Family Limited Partnerships—Well-Advised?

By Stephen J. Dunn

In 1994, Fortress Financial, Inc. began holding seminars on its "Fortress Plan" estate tax avoidance scheme. In the scheme, the client, whom we will call "transferor," creates a family limited partnership (FLP) and transfers all or practically all of his or her property to it. Transferor then makes annual gifts of interests in the limited partnership to his or her children and grandchildren. The gifts are free of federal gift tax to the extent they do not exceed the per-donee annual exclusion under IRC § 2503(b) (currently $12,000).

If transferor owns an interest in the FLP at his or her death, it is likely to be less than a 50 percent profits interest. Therefore, transferor's personal representative takes aggressive discounts for minority interest and lack of marketability in valuing transferor's remaining interest in the FLP in transferor's federal estate tax return.

The problem is Internal Revenue Code of 1986, as amended (IRC), § 2036(a), which provides:

> The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—
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> (1) the possession or enjoyment of, or the right to the income from, the property, or
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> (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

Notably absent from § 2036(a) is a de minimis exception for retained enjoyment of the transferred property.

To a lesser extent, IRC § 2035 is also a problem. Section 2035 includes in the transferor's gross estate at date-of-death value property that the transferor gave away within three years before his or her death.

In a growing litany of cases, the Commissioner of Internal Revenue (Commissioner) has found enjoyment retained by the transferor in FLP assets, and therefore included all of the FLP assets in the transferor's gross estate at date-of-death value under § 2036(a).[1] *Lillie Rosen Estate*[2] is illustrative. In 1994, after attending a seminar on family limited partnerships, Ms. Rosen's son-in-law, an attorney, concluded that Ms. Rosen should create an FLP and transfer her property to it as a means of avoiding federal estate tax. Ms. Rosen, who was then 87 years of age and suffering from Alzheimer's disease, did as her son-in-law advised. The Lillie Rosen Family Limited Partnership (LRFLP) was created and $2,404,781 of Ms. Rosen's cash and marketable securities were transferred to it. In return, Ms. Rosen received a limited partnership interest with a 99 percent profits interest. Ms. Rosen's two children each contributed $12,145 to the LRFLP in exchange for a general partnership interest with a .5 percent profits interest. After the transfer, the only assets remaining in Ms. Rosen's name were the following:

50 percent interest in Miami Beach condominium	$50,000
Bank savings account	$917
Joint checking account	$17,731
Money market account	$6,647
Certificate of deposit	$27,313
Annuity	$1,600/yr.
Social Security benefits	$1,459/mo.

After the transfer to the LRFLP, Ms. Rosen made annual exclusion gifts each year to her children and grandchildren. Most of the gifts were of interests in the LRFLP. In some cases, Ms. Rosen made annual exclusion gifts in the form of promissory notes. And Ms. Rosen's remaining assets were insufficient for her living expenses. Ms. Rosen's daughter, as her attorney-in-fact, withdrew funds from the LRFLP to pay Ms. Rosen's living expenses and to satisfy obligations under Ms. Rosen's gift-giving plan, as follows:

Year	Total Withdrawn
1996	$80,000
1997	$20,000
1998	$65,000
1999	$70,100
2000	$23,744

Fast Facts:

Family limited partnerships (FLPs) became popular in the mid-1990s as an estate tax avoidance device, and they remain so today. But developing case law casts doubt on the ability of FLPs to accomplish their tax avoidance objective. The author examines the risk and offers an alternative.

Ms. Rosen died in 2000. After her death, pursuant to the limited partnership agreement, the LRFLP redeemed her remaining limited partner interest, representing a 34.9988 percent interest in LRFLP profits, for $743,263. This amount was reported on Ms. Rosen's federal estate tax return, less $356,001 in purported loans in Ms. Rosen's gift-giving plan and $45,285 in purported interest. As the resulting net estate, $341,977, was less than the unified credit in effect at the time of Ms. Rosen's death, her federal estate tax return reported no tax due.

The Commissioner disagreed, and included the LRFLP assets in Ms. Rosen's gross estate at their full date-of-death value under IRC § 2036(a). This resulted in a $1,107,085 federal estate tax deficiency. The tax court sustained the Commissioner.

In some cases, the objects of the transferor's bounty paid something for their limited partnership interests in an effort

