Gift and Estate Tax Valuation Insights

Analysis and Observations Regarding the Keller v. United States *Decision*

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The Keller v. United States *District Court decision represents a significant taxpayer victory in a case regarding the formation and the valuation of a family limited partnership (FLP). In this judicial decision, the decedent died before all of the FLP documents were completed and all of the trust provisions were fully funded. Nonetheless, the District Court considered the intent of the decedent and the Court upheld the FLP provisions. In addition, the District Court allowed the 47.5 percent total valuation discount (including a discount for lack of control and for lack of marketability) claimed in the taxpayer's estate tax valuation.*[1]

Introduction

The judicial decision in *Keller v. United States*,[2] relates to an estate tax refund case. This decision was published about 2½ years after a four-day trial.

In this case, the decedent signed a partnership agreement, and she expressed the intent to fund the partnership with a specifically identified bond portfolio and cash. However, the partnership funding did not formally occur before her death.

The decedent died unexpectedly, so the estate planner put the funding on hold for about a year until one of the estate planners heard about the *Church* case. That case had recognized a partnership that had similarly not been formally funded at the decedent's death.

The estate planners completed the formal funding transfers and the estate filed an estate tax return (1) reporting the partnership interests (without a valuation discount) and (2) reporting about $143 million of estate tax.

The estate later filed a claim for refund for about $40 million of estate tax. The District Court concluded that the decedent had expressed the clear intent to fund the partnership with the identified assets. And, the District Court concluded that under Texas law that intent caused the assets to become partnership assets.

The District Court concluded that the bona fide sale exception to Internal Revenue Code Sections 2036 and 2038 applied. This judicial conclusion was because of the following:

1. The partnership was genuine.
2. There was a legitimate business purpose for the partnership (protecting family assets from divorce proceedings and facilitating the administration of family assets).
3. She retained significant assets outside the partnership.

The value conclusion of the taxpayer's valuation analyst[3] was accepted, representing a 47.5 percent total valuation discount. The value conclusion of the Service's valuation analyst[4] opinion was rejected.

The District Court rejected the opinion of the Service's valuation analyst because it violated several of the tenets of the hypothetical willing buyer-willing seller valuation principle, including considering the true identities of the buyer and seller, speculating as to future events, and aggregating the interests of the various owners.

The estate borrowed $114 million from the partnership to pay estate taxes and other debts. The interest on the 9-year loan was deductible for estate tax purposes. This judicial decision was because the interest expense was actually and necessarily incurred in the administration of the estate.

The Facts of the Case

1. Mr. Williams died in January 1999. He and Mrs. Williams ["Wife"] had created a "Family Trust" which at his death was to be distributed into Trust M (a QTIP trust) and Trust A (containing Wife's separate property and one-half of community property). Wife was a trustee of both trusts.

   Apparently, there were about $300 million of liquid assets and considerable land and mineral holdings.

   The QTIP trust and Trust A apparently were not funded before Wife's subsequent death about 16 months

later; that became relevant because it became necessary to fund those trusts before the partnership at issue in this case could be funded.

2. Wife was "an impeccably shrewd businesswoman and frugal heiress—with annual living expenses of about $60,000."
3. Wife was particularly concerned as she worked to protect the family's interests with the risk of losing control of significant family assets through divorces. One of Mrs. Williams daughters had gone though a quite lengthy and expensive divorce.
4. The estate planners (including Rayford Keller, and his son, Lane Keller, who had been longtime accountants for the family) discussed with Wife creating a series of family limited partnerships for the different classes of assets.

> It is clear to the Court that the primary purpose of these partnerships was to consolidate and protect family assets for management purposes and to make it easier for these assets to pass from generation to generation. Any estate tax savings that resulted from these partnerships were, in the court's view, merely incidental. It is therefore, clear to the Court that the primary purpose of these partnerships was not federal estate tax avoidance, and the actions taken to form these partnerships were not done so to create a disguise gift or sham transaction as those terms are used in estate taxation.

Observation: That judicial finding of fact very early in the opinion clearly telegraphs the District Court's ultimate resolution of the case.

5. There were various meetings in the summer of 1999, and Wife was particularly interested in creating an Investment Partnership to own the community property bonds. The plan was for the QTIP Trust and Trust A to contribute the bonds in return for limited partnership interests (49.95% each). A corporation initially owned entirely by Wife would be the general partner (0.1%).

   There was oral agreement that Mrs. Williams would immediately sell her stock to one of her daughters and two of her grandchildren.

