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In *Estate of Black*, because the Tax Court held the Blacks' transfers fell within the bona fide sales exception of section 2036, they were successful at avoiding the application of the provision. Thus, they were able to obtain valuation discounts for their transfers of property mostly marketable securities to their son and grandchildren. The court also decided the marital trust funding valuation date issue in the executor's favor and allowed almost half of the claimed administrative expense deductions.

For most of his life Samuel Black Jr. worked for Erie Indemnity Co., and according to its founder, he was responsible for much of the insurance company's success.[1] During those years, Mr. Black acquired Erie stock and became its second largest shareholder. His investment philosophy was characterized by a ''buy and hold'' attitude.[2] When Mr. Black retired from Erie, he opened his own insurance company, an independent agent of Erie. In 1992 Mr. Black retired from managing his company but remained active in the business for the next nine years.[3] He died December 12, 2001, at age 99.[4]

Mrs. Black, to whom Mr. Black had been married for 69 years, died on May 25, 2002. They had one son (the petitioner), who served as executor of his father's estate, and two adult grandsons.[5] Before 1998 Mr. Black gave his son both voting and nonvoting Erie stock. In 1988, with his son as trustee, Mr. Black established for each grandson a trust funded with Erie nonvoting stock. Over the next few years, Mr. Black transferred Erie stock to his son and to his grandsons' trusts.[6]

Between 1988 and 1993, the Erie stock split several times and appreciated significantly. With that increase, Mr. Black feared that his son and grandchildren would sell. Those concerns stemmed from his son's potential default on a personal bank loan collateralized with Erie stock, the son's marital problems, which ended in divorce, and pressures on the son to rescue his in-laws from bankruptcy. Mr. Black also worried that his two grandsons, who were unemployed, were financially naïve and too dependent on their mother.[7]

At about that same time, Mr. Black was anxious about family discord among the children of one of the company's founders, who as trustees controlled 76.2 percent of Erie's voting stock. Also, the husband of one of those children had an affair with a senior Erie officer, which created further business disruptions.[8] Mr. Black wished ''to consolidate and retain the family's Erie stock'' in order to have the Black family stock, representing 13-14 percent of the total Erie stock, constitute ''the swing vote in favor of the Hirt camp against the Hagen camp.''[9]

Mr. Black's estate planners and tax advisers recommended a family limited partnership (FLP) to unite and protect the Erie stock and to minimize estate taxes.

On October 12, 1993, Black LP was formed with Mr. Black and his son (individually and as trustee of the grandsons' trusts) as partners. At that time, Mr. Black was a healthy and active 91-year-old. He and his son were the general partners, and they and the trusts were limited partners in the FLP. Each made contributions to the entity, and each received his proportionate interest in exchange. Mr. Black was managing partner until 1998, when he relinquished his 1 percent general partnership interest to his son.[10]

Black LP retained all the Erie stock until after Mr. Black's death in 2001, and its net asset value increased from approximately $80 million to more than $315 million.[11] Besides Erie stock, the FLP invested in some real estate and in shares of Mr. Black's own insurance company.[12] Between 1993 and 2001, Mr. Black made gifts to his son, his grandsons, his grandsons' trusts, and to several private charities so that at his death, he owned a 77.0876 percent interest in Black LP.[13] When Mr. Black formed his FLP, he and Mrs. Black retained more than $4 million in assets and received income that ranged from

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[1] *Estate of Black v. Commissioner*, 133 T.C. No. 15 (2009), *Doc 2009-27388*, *2009 TNT 238-10*.
[2] *Id.* at 7.
[3] *Id.* at 8.
[4] *Id.* at 6.
[5] *Id.*
[6] *Id.* at 8. Before 1993 all of the stock owned by Mr. Black's son was the result of his father's gifts.
[7] *Id.* at 9-10.
[8] *Id.* at 10.
[9] *Id.* at 11.
[10] *Id.* at 12-15. The FLP held all of the Black family Erie stock, except for 125,000 shares Mr. Black's son had pledged as collateral to the bank and except for 20 class B voting shares, held half by Mr. Black and half by his son. *Id.* at 13.
[11] *Id.* at 17-18.
[12] *Id.* at 18.
[13] *Id.* at 19.

