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# Family Limited Partnerships: Are They Still a Viable Weapon in the Estate Planner's Arsenal?

Matthew Van Leer-Greenberg Esq., LLM
*Associate at the Law Firm of Van Leer and Greenberg Esqs.*

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## INTRODUCTION

The O'Brien family has owned the very same butcher shop for four generations. Mr. and Mrs. O'Brien, the current owners, are in their early sixties and plan on retiring within the next ten years. They desire to pass on the family business to their three sons. The eldest son is a lawyer, the middle son is a doctor, and the youngest son is an apprentice butcher and a quick learner. The third son wants to take over the family business and continue to sell the best chop-meat in the township. Mr. and Mrs. O'Brien wish to retain control and ownership over the business until they feel that their children have been properly trained and are ready to manage this responsibility.

Seeking counsel on how to effectively pass this particular asset to the next generation, the O'Briens have come to you. The O'Briens have several different options for transferring the business, including transferring the business into a corporation or a limited liability company while retaining the majority interest in the entity, or even making the business a gift to their sons when they feel that they are ready to retire. While these are all good options, the main discussion in this Article is whether it is still

* Associate at the Law Firm of Van Leer and Greenberg Esqs., Trusts and Estates Department. LLM, Taxation, Boston University School of Law, 2019; J.D., Roger Williams University School of Law, 2018. This article is dedicated to The Rainmakers Dean William Schwartz, Esq. and Ira I. Van Leer, Esq., LLM.

viable to put this burgeoning butcher business into a Family Limited Partnership (FLP).

The FLP is a business entity and an estate planning tool that is designed to allow for protection against creditors and smooth succession of a family business upon the death of the owner.[1] The FLP also provides valuable discounted rates on a business or assets within the FLP, as well as removes assets from a person's estate in order to limit their estate tax liability.[2] Even though this estate planning option provides significant benefits to the benefactor, upon the transfer of the property to the FLP, both federal appellate and tax court decisions have reduced the effectiveness of this tool as a means of devaluing property and removing property from the decedent's estate.[3]

The purpose of this Article is to provide a novice estate planner with the general mechanics of an FLP, as well as provide guidance as to the circumstances that must be present for an FLP to be a viable estate planning technique. Part I discusses Internal Revenue Code section 2036 and how it relates to FLPs. Part II dives into the concept of valuation and how an FLP devalues assets within the partnership entity itself. Part III explains what an FLP is and its benefits as an estate planning tool. Part IV provides an in-depth look at *Strangi* and *Powell,* and the Internal Revenue Service's (IRS) attack on the FLP. Lastly, this Article explains of what an estate planner needs to be aware when planning with an FLP, and that, even considering the intense restraints imposed by various courts, using an FLP as a method of transferring wealth is a legitimate option when a business is a central part of a family's income.

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1. *See* Milton Childs, *Using Family Limited Partnerships for Estate Planning*, 5 MARQ. ELDER'S ADVISOR 193, 194–95 (2004).

2. *See id.* at 193–94.

3. *See* Strangi v. Comm'r, 417 F.3d 468, 472 (5th Cir. 2005); *see also* Estate of Powell v. Comm'r, 148 T.C. 392, 393 (2017). *Powell* and *Strangi* are two of the seminal cases regarding the restriction of power on the use of the FLP in the estate planning field, but there are numerous cases arising out of both the Tax Court and the Circuit Courts (post-*Strangi*) that curtail the use of the FLP even further.

## I. WHAT IS I.R.C. SECTION 2036?

Before tackling FLPs, it is important that certain components of both estate and gift tax law, along with estate and gift tax planning, are reviewed to understand why the FLP business structure is important and why it has been under significant scrutiny by the IRS. In other words, one needs a general understanding of Internal Revenue Code sections 2036(a) and 2036(b).[4] Section 2036 was created to prevent estate tax evasion by transferring title of a piece of property from the decedent to a beneficiary while allowing the transferor to retain all indicia of ownership over the piece of property.[5] The statute is further broken down between subsections (a)(1), (a)(2), and (b)(1).[6]

Subsection (a)(1) states that property will be retained by the decedent's estate if the property is transferred from the decedent to the beneficiary and the decedent retained *possession* or *enjoyment* of the property or the right to income from such property.[7] Possession and enjoyment do not necessarily mean that the decedent had fun with the property but rather that he derived a

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4. For the purpose of this Article, the relevant code provisions are specifically: I.R.C. § 2036(a)(1)–(2), (b)(1) (2012). Section 2036 is entitled "Transfers with Retained Life Estates"; it reads in pertinent part as follows:

> (a) General rule.—The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—
>
> (1) the possession or enjoyment of, or the right to the income from, the property, or
>
> (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.
>
> (b) Voting rights.—
>
> (1) In general.— For purposes of subsection (a)(1), the retention of the right to vote (directly or indirectly) shares of stock of a controlled corporation shall be considered to be a retention of the enjoyment of transferred property.

5. *See* § 2036.
6. *See id.*
7. § 2036(a)(1).

"substantial present economic benefit" during his life that he would not have otherwise enjoyed if the property was sold to an unaffiliated third party in an arms-length transaction.[8] Right to income under section 2036(a)(1) means that the income is used for the decedent's benefit during her or his life, not that she or he received the income directly.[9] For example, the decedent transfers money to a trust, but then directs the trustee to pay money out of the trust for the decedent's debts and support obligations. Such a maneuver would require the decedent to include those assets in his estate under section 2036(a)(1).

