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The Care and Feeding of Family Limited Partnerships

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Introduction

Of all the techniques commonly used by estate planners, perhaps none is more subject to IRS scrutiny and challenge than the family limited partnership (FLP). Over the years, the IRS has attacked the FLP using a variety of arguments, all intended to "look through" the partnership to tax the full value of the underlying assets: that FLPs lack economic substance (or a valid nontax business purpose); that one or another of the special valuation rules of chapter 14 applies to the formation or existence of FLPs; that the "string" provisions of section 2036 apply to a retained partnership interest held by the principal contributing partner; that the formation of an FLP in and of itself constitutes a taxable gift; and that the valuation discounts claimed by taxpayers for FLP interests are not supportable by economic analysis.[i]

For a number of years, most of those arguments -- particularly the first two -- fell on deaf ears in the courts, except under the most egregious facts.[ii] However, the opinion of the Tax Court in the Strangi case on remand from the Fifth Circuit[iii] set the planning world on its ear. In that opinion (Strangi II), Judge Cohen appeared not only to agree with the IRS's assessment that the facts of the case justified inclusion of the partnership assets at their full value in the decedent's estate, but also to adopt the view that any right or ability to receive distributions of partnership income, or any retained power to vote a partnership interest, could potentially cause inclusion of the partnership assets in the estate of the transferor under section 2036(a)(2), even in a nonabusive case.[iv]

The profession heaved a collective sigh of relief when subsequent cases appeared to retreat from that novel interpretation of the law.[v] However, those cases do not entirely put to rest the fears raised by Strangi II. Although the Kimbell opinion in particular clearly indicates that retaining some ability to vote on partnership matters, including distributions, is not in and of itself sufficient to cause estate tax inclusion of the partnership assets under section 2036(a)(2), just how much retained control is permissible remains an open question.[vi] Moreover, those cases seem to signal a new willingness on the part of the courts, perhaps especially the Tax Court,[vii] to scrutinize the bona fides of the FLP beyond its validity as an entity under state law. Taken collectively, those cases serve as notice to the practitioner that an FLP must be conducted in a businesslike manner and that it must have valid reasons for its existence beyond the creation of a discount for transfer tax purposes.

This article examines some of the implications of the recent case law and of the requirement that an FLP have a valid business purpose. The "business purpose" requirement -- for so it can fairly be called -- raises implications, both tax and nontax, that the practitioner should address at the outset. Second, this article examines the management question in light of the developing state of the law. Finally, it examines some of the issues, particularly income tax issues, raised by the operation of the FLP. Although in my opinion the FLP continues to be a valid planning strategy, the practitioner must be more cognizant than ever of the need to respect the entity and of the implications -- beyond

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the federal wealth transfer tax consequences -- of establishing and maintaining the entity.

'Business Purpose'

One conclusion that can be drawn from the recent cases is that the courts now are likely to pay closer attention to the business (that is, nontax) purposes of the partnership. In Stone, for example, the partnerships at issue were formed to resolve a serious and costly family dispute by segregating ownership of family business assets among the Stone children.[viii] In Kimbell, the court quoted at length the recitations in the partnership agreement regarding business purpose. It also cited several cases, including Stone, involving partnerships formed for bona fide business purposes, before concluding that the decedent had received adequate and full consideration for the assets she had transferred to the partnership and thus the partnership assets were not includable in her estate under section 2036.[ix] In evaluating the bona fides of the transaction, the court gave weight to the fact that Kimbell had transferred to the partnership working oil and gas interests that required active management and involved liability issues best minimized by use of a partnership. Likewise, the Bongard court paid particular attention to the ostensible motivating factor behind the creation of the family limited liability company whose existence was respected for estate tax purposes, namely the need to attract outside investment.[x]

Thus, while a "business purpose" apart from, say, management of investments may not be a sine qua non of a successful family partnership,[xi] at minimum it is safe to conclude that a genuine business reason for the formation of the partnership -- in the words of the Tax Court, a "legitimate and significant nontax reason for creating the family limited partnership"[xii] -- supports the bona fide nature of the transaction. In the wake of Strangi II, most commentators seem to agree that personal use assets such as a residence should not be contributed to a family partnership. However, in light of Stone and Kimbell, it seems advisable to contribute assets that require active management and that involve risks that are best minimized through ownership in an entity that limits liability, such as a limited partnership or LLC.[xiii] A prime example of such an asset might be rent-producing real property. The contribution of that property to a partnership does raise income tax concerns discussed below, particularly regarding distributions of other partnership assets, especially marketable securities, and careful consideration must be given to those issues. In spite of those concerns, though, and given the potential transfer tax consequences of the failure of the partnership strategy, serious consideration should be given to contributing those assets, if available, to the partnership.