approximately $303,000 to $2.2 million annually, which satisfied their personal expenses.[14]

Shortly before his death, Mr. Black transferred his FLP interest to his revocable trust. According to the trust, Mr. Black was the income beneficiary for his life, and at his death the principal would pass according to his testamentary power of appointment, or, if he failed to appoint anyone, as happened, it would pass as directed in the original trust. At his death, Mr. Black's revocable trust created a marital trust benefiting his wife for her life, with a remainder to the son and a residual trust for his son.[15] The amended trust provided, on his wife's survival, for $20 million to go to his son; if he disclaimed any of this bequest, the amount disclaimed would pass to a charitable endowment established previously by his parents.[16]

Mrs. Black died soon after Mr. Black. There was not enough time to fund the marital trust before her death, and the trust remained unfunded because it terminated at her death. As executor, their son made a qualified terminable interest property election on Mr. Black's estate tax return to qualify the trust for the marital deduction. On that return, as successor trustee of the revocable trust, he stated that he had ''intended to fund the marital trust with a portion of the 77.0876-percent class B limited partnership interest in Black LP that Mr. Black had assigned to the revocable trust during his lifetime.''[17] The parties stipulated and the court found that the value of that interest as of Mr. Black's death was $165,476,495. Likewise, the parties stipulated that the value of a 1 percent class B limited partnership at that date was $2,146,603, while at Mrs. Black's death its value was $2,469,728 ($2,281,124 on the elected alternate valuation date).[18]

Although Mr. Black's estate had sufficient cash assets to pay its approximately $1.7 million estate tax liability, Mrs. Black's estate did not have enough assets to pay her large administrative expenses and tax liabilities. Their son, as executor, unsuccessfully tried to borrow money from the bank and then from Erie. To deal with the liquidity problem, the estate's attorney suggested that Erie participate in a secondary offering of about a third of Black LP's Erie stock. Erie assented on the condition that the FLP agree to pay the expenses, including a $1.81 per-share underwriting discount amounting to approximately $98 million. Mr. Black's son, as executor of his mother's estate, then entered into a loan agreement with Black LP whereby the FLP agreed to lend her estate $71 million with interest and principal payable in full, but not earlier than on November 30, 2007. In addition, Mrs. Black's estate agreed to reimburse the FLP for all expenses in connection with the secondary offering. The FLP sold 3 million shares of Erie stock in a secondary offering. The interest on the loan was deducted in the amount of $20,296,274. Mrs. Black's estate deducted the Erie reimbursement costs totaling $982,070, the son's executor/trustee fees of $1,155,000, and legal fees of $1,155,000.[19]

The court first decided the section 2036 issue[20] and held that Mr. Black's transfer of his Erie stock to Black LP constituted a bona fide sale for adequate and full consideration, the exception from the application of that statute. Under *Thompson*,[21] a taxpayer's transfer of assets to an FLP must be in good faith, which requires that the taxpayer show a benefit in addition to the estate tax valuation reduction.[22] The court then analogized that principle to its own criteria of a legitimate and significant nontax reason under *Bongard*.[23]

The estate argued that Mr. Black's transfer was motivated by a desire to:

- provide centralized long-term management and protection of the Black family's holdings in Erie stock;
- preserve Mr. Black's buy-and-hold investment philosophy for that stock;
- pool the family's stock so it could be voted as a block (thereby giving the family the swing vote in the likely event of a split between the two H.O. Hirt trust shareholders); and
- protect the Erie stock from creditors and divorce.[24]

The government contended that those purported goals were unnecessary and insignificant factors for the formation of Black LP. It also maintained that the FLP did not have a functioning business and held only passive assets, that Mr. Black did not play an important role in forming the entity, and that he did not retain sufficient funds to pay estate and inheritance taxes or fund the charitable donation.[25] The court dismissed the government's last argument as irrelevant to the bona fide sales exception, but only to the question whether Mr. Black retained a section 2036 power or interest.[26] The parties also disagreed about the application of the Tax Court's *Schutt*[27] decision to the facts in *Black*.

