



FLP Battle Lines Materialize

By Robert L. Moshman

There has been a mixed bag of cases for taxpayers in family limited partnership (FLP) cases, but there are several reasons to conclude that the FLP glass remains more than half full. FLPs have significant non-tax benefits.¹ Most FLPs continue to provide significant valuation discounts. And even recent losses in Tax Court have identified errors that good draftsmen can now avoid. There are now clear battle lines for the next judicial showdown.

How will FLPs play out in the foreseeable future? Recent cases such as Harper, McCord, Hillgren, and Abraham, may reveal judicial thinking. But the most significant FLP decisions (including Strangi part 3) are still to follow. Let's take this opportunity to take stock of where the FLP is right now and how it may be impacted by forthcoming decisions.

A Change in Strategy

Family limited partnerships have been around for many years. Arguably the most notable and successful FLP of all time was drafted in 1953. That agreement made it possible for Sam Walton to transfer a \$25-billion estate to his widow and children without any estate tax. However, the Walton FLP generated tax benefits primarily by transferring assets out of the founder's gross estate early on. This kept the vast appreciation of those assets out of the Walton estate when Wal-Mart later expanded and became the nation's largest retailer.²

That's using the FLP as a long-term planning tool that relocated assets before they appreciated and let the passage of time do the rest. But if you have the foresight to plan anything 30 years ahead of time, you can have a fair degree of success.

By comparison, the modern wave of FLPs is being used to recharacterize assets when the owner has little time left to plan. Perhaps the seminal case was the 1987 case of Harrison, in which an incompetent testator's family, using powers of attorney, set up a limited partnership with \$59 million of assets. Presto chango, the assets were worth \$33 million. This means \$26 million of assets were just vaporized.³

The Winning Streak

Would the Courts tolerate this financial alchemy? Estate planners got their reassurances about FLP over time. It may only be a matter of perception, but it seemed as though FLPs did not become such a popular estate-planning tool until the late 1990s. There may be several reasons for this. Other estate-planning tools were being restricted, one by one. But the winning streak of FLP cases seemed to send FLPs directly into the front lines of estate planning.

It was irresistible. A client who had otherwise failed to plan an estate could nevertheless engage in a last-minute rearrangement of assets and have the valuation of assets discounted by 50%!

In Strangi, assets were transferred just 62 days before the plaintiff's death. In that case, Albert Strangi exchanged \$10 million of assets, consisting mostly of cash and marketable securities, for a 99% limited partnership interest in an FLP. A corporation held the 1% general partnership interest. Decedent also owned a 47% share of the corporation that held the general partnership interest.



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Despite IRS arguments that the FLP lacked any business purpose, a majority of the Tax Court placed great emphasis on the fact that the FLP was valid under state law (Texas), and therefore was enforceable with respect to the relationships between heirs and potential creditors. The FLP was found to have economic substance; §2703 was found to be inapplicable; the formation of the FLP did not constitute a taxable gift.

The bottom line: The FLP qualified for a 31% valuation discount, effectively transforming \$10 million into \$6.9 million for estate tax purposes. Not a bad result considering that it was accomplished 62 days prior to death and that Decedent retained 99.47% ownership of relatively liquid assets.⁴

Obviously, cases like these have provided the estate-planning community with great motivation. In *Estate of Church*, an FLP was upheld despite being formed only two days before the plaintiff's death. And in *Estate of Knight*, taxpayers prevailed with an FLP that kept no records and had no activities. The Tax Court again rejected IRS arguments about the lack of economic substance and found that the transfers were of partnership interests and not of the underlying assets. It was as if all the traffic lights had turned green for FLPs.⁵

Achilles' Heels Emerge

Apart from the strategic-planning questions about whether an estate is large enough to benefit from an FLP or whether changes in federal estate tax, state death taxes, and capital gains implications continue to warrant an FLP approach in a given estate, there are also limits to what types of FLP arrangements Courts will tolerate.⁶

In *Harper Estate*, the Court remarked on the "indifference by those involved toward the formal structure of the partnership arrangement." That, plus the decedent's retention of benefits from partnership assets and the commingling of personal and partnership funds, led the Tax Court to affirm the IRS in including such assets in the decedent's gross estate.⁷

Inappropriate Funding: One of the most recent FLP cases involved the unfortunate case of an individual who won a \$17-million lottery but died after receiving only the first of 20 scheduled payments. The remaining 19 payments were held by a family limited trust. The issue was whether their value should be discounted because of their inclusion in the trust. Citing the case of *Gribauecas v. U.S.*, 116 T.C. 142 (2001), it was found that the 19 payments were capable of being valued as an annuity using the tables in Reg. §2031-7. *Cook Estate Tax Court* (2001).⁸

Design Defects: In *Estate of Jones*, 116 T.C. 121 (2001), for example, an FLP allowed the plaintiff to liquidate the FLP interest. This design defect reduced the available discount to 8%. In *Shepherd*, the donor signed the deed transferring land to the partnership and executed the partnership agreement simultaneously but his sons failed to sign the partnership agreement until the following day, causing the transfer of land to be deemed an indirect gift.⁹

Operational Defects: Even a properly drafted FLP may be operated in a manner that undermines the existence of a bona fide FLP. For example, after an FLP is established and funded, the partners



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may make the mistake of commingling personal and FLP assets. Plaintiffs who wish to prevail should be documenting their respect for the partnership as a separate entity.

