Price & Farrington's Estate and Tax Planning *Fast*Faxts

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Estate, Tax , Business and Wealth Planning for Advisors and Clients

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Family Limited Partnerships: *Recent Court Ruling is a Major Taxpayer Victory*

Family limited partnerships (FLP) have become common estate, tax, business and asset protection planning tools. And they aren't just exotic planning devices which benefit only the very wealthy. We last addressed the subject of FLPs in our May, 2000 Estate and Tax Planning *Fast*Faxts, available in our *Fast*Faxts archives on our website at www.pricefarringon.com. For useful background information on FLPs, we direct you to the *Articles* tab on our site to the article: "Introduction to Family Limited Partnerships."

The viability of FLPs was recently confirmed in Kimbell v. U.S. (5th Circuit U.S. Court of Appeals, May 20, 2004) and represents a major blow to the IRS's ongoing attack on FLPs. While the IRS will probably try to put a "spin" on the Kimbell decision, it is a major taxpayer victory which reminds us that a properly created FLP is a formidable legal tool.

The 5th Circuit, overturning a lower court's decision, found that $2.5 million in assets transferred by a family matriarch into an FLP were not includible in her estate under Internal Revenue Code Section 2036 (a). That provision returns assets to the estate that were transferred before death, unless the transfer was "a bona fide sale for an adequate and full consideration". The lower court had held that the transfer—in which Ruth Kimbell contributed more than 99% of the assets into a partnership managed by her son—wasn't bona fide because the parties were related and the underlying deal was a "recycling of value". The 5th Circuit Court reversed.

Facts. The decedent, Mrs. Kimbell, had formed an FLP, retaining a 99% limited partnership interest. The 1% general partner was a limited liability company (LLC) which was owned 50% by the decedent, 25% by her son and 25% by her daughter-in-law. Her son was manager of the LLC. About 13% of the assets transferred to the partnership consisted of working oil and gas interests, requiring active management. The partnership agreement provided that 70% of the limited partners could remove the general partner.

The court's holding. The 5th Circuit reversed the district court's ruling and held: (1) family members can enter into a bona fide transaction; (2) a transfer of assets in return for a pro rata partnership interest is a transfer for full and adequate consideration; and (3) the decedent did not retain sufficient control of the assets transferred to the LLC to make her transfer subject to estate taxes under IRC Section 2036(a) because she only held a 50% interest in the LLC and her son had sole management powers over the LLC.

Analysis. The purpose of Section 2036 is to prevent a taxpayer like Mrs. Kimbell from avoiding estate tax by using a transaction by which she keeps the lifetime enjoyment of property which has supposedly been transferred to others.

Standard for "bona fide sale" requirement in 2036. The 5th Circuit rejected the district court's conclusion and decided that *transfers between family members that are made in good faith can meet the bona fide sale requirement* of Section 2036. The basic requirement is whether the transferor (decedent) actually parted with the interest and the transferee actually parted with *adequate and full consideration.*

"If you don't go to people's funerals, you can't expect them to come to yours."

The court said that while it will always require "heightened scrutiny" of transfers between family members to make sure that they aren't sham transactions or disguised gifts, the Internal Revenue Code doesn't automatically invalidate them.

The court stated that the decedent's subjective intent and tax-planning motives don't prevent a sale from being bona fide if it is otherwise "real, actual or genuine". "The scrutiny is limited to the examination of objective facts that would confirm or deny the taxpayer's assertion that the transaction is genuine." The court added that "[a] transaction motivated solely by tax planning with no business or corporate purpose is nothing more than a connivance without substance that is rightly ignored."

Application of the bona fide sale requirement. The objective facts here were:

☞ The decedent retained other assets outside of the FLP which were sufficient for her support.

☞ There was no commingling of partnership and personal assets.

☞ Formalities were satisfied.

☞ Assets were actually assigned (transferred) to the partnership.

☞ The assets that were contributed to the partnership (including working interests) required active management.

☞ The partnership satisfied business strategies that couldn't be met by simply

Redefinitions

1. ***Intuition (n.),*** *"knowledge that your salary won't cover the cost of your children's education"*
2. ***Commute (v.),*** *"travel to and from work without speaking"*
3. ***Grammarian (n.),*** *"well-spoken grandmother"*
4. ***Defibrillator (n.),*** *"lie detector"*
5. ***Warship (n.),*** *"adoration of the Navy"*
6. ***Bashful (adj.),*** *"being harsh or abusive towards someone"*
7. ***Rebuffs (n.),*** *"polished athletic shoes"*
8. ***Kindred (n.),*** *"fear of family reunions"*

holding assets in a revocable living trust. For example:

a). Legal protection from creditors, especially important because the decedent owned oil and gas working interests;

b). The decedent wanted to continue oil and gas operations beyond her lifetime, and the partnership allowed keeping a pool of capital together in one entity;

c). Administrative costs were reduced by keeping all accounting functions together;

d). Costs of recording transfers of oil and gas properties in passing them from generation to generation were avoided;

e). Property was preserved as separate property for Mrs. Kimbell's descendents;

f). Management succession was provided should something happen to her son;

g). All disputes could be resolved through mediation or arbitration; and

h). The purposes recited in the partnership agreement were confirmed by the objective facts.

