In some instances, the basis of the property may be increased by a portion of gift tax paid on the gift; see Section 1015.
⁵⁶ Section 1015(a). Section 1015(d) provides for the basis of gift property to be increased for the gift tax payable on the inherent appreciation in the asset at the time of the gift. If, however, the wife gives away the partnership

interest inherited from her husband soon after his death, there likely would be little if any appreciation—especially if the non-controlling interests given away are valued with discounts.
⁵⁷ See note 33, *supra*.
⁵⁸ Blattmachr, Gans, and Jacobson, *supra* note 34.
⁵⁹ See CCA 200923024.
⁶⁰ CCA 200937028.

sible, it would not seem wise to make gifts of partnership interests to persons other than the transferor's spouse during lifetime as those gifts of partnership interests (or the pro rata portion of the underlying partnership assets attributable to them) cannot be made to qualify for the marital deduction.

It is potentially possible that, even if partnership interests are sold to a grantor trust, the underlying assets of the partnership will be deemed included in the decedent's estate under Section 2036 (or Section 2035) or otherwise.⁶¹

If a sale might be made to a trust (whether or not it is a grantor trust), that trust should provide that, to the extent partnership interests are included in the gross estate of a partner who is married,⁶² the partnership interest is to pass in a form qualifying for the estate tax marital deduction (a "contingent" marital deduction provision).⁶³

Even that, however, will not help with the valuation mismatch raised in *Black, Shurtz, and Turner II* if the underlying partnership assets are included in the gross estate of the married partner. Nonetheless, there seems to be a solution to that problem and, as discussed earlier, it may be the reason why the IRS did not raise the valuation mismatch in *Turner*: the surviving spouse had the unilateral right to withdraw the underlying assets from the partnership to the extent she inherited partnership interests from her husband.

Thus, just as the trust to which

partnership interests would be sold would have a contingent marital deduction provision (as mentioned above) if property in the trust is included in the deceased married partner's estate, the partnership agreement could provide for a contingent marital deduction. In other words, the partnership agreement could provide that assets of the partnership that are included in a deceased married partner's gross estate are to pass in a form qualifying for the estate tax marital deduction.⁶⁴ That should mean that there is no problem with respect to the allowance of the marital deduction: the included assets themselves are being transferred to (or for) the surviving spouse and there should be no valuation mismatch.⁶⁵

There may be some additional issues to consider. For example, assume the spouse dying first, and in whose estate the underlying partnership assets are included, wishes the marital deduction share to pass into a marital deduction trust and not directly to the surviving spouse.⁶⁶ Even if there is a provision in the partnership agreement that requires the assets of the partnership that are included in the deceased spouse's gross estate to be distributed to the surviving spouse or a marital deduction trust if, but only if, those assets would be so included in the estate of the deceased spouse without regard to that provision in the partnership agreement, the IRS might argue that the provision gave the deceased spouse additional control.

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⁶¹ For example, if the partnership interest is sold within three years of death, Section 2035 might apply to cause the underlying assets to be included in the seller's gross estate.

⁶² Although the trust might provide that if the underlying partnership assets are included in the grantor's gross estate the trust must distribute those to the contingent marital deduction interest, the trust will not have the power to accomplish that unless the partnership gives the trust that authority. Perhaps, as discussed later, such a provision should be placed into the partnership agreement itself.

⁶³ This type of "contingent" marital deduction is common in life insurance and other trusts. See Slade, 807 T.M. (BNA), *Personal Life Insurance Trusts*, page A73. This contingent marital deduction can be conditioned on the decedent's being married to a named spouse (as opposed to another spouse at death).

⁶⁴ Many practitioners use a qualified terminable interest property (QTIP) trust described in Section 2056(b)(7) as the form of the contingent marital deduction because, among other advantages, it permits the decedent's estate to elect how much, if any, of the trust will qualify for the estate tax marital deduction. If the surviving spouse may not be a U.S. citizen, it should be in the form of a QDOT described in Section 2056A.

⁶⁵ It appears that the payment of the assets to or for the surviving spouse pursuant to the terms of the partnership agreement would be considered as passing from the deceased spouse to the surviving spouse for purposes of Reg. 20.2056(c)-2(b).

⁶⁶ As noted in note 65, *supra*, if the surviving spouse is not a U.S. citizen the estate tax marital deduction would be permitted only for assets passing into a QDOT described in Section 2056A.



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For example, if the partnership agreement required that the interest transferred by the deceased spouse or a marital deduction trust must be redeemed as of the deceased spouse's death by a distribution of a pro rata portion of the partnership's underlying assets, the decedent would have the power until death to control whether the partnership assets so included would pass outright or in trust for his or her spouse. The Service might contend that this power to control that disposition caused the underlying assets of the partnership to be included in the deceased spouse's gross estate under Section 2036(a)(2).