   In September 1999, the Kellers prepared a spreadsheet describing the funding of the partnership from the QTIP Trust and Trust A, reflecting funding of about $250 million (municipal bonds, treasury securities and cash).

   The spreadsheet was discussed with Wife in a meeting in September 1999, and her instructions were to proceed with forming the partnership and funding it in accordance with the numbers in the spreadsheet. Mrs. Williams did not sign anything evidencing those oral instructions.

6. A well respected Dallas attorney (Sandy Bisignano) prepared drafts of the partnership agreement before the end of September 1999. The various estate planners were involved in drafts and redrafts through the fall of 1999, and the drafts were discussed with Wife in January 2000 and she suggested further changes to further restrict the potential of interests passing to non-blood relatives.

   In January 2000, Lane Keller produced a flowchart and a set of notes laying out the plans for funding the partnership. He tried on several occasions to convince Wife to contribute other assets to the partnership. However, Wife rebuffed those efforts.

7. Wife retained assets at her disposal totaling in excess of $110 million.
8. Wife was diagnosed with cancer in March 2000.
9. Final drafts of the partnership and corporate documents were discussed with Wife on May 9, 2000, and she signed the documents creating the partnership (as trustee on behalf of the trusts) and the corporation.

   The partnership agreement stated that each partner would contribute assets described on Schedule A, and a separate Subscription and Acceptance by Limited Partners Section also referenced Schedule A. Schedule A had blanks for the amounts to be contributed by each partner.

   The accountant said the dollar amounts were left blank because he did not have a firm market value of the bonds or the interest accrued on the bonds as of that date. The amounts were to be filled in when the values were finalized.

10. The following day (May 10), the accountant took steps to request tax identification numbers for the partnership and trusts and spoke with the Vanguard Group (where the investment assets were kept) about creating new accounts for the partnership assets when the tax identification numbers were obtained.

    The accountant also cut a check for $300,000 to be contributed by Wife to the LLC. The accountant planned to complete the funding after the tax identification numbers were received and the accounts could be opened and planned to have Wife sign the $300,000 check the following week, when Wife was expected to be home from the hospital.

    The partnership and the LLC articles and certificate were filed with the Secretary of State.

11. Before the funding could be completed, Mrs. Williams died unexpectedly on May 15 (before the accountant received the tax identification numbers, before he could open the Vanguard accounts, and before he could present the $300,000 check to Wife for her signature).

    Rayford Keller was one of the co-executors of the Wife's estate (hence, the name of this case).

12. After Wife's death, all activity regarding the partnership (including transferring the bonds to the partnership)

was put on hold. No assets were transferred to the partnership and the Schedule A remained blank.

13. About nine months after the date of death (on February 12, 2001), the estate filed with the Internal Revenue Service an extension request for filing the estate tax return together with "a check in the amount of $147,800,245 … drawn from accounts relating to the Family Trust and made payable to the United States Treasury."

14. About one year after Wife's death (on May 17, 2001), Lane Keller heard a discussion of the *Church* case (which had recognized a partnership that similarly had not been formally funded at the decedent's death) at an estate planning seminar.

    The estate planners quickly moved forward with formally funding the partnership.

15. Wife's estate filed an estate tax return on August 14, 2001, reporting a gross estate of about $380.7 million including the interests in the partnership owned by the QTIP Trust and Trust A of about $260.8 million, determined without any discount, and reflecting an estate tax liability of about $143.5 million.

    The gross estate and partnership values are described in the summary judgment case described in paragraph 17 below.

    Three months later, the estate filed a Claim for Refund, requesting a refund of about $40 million "or such other amount as is legally and/or equitably refundable, together with interest thereon."

16. After funding the partnership, "with an eye towards preserving the liquidity of Mrs. Williams' estate," the estate (and the Family Trust) borrowed $114 million from the partnership to pay federal estate taxes, state inheritance taxes and other debts and obligations arising from the partnership.

    The $114 million debt was evidenced by a 9-year note with annual interest payments based on a 5.07 percent rate. The principal is due at the end of 9 years.

    The estate had paid about $30 million of interest payments to the partnership by the time of trial; the partners paid income taxes on this flow-through interest income from the partnership.

17. The District Court rejected the Service arguments to dispose of major issues in the case on summary judgment, including that the trusts did not exist for want of a corpus, that the corporate general partner was not authorized to conduct business, that the partnership never came into existence, that there were no assets in the partnership at decedent's death, and that the partnership assets would be included in the estate in any event under Sections 2036(a) and 2038(a). *Keller v. U.S.*, 96 AFTR 2d 2005-6736 (S.D. Tex. 2005).

