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AALU Bulletin No: 11-84 September 15, 2011

Subject: **Tax Court Finds that Assets Transferred to Family Limited Partnership Are Includible in Gross Estate, But That Annual Exclusion Gifts to Trust to Fund Life Insurance Premiums Were Gifts of a Present Interest in Property**

Major References: ***Estate of Turner v. Commissioner, T.C. Memo. 2011-209 (August 30, 2011).***

Prior AALU Washington Reports: *91-79; 00-43; 02-71; 02-78; 02-114; 03-56; 04-30; 04-42; 04-110; 05-74; 05-77; 07-11; 07-107; 08-23; 09-49; 11-65.*

MDRT Information Retrieval Index Nos.: *4400.00*

SEE THE CIRCULAR 230 DISCLAIMERS APPENDED TO THE CONCLUSION OF THIS *WASHINGTON REPORT*.

In Estate of Turner v. Commissioner, the Tax Court held, in a memorandum opinion, that the assets contributed to a family limited partnership were includible in the general partner's gross estate under §§ 2036(a)(1) and (2) of the Internal Revenue Code (regarding "Transfers With Retained Life Estate").

In a second and arguably more important ruling, from AALU's perspective, the Court determined that gifts made to an irrevocable life insurance trust through the use of "Crummey" withdrawal powers were present interest gifts entitled to the annual gift tax exclusion under § 2503(b) of the Code.

Partnership Issues

Facts: Clyde W. Turner, Sr. ("Clyde Sr.") resided in Georgia when he died on February 4, 2004, survived by his wife of nearly 60 years, Jewell H. Turner (Jewell). Clyde Sr. and Jewell had four children: Clyde Turner, Jr. (Clyde Jr.), Betty T. Crane (Betty), Joyce T. Crumley (Joyce), and Janna T. Lovell (Janna). Jewell died on July 8, 2007. Joyce died in 1993, leaving Clyde Sr. and Jewell with three surviving children, and at least four grandchildren.

On April 15, 2002, Clyde Sr. and Jewell, on the advice of their grandson, established Turner & Co. as a Georgia limited liability partnership by filing a certificate of limited partnership. The Agreement of Limited Partnership of Turner & Company, L.P. (partnership agreement), provided that Clyde Sr. and Jewell each would own a 0.5-percent general partnership interest and a 49.5-percent limited partnership interest. The partnership was funded - some 8 months after its purported formation - with a combination of cash and bank stock with a value on the date of funding of $8,667, 342.

The partnership agreement was a form agreement used by the law firm that advised the Turners with regard to their estate planning. It recited a laundry list of "business purposes," including three general purposes, as follows; (1) To make a profit; (2) to increase the family's wealth; and (3) to provide a means whereby family members can become more knowledgeable about the management and preservation of the family's assets. To facilitate the general purposes, the partnership agreement listed nine specific purposes for formation of Turner & Co., a number of which had no application to the Turners.

On December 31, 2002, and January 1, 2003, Clyde Sr. and Jewell gave limited partnership interests representing 43.6% of the total partnership interests in Turner & Co. to their three children and to Joyce's children. According to the gift transfer documents, the aggregate fair market values of the partnership interests transferred on December 31, 2002, and January 1, 2003, were $1,652,315 and $474,315, respectively. The values were derived from a valuation by Willis Investment Counsel dated May 18, 2004, and were added to the gift transfer documents on or after that date. No values appeared on the gift transfer documents when the documents were signed. The Turners each retained a .5% general partnership interest and a 27.8% limited partnership interest.

Turner & Co. undertook little investment activity prior to Clyde, Sr.'s death. It paid some of the personal expenses of the Turners' (principally estate planning fees and amounts to be paid as premiums on behalf of the life insurance trust described below) and Clyde, Sr. paid some of the expenses and debts of the partnership out of his personal funds, which payments were later reflected as loans to the partnership. Non-pro-rata distributions made to Clyde, Sr. and Jewell were reflected on the partnership books as reductions in the loan amounts.

Clyde Sr. became seriously ill and was hospitalized in October 2003, and died on February 4, 2004. The estate obtained an appraisal of the 0.5-percent general partnership interest and the 27.8-percent limited partnership interest in Turner & Co. that Clyde Sr. owned at his death, and reported them on the estate's federal estate tax return at values of $30,744 and $1,578,240, respectively.

On or about August 4, 2008, the government issued a notice of deficiency to the estate in which he determined that the values of the assets Clyde Sr. transferred to Turner & Co. were included in his gross estate under sections 2035, 2036, and 2038. The notice stated that Turner & Co.'s net asset value as of February 4, 2004, was $9,488,713, and that one-half of that amount was included in Clyde Sr.'s gross estate. The parties later agreed that Turner & Co.'s net asset value as of February 4, 2004, was $9,580,520, one-half of which would be $4,790,260, or more than double the amount at which they were reported.