De minimis contributions. The fact that only de minimis (minor) contributions to the partnership were made by other partners doesn't justify treating the partnership as a sham. There is no principal of partnership law that requires a minority partner to own a certain minimum percentage of the partnership assets for the entity to be considered legitimate and the transfers bona fide.

Management. The fact that the decedent's son managed the assets both before and after the partnership was created doesn't matter. What is important is that he contributed his management expertise after the partnership was formed.

Adequate and full consideration: the standard. The test for whether transfers to a partnership are made for adequate and full consideration is an objective test, and is not related to tax-savings motives. The court states that the exchange of assets for partnership interests must be "roughly equivalent" so the transfer doesn't deplete the estate. When the transaction is between family members, it is subjected to more scrutiny to insure that the sale isn't a sham transaction or a disguised gift. But as Kimbell shows, the scrutiny is based on an examination of objective facts.

Adequate and full consideration: the application. In trying to invalidate the FLP, the government made an "inconsistency argument" in the Kimbell case. The argument is that it is inconsistent for the decedent's estate to argue (for discounting for estate tax purposes) that the partnership interest is worth only 50% of the assets transferred to the partnership but claim that the partnership interest received in exchange for the assets transferred was adequate and full consideration.

The 5th Circuit rejected the government's inconsistency argument as "a classic mixing of apples and oranges". In a pointed analysis, the court said:

"This conflation misses the mark: the business decision to exchange cash or other assets for a transfer-restricted, nonmanagerial interest in a limited partnership involves financial considerations other than the purchaser's ability to turn right around and sell the newly acquired limited partnership interest for 100 cents on the dollar. Investors who acquire such interests do so with the expectation of realizing benefits such as management expertise, security and preservation of assets, capital appreciation and avoidance of personal liability. Thus there is nothing inconsistent in acknowledging, on the one hand, that the investor's dollars have acquired a limited partnership interest at arm's length for adequate and full consideration and, on the other hand, that the asset thus acquired has a present fair market value, i.e., immediate sale potential, of substantially less than the dollars just paid-a classic informed trade-off."

The opinion recognizes that investors routinely make investments that can't be liquidated the next day for the full amount invested. The transfer was therefore found to be for full consideration even though at the time of the decedent's death she didn't have the right to retrieve the full amount she contributed.

Focus. The 5th Circuit stated that the proper focus on whether a transfer to a partnership is for adequate and full consideration is:

☞ (1) whether the interests credited to each of the partners was proportionate to the fair market value of the assets each partner contributed to the partnership;

☞ (2) whether the assets contributed by each partner to the partnership were properly credited to the respective capital accounts of the partnership, and;

☞ (3) whether upon termination or dissolution of the partnership the partners were entitled to distributions from the partnership in amounts equal to their respective capital accounts.

In the Kimbell case, the answer to each of these questions is yes. Mrs. Kimbell received a partnership interest that was proportionate to the assets she contributed to the partnership. There is no question that her partnership account was properly credited with the assets she contributed. And on termination and liquidation, the partnership agreement required distribution to the partners according to their capital account balances.

The LLC. The lower court found that the assets transferred to both the partnership and the LLC should be included in Mrs. Kimbell's estate under IRC 2036(a). The 5th Circuit found that the decedent didn't retain "sufficient control" of assets transferred to the LLC to cause 2036(a) to apply. The court reasoned that the decedent had only a 50% interest in the LLC and her son was the manager. It decided there was no reason to apply the bona fide sale analysis.

Business Purpose. While the court didn't require a strict business purpose, it did list many "objective facts" to show the existence of "substantial business and other non-tax reasons"for the FLP in the Kimbell case, which would likely be present in most FLP situations. (One factor that might not ordinarily be present, at least with investment partnerships, is assets requiring active management.) Non-tax purposes can be amorphous, but in evaluating business purpose, we can lool at the sham transaction standard to weed out abusive situations in which the parties ignore the partnership or it is disregarded by the decedent after creation.

Bottom line. *Despite the IRS's steady assault, the family limited partnership is alive and well as a legal planning tool. Be sure to contact a knowledgeable estate and tax planning attorney to make sure it is properly drafted and implemented. For additional information or answers to your questions about family limited partnerships or other planning techniques, feel free to contact us.*