That argument should not prevail if the redemption of the partnership interest bequeathed by the deceased spouse outright to the surviving spouse or to a marital deduction trust occurs if, but only if, the partnership assets with respect to the partnership interest bequeathed to the surviving spouse or marital deduction trust are included in the deceased spouse's gross estate without regard to the partnership redemption interest.

Some will perhaps be concerned that such a provision in a partnership agreement will be used as evidence that there was no significant and legitimate non-tax reason for the formation of the partnership. But that should not be the case. The fact that the IRS has repeatedly attempted to have a partnership's underlying assets included in the gross estate of a deceased partner is not a secret. That every planner should be aware of it and take action to avoid the adverse consequences which would arise in such event does not

seem to belie the non-tax reasons for the partnership's formation.

An alternative that might be considered is to have the partnership agreement provide that, with respect to any partnership interest inherited by the surviving spouse (or a marital deduction trust), the surviving spouse (or marital deduction trust) has a unilateral right to "put" the partnership units to the partnership in exchange for a pro rata portion of the underlying partnership assets to the extent the underlying partnership assets are included in the deceased spouse's gross estate.⁶⁷ (The surviving spouse may wish to rid himself or herself of this put right prior to death by sale, for example, of that right.⁶⁸) As mentioned above, such a put right may be why the IRS did not raise the valuation mismatch in *Turner I*: the surviving spouse could redeem the units on account of her status as a general partner.

In any event, an automatic redemption provision in the partnership agreement or the granting of a put right to the surviving spouse (or the marital deduction trust) would not seem to salvage the marital deduction for partnership interests given away during lifetime to persons other than the surviving spouse by the deceased spouse, as happened in *Turner*. Presumably, any redemption of those partnership interests would result in underlying partnership assets being transferred to the recipients of the gifts and not to the surviving spouse. Some may consider going all the way: providing in the partnership agreement that, to the extent underlying partnership assets are included in the estate of the deceased spouse without regard to the partnership provision, those assets

must pass to the surviving spouse or a marital deduction trust.⁶⁹

CAN THE INCLUDED ASSETS QUALIFY FOR A MARITAL DEDUCTION WITHOUT A REDEMPTION?

There is another possible solution, which in some respects is similar to the manner in which the assets of a grantor retained annuity trust (GRAT) or a qualified plan or an individual retirement account (IRA) may be qualified for an estate tax marital deduction. In a GRAT, the annuity causes estate tax inclusion under Section 2036 of the underlying assets held in the GRAT.⁷⁰ In a qualified plan or IRA, the decedent's interest causes inclusion of the underlying assets of the qualified plan or IRA.

The decedent or the decedent's estate cannot always control the administration of the trust or plan that holds the assets included in the gross estate. Nevertheless, it seems that in each of those cases, if all the income from the GRAT, plan, or IRA is in fact distributed to the surviving spouse or to a marital deduction trust, followed by that income being distributed to the surviving spouse, with no possibility of the underlying assets being paid to anyone else, then the GRAT, plan, or IRA itself may be qualified for a marital deduction.⁷¹ This may mean that the valuation mismatch problem could be avoided if the partnership agreement requires the underlying assets included in the deceased spouse's gross estate to be administered as a marital deduction trust.

This solution might be easiest to comprehend in the context where the deceased spouse continues to

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⁶⁷ Cf. Estate of Nowell, TCM 1999-15 (general partnership interest inherited was valued as a full partnership interest, and not as an assignee interest, by reason of a partnership provision conferring general partnership status on the inheritor).

⁶⁸ If the right is conferred on a QTIP trust described in Section 2056(b)(7), consideration should be given to ensuring the transfer of this right will not trigger Section 2519. Perhaps distributing the right outright to the surviving spouse, who could dispose of it, would be a safer course than having the

QTIP trust sell it. It should be made certain that the put right does not disappear on the transfer, to ensure that Section 2704 does not apply. In fact, it might be a "floating" put right that would apply to the "number" of partnership units the surviving spouse inherited as opposed to only the specific units the survivor inherited from the deceased spouse.

⁶⁹ Using a QTIP trust described in Section 2056(b)(7) as the recipient of the partnership assets provides an additional measure of flexibility on estate taxation: the deceased spouse's executor could determine not to

elect marital deduction treatment for the trust (or elect it only in part). Another option to engage in post-mortem estate tax planning may be for the surviving spouse to disclaim pursuant to Section 2518 the partnership interest received by the spouse or a marital deduction trust by reason of the deceased spouse's death.

⁷⁰ See Blattmachr, Gans, and Zeydel, "Final Regulations on Estate Tax Inclusion for GRATs and Similar Arrangements Leave Open Issues," 109 JTAX 217 (October 2008).