Along with possession or enjoyment, property can also be included in the decedent's estate if the decedent designated who can enjoy the property or its income.[10] Under subsection (a)(2), if the transferor retains an inter vivos or testamentary power to choose who will receive property, then that property will be included in the decedent's gross estate.[11] It is also possible that subsection (a)(2) comes into effect if the decedent retained the right to property indirectly.[12] By way of illustration, if the decedent includes in an *inter vivos* trust document a provision where the resignation of the current trustee provides the decedent with the ability to become trustee and name beneficiaries of the property or trust income, the property will be included in the beneficiary's estate.[13]

While subsections 2036(a)(1) and (a)(2) cover the decedent's direct control over property, subsection (b)(1) addresses the decedent's ability to control stock in a corporation that he might own at the time of his death.[14] Here, if a decedent was to try and rid himself of any ownership rights in stock owned in a corporation to a trustee and the trustee was to have discretion over what third party could obtain ownership, even though the corporate stock was out of both the decedents hands and his discretion, it is possible that the stock could be included in his gross estate if the decedent

8. *See* Estate of Trotter v. Comm'r, 82 T.C.M. (CCH) 633, 636 (2001).

9. *See* RICHARD B. STEPHENS ET AL., FEDERAL ESTATE AND GIFT TAX, ¶ 4.08(4)(b) (9th ed. 2013).

10. § 2036(a)(2); *see also* STEPHENS ET AL., *supra* note 9, ¶¶ 4.08(4)(b), 4.08(5).

11. *See* STEPHENS ET AL., *supra* note 9, ¶ 4.08(5).

12. *Id*. ¶ 4.08(5).

13. *See id.*

14. § 2036 (b).

was to retain voting rights over the corporate stock.[15] Under section 2036(b), the stock will be treated as if the decedent never renounced enjoyment or control if he were to retain voting rights over the stock during his life.[16] Under section 2036(b), referred to as the anti-*Byrum* provision, "the direct or indirect retention of voting rights in a 'controlled corporation' is 'considered' a retention of the 'enjoyment' of transferred property so as to trigger application of Section 2036(a)(1)."[17] For the purposes of subsection (b)(1), as stated in subsection (b)(2), a "'controlled corporation' [is] one in which the decedent owns, directly or by attribution . . . at least 20% of the combined voting power of all classes of stock of the corporation" at the time of his death.[18]

One way to side step the technicalities of section 2036 is to sell the property for full and adequate consideration.[19] However, one must satisfy two elements in such a sale to bypass section 2036: (1) there must be a "bona fide sale" in an arms-length transaction and (2) it must be for full consideration in "money or money's worth."[20] Generally speaking, the selling price should be at least close to full fair market value.[21] A legitimate sale of property will show that any retention of ownership has been extinguished but this is not helpful, especially if one wants to retain the property within a business entity such as an FLP.[22] Understanding section 2036 is important for the purposes of depositing property within an FLP. If there are incidents of ownership that are retained by the transferor, that property will be includable within the decedent's estate, which is counterproductive if you are trying to remove the item from the decedent's estate and move it downstream to the next generation.[23]

15. STEPHENS ET AL., *supra* note 9, ¶ 4.08(6)(d).
16. *Id*.
17. *Id*.
18. *Id*. (internal quotations marks omitted); *see generally* I.R.C. § 318 (2012) (providing attribution rules for partnerships, estates, trusts and corporations).
19. STEPHENS ET AL., *supra* note 9, ¶ 4.08(1)(a).
20. *Id*.
21. *See* Kevin A. Lucid, *It's A Tax Thing: The Misnamed "Heightened Scrutiny" Standard for Evaluating Family Limited Partnerships*, 26 QUINNIPIAC PROB. L.J. 403, 408 (2013).
22. *See id.* at 404.
23. *See id.* at 411.

## II. THE PRINCIPLES OF VALUATION

As one of my law school professors described, valuation is the ocean of gray that abuts the shore of black letter law. Valuation of property is crucial for two important reasons: (1) it allows attorneys to be creative in their determination of how to properly evaluate assets for income, gift, and estate tax, and (2) it can determine the discount or deduction that a person can take when they place an item of property, or even a business, into an FLP. In recent years, valuation has become an effective planning tool in order to reduce the total value of the decedent's gross estate.[24]

Valuation is an essential building block of estate planning, for it is determinative of the fair market value of an asset that can either be in the decedent's estate or determine the gift taxes that are required to be paid when a decedent makes a gift to a beneficiary.[25] As the axiom of income taxation goes, fair market value is "the price a buyer and a seller would reach at the bargaining table, under the circumstances without any coercion or compulsion."[26] When someone takes an asset and either places significant restrictions on the disposition of that asset or places the asset in a business entity, the fair market value is reduced. That asset value reduction is referred to as a valuation discount.[27]

Valuation discounts can be understood using the following example: A owns Blackacre, a parcel of land with no restrictions. A sells Blackacre to Third Party for $100,000. The completed transaction represents that in an arms-length sale, the fair market value of the property is $100,000. Conversely, imagine that A puts Blackacre into a partnership or other corporate entity. The partnership agreement specifically prevents A from selling Blackacre to a third party, unless a plethora of different requirements are met. Because of that lack of marketability, or restraint upon A's ability to convey Blackacre only upon certain conditions, A's ability to sell the property has been greatly

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24. *See* Jonathan C. Lurie & Edwin G. Schuck, Jr., *Valuation*, *in* ESTATE PLANNING IN DEPTH: ALI-ABA COURSE OF STUDY 231, 235 (2008).