The court discussed the lengthy and loyal relationship between Mr. Black and Erie. To underscore the particular need for Mr. Black's 1993 transfers, the court explained that Mr. Black was then especially anxious about his son's marital difficulties and money complaints from the son's in-laws.[28] In holding that Mr. Black created his FLP to

[14]*Id.* at 22.
[15]*Id.* at 19-21.
[16]*Id.* at 21-22. Mr. Black's son disclaimed the entire $20 million bequest. *Id.* at 22.
[17]*Id.* at 24.
[18]*Id.* at 25 and 55.
[19]*Id.* at 25-29.
[20]Preliminarily, the court held that the case was not decided based on burden of proof. *Id.* at 29-30.
[21]*Estate of Thompson v. Commissioner*, 382 F.3d 367 (3d Cir. 2004), *Doc 2002-22023*, *2002 TNT 188-7*. Appeal in *Black*, the court noted, would be to the Third Circuit. *Black*, 133 T.C. No. 15, at 33.
[22]Black, 133 T.C. No. 15, at 33-34.
[23]*Estate of Bongard v. Commissioner*, 124 T.C. 95 (2005), *Doc 2005-5359*, *2005 TNT 50-11*.
[24]*Id.* at 35.
[25]*Id.* at 37.
[26]*Id.*
[27]*Estate of Schutt v. Commissioner*, T.C. Memo. 2005-126, *Doc 2005-11675*, *2005 TNT 102-12*.
[28]*Black*, 133 T.C. No. 15, at 41.

protect the Erie stock from creditors, the court emphasized that the son's Erie stock would be at risk in a divorce because it constituted the son's principal asset.[29] Moreover, the court held that Mr. Black was motivated to transfer the Erie stock in his grandsons' trusts to Black LP because he worried that his grandsons, with their lack of ambition and financial expertise, would sell their Erie stock when the trusts terminated.[30]

Repeating its language from *Schutt*, the court concluded that the consolidated case provided ''a set of unique circumstances'' that satisfied the *Bongard* test.[31] The court held that the second requirement under *Bongard* was met when both parties stipulated that the transferors received their proportionate FLP interests.[32] The government had cited *Thompson*[33] to require that without an operating business, there is insufficient consideration for the valuation discounts the estate receives. But the court rejected that interpretation of the Tax Court's criteria under *Bongard*, which it also considered in line with the Third Circuit's position. Moreover, the court stated that the government had conceded the issue of adequacy of consideration when it stipulated that the transferors received their proportionate FLP interests.[34]

The dispute over the correct value of the marital deduction was mooted by the court's holding on the section 2036 question.[35] However, the novel aspect of *Black* is the marital trust funding date issue in which the court considered whether the funding date of a pecuniary marital trust with date of distribution values that was in fact unfunded at the surviving spouse's death should be deemed funded at the date of the first spouse to die's death or at the date of the surviving spouse's death. At Mr. Black's death, the value of the marital trust Black LP 1 percent class B interest was $2,146,603. At his widow's death approximately six months later, its value was $2,469,728. Consequently, the earlier funding date would require more units to fund the trust than if the later funding date were used, so that if the date of Mrs. Black's death was the deemed funding date, the amount included in her estate under section 2044 would be less.[36]

The estate argued that because Mr. Black's revocable trust provided for termination at Mrs. Black's death, under Example 8 of reg. section 20.2044-1(e) and as a matter of logic, the marital trust should be deemed funded at her later date of death. The government maintained that the regulation was immaterial and that because Mrs. Black's legacy passed to her at his death, the earlier date was the applicable deemed funding date.[37]

To answer this question, the court first analyzed the application of the section 2044 regulation and held that the example in the regulation was inapposite. However, the court then considered the government's position that the widow's legacy passed to her at her husband's death but rejected that contention because the terms of Mr. Black's revocable trust required a pecuniary amount not in fact ascertainable until after the widow's death. The court thus held that because the deemed funding date had to be a date after Mr. Black's death, the deemed funding for the marital trust, which was unfunded at Mrs. Black's death shortly after her husband's, was reasonably the date of the surviving spouse's death.[38] Moreover, because the revocable trust allowed the marital trust to be funded with cash, the Black LP interest could have been sold and it would not make sense to assume that more stock than required to satisfy the date of distribution value would have been sold to satisfy that value. The same result should be reached, therefore, with a decision to fund the marital trust with assets in kind.[39]

