taxnotes®

Volume 154, Number 6 ■ February 6, 2017

(C) Tax Analysts 2016. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Estate of Purdue: A Blueprint for FLPing

By Phyllis C. Taite

Reprinted from *Tax Notes*, February 6, 2017, p. 759

(C) Tax Analysts 2017. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Estate of Purdue: A Blueprint for FLPing

by Phyllis C. Taite

Phyllis C. Taite

Phyllis C. Taite is a professor of law at the Florida A&M University College of Law.

In this article, Taite examines *Estate of Purdue*, in which the Tax Court held that assets of the decedent that were transferred to the family limited liability company were not includable in the gross estate, that transfers to the family trust qualified for an annual exclusion, and that the estate could deduct interest on loans from the estate's beneficiaries.

Estate of Purdue[1] involved property transferred to Purdue Family LLC (PFLLC), Purdue Family Residence Trust (PFRT), and the Purdue Family Trust (PFT). Barbara M. Purdue (decedent) was previously married to Robert A. Purdue (Purdue). They had five children as well as several grandchildren and great-grandchildren.

Decedent and Purdue had a net worth of about $28 million, held in five different brokerage accounts at three separate management firms.[2] Based on the advice of an attorney at Montgomery Purdue Blankinship & Austin PLLC (MPBA),[3] decedent and Purdue established PFLLC and the PFT and transferred $22 million, an interest in a commercial building worth $900,000, a $375,000 promissory note, and an $865,523 certificate of deposit in exchange for all the PFLLC membership interests.[4] No other assets were contributed to PFLLC after the initial transfers. Decedent retained the right to income and distributions from the property in PFLLC in proportion to her ownership interest.

The stated purposes of the operating agreement were to: (1) consolidate the management and control of specific property and improve the efficiency of the management by holding the properties in a single flexible entity; (2) avoid fractionalization of ownership; (3) keep ownership of the assets within the extended family; (4) protect assets from unknown future creditors; (5) provide flexibility in management of assets unavailable through other business entities; and (6) promote education and communication among members of the extended family regarding financial matters.

Further, a memorandum prepared by the attorney at MPBA noted the tax savings and four other nontax business reasons for forming PFLLC, a family limited partnership: (1) limited liability; (2) passthrough income taxation; (3) minimal formalities; and (4) an LLC is an ideal entity for owning real estate.

On November 24, 2000, decedent and Purdue formed the PFT in which they were both beneficiaries along with their descendants and their descendants' spouses. The trust was funded with $400,000. The PFT gave each beneficiary the right to withdraw the lesser of the annual gift exclusion amount or a per capita share of the value of the assets transferred to the trust during the year. On December 29, 2000, the PFT distributed $235,000 of the cash to the Purdue children and other PFT beneficiaries.[5]

From 2002 through 2007, decedent generally made an annual exclusion gift of PFLLC interests to the PFT in the amount of the number of PFT beneficiaries. Additional annual exclusion gifts were made if the number of PFT beneficiaries increased during the year.

Purdue died unexpectedly on August 3, 2001.[6] His will established three trusts for the benefit of decedent: a bypass trust and a qualified terminal interest property trust comprised of a non-generation skipping transfer tax exempt qualified

---

[1] *Estate of Purdue v. Commissioner*, T.C. Memo. 2015-249.

[2] The three management firms provided independent advice, did not consult with each other, and did not consider the other assets managed by other firms.

[3] Purdue was an attorney and founding partner of MPBA.

[4] Around August 25, 2000, the parents loaned $375,000 to decedent in exchange for a demand promissory note secured by a mortgage on a beach house, which decedent acquired with the loan.

[5] Before the year 2000, Purdue and decedent made annual cash gifts of $40,000 to each of their children and other cash gifts to their grandchildren.

[6] Purdue appeared to be in good health when they formed PFLLC.

For more *Tax Notes* content, please visit www.taxnotes.com.

trust and the GSTT-exempt qualified trust. When Barbara died on November 27, 2007, she owned $3,228,125 outside of the QTIP trust and PFLLC. PFLLC's ownership interest was divided as follows: decedent 24.92 percent, QTIP Trust 42.16 percent, PFT 20.76 percent, the children 7.29 percent, and 4.85 percent by the bypass trust.[7]

The estate filed Form 706, ''United States Estate (and Generation-Skipping Transfer) Tax Return'' on March 1, 2009. The estate had insufficient funds to pay the estate tax.[8] Some beneficiaries and the QTIP trust loaned the money to the estate to pay the estate tax. On the estate tax return, the estate deducted the interest paid on the loan.

The IRS issued a notice of deficiency for the estate tax on February 21, 2012, and a notice of deficiency for the gift tax on September 12, 2012, for tax years 2001, 2002, and 2004 through 2007.

First, section 2036 includes property transferred by a decedent, in trust or otherwise, and the decedent retained a right to possession or income from the transferred property unless the retained right was released or relinquished before death.[9]

An exception to section 2036 is a transfer based on a bona fide sale for adequate consideration in ''money or money's worth.''[10] The estate must also show a legitimate and significant nontax reason for creating the FLP.[11]

The IRS argued that the transaction did not qualify as a bona fide sale and that the decedent did not receive adequate consideration in money or money's worth. The IRS contended that a factor in determining whether a sale is bona fide is the motive for selling.[12] The IRS argued that the transfer to PFLLC was a testamentary substitute and that transfer tax savings was the primary motive for formation.

