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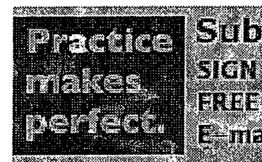

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Guest Article

As The FLP World Turns: The Latest Ruling In The Ongoing Saga

By Jeffrey A. Baskies Special to Lawyers Weekly US

On Sept. 1, the 3rd Circuit issued the latest ruling in the area of family limited partnerships. This time the Internal Revenue Service won.

If you have been following the rulings on FLPs these past couple of years and it seems like a tennis match at the U.S. Open (your head turning rapidly to the left and then to the right), that's because it has been. Every couple of months, so it seems, a new ruling comes down in an opposite direction.

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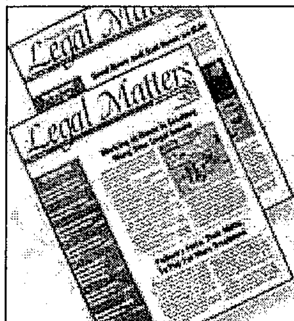

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This latest case is Estate of Thompson v. Commissioner (herein referred to as Thompson). (See "FLP Assets Must Be Included In Estate," Lawyers Weekly USA, Sept. 27, 2004. Search words for LWUSA Archives: Gertner and Theodore.)

Background

Procedurally, here's what happened.

In the early 1990s, the decedent and his family investigated estate planning options. Hopefully, that's not now a crime.

Then, in April 1993, they implemented a plan which included creating and funding FLPs, purchased through Fortress Financial Group - now that may be coming closer to a crime, as it was a Fortress plan that the IRS also challenged in the *Strangi* case. *Estate of Strangi v. Commissioner*, T.C. Memo 2003-145 (2003).

The decedent in *Thompson* contributed about $2.8 million in marketable securities, plus some notes receivable to two family limited partnerships, owning limited partnership interests. He also held an interest in the corporations that served as the general partners. One partnership was

formed with his daughter Betsy, and the other was formed with his son Robert.

In each case, the decedent's children contributed assets to the FLPs. In Betsy's case, her husband contributed a little cash ($1,000) and some Vermont property worth about $49,000. In Robert's case, he contributed mutual funds worth $372,000 and a ranch property in Colorado worth about $460,000.

Thus, in both cases, the family member partners made real and, in Robert's case substantial, contributions to the newly formed FLPs.

Other assets were subsequently added to the partnerships and some commercial activity took place in each, but the decision indicates that there was minimal real business activity.

The decedent died in May 1995 at age 97. On the form 706, the estate claimed a 40 percent discount for minority and lack of marketability discounts.

The IRS issued its notice of deficiency denying any discounts on the FLPs.

The estate filed in Tax Court, but the Tax Court held for the IRS.

Relying on Sect. 2036(a)(1), the Tax Court found an implied agreement "that decedent would retain lifetime enjoyment and economic benefit of the transferred assets."

Further, the Tax Court found: "In light of decedent's personal situation, the fact that the contributed property constituted the majority of decedent's assets, including nearly all of his investments, the establishment of the partnerships is far more consistent with an estate plan than with any sort of arm's-length joint enterprise between partners. In summary, we are satisfied that the partnerships were created principally as an alternate vehicle through which decedent would provide for his children at his death."

As a result, the Tax Court held this was not a transfer exempt from Sect. 2036 as it was not for adequate consideration, and thus all the transferred funds should be taxed in the decedent's estate.

The Decision

In affirming, the 3rd Circuit apparently latched onto a theory used by the Tax Court claiming that the transfer to the FLPs constituted a mere "recycling of value."

The 3rd Circuit stated that the basis for this theory came from an earlier tax court decision - namely *Estate of Harper v. Commissioner*, T.C. Memo 2002-121; 2002 Tax Ct. Memo LEXIS 127, 83 T.C.M. (CCH) 1641 (2002).

As the theory goes, a transfer such as those made to these FLPs did not really change the relationship the decedent had with his assets and merely created a vehicle to claim discounts. The argument was supported by some of the provisions in the FLPs (indeed added a year later), which allowed for the contributors of real property to retain all economic benefit from the property contributed. Thus both of the children retained all the economic benefits from the assets they contributed.

