IRS Respects Well-Drawn Family Limited Partnerships

By Bruce Givner

On Feb. 19 and March 4, Judges Robert P. Ruwe and Mary Ann Cohen of the U.S. Tax Court handed the IRS its fifth and sixth victories in family limited partnership cases since the seminal *Harper*, T.C. Memo. 2002-121 (May 15, 2002), decision on May 15, 2002. *I. Abraham Estate*, T.C. Memo. 2004-39. *L.K. Hillgren Est.*, T.C. Memo. 2004-46. The scorecard now stands IRS 6, Taxpayers 1, with the sole taxpayer victory being *Estate of Stone*, T.C. Memo. 2003-309 (Nov. 7, 2003).

Despite the grim scorecard, the latest IRS victories are further proof that a properly drafted, operated and timed family limited partnership will be respected by both the courts and the IRS as a tool to reduce values for both gift and estate tax purposes. These cases contain good news for taxpayers; tax lawyers; accountants; insurance agents; and appraisers.

The first four IRS victories *M.B. Harper Estate*; *T.R. Thompson Estate*, T.C. Memo. 2002-246 (Sept. 26, 2002); *Ruth Kimbell Estate*, 2003-1 USTC 60,455 (Jan. 15, 2003); and *Estate of Albert Strangi*, T.C. Memo. 2003-145 (May 20, 2003)) are striking example of "bad facts." Two of them involved terminally ill octogenarians: Harper was suffering from cancer and died at 85; Strangi was suffering from cancer and died at 81. The other two involved nonagenarians: Thompson died at 97; Kimbell died at 96. In all four cases, the family limited partnerships did not have the fine patina of time that is so necessary for good tax planning. Of the four, only one partnership was created as much as two years before the decedent's death, and that was in the case of a 97-year-old. (Harper's family limited partnership was established eight months before his death at 85; Thompson's family limited partnership was established 25 months before his death at 97; Kimbell's family limited partnership was established two months before her death at 96; Strangi's family limited partnership was established two months before his death at 81.)

In the IRS' Feb. victory, Abraham's age is not given, so we cannot know if this involved another terminally ill octogenarian. However, the timing suggests similar bad facts: less than two years after her husband's death, Abraham was placed under a court ordered guardianship (March 10, 1993); a little more than one year later the family limited partnerships were established (June 13, 1994); almost exactly three years later, she died (June 9, 1997). Note her three-year survival after the family limited partnerships were established is a new record in the reported IRS victories.

In addition to poor timing, this structure violated one of the prime concerns Judge Arthur L. Nims III expressed in *Harper*: the decedent's support had to come from the family limited partnerships. In *Abraham*, the evidence of this was more damaging than it had been in *Harper* because it was a matter of public record: "According to the decree, decedent's needs for support were contemplated *first* from the income that the partnerships generated. Only after decedent's support needs, if any, were met did the children/limited partners receive their proportionate share of partnership income. Decedent's support needs were treated as an obligation of the partnerships."

Then, as in *Thompson*, poor preparation by trial counsel was a significant factor in the defeat. There was damaging testimony by the daughters that their mother would be protected no matter what: "Q: You said that if the money wasn't sufficient from your mother's share of the partnerships to pay for her needs, extra funds would come out of your share, your sister's share and your brother's share? A: Yes." That testimony, and other bad facts, made it easy for the court to conclude that, under Internal Revenue Code Section 2036, Abraham "retained for [her] life or for any period not ascertainable without reference to [her] death or for any period which does not in fact end before [her] death (1) the possession or enjoyment of, or the right to the income from, the [transferred] property".

There was a single ray of sunshine in the case. One of Abraham's children brought a lawsuit against the estate of his deceased father. This son received an interest in Abraham's family limited partnership in exchange for dropping his claim. That was viewed as sufficient consideration so that the partnership interest he received was not included in the decedent's estate. Similarly, in *Estate of Stone*, the sole prior taxpayer victory, lawsuits among the children lasted for four years before the parents agreed to establish the family limited partnerships. The good results in these two cases almost invites litigation to reduce the likelihood of a successful IRS Section 2036 claim. However, as a cautionary note, see Judge David Laro's rejection of family litigation as the basis for making a valid claim to reduce the size of the estate in *Estate of Emanuel Trompeter*, T.C. Memo 1998-35 (Jan. 27, 1998) ("we find that the state court proceeding did not involve a real and bona fide controversy between adverse parties ...")