The District Court Judicial Decision

Wife had expressed the clear intent to fund the partnership with particular assets, and under Texas law that caused the assets to become partnership assets even though they had not been formally transferred into the partnership by the time of Wife's death.

The interests in the partnership owned by the QTIP Trust and Trust A are included in the estate rather than the underlying assets in the partnership attributable to those interests.

Sections 2036 and 2038 do not apply to include the assets contributed to the partnership in the estate. This is because the transfers to the partnership satisfied the bona fide sale for full consideration exception to Sections 2036 and 2038.

The estate's interest in the partnership was valued as an assignee interest. The District Court accepted the value opinion of the taxpayer's valuation analyst, resulting in a total valuation discount of 47.5% with respect to the bonds and cash in the partnership.

The interest on the amount that the estate and an includable trust borrowed from the partnership to pay federal and state estate taxes and other debts was deductible for estate tax purposes because the interest expense was actually and necessarily incurred in the administration of the estate.

In addition, the attorney's fees and miscellaneous administrative expenses such as court costs, accountants' fees, executor and trustee fees, and valuation analyst fees are deductible for estate tax purposes.

Analysis and Observations Regarding This Judicial Decision

1. Assets Treated as Partnership Assets Even Though Not Formally Transferred to Partnership Before Decedent's Death

As evidenced by the "basic" description of the facts, this was a very fact-intensive oriented decision. There was a four-day trial, and the Facts of the Case section comprises about two-thirds of the opinion.

The decedent never signed any written document indicating an intent to convey her bond portfolio (and some cash to bring the total to $250 million) to the partnership and to sell her stock in the corporate general partner.

Nevertheless, the District Court was persuaded by the very careful and detailed planning steps of the planners (including detailed spreadsheets and documentation of individual meetings, etc.) that the decedent in fact had the intent to convey those assets to the partnership, to capitalize the corporate general partner with the $300,000

check waiting for her signature, and to sell her stock in the corporation.

In light of the decedent's unexpected death, there were understandable reasons for why the partnership did not get funded prior to her death.

Reminiscent of the *Church* decision (a 2000 decision from the Western District Texas Federal Court), the District Court found that under Texas law, "the intent of an owner to make an asset partnership property will cause the asset to be property of the partnership. . . . This is the case whether or not legal or record title to the property has yet been transferred." (numerous case citations omitted).

The District Court addressed and rejected various evidentiary objections raised by the government, including:

1. the Fifth Circuit rule imposing a qualified ban on parol evidence in federal tax cases,
2. various hearsay objections, and
3. the Texas "Dead Man's Rule."

Observation: The decedent never signed a funding document, and the Schedule A on the partnership agreement was never completed. Nevertheless, the District Court found that Mrs. Williams had expressed the intent to fund the partnership with specifically identified bonds and cash.

The accountants' very careful planning and documentation of their various meetings and planning discussions were critical in convincing the court of the decedent's expressed intent to fund the partnership.

The accountants' professionalism and high sense of ethics were no doubt important in convincing the court of their credibility and that they were trying to do the right thing. For example, it may have been tempting to fill in Schedule A after the decedent's death to reflect her expressed intent.

Furthermore, this judicial decision suggests that the planners' (and executor's) testimonies never wavered from admitting that at the date of the decedent's death, they did not realize that the partnership had been funded under applicable state law.

The estate's trial lawyer obviously did an excellent job presenting the case to the District Court in the four-day trial.

2. Bona Fide Sale Exception to Sections 2036 and 2038 Applies

There is an exception in Sections 2036 and 2038 for bona fide sales for full and adequate consideration. The bona fide sale test was analyzed under the rationale of the Fifth Circuit's *Kimbell* case rather than the "legitimate and significant non-tax purpose" test used by the Tax Court since the time of the *Bongard* case.

Applying the *Kimbell* analysis, the District Court found that the estate satisfied the bona fide sale requirement for the following three reasons.

- **Genuine Transaction**

  "[T]he lengthy discussion that went into creating the Partnership Agreement, which Mrs. Williams signed, provides sufficient objective evidence that the Partnership transaction was 'real, genuine, and not feigned.'"

- **Legitimate Business Purpose—Divorce Protection; Administration of Family Assets**

  "[T]he primary purpose underlying the Partnership's formation was to protect family assets from depletion by ex-spouses through divorce proceedings. This was accomplished by creating an entity that, by altering the legal relationship between Mrs. Williams and her heirs, could facilitate the administration of significant family assets.

