

## Family Limited Partnerships and LLCs

By Dean I. Friedman, Esq.

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In our Fall 2003 edition of *Legal Issues* we reviewed the Strangi 2 decision, a Tax Court memorandum opinion unfavorable to the estate of a father who created a *family limited partnership* (“FLP”) with his children to limit federal estate taxes. The ruling “pulled back” into his estate the assets he transferred to the FLP because an “implied agreement” between the father and his children allowed the father to retain enjoyment of the conveyances. The Tax Court rejected the argument that the father owed “partner” fiduciary duties to his children sufficient to limit retained enjoyment.

Last November the Tax Court spoke again of the application of the pull-back rule (Internal Revenue Code section 2036(a)), finding for the taxpayers’ estates (the wife survived her husband by less than two years). The case is *Estates of Eugene E. Stone, III and Allene W. Stone*, a lengthy memorandum opinion which exhaustively considers the formation and operation of five FLPs. Just before organizing the FLPs, small undivided interest gifts were made by the Stones to their children. Each FLP held different real property and other assets including preferred stock in a holding company of the Stones’ principal business. The assets transferred by the Stones to the FLPs were in exchange for partnership interests proportionate to concurrent property contributions made by their children. The parents’ transfers were considered *bona fide* sales for adequate and full consideration in money or money’s worth. Thus, a *statutory exception* to the “pull-back” rule applied. Whether the parents retained enjoyment of the properties conveyed became irrelevant. Accordingly, only the discounted FLP interests (and

not the transferred properties) were included in the parents' gross estates for federal estate tax purposes.

Why the favorable outcome? First, the Tax Court found *Estate of Harper* (the seminal circuitous "recycling-of-value," inadequate consideration case) and other cases factually similar to *Harper* to be distinguishable. The IRS relied on that line to support its estate tax deficiency argument. Rejected was the position that, because the Stones did not actively participate in the negotiations by their children for formation of the FLPs (settling litigation brought by certain of the children involving two trusts the Stones had previously established), the asset conveyances were not *bona fide*, arm's-length transfers. Each family member was represented by his or her lawyer and had input into the decision-making process of how each FLP was to be structured and operated and identified the properties suggested to be transferred. The children understood that their parents would not be bound by any agreements they negotiated, leaving the parents with the ultimate choice of appropriate assets. While the parents considered the children's recommendations, the property transfers were found to have been predicated upon valid business reasons and investment considerations and were not "gifts" because the FLP interests received in exchange were proportionate to the values of the properties conveyed.

Second, the parents retained sufficient assets to support their accustomed standards of living. The children's negotiations were not accepted by their parents without thought, comment or question. The FLPs had economic substance and operated as joint enterprises of profit through which the children actively managed and developed FLP assets while their parents lived and after their passing.

Third, that the parents' FLP interests were subject to valuation discounts (to amounts less than the values of the properties conveyed) did not mean that the FLP interests were inadequate consideration, or something less than full value.

Each FLP was created, funded and operated as a joint enterprise for profit for the management of its assets. There was a genuine pooling of properties and services. The parents and children contemplated that the children would contribute management services, the parents no longer wanting to be actively involved.

Obviously, FLPs can be successfully arranged, though the landscape has changed. Since Tax Court memorandum opinions are applications of established legal principles to particular facts, it's difficult to predict with certainty the "litigated" result in any particular situation. Yet, because of *Stone* the guidelines are becoming clearer for the use of FLPs in estate planning. Whether these guidelines can be successfully matched to the facts of FLP formation and operation in a specific circumstance may be the only practical challenge ahead.