Illusory Transfers: Decedent transferred 30.4% limited partnership interests to each of his two children without a bona fide sale and with the "understanding" that he would be able to continue using property that had been transferred to the limited partnership. The FLP assets were included in Decedent's gross estate. *Reichardt v. Comm'r.* Similarly, in *Estate of Godley*, it was concluded that no minority discount applied where options to purchase the decedent's partnership interests did not affect the contractual stream of income or the decedent's control. The IRS has also addressed what it considered "sham transactions" in a number of Tax Advisory Memoranda.¹⁰

New Arrivals

The family limited partnership that enjoyed such a winning streak in the courts has struggled through a more recent series of losses in various courts. In, *McCord v. Comm'r.*, a limited partnership was formed by spouses, their four sons, and another partnership. The spouses made a significant transfer worth more than \$7 million to the FLP.

A majority of the Tax Court found that agreement only transferred economic interests since the partnership had not consented to the admission of additional partners. The Court applied a 15% minority interest discount and a 20% lack of marketability discount. However, a majority of the Tax Court saw transfers to a limited partnership as gifts and limited the available discounts.¹¹ Then the earlier taxpayer victory in *Strangi* began to unravel. The United States Court of Appeals for the Fifth Circuit permitted the IRS to amend its claim and argue that assets transferred to the FLP were includible in the decedent's gross estate under §2036. Upon remand, the IRS has now prevailed. The transferred assets were included in the Decedent's gross estate under §2036(a) because he retained the right to designate who benefited.¹²

Additional inroads against FLPs arrived in other cases throughout 2003. In *Lappo*, extensive analysis of discounts resulted in relatively modest adjustment of 8.5% minority discount for publicly traded securities, and a 24% discount for marketability. *Peracchio*, also involved a showdown over the size of discounts with a similar result.¹³

In, *Thompson*, a Decedent formed FLPs two years before his death and contributed \$2.8 million of assets. His estate valued the FLP assets at \$1.7 million based on a 40% discount for a minority interest and lack of marketability. The IRS valued the FLPs at \$3.1 million and assessed a \$707,054 estate tax deficiency. On the one hand, the Tax Court said the FLPs had sufficient substance for tax purposes and that they were validly created under State law (Florida). The Court even noted that potential purchasers of the decedent's assets would have to respect that. However, the circumstances of the transfer led the Court to conclude that there was an implied agreement that the decedent would retain the enjoyment and economic benefit of the contributed property during his lifetime. Rather than being motivated by business concerns, the FLP transfers were simply a means of implementing the Decedent's estate plan. The FLP assets had to be included in the decedent's gross estate under §2036(a)(1) based on their fair market value as of the date of death.¹⁴



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Similarly, in *Kimbell*, a 96-year-old woman created a partnership two months before her death. She placed her 99% limited partnership interest in a revocable living trust held while retaining half of an LLC which held the other 1% interest as general partner. Upon the woman's death, her son valued her estate at \$1,257,000. The IRS valued the estate at \$2,463,000. By retaining the power to remove the LLC as general partner, the women retained interests in the property.¹⁵

There have also been bright spots for taxpayers. In *Stone*, for example, a couple transferred assets to five separate family limited partnerships—one for each child and one for the father. In return the couple received partnership interests. At the father's death, his FLP interests were transferred to his wife's qualified terminable interest trust (QTIP). At her death, the IRS concluded that assets transferred to the FLPs were includible in both estates.

Rejecting this conclusion, the Tax Court noted the investment and business concerns related to the management of the assets. These were bona fide sales for adequate and full consideration [satisfying §2036(a)], so the transferred assets were not included in the couple's gross estates. The case of *Harper v. Comm'r.*, T.C. Memo. 2002-121, was distinguished. Since the FLP assets were not includible in the husband's estate, they never reached the wife's QTIP either.¹⁶

The Latest Battles

In *Hillgren*, a brother and sister invested in real estate together. Due to the sister's problems, the brother helped manage her affairs. Toward the end of the sister's life, brother formed an FLP with her that was ultimately ruled inadequate under §2036(a). FLP assets were being used to support the sister. There was no FLP entity for tax purposes.