25. *See* JOHN A. BOGDANSKI, FEDERAL TAX VALUATION, ¶ 42.03(1) (1996).

26. Lucid, *supra* note 21, at 408 (citing Treas. Reg. § 20.2031–1 (as amended in 1965)); *see also* 26 C.F.R. § 25.2512–1; James R. Hamill & Donald W. Stout, *Valuation Discounts for Intrafamily Transfers*, TAX'N FOR ACCTS., Aug. 1997, at 75, 75.

27. *See* Lucid, *supra* note 21 at 408.

diminished, and if Third-Party wanted to buy A's stake in the partnership, Third Party's ability to sell his shares of the partnership interest would be greatly reduced. In light of this reduction in alienability, A's partnership interest would not be valued at $100,000, but would in fact be deflated anywhere from 15% to 30% (depending on what an expert evaluator determines).

As the aforementioned example indicates, when an asset is owned by a business entity, a third-party purchaser would likely pay less for the asset than if it was owned outright by the decedent, making the asset unmarketable and subsequently lessening its value.[28] There are a few manners in which one could achieve such a valuation discount when placing an asset into an FLP or any other type of business entity. The first is called the minority interest method, where the owner of the asset transfers the asset into a closely held business and in return is given a minority interest in the closely held business entity; the asset may be eligible for a valuation discount because the owner of the interest now lacks total and complete control over the entity in question.[29] The second manner of valuation discount is caused by a lack of marketability.[30] While the lack of marketability can be due to a minority interest in the asset, it can also occur because the asset is no longer easily removable from the business entity (i.e., removing an asset from a C-corporation or a closely held corporation requires a significant amount of legal maneuvering to wrest the asset out of the business entity in question).[31] The last type of valuation discount is referred to as a portfolio discount, the principle behind which is "that if an entity contains an undesirable mix of different assets, there should be a discount to reflect the fact that a buyer may be forced to accept assets not wanted in order to buy the assets that are wanted."[32]

Valuation discounts are unlike a flat rate postage stamp, where each discount will be the same. Rather, discounts will vary depending on a multitude of different factors, including the type of asset or assets, the type of business entity into which the asset is

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28. *See id*. at 408–09.
29. *See* Martin A. Goldberg & Cynthia M. Kruth, *New Life for Valuation Discounts in Family Entities*, 16 QUINNIPIAC PROB. L.J. 48, 49 (2002).
30. *See id.*
31. *See id.*
32. *Id.*

placed, the minority interest that the decedent receives in return, market forces at the time of the transaction, and the allowable disposition of the asset in question.[33] For example, "[a] limited partnership interest in a partnership owning real property will have a higher range of discounts than a limited partnership interest in a partnership owning marketable securities."[34] Moreover, "some appraisers discount marketable securities differently depending upon the risk associated with the security."[35] Valuation discounts can vary amongst lawyers and appraisers across the country. A lack of marketability interest or a valuation discount can range from 30-60% of the total fair market value, and many IRS examiners allow up to 40% for real estate partnerships and 25% for securities-based partnerships.[36] Thus, one should advise that mixing assets such as real-estate, securities, and passive income would be the best way to maximize the total valuation discount that a decedent could achieve.[37] Valuation discounts are the keystone to the use of the FLP because of the accepted ability to "shrink" the value of the asset that was previously contained in the decedent's estate by anywhere from 30–60%. While obtaining a valuation discount is one of the major reasons to create an FLP, there are also other benefits of this estate planning tool.

## III. (ENTER STAGE RIGHT) THE FAMILY LIMITED PARTNERSHIP

### A. *An Introduction to the Benefits of a Family Limited Partnership*

Just to reiterate, an FLP is a partnership entity whereby a family member puts assets into a partnership entity and each family member is provided with shares of stock in the partnership, as enumerated in the partnership agreement.[38] Normally, there are general partners of the business who retain the majority

33. *See* Dennis I. Belcher, *Valuation Discounts: Theory and Practice*, *in* ESTATE PLANNING IN DEPTH: ALI-ABA COURSE OF STUDY 273, 308 (2003).

34. *Id.*

35. *Id.*

36. *Id.*

37. *Id.* at 309.

38. *See Family Limited Partnership (FLP)*, INVESTOPEDIA, https://www.investopedia.com/terms/f/familylimitedpartnership.asp [https://perma.cc/27YU-YN4Z] (last updated May 15, 2019).

ownership in either the business or the assets, and run the day-to-day operation of the partnership.[39] Additionally, there are limited partnership members who have no managerial responsibilities of the partnership entity, and who will buy shares of the partnership interest in exchange for any dividends generated.[40] The limited partners will also be insulated from any liability that befalls the business during its operation.[41]

One of the beneficial uses of the FLP is the continuity of control when either assets or a business is transferred to the FLP.[42] If a business owner wanted to transfer his business outright to a beneficiary, this is a feasible option. However, the business owner, upon transfer, would no longer have any control over the entity, and would lack any authority to dictate how to run the business. Conversely, putting the business into an FLP will allow for parents, such as the O'Briens, to continue to have control of the business and assets while preventing unintended beneficiaries from obtaining rights in the business and allowing for their children to slowly buy shares of the business until the parents retire or die.[43]

