



FAMILY LIMITED PARTNERSHIP PLANNING

Expert's Discussion: The Tax Court in *Bongard* Requires a Legitimate and Significant Nontax Reason to Sustain FLP Discounts

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In *Estate of Bongard*, 124 T.C. No. 8 (March 15, 2005), the Tax Court raised the bar on what constitutes "a bona fide sale for an adequate and full consideration" for the purpose of avoiding inclusion in the gross estate, under Code Sec. 2036(a), of property transferred to a family limited partnership (FLP). In *Bongard*, the court held that a bona fide sale is only satisfied if there exists: (1) a "legitimate and significant nontax reason for creating" the FLP and (2) the transferors receive "partnership interests proportionate to the value of the property transferred." The court found that there was no legitimate and significant nontax reason for the FLP. The court also found that an implied agreement existed that allowed decedent to enjoy and control the transferred property.

The Business and FLP Structures

Bongard, an entrepreneur, started an electronics packaging business in 1980 known as Empak. The business prospered and in 1986 Bongard established an irrevocable trust (Trust) for the benefit of his children funded with a portion of his stock in Empak.

Corporate Liquidity Event

In the mid-nineties, the Empak board of directors determined that pooling all of the Bongard family controlled stock into a holding company would better position the business for a corporate liquidity event, which was deemed necessary to raise capital and remain competitive.

Accordingly, in 1996, both Bongard and the Trust transferred their respective stock interests in Empak to WCB Holdings, LLC (Holdings) in exchange for proportionate membership interests in Holdings. The Holdings membership interests were divided into class A governance and financial units and class B governance

and financial units. Only the governance units were entitled to vote. While Bongard became the manager of Holdings, his authority to effect certain key corporate actions was subject to agreement of a majority of the owners of the voting units. Bongard remained as the CEO and sole director of Empak.

The day after the transfers to Holdings, Bongard and the Trust created the Bongard Family Limited Partnership (BFLP). Bongard transferred all of his class B Holdings membership interests to BFLP in exchange for a 99 percent limited partnership interest. The Trust transferred a portion of its class B Holdings membership interests in exchange for a one percent general partnership interest in BFLP.

Nontax Reasons for Creating BFLP

In a letter to his children, Bongard stated that he was creating BFLP in order to give them assets without deterring them from working hard and pursuing their education, to teach them the responsible handling of wealth, to protect assets from creditors, to provide better flexibility than a trust, and for transfer tax benefits. One year later, Bongard gave a 7.7 percent limited partnership interest in BFLP to his wife in connection with their execution of a post-nuptial agreement. BFLP did not own any other assets except for Holdings class B membership interests. After creating BFLP, Bongard also created several trusts for the benefit of children, grandchildren and his wife. These trusts were funded with class A governance and financial membership interests in Holdings. In 1998, Bongard died unexpectedly while on a business/hunting trip in Austria.

The Activities of BFLP

From inception until Bongard's death, BFLP did not perform any activities and never acted to diversify its assets or make any distributions. Most importantly to the court, only Bongard, as the CEO and sole director of Empak could determine whether any Empak stock held by Holdings could be redeemed. Holdings did not redeem any of its membership interests held by BFLP.

IRS Position

The IRS took the position that Bongard's transfer of the Empak stock to Holdings and the transfer

of Holdings class B membership interests to BFLP were transfers with a retained life estate under Code Sec. 2036(a) and were therefore includible in his gross estate for estate tax purposes. This would eliminate all discount factors normally attributable to the entities. The IRS determined a deficiency of almost \$53 million.

Transfer With Retained Life Estate

Code Sec. 2036(a) generally includes in the estate lifetime transfers of a testamentary nature. In order to dodge this commonly used IRS attack, an estate must avail itself of the exception for a “bona fide sale for an adequate and full consideration in money or money’s worth.” Several decisions have interpreted the requirement for qualifying for the exception as a prohibition against “recycling of value,” where there are no substantive changes before and after the partnership is funded.

Adverse Tax Court Decision

The *Bongard* court refuted the Estate’s nontax reasons, stating that they were not the motivating factors for creating BFLP. For example, the stated purpose of the FLP was to simplify gifting. The Court, however, noted that the only FLP interests transferred subsequent to formation was in connection with Bongard’s post-nuptial agreement with his wife.

On the subject of protecting assets from creditors, the court noted that Holdings, an LLC, was already performing that function without the need for the additional protection afforded by BFLP. While Bongard owned assets outside of BFLP, the Court found that he, through his control of the underlying operating business, could also control the partnership, chose not to participate in any liquidation, thus limiting BFLP to owning the B membership interests. He continued using trusts for estate planning even after setting up the “more flexible” FLP. There was no operating business in BFLP, it did not attempt to diversify its assets, and it did not perform any management function for the assets it owned. Hence it could not “teach” anything to descendants. Bongard did not receive any benefit from BFLP other than estate tax savings.

Retention of Life Estate in BFLP

Since there was no bona fide sale, it was necessary to satisfy the retention test under Code Sec. 2036(a): whether Bongard retained either (1) the possession or enjoyment of, or the right to the income of the property, or (2) the right, either alone or in conjunction with another, to designate who shall possess or enjoy the property. The court concluded that an implied agreement existed between Bongard and the Trust that allowed

decendent to retain enjoyment of the property owned by BFLP. Therefore, the gross estate includes the fair market value of the Holdings class B membership interests proportionate to Bongard’s 91.28 percent limited partnership interest in BFLP. No discounts were allowed for the BFLP interests.

Wife’s BFLP Interests

Bongard transferred a 7.72 percent interest in BFLP to his wife within three years of his death. Since that interest would have been included in his estate if it had been retained, then, under Code Sec. 2035(a), (transfers within three years of death), Bongard’s estate includes the value of Holdings class B interests proportionate to the wife’s 7.72 percent interest in BFLP.

Transfers to Holdings are Within the Bona Fide Sale Exception

The court found that the transfers of Empak stock by Bongard and the Trust to Holdings were for a legitimate and substantial nontax business purpose. That purpose was to facilitate a corporate liquidity event. Each transferor received adequate and full consideration for their respective interest proportionate to the number of shares contributed to Holdings so that the test for the bona fide sale exception was satisfied. Therefore, Code Sec. 2036(a) did not apply and discounting was proper. The Service and the Estate had previously agreed to use a 13 percent lack-of-control discount, a 17.5 percent lack-of-marketability discount and, when applicable, a 5 percent discount for lack of voting rights.

Observations:

Using multiple layers of FLPs and LLCs is not unusual, especially in situations where the individual owns several different types of assets and businesses. Typically, an FLP would be used as a holding company for a group of LLCs which own individual assets. The problem in *Bongard* is that only one asset was involved, Empak. The transfer of the Empak stock to Holdings (an LLC) established all the benefits Bongard was seeking (including transfer tax and nontax benefits). Creating the second layer through BFLP had no benefit other than transfer tax savings. This “double dipping” could not survive the “legitimate and significant nontax reason” test for creating BFLP established by the court. If BFLP had not been created, the decision would have been viewed as a taxpayer victory.

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