



Estate Planning: The Family Limited Partnership

BY DAVID M. FOGEL, EA, CPA

For decades, estate planning attorneys have used the family limited partnership as an effective tool for estate planning and the reduction of gift and/or estate taxes. However, its effectiveness has been eroded by several recent court cases where taxpayers made errors in either forming or operating the partnership. This article discusses the benefits of using a family limited partnership as part of an estate plan, and the pitfalls to avoid in forming and operating such a partnership in light of the recent court cases.

Introduction

A family limited partnership (“FLP”) is a limited partnership established under state law in which all of the partners are members of a family. The partnership is created for both tax and non-tax purposes as part of an overall estate plan.

The tax benefits are well-publicized: a substantial savings in Federal and California estate taxes can result. The non-tax benefits are not so well known: the management of the family’s assets becomes more centralized, restrictions are placed on the transfer of partnership interests ensuring that the assets remain in the family, the FLP facilitates the gifting of limited partnership interests to other family members, and the FLP entity provides some protection from claims of creditors, and from claims of spouses in the event of a divorce.

Illustration — How an FLP Saves Estate Taxes

The following hypothetical situation will illustrate the estate tax savings that may result from establishing such an FLP. Suppose a widower and his three sons run the family business, a small winery with 1,000 acres of vineyards in the California Central Valley. The father is 70, and his three sons are 37, 40 and 42 years of age. The father’s assets consist of a residence worth \$300,000, cash of \$500,000, and stocks and bonds worth \$1,500,000. The winery and vineyards have a fair market value of \$2,000,000. In his will, the father leaves all of his assets to his sons.

Altogether, the father’s estate has a fair market value of \$4,300,000, which means that his sons will owe a substantial amount of estate tax upon his death. For decedents who die in 2004, a taxable estate of \$4,300,000 will owe \$1,329,000 in combined Federal and California estate taxes.

The father and his sons decide to form an FLP. The father transfers the assets of the winery business, the stocks and bonds, and \$200,000 cash to the FLP in exchange for a 1% general partnership interest and a 91.5% limited partnership interest. Each of the three sons transfers \$100,000 to the partnership in exchange for a 1% general partnership interest and a 1.5% limited partnership interest. The following table illustrates the assets transferred to the FLP and the ownership of the FLP:

Assets Transferred to Partnership	Fair Market Value	Percentage of Total Assets	General Partnership Interest	Limited Partnership Interest	Total Partnership Interest
Father:					
Winery Business	\$2,000,000				
Stocks and Bonds	1,500,000	92.5%	1.0%	91.5%	92.5%
Cash	200,000				
Son #1: Cash	100,000	2.5%	1.0%	1.5%	2.5%
Son #2: Cash	100,000	2.5%	1.0%	1.5%	2.5%
Son #3: Cash	100,000	2.5%	1.0%	1.5%	2.5%
Totals	\$4,000,000	100.0%	4.0%	96.0%	100.0%

All of the required papers are executed and/or filed to form the partnership and transfer assets into the partnership (e.g. limited partnership agreement, assignments of assets, deeds, certificate of limited partnership).

During each of the next three years, the father sells a 10% limited partnership interest to each son¹. An appraisal is obtained from a qualified appraiser in each year to establish the fair market value of each 10% limited partnership interest sold. Assume that each 10% limited partnership interest has a fair market value of \$300,000². In exchange for the purchase price, each son gives the father a \$300,000 promissory note. At the end of three years, the father has decreased his limited partnership ownership by 90%, and each son has increased his limited partnership ownership by 30%. The ownership of the partnership is therefore as follows:

Partner	General Partnership Interest	Limited Partnership Interest	Total Partnership Interest
Father	1.0%	1.5%	2.5%
Son #1	1.0%	31.5%	32.5%
Son #2	1.0%	31.5%	32.5%
Son #3	1.0%	31.5%	32.5%
Totals	4.0%	96.0%	100.0%

At the end of three years, the father owns the residence, \$300,000 cash, a 1% general partnership interest, a 2.5% limited partnership interest, and nine promissory notes, each with a face amount of \$300,000. The father dies two years later. Appraisals are obtained to establish the date-of-death values of the residence, the partnership interests and each of the nine promissory notes. Assume that the appraisals value the residence at \$300,000, the 1% general partnership interest at \$35,000, the 2.5% limited partnership interest at \$65,000, and each of the nine promissory notes at \$200,000³. As shown in the following table, the father’s total estate is worth \$2,500,000.

Asset	Fair Market Value
Residence	\$300,000
Cash	300,000
1% General Partnership Interest	35,000
2.5% Limited Partnership Interest	65,000
9 Promissory Notes	1,800,000
Total Value of Estate	\$2,500,000

The combined Federal and California estate tax is \$465,000⁴. Through the creation of the FLP, the sons have saved a total of \$864,000 in Federal and California estate tax.