Asset protection and consolidation are other positive attributes of using the FLP. Rather than having a multitude of different assets that are owned by many persons or entities, putting the partnership assets into a singular entity can help with management and reduce federal income and estate taxes if the assets were to generate income on a yearly basis.[44] Aside from management and tax reduction, the FLP also helps with protecting assets from any liability that might arise in the future.[45] When an asset is placed into a limited partnership, the limited partnership owns the interest, and hence, it is protected from any personal liability incurred by the general partners.[46]

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39. *See id.*
40. *See id.*
41. *See* Childs, *supra* note 1, at 194.
42. *See id.*
43. *See id.* at 194–95.
44. *See id.* at 195, 197–98.
45. *Id.* at 195.
46. *See id.* Limited partners and managers generally will not subject the assets to creditor claims. *See id.*

The FLP can also aid in the income taxation of the general partners.[47] A partnership is a "pass through" entity, meaning that the income or loss that is generated by the partnership will flow through the business entity and will be taxed to the partners either in a pro-rata share or according to the partnership.[48] While this can be an optimal business situation, depending on the type of business that one is running, it can have less than ideal effects if the partnership is earning a significant amount of money and the partners are in a high-income tax bracket. [49]

As set forth in the preceding section, the FLP provides significant estate planning benefits such as the valuation discount.[50] When an asset owner contributes an asset to the FLP, and in return receives stock in the FLP, the asset owner lowers the total value of his gross estate through the use of the valuation deduction associated with the non-marketability of his stock.[51] This means that instead of the owner paying tax on 100% of the value of the asset in his gross estate, he would pay tax on anywhere from 40% to 70% of the total value of his estate's assets (reflecting a valuation discount of 30% to 60%).

The FLP is a useful tool in the realm of estate planning. This planning device not only allows for the smooth transition of a business interest from the elder generation to a beneficiary, but also provides asset protection, income tax benefits, and an estate tax deduction for the person that is contributing the asset. While this estate planning tool might appear to be a true windfall to the grantor of the property or assets to such FLPs, the IRS has begun to mount a full offensive against the use of FLPs in the estate planning realm and has attempted to restrict its use.

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47. *See id.* at 197.

48. *Id.* at 197.

49. *Id.* at 197–198 ("The family limited partnership can provide tax savings to the partners by spreading income from the parents, who are probably in a higher income tax bracket, to the children, who are probably in a lower income tax bracket. Additionally, the partnership agreement can be written to state that all proceeds to the children will not be distributed; portions may be used to pay their income tax and some or all the rest may be put aside for savings.").

50. *Id.* at 198.

51. *Id.*

### B. *How to Set Up a Family Limited Partnership Entity*

As previously discussed, an FLP comes with benefits (as well as burdens), but the benefits cannot be appreciated without understanding how this business entity is constructed and funded. For example, returning to the O'Brien family mentioned in the opening paragraph, Mr. and Mrs. O'Brien have tasked you with creating an FLP in order to transfer their business to their youngest son. So how do you go about forming the FLP?

#### *1. Timing*

Even before drafting the partnership agreement and submitting the necessary paperwork to the secretary of state, the attorney must ensure that the owners of the property funding the FLP are not near death, or exceedingly aged.[52] This is important for two reasons: the more elderly the FLP owners are, the more likely the IRS will try to substantiate that this was a "death bed transfer," or that the family engaged in this transaction for estate tax defeating purposes.[53] Here, Mr. and Mrs. O'Brien are in their early sixties, thus, the attorney could easily substantiate that the family made the transfer for business-related purposes and not to limit their estate tax liability.

#### *2. Drafting the Partnership Agreement*

The partnership agreement is one of the most important aspects of the FLP, for it not only dictates the purpose of the limited partnership, but will explain what assets are being held in the business entity, how the partnership classes of stock will be allocated amongst the partners, what other limitations there are on the alienability and transferability of the stock by the stockholder, and any other business formalities the limited partnership might have.[54]

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52. *See* Estate of Erickson v. Comm'r, 93 T.C.M. (CCH) 1175, 1182 (T.C. 2007).

53. *See id*. at 1181–82 (stating that one of the major factors in determining retention of possession or enjoyment was the fact that Decedent's assets were not transferred until mere days before her death).

54. RAY D. MADOFF ET AL., PRACTICAL GUIDE TO ESTATE PLANNING, § 8.07[B][3] (Barbara L. Post, ed., 2019); *The Family Limited Partnership*

a. *The FLP's Purpose*

The FLP agreement has to set out its purpose to substantiate that the particular entity is not being used merely for estate tax avoidance, but rather for a legitimate business-based purpose.[55] Some legitimate purposes include consolidation of business assets for the purpose of easier administration or organization; effortless transition of business property from the senior generation business owner to the incoming generation; providing incremental transfer of the family business to the incoming family member as the new generation becomes more comfortable with operating the family business; and creating a liability shield to protect the business owners from any and all civil liability that might occur. In our instance, it is clear based on the facts above, that the business purpose of this FLP is to slowly hand over the reins of the family business to the youngest of the O'Brien family members who desires to carry on the family business.

b. *The Family Limited Partnership Property*

When structuring the limited partnership agreement, it is important to list what assets will be provided to the partnership when the limited partnership is initially funded. Generally, both the IRS and courts will look down upon FLPs that are funded with only passive assets; courts generally consider that FLPs housing passive assets are being used for estate tax evasion rather than for legitimate business purposes.[56] Passive assets include stocks, bonds, securities, tangible property, and items of property.[57] When

*Agreement*, L. OFFS. ROBERT J. MINTZ, https://www.rjmintz.com/family-limited-partnership/the-partnership-agreement-and-capital-structure [https://perma.cc/47EN-AFG3] (last visited March 30, 2019).

