Family Limited Partnerships: Holding up Under Fire? Part I

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The estate planning profession has failed miserably in predicting the future of the estate tax. Still, most practitioners believe it will continue to be with us in some form starting next month! So keeping current on the treatment of family limited partnerships remains worthwhile. A family limited partnership is a well-known estate planning technique designed to take advantage of the valuation discounts generally available for limited partnership interests.

The typical strategy is to wrap stock, securities, real estate or a family business within a partnership or LLC. This structure allows parents to give or sell appreciation opportunities to their children on a discounted basis, while minimizing the value of their own retained interests.

IRS Assault on FLPs

The IRS makes no secret of its hatred of family limited partnerships. PLI's *41st Annual Estate Planning Institute* included a thorough overview of the storied history of FLPs. Ronni G. Davidowitz, Partner at Katten Muchin Rosenman LLP, pointed out several theories that the IRS aggressively pursues in its audits:

- The economic-substance doctrine, which generally provides that a transaction is ignored if it has no business purpose apart from tax considerations
- Internal Revenue Code Section ("Code Sec.") 2703, which disregards for valuation purposes certain restrictions on the ability to use assets, where the assets remain under family control after the transfer
- Code Sec. 2704, which disregards for valuation purposes certain restrictions on liquidation of a family entity
- Code Sec. 2036, which requires inclusion in the gross estate of transferred property, such as assets held by an FLP, over which the decedent retained enjoyment or control at the time of death
- Gift on formation, under which a donative transfer arguably occurs where value "disappears" on the formation of a partnership
- The step-transaction doctrine
- Challenging the discounts, particularly those claimed for marketable securities and other liquid assets held by the partnership

In recent years, the IRS has achieved significant victories that have caused practitioners to be more cautious about the use of these entities for estate tax planning. Indeed, in light of the high–audit profile of FLPs, co-panelist Sanford J. Schlesinger questioned whether it is worth using an FLP wrapper to get an additional 10–20-percent discount, or if it might be easier instead to give fractional interests in the underlying property. Clients should enter into these structures only if they are aware of the risks and potential alternatives.

Scrutiny of Facts and Circumstances

Judging from the overall record, the government's most successful theory appears to be under Code Sec. 2036(a). Code Sec. 2036(a) includes in a decedent's gross estate the value of all property that the decedent transferred and retained either the possession, enjoyment or income from the property, or the right to designate the persons who possess or enjoy the property or its income.

For example, if a donor makes a gift of a personal residence to his child, but retains the right to live in it for a term of years, the personal residence will be included in the donor's estate if the donor dies during the retained term of use. [Reg. §20.2036-1(c)(1)(ii), Example 2.] A donor will be deemed to have retained an interest or right in the transferred property if there is evidence of either an express or implied agreement that the interest or right would later be conferred. [Reg. §20.2036-1(a).] Thus, the existence of an agreement or understanding can be inferred from the circumstances surrounding the transfer of property and its subsequent use.

An important exception to Code Sec. 2036 is that transfers made in a *bona fide* sale for adequate and full consideration in money or money's worth are not drawn back into the transferor's estate. The courts determine the existence of a *bona fide* sale, as well as any implied retention of the right to use transferred property, based on close scrutiny of the facts of each individual case. Consequently, planning in this area should not to be taken lightly.

Ms. Davidowitz indicated that the first significant IRS victory with respect to family limited partnerships came in 1997 with the Tax Court case of *D.M. Schauerhamer Est.*, 73 TCM 2855, Dec. 52,061(M), TC Memo. 1997-242. In *Schauerhamer*, the decedent formed three limited partnerships and made gifts of limited partnership interests to each of her children. The Tax Court held that, notwithstanding the prior gifts, all of the partnership assets should be included in the decedent's estate under Code Sec. 2036(a)(1). The court noted that the partnership agreements required the establishment and use of separate partnership bank accounts.

However, the decedent violated the terms of the partnership agreements by depositing all income from partnership assets into her personal account and using these funds for personal expenses, without accounting separately for partnership funds. The court concluded that the decedent thereby retained possession and enjoyment of the partnership property within the meaning of Code Sec. 2036(a)(1). Similar IRS victories followed in which the courts found that a disregard for the formalities of partnership administration triggered inclusion of the partnership's assets in the decedent's estate under Code Sec. 2036(a).

