Court Refines Formula for Family Limited Partnerships

By Bruce Givner

The U.S. Tax Court's recent decisions in *Estate of Wayne Bongard*, 124 TC No. 8 (2005), and *Estate of Virginia Bigelow*, TC Memo 2005-65 (2005), help taxpayers and their advisers form, fund and operate family limited partnerships — a powerful estate tax planning tool — with a great deal of certainty.

Past tax litigation involving family limited partnerships typically addressed the amount of the discount available for transfer (gift, estate and generation skipping transfer) and tax purposes for transfers of limited partnership interests to heirs (or trusts for their benefit).

For example, *LeFrak v. Commissioner*, 66 TCM 1297 (1993), involved a taxpayer's attempt to characterize a transfer as a gift of a limited partnership interest eligible for a 40 percent valuation discount. The taxpayer lost; the gift was held to be a gift of a tenancy in common interest in real estate. However, the consolation prize was a 30 percent valuation discount, which reduced the value of the gift by $3,000,000.

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While the discount battle raged in dozens of reported cases, the Internal Revenue Service used a new attack: Internal Revenue Code Section 2036(a), or Transfers With Retained Life Estate. When this section applies, the result is more devastating (than a reduction in the valuation discount): All of the family limited partnership's assets are included in the decedent's estate.

The first two IRS victories using this weapon, *Estate of Schauerhamer*, TCM 1997-242 (1997), and *Estate of Reichardt*, 114 TC 144 (2000), involved extremely bad facts — for example, the family limited partnerships were established shortly after the parent was diagnosed with a terminal illness; the parent, as general partner, commingled partnership and personal assets; the parent died soon after the family limited partnership was established; and the children/limited partners failed to prevent the commingling, suggesting the existence of an agreement to permit the parent/general partners to retain the economic benefits of the partnership assets.

On May 15, 2002, the landmark case *Harper Estate v. Commissioner*, TCM 2002-121, was announced. Judge Arthur L. Nims held that the value of the property of plaintiff Harper's trust contributed to an family limited partnership was included in his gross estate under Section 2036(a) because Harper retained the enjoyment of the property during his lifetime.

Unlike the IRS' previous two IRC Section 2036 victories, *Harper* was significant because it did not involve extreme facts (although — as in *Schauerhamer* and *Reichardt* — the decedent had been diagnosed with cancer before the transfers to the family limited partnership began). Nims viewed the fact that not all of the assets were immediately transferred to the family limited partnership (a common enough occurrence, at least before *Harper*) as objective evidence of an implied agreement that the decedent would retain the economic benefits of the assets. He characterized it as a commingling of funds and said it reflected an "indifference by those involved toward the formal structure of the partnership arrangement." He was exorcised over the fact that the general partner, Harper's son (one improvement over *Schauerhamer* and *Reichardt* is that the decedent was not a general partner), did not hire an accountant to undo the "commingling" until two months after Harper's death. Even then, Nims dismissed the adjustments as "post mortem accounting manipulations," noting that "no money actually changed hands in connection with the adjustments," even though that is often true of accounting adjustments.

Nims also noted disproportionate distributions to Harper; the son's passive administration of the portfolio; and that Harper made all the decisions — the family limited partnership only did what he wanted it to do. Nims found that no transfer of assets had occurred because the entire value of the partnership interest was derived only from the assets that the trust had contributed, and he concluded that the subjective motive in creating the family limited partnership was testamentary; he characterized the partnership as a "testamentary substitute."

Immediately after *Harper*, the appeals court reversed another case that had been pro-taxpayer. *Estate of Albert Strangi*, TCM 2003-145 (2003) (*Strangi III*), on remand from 293 F.3d 279 (2002) (*Strangi II*), affirming in part and reversing and remanding in part 115 TC 478 (2000) (*Strangi I*).

