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FAMILY LIMITED PARTNERSHIPS

— by Neil E. Harl*

In recent years, family limited partnerships have gained in popularity for various reasons.[1] Much of the popularity has stemmed from perceptions that substantial discounts could be obtained.[2] That feature has drawn the interest of the Internal Revenue Service and has resulted in targeting of family limited partnerships as a tax abuse area. Regulations have been proposed disallowing valuation at less than fair market value.[3]

Challenges to discounts

The idea that family limited partnerships could be created with the sole or primary purpose of obtaining a discount for federal estate or federal gift tax purposes has led to several challenges by the Internal Revenue Service. Although a 1985 Tax Court decision[4] allowed a substantial discount for a family partnership, a 1990 Tax Court case[5] disallowed a valuation discount when the partnership was formed for the sole purpose of reducing federal estate tax. A 1997 Tax Court decision rejected discounts proposed by the estate as producing unrealistically low values.[6]

Beginning in 1997, a series of private letter rulings has challenged family limited partnerships set up with an apparent purpose of depressing values at death or in the event of a gift. In the first of the rulings, a family limited partnership formed two days before death was disregarded by IRS for valuation purposes.[7] In that ruling, IRS observed that the only purpose for the partnership was to depress the value of partnership assets in the decedent's gross estate for the benefit of children.[8] A little over a month later, IRS ruled that a limited partnership formed pursuant to a power of attorney two months before a decedent's death was disregarded by IRS for federal estate tax valuation purposes.[9] In that ruling, the transfer of the decedent's two residences and personal property in exchange for a 98 percent limited partnership interest was followed by transfer of the partnership interest to a revocable trust for distribution to the son. Those steps were treated as a single testamentary transaction. IRS believed that nothing of substance was intended by the partnership arrangement.[10] In a letter ruling issued the following month,[11] a partnership formed from assets held in a revocable trust two months before the decedent's death at a time when the taxpayer was incompetent was disregarded for valuation purposes as serving no business purpose and because it was not a bona fide, arm's length business arrangement.[12]

About a month later, IRS ruled that exchange of $400,000 of farmland for a 99 percent limited partnership interest did not result in the claimed 40 percent discount at death 54 days later.[13] In the following year, 1998, IRS ruled that the existence of a family limited partnership would be disregarded when the sole or primary purpose was the reduction of federal estate tax for a transfer within six weeks of death.[14]

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In a 1999 federal district court case in Texas,[15] the only discount allowed to the holder of a 25 percent interest in a family partnership was a 5.4 percent discount to reflect liquidation costs.[16]

Restrictive agreements in partnership documents

If the only purpose behind the formation of a family limited partnership is to depress asset values, with nothing of substance changed as a result of the formation, any restrictions imposed by the partnership agreement are likely to be disregarded.[17] The Internal Revenue Service evaluates such transactions in light of whether the arrangement—(1) was a device to transfer property to a family member for less than adequate consideration and (2) was not the result of arm's length negotiation having a valid business purpose.[18]

Discounts based on restrictive agreements have been allowed in the past.[19] However, enactment of the "freeze" rules in 1990[20] has called that line of cases into question.[21] In a 1999 Tax Court case,[22] the court refused to approve a scheme whereby the use of "assignee interests" were used to transfer interests to children to get around the provision of I.R.C. § 2704(b).[23] The court did, in that case, agree that the partnership agreements did not contain an "applicable restriction" within the meaning of I.R.C. § 2704(b) on the grounds that the provision was no more restrictive than state law. Accordingly, a discount for lack of liquidity could be used in computing the value of partnership interests transferred for federal gift tax purposes.[24]

Conclusion

There is little doubt that IRS has their eye on family limited partnerships. Certainly any use of the concept should be accompanied by a showing of ample business reason for the transaction and should involve a careful assessment of the limitations in I.R.C. § 2704(b).

FOOTNOTES

1 See generally 8 Harl, *Agricultural Law* § 60.07 (family farm partnerships), ch. 61 (limited partnerships); Harl, *Agricultural Law Manual* § 7.04 (1999) (limited partnerships).

2 See, e.g., Estate of Watts v. Comm'r, T.C. Memo. 1985-595 (35 percent discount of 15 percent partnership interest for non marketability for federal estate tax purposes).

3 Prop. Treas. Reg. §§ 25.2704-1(a), 25.2701-1(f).

4 Estate of Watts v. Comm'r, n. 2 *supra*.

5 See Estate of Murphy v. Comm'r, T.C. Memo. 1990-472.

6 See Estate of Lehman v. Comm'r, T.C. Memo. 1997-392 (value of decedent's interest in limited partnership owning real property determined from discounted cash flow methodology with adjustments).

7 Ltr. Rul. 9719006, Jan. 14, 1997.

8 *Id*.

9 Ltr. Rul. 9723009, Feb. 24, 1997.

10 *Id*.

11 Ltr. Rul. 9725002, March 3, 1997.

12 *Id*.

13 Ltr. Rul. 9730004, April 3, 1997.

14 Ltr. Rul. 9842003, July 2, 1998.

15 Adams v. United States, No. 3:96-CV-3181-D (N.D. Tex. 1999).

16 *Id*.

17 Ltr. Rul. 9730004, April 7, 1997.

18 See Ltr. Rul. 9842003, July 2, 1998.

19 See Estate of Novak v. United States, 87-2 U.S. Tax Cas. (CCH) ¶ 13,728 (D. Neb. 1987) (discount based on buy-sell agreement).

20 See I.R.C. §§ 2701-2704, enacted by OBRA, Sec. 11602(a) (1990).

21 I.R.C. § 2704(b); Treas. Reg. § 25.2704-1(b)(1). See Ltr. Rul. 9735003, May 8, 1997 (restrictions imposed in family limited partnership failed to satisfy I.R.C. § 2704(b) exceptions); FSA Ltr. Rul. 9919009, Jan. 13, 1999 (partnership agreement provisions preventing liquidation were an "applicable restriction" under I.R.C. § 2704(b) which was disregarded in valuing transferred partnership interests to extent more restrictive than limitations under state partnership law; 45 percent discount in family limited partnership disallowed).

22 Kerr v. Comm'r, 113 T.C. No. 30 (1999).

23 *Id*.

24 *Id*.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

ANIMALS

HORSES. The plaintiff's vehicle struck the defendant's horse on a public street. The horse had escaped a fenced enclosure. The horse was kept in the limits of a municipality which had an ordinance which required owners of animals to keep their animals physically confined or restrained. The plaintiff argued that the ordinance created a strict liability for owners of animals. The court held that the ordinance did not create a strict liability standard but only established a claim for negligence per se for violation of the ordinance. **Lui v. Barnhart, 987 P.2d 942 (Colo. Ct. App. 1999)**.

BANKRUPTCY

CHAPTER 12-*ALM* § 13.03.*

ELIGIBILITY. The debtors, husband and wife, had been engaged in farming for over 15 years and owned as much as 360 acres on which they operated a cow/calf operation and grew crops. Because of financial difficulties from weather

**Agricultural Law Manual* (ALM).