Given the multiplicity of family situations and assets, perhaps the most useful conclusion to be drawn from the recent cases is that a partnership must be drafted to fit the circumstances. Nearly every family situation offers a variety of genuine, nontax reasons for establishing a family partnership; in addition to the presence of assets requiring active management, there may be concerns with creditors, spouses, or ex-spouses; potential or actual family disputes; or economies of scale that are best addressed through use of the partnership form. Practitioners should not rely on a typical list of business purposes in drafting a partnership agreement, but instead should draft carefully to fit the particular circumstances. Perhaps more importantly, the management of the partnership must be structured and conducted appropriately. As in virtually every other aspect of wealth transfer planning, a one-size-fits-all approach to partnership planning and structure is simply inadequate, especially in the current legal climate.

Management

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Strangi raised significant concerns among practitioners that the partnership structure as a planning device was, if not dead, at least significantly reduced in applicability. Taken to its logical conclusion, the Strangi II dicta would seem to indicate that if the contributing partner retained any measure of control over the partnership, even as a limited partner, or retained any ability to receive partnership distributions, even in the complete discretion of others, the partnership assets would be includable in the contributing partner's estate at their full value under section 2036(a)(2). Thus, the partnership would be respected for transfer tax purposes only in the rare circumstance in which the contributing partner retained no ownership in or control over the partnership, but transferred all of his or her interest therein to others.

That analysis runs counter to the experience of practitioners in many other aspects of wealth transfer planning. For example, suppose a senior family member gives a controlling interest in a closely held corporation to his children, retaining only a minority interest with no special voting rights. As a minority shareholder, the senior family member is entitled to vote his shares and to receive distributions from the corporation as and when determined by the majority, but exercises no control over the corporation except in conjunction with the other shareholders. In those circumstances, it is almost unimaginable that the IRS would assert that the full value of the corporation's assets were includable in the senior family member's estate under section 2036(a)(2). But that is precisely the result that the Strangi II dicta, taken to their logical conclusion, would produce.

Thankfully, the Kimbell decision seems to have laid such concerns to rest, at least for the moment. Although the Kimbell court concluded that the decedent's transfer of assets to the partnership in exchange for partnership interests was a bona fide sale for adequate and full consideration, and thus there was no need to proceed to the section 2036(a)(2) analysis regarding the partnership, it applied that analysis to the decedent's transfer to the LLC general partner, in which she retained a 50 percent interest and no management powers. The court concluded that such an interest was not a "sufficient" level of control to invoke section 2036(a)(2). Thus, at least insofar as the Fifth Circuit is concerned, from Kimbell it is apparent that the more extreme implications of Strangi will not be pursued by the courts.

The court's conclusion, though, raises the question of just how much control would be "sufficient" to cause includability under section 2036(a)(2). The conservative answer, and one that long has been accepted by many practitioners (myself included), long before Strangi, is that the principal contributing partner -- typically the senior family member -- should not retain a controlling interest in the general partner.[xiv] Ideally, the ownership and management of that entity should be vested in others, whether family members or unrelated parties, with no participation by the contributing partner. At a minimum, the contributing partner should own a noncontrolling interest therein, and Kimbell indicates that lack of management powers in the entity is helpful, if not crucial.[xv]

But practice must follow form: If the management of the general partner is vested in persons other than the contributing partner, those persons must exercise their management powers, rather than simply deferring to the wishes of the matriarch or patriarch. Active management of the assets, regular meetings, an adequate record of management decisions, are all crucial in establishing the bona fides of the entity and the absence of an "implied agreement" among the family members that might cause an otherwise solid partnership to be undone under section 2036.