What Happened? How Did The Estate Tax Savings Occur?

The \$864,000 estate tax savings resulted from *valuation discounts*.

It is well settled that fair market value is the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts⁵.

When determining the fair market value of a partnership interest for estate tax purposes, an appraiser may apply discounts to reflect the partner’s lack of control over the partnership (known as “minority interest”) and the inability to sell the partnership interest in the marketplace (known as “lack of marketability”). The courts have commonly allowed such discounts in the 15% to 50% range, depending upon the types of assets held by the partnership, the rights of the partners, restrictions in the partnership agreement concerning the transferability of partnership interests, and other factors. Also, a promissory note is often valued at less than its face value (or unpaid balance) after considering several factors such as a comparison of the note’s interest rate to current market rates, the term of the note, the value of collateral (if any) that secures the note, and the credit worthiness of the debtor.

In an effort to reduce the estate tax savings achieved through use of an FLP, the IRS began to scrutinize any estate tax return that reported an interest in an FLP. The IRS announced that the amount of discount taken in valuing the partnership interest would be an Appeals Coordinated Issue⁶.

Court Cases

Over the past several years, the IRS has litigated several cases where the estate included an interest in an FLP. As explained below, the IRS has not been very successful in this endeavor until recently. Here is a brief history of this litigation.

Initially, the IRS argued that the FLP should be disregarded because it had no business purpose or economic substance and was simply a substitute for a testamentary device. The IRS argued that the FLP was formed solely for tax avoidance purposes so that assets in the estate could be valued at less than fair market value. The courts rejected this argument and held that if the FLP was properly formed under state law, it must be recognized as a valid entity for Federal tax purposes even if it had no business purpose⁷.

Next the IRS argued that a gift resulted upon formation of the FLP because after the assets were transferred to the FLP, the fair market value of the partnership interests, in the aggregate, after applying the appropriate discounts, is less than the fair market value of the assets immediately before the transfer, thus the decrease in value must be a gift. The courts rejected this argument because in transferring assets to the FLP, taxpayers had no gratuitous donative intent⁸.

Next, the IRS used an argument based on Section 2703(a)(2). This section provides that in valuing property for estate and gift tax purposes, any restriction on the right to sell or use the property shall be disregarded. The IRS argued that since the partnership agreement placed restrictions on the sale or transfer of partnership interests, the fair market value of the decedent’s interest in the FLP should be based on the values of the assets of the FLP, disregarding any discounts. The courts rejected this argument because the restrictions on the sale or assignment of a partnership interest are created by state law, and are not the types of restrictions Congress intended to reach in enacting Section 2703⁹.

Next, the IRS crafted an argument under Section 2704(b). Section 2704(b) provides another set of rules for disregarding a restriction in valuing an interest in a corporation or a partnership under certain circumstances. Rather than go into the details of this section and the arguments involved, it is sufficient to say that the courts rejected this argument as well¹⁰.


Lastly, the IRS made an argument based on Section 2036(a), and this argument has had some success. In essence, Section 2036(a) operates to include in the gross estate any property that the decedent transferred during his lifetime if he retained an interest in the property or the income from it. The section states that if the decedent, at any time during his life, made a transfer of property that was not a bona fide sale for adequate and full consideration, and retained an interest in that property (either the possession, enjoyment, or right to the income from the property), or retained the right to designate who could possess or enjoy the property or its income (either alone or in conjunction with another person), then the property is included in his gross estate. What this section does in the context of an FLP is to disregard the decedent’s transfer of assets to the FLP.

Whether Section 2036(a) applies depends upon the facts and circumstances involved in forming and operating the FLP. The IRS has been successful in using Section 2036(a) in six cases¹¹, and unsuccessful in two cases¹². As a result of taxpayer losses in this area, numerous commentators have offered the following suggestions for avoiding the Section 2036(a) problem:

- In forming the FLP, make sure that the partners receive partnership interests that are proportionate to the fair market value of property that they contribute.
- There should be non-tax or business reasons for forming the FLP, and such reasons should be cited in the partnership agreement.
 - If possible, when forming the FLP, each partner should be represented by counsel, and there should be arm’s length negotiations of the terms of the partnership agreement.
 - Personal assets, such as a principal residence, should not be transferred into the FLP, and if possible, the FLP should operate a bona fide business.

- The main transferor (e.g. father) should not transfer to the FLP assets that he needs to maintain his usual style of living. In addition, he should not depend upon future distributions from the FLP to meet those needs.
- In operating the FLP, the formalities of the partnership structure should be respected. The partnership should have a separate bank account, assets should be titled in the name of the partnership, state law requirements should be met, the provisions of the partnership agreement should be followed, and the partnership should file income tax returns.
- Any distributions to the partners should be made in accordance with the partners' capital account balances (*i.e.*, pro rata).