  In other words, the creation and funding of the Partnership was undertaken for a legitimate business purpose and not the mere 'recycling' of wealth." (A judicial Finding of Fact held that the primary purpose of the partnership in the initial planning stage was "to consolidate and protect family assets for management purposes and to make it easier for these assets to pass from generation to generation." The judicial Conclusions of Law did not restate those particular reasons.)

  Observation: Very few prior cases have given much weight to asset protection or divorce protection aspects of limited partnerships as business purposes of the partnerships. Perhaps it is very significant that there had actually been a "quite lengthy and expensive" divorce with one of the decedent's daughters.

  Interestingly, another daughter fared much better in a divorce after that time because of various trusts that had been created after the first daughter's divorce.

  The District Court did not address why the additional protection from the partnership planning was significant. Also, very few prior cases have given much weight to "facilitating gift-giving" as a legitimate non-tax purpose with respect to the bona fide sale exception to Sections 2036 and 2038.

  This District Court decision seemed to give weight to facilitating passing assets from generation to generation in the judicial Findings of Fact in finding that the primary purpose of the partnership was not federal estate tax avoidance.

- **Retained Significant Assets**

  "[T]he fact that Mrs. Williams had a significant collection of assets outside of the Partnership—well over $100 million—further supports the conclusion

> that the transfer was made pursuant to a bona fide sale."

The District Court also found that the transfers to the partnership satisfied the "full and adequate consideration" requirement in the Sections 2036 and 2038 exception, again applying the test announced in *Kimbell*. (1) The interests credited to the partners were proportionate to the fair market value of assets contributed by each partner, (2) assets contributed to the partnership were properly credited to the respective capital accounts of the partners, and (3) on termination or dissolution of the partnership the partners were entitled to distributions in amounts equal to their respective capital accounts.

The District Court distinguished the Fifth Circuit *Strangi* case, which had found that the bona fide sale test was not satisfied, because in that case the decedent "transferred his entire accumulated wealth to the partnership, relied on partnership funds to satisfy his various post-transfer financial needs, and continued to live in the residence that comprised a portion of the partnership's corpus."

Observation: This is now the eighth case in which taxpayers have survived a Section 2036 attack (at least as to part of the assets contributed to an FLP).

All eight cases have found that the bona fide sale exception applies. The other seven cases are *Church*, *Stone*, *Kimbell*, *Bongard*, *Schutt*, *Mirowski*, and *Miller*.

3. Valuation of Interests in the Partnership

The District Court valued the interests as assignee interests (without much discussion as to why they were valued as assignee interests rather than full limited partnerships interests). The prior cases have split on this issue, sometimes valuing interests as assignee interests and sometimes valuing them as full limited partnership interests.)

The District Court accepted the valuation opinion of the taxpayer's valuation analyst. The District Court rejected the government's valuation analyst.

This was because the government's valuation analyst position violated several of the tenets of the hypothetical buyer and seller standards, including considering the true identities of the buyer and seller, speculating as to future events (citing *Estate of Simplot*), and aggregating the interests of the various owners (citing *Estate of Bonner*).

The fair market value of the partnership assets was $261,042,664, and the value of the QTIP Trust and Trust A's assignee interests collectively was $136,878,000.

Taking into account that the trusts held a 99.9% interest in the partnership, this reflects a 47.5% discount.

Observation: The District Court's objection to the government appraiser's analysis is reminiscent of the *Holman* case, where the court concluded that only a 12.5 percent lack of marketability discount should apply in valuing assignee interests for gift tax purposes, reasoning in part that the partners could agree to dissolve the partnership at any time and there would be an economic interest to both a limited partner wanting to exit the partnership and the remaining partners "to strike a deal at some price between the discounted value of the units and the dollar value of the units' proportional share of the partnership's NAV."

The taxpayers have appealed the valuation portion of that case to the Eighth Circuit Court of Appeals on the basis that the analysis violates the basic hypothetical willing buyer-willing seller valuation principle.

Observation: A 47.5 percent total valuation discount for an assignee interest in a limited partnership holding bonds and cash seems to be a high discount as compared to discounts allowed in most of the prior cases.

The judicial opinion does not discuss how much of the 47.5 percent discount is attributable to the fact that the interest was valued as an assignee interest rather than as a full limited partnership interest.

The District Court clearly picked one appraisal or the other. And, the District Court was concerned with the errors mentioned above with the government's appraisal. The high discount may be primarily attributable to a lack of evidence from the government supporting a lower discount.