Soon after *Harper* came two more anti-taxpayer results involving elderly taxpayers. *Estate of Theodore Thompson*, TCM 2002-246 (2002), affirming 2004-2 USTC 60,489, 382 F.3d 367 (2004); *Estate of David Kimbell*, 2003-1 USTC 60,455 (2003), affirming 2004-1 USTC 60,486, 371 F.3d 257 (2004).

(In May, 2004, when the 5th Circuit reversed the District Court in *Kimbell*, we learned the importance of having non-tax reasons for a family limited partnership's formation.) In 2004 there were two more anti-taxpayer results involving bad facts: *Estate of Ida Abraham*, TCM 2004-39 (2004) (elderly taxpayer whose guardian established the family limited partnership); *Estate of Lea Hillgren*, TCM 2004-46 (2004) (decedent died at 41, but the family limited partnership [in question was established just months after her first [unsuccessful] suicide attempt and months before her second [successful] attempt).

Both of the March 2005 cases involved prominent counsel. In *Bongard*, counsel for the (partly) successful taxpayer was John Porter, who also represented the successful taxpayers in another family limited partnership case, *Estate of Eugene Stone III*, TCM 2003-309 (2003). (The *Stone* taxpayers employed accountants to determine how much they needed to maintain their standard of living, and then omitted from the partnership the assets needed to generate that income stream.) In *Bigelow*, counsel for the United States was Donna Herbert, who also was government counsel in the landmark *Harper* decision.

Wayne Bongard died at 58 and "appeared to be in good health before his death," making the case unique in the *Harper* line of estate tax cases. However, the formal reason the *Bongard* taxpayer won was because the facts were such as to allow the Tax Court to rule that the transfer was a bona fide sale for full and adequate consideration supported by a significant and legitimate non-tax reason: It was part of a plan to raise capital.

The formation of the entity in question and the transfer of stock to it was one of numerous steps undertaken to position the decedent's corporation for a liquidity event, which would provide it with the necessary capital to remain competitive. The value of the shares was maximized by the corporation to attract potential investors and the potential market for the shares was increased. Other steps included the formation of a subsidiary and creation of incentive stock options.

Whether or not these transactions were primarily tax motivated, they certainly saved tax. The parties had stipulated to control marketability, and voting discounts of 13 percent, 17.5 percent and 5 percent, respectively, at the family limited partnership level, for a total effective discount of 30 percent. Applied to more than $120 million of pre-discounted values, this was a good taxpayer result.

When reading Judge John O. Colvin's *Bigelow* opinion, it is easy to tell that the result is going to be bad for the taxpayer. The second paragraph includes the facts that:

- The family limited partnership was formed when the decedent was about age 85 (she died at 88).
- The family limited partnership was formed a few months after she suffered a stroke and began living in an assisted-living facility (meaning the decedent's signature was affixed by a family member acting under a durable power of attorney).
- The family limited partnership was funded with the decedent's personal residence — however, the decedent remained personally liable on the debt secured by the residence.
- "After the transfer, the decedent was left with an insufficient amount of income to meet her living expenses or to satisfy her liability for the debt."
- "Decedent's sole purposes in establishing the [family limited partnership] were to facilitate gift giving and to reduce federal estate tax."

There were other bad facts, including that the partnership agreement prohibited it from engaging in any activity than "the business of owning and operating residential real property"; that the only partners were family members (meaning the family limited partnership was a "testamentary substitute," though that term is not used in the opinion); that none of the partners' K-1s were accurate; that no partner other than the decedent received a distribution before the decedent's death; that, because the decedent's trust was the general partner, there was no creditor protection benefit to the structure (at least for the decedent); and there was no continuity of management benefits because the partnership terminated if the general partner terminated.

In conclusion, the IRS is forced — due to severe budgetary constraints — to trumpet its Tax Court victories. However, a close reading of the cases shows that the only cases litigated to the point of an IRS victory have horrendous facts.

By contrast, well-advised taxpayers can be confident about constructing partnerships that will yield attractive results with little or no attention from the government.

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