

## IRS continues to battle an important estate planning tool

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Family limited partnerships (FLPs) continue to be a powerful tool of both estate tax planning and asset protection planning. The latter was strengthened by California's repeal of its original LLC act - the Beverly-Killea Limited Liability Company Act (1994) - and the Jan. 1, 2014, effective date of the Revised Uniform Limited Liability Company Act. Old Corporations Code Section 17302(c)(2) allowed another member of an LLC to buy the interest of a member which was subject to a charging order "With property other than property of the [LLC]." In other words, it did not specify the price or terms. That provided the opportunity for the

membership agreement to allow the other member to pay for the charged member's interest on terms unattractive to the creditor. By contrast, new Section 17705.03(d) permits another member to buy a charged member's interest by paying "to the judgment creditor the full amount due under the judgement." That dramatic change means that closely held entities will eschew LLCs in favor of limited partnerships which, happily, have language similar to old Section 17302(c)(2) in Corporations Code Section 15907.03(c)(2).

In the estate tax planning arena the Tax Court has been relatively quiet on the subject of FLPs since 2013. That may have been due to the fact that taxpayers have learned their lessons from past adverse cases and from the fact that the IRS Appeals Division is so good at settling cases considering the "hazards of litigation." Then, all of a sudden, we have two Tax Court FLP cases in the space of four months. One was a taxpayer victory, the other a taxpayer loss. We can learn lessons from each.

*Estate of Barbara M. Purdue*, T.C. Memo 2015-249 (Dec. 28, 2015) involved a \$3,121,959 estate tax deficiency, so the taxpayer had enough at stake to make it worth litigating. When the decedent was 88, her husband's law partner recommended forming an FLP which, under Washington state law, ended up becoming a family LLC. The decedent's husband, who had been in good health, died unexpectedly eight months after forming the FLLC. Meanwhile the decedent required 24-hour, in-home health care from the date of her husband's death to her own death.

One reason the taxpayer won is because, before the FLLC was formed, the parents used three different brokerage firms whereas after formation all the accounts were consolidated with one investment advisor. That confirmed a significant non-tax purpose for establishing the entity. Other favorable factors were that (i) the parents were not financially dependent on FLLC distributions; (ii) the parents' funds were not commingled with those of the FLLC; (iii) the FLLC (a) maintained its own bank accounts and (b) held meetings at least annually with written agendas, minutes and summaries; and (iv) the decedent never experienced mental or life-threatening illness (the court was in a generous mood citing this despite the fact that the decedent needed 24-hour, in-home health care).

Another issue was whether the parents' annual gifts of limited partnership interests to the children qualified for the annual gift tax exclusion. This has been a much-litigated issue in the past. For example, *Hackl*, 118 T.C. 279 (March 27, 2002), *aff'd* 635 F. 3d 664 (CA-7, 2003), held that the gift of membership interests were not gifts of present interests eligible for the annual gift tax exclusion because the parties "did not expect that [the LLC] would be making distributions to members" and "there was an absence of distributions." The IRS had argued that "the inability of the donees to freely transfer the units or to compel distributions from the entity prevented them from receiving any ... benefit."

Estate of Sarah D. Holliday, T.C. Memo 2016-51 (March 17, 2016), involved a \$785,019 deficiency. In light of the costs of trying such a complex case in Tax Court, the facts and the ultimate result (we have the benefit of hindsight), the taxpayer and/or the advisors made a mistake in not reaching agreement with IRS Appeals. The decedent was 81 and living in a nursing home when the FLP began and she died at 84, which is never a good set of facts (meaning it is an invitation to intense IRS scrutiny). The first problem with this partnership was that the assets were solely marketable securities. That is not an insurmountable problem. See *C.P. Schutt*, T.C. Memo 2005-126, in which a Dupont family member formed the Delaware equivalent of an FLP the sole assets of which were Dupont and Exxon stock. The second problem was that there was only one partnership distribution during the decedent's lifetime. The third problem was that the person in charge of the partnership, one of decedent's sons, testified that "[I]t seemed to me when I reviewed [the partnership agreement] this sort of gave you broad powers to do anything you needed to do, including make distributions. But it wasn't necessary. No one needed a distribution." The court viewed that as meaning "there was an implied agreement that decedent retained the right to `the possession or enjoyment of, or the right to the income from, the property' she transferred to" the partnership. As a result, the partnership's assets were included in her estate.

The court rejected the estate's argument that the partnership was created for creditor protection purposes because "decedent had never been sued and that because she lived in a nursing home her risk of being vulnerable to trail attorney extortion was minimal." The court was unhappy that there was "no meaningful negotiation or bargaining associated with the formation of the partnership." Also, shockingly, the partnership failed to maintain books and records; did not hold formal meetings; no minutes were kept; and provisions of the agreement were ignored.

Family limited partnerships remain an important tool in the estate tax (and asset protection planning) arsenal of planners. The rules have been carefully enunciated in a series of cases going back to the original "modern" case, *M.B. Harper Estate*, T.C. Memo 2002-121 (March 15, 2002). They should lead to good results even in tough fact situations if carefully constructed and operated.

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