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Publisher/Editor
Robert P. Achenbach, Jr.
Contributing Editor
Dr. Neil E. Harl, Esq.

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MORE ON FAMILY LIMITED PARTNERSHIPS

— by Neil E. Harl*

Three recent Tax Court cases¹ have provided significant insights into the treatment of family limited partnerships.² While the Internal Revenue Service took an aggressive stance in challenging family limited partnerships or FLPs in 1997 and 1998,³ particularly where the only purpose behind the formation of a family limited partnership was to depress asset values with nothing of substance changed as a result of the formation,⁴ the recent cases have focused on the possibility of a gift on formation of the FLP⁵ and on whether a business purpose must be shown for a FLP to be recognized for tax purposes if properly formed under state law.⁶

Possible gift on formation

In a case decided October 26, 2000, *Shepherd v. Commissioner*,⁷ leased timber land and bank stock were transferred to a general family partnership in which the donor held a 50 percent interest (and each son a 25 percent interest). The taxpayer initially contributed \$10 and each son \$5 to the partnership. On the same day, the taxpayer transferred land to the partnership and, about a month later, transferred bank stock to the firm. Under the terms of the agreement, ownership of the property was allocated among the partners in accordance with their initial percentages (50 percent to the taxpayer and 25 percent to each son). The court viewed the transaction as an indirect gift to each son of 25 percent of the land and bank stock, not as gifts of 25 percent of the partnership. Accordingly, the gifts could not be discounted as minority ownership interests and for lack of marketability and lack of control. The only discounts allowed were a 15 percent fractional interest discount and a 15 percent minority interest discount.⁸ Had the land and bank stock been first transferred to a valid partnership or LLC with the sons then brought in as partners, the larger discounts should have been available.

Necessity for business purpose

In *Estate of Strangi v. Commissioner*,⁹ the Tax Court rejected the IRS position that, under the business purpose and economic substance doctrines, the limited partnership at issue should be disregarded in valuing assets in the decedent's estate. The taxpayer had formed a family limited partnership and transferred assets, including securities, real estate, insurance policies, annuities and partnership interests to the entity in return for a 99 percent limited partnership interest. While the court was skeptical of the estate's claims of business purpose for the formation, the court found that the family limited partnership was validly formed under state law. The court agreed that the partnership "had sufficient substance to be recognized for tax purposes."¹⁰

The Internal Revenue Service also argued that I.R.C. § 2703(a)(2) applied and

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

See the back page for details about the
2001 Agricultural Tax and Law Seminars
by Dr. Neil Harl and Prof. Roger McEowen

supported the argument that the limited partnership should be disregarded for transfer tax purposes. That subsection deals with restrictions on the right to sell or use property which reduce the value of a decedent's assets for federal estate tax purposes.¹¹ The court said neither the statute nor the regulations support the IRS interpretation. The court, citing *Kerr v. Commissioner*,¹² concluded that Congress did not intend that partnership assets be treated as if they were assets of the estate where the legal interest owned by the decedent at the time of death was a limited partnership (or corporate) interest.

A discount of 31 percent was allowed (eight percent for minority interest, 25 percent for lack of marketability) as to the limited partnership interest and 19 percent for the general partnership interest (five percent minority interest and 15 percent lack of marketability).

The third case, *Knight v. Commissioner*,¹³ involved the question of whether a family limited partnership interest should be recognized for federal gift tax purposes. The Tax Court observed that all requirements of state law were met. A discount of 15 percent was allowed for minority interest and lack of marketability.¹⁴

As for the IRS argument that I.R.C. § 2704(b) applied, which makes reference to an "applicable restriction," the court noted that the restrictions were not more restrictive than the limitations that would apply to partnerships under state law and, therefore, the Section 2704(b) provisions do not apply. Under that subsection, restrictions required or imposed by state or federal law are not included in "applicable restrictions."¹⁵

In conclusion

The picture has become more clear with the three recent Tax Court decisions. Certainly the family limited partnership is under less of a cloud as a result but it is vital that FLPs be set up carefully to avoid challenges of the type raised in *Shepherd v. Commissioner*.¹⁶

FOOTNOTES

¹ *Shepherd v. Comm'r*, 115 T.C. No. 30 (2000); *Estate of Strangi v. Comm'r*, 115 T.C. No. 35 (2000); *Knight v. Comm'r*, 115 T.C. No. 36 (2000).

² See generally, Harl, "Recent Developments in Family Limited Partnerships," 9 *Agric. L. Dig.* 65 (1998).

³ Ltr. Rul. 9719006, Jan. 14, 1997 (only purpose for partnership was to depress value of partnership assets through decedent's gross estate into control of children); Ltr. Rul. 9725002, March 3, 1997 (partnership formed from assets held in revocable trust two months before death at time when taxpayer incompetent; partnership disregarded for property valuation purposes as serving no business purpose and not bona fide arm's length arrangement); Ltr. Rul. 9723009, Feb. 24, 1997 (transfer of decedent's two residences and personal property in exchange for 98 percent limited partnership interest followed by transfer of partnership interest to revocable trust for distribution to son treated as single testamentary transaction; IRS believed nothing of substance was intended by partnership arrangement); Ltr. Rul. 9730004, April 3, 1997 (\$400,000 of farmland exchanged for 99 percent limited partnership interest; unsuccessful attempt to value partnership 54 days later for federal estate tax purposes with 40 percent discount); Ltr. Rul. 9842003, July 2, 1998 (sole or primary purpose was reduction of federal estate tax for transfer within six weeks of death; existence of family limited partnership disregarded) FSA Ltr. Rul. 200049003, Sept. 1, 2000 (same).

⁴ *Id.*

⁵ See *Shepherd v. Comm'r*, 115 T.C. No. 30 (2000).

⁶ *Estate of Strangi v. Comm'r*, 115 T.C. No. 35 (2000); *Knight v. Comm'r*, 115 T.C. No. 36 (2000).

⁷ 115 T.C. No. 30 (2000).

⁸ *Id.*

⁹ 115 T.C. No. 35 (2000).

¹⁰ *Id.*

¹¹ I.R.C. § 2703(a)(2).

¹² 113 T.C. 449 (1999).

¹³ 115 T.C. No. 36 (2000).

¹⁴ *Id.*

¹⁵ See *Kerr v. Comm'r*, 113 T.C. 449 (1999).

¹⁶ 115 T.C. No. 30 (2000). See notes 7-8 *supra*.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

Chapter 12-ALM § 13.03[8].*

DISMISSAL. The debtor participated in a horse farm in Ohio with the debtor's aunt and mother. The operation encountered financial difficulties and one creditor attempted to sell some horses at a sheriff's sale. Before the sale could commence, the debtor filed for Chapter 13 in order to stop the sale. The creditors decided to continue the sale, and prior to dismissing the Florida case, the debtor filed for Chapter 12 in Ohio. The court held that

the Chapter 12 case was to be dismissed for cause because (1) the debtor was not qualified for Chapter 12, (2) the debtor failed to prove that the horses were estate property, (3) the petition was filed solely to halt the sale of the horses, (4) the debtor did not list the horses as estate property and did not timely file the bankruptcy schedules, and (5) the debtor's schedules demonstrated that the debtor had minimal debt and did not need reorganization. *In re Burger*, 254 B.R. 692 (Ohio S.D. 2000).

FEDERAL TAX-ALM § 13.03[7].*

EARNED INCOME CREDIT. The debtor filed for Chapter 7 in 1996 but did not make the election to terminate the tax year on the date of the petition. The debtor filed the 1996 tax return in