Opinion: Section 2036(a) provides that the value of the gross estate includes the value of all property that the decedent has transferred during his lifetime (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, to the extent that he has retained --

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

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

The Court found that Clyde, Sr. had retained rights under both §§ 2036(a)(1) and (2).

With respect to § 2036(a)(1), the Court found that there was no "bona fide" sale for adequate consideration because there were no legitimate and substantial non-tax business reasons for establishing the partnership. The Turners' stated reasons (both in the partnership agreement and on audit) were dismissed as illusory. Several additional factors indicated to the Court that the transfers to Turner & Co. were not bona fide sales. First, Clyde Sr. stood on both sides of the transaction; second, Clyde Sr. commingled personal and partnership funds when he used partnership funds to make personal gifts to Marc and Travis, to pay premiums on life insurance policies for the benefit of his children and grandchildren, and to pay legal fees relating to his and Jewell's estate planning; and third, Clyde Sr. and Jewell did not complete the transfer of assets to Turner & Co. for at least 8 months after formation of the partnership.

The Court also found that Clyde, Sr. retained the "possession and enjoyment" of the transferred property, pointing to the partnership's payment of personal expenses, the disproportionate distributions, and the testamentary nature of the arrangement.

With respect to § 2036(a)(2), the Court found that Clyde, Sr. had retained the right to designate the person who could possess or enjoy the transferred property. Clyde, Sr. (with his wife) was, for all intents and purposes, the sole general partner of Turner & Co., . . .

> "and the partnership agreement gave him broad authority . . . [He 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, Clyde Sr. 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, Clyde Sr. and Jewell 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."

The Court therefore held that the full value of the assets transferred to the partnership by Clyde, Sr. were includible in this gross estate.

For cases decided adversely to the taxpayer on the basis of IRC § 2036, *see* ***Estate of Schauerhamer,*** T.C. Memo. 1997-242, ***Estate of Reichardt***, 114 T.C. 144 (2000), ***Estate of Harper***, T.C. Memo. 2002-121, ***Estate of Abraham***, T.C. Memo. 2004-39, *aff'd* 408 F.3d 26 (1st Cir. 2005), ***Estate of Hillgren***, 87 T.C.M. 1008 (2004), ***Estate of Thompson***, T.C. Memo. 2002-246, *aff'd sub nom* ***Turner v. Commissioner***, 382 F.3rd 367 (3rd Cir. 2004), ***Estate of Strangi v. Commissioner***, 115 T.C. 478 (2002), *aff'd in part rev'd in part sub nom* ***Gulig v. Commissioner***, 293 F.3d 279 (5th Cir. 2002), *rehearing denied* ***Gulig v. Commissioner***, 48 Fed. Appx. 108 (2002), *on remand at, judgment entered* ***Estate of Strangi v. Commissioner***, T.C. Memo. 2003-145, *aff'd* ***Strangi v. Commissioner***, 417 F.3d 468 (5th Cir. 2005), *review or rehearing granted* 429 F.3d 1154 (5th Cir. 2005), ***Estate of Bongard***, *supra*, ***Estate of Bigelow***, T.C. Memo. 2005-65, *aff'd* 503 F.3d 955 (9th Cir. 2007), the companion ***Korby*** cases, T. C. Memo. 2005-102 and 103, *aff'd.* 471 F.3d 848 (8th Cir. 2006),***Estate of Rector v. Commissioner,*** T.C. Memo 2007-367 and ***Estate of Jorgensen v. Commissioner***, *__ F.3d __, No. 09-73250 (9th Cir. 05/04/2011)*. (*See* our Bulletins

Nos. 00-43, 02-71, 02-78, 02-114, 03-56, 04-30, 04-42, 04-110, 05-74, 05-77, 07-11, 07-107, 08-23, 09-49 and 11-65.)

Life Insurance

On January 7, 1992, Clyde Sr. established the Irrevocable Trust of Clyde W. Turner, Sr. (Clyde Sr.'s Trust) to own life insurance policies for the benefit of his children and grandchildren. Clyde Jr. and Betty were named trustees of the trust. In 2000-2003 Clyde Sr.'s Trust had 12 beneficiaries, consisting of Clyde Sr.'s then-living children and grandchildren.

The Trust held several life insurance policies on Clyde senior's life, one from Jackson National Life Insurance Co. (purchased in 1992), a second from Sun Financial Life (purchased in 1997), and a third from State Farm, purchased on an undisclosed date.