55. *Following FLP Formalities*, L. OFFS. ROBERT J. MINTZ, https://www.rjmintz.com/family-limited-partnership/following-flp-formalities [https://perma.cc/8HK9-GNRH] (last visited October 27, 2019). Many estate-tax cases that revolve around FLPs generally speak about the FLP's purpose and whether that purpose was for a legitimate business reason or merely a façade to estate tax evasion. Before drafting any limited partnership agreement, an estate tax attorney should research related cases, and see what business purposes have been upheld by either the Tax Court or other federal courts and how the taxpayer was able to substantiate their limited partnership purposes.

56. *See, e.g.*, *Estate of Erickson*, 93 T.C.M. (CCH) at 1181.

57. *See id.*

funding an FLP, it is important to include in the funding of the partnership some non-passive assets, such as a business that requires oversight and regular management. Since Mr. and Mrs. O'Brien have no desire to transfer any of their assets to their son besides the business, it is unlikely that the IRS would challenge this FLP because there is only one asset—an active one—being transferred to the next generation.

c. *Ownership Interest in the Family Limited Partnership*

Once the attorney has devised the purpose of the limited partnership and planned which assets will initially be placed in the entity, the next step is to figure out the ownership interest. One can be as creative as they want with respect to devising the ownership interest of the limited partnership. To keep things simple, the donors of the property should retain a small general partnership interest and a majority of the limited partnership interest in the corporation to maintain majority control over the assets put into the FLP.[58] The beneficiary of this partnership interest should either be given a small limited partnership interest or buy his share of the limited partnership interest.[59]

Here, Mr. and Mrs. O'Brien would retain a small general partnership interest and most of the limited partnership interest in the FLP that would now own the Butcher Shop, and their youngest son can either buy his initial limited partnership interest or his parents can provide his interest as an initial gift. Over a period of time, the youngest son could be gifted more shares of the limited partnership interest or purchase more shares of the limited partnership interest from his parents.

*3. Filing and Funding*

After creating a partnership agreement, the next step in the process is to follow your state's local procedure for the creation of

58. Lawrence Peck, *Family Limited Partnerships 101*, BIZFILINGS, https://www.bizfilings.com/toolkit/research-topics/running-your-business/asset-strategies/family-limited-partnerships-101 [https://perma.cc/7Y83-ZR4K] (last visited November 29, 2019).

59. *See id.*

an FLP.[60] Upon certification that the FLP is a recognized entity by the state, the owner of the assets should then retitle the assets to the FLP. The retitling of the assets should take place immediately after the certificates of limited partnership are filed with the secretary of state.

#### *4. Following the Business Formalities Set Forth in the Partnership*

Upon transferring the assets to the partnership, the general partners can no longer treat the assets as if they were their own. The general and limited partners must treat the assets as if they were owned by a third-party who had purchased the assets. This means that the general partners can no longer hold out that such property is their own and must keep separate financial records for the limited partnership, not co-mingle any property, and follow all formalities set out by the partnership agreement.[61]

#### *5. Transferring of the Partnership Interest to the Next Generation*

Once the aforementioned formalities have been followed, the general partners (or donors) can begin shifting their limited partnership interest to their limited partner and transferring ownership (not managerial) interest to the intended beneficiary.[62] Upon the creation of the FLP, the O'Briens will be able to remove the family business from their total gross estate, yet retain a general ownership interest in the partnership entity. Furthermore, the O'Briens can begin transferring the limited partnership interest to their youngest son over time.

While these are the basic mechanics of how to properly erect an FLP, an attorney can create a limited partnership that is more complex and nuanced to suit the needs of his or her client. Even though these documents can be more complex, all FLPs must have a well-written partnership agreement and partners who will respect the partnership entity, while also following the business formalities that the limited partnership has created.

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60. *See, e.g.*, MASS. GEN. LAWS ch. 109, § 13 (1982). It is also at the time of filing with the state that the partnership should obtain a registered Federal Employment Identification Number (FEIN).

61. MADOFF ET AL., *supra* note 54, § 8.07[B][3], at 8042; *The Family Limited Partnership Agreement*, *supra* note 54.

62. *See* MADOFF ET AL., *supra* note 54, § 8.07[B][3], at 8044.

### C. *(Enter Stage Left)* Strangi *and* Powell

The seminal case that has hampered and restricted the use of FLPs is *Strangi v. Commissioner*.[63] Albert Strangi died on October 14, 1994, and was survived by four children from his first marriage: Jeanne, Rosalie, Albert Jr., and John (Strangi Children).[64] After divorcing his first wife, Strangi married Delores Seymore, who had two children from a prior marriage.[65] In 1990, Strangi executed a will naming the Strangi Children as the sole beneficiaries should his second wife pre-decease him, effectively cutting out Seymore's children.[66] Strangi's attorney Gulig—married to Rosalie Strangi—discussed Strangi's estate with a retired Texas probate judge, Judge David Jackson.[67] Judge Jackson stated that Gulig would have to protect the assets from any impending litigation facing the family.[68]