The estate asserted the following seven nontax motives for creating PFLLC: (1) to relieve decedent and Purdue from the burdens of managing their investments; (2) to consolidate investments with a single adviser to reduce volatility according to a written investment plan; (3) to educate the five Purdue children to jointly manage a family investment company; (4) to avoid repetitive asset transfers among multiple generations; (5) to create a common ownership of assets for efficient management and meeting minimum investment requirements; (6) to provide voting and dispute resolution rules and transfer restrictions appropriate for joint ownership and management by many family members; and (7) to provide the Purdue children with a minimum annual cash flow.

Based on the facts and circumstances, the Tax Court found that consolidation of assets was a legitimate nontax motive.[13] Following the transaction, the parents' assets were consolidated into PFLLC accounts with the Rainier Group, and all the investments were subject to an overall and well-coordinated professional investment strategy. Also, decedent received an interest in PFLLC proportionate to the property she contributed. Further, the parties operated in accordance with the operating agreement.[14] So even though decedent was advised of and received a tax benefit, the court found the transaction to be a bona fide sale.

The IRS also argued there was not adequate consideration in money or money's worth. Usually receipt of a partnership interest is not part of the full consideration when intrafamily transactions simply change the form of a financial transaction and not its substance.[15] In this case the court found there were legitimate nontax reasons for creating PFLLC, therefore, the transfer was not an attempt to change the form in which the decedent held property. Thus, section 2036 did not apply and PFLLC was not included in the gross estate. Because section 2036 was inapplicable, section 2035(a) was also inapplicable.

The IRS also challenged whether the gifts were a ''present interest'' because if they were not, the transfers did not qualify for the annual exclusion. A present interest is an ''unrestricted right to the immediate use, possession, or enjoyment of property or the income from property.''[16] The court indicated the proper inquiry was to determine whether the donees received any meaningful rights after the transfer of the ownership interest in PFLLC.[17]

The court found that the donees had a right to the income, even though the rights were limited; that the members could not transfer their interests without a unanimous vote; and that they did not receive unrestricted use and possession. The transfers qualified for the annual exclusion because the estate

[7]Numbers are rounded.

[8]PFLLC funds were unavailable because the operating agreement required the unanimous consent of the children, and one of the children objected.

[9]Section 2036.

[10]*Id*.

[11]*Estate of Bongard v. Commissioner*, 124 T.C. 95 (2005).

[12]*Purdue* citing *Estate of Liljestrand v. Commissioner*, T.C. Memo. 2011-259.

[13]*Purdue* citing *Estate of Schutt v. Commissioner*, T.C. Memo. 2005-126.

[14]The evidence showed that PFLLC maintained its own bank accounts and held meetings at least annually with written agendas, minutes, and summaries.

[15]*Estate of Gore v. Commissioner*, T.C. Memo. 2007-169.

[16]Reg. section 25.2503-3(b).

[17]*Purdue* citing *Hackl v. Commissioner*, 118 T.C. at 292.

(C) Tax Analysts 2017. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes* content, please visit www.taxnotes.com.

was able to demonstrate that PFLLC would generate income, the income would flow steadily to the donees, and the income could be readily ascertainable.

Finally, the IRS challenged the deductibility of $20,891 in interest paid on the loans. The estate argued the loans were necessary to pay the expenses of the estate and therefore deductible. For the interest expense to be deductible, the loan must be a bona fide obligation and necessarily incurred in the administration of the estate.[18]

The court found that the loan was bona fide. The PFLLC operating agreement required its members to unanimously agree on decisions. One member did not agree, thereby making PFLLC assets unavailable. The court held the estate had met its burden in demonstrating the interest was deductible under section 2053.

Analysis and Conclusion

As I mentioned in an analysis of *Holliday*,[19] the IRS has been vigilant in its war against entities it believes were created to avoid tax obligations. Although it has been a few years since the tax world has last seen an FLP case, the Tax Court decided two FLP cases within a few months of each other.

In *Holliday*, the asserted nontax reasons and the lack of care the parties took in managing the case were damaging to the estate. They did not follow the operating agreement's basic formalities such as maintaining books, keeping minutes of meetings, and making required distributions and compensation payments to the general partner.

On the other hand, the *Purdue* court found that section 2036 did not apply to contributions made to the FLP. The court found that the nontax reasons for creating the PFLLC were legitimate. Also, the parties took great care in managing PFLLC as a legitimate business. Unlike *Holliday*, the children followed the operating agreement, discussed the Purdue family's accounts and assets, ratified prior PFLLC distributions, approved annual cash distributions, heard presentations from the Rainier Group investment manager, and received estate tax planning updates and advice from their attorney.

This case demonstrates that the more an FLP looks and operates like a legitimate business, the better the chances that the transaction will be respected. The case is a blueprint for estate planners to educate clients how to manage and operate an FLP. ■

[18]Reg. section 20.2053-1(b)(2).

[19]*Estate of Holliday v. Commissioner*, T.C. Memo. 2016-51.

taxnotes®

Worldwide Tax Treaties

The world of tax is constantly changing.

Stay current with the most comprehensive treaty coverage, including more than 12,200 treaties.

Worldwide Tax Treaties is the only source to include treaties, protocols, and integrated links to related developments and legislative history, as well as the full version of the latest OECD model convention and commentary.

taxnotes.com/treaties

Be ready for what happens next.

(C) Tax Analysts 2017. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes* content, please visit www.taxnotes.com.