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None of that is particularly new or surprising; practitioners always have advised clients who set up family partnerships that the entity must be respected. Earlier cases such as Schauerhamer and Reichardt simply confirmed what practitioners already knew: If the partners do not respect the entity, the IRS will not either, and the courts will support the government. What the more recent case law has served to do is to throw into sharper focus the limits of what constitutes acceptable behavior in that regard, and to focus our attention on the proper structure and conduct of partnership management. The conclusion stated previously deserves repeating: The partnership must be tailored to meet the circumstances. If the assets contributed to the partnership require active management, they should be managed by the persons in control of the entity. If, for example, the children are in charge of the general partner and have no expertise or interest in managing rental property, careful consideration should be given to the question whether that property should be owned by the partnership. At minimum, the management of the property should be delegated by the managers of the general partner to an appropriate party, and a record kept of the determination to do so. Likewise, if distributions of partnership cash flow are to be made within the discretion of the general partner -- and that certainly is the preferred arrangement if the senior family member retains a limited partnership interest and thus the ability to receive those distributions -- then that discretion should be exercised and its exercise recorded. Of course, any distributions that are made should be made to the partners in proportion to their interests.

One additional related issue deserves mentioning, particularly in light of the Tax Court's recent memorandum decision in Senda.[xvi] Although Senda is an extreme case -- the parties involved acted with what one commentator has called a "reckless disregard" for the partnership form[xvii] -- its lesson is applicable to partnerships in general. In addition to careful documentation, all steps in the partnership transaction must be done in the proper sequence. Thus, for example, if the plan is to fund the partnership, then transfer partnership interests to children, it is crucial that those steps happen in that order. No attempt to "shortcut" the necessary steps -- for example, by admitting the children as partners, then contributing the property, then making adjustments in the children's capital accounts -- should be made. In Senda, as well as in the earlier Shepherd case,[xviii] the IRS was able successfully to argue that following just such a shortcut resulted in a gift of the underlying assets, rather than of the partnership interests, with a resulting loss of any valuation discounts for use of the entity. Thus, it is important that the entity be respected, not only regarding its structure and management, but also regarding its funding and to transfers of partnership interests.

Operational Issues: Partnership Distributions

As discussed above, in light of recent case law it is advisable to fund a family partnership with assets that require ongoing management and that may carry liability or other problems that are best minimized by ownership in the limited partnership form. Typically, those will be assets other than cash or marketable securities, neither of which by its nature recommends ownership through such an entity (although there may be other circumstances recommending use of a partnership, regardless of the assets involved). However, while the use of those assets -- for ease of reference, "noncash" assets -- is recommendable from a transfer tax perspective, their contribution to a family partnership, particularly in conjunction with "cash" assets (that is, cash or marketable securities), raises income tax issues that must be carefully considered in the planning stage. Those issues must be considered, not only regarding the

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ongoing operation of the partnership, but also regarding its eventual liquidation.

Of particular concern are the income tax rules regarding partnership distributions, whether current or liquidating. The general rule is that a distribution of partnership assets to a partner is not a taxable event; the partner's income tax basis in his or her partnership interest ("outside" basis) is reduced by the fair market value of the property received, and her basis in the distributed property is equal to the partnership's basis in the asset ("inside" basis) in the case of a current (nonliquidating) distribution or to the partner's outside basis in the case of a liquidating distribution.[xix]

However, that general rule is subject to numerous exceptions, many of which make partnership planning a minefield of income tax issues. Of greatest concern to us here are the exceptions regarding distributions of "money" and distributions of appreciated property to a partner other than the partner who originally contributed that property.

Regarding distributions of money, the rule is that a partner will recognize taxable gain to the extent that the money received exceeds her outside basis.[xx] What is important for those purposes is the code's definition of money, which includes not only actual cash but also "marketable securities," defined broadly as all actively traded financial instruments.[xxi] Thus, a partner who receives publicly traded stock in a current distribution from the partnership will recognize taxable gain to the extent the FMV of the stock (determined as of the date of distribution) exceeds the partner's outside basis, unless the partnership meets the definition of an investment partnership under section 731(c)(3)(C), which is a partnership that never has been engaged in a trade or business and substantially all of the assets of which consist of cash, stock, or other financial instruments. If a partnership is funded with both marketable securities and income-producing real property, in most circumstances a distribution of the securities to a partner will be a taxable event to the extent that the value of the securities exceeds that partner's outside basis.