To devise a method to protect the estate's assets, Gulig attended a seminar provided by Fortress Financial Group, which was touting its "Fortress Plan" as a means of asset protection.[69] The Fortress Plan used an FLP to protect the assets of the estate, provide income tax benefits, and lower the value of the taxable estate.[70] Gulig opted to use the FLP plan and created the "Strangi Family Limited Partnership" (SFLP).[71] He immediately thereafter created Stranco, Inc. (Stranco).[72] Gulig transferred into the SFLP a total of $9,932,967 of Strangi's wealth in exchange for a 99% limited partnership interest.[73] He also transferred $49,350 of Strangi's assets to Stranco in exchange for 47% of Stranco's common stock, facilitated the purchase of the remaining 53% of Stranco's common stock by the Strangi Children for $55,650, and issued a check from Stranco for a 1% general partnership interest.[74]

63. 417 F.3d 468 (5th Cir. 2005).
64. *Id.* at 472.
65. *Id.*
66. *Id.*
67. *Id.* at 473.
68. *Id.*
69. *Id.*
70. *Id.*
71. *Id.*
72. *Id.*
73. *Id.*
74. *Id.*

Gulig created a three-tiered structure, with roughly $10 million in assets in the FLP.[75] Stranco had a 1% general partnership interest in the SFLP and had the sole authority to run and conduct the business affairs of the partnership, while Strangi had a 99% interest and had no formal control over the assets in the partnership.[76] In the Stranco tier, Strangi owned 47% of Stranco's common stock, while each child owned a 13% interest in the stock of the company.[77] All of the corporate formalities, such as creation of a board of directors and shareholder agreements, were formalized on August 17, 1994.[78]

Before Strangi's death in October 1994, the SFLP made two distributions in the amounts of $6,000 and $8,000 to Strangi because Strangi retained minimal liquid assets with which to support himself.[79] After his death, the SFLP had to distribute an additional $40,000 to pay for funeral expenses.[80] Moreover, Strangi lived in one of the two properties that were transferred to the SFLP and he did not actually pay the rent until approximately two years after his death.[81] In 1998 the IRS reported a deficiency, stating that the estate owed either $2,545,826 in estate tax or $1,629,947 in gift tax, because Strangi actually owned the $10,947,343 in assets under IRC section 2036(a) since he retained control and benefitted from the property in question.[82] Strangi's estate denied that the assets in the SFLP were included in Strangi's estate under section 2036(a), and that there was no retention or enjoyment of the property by the decedent.[83] Ultimately, the United States Tax Court (Tax Court) found that the assets that were retained by the SFLP were includable in Strangi's estate because he did in fact retain possession and control thereof before his death.[84]

The United States Court of Appeals for the Fifth Circuit (Fifth Circuit) also sided with the IRS, stating that amongst the Strangi

75. *Id.*
76. *Id.*
77. *Id.*
78. *Id.* at 474.
79. *Id.*
80. *Id.*
81. *Id.*
82. *Id.*
83. *Id.* at 475–76.
84. *Id.* at 476.

Children, there was an implicit agreement where after the assets were transferred from Strangi's estate to the SFLP, Strangi would still benefit from the SFLP.[85] The Fifth Circuit's opinion was based chiefly on the facts that the SFLP disbursed funds to Strangi prior to his death in the amount of $14,000, and that after his death the SFLP also paid $100,000 to the estate to pay for funeral and administration expenses.[86] The court was also swayed by the fact that, after Strangi had transferred his residence to the SFLP, he did not pay rent on the residence until two years after his death, hence enjoying an economic benefit.[87] Additionally, the court noted that upon transfer of the assets to the SFLP, Strangi lacked the liquidity (having only $752) necessary to support himself and was reliant upon the SFLP for disbursements of cash in order to survive.[88]

The Fifth Circuit was not persuaded by the estate's "bona fide sale exception" argument, stating that even though the SFLP was created to (1) protect Strangi's estate from attacks by creditors, (2) protect against possible lawsuits from his housekeeper and children from the second marriage, and (3) permit the centralization of the assets, that these reasons were implausible, and lacked any evidence that such claims were to materialize.[89] The estate also argued that the SFLP was created for the purpose of business management as well as being an investment vehicle.[90] The court concluded that there was no evidence that the SFLP was either investing into other assets or was being used for the purpose of managing Strangi's business.[91]

The court's decision in *Strang*i precipitated a plethora of new "routes" for estate planners to consider when they begin to ponder the implementation of an FLP for the purposes of estate planning. Some of these new guideposts are: (1) make sure that the transferor retains a reasonable amount of liquid assets to pay for living expenses after their assets have been drawn into the FLP; (2) the FLP should have a valid reason as to its creation, such as being an

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85. *See id.* at 478.
86. *See id.* at 477.
87. *See id.*
88. *See id.* at 477–78.
89. *See id.* at 480–81.
90. *See id.* at 481.
91. *See id.*

investment vehicle (to show that it has not been created for the sole purpose of tax avoidance); (3) the transferor should receive adequate and full consideration for assets that were transferred to the FLP, such as a proportional interest in the FLP; and (4) the transferor, upon the transfer of assets—such as a house—should be required to comply with all necessary and appropriate business formalities such as supplying rental payments to the business to make the transaction compliant with the precepts of *Strangi*.[92]