Further, the court noted that the assets in the FLPs were virtually all of those owned by the decedent. As we have seen in other cases (such as *Strangi*), contributing virtually all of one's assets to an FLP (or two) seems to be a very bad indicator of success. The court even noted the similarities to *Strangi*: "Similar to the facts at issue here, *Strangi* involved an inter vivos transfer of assets to a family limited partnership as part of a Fortress estate plan."

The court did recognize the recent decision of the 5th Circuit in *Kimbell v. United States*, 371 F.3d at 265 (2004), and agreed with *Kimbell*'s assertion that the mere fact that a transaction takes place with family members does not automatically negate the transaction from being a bona fide sale within the meaning of the exceptions to Sect. 2036.

However, the court still held that, "while a 'bona fide sale' does not necessarily require an 'arm's length transaction,' it still must be made in good faith. ... A 'good faith' transfer to a family limited partnership must provide the transferor some potential for benefit other than the potential estate tax advantages that might result from holding assets in the partnership form. Even when all the 'i's are dotted and t's are crossed,' a transaction motivated solely by tax planning and with 'no business or corporate purpose ... is nothing more than a contrivance.'"

To hold otherwise, the court said, "would be to 'exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.' ... As discussed in the context of 'adequate and full consideration,' objective indicia that the partnership operates a legitimate business may provide a sufficient factual basis for finding a good faith transfer. But if there is no discernable purpose or benefit for the transfer other than estate tax savings, the sale is not 'bona fide' within the meaning of Sect. 2036."

After a "thorough review of the record," the 3rd Circuit "agree[d] with the Tax Court that decedent's inter vivos transfers do not qualify for the Sect. 2036(a) exception because neither the Thompson Partnership nor Turner Partnership conducted any legitimate business operations, nor provided decedent with any potential non-tax benefit from the transfers."

Once Again, Bad Facts Create Bad Decisions

After reading the opinion, it does not seem to be adding novel law.

Thompson seems to say that a transfer must be in good faith, but that always was a requirement. Further, *Thompson* seems to pick up on another "bad facts" case and make law from it.

The logic of the decision seems to be stemming from the rather absurdity of the facts presented. And that's not a good way to make good law.

In this case, as in several others where the IRS won, the decedent was near death already (95 years old and died within about 2 years). In this case, the decedent put virtually all of his assets into the FLPs (we can all agree that's a damaging fact). In *Thompson*, the manner in which the partnerships were created to allow the contributors to benefit from their investments without sharing the profits must have been a really damaging fact. How could the estate argue with a straight face that there was business integrity to the FLP?

Thus, it appears once again, that we have a case where bad facts lead to bad decisions that may or may not lead to bad laws. With the 5th and 3rd circuits split on whether contributions to FLPs meet the bona fide sale exceptions to Sect. 2036 and with a decision in *Strangi* still waiting in the wings, discount planning with FLPs is far from dead.

However, as discussed in the past, take notice and heed from the decisions that have come out. If you have clients considering FLPs, beware of a few things:

1. Do not let them adopt a plan from Fortress Financial Group. Your clients don't want to have the IRS, the Tax Court and now even the federal circuit courts already being predisposed against their "packaged" plan.

2. Beware of creating FLPs with very elderly clients near death.

3. Do not let your clients put all of their assets into FLPs. This is a sure-fire miscalculation.

Clients should also be wary of putting personal residences in.

4. Do not let your clients receive preferential distributions from the FLPs to make gifts or to pay for living expenses. The more the FLP is part of their personal necessities of life, the less likely it is to be upheld.

5. Adding non-marketable securities investments to FLPs should help. Having investment properties that are managed and sold, having ranch property that is developed or income producing, or having similar investments should help. But, in *Thompson*, the way the FLP was designed, negated the positive effects of having real property in the FLPs. So be wary of designing FLPs to be "too cute" by allowing investments to be made into the FLPs without any real substance - such as the case here where the contributors got all the economic benefits from the assets they contributed. That sort of provision negates the joint venture of the FLP.

Ultimately, this case is another reminder that not all FLPs will work to get discounts. But it should also be a reminder, that some might still be successful.

What will happen next? Stay tuned, as this really has shaped up to be the most interesting estate planning soap opera of the past decade.

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