



FCG Valuation Case E-Flash

Authored by Chris D. Treharne, ASA, MCBA, BVAL and John Walker
of Gibraltar Business Appraisals, Inc., a member firm of FCG
Issue 11:5

CITATION:

Estate of Roger D. Malkin, Deceased, Jonathan R. Malkin and Melissa Malkin, Executors, et al v. Commissioner, T.C. Memo. 2009-212, Docket Nos. 9222-05, 9252-05, 9253-05, 9531-05, September 16, 2009

COMMENTS:

While lengthy, the following summary captures the salient points of the case. A close reading of the case indicates that more attentive estate planning by the Decedent and his advisors could have radically changed the outcome of the ruling. Petitioners failed to raise issue of Section 7491(a), which could have shifted the burden of proof to the Commissioner.

- Transfers of publicly traded stock from the gross estate to FLPs were not for full and adequate consideration and therefore includable in the gross estate.
- Transferred property to FLPs and transferred interests in those FLPs to trusts were taxable gifts.
- Payments of LLC debts were gifts to the beneficial members of the LLCs.
- Cash loans to the Decedent’s children were gifts.
- Significant portions of the Estate’s accounting, attorney, and executor’s fees were disallowed.

THE FACTS:

In the findings of fact for the case, the Petitioners failed to set forth objections to the Commissioner’s findings of fact. In so doing, the Petitioners effectively accepted the Commissioner’s findings except for those that don’t match the Petitioner’s facts or those already in evidence.

Roger D. Malkin (the “Decedent”) engaged in sophisticated estate planning between 1998 and his death from cancer in November 2000. The Decedent created two FLPs (MFLP and CRFLP) and four trusts as part of his estate planning.

MFLP was formed on August 31, 1998, and capitalized with the Decedent’s personally owned, publicly traded employer stock and cash from two trusts which had been created prior to the partnership’s formation. The trustees also paid cash and executed self-cancelling installment notes (SCINs) with the Decedent to purchase additional limited partnership interests he purchased as part of MFLP’s original capitalization. On September 24, 1999, the Decedent pledged MFLP’s assets as security against a

personal bank loan with the trustees' permission. The following April, he repledged the assets with a second bank.

After being diagnosed with cancer during May 1999, the Decedent and two new trusts allegedly formed a second partnership, CRFLP, on February 29, 2000. Formation capital again included the Decedent's personally owned, publicly traded employer stock plus the Decedent's member interests in four LLCs that he owned with his son (as will be discussed later, the Decedent effectively attempted to create a partnership without any other partners). The same day, Decedent allegedly transferred limited partnership interests to two new trusts. However, the trusts were not legally formed until the following day, March 1, 2000. As with MFLP and the two earlier trusts, the new trusts paid cash and executed SCINs with the Decedent for the purchase of additional CRFLP limited partnership interests. Immediately prior to his death on November 22, Decedent then contributed additional shares of his publicly traded employer stock to CRFLP. As was the case with the shares owned by the other partnership, the shares had been pledged as collateral against personal debt. Unlike the other partnership, the pledge had been made before the stock was transferred to CRFLP. The Decedent died before the first payment came due on the CRFLP SCINs. Further, the Estate never demanded payment.

Decedent was the general partner of each of the FLPs, while he and the two trusts were limited partners of each FLP.

In addition to the preceding partnership transactions, the Decedent transferred cash to his children, purportedly as loans. However, promissory notes were executed for only two of the transfers, no interest was paid, and no demands for payment occurred.

The Decedent also paid debts associated with two of the LLCs.

During September 2000, Decedent also paid money to one of the LLCs related to a capital call. However, in March 2000, he transferred his LLC interests to CRFLP.

DISCUSSION:

IRC § 2036(a) requires estates to include assets from the value of the gross estates except in certain instances ("except in the case of a bona fide sale for an adequate and full consideration in money or money's worth"). In particular, § 2036(a)(1) includes in gross estates "the possession or enjoyment of, or the right to the income from, the property" which the decedent (in general) enjoyed even if a transfer of the property had taken place.

The IRS argued that the pledge of FLP assets to secure Decedent's personal debt created an implied agreement that the Decedent would retain the right to use transferred stock. Estate Tax Regulation § 20.2036-1(b)(2) states the discharge of a legal obligation of an individual falls under the "use, possession, right to the income or other enjoyment of the transferred property" of IRC § 2036(a)(1).

The Estate argued that the pledge of MFLP assets benefited MFLP and was an arm's-length investment decision guaranteed by the Decedent and approved by the trustees. Regarding the CRFLP assets, the Estate noted the assets had been pledged prior to their transfer to the partnership.

In addition to the preceding issues, the IRS asserted there were "no legitimate and significant nontax reasons for creating either of the FLPs" that would qualify the transfers of the publicly traded stock for the bona fide sale exception of IRC § 2036(a). The IRS position relied on the following:

- the Estate provided no evidence that the FLPs were created for nontax purposes,
- the Decedent did not need the FLP structure to control the stock he contributed because he already controlled the stock prior to contributing them to the partnerships, and
- use of the Decedent's (but not his children's') assets to capitalize both partnerships was evidence that there was no pooling of family assets, especially after recognizing that the children's personal net worth was more than adequate to provide personal asset contributions to the partnerships.

In response, Estate argued that the partnerships were formed so that the Decedent could:

- provide for his children,
- control disposition of the public stock used to capitalize both partnerships so as to not undermine public investors' confidence in his employer and to maintain the upside potential in stock value appreciation for the economic benefit of his children, and
- centralize family wealth management.