Tax Court judges seem more inclined to do their own valuation analysis and arrive at a value different than any of the experts' conclusions. I suspect that some Tax Court judges would have concluded that a lower discount should apply.

4. Interest on Post-Death Borrowing from Partnership Deductible

The estate made an estimated federal estate tax payment on February 21, 2001, of almost $148 million (from assets in the Family Trust). That was before the accountant learned of the *Church* case and funded the partnership.

After the partnership was funded (sometime in the late spring or early summer of 2001), the estate and the Family Trust borrowed $114 million from the Partnership "with an eye toward preserving the liquidity" of the estate.

The note is due in February 2010, or about 9 years after the borrowing. The estate had actually made $30 million of interest payments to the partnership at the time of the trial.

At a 5.07 percent interest rate, the interest is almost $5.8 million a year, resulting in a very large deduction over nine years of interest payments; however, the estate tax savings due to the interest deduction for estate tax purposes is partially offset by large income taxes paid on these amounts by the partners of the partnership over the nine-year period.

The District Court concluded that the "estate lacked sufficient liquid assets to pay its necessary taxes and obligations without forcing the sale of its illiquid properties."

The District Court concluded that the interest on the borrowing was "actually and necessarily incurred in the administration of the decedent's estate," Regulation Section 20.2053-3(a), and therefore deductible as an administration expense under Section 2053.

Observation: The judicial opinion does not clarify whether the interest deduction is allowed for the full 9-year term of the note, even before the interest payments have actually been made (in accordance with the *Graegin* case, which addressed payments under a note with a fixed interest rate for a fixed period of time that does not allow prepayment).

Interestingly, the District Court cites the *Graegin* case as support for allowing the interest deduction. At this point, there is not much difference whether the interest is deductible up front, or only as it is paid.

This is because the estate is fairly close to the end of the 9-year term of the note and most of the interest payments have been made.

Observation: The judicial opinion does not clarify why there were insufficient liquid assets to pay the estate taxes when the $148 million tax payment had already been made. The judicial opinion also does not clarify how the Family Trust raised the $148 million that was paid in February 2001.

Perhaps the Family Trust had borrowed the money from a bank, or perhaps the estate had used liquid funds in the Family Trusts, not yet realizing in February 2001 that under Texas law those funds legally belonged to the partnership.

Observation: The judicial opinion does not suggest that the Internal Revenue Service made arguments similar to its conclusion in Technical Advice Memorandum 200513028, where the interest deduction was denied regarding amounts that an estate borrowed from a partnership created by the decedent.

In that TAM, the Service took the position that the deduction was disallowed. This was because the loan was not necessary because the partners were the same as the estate beneficiaries (which appears not to be the situation under the *Keller* facts), one of the sons was both a co-executor and a general partner of the partnership, the partnership was not engaged in any active business that would necessitate retention of liquid assets, and there was no fiduciary restraint on the co-executor's ability to access the partnership funds.

In addition, the Service reasoned in the TAM that the repayment of the loan had no economic impact on the parties, but just represented a circular flow of funds.

5. Post-Death Use of Partnership Assets as a Factor in Applying Section 2036

A number of judicial decisions have now looked to the post-death use of partnership assets to pay estate taxes as evidence of retained enjoyment of assets to trigger Section 2036(a)(1).

That is not relevant in this case, because the exception to Section 2036 applies. Therefore, the District Court never had to address whether there was an implied retained enjoyment of partnership assets within the meaning of Section 2036(a)(1).

If an estate must utilize partnership assets in some way in order to pay estate taxes, tax litigation attorneys generally prefer accessing partnership funds by borrowing rather than having the partnership directly paying estate taxes or making distributions to the estate to pay estate taxes.

The estate in this case followed the preferred route of borrowing rather than making direct payments of taxes or making distributions to the estate to pay taxes.

Notes:

1. This article was adapted with the permission of Bessemer Trust Company, N.A., from the white paper titled "*Keller v. U.S.*, Civil Action No. V-02-62 (S.D. Tex. August 20, 2009)." We sincerely appreciate the fact that Bessemer Trust Company, N.A. allowed *Insights* to adapt that white paper.
2. *Keller v. United States,* No. V-02-62 U.S. Dist. Ct. (S.D. Tex. August 20, 1009).
3. The estate's valuation analyst was Robert F. Reilly of Willamette Management Associates.
4. The government's valuation analyst was Alan Shapiro, Ph.D., a University of California professor who was a consultant to LECG (i.e., Litigation Economic Consulting Group).

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