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Ninth Circuit Ruling Poses Threat to Family Limited Partnerships

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Introduction

The Ninth Circuit Court of Appeals recently joined the Third, Fifth and Eighth Circuits in ruling on the applicability of Section 2036 of the Internal Revenue Code to family limited partnerships. The decision, Bigelow v. Commissioner, determined that assets which had been transferred to a family limited partnership ("FLP") during the decedent's lifetime were properly included within the decedent's taxable estate for estate tax purposes.

The Bigelow decision is of concern to estate planners primarily because of certain language within the opinion suggesting that for an FLP arrangement to withstand a challenge from the IRS, a "pooling" of assets by all partners to the FLP must be found. As discussed below, given the structure of the FLP and the planning objectives of such a structure, this language creates concern among planners as to the effectiveness of the FLP as an estate planning vehicle. Whether the "pooling" requirement becomes an integral part of the test for inclusion of FLP assets in an estate pursuant to Section 2036 will remain an open question pending further judicial decisions.

Background

Limited partnerships can be formed for any valid business purpose in Minnesota , and a FLP is simply a limited partnership established for family purposes. Unlike a general partnership where all partners share equally in voting and liability, a limited partnership divides partners into two categories - general partners, who possess management/voting control and who can be held personally liable for the debts and obligations of the partnership, and limited partners, who possess only financial rights and who have limited personal liability.

The distinction between voting and financial rights makes it possible for a real estate owner to transfer his/her holdings to the FLP while still retaining management control over the real estate through retention of the general partnership interest. Assets transferred to an FLP are removed from the estate of the transferor during life and replaced with an ownership interest in the FLP. Once the FLP holds the real estate, transfers of limited partnership interests (rather than direct ownership interests in the real estate) can be made to spouse and children through use of the transferor's annual gift tax

[1] These purposes include farming, as Minnesota's corporate farming law, Minnesota Statutes Section 500.24, which otherwise prohibits corporate ownership of farming, explicitly allows for the creation of a "family farm partnership", which is defined as "a limited partnership formed for the purpose of farming and the ownership of agricultural land in which the majority of the interests in the partnership is held by and the majority of the partners are natural persons or current beneficiaries of one or more family farm trusts in which the trustee holds an interest in a family farm partnership related to each other within the third degree of kindred according to the rules of the civil law, and at least one of the related persons is residing on the farm, actively operating the farm, or the agricultural land was owned by one or more of the related persons for a period of five years before its transfer to the limited partnership, and none of the partners is a corporation." M.S. §500.24, Subd. 2(j).

exclusion (currently $12,000.00 per donee) and these transfers reduce the value of the transferor's estate (and, by extension, any possible estate tax obligation arising from the transferor's ownership of the assets).

An additional benefit of using a FLP is that the value of the interest transferred with the limited powers can be discounted, which generates a maximization of the use of gift tax exemptions and/or a maximization of the use of generation-skipping tax exemptions, depending on the generations of the recipients . These discounts (for lack of marketability and lack of control) can be as much as 30%-40%. Hence, when combining the annual gift tax exclusion with the maximum allowable discount of 40% it is possible to transfer $30,000 of real estate to a single donee free of gift tax by utilizing a FLP structure.

IRS Challenges to FLPs

Given the tax avoidance and minimization potential inherent in FLPs, the IRS has in recent years sought judicial intervention to apply IRC Section 2036 in order to include FLP assets in a decedent's taxable estate. Section 2036 provides that:

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 anytime 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.

IRC §2036. The courts of the Fifth Circuit (Strangi v. Commisioner, 417 F.3d 468; Kimbell v. U.S., 371 F.3d 257), Third Circuit (Estate of Thompson v. Commissioner, 382 F.3d 367) and Eight Circuit (Estate of Austin Corby v. Commissioner) have all held that Section 2036 is applicable to FLPs.

The Bigelow Decision

The Bigelow decision upheld a Tax Court finding that Section 2036 caused the inclusion of all FLP assets in the decedent's gross estate without a discount. This determination breaks no new ground in FLP law.

Of concern in the opinion, however, is a requirement that in order to satisfy the "full consideration" exception to Section 2036 there must be more than just transfers to the

[1] Note: if the transferor retains less than a 50% limited partnership interest at the outset, the transferor has already achieved a savings in that a discount can be applied to this interest on account of it being a minority interest (any interest which alone cannot exercise control over the FLP is considered a "minority" interest).

FLP for a proportionate percentage partnership interest and that there must be a "genuine pooling of assets", which would indicate a requirement that all partners contribute assets to the FLP. The court, however, does not expound on this language and thus planners are left hanging as to the viability of these requirements for future FLP planning.

Conclusion

The Bigelow decision represents the latest in a long line of cases applying Section 2036 to FLPs. Planners should take caution given these decisions in putting together an FLP structure that complies with the requirements set forth in the Bigelow case and its predecessors.

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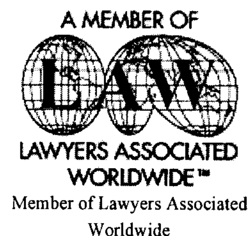

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