S Corporation's Investment in Family Limited Partnership Lacked Economic Substance

By Donald P. Board • Wood LLP

In 2010, Congress enacted Code Sec. 7701(o), which codified several elements of the economic-substance doctrine. Eight years later, the Tax Court is still working its way through an inventory of economic-substance cases from pre-2010 tax years. The common-law formulations of the doctrine are going to be with us for a while.

Although Code Sec. 7701(o) is billed as a "clarification" of the economic-substance doctrine, Congress refused to shed any light on the basic question of when the doctrine should be applied. The statute says only that the "relevance" of the economic-substance doctrine to a transaction must be determined "in the same matter as if this subsection had never been enacted." [Code Sec. 7701(o)(5)(C).]

This means that tax advisors must consult case law to gain insight into the kinds of transactions that are beyond the pale. Unfortunately, the cases tend to be fact-specific and sometimes reflect inconsistent views of what the role of the economic-substance doctrine should be. Advisors reviewing a proposed transaction can often imagine a court coming down either way.

However, some transactions should strike just about any advisor as over the line. These schemes may be less likely to find their way into the case reports, but they do come up from time to time. The Tax Court's recent decision in *R.E. Smith* [114 TCM 518, Dec. 61,062(M), TC Memo. 2017-218] is a salutary case in point.

Deduct the Discount?

Robert Smith, an accomplished inventor, decided to retire when the corporation he worked for was acquired in 2009. On his way out the door, Mr. Smith picked up a substantial cash bonus and sold his shares in the company.

An estate planner proposed a strategy that was supposed to eliminate the income tax on Mr. Smith's recent windfall. Mr. Smith jumped in with both feet. On July 9, 2009, the estate planner set up an S corporation, to which Mr. Smith transferred $1.9 million in cash and securities—substantially all of his assets.

The S corporation then contributed the cash and securities to a newly organized family limited partnership (FLP) in exchange for a 98-percent limited partnership interest. The estate planner, who was a CPA as well as a tax lawyer, valued the partnership interest at $1.1 million. That was 40 percent *less* than the value of the cash and securities contributed to the FLP. But the estate planner thought the partnership interest deserved to be discounted for lack of marketability and control.

Using limited partnerships to depress estate and gift tax valuations was common enough in 2009. A 40-percent discount wasn't out of the question, either. What was distinctive about this strategy was that it was supposed to make the discount *deductible*.

The key step was the liquidation of the S corporation on December 31, 2009. The corporation distributed its interest in the FLP (valued at $1.1 million) to Mr. Smith. Having invested $1.9 million in the S corporation, Mr. Smith contended that he had suffered an $800,000 *loss*, which he sought to apply against his 2009 income.

No Such Luck

The IRS challenged the deduction on several grounds, including lack of economic substance. Mr. Smith's case was appealable to the Fifth Circuit, so the Tax Court applied the test articulated in *Klamath Strategic Inv. Fund* [CA-5, 2009-1 USTC ¶50,395, 568 F3d 537]. Under *Klamath*, a transaction must satisfy: (1) an "objective" test, analogous to Code Sec. 7701(o)(1)(A), which asks whether the transaction had any real consequences other than tax effects; and (2) a "subjective" test, analogous to Code Sec. 7701(o)(1)(B), which focuses on whether the taxpayer had a substantial non-tax business purpose for entering into the transaction.

The Tax Court observed that the S corporation had done nothing during its brief life except serve as a conduit for Mr. Smith's contribution of cash and securities to the FLP. From the first meeting with the estate planner, it had been clear that the new S corporation would be liquidated later in 2009. The whole point of interposing the S corporation was to allow Mr. Smith to harvest the $800,000 tax loss generated by the estate planner's 40-percent valuation discount.

The Tax Court came down hard on Mr. Smith, disallowing the loss and upholding a 20-percent accuracy-related penalty under Code Sec. 6662(b). After dismissing most of Mr. Smith's testimony as incredible, the court found that that he had not acted in good faith. Hence, under Code Sec. 6664(c)(1), Mr. Smith could not escape the penalty by pointing to his reliance on the estate planner's advice.

Mr. Smith was at least fortunate that his transaction took place in 2009. Under Code Sec. 6662(i), enacted in 2010, he would have faced a *40-percent* penalty because his understatement resulted from a "nondisclosed noneconomic substance transaction." Code Sec. 6664(c)(2) bars the reasonable-cause defense in economic-substance cases. So, Mr. Smith would have been penalized even if he *had* acted good faith.

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