While *Strangi* provides guidance on how to structure an FLP to avoid inclusion in a decedent's estate under IRC Section 2036(a), *Estate of Powell v. Commissioner*[93] addressed both the timing concerns connected to the creation of an FLP along with the assignment of the partnership property to beneficiaries by the decedent in the FLP. In *Powell*, the decedent's son, Mr. Powell, was a general partner of NHP Enterprises LP (NHP), over which he had the sole discretion for the timing and amount of distributions.[94] On August 8, 2008, Mr. Powell assigned to the decedent's trust a 99% limited partnership interest in NHP, a trust that was to be split between Mr. Powell and the decedent's brother upon the decedent's death.[95] Pursuant to a power of attorney, Mr. Powell had the ability to grant, convey, and transfer gifts and principal on the decedent's behalf.[96]

Mr. Powell, pursuant to that power of attorney, contributed on the same day approximately $10 million of cash and marketable securities to an FLP in return for a 99% limited partnership interest.[97] The decedent's two sons also contributed unsecured notes in return for a 1% general partner interest.[98] The partnership agreement allowed for the partnership's dissolution

92. Strangi III *Gives New Guidelines for Using Family Limited Partnerships as a Valuation Discount Tool*, FINDLAW, https://corporate.findlaw.com/law-library/strangi-iii-gives-new-guidelines-for-using-family-limited.html [https://perma.cc/P42C-ZNGU] (last visited Oct. 23, 2019).

93. 148 T.C. 392 (2017).

94. *Id.* at 393–95.

95. *Id.* at 395.

96. *Id.*

97. Steve R. Akers, *Estate of Powell v. Commissioner, 148 T.C. No. 18 (May 18, 2017)*, BESSEMER TRUST (June, 2017), https://www.bessemertrust.com/sites/default/files/2018-06/Powell%20Summary_Website.pdf [https://perma.cc/56VA-RVFF].

98. *Id.*

with the consent of all partners.[99] The trust to which the 99% limited partner interest was distributed was a charitable lead annuity trust (CLAT) paying an annuity to charity for the decedent's life with the remainder passing to the decedent's two sons, which remainder was valued by assuming a 25% discount for lack of control and marketability of the 99% limited partner interest.[100] On the decedent's 2008 gift tax return, the estate reported a taxable gift of $1,661,422 to the trust—the value of the 99% limited partner interest.[101] The estate, which now owned that interest, was valued at $7,561,773 after the 25% discount due to the lack of control and marketability.[102] In response to the decedent's estate and gift tax return, the IRS issued a Notice of Deficiency in regards to both, citing that the full value of assets was to be included in the decedent's gross estate in light of the fact that the decedent retained full possession and enjoyment over the income, as well as having retained the power to change the enjoyment of the property to a different beneficiary.[103]

The Tax Court held that the total amount of the assets now held in the FLP was to be part of the decedent's gross estate under section 2036(a)(2).[104] The court decided that the items of the gross estate were includable under section 2036(a)(2) if, in conjunction with another person, the decedent was to control the disposition or enjoyment of the property to another person.[105] The court affirmed the IRS's argument stating that if the decedent, at the time of her death, held a partnership interest in conjunction with another (which she did), and the attorney-in-fact (her son) makes decisions such as "distribution decisions," then such action would cause the assets to be retained by the decedent.[106]

*Powell*, much like *Strangi*, had significant and practical effects on the use of FLPs. Essentially, *Powell*'s holding allows for the parents' generation, if issuing a limited partner stock on a minuscule scale, to be considered participants in the liquidation of

99. *Id.*
100. *Id.*
101. *Estate of Powell*, 148 T.C. at 395.
102. *Id.* at 395–96.
103. *Id.* at 396.
104. *Id.* at 399–401.
105. *See id.* at 401–02.
106. *See id.* at 402–04.

the partnership even if they were intentionally trying to not provide themselves with the power to engage in the partnership liquidation or providing the benefits to a different beneficiary.[107] The tax planner should now take into consideration that a client being merely issued a limited partner interest in a business will no longer protect their estate from IRS audits and the type of power that the decedent has in the business will now be scrutinized to determine if they retained any control over the disposition of the assets to other beneficiaries (through the use of their appointed representative).[108]

## IV. IS A FAMILY LIMITED PARTNERSHIP STILL A VIABLE PLANNING TOOL?

FLPs were a favored wealth transfer tool amongst estate planners for many years. However, since the directives found in *Strangi* and the cases that have followed in its wake,[109] FLPs now come with a plethora of "dos" and "don'ts" to insulate them from IRS attacks. In order to assess the FLP's practical use as an estate planning weapon, one has to analyze an FLP under the current regime of estate planning. As of 2019, the current estate and gift tax unified credit amount is $11,400,000.[110] With spouses, the total estate and gift tax credit is $22,800,000.[111] In light of the fact that the exclusion amount is so high, there is less of an impulse amongst estate planners and clients to rapidly send assets downstream to children or other beneficiaries, but this ultimately depends on the desires of the client. Aside from the lack of a need to send assets down to the next generation, it is possible that entire partnership

107. *See* Akers, *supra* note 97.

108. *See generally Steve Leimberg's Estate Planning Email Newsletter Archive Message #2673*, SHENKMAN L. (Oct. 22, 2018), https://shenkmanlaw.com/uploads/2018/10/2018-10-22-MS-Day-2-Notes-from-44th-Notre-Dame-Tax-Estate-Planning-Institute.pdf [https://perma.cc/QW5K-T82H].

