

Estate of Hurford

Tax Court Has a Cow Over Bad Estate Planning

True or False: A terminally ill widow with a $14 million estate can leave everything to her children free of all federal gift and estate tax simply by signing a few documents.

Answer: False.

"How could the plan go wrong? Let me count the ways."

Multiple Choice Question: If you claimed the correct answer was True, you might be: (A) Texas attorney Joe Garza; (B) his client who paid him over $300,000 to prepare the documents; or (C) his malpractice defense counsel. **Answer:** All of the above.

In *Estate of Hurford*,[1] Tax Court Judge Mark V. Holmes[2] used some of the most colorful and pointed language imaginable from a federal bench in describing and excoriating Mr. Garza's overly aggressive estate planning, beginning with his opening paragraph:

> It is a truth universally acknowledged, that a recently widowed woman in possession of a good fortune must be in want of an estate planner.[3] Thelma Hurford had devoted her life to family and friends, leaving the management of the finances to her husband Gary. When he died suddenly, she had to learn what they owned and decide what to do with it. While she struggled with this burden, she was herself stricken with cancer and so had to arrange the accelerated planning of her own estate. Two attorneys vied for her attention and she chose Joe B. Garza.[4] She lost her life to the cancer. We must now decide how much of her estate will be lost to taxes.

Judge Holmes decided that most, perhaps all, of the estate, would be lost to taxes. The court upheld the Commissioner's gift tax assessment of more than $8 million and estate tax assessment of more than $9 million.[5]

The Garza Plan. Mr. Garza's plan was a combination of two familiar and well-established estate planning techniques, a family limited partnership and a private annuity.

A family limited partnership (FLP) can be useful for many non-tax purposes, but one of its most useful benefits is that it can also depress the value of the estate of anyone contributing assets to the partnership capital in exchange for a partnership interest. This is because state law restricts the ability of a limited partner to withdraw from the partnership, creating a valuation "discount" in the value of the partnership interest for lack of marketability. In addition, the FLP is usually designed so that the wealthy parent is not in control of the general partner, creating an additional "discount" for lack of control. This combination of "discounts" in value reflects economic realities based on state law, so that the fair market value of the partnership interest is legitimately less than the value of the underlying assets, thus potentially reducing gift and estate taxes.

A private annuity, like a sale for an installment note, is a sale of an asset in exchange for a promise to pay future fixed payments. The difference is that private annuity payments last for the life of the seller, and cease upon the seller's death. When the seller dies, the seller's estate includes any payments

actually received (and not consumed) during life, but the value to the estate of the remaining annuity payments is zero, since payments stop. Typically, the amount of the monthly payment is calculated under IRS mortality tables in such a way that the present value of the payments for life exactly equals the value of the asset sold, so that there is no gift component. To reflect the mortality risk, the payments are usually greater than under a typical installment sale. However, families typically use a private annuity only when they know that the seller's true life expectancy is probably shorter than the IRS tables assume, in an attempt to "beat the tables."

Under Mr. Garza's plan (somewhat oversimplified), Mrs. Hurford contributed almost everything she owned to a family limited partnership, in exchange for a 96-percent limited partnership interest and a 25-percent interest in the 1-percent general partner, an LLC created for that purpose. Each of her three children also received a 1-percent limited partnership interest and a 25-percent interest in the general partner. Mr. Garza then valued Mrs. Hurford's limited partnership interest at a significant discount. Finally, Mrs. Hurford sold her entire limited partnership interest to her children at the discounted value, in exchange for a private annuity calculated using the IRS mortality table, which amounted to $80,000 per month for life. Since she lived only 10 months after the transaction, her entire estate was only about $800,000.

How Could the Plan Go Wrong? Let me count the ways.

(1) Courts have consistently held that to be recognized as valid, an FLP must have some legitimate and significant nontax purpose. The court could find no purpose at all, other than to save taxes. It was "nothing more than a transparently thin substitute for a will." None of the children participated in any part of the management or decision-making of the FLP. Nobody's position really changed in any material way as a result of the alleged transactions.