The facts are clearly all-important. Some of the facts that the courts have found to be unfavorable to the taxpayer include commingling of personal and partnership assets; rent-free use of partnership property; failure to maintain capital accounts and other records; disproportionate partnership distributions; retention of insufficient assets outside of the partnership to maintain the decedent's obligations; deathbed creation of the partnership (indicating the testamentary nature of the transaction); and the expectation that the partnership assets would be needed to meet debts and expenses after death.

Elements of Taxpayer Victories

However, taxpayers who have respected the business formalities of the partnership and have been able to demonstrate significant non–tax-related purposes for establishing the family partnership or LLC have successfully defended family LLCs and limited partnerships against IRS attack.

In *W.C. Bongard Est.*, 124 TC 95, Dec. 55,955 (2005), the Tax Court found the exception for a *bona fide* sale for adequate and full consideration to be satisfied. The creation of the family limited partnership was motivated by a legitimate and significant nontax purpose, and the transferors received partnership interests proportionate to the value of the property transferred. The court stressed that the nontax purpose must be an *actual* motivation, not a mere theoretical justification. A list of factors indicating a *lack* of nontax purpose include the taxpayer's standing on both sides of the transaction, the taxpayer's financial dependence on distributions from the partnership, the partners' commingling of partnership funds with their own and the taxpayer's actual failure to transfer the property to the partnership.

The case of *V.M. Miller Est.*, 97 TCM 1602, Dec. 57,835(M), TC Memo. 2009-119, is a useful illustration of when the *bona fide* sale exception may or may not apply. In *Miller*, the decedent's husband had actively managed the family's investment portfolio using a unique (and well-documented) charting strategy. He also taught this investment style to his son Virgil.

Mrs. Miller inherited the portfolio upon her husband's death. At a time when she was in good health, Mrs. Miller transferred a portion of this portfolio to a family limited partnership of which Virgil was a general partner. Virgil actively traded the portfolio after the transfer, devoting over 40 hours a week to his management activities. Mrs. Miller later made a second contribution of securities to the partnership, but only after she had broken her hip and experienced other serious health problems. She died only a few weeks after the second transfer.

The Tax Court held that the first transfer of securities qualified for the *bona fide* sale exception to Code Sec. 2036(a), and accordingly were properly valued at a discount. The court found that the driving force behind the formation of the FLP was the desire to continue management of family assets in accordance with her husband's previous management style. The court noted that Mrs. Miller had retained sufficient assets after the initial transfers to meet her day-to-day living expenses.

In contrast, the second transfer, occurring shortly before Mrs. Miller's death, did not qualify for the *bona fide* sale exception. The court found that the driving forces behind these transfers were Mrs. Miller's declining health and the desire to reduce estate taxes. The court rejected the estate's contention that the desire for Virgil's investment management was the true motive.

The court reasoned that, had this been the case, Mrs. Miller would not have waited until the last weeks of her life to transfer additional securities to the partnership. The court further held that Mrs. Miller retained possession or enjoyment of the assets of this second transfer because the partnership assets were expected to be needed to meet the estate tax due upon Mrs. Miller's death. Accordingly, the securities attributable to the second transfer were included in her taxable estate at their full fair-market value, without regard to any discount.

In light of the scrutiny to which family LLCs and partnerships are often subjected, Ms. Davidowitz stressed that an FLP must observe the following formalities to reduce the risk of adverse estate tax consequences:

- Establish and document a legitimate non-tax purpose for each transfer of assets to the entity.
- Observe the business formalities set out in the operating agreement, including the maintenance of capital accounts, corporate minutes and other records.
- Avoid commingling company and personal assets.
- Avoid transferring personal-use items, such as residences or vacation homes, to the FLP, unless the partners timely pay market rent to the partnership for their use of these items.
- Retain sufficient assets outside of the FLP to meet personal obligations.
- Avoid making distributions that are not in proportion to members' interests.

Part II will appear in the January 2011 issue.