Careful Counseling Can Result In a Partnership IRS Will OK

By Bruce Givner

Family limited partnerships fared well in the federal courts in 2005. Following is a brief summary of six major cases.

Estate of Wayne C. Bongard, 124 T.C. 95 (March 15, 2005), is instructive for several reasons. First, successful cases typically have large amounts at risk. Here the IRS asserted a $52,878,785 deficiency. Large stakes enable taxpayers to afford highly competent counsel. Taxpayer losses typically involve amounts insignificant compared to the 6-digit cost of trying a case. See, for example, *T.R. Thompson Estate*, T.C. Memo 2002-246 (Sept. 26, 2002), affirmed 2004-2 U.S. Tax Code Section 60 (3rd Cir. April 21, 2004) ($707,054 deficiency); and *Estate of Virginia Bigelow*, T.C. Memo 2005-65 (March 30, 2005), discussed in more detail below ($217,000 deficiency).

Given the large amount at stake in *Bongard*, the (partly) successful taxpayer was able to hire John Porter of Baker & Botts, who also represented successful taxpayers in *Estate Of Eugene E. Stone*, III, T.C. Memo 2003-309 (Nov. 7, 2003) and *C.P. Schutt Estate*, T.C. Memo 2005-126 (May 26, 2005), discussed in more detail below.

Third, *Bongard* emphasized the need for a significant nontax reason to justify creation of the entity. This case involved both an investment LLC formed to hold corporate stock and an FLP to hold the LLC units. Stock transferred to the LLC was not included in the decedent's estate because the LLC was formed to facilitate a "corporate liquidity event" that would provide needed capital for expansion, the legitimate and significant nontax motive.

By contrast, the LLC units transferred to the FLP were included in the decedent's estate. The FLP never diversified its assets, had an investment plan, engaged in any investment transactions or decisions, functioned as a business enterprise or otherwise engaged in any meaningful economic activity.

The taxpayer argued that the FLP allowed the decedent to make gifts without diversifying direct ownership of the stock. However, the court was unconvinced, as there was no immediate or definite plan for gifts, and mere intent is insufficient to establish that the transfer was motivated by a significant nontax reason. The estate's creditor protection argument for the FLP rang false because the LLC already served that function.

Finally, though he was not the general partner, the decedent, through his control of the corporation, determined whether the FLP could liquidate its sole asset (the LLC membership units). It is worth noting that the 28-page opinion triggered nearly 20 pages of concurrences, partly due to disagreements with the majority's analysis of the "bona fide sale" exception to the application of IRC Section 2036 (transfers with retained income interests or the right to designate who shall possess or enjoy the property or the income).

Although the *Estate of Virginia Bigelow*, T.C. Memo. 2005-65 (March 30, 2005), was a taxpayer loss, clients can easily avoid the bad facts. First, the FLP was formed when the decedent was 85, a few months after she suffered a stroke and moved to an assisted-living facility. She died three years later.

Second, the beneficiaries terminated the FLP one year after her death, belying any nontax motives for the structure. Third, the FLP agreement provided that its purpose was to own and operate residential real property, and prohibited it from other businesses. Fourth, the decedent's trust was both the sole general partner, meaning management did not change and the estate was not protected from creditors.

Fifth, the decedent was wholly dependent upon the FLP (her personal bank account contained $23,500). After the FLP was formed and two residential-care policies expired, her income was $4,800 per month less than her expenses. Sixth, the FLP did not make distributions to its partners before decedent's death.

Seventh, after the transfer of real property to the FLP, the property continued to secure the decedent's legal obligation to pay her debts. Worse, she agreed to hold the FLP harmless for the debts. Eighth, the FLP did not adjust her capital account as required by the FLP agreement when it paid her debts.

One final note: continuing the topic of competent counsel, the government was represented by Donna Herbert, who won the seminal *Estate of Harper*, T.C. Memo 2002-121 (May 15, 2002).

The *Estates of Edna and Austin Korby*, T.C. Memo 2005-102 and T.C. Memo 2005-103 (May 11, 2005), are simple examples of bad facts. First, the taxpayers formed the FLP when the wife was 70 and living in a nursing home, and the husband was 80, had suffered a stroke and was diagnosed with Type II diabetes, hypertension and cardiac arrhythmias. The wife died at 74 and the husband died five months later, at 84.