(2) In order to avoid inclusion of the assets contributed to the FLP in the taxable estate, the decedent must not have retained an interest or control over the contributed assets, as distinguished from control only to the extent of the general partnership interest. "A planner using a FLP has to make sure that it is not the assets in the partnership that are being transferred among family members, but only interests in the partnership itself." The court found Mrs. Hurford had expressly or impliedly retained several interests, primarily because she had contributed to the partnership virtually all of her assets, retaining nothing else upon which to live. Also, she retained signatory authority on some partnership assets, writing personal checks on allegedly partnership accounts to pay her personal income taxes. She also commingled her personal funds with the partnership funds, disregarding partnership formalities.

(3) The children never contributed any assets or services to the partnership, despite being shown as 1-percent limited partners (and having 25 percent of the 1-percent general partnership interest) from the outset. Nor was any gift of a partnership interest from Mrs. Hurford to her children reported. The entire partnership was funded only by Mrs. Hurford, negating the existence of any real partnership. "We have found no legal authority for Garza's position that partners can have a partnership interest with nothing more than a shuffle of paper."

(4) Mr. Garza's documents were "sloppy," says the court: "These agreements show an unsteady drafting ability to even an untrained eye." Many key documents were never even signed.

(5) Mr. Garza did not hire an expert appraiser for the FLP interests, but instead, says the court, "Garza conjured the partnership discounts out of the air." Moreover, he did not update values of underlying assets of the partnership before claiming a discounted value.

(6) On Mr. Garza's advice, Mrs. Hurford terminated, paid to herself, and contributed to the partnership the assets in the "credit shelter trust" created under her husband's will, which would normally have passed to her children tax-free at her death. "Garza mangled [her husband's] estate plan[6] by terminating the Family Trust, leading to the inclusion of that Trust's assets in Thelma's own taxable estate."

(7) Everything was done in a rush and incompletely. The partnership interests were sold in exchange for the private annuity just weeks after the partnership was created, and before the partnership had been fully funded with Mrs. Hurford's assets.

(8) Since Mrs. Hurford was terminally ill, it was improper to use the IRS mortality tables to determine the payments in a private annuity. Her shortened life expectancy, well known to Mr. Garza and the whole family, would have required enormous monthly annuity payments in order to eliminate any gift component to the transfer.[7]

(9) The terms of the private annuity were ignored by the parties during Mrs. Hurford's life. The court found there was an implicit agreement among the children to share in the benefit in a manner other than as explicitly set forth, so the court felt similarly free to ignore the private annuity as well.

(10) The private annuity lacked economic substance, since the children did not have the wherewithal to make the annuity payments themselves and did not even treat the assets as their own but kept them in their original form. "What Thelma's children did … was to hold the assets in the exact same form that they were in before the private annuity and then slowly transfer bits and pieces of them back to her, planning to divide what was left over … after she died."

In a sort of summary, Judge Holmes stated: "Garza's particular method of estate planning was … far off the mark. Garza's schemes were not within the realm of legitimate estate planning prac-

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retaliatory discharge claim more than consistent, documented reasons for your client's decisions — especially when those reasons are supported by truthful performance evaluations. If an employer waffles back and forth between explanations for the discipline or termination, and the employee can point to great performance reviews that are inconsistent with the reason for the adverse action, the employee's claim that he or she was fired for blowing the whistle on the employer's accounting practices sounds a little more realistic. Performance evaluations, discipline and terminations are some of the most difficult aspects of being an employer, but diligence will likely prove to be beneficial later on.



