'Stone' Proves Family Limited Partnership Is Alive and Well

By Bruce Givner

The Nov. 7 decision in *Estate of Stone*, T.C. Memo. 2003-309 (Nov. 7, 2003), confirms that family limited partnerships are alive and well as a device for gift and estate-tax planning. *Stone* will encourage tax advisers, who had become increasingly negative about using these partnerships after *Estate of Harper*, T.C. Memo. 2002-121 (May 15, 2002), to recommend family limited partnerships in the right fact situations.

Harper sent shock waves through the estate-tax planning community because it was the first case in which a court ignored a properly drafted and operated (nonsham) family limited partnership. Before *Harper*, the Internal Revenue Service had been successful getting the courts to ignore family limited partnerships only twice: *Estate of Schauerhamer*, TC Memo. 1997-242 (May 28, 1997); *Estate of Reichardt*, 114 TC 144 (March 1, 2000).

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However, both *Schauerhamer* and *Reichardt* had elements of a sham. In both cases, partnership income was deposited into the parent's personal account. In *Schauerhamer*, no partnership books or bank accounts were kept. In *Reichardt*, the parent did not pay rent on the residence, which he occupied but which was a partnership asset.

Judge Arthur L. Nims' decision in *Harper*, involving a Los Angeles-area lawyer, focused on a number of defects in the partnership. For example, the partnership was not begun until the aged parent was diagnosed with a terminal illness. This is a characteristic of each of the IRS victories and is a result of a natural hesitancy of people to plan.

One "defect" that drew Nims' ire but that was surprising to practitioners was that the assets were not immediately transferred to the partnership. The funding process did not begin until six weeks after the partnership was signed and dragged on over an additional four months. To many practitioners, that type of delay seems understandable in the average law firm.

Nims also noted the fact that a certified public accountant was not involved at the partnership's creation and during its short operation, as a result of which a general ledger was not established for the partnership until after Morton Harper's death. Because there were no partners other than those who would inherit on Harper's death, Nims characterized the partnership as a mere "testamentary substitute."

Nims ruled that Harper retained control over the assets. As a result, the partnership's assets were included in Harper's estate, despite gifts of limited-partnership interests to his children.

Other critical facts included the following: The partnership made disproportionate income distributions to Harper; Harper did not retain adequate assets outside of the partnership, so he was wholly dependent on distributions from the partnership to maintain his lifestyle (and the partnership was the sole source to pay the estate tax); and Harper's adult child, though nominally the general partner, did not exercise management over the partnership.

Harper was just the beginning. Three months later came *Estate of Thompson*, T.C. Memo 2002-246 (Sept. 26, 2002). In that case, the two partnerships were set up two years before Theodore Thompson's death at 97. A prime bad fact was the existence of correspondence about the partnership satisfying the decedent's income needs. Also, the court emphasized that Thompson's transfers did not leave him with enough assets to support himself.

Then on Jan. 15, 2003, came *Kimbell v. United States*, 244 FSupp.2d 700 (N.D. Tex. 2003), in which the partnership was formed on Jan. 29, 1998. Ruth Kimbell died on March 25, 1998, at 96. Kimbell had a 99.5 percent interest in the partnership.

Finally came the decision on remand in *Estate of Strangi*, T.C. Memo. 2003-145 (May 20, 2003). In that case, the son-in-law, acting under a power of attorney, formed the partnership after Albert Strangi had cancer removed from his back, had prostate surgery, was diagnosed with a brain disorder and was given 12-to-18 months to live.

Although Strangi was charged rent for the partnership's two-month operation, it was a mere bookkeeping entry, not in fact paid until after his death. At death, Strangi had 98 percent of the limited-partnership units and 47 percent of the general-partnership units, which he had received in exchange for 99 percent of his assets. However, the court admitted that "the proverbial 'I's were dotted' and 't's were crossed.'"

With these four IRS victories, taxpayers have been in need of reassurance that family limited partnerships are available as a transfer tax-planning tool. For that reason, *Stone* is especially timely and welcome.

In *Stone*, the IRS was seeking $5 million of additional estate tax from the estates of Eugene and Allene Stone and based its arguments almost completely on those that carried the day in *Harper* and the three victories that followed it.

Stone had bad facts, which gave the IRS reason to hope that its winning streak would continue: The partnerships were drafted in April 1996, signed May 9, 1996, and filed with the South Carolina secretary of state Oct. 15, 1996. On Jan. 31, 1997, Eugene Stone was diagnosed with gall bladder cancer. On April 9, 1997, the partnerships were funded (a delay of one year).

In addition, following the pattern of the prior cases, both of the Stones died shortly after the partnerships were started, and both died at advanced ages: On June 5, 1997, Eugene Stone died at 89; and Oct. 16, 1998, Allene Stone died.

Another fact that favored the IRS in *Stone* was that the partnerships had to pay the estate tax and make non-pro-rata distributions to the estate to give the estate the funds with which to pay the estate tax.

However, counsel for the taxpayers was the formidable litigator John Porter, who cowed the IRS into a favorable compromise in a nine-digit case involving a woman who died two days after her partnership was funded. He marshaled the facts with full knowledge of what Nims did not like in *Harper*.

Porter emphasized the following:

- Four years of litigation among the children preceded the drafting of the partnerships, giving the partnerships an inter vivos purpose (to avoid the argument that they were a mere "testamentary substitute").
- Each child, as general partner of the partnership set up for that child, actively managed that partnership (in other words, the parents did not manage the assets).
- The partnerships offered "flexibility in business and estate planning not available through trusts, corporations or other business entities."
- The partnerships made it easier "to reduce transaction costs and multiple deeds in transferring property among Family members ... and acquiring, financing, developing, subdividing, managing, improving, operating, leasing, mortgaging, refinancing, pledging, selling or otherwise dealing with the Partnership Property."
- The parents' accountants analyzed the amount of assets they would need to maintain their standard of living and did not transfer them to the partnerships.
- Each partnership had advisers separate from each other partnership.
- There was no commingling of partnership and personal assets.

The court rejected the IRS' arguments that, because the parents received back limited-partnership interests, which were discounted in value (43 percent), there were no bona fide sales for adequate and full consideration in money or money's worth under Internal Revenue Code Section 2036(a).

The court also rejected the argument that no evidence in the record indicated that the decedents intended to conduct a joint enterprise for the mutual profit of their children and themselves.

The court specifically rejected the IRS' winning argument in *Harper* that the decedents' transfers were a mere recycling of value and form of ownership.

Stone is a difficult case to follow factually. Parents with minor children cannot have them actively manage assets. Parents with adult children may hesitate to give up management just to achieve estate-tax benefits. How often will there be years of litigation among the children preceding formation of a partnership?

However, *Stone* has established boundaries to the IRS' chain of Section 2036 victories. Receipt of discounted limited-partnership units does not vitiate the "adequate and full consideration" exception from Section 2036. The "testamentary substitute" attack is not, in and of itself, fatal (all the partners in *Stone* were family members).

Estate and income-tax planning attorneys should persuade clients to engage in sophisticated planning, years in advance of need. Parents should include as limited partners those who will not inherit under the parents' estate plan, to avoid the argument that the partnership is a mere "testamentary substitute."

This is an opportunity to introduce charitable planning, an excellent income and estate-tax planning device. Clients should document carefully non-estate-tax motives for establishing family limited partnerships, such as creditor protection, joint investments and reduced transaction costs.

Bruce Givner is a tax and estate-planning attorney in Los Angeles.