109. This article only discusses the effects of *Strangi* and *Powell* on FLPs, but there are a number of cases that further limit the use of the Family Limited Partnership. *E.g.*, Estate of Mirowski v. Comm'r, 95 T.C.M. (CCH) 1277 (T.C. 2008); Estate of Erickson v. Comm'r, 93 T.C.M. (CCH) 1175 (T.C. 2007); Estate of Thompson v. Comm'r, 84 T.C.M. (CCH) 374 (2002), *aff'd* 382 F.3d 367 (3d Cir. 2004).

110. *See* I.R.C. § 2010(c) (2012).

111. *See* § 2010(c)(3).

interests can be included in decedents' estates along with all of their other assets and still be under the unified credit amount, resulting in clients' estates not being required to pay federal estate taxes.[112] Thus, it would not be compulsory (from a tax savings point of view) to start funneling the "family business" down to the next generation using some form of business entity because the total value of the business would not trigger federal estate taxes. Conversely, even though the majority of Americans will not be filing a Form 706 (the federal estate tax return), they will still be paying state estate taxes, where the estate's exclusion amount is much lower than that of its federal counterpart.[113] Hence, estate planning tools are still necessary in order to plan on a state-based level.

In order for the FLP to be of use to the client and successfully insulated from an IRS challenge, one needs to ponder the timing, purpose, and assets that will be used for the business entity. If a decedent merely wants to protect assets from the estate tax imposed by the Internal Revenue Code, and they transfer the assets to the partnership entity, then the IRS will consider that a sham transaction and subsequently disallow any deductions associated with the transfer.[114] The IRS looks at the time period in which the entity was created as well.[115] In *Powell*, the Tax Court looked at the fact that the FLP was created just days before the death of the decedent,[116] while in *Strangi*, the FLP was created a few months prior to death.[117] Thus, the IRS views death bed transfers from a decedent to an FLP as highly suspicious. Another element that raises red flags for the IRS is the type of property that is placed into the FLP. While a business entity would more than likely pass

112. Albert B. Ellentuck, *Accounting for the Death of a Partner*, TAX ADVISOR (Oct. 26, 2019), https://www.thetaxadviser.com/issues/2015/aug/accounting-for-death-of-partner.html [https://perma.cc/QG3D-EGG5].

113. By means of illustration, New York's estate tax exemption is $5,740,000, Connecticut's exemption amount is $3,600,000, and Massachusetts's exemption amount is $1,000,000. *State Death Tax Chart*, AM. C. OF TR. & EST. COUNS., https://www.actec.org/resources/state-death-tax-chart/ [https://perma. cc/PD88-AZNJ] (last visited Nov. 30, 2019).

114. Courtney Lieb, *The IRS Wages War on Family Limited Partnership: How to Establish A Family Limited Partnership That Will Withstand Attack*, 71 UMKC L. REV. 887, 894 (2003).

115. *Id.*

116. Powell v. Comm'r, 148 T.C. 392, 395 (2017).

117. Strangi v. Comm'r, 417 F.3d. 468, 473–74 (5th Cir. 2005).

muster for a valid transfer, merely putting illiquid passive assets into the partnership will be looked down upon and carefully scrutinized by the IRS.[118]

Even though cases such as *Strangi* and its progeny have provided some significant roadblocks to the use of the FLP, commentators have suggested that such roadblocks are capable of being overcome by the use of the bona fide sale exception under section 2036(a)(1).[119] Hence, if someone wishes to contribute to the FLP, she or he will have to be paid back the full fair market value of the assets in question or be issued stock of the same value as the assets transferred to the partnership.[120]

## CONCLUSION

Using an FLP would be analogous to using Micky Thompson Drag-Slick tires: they are excellent for trying to get your 1971 Plymouth 'Cuda down the quarter mile at Raceway Park in Englishtown, New Jersey, but you would not want to use them for commuting to and from work on a daily basis. In layman's terms, an FLP has its specific purpose. If a savvy estate planner wanted to implement an FLP, she or he would need to have the right factors in place in order to properly propose such a tool. First, the estate planner would need to make sure that the FLP is created a significant amount of time before the death of the decedent (preventing what looks like a death bed transfer), such as when the decedent is alive and not suffering from any medical or mental maladies that would lead one to think that death is impending. Next, she or he must ensure that when the partnership is created, it has a formulated, bona fide purpose, such as being used to transfer a business from one family member to another. Simply transferring assets for the purpose of defeating estate taxes will likely generate suspicion and an audit from the IRS.

Third, she or he should ensure that when funding the FLP, a business entity is put into the FLP with any and all other assets that the client would want to transfer from the first to the second generation. Placing a running business in the FLP, and not just passive assets that are being consolidated for "managerial

118. Lucid, *supra* note 21, at 404–05.
119. *Id.* at 404.
120. *Id.* at 410.

investment purposes," will provide validation to the "business purpose" reasoning. As for drafting the FLP agreement, a savvy estate planner should ensure that the decedent (who is receiving the share of the business assets) is not provided too much power to determine who provides beneficial enjoyment of the partnership interest, for this will surely create inclusion under section 2036(a)(2). Finally, when the assets are transferred to the partnership, the estate planner must ensure that if the transferor is still using the property that was transferred, the decedent is following all accepted business formalities required to show that this is now an arm's length business relationship (such as paying to use a car or providing rent to live in a transferred house).

An FLP is a useful estate planning mechanism that allows for a person to transfer his or her assets from one generation to the next while providing substantial benefits to both the transferor and the transferee. Even though cases such as *Strangi* and the current state of the estate planning field have made the FLP a less relevant estate planning tool, it still provides benefits to clients in certain situations where a business is a central part of the family income and wealth generation.