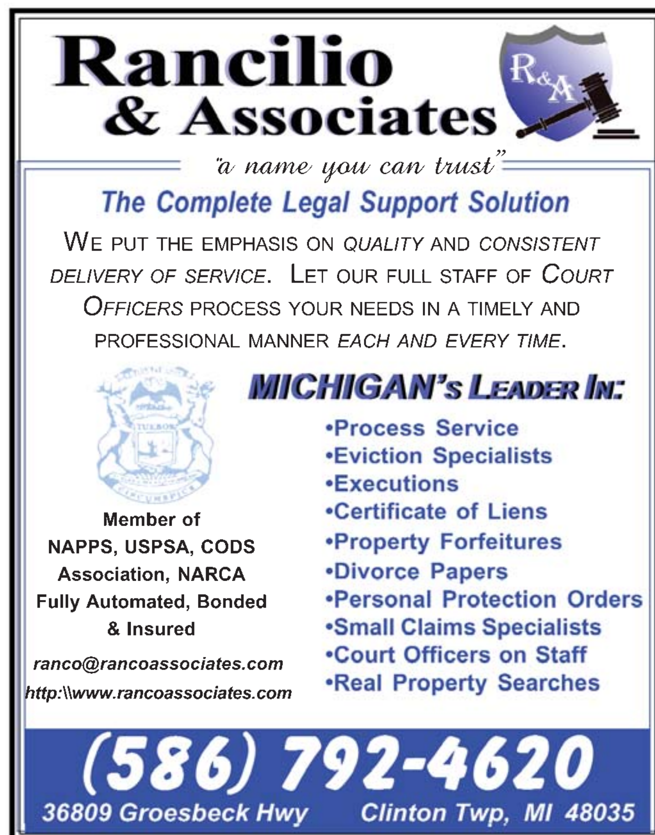
to avail themselves of the "bona fide sale for adequate and full consideration in money or money's worth" parenthetical exception to IRC § 2036(a). But most courts have not found the sale to be "bona fide."[3]

Several courts have questioned the use of limited partnerships, a form of doing business so as to minimize potential liability for claims arising out of the business, in an estate plan for the purpose of avoiding estate tax, and not for a business purpose.[4]

When a transferor transfers a residence to an FLP for the benefit of his or her children (or directly to his or her children or to an irrevocable trust for their benefit), but continues living in the house, or retains the right to use the house, it is a relatively easy case for inclusion of the residence in the transferor's gross estate under IRC § 2036(a).[5] IRC § 2702, a gift tax provision, does not affect this result.

It is a closer question if the founder of a closely-held business transfers his or her interest in the business to an FLP for the benefit of his or her children (or directly to his or her children or to an irrevocable trust for their benefit). The transferor may remain in the company's employ, for alleged fair market compensation. He may have the use of a company-owned vacation residence, allegedly for company business. He may influence or control company decisions in his role as founder and patriarch. Has he retained § 2036(a)(1) "enjoyment"?

If FLP assets enter the transferor's gross estate, they do so at date-of-death value. The transferor will be out the cost of creating the FLP, and the estate will be out the cost of a post-death controversy with the IRS, as well as penalties and interest.



There is a less risky alternative to an FLP. Rather than transferring all or nearly all of his or her assets to an FLP and risking inclusion of those assets in his or her gross estate at date-of-death value due to alleged rights retained with respect to the FLP, a transferor could instead transfer discrete interests in property that he she does not need, retaining no rights of enjoyment or income in the transferred property. The transferor could avoid gift tax on such transfers by virtue of the $1,000,000 lifetime exclusion of IRC § 2505(a)(1) or the per-donee annual exclusion of IRC § 2503(b). The § 2503(b) annual exclusion is available to an unlimited number of donees. The per-donee annual exclusion currently is $12,000, and it doubles if the transferor is married and his or her spouse joins in the gift.

Gifts made by the transferor within three years before his or her death will return to his or her gross estate at date-of-death value.

Cash or marketable securities could qualify as such discrete property interests. So could an interest in a closely held business, provided that the transferor has nothing to do with the business after the transfer.

Of course, gifts made by the transferor within three years before his or her death will return to his or her gross estate at date-of-death value under IRC § 2035.

Congress could go a long way toward diffusing interest in FLPs if, as expected, it raises the IRC § 2010 estate tax unified credit to $5,000,000 per individual. Then, in a well-planned estate, a married couple could pass up to $10,000,000 in property to the next generation free of estate tax. ◆

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Footnotes

1. E.g., *Strangi v Comm'r,* 417 F3d 468, 96 AFTR 2d 2005-5230 (CA 5, 2005); *Estate of Abraham v Comm'r,* 408 F3d 26, 95 AFTR 2d 2005-2591 (CA 1, 2005); *Turner v Comm'r,* 94 AFTR 2d 2004-5764 (CA 3, 2004); *L. Rosen Estate,* TC Memo 2006-115; *Estate of W. Bongard,* 124 TC 95; *Estate of Morton B. Harper,* TC Memo 2002-121. But see *Kimbell v US,* 371 F3d 257, 93 AFTR 2d 2004-2400 (CA 5, 2004); *Estate of Eugene E. Stone, III,* TC Memo 2003-309.
2. TC Memo 2006-115 (2006).
3. E.g., *Strangi, supra; Estate of Abraham, supra; Turner v Comm'r, supra; L. Rosen Estate, supra; Estate of Wayne C. Bongard, supra; Estate of Morton B. Harper, supra.* But see *Kimbell v US, supra; Estate of Eugene E. Stone, III, supra.*
4. E.g., *Turner v Comm'r, supra; Strangi v Comm'r, supra; L. Rosen Estate, supra.*
5. E.g., *Estate of T. Tehan,* TC Memo 2005-128.