

Issue Contents

Bankruptcy

Federal tax

Discharge **155**

Environmental Law

Clean Water Act **155**

Federal Agricultural Programs

Tuberculosis **155**

Federal Estate and Gift Tax

Charitable deduction **155**

Transfers with retained
interests **155**

Valuation **155**

Federal Income Taxation

Business expenses **156**

C corporations

Compensation **156**

Distributions **156**

Merger **156**

Sale of assets **157**

Cooperatives **157**

Court awards and settlements **157**

Depreciation **158**

Disaster losses **158**

Discharge of indebtedness **158**

Employee expenses **158**

Hobby losses **158**

IRA **159**

Medical savings accounts **159**

Partnerships

Partner's distributive share **159**

Pension plans **159**

Social security benefits **159**

Tax shelters **160**

Trusts **160**

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FAMILY LIMITED PARTNERSHIP UPHeld ON APPEAL

— by Neil E. Harl*

A decision by the Fifth Circuit Court of Appeal,¹ on July 18, 2001, affirmed a decision of the United States District Court for the Western District of Texas² which had upheld a family limited partnership formed two days before death to consolidate interests in a 23,000 acre family ranch.³ In that case, the decedent suffered from cancer but died from another malady.⁴

Facts in *Church v. United States*

In the facts of *Church v. United States*,⁵ the decedent, Elsie Church, died unexpectedly on October 24, 1993.⁶ The death occurred two days after Mrs. Church and her children signed a limited partnership agreement consolidating their interests in a ranch.⁷ Each partner contributed their individual interests in the ranch; in addition, Mrs. Church contributed approximately \$1 million in securities inherited from her mother and her husband. At that time, the limited partners owned 57 percent of the ranch with another family, including Mrs. Church's nephew, owning the remaining 43 percent.⁸

Mrs. Church owned 62 percent of the partnership and was to receive 99 percent of the taxable income from the securities and 62 percent of the income from ranch operations.⁹

As of October 24, 1993, the date of death, the corporate general partner had not been formed and the Certificate of Limited Partnership had not been filed with the State of Texas. Indeed, the corporate general partner was not formed until March of 1994 and the brokerage account in the name of Elsie Church was not changed to a partnership account until the same month.¹⁰ Her physician, who was treating Mrs. Church for cancer, testified that her death was unexpected and was unrelated to her bout with cancer.

The fair market value of the assets contributed to the limited partnership by Mrs. Church totaled slightly less than \$1.5 million at her death.¹¹ Of this figure, the value of the ranch accounted for \$380,038 and the value of cash and securities contributed by Mrs. Church was \$1,087,710.¹²

Controversy over the partnership

The estate's valuation expert valued Mrs. Church's limited partnership interest at \$617,591.¹³ That figure was not challenged nor was any explanation provided in either court opinion¹⁴ of the methodology used in establishing the discounts to reach that value.

The district court found that the partnership was a valid limited partnership under state law as of the date of her death.¹⁵ The court rejected the argument by the government that Mrs. Church had an equitable interest in the securities at

* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.

death. The court indicated that Mrs. Church clearly expressed her intent to relinquish her beneficial interest in the assets when she signed the partnership agreement.¹⁶

The government also argued that Mrs. Church had made a taxable gift in forming the partnership, represented by the difference between the value of the assets she contributed and the value of the partnership interest she received.¹⁷ The court rejected that argument, noting that the assignee interest that passed at her death was not comparable to the limited partnership interest she received in return for her contribution of assets and that the limited partnership did not increase the wealth of any partner.¹⁸ As the court noted, there was no donee for the purported gift.¹⁹

The court held, as a matter of fact, that the partnership was not a sham inasmuch as it had business purposes.²⁰ The court also found that the limited partnership “was not formed solely to reduce estate taxes.”²¹

The court observed that Mrs. Church did not have the unilateral right to amend or revoke the limited partnership agreement and that the partners had no express or implied agreement that Mrs. Church could continue to use or possess partnership property.²² The presence of such rights could have provided an additional argument for includibility of the full asset value in her estate.

In conclusion

With the taxpayer success in three recent Tax Court cases in addition to *Church v. United States*,²³ IRS faces an uphill battle in pursuing its litigating position on family limited partnerships. In *Estate of Strangi v. Commissioner*,²⁴ a family limited partnership was recognized for transfer tax purposes, with the court noting that a partnership is recognized if properly formed under state law regardless of business purpose even though set up two months before death. A similar outcome occurred in *Knight v. Commissioner*²⁵ where a family limited partnership was recognized for federal gift tax purposes where all requirements of state law were recognized. In *Estate of Jones II v. Commissioner*,²⁶ the transfer of a limited partnership interest by the donor of ranch interests to children was eligible for discounts for lack of control and lack of marketability (40 percent). Finally, in *Estate of Hoffman v. Commissioner*,²⁷ the decedent's 27.5 percent interest in a partnership was valued using a net asset value approach by applying a 47 percent discount for non-marketability and minority interest. In light of Congressional action to repeal the federal estate tax at the end of 2009²⁸ (even though the repeal “sunsets” a year later)²⁹ it seems unlikely that IRS will pursue the limited partnership issue aggressively.

FOOTNOTES

- ¹ Church v. United States, 2001-2 U.S. Tax Cas. (CCH) ¶ 60,415 (5th Cir. 2001).
- ² Church v. United States, 2000-1 U.S. Tax Cas. (CCH) ¶ 60,369 (W.D. Tex. 2000).
- ³ See generally 8 Harl, *Agricultural Law* ch. 61 (2001); Harl, *Agricultural Law Manual* § 7.04 (2001). See also Harl, “More on Family Limited Partnerships,” 12 *Agric.*

L. Dig. 1 (2001); Harl, “Recent Developments in Family Limited Partnerships,” 9 *Agric. L. Dig.* 65 (1998).

- ⁴ See notes 1 and 2, *supra*.
- ⁵ 2001-2 U.S. Tax Cas. (CCH) ¶ 60,415 (5th Cir. 2001, *aff'g*, 2000-1 U.S. Tax Cas. (CCH) ¶ 60,369 (W.D. Tex. 2000).
- ⁶ *Id.*
- ⁷ Church v. United States, 2000-1 U.S. Tax Cas. (CCH) ¶ 60,369 (W.D. Tex. 2000).
- ⁸ *Id.*
- ⁹ *Id.*
- ¹⁰ *Id.*
- ¹¹ *Id.*
- ¹² *Id.*
- ¹³ *Id.*
- ¹⁴ See notes 1 and 2 *supra*.
- ¹⁵ *Id.*
- ¹⁶ *Id.*
- ¹⁷ *Id.*
- ¹⁸ *Id.*
- ¹⁹ *Id.*
- ²⁰ *Id.*
- ²¹ *Id.*
- ²² *Id.*
- ²³ See notes 1 and 2 *supra*.
- ²⁴ 115 T.C. 478 (2000).
- ²⁵ 115 T.C. 506 (2000).
- ²⁶ 116 T.C. 121 (2001).
- ²⁷ T.C. Memo. 2001-109.
- ²⁸ Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-17, Sec. 501(a), enacting I.R.C. § 2210(a).
- ²⁹ *Id.*, Sec. 901.

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