The significance of *Hillgren* is that the same estate still managed to qualify for discounts ranging from 35% to 50% on 4 of the sister's 7 property interests. These discounts were based on the existence of a valid business loan agreement (BLA) which was not superseded by FLP. The discount was based on what a hypothetical buyer of the assets would pay to acquire those assets from the sister's estate. This juxtaposition of techniques drives home the conclusion that where the FLP is being used to seek valuation discounts, there are alternatives (such as the BLA) which are valid and enforceable and which will limit the transferability of assets sufficiently to qualify for discounts.¹⁷

In *Estate of Abraham*, §2036(a) was once again the focal point of the IRS argument and the Court bought into the theory once again. An Alzheimer's patient was declared incompetent and her guardians received court approval to make gifts of assets not needed for her support. The IRS wanted FLP assets included in the woman's estate based on the "implied agreement" to have support continue. Testimony of the woman's children that "nothing was to change," helped convince the Court that there was an implied agreement. The Court concluded that the decedent's plan was simply a "testamentary vehicle employed to shift her assets to future generations while maintaining her continued right to benefit from the FLP interests transferred."

Consider where the battle lines have moved. In the earlier cases, the battle was on the formation of a valid FLP, after which Courts stepped back with respect. Now, the battle lines have shifted. An



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implied agreement approach invites Courts to make subjective evaluations of motives. Even court-approved gifts in the context of a conservatorship are ascribed with testamentary motives. When decisions turn on what plaintiffs have "implied," the outcome of cases becomes far less predictable.¹⁸

Looking Ahead

As this article is being prepared, the 5th Circuit is expected to rule on an appeal in Kimbell, the 5th Circuit court of Appeals will also revisit Strangi II and in the 3rd Circuit will address Thompson. We will continue watching how the next round of cases influences these ongoing battles.

TECHNICAL REFERENCES

¹ Moshman, "Estate Planning With FLPs", *The Estate Analyst* (March, 1999).

² Moshman, "The Walton FLP Estate", *The Estate Analyst*, p. 4 (March, 1999).

³ *Harrison v. Comm'r.*, 52 T.C. Memo. 1306 (1987).

⁴ *Strangi Estate*, 115 T.C. 478 (2000).

⁵ *Estate of Church*, DC Tex, 2000-1 USTC (Jan., 2000); aff'd, CA-5, 2001-2; Ct of Appeals (2001); *Knight v. Comm'r.*, 115 T.C 506 (2000). See also, *Kerr v. Comm'r.*, 113 T.C. 450 (1999).

⁶ Moshman, "How Not To FLP", *The Estate Analyst* (July, 2002); Moshman, "An Achilles' Heel for FLPs", *The Estate Analyst* (Oct., 2001). This publication has continued to warn of the inherent limitations of FLPs and other arrangements that are too good to be true. Aside from pitfalls illustrated in court cases, there is the general observation that anything too good to be true won't last. When the IRS starts losing the game, Congress will just rewrite the rules. Another useful reference on point is Leimberg's *Estate Planning Newsletter* #651 at <http://www.leimbergservices.com> in which attorney Steven Akers provides a checklist of what not to do.

⁷ *Harper Est.*, T.C. Memo. 2002-121 (May, 2002).

⁸ *Gribauscas v. U.S.*, 116 T.C. 142 (2001); *Cook Estate*, T.C. (2001).

⁹ *Estate of Jones*, 116 T.C. 121 (2001); and *Shepherd v. Comm'r.*, 115 T.C. 376, (2000), aff'd 11th Cir. 2002-1 (2002).

¹⁰ *Estate of Reichardt v. Comm'r.*, 114 T.C. 144, 151 (2000); Reg. Sec. 20.2036-1(a); *Estate of Godley v. Comm'r.*, 2002-1 USTC , 4th Circuit Court of Appeals, (April, 2002). For IRS discussion of "sham transactions," see TAMs 9719006, 9730004, 9725002, and 9723009.

¹¹ *McCord v. Comm'r.*, 120 T.C. 13 (May, 2003).



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¹² *Estate of Strangi*, Court of Appeals, 5th Cir., USTC 2002-2, No. 01-60538 (June, 2002); *Estate of Strangi*, ("Strangi II") T.C. Memo. 203-145 (May, 2003).

¹³ *Lappo v. Comm'r.*, T.C. Memo. 2003-258 (Sept., 2003); and *Peracchio v. Comm'r.*, T.C. Memo. 2003-280 (Sept., 2003).

¹⁴ *Estate of Thompson v. Comm'r.*, T.C. Memo. 2002-246, 84 T.C. Memo. 374 (Sept., 2002).

¹⁵ *Kimbell v. United States*, 2003 U.S. Dist. LEXIS 523 (N.D. Tex. Jan., 2003).

¹⁶ *Stone v. Comm'r.*, T.C. Memo. 2003-309 (2003).

¹⁷ *Estate of Hillgren v. Comm'r.*, T.C. Memo. 2004-46 (March, 2004).

¹⁸ *Estate of Abraham v. Comm'r.*, T.C. Memo. 2004-39 (Feb., 2004). *Leimberg Estate Planning Newsletter #644* discusses Abraham and provides a 20-question FLP success checklist.

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