Finally, the court reviewed the amount of several section 2053 deductions taken by the estate. The court held that because the $71 million loan from Black LP to Mrs. Black's estate and the revocable trust was unnecessary, the interest expense was not deductible under section 2053(a)(2) to the estate:

> The only distinction between the loan scenario and the partial redemption scenario is that the former gave rise to an immediate estate tax deduction for interest in excess of $20 million. . . . That the loan scenario, like the partial redemption scenario, required a sale of Erie stock to discharge the debts of Mrs. Black's estate, i.e., that Erie stock was available and actually used for that purpose, negates petitioner's contention that the loan was needed to solve a ''liquidity dilemma.''[40]

However, the court allowed almost half of several other administrative expenses because only 49 percent of the proceeds from the secondary offering were used by Mrs. Black's estate to satisfy its debts.[41] The court held that the fees paid in connection with the secondary offering of Black LP's Erie stock were deductible to the extent of $481,000 of its reimbursement,[42] $577,500 in executor's fees,[43] and $577,500 in legal fees.[44]

Schutt

In *Schutt*, unlike *Black*,[45] the government had the burden of proving that section 2036 applied because it was not raised as an issue in the estate's deficiency notice.[46] According to the estate, the decedent's nontax

[29]*Id*. at 43-44.
[30]*Id*. at 45 and 47.
[31]*Id*. at 47-48.
[32]*Id*. at 48.
[33]*Estate of Thompson v. Commissioner,* 382 F.3d 367 (3d Cir. 2004), *Doc 2004-17577*, *2004 TNT 171-8*.
[34]*Black*, 133 T.C. No. 15, at 50-53.
[35]*Id*. at 54.
[36]*Id*. at 55.
[37]*Id*. at 56.
[38]*Id*. at 56-60.
[39]*Id*. at 59-60.
[40]*Id*. at 67-68.
[41]*Id*. at 72-73.
[42]*Id*. at 73.
[43]*Id*. at 76.
[44]*Id*. at 78.
[45]''We need not decide whether section 7491(a) applies to the material factual issues in these consolidated cases because we find that a preponderance of the evidence supports our resolution of each of those issues. Therefore, resolution of those issues does not depend on which party bears the burden of proof.'' *Id.* at 30
[46]*Schutt*, T.C. Memo. 2005-126, at 58.

motive for forming Schutt I and II was to create an entity to buy and hold investments according to the decedent's investment philosophy for DuPont and Exxon stock owned by both the decedent and several trusts benefiting his children and grandchildren. The FLPs' purpose was to supply centralized management and to avoid unwise sales of the decedent's family's stock holdings in those companies, especially because the trusts were due to terminate at various times, with a resulting distribution of trust assets. During the negotiations, there was little indication of a tax or estate planning motive. The court held that the government had not sustained its burden of proof that estate tax savings were the principal reason for creating the FLPs or that the estate's assertion of a nontax motive was disingenuous.

Schutt acknowledged that the Third Circuit in *Thompson* had found that when an FLP was established for the sole purpose of holding marketable securities, it was unlikely that the court would find a significant nontax motive. However, in *Schutt*, the court listed factors indicating a nontax motive: There was an actual transfer of the property to the FLPs, there was no commingling of assets, the decedent had retained sufficient assets for his support and the maintenance of his lifestyle, and the decedent was not on both sides of the transaction. Regarding that last point, the *Schutt* court explained that there was sufficient evidence of give and take and the trust's representatives were very involved in the process: ''Such a scenario bears the earmarks of considered negotiations, not blind accommodation. There is no prerequisite that arm's-length bargaining be strictly adversarial or acrimonious.''[47] The court underlined that in *Schutt*, in which others contributed most of the property and the decedent wanted to create an entity primarily to restrict the sales of certain assets, there was not merely a recycling of the decedent's holdings.[48]

Thompson

In *Thompson*, after the partnership's formation, there was a minimal practical change in the decedent's relationship to the assets he contributed to his FLP: ''Other than favorable estate tax treatment resulting from the change in form, it is difficult to see what benefit could be derived from holding an untraded portfolio of securities in this family limited partnership with no ongoing business operations.''[49] *Thompson* provided neither a pooling of assets, a change in investment strategy, nor a business reason for the transfer. *Thompson* emphasized that the transfer of liquid assets for illiquid ones, thereby reducing the value of those assets by 40 percent in the decedent's estate, in itself indicates a lack of consideration.[50] The Third Circuit held that because the partnership did not conduct an active business and the valuation discount was the sole reason for converting marketable assets into illiquid ones, there was no consideration for the decedent's transfer of assets to the partnership.