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Notes

1. Both the statutory and common law remedy require an employee to show he or she was discharged from an employment relationship. They differ, however, in the level of proof an employee must offer regarding his or her activities and their alleged impact on the employee's termination. The statutory cause examines whether the employee refused to "participate in, or remain silent about, illegal activities" on the part of his or her employer and whether this decision was the exclusive cause of his termination. The common law cause of action is more relaxed — it looks only at whether the employee "attempted" to exercise a statutory or constitutional right or comply with clear public policy and whether doing so was a "substantial factor" in the employee's termination. In comparison, the common law cause of action is an easier burden for employees to meet. Employees are free to pursue either or both of these remedies as one is not preemptive of the other. *Guy v. Mutual of Omaha*, 79 S.W. 3d 528 (Tenn. 2002). The statutory cause of action, however, may make punitive damages available to a plaintiff.

2. There may be some confusion regarding who is an "employee" under the TPPA because the definition section of the statute does not include private employees, even though the substantive provisions of the statute expressly reference private employees. In 1997, the Tennessee General Assembly approved an amended definition of "employee" under the TPPA to read "also includes an employee of the state … or any other entity thereof." See 1997 Tenn. Public Acts 511. However, the codification of this amendment does not include the term "also." See *Tenn. Code Ann.* § 50-1-304 (a)(1) ("Employee includes an employee of the state …"). The literal reading of this codified definition would exclude the application of the TPPA to private sector employees, which is in conflict with other portions of the statute which seem to assume coverage for private sector employees. See *Tenn. Code Ann.* § 50-1-304(c) ("In addition to all employees in private employment, this section applies to all employees who receive compensation from the federal government …"). The Tennessee Supreme Court, however, has assumed coverage in light of the literal definition found in the statute. See *Guy*, 79 S.W. 3d at 537 ("Clearly, the General Assembly has recognized the importance of encouraging all employees — both public and private — to report infractions …"). This is a possible issue for resolution by the Tennessee legislature.

3. See *Conley v. Yellow Freight System Inc.*, 521 F. Supp. 2d 713 (E.D. Tenn. 2007).

4. 2006 U.S. App. LEXIS 21882 (6th Cir. Aug. 24, 2006).

5. 2007 Tenn. App. LEXIS 524 (Tenn. Ct. App. Aug. 15, 2007).

6. See *Sparks v. Westgate Resorts Inc.*, 2007 U.S. Dist. LEXIS 79639, at **13-14 (E.D. Tenn. Oct. 26, 2007).

7. See "Georgia's Parking Lot Law Has Less Bang for Employers Than Predicted," Don Benson and Julie Jordan, Littler Mendelson ASAP June 2008, at http://www.littler.com/PressPublications/Lists/ASAPs/DispAsaps.aspx?id=1249&asapType=Southern; see also O.C.G.A. § 16-11-113; see also Fla. Stat. § 790.251.

8. See 2008 Tennessee Legislature House Bill 3063/Senate Bill 2928.

9. *Boyl v. Merchants Dist. Inc.*, 2006 U.S. Dist. LEXIS 64672, at **14-17 (E.D. Tenn. Sept. 8, 2006).

10. *Tenn. Code Ann.* § 39-17-309

11. *Hisel v. City of Clarksville*, 2007 U.S. Dist. LEXIS 15145, at **43-44 (M.D. Tenn. March 2, 2007).

12. *Garmley v. Opryland Hotel Nashville LLC*, 2007 U.S. Dist. LEXIS 91766, at *4 (M.D. Tenn. Dec. 13, 2007).

13. *Brock v. Positive Changes Hypnosis LLC*, 2008 U.S. Dist. LEXIS 49281, at **24-27 (W.D. Tenn. June 26, 2008).

14. *Rennell v. Through the Green Inc., 2008 Tenn. App. LEXIS 151 (Tenn. Ct. App. Mar. 14, 2008).*

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tices … [and he] lacked sufficient competence in estate tax law." Indeed, the Hurford family ended up worse off than if they had never consulted a lawyer at all. This case is a classic illustration of how normal tax planning tools can fail when they are improperly planned and executed. It also illustrates the old adage that pigs get fat, but hogs get slaughtered.

Perhaps it mostly illustrates that a recently widowed woman in possession of a good fortune must first be in want of a *competent* estate planner.

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