Turning to the issue of gifts, the facts associated with the formation of CRFLP and its two trusts undermined the legitimacy of the Decedent's limited partnership transfers. First, the "partnership" was allegedly formed with the trusts as limited partners *even though the trusts were not formed until the next day* (the court particularly noted that Mississippi law does not recognize one person partnerships). Second, the alleged limited partnership interests were transferred to trusts *that didn't exist on the transfer date* (they were created the next day). Accordingly, CRFLP did not validly exist until the day of formation of the trusts, and the date-of-formation transfers were of the father's LLC member interests, not CRFLP limited partnership interests.

Regarding the "loans" to Decedent's children, they didn't recall signing promissory notes for some of the loans, did not recall getting at least one of them, did not pay interest on them, and repayment was never demanded. As a result, the IRS asserted the loans were gifts.

In May 2000, the Decedent transferred to one LLC a promissory note worth approximately \$1 million. In September of the same year, Decedent paid a capital call of the LLC. However, as of March 1, 2000, the Decedent had transferred his interest in the LLC to CRFLP. Under Delaware law (the state of registration for both LLCs), no member is obligated to pay the debts of an LLC. In response, the Estate argued that the LLC operating agreements extended personal liability for LLC debts to their members.

Finally, the Tax Court had to determine which Form 706 estate tax deductions were appropriate. The Commissioner asserted that the Estate attempted to claim deductions that exceeded the value of the gross estate, including:

- the value of debt in excess of the collateral securing it,
- LLC debt for which the Decedent was no longer personally liable, and
- executor's commissions, legal fees, and accounting fees.

CONCLUSION:

The court ruled that the transfer of the LLCs to CRFLP did not imply the Decedent retained the right to present economic benefit of the LLCs. However, the court agreed with and accepted the IRS argument that the Decedent had retained the right to use the publicly traded employer stock transferred to both FLPs.

Further, the court held that the Estate failed to show that the pledge of publicly traded employer shares to secure the Decedent's personal debt was an arm's-length business decision even though the trusts charged the Decedent a fee for doing so (timely payment of the fee to MFLP might have strengthened the Estate's argument). Further, the timing of the pledging of the CRFLP shares (i.e., prior to the contribution to the partnership) was not relevant to the court.

The Estate failed to prove that there were significant nontax reasons for the transfer of the Decedent's publicly traded employer stock into the FLPs.

The court also ruled that the SCIN sale of CRFLP limited partnership interests by the Decedent were a sham because:

- at the time the SCINs were executed, the Decedent was terminally ill,
- Decedent provided the cash down payment for the purchases even though both children had the financial ability to do so,
- the Estate provided no evidence that the transaction was an arm's-length sale, and
- the Estate could not explain its failure to demand payment on the promissory notes.

Because the preceding transfers were not bona fide sales for full and adequate consideration, the value of the stock was includable in the Decedent's gross estate. To bolster its conclusion, the Tax Court cited both *Estate of Bigelow* and *Strangi* Circuit Court rulings (which, in both cases, affirmed the Tax Court). Further, the transferred stock was includable in the Estate because the Decedent retained possession and enjoyment of the stock within the meaning of IRC § 2036(a)(1).

Turning to another disputed matter, the loans from the Decedent to his children were treated as gifts by the court.

Tax Court determined the Decedent's payment of debts owed by LLCs represented indirect gifts. Because the Decedent had transferred his interest in an LLC to CRFLP, he was no longer a member of the LLC, and his transfers to the LLC (the promissory note and capital call) should be treated as indirect gifts to the beneficial owners (his children) of the LLC.

Regarding the Form 706 deductions, the Tax Court:

- accepted a deduction for the value of the secured debt as an estate tax deduction but disallowed that portion of debt exceeding the value of the collateral,
- disallowed deductions for LLC debt for which the Estate claimed the Decedent was personally liable because the Decedent was no longer a member (having transferred his interest to CRFLP), and
- disallowed more than \$500,000 of executors' commissions, legal fees, and accounting fees as the Estate offered no evidence the fees were actually paid.

Although the Decedent engaged in sophisticated estate planning (establishment of FLPs, family trusts, promissory notes, etc.), the Estate's lack of attention to detail in the execution doomed the Estate in Tax Court. Had the Estate and its advisors executed the estate planning properly (e.g., establishing trusts before making them limited partnerships in a partnership, understanding the Decedent was no longer a member of an LLC), the Court's ruling likely would have been much more favorable to the Estate.

Brueggeman and Johnson Yeanoplos, PC specializes in business valuation and litigation support services. Because of our education and background as CPAs we have a broad understanding of the financial, accounting, and tax issues surrounding valuation and commercial damage issues.

The Financial Consulting Group's members provide Business Valuation, Expert Testimony, and Litigation Consulting services nationally and internationally. For the full-text of this case or more information on FCG visit us on our website: <http://www.gofcg.org>.

We encourage you to forward this E-flash, with attribution intact, to other interested parties.

This FCG Estate & Gift Valuation E-Flash has been sent to you by your local Financial Consulting Group member firm:



(206) 628-3100 • Fax (206) 628-0106 (520) 327-8258 • Fax (520) 327-7080
601 Union Street, Suite 3501 7363 East Tanque Verde Road
Seattle, WA 98101 Tucson, AZ 85715
Toll free (800) 889-6890

www.bjyvalue.com • valuation@bjyvalue.com