Clyde Sr. did not transfer money to the trustees of Clyde Sr.'s Trust to pay the life insurance premiums in 2000-2003. Instead, Clyde Sr. paid the premiums directly from a joint checking account he shared with Jewell. (The parties agreed that these payments were indirect gifts to the trusts.)

Clyde Sr.'s Trust agreement provided that after each direct or indirect transfer to the trust that was treated as a gift for Federal gift tax purposes, each beneficiary, *i.e*., each then-living child and grandchild of Clyde Sr., had the absolute right and power to withdraw from the trust the lesser of (1) $20,000 ($10,000 if the beneficiary was not married at the time of the withdrawal), minus the total amounts previously withdrawn by that beneficiary during the same calendar year, or (2) the amount of the transfer, divided by the number of beneficiaries.

A beneficiary wishing to make a withdrawal from Clyde Sr.'s Trust was required to give notice of his exercise of the withdrawal right within 30 days of the transfer to the trust giving rise to such right. Upon timely receipt of a request for withdrawal, the trustees of Clyde Sr.'s Trust were required to distribute from the trust the amount necessary to satisfy the request. For this purpose, the trustees were authorized to distribute cash or any other trust property or to borrow against the cash value of any insurance policy to obtain cash for the distribution. None of the beneficiaries ever requested or made withdrawals from Clyde Sr.'s Trust before his death.

The government challenged the payment of these premiums as eligible for the annual exclusion from taxable gifts on the grounds that they were not gifts of present interests in property as required under Code § 2503(b).

The Court began by noting that the test for whether a gift is one of a present interest "is not whether the beneficiary was likely to receive the present enjoyment of the property, but whether he or she had the legal right to demand it." *Citing* ***Estate of Cristofani v. Commissioner***, 97 T.C. 74, 78 (1991) (*see* our Bulletin No. 91-79) and ***Crummey v. Commissioner***, 397 F.2d 82, 88 (9th Cir. 1968), *affg. in part and revg. in part* T.C. Memo. 1966-144:

Although the government did not contest the fact that Clyde Sr.'s payment of the premiums directly to the insurance company was an indirect gift to the trust, it did assert that these payments were gifts of future interests because the beneficiaries' rights were illusory. The reasons given were that (i) Clyde Sr. did not deposit money with the trustees of Clyde Sr.'s Trust but instead paid the life insurance premiums directly, and (ii) the beneficiaries did not receive notice of the transfers. Consequently, the government argued that the beneficiaries had no meaningful opportunity to exercise the right of withdrawal.

The Court, however, found that:

"The terms of Clyde Sr.'s Trust gave each of the beneficiaries the absolute right and power to demand withdrawals from the trust after each direct or indirect transfer to the trust. The fact that Clyde Sr. did not transfer money directly to Clyde Sr.'s Trust is therefore irrelevant. Likewise, the fact that some or even all of the beneficiaries may not have known they had the right to demand withdrawals from the trust does not affect their legal right to do so. . . . We therefore conclude that the premium payments Clyde Sr. made as indirect gifts to Clyde Sr.'s Trust in 2000-2003 were gifts of present interests and are subject to the annual exclusion."

The government also argued, in the alternative, that even if the premium payments were gifts of present interests, some of the gifts made in 2002 and 2003 were still includable in Clyde Sr.'s taxable estate because the transfers of limited partnership interests to Clyde Jr., Betty, Janna, and two grandchildren in 2002 and 2003 used up their annual exclusions and any additional gifts to those beneficiaries during 2002 and 2003 should be includable in Clyde Sr.'s estate.

However, the Court found that, because it had concluded that the value of the property transferred to Turner & Co. was includible in his gross estate under section 2036, the gifts of the limited partnership interest must be disregarded for purposes of calculating Clyde Sr.'s adjusted taxable gifts. "To do otherwise would result in the double inclusion of a significant part of the property transferred to Turner & Co. in Clyde Sr.'s estate."

The decision in ***Estate of Turner v. Commissioner*** is broadly favorable to the taxpayer in this case, given the disregard of the formalities of transferring property to the insurance trust and the disregard of the notice provisions. Since such formalities are often more honored in the breach than in the observance, this should be welcome news to the insurance community.

Any AALU member who wishes to obtain a copy of the complaint in ***Estate of Turner v. Commissioner*** may do so through the following means: (1) use hyperlink above next to "Major References," (2) log onto the AALU website at www.aalu.org and enter the *Member Portal* with your last name and birth date and select *Current Washington Report* for linkage to source material or (3) email Anthony Raglani at raglani@aalu.org and include a reference to this *Washington Report*.

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