A properly drafted, operated and timed family limited partnership will be respected by both the courts and the IRS, while a poorly conceived partnership will get punished in tax court.

The IRS' March victory, while it did not involve a "terminally ill octogenarian" (the decedent was only 41 years old), is a compendium of easily avoided bad facts: (i) the family limited partnership was formed two months after the decedent tried to commit suicide, and five months later another suicide attempt was successful; (ii) the decedent never transferred the properties to the family limited partnership; (iii) the family limited partnership did not have a bank account, as a result of which the family limited partnership's banking was done through the decedent's own bank account; (iv) the decedent's residence was an asset of the family limited partnership; (v) family limited partnership bookkeeping did not begin until after decedent's death; (vi) the LP-1 was not filed until after the decedent's death; and (vii) family limited partnership distributions were made to decedent to cover her personal expenses, no distributions were made to the other partner, and the only source of payment for the estate taxes was the family limited partnership. Each of these bad facts was present in *Harper* or other, earlier taxpayer losses.

Having reviewed the good news for taxpayers and tax lawyers, it is time to move on to the good news for accountants. A lesson that is easier (than family litigation) to learn from *Stone* is to be certain there are enough nonfamily limited partnership assets to pay for the parent's ordinary expenses. *Stone* contained a detailed discussion of the fact that the Stones wanted to retain sufficient assets to enable them to "maintain their respective accustomed standards of living." Therefore, they used "certain accountants to advise them what assets to retain .... To formulate the advice, the accountants performed various cash-flow analyses and appraisals, using different assumptions regarding [their] respective life expectancies ... and the anticipated returns on their ... investments. The accountants ... recommended that they retain ... assets that would yield a monthly total cash flow of between $12,000 and $15,000." So this is the opposite of the *Harper* debacle, where Nims noted that the CPA was not hired until after Harper's death. The advice is what any smart tax lawyer would do anyway: involve the CPA in the first planning meeting about the family limited partnership.

Another failing in both recent taxpayer losses is good news for insurance agents: the family limited partnership was the sole source to pay the estate tax. Nims in *Harper* cited that as "strong evidence of an implied agreement under which decedent did not divest himself economically of the contributed assets." This encourages buying life insurance on the parents and having it owned either by the children directly or — for creditor protection benefits (see Probate Code Sections 15307 and 15306.5) — irrevocable trusts for the children's benefit (even adult children can benefit from this protection, e.g., from their future ex-spouses).

Two other, easily correctable, failures in *Abraham* are worth noting. First, this family limited partnership was subject to the same "mere testamentary device" criticism that Nims made in *Harper*. That is easily overcome by involving nonfamily members. (A nonfamily member is a person or institution not inheriting in the parent's estate plan; i.e., will or living trust.) For example, a gift of a 1 percent limited partnership interest to charity creates an income tax deduction for the parent. Also, the discount that the parent is forced to take on the income tax deduction is the same type of discount that the family wants the IRS to accept for transfer (gift and estate) tax purposes, and the IRS and courts both love it when taxpayers act consistently. Making this 1 percent gift each year for three to five years, perhaps to different charities, allows a substantial enough nonfamily member presence to thwart an IRS attack based on Nims' "mere testamentary device" criticism. Second, the taxpayer's failure in *Abraham* to use a competent entity valuation expert to determine the discounts is incomprehensible at this stage of the history of family limited partnerships in tax court. This point has been hammered home by judges in case after embarrassing case. See, for example, *Estate of Norma A. Hagerman*, 98-1 U.S.T.C. 60,312 (April 22, 1998).

In conclusion, well-conceived, operated and timed family limited partnerships are alive and well. Poorly conceived, operated and timed family limited partnerships will continue to get punished by the IRS in tax court and in the audit process.

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