Although the court concluded that a bona fide sale did not require an arm's-length transfer to an unrelated third party, the court held that the sale must be in good faith. In this context, the court explained, good faith means that the transferor should expect some business benefit — and not merely a reduction in his estate taxes — for the transfer of his assets to a partnership. The court affirmed the Tax Court essentially because, as it stated, ''neither the Thompson Partnership nor Turner Partnership conducted any legitimate business operations, nor provided the decedent with any potential nontax benefit from the transfers.''[51]

The Third Circuit emphasized that the creation of an FLP and the decedent's late-in-life transfers to that entity had an abuse potential:

> Nonetheless, we believe this sort of dissipation of value in the estate tax context should trigger heightened scrutiny into the actual substance of the transaction. Where, as here, the transferee partnership does not operate a legitimate business, and the record demonstrates the valuation discount provides the sole benefit for converting liquid, marketable assets into illiquid partnership interests, there is no transfer for consideration within the meaning of section 2036(a).[52]

Citing *Gregory v. Helvering*,[53] the Third Circuit stated:

> Even when all the ''i's are dotted and t's are crossed,'' a transaction motivated solely by tax planning and with ''no business or corporate purpose . . . is nothing more than a contrivance. To hold otherwise would be *to exalt artifice above reality* and to deprive the statutory provision in question of all serious purpose.''[54]

Analysis and Conclusion

Does *Black* follow *Schutt*? Yes — although it is less certain that the Third Circuit has in fact embraced the *Bongard* test. However, the court in both *Black* and *Schutt* underlined the uniqueness of the facts in each case as providing an ''unusual scenario'' in which the FLP provided the limitations not currently available because of the terms of the trusts. Yet categorizing a buy-and-hold investment strategy as a significant nontax reason for establishing an FLP is ironic. Like the decedent in *Schutt,* Mr. Black wanted to retain control of the investment decisions of his grandsons' trusts, so he created an FLP

[47]*Id.* at 79.
[48]*Id.* at 83-84.
[49]*Thompson*, 382 F.3d 367 at 380.
[50]*Id.* at 380-381. Citing *Wheeler v. United States*, 116 F.3d 749 (5th Cir. 1997), the *Thompson* court explained, ''If assets are transferred *inter vivos* in exchange for other assets of lesser value, it seems reasonable to conclude there is no transfer for 'adequate and full consideration' because the decedent has not replenished the estate with other assets of equal value.'' *Id.* at 381, citing *Wheeler*, 116 F.3d 749 at 762. (''Unless a transfer that depletes the transferor's estate is joined with a transfer that augments the estate by a commensurate (monetary) amount, there is no 'adequate and full consideration' for the purposes of either the estate or gift tax.'')
[51]*Id.* at 383.
[52]*Id.* at 381.
[53]293 U.S. 465, 469 (1935).
[54]*Thompson*, 382 F.3d 367 at 383. (Emphasis added.)

(Footnote continued in next column.)

for that supposed nontax purpose. But isn't that inherently a *tax* purpose since it is the equivalent to retaining control of assets after transferring them to an irrevocable trust? If the grandsons' trusts had themselves provided Mr. Black with a retained unrestricted power to impose his own investment choices on the trusts, wouldn't section 2036(a)(2) have pulled the trust assets back into Mr. Black's estate?

Moreover, there are questions suggested by this line of cases that should be addressed by Congress if not by the courts. Does *Black/Schutt* produce a good result? Is *Bongard* an adequate test to distinguish between those limited partnerships that are created primarily to effect transfer tax valuation discounts and those that would have been established without such a heavy tax incentive? Aren't these FLP discounts a clear example of "exalting artifice above reality?"