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July 21, 2005

IRS Wins Battle Not War in Family Limited Partnerships

While the IRS won the latest round, the use of family limited partnerships to reduce exposure to the federal estate tax remains a viable planning opportunity. The Appeals Court recently issued its decision in Strangi v. Commissioner, 2005 U.S. App. LEXIS 1449 (5^{th} Cir. July 2005). There, the Decedent transferred over 98% of his wealth, including his residence to a limited partnership in exchange for a 99% limited partnership interest and a 47% interest in the corporate general partner. Decedent hoped to receive a discount on the valuation of his limited partnership interest for estate tax purposes rather than report the full value of the limited partnership's underlying assets.

Initially, the Tax Court held for the estate rejecting all IRS arguments. The Appeals Court remanded the case on procedural grounds, without addressing substantive issues. On remand, the Tax Court ruled that the transfer of assets to the limited partnership would be disregarded for estate tax valuation purposes under Code Section 2036. The Appeals Court affirmed the Tax Court decision.

Code Section 2036(a) provides that the value of the gross estate includes the value of all property transferred by the decedent where the decedent retained the possession or enjoyment of the property or right to the income. The Court in Strangi determined Code Section 2036 applied, finding that the Decedent had an implied agreement to retain the transferred property. The Court noted that the Decedent lacked liquid assets after the transfer, he continued to live in his residence after its transfer and the limited partnership paid personal expenses of the Decedent.

The Court further found that the transfer to the limited partnership in Strangi was not a bona fide sale for an adequate and full consideration. Transfers that are considered a bona fide sale for an adequate and full consideration cannot be included in the gross estate under Code Section 2036. A sale is bona fide if it serves a substantial business or other non-tax purpose. The Court reasoned that the transfer to the limited partnership in Strangi was made only to reduce estate taxes.

Nevertheless, the Tax Court and even the same Fifth Circuit Appeals Court have rejected the Code Section 2036 argument and allowed discounts in valuing family limited partnerships for estate taxes in other cases. Specifically, in Kimbell v. U.S., 371 F.3d 257 (5^{th} Cir. May 2005) the Court ruled that Code Section 2036 was not applicable because the transfer to the partnership was a bona fide sale for an adequate and full consideration. There, the Decedent transferred about $2.5 million of assets to a family limited partnership. The estate claimed a 49% discount on the value of Decedent's interest in the limited partnership. The Court in Kimbell cited several non-tax business reasons for the limited partnership, including, protection from creditors, the ability to pool assets in one entity and the reduction of administrative costs. Thus, the Decedent satisfied the bona fide sale exception to Code Section 2036.

Similarly, the Tax Court in Estate of Bongard v. Commissioner, 124 T.C. No. 8 (March 2005), found a transfer of assets to a limited liability company was a bona fide sale for an adequate and full consideration and thus not subject to Code Section 2036. Among other things, the limited liability company provided the estate creditor protection, a substantial non-tax purpose. The Court in Bongard also implied that the ability to facilitate gift giving may be considered a substantial non-tax purpose.

All of these cases are a lesson to taxpayers and practitioners that proper implementation is crucial in using family limited partnerships to reduce exposure to estate taxes. Clients must leave some assets outside the partnership, not transfer their personal residence to the partnership and not use partnership assets for personal expenses. Moreover, without non-tax purposes, the IRS has a significantly stronger case against family limited partnerships. Further, the IRS has only succeeded in disregarding limited partnership valuation discounts under Code Section 2036, an estate tax provision. There are no similar IRS victories in the gift tax arena.

Even though the IRS won the battle in Strangi, family limited partnerships that serve legitimate non-tax purposes remain a viable and important weapon in the war to reduce exposure to estate taxes.