Conclusion

Using an FLP as part of an overall estate plan is still a viable alternative. However, care needs to be taken in establishing the FLP, in drawing up the proper documents, and in operating the FLP. Clients who wish to explore the idea of forming an FLP should consult with an experienced estate planning attorney to make sure that they form and operate the FLP correctly. 

David M. Fogel, EA, CPA is a non-attorney tax advisor for the Sacramento law firm of McDonough Holland & Allen PC and a regular contributor to California Enrolled Agent. He assists in resolving clients' tax disputes and providing tax research support for transactional planning, mostly in the estate planning area. David spent more than 26 years working for the IRS – 8 years as a Tax Auditor and Revenue Agent, and 18 years as an Appeals Officer. David is an Enrolled Agent, a CPA, and is also admitted to practice before the United States Tax Court, having passed the Court's examination for non-attorneys. He can be reached at dfogel@mhalaw.com.

¹ This will cause reassessment of the real property in the partnership for real estate tax purposes because more than 50% of the ownership will have changed.

² The 25% discount used in this example is for illustration purposes only and does not necessarily reflect the discount that an appraiser or the IRS may allow.

³ See footnote 2.

⁴ For purposes of this example and for comparison purposes,

it is assumed that the estate tax rates in the year of death are the same as the rates for a person who dies in 2004.

⁵ Treas. Reg. §§20.2031-1(b) and 25.2512-1.

⁶ See section 8.7.3.11.12.4 of the Internal Revenue Manual. An Appeals Coordinated Issue (ACI) is an issue or category of case that has an impact or importance within the IRS to require coordination to ensure uniformity and consistency nationwide. This is achieved through the coordination of efforts between appeals officers and designated ACI coordinating officials.

⁷ *Kerr v. Commissioner*, 113 T.C. 449 (1999); *Estate of Knight v. Commissioner*, 115 T.C. 506, 513-515 (2000); *Estate of Strangi v. Commissioner*, 115 T.C. 478, 487 (2000); *Estate of Harper v. Commissioner*, T.C. Memo. 2000-202; *Estate of Jones v. Commissioner*, 116 T.C. 121 (2001); and *Estate of Dailey*, T.C. Memo. 2001-263.

⁸ *Estate of Church v. United States*, No. SA-97-CA-0774-OG, 2000-1 USTC (CCH) ¶60,369, 85 AFTR 2d (RIA) 2000-804 (W.D. Tex. 2000), *aff'd. per curiam under unpublished rules*, 2001-2 USTC (CCH) ¶60,415, 88 AFTR 2d (RIA) ¶2001-5142 (5th Cir. 2001); *Estate of Jones v. Commissioner*, *supra*.

⁹ *Estate of Church v. United States*, *supra*; *Estate of Strangi v. Commissioner*, *supra*.

¹⁰ *Kerr v. Commissioner*, *supra*; *Estate of Jones v. Commissioner*, *supra*.

¹¹ *Estate of Schauerhamer v. Commissioner*, T.C. Memo 1997-242; *Estate of Reichardt v. Commissioner*, 114 T.C. 144 (2000); *Estate of Harper v. Commissioner*, T.C. Memo. 2002-121; *Estate of Thompson v. Commissioner*, T.C. Memo. 2002-246, *aff'd by Turner v. Commissioner*, 382 F.3d 367, 2004-2 USTC (CCH) ¶60,489, 94 AFTR 2d (RIA) 2004-5763 (3rd Cir. 2004); *Estate of Strangi v. Commissioner*, 115 T.C. 478 (2000), *aff'd in part, rev'd and rem'd in part* 293 F.3d 279, 2002-2 USTC (CCH) ¶60,441, 89 AFTR 2d (RIA) ¶2002-2977 (5th Cir. 2002), *on remand* T.C. Memo. 2003-145, (taxpayer currently on appeal to 5th Cir.); and *Estate of Abraham v. Commissioner*, T.C. Memo. 2004-39 (taxpayer currently on appeal to 1st Cir.).

¹² *Estate of Kimbell v. United States*, 244 F.Supp.2d 700, 2003-1 USTC (CCH) ¶60,455, 91 AFTR 2d (RIA) ¶2003-585 (N.D. Tex. 2003), *vacated and remanded* 371 F.3d 257, 2004-1 USTC (CCH) ¶60,486, 93 AFTR 2d (RIA) 2004-2400 (5th Cir. 2004); and *Estate of Stone v. Commissioner*, T.C. Memo. 2003-309.