

‘Classic’ FLP Case by Judge Laro Finds No §2036 Estate Tax Exception

Estate of Lillie Rosen v. Internal Revenue Service, 2006 T.C. Memo LEXIS 116 (June 1, 2006)

When Lillie Rosen’s son-in-law attended a seminar on family limited partnerships (FLPs) in 1994, the federal Tax Court had yet to develop its “economic substance approach” to transfer tax cases. So by the time this case reached Judge David Laro, a notable authority on the subject, he was able to produce a primer on “what not to do” when trying to form an FLP to fall within the exception of IRC Section 2036.

A ‘simple change in form’ is not enough

It’s hard to read the facts of the *Rosen* case, given all that BV appraisers know today. After his seminar, the son-in-law consulted with the family attorney, who advised him that “simply changing the form in which the decedent’s assets were held from a trust to a limited partnership would generate significant tax savings,” and that these savings were a “major and significant reason” to form an FLP. On the basis of his “general” understanding of FLPs and his discussions with the son-in-law—but without meeting with any other family members, the attorney determined who among them would be the general and limited partners, the percentage amount each would contribute, and which assets would fund the FLP. He never spoke about forming an FLP with Lillie Rosen, who was ill and aged at the time, suffering from what would become “full blown” dementia by the time the documents were done in 1996.

Only one family member signed the documents in the presence of the attorney. None of them knew (or had calculated) the dollar amount of their capital calls until a couple of months later, even though the documents required contribution at the time of execution. The stated purpose of the FLP was the “business of making, protecting, enhancing, and otherwise investing. . . in any type of security,” which amounted to \$2.4 million in cash and marketable securities in a Merrill Lynch account, transferred from the family trust to the FLP, with the trust becoming the 99% limited partner. After the opening of a new Merrill Lynch account in the FLP name, “there was no material change in the manner in which the . . . assets were managed.”

Over the next four years, the FLP provided living expenses for the ailing Mrs. Rosen, and continued her gift-giving program to many family members, characterizing these withdrawals from the Merrill Lynch account as “loans” supported by two demand notes. But no other partner took similar loans; and one of the notes was prepared after her death in 2000, back-dated to the day she died. By this time, the FLP had given away 64% of the limited partnership interests; it then redeemed the trust’s interest to pay decedent’s legal fees, funeral expenses, and other bequests.

For tax purposes, the IRS sought to bring all of the FLP’s assets back into her gross estate, pursuant to §2036(a)(1). Per that same provision, the estate claimed exemption because the transfers were a “bona fide sale for full and adequate consideration,” and that the decedent did not retain full possession and enjoyment of the assets. (It also argued that §2035(a) limited the estate because Ms. Rosen had given away a 48.5% limited partnership interest more than three years before her death, from 1996-1998. “To state the obvious,” the Court said, the 1998 gifts “were not more than three years before her death in 2000.”)

The law on FLP’s is also obvious—now

Citing the (by now) well known case law of *Estate of Thomson* (2004), *Estate of Abraham* (2004), *Estate of Strangi* (2005), and *Estate of Bongard* (2005) (copies of full-text court opinions available for subscribers of the *BVLaw™* database at *BVLibrary.com*), the Court explained that to fall within the 2036(a)(1) exception for a

bona fide transfer, the FLP must have: (1) served a legitimate, non-tax purpose; and (2) bestowed on each transferor a partnership interest proportionate to the fair market value of the transferred property. Given its findings on the first prong, the Court didn't need to discuss the second.

Despite its stated purpose, the Rosen FLP "conducted no business activity and had no business purpose for its existence," according to Judge Laro, "other than the avoidance of Federal estate (and gift) tax." A legitimate, significant non-tax reason is "one that actually motivated the formation of [the] partnership from a business point of view." A "theoretical justification" won't suffice.

To support its holding, the Court also compiled the following "laundry list" of factors—a comprehensive summation which could help current practitioners avoid the fate of the Rosen FLP:

- It conducted minimal and mostly passive investment activity.
- It failed to follow "commonplace" business procedures such as maintaining books of account, making proper capital calls, holding formal partnership meetings, etc.
- None of the FLP partners negotiated its original terms, and decedent's daughter stood "on all sides of the transaction" as general partner, trustee of the largest limited partner interest, and decedent's attorney-in-fact.
- Compared to the decedent's contribution, the children's contributions were "de minimus," and given her contemporaneous gifts to the children, decedent arguably funded the FLP on her own.
- The management of the assets was the same before and after the transfer.
- During the first four years of the FLP (and the last four years of her life), decedent gave away almost 65% of her limited partnership interest.
- After forming the FLP, decedent was unable to meet her personal living expenses and gift giving program, which required withdrawal of FLP funds, which also went to meet her death expenses.
- The assets of the FLP consisted solely of marketable securities and cash. (Note: "the mere holding of an untraded portfolio of marketable securities weight against the finding of a non-tax benefit for a transfer of that portfolio to a family entity.")
- Decedent was 88 years old and in failing health when the FLP was formed.
- The FLP provided no more meaningful protection from her creditors than the former family trust.
- Decedent enjoyed the FLP assets and their income during her lifetime, receiving distributions when and as she needed them—just as she had from the trust. This arrangement could be implied from her age and condition at the formation of the FLP, the transfer of all her assets, and the failure of the loans to qualify as bona fide debts.

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