

Effectiveness of Family Limited Partnerships in Light of New Case Law

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PRACTICES Tax-Exempt Organizations and Private Foundations, Trust and Estate Administration, Family Office, Family Wealth and Estate Planning, Private Clients and Estate Planning, Tax

In two recent decisions, the Tax Court issued rulings that could impact the effectiveness of family limited partnerships in estate planning.

For the first time, the Tax Court held that assets of a limited partnership could be taxed as part of the estate of a decedent who held only a limited partnership interest. The Tax Court cited certain provisions in Code Section 2036 that call for inclusion in the decedent's estate of property the decedent has transferred where he or she had "the right, either alone or in conjunction with another person, to designate the persons who shall possess or enjoy the property or the income therefrom." The Court determined that, in one of these cases, that the decedent (i) could dissolve the partnership at any time by voting her limited partnership interest together with all of the other partners, and (ii) could determine the time and amount of distributions made to the partners pursuant to her general partnership interest.

It is important to note that the provisions in Code Section 2036 cited by the Court do not apply if the transfer of the property to the partnership (or transfer of partnership interests to family or trusts) was a "bona fide sale for an adequate and full consideration in money or money's worth." As in most unfavorable tax cases, the planning and execution of limited partnership formation and operation was not flawless; often, "bad facts" result in "bad law." So, these cases may not pose any risk for well-planned, well-executed transactions with conservative appraisal reports issued by highly qualified valuation firms.

Nevertheless, these cases raise the risk that the IRS will argue for estate taxation of prior transfers of partnership interests where the client has retained any interest in a partnership, whether the client retained a general partnership interest or a limited partnership interest, that allows the client to vote on amendment of the limited partnership agreement, dissolution of the limited partnership, or distributions to the partners.

We are in the process of sending out more detailed letters to those clients who have established family limited partnerships with us. The letter includes some potential options to consider in light of these recent cases.

Please contact us if we can assist you in (i) reviewing your current partnership agreement, and (ii) discussing how you might structure, fund, and operate a family limited partnership properly in order to avoid attacks by the IRS.