⁷¹ See, e.g., Rev. Rul. 2006-26, 2006-1 CB 939.

own limited partnership units until the deceased spouse's death. The deceased spouse's estate believes the deceased spouse's gross estate includes the limited partnership units, but the IRS asserts that under Section 2036 the underlying assets of the partnership are included in the deceased spouse's estate.

Suppose that the partnership agreement requires that if any of the assets of the partnership are included in gross estate of a deceased partner or former partner, then the partnership is to hold the included assets in a segregated fund, and to distribute in respect of the deceased partner's partnership interest from the date of the deceased partner's death all of the income (as defined for purposes of the estate tax marital deduction) of the segregated fund to the owner of the deceased partner's partnership interest. Might that permit the included assets to qualify for a marital deduction? Perhaps a prohibition on distributions to any other partner coupled with a mandatory distribution of all income (as defined for marital deduction purposes) to the spouse or to a marital deduction trust for the spouse might be sufficient to obtain a marital deduction.

Furthermore, what is essentially a conversion to a partnership that is required to distribute all its income to its partners may be less detrimental from a valuation standpoint than a mandatory redemption clause. With an automatic redemption, the underlying partnership assets will be owned by the surviving spouse and included in his or her gross estate, barring other action, without any discount. By contrast, with the marital deduction trust arrangement, it may be that a discount would be permitted because the surviving spouse never acquired ownership of the partnership's assets.

Of course, if only the partnership units are included in the gross estate of the surviving spouse (because they were in the marital deduction trust for the surviving spouse), they may be valued with a lesser discount than if the partnership was not required to distribute its income (as defined for

marital deduction trust qualification purposes). In any event, the redemption provision or the mandatory payment from the partnership of income to the marital deduction trust, as the case may be, should be conditioned on the underlying partnership assets being included in the deceased partner's gross estate without regard to the provision.

The difficulty with this "mandatory partnership income distribution to a marital deduction trust" solution may be a metaphysical one. It may be that the IRS will assert that what is transferred to or in trust for the surviving spouse is a limited partnership interest, not the underlying assets that are included in the deceased spouse's gross estate. In that event, even if the partnership distributes all of its income (as defined for marital deduction purposes) to the surviving spouse or a marital deduction trust for the surviving spouse, the partnership interest commands a valuation discount, causing the valuation mismatch problem. Nevertheless, if the spouse in fact receives a qualifying income interest in the assets included in the deceased spouse's gross estate, it seems possible for those assets to qualify for a marital deduction in the manner described above, even if the limited partnership interest is discountable for other purposes.⁷²

CONCLUSION

Turner II holds that partnership interests transferred by gift prior to death to someone other than the deceased partner's spouse cannot be

treated as qualifying for the estate tax marital deduction even if the underlying assets of the partnership with respect to those gifts are included in the deceased partner's gross estate. The IRS and the Tax Court, however, did allow a marital deduction for the value of the underlying assets of the partnership that were included in the decedent's gross estate even though those assets could not pass to the surviving spouse and were worth more than the partnership interests the decedent did transfer to his wife. The case suggests that gifts should not be made of partnership interests if there is a risk that the partnership's underlying assets may be included in the decedent's gross estate. Indeed, that result may occur even if the taxpayer gives away or sells all partnership interests because Section 2035 may apply if the transfer occurs within three years of death.

Turner II raises other and, in some ways, more troubling issues which range from double estate tax inclusion to no or a limited marital deduction where the underlying assets are included in the gross estate of the deceased spouse but only the partnership interest itself (and not the underlying assets) is inherited by the surviving spouse.

It seems appropriate to attempt to avoid Section 2036(a) to begin with. That may not be possible and, in any event, on account of basis issues, it may be that no discount in valuation should be sought when the first spouse dies. In fact, married couples have unique opportunities to avoid Section 2036(a) and to achieve an enhanced income tax basis. ■

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⁷² Courts, including the Tax Court in *Turner I*, have indicated that the purpose of Section 2036 is to bring into the gross estate *inter vivos* transfers that are part of a testamentary plan. They have considered the testamentary nature of the plan not only in analyzing the applicability of the bona fide exception but also in determining whether the decedent had retained the requisite "string" to cause the section to apply. See *Turner I* ("Factors indicating that a decedent retained an interest in transferred assets under section 2036(a)(1) include a transfer of most of the decedent's assets, continued use of transferred property, commingling of personal and partnership assets, disproportionate

distributions to the transferor, use of entity funds for personal expenses, and *testamentary characteristics of the arrangement*" (emphasis added)). While it would seem that the "string" issue should not be affected by the testamentary flavor of the transaction (for example, it is uncertain how it would affect the right to income or control of the transferred assets), it must be acknowledged that the courts nonetheless seem to be taking this approach. Thus, before using the QTIP approach suggested in text, consideration should be given to the question whether such an approach would lead the courts to view the arrangement as a testamentary one.