Regarding distributions of appreciated property, the general rule is that such a distribution to a partner other than the partner who contributed the property will be taxable to the contributing partner to the extent of the "precontribution" gain (that is, the taxable gain in the property at the time it was contributed).[xxii] For example, if partner A contributes property with a basis of $100 and an FMV of $500 and the property is subsequently distributed to partner B, partner A will recognize $400 of taxable gain. There is an exception under section 704(c) for transferees of a partner's interest: If partner B received his interest from partner A, for example by gift, partners A and B are considered one and the same for these purposes and A is not taxed. However, partner B, rather than partner A, may be taxed on the gain by virtue of section 737, which does not contain the same "step in the shoes" rule.[xxiii] In general, that section taxes a distributee partner of property other than money to the extent of the lesser of (1) the excess of the FMV of the property (other than money, and other than property contributed by the distributee partner) received over the partner's outside basis or (2) the partner's "net precontribution gain" (that is, the "built-in" gain in any assets the distributee contributed to the partnership). Thus, in the previous example if B had no net precontribution gain the distribution to him of the property contributed by A would not be a taxable event.

However, suppose that B were A's transferee. Section 737 and the regulations thereunder provide that a transferee succeeds to the transferor's net precontribution gain. To expand on the example, suppose that after contribution of the property described, A gives half of her

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partnership interest to B. B's share of the net precontribution gain would be $200. Because of the step in the shoes rule described above, the distribution of the property to B would not be taxable to A. However, there appears to be no equivalent rule for section 737; thus, B is not treated as being the contributing partner for section 737 purposes, with the result that B is subject to tax on the distribution. Suppose, for example, that the FMV of the property at the time of distribution were $750. B would be taxable on his net precontribution gain because that is less than the excess of the FMV of the property received ($750) over B's outside basis ($50, or half of A's original outside basis).

It should be noted that section 737 has a "seven-year rule": The distribution of property contributed more than seven years before its distribution is not taxable under that section.

The income tax rules regarding partnership distributions and liquidations are complex and require careful study. The discussion herein has only touched on some of the more salient concerns. The practitioner must keep those rules in mind, both in advising clients on the tax consequences of establishing and operating a partnership, and in developing exit strategies. Failure to consider those rules along with transfer tax considerations could produce unwelcome income tax consequences.

Conclusion

It is my firm opinion that the FLP continues to be a valid and useful planning strategy. However, the recent case law in light of the ongoing IRS assault against the FLP highlights the need for caution. The practitioner is well served to advise her clients of the necessity to have valid nontax reasons for the partnership's existence, and to operate the partnership accordingly. Also, a conservative approach is recommended regarding the participation of the principal contributing partner in the management of the partnership. Pending further developments in the courts, the matriarch or patriarch should turn over active management of the partnership to others. Finally, the practitioner and the family should be cognizant of the potential income tax consequences of partnership operations and distributions.

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i A summary of those arguments, and the IRS's frank assessment of their merit, can be found in FSA 200049003, Doc 2000-31663, 2000 TNT 239-42 (Dec. 8, 2000).
ii See, e.g., Estate of Strangi v. Commissioner, 115 T.C. 478, Doc 2000-31014, 200 TNT 232-12 (2000); Kerr v. Commissioner, 113 T.C. 449, Doc 2000-296, 2000 TNT 247-58 (1999). Compare Estate of Reichardt v. Commissioner, 114 T.C. 144, Doc 2000-6219, 2000 TNT 42-11 (2000); Estate of Schauerhamer v. Commissioner, T.C. Memo. 1997-242, Doc 97-15298, 97 TNT 103-7.
iii T.C. Memo. 2003-145, Doc 2003-12584, 2003 TNT 98-16 (hereinafter referred to as Strangi II).
iv See Strangi II. The facts of the case were, in the court's view, sufficient to justify inclusion of the partnership's assets under section 2036(a)(1) on the basis that an "implied agreement" existed between the decedent and the other family members involved in the partnership

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that the decedent would retain possession or enjoyment of the assets. Also, though, the court questioned whether such an agreement was even necessary or whether simply being a potential recipient of partnership income was sufficient. Moreover, the court determined that the decedent's ability, in conjunction with the other partners, to vote on partnership distributions, constituted a retained right to designate the persons who shall possess or enjoy the property or the income therefrom, as described in section 2036(a)(2).