Second, their living trust was the general partner. Third, the FLP did not file a return for 1994 because it was not funded until 1995. Finally, after transferring all of their liquid assets to the FLP, the parents did not even have a bank account.

In *C.P. Schutt Estate*, T.C. Memo 2005-126 (May 26, 2005), the IRS asserted an $11,118,981 deficiency. However, the taxpayer prevailed principally by demonstrating in detail the "significant non-tax reason" for creation of the Delaware business trusts (substitute for an FLP): the decedent's buy and hold investment philosophy.

The decedent, who married into the DuPont family, had repeatedly expressed concern about family members selling DuPont or Exxon shares, and was displeased with past sales by the heirs. Three other positive facts persuaded the court. First, the decedent contributed less than half the assets to the business trusts ($40 million compared to $42 million contributed by the heirs' trusts).

Second, the Wilmington Trust Co., trustee for the heirs' trusts, negotiated important changes in the structure; e.g., requiring annual distribution of cash flow. Third, the decedent had $30 million that was not contributed to the business trusts. Despite the fact that the assets in the business trusts were liquid, the estate was sustained in taking a 46 percent discount.

The key issue in valuation was a right of refusal in the FLP agreement that would cause a significant marketability discount.

In *Estate of Webster E. Kelley*, T.C. Memo 2005-235 (Oct. 11, 2005), the taxpayer argued for a 53.5 percent valuation discount, while the IRS wanted 25.2 percent. The court agreed to 35.75 percent, which is less than splitting the difference between the two positions. However, this is still a great result for the taxpayer because the FLP's assets were liquid. The case is notable for at least three other reasons.

First, the decedent only survived nine months after the FLP was formed and only three months after his daughter's capital contribution. Second, his daughter contributed $50,000 in cash (compared with the decedent's $1.2 million in liquid assets).

Third, at death the decedent owned 94.83 percent of the FLP and a third of the LLC which was the 1 percent general partnership. Finally, the IRS conceded all issues under that would have resulted in inclusion of the gifted assets in the decedent's estate.

In *Smith v. U.S.*, Case #02-264 Erie (W.D. Pa. Sept. 29, 2005), the FLP owned stock in an operating company. Smith gave limited partnership interests to his children and reported a $1,025,392 gift, causing a $262,243 gift tax. The IRS asserted a $361,000 deficiency.

The key issue in valuation was a right of refusal in the FLP agreement that would cause a significant marketability discount. The IRS was sustained in ignoring it due to Internal Revenue Code Section 2703(a). That section generally requires that, for purposes of calculating estate, gift and generation-skipping taxes, a property's fair market value is to be determined without regard to any option, agreement, or other right to acquire or use the property at a price less than its fair market value; or any restriction on the right to sell or use such property.

The court noted that one requirement of pre-Section 2703 law is that a restrictive agreement must be binding both during life and after death. Because Smith owned two-thirds of the general partnership interests and a 95.15 percent limited partnership interest, and the agreement required action by a majority of the general partnerships and approval of at least half of the limited partnerships, at all times before his death, Smith owned and was able to unilaterally make all general partnership decisions.

As a result, the agreement, and the restrictive provision, were not binding during his lifetime and were disregarded in determining value.

Among other important points, these cases demonstrate the need for:

- Parents to retain sufficient assets so they are not wholly dependent on the FLP for income.
- Children to be separately represented, with proof their efforts resulted in substantive changes to the FLP agreement.
- Parents to form the FLP while in good health; for parents to not be the general partnerships; for articulation of significant nontax reasons for the FLP.
- Annual pro rata distributions to all partners, strict observance of the FLP agreement and prompt transfer of the assets to the FLP.
- Significant contributions to the FLP by the heirs and continuation of the FLP until conclusion of the estate tax audit.

Careful counseling can result in an FLP that the IRS will respect.

Bruce Givner of the Law Office of Bruce Givner is a tax attorney in Los Angeles.