v See, e.g., Kimbell v. U.S., 371 F.3d 257, Doc 2004-10976, 2004 TNT 100-9 (5th Cir. 2004); Estate of Stone v. Commissioner, T.C. Memo. 2003-309, Doc 2003-24235, 2003 TNT 217-26; see also Estate of Thompson v. Commissioner, T.C. Memo. 2002-246, Doc 2002-22023, 2002 TNT 188-7, aff'd sub nom. Turner v. Commissioner, 387 F.3d 367, Doc 2004-17577, 2004 TNT 171-8 (3d Cir. 2004).

vi In Kimbell, the decedent retained a minority membership interest in the LLC that served as general partner of the partnership. The LLC was managed by one of the decedent's children, and the decedent, as a minority member, had no ability either to manage the entity or to remove the manager. Although the court of appeals determined that this interest was insufficient to cause 2036(a)(2) inclusion, it declined to determine what a threshold amount of control to cause that inclusion might be.

vii See, e.g., Estate of Bongard v. Commissioner, 124 T.C. No. 8, Doc 2005-5359, 2005 TNT 50-11 (2005); see also Estate of Bigelow v. Commissioner, T.C. Memo. 2005-65, Doc 2005-6581, 2005 TNT 61-9.

viii The court made note of the fact that the Stone children had incurred total legal fees of somewhere between $2 million and $3 million.

ix Section 2036 excludes from its purview any transfers for which the decedent received an adequate and full consideration in money or money's worth. Section 2036(a). In concluding that Kimbell had received that consideration, the Fifth Circuit applied a two-part analysis: First, that the partnership was pro rata, that is, each partner received a partnership interest and capital account in proportion to the property he had contributed, and each partner was entitled to receive his proportionate interest on dissolution or termination of the partnership; second, that the exchange of assets for partnership interests was bona fide because the partnership had valid, nontax

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business reasons for its existence. It is on the second prong of the court's analysis that this article focuses.
x Bongard, 124 T.C. at _______.
xi See, e.g., Peracchio v. Commissioner, T.C. Memo. 2003-280, Doc 2003-21238, 2003 TNT 187-14 (gift tax case involving partnership funded entirely with cash and marketable securities; 30 percent valuation discount upheld).
xii Bongard, 124 T.C. at _____.
xiii Estate of Hillgren, T.C. Memo. 2004-46, Doc 2004-4541, 2004 TNT 43-14, provides an excellent example of a partnership formed for defensible business reasons (real property requiring active management) that nevertheless failed for estate tax purposes because of sloppy management.
xiv But see Stone, supra note 5 (decedent retained individual general partner interest).
xv Bongard involved two entities: one, an LLC whose existence was respected for estate tax purposes, the other a limited partnership whose existence was disregarded. The Tax Court concluded that because the LLC had been formed for a "substantial and legitimate nontax reason," the bona fide sale test had been satisfied and no further inquiry was needed. Because in the court's estimation no such reason existed for the creation of the limited partnership, a further analysis was required as to the applicability of section 2036. Because the decedent retained control over the underlying assets (stock in the family-owned corporation), the court concluded, rather summarily, that the full value of the partnership assets was includable in the decedent's estate. In dissent, Judge Chiechi criticized the majority for neglecting to properly apply the analysis in the Supreme Court's decision in United States v. Byrum, 408 U.S. 125 (1972). See Bongard, 124 T.C. at ____ (Chiechi, J., concurring in part and dissenting in part).
xvi Senda v. Commissioner, T.C. Memo. 2004-160, Doc 2004-14321, 2004 TNT 134-11.
xvii Hoffman, "Reckless Disregard for Partnership Formalities Results in Indirect Gifts," http://www.fmv.com/index.php?C=ValuationToday_Archive_7_16_04>.
xviii Shepherd v. Commissioner, 115 T.C. 376, Doc 2000-27642, 2000 TNT 209-15 (2000).
xix Sections 731(a), 732(a) and (b).
xx Section 731(a)(1).
xxi Section 731(c)(2).

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xxii Section 704(c)(1)(B).
xxiii For a helpful discussion of the difference, see Carman, “Unwinding the Family Limited Partnership: Income Tax Impact of Scratching the Seven-Year Itch,” 96 J. Txn. 163 (2002).

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