Family Limited Partnerships Come Under Closer IRS Scrutiny

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The family limited partnership (FLP) can be a valuable estate planning tool for managing family wealth and for creating substantial estate and gift valuation discounts. Careful attention must be paid to the partnership agreement, the underlying assets, and the ownership of partnership interest to determine appropriate discounts. The popularity in the FLP has increased as a result of the Internal Revenue Service's issuance of Revenue Ruling 93-12. In that ruling, the Service reluctantly abandoned its position that family interest were aggregated for determination of appropriate discounts for estate and gift valuation purposes. In other words, if the combination of individual family ownership of an asset adds up to more than a 50% interest, each individual family member's ownership is not included with other family members' interests and considered a controlling interest for estate and gift valuation purposes.

A representative of the Internal Revenue Service Estate Tax Division (Michael G. DePalma) recently spoke on FLP issues at an Estate Planning Council of Rhode Island meeting. The representative explained that the IRS is attempting to centralize and record FLP information concerning discounts in the Service's Washington, D.C. offices. The FLP data will then be closely scrutinized by IRS estate personnel, for possible further action. In 1997 the IRS issued several Technical Advice Memorandums disallowing valuation discounts for family owned limited partnership interests (Technical Advice Memorandums 9719006, 9723009, 9725002, 9730004, 9735003). Each of these cases involved deathbed transfers and set forth rather egregious fact patterns. In one case, the formation and transfer of the FLP interests occurred two days before death. Many conservative estate planners would agree with the IRS conclusions given the extreme fact patterns of each case. However, despite the fact that the TAM's were based on deathbed transfer facts, it is quite likely the IRS plans to apply its position to most all FLP discount situations.

In Technical Advice Memorandum 9719006, the Service advanced two lines of legal arguments that could effectively end the application of any valuation discounts to limited partnership transfers. Similar arguments were also made in the other TAMs. These arguments were also advanced in the Estate of Dorothy Morganson Schauerhamer V. Commissioner (T.C. Memo 1997-242, 73TCM2855), which was ultimately decided on other grounds.

The first legal argument, by the IRS, is that the formation of an FLP and the subsequent sale or transfer of FLP ownership interest at a discount to the next generation of family members is a single testamentary transaction. This argument is based on the Tax Court decision in the Estate of Murphy, (T.C. Memo 1990-472). The service often refers to this integrated series of transactions as a "step transaction."

Relying on the Murphy case, the TAM concludes that the creation of the FLP was for the sole purpose of avoiding estate tax and for no other reason, and would therefore be disregarded. The creation of the FLP, the transfer of property to the FLP, and all related transactions would be considered as a single testamentary disposition. The series of transactions would be treated as effective at death rather than when created.

In a recent article by John A. Bogdanski, "Family Limited Partnerships: Meet Section 2703", Estate Planning, June 1997 pp. 235-241, the author states "... If the IRS's reasoning is pushed to an extreme, every estate plan might be characterized as one huge step transaction. The TAM, however, may be read much more narrowly, by focusing sharply on its presumably unusual facts. Only time will tell how far the IRS, and more importantly the courts, will push step transaction reasoning in the transfer tax context."

The second legal argument the IRS puts forth is based on Internal Revenue Code Section 2703. Code Section 2703 (a) (2) provides that the value of any property shall be determined without regard to any restriction on the right to sell or use the property. The IRS argument is that the creation of the FLP and related transactions constitute the restriction referred to in the statute and that the property referred to in the statute is the decedent's property transferred to the FLP. The fact that Congress wanted "restrictions" to be disregarded, no matter which type of document imposed them, does not necessarily imply that a partnership agreement is in itself "a restriction" on the partnership assets, at least not within the context of Section 2703 (a) (2). A close review of Code Section 2703, the regulations thereunder, and the legislative history would offer little support for the IRS's position. The fundamental premise of the Chapter 14 provisions (Sec 2701-2704) is that valuation should not be determined by artificial conditions imposed by family members. However, the legislative history is clear that Chapter 14 was not intended to disrupt traditional valuation concepts.

Code Section 2703 (b) provides an exception to the application of Code Section 2703 (a). Adherence to the following requirements will allow agreements and restrictions to be used in the valuation of interest in family partnerships for transfer tax purposes. To meet this exception the following three requirements must be met:

1. It is a bona fide business transaction.
2. It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.
3. Its terms are comparable to similar arrangements entered into by persons in an arm's-length transaction.

While the Tax Court has ruled, in past cases, that a valid business purpose did exist in the family transfer context, the other two requirements are much more problematic. It would seem very difficult to show that a FLP could ever meet all three requirements.

There seems to be little authority or rationale for the IRS to extend the TAM deathbed transfer rulings to other FLP transfers. However, estate planners and business valuation professionals anticipate these legal issues will be fought out in one or more key court cases over the next year or two. Shannon Pratt's Business Valuation Update, October, 1997, included an article by Butch Williams "Family Limited Partnerships : Lets get ready to rumble!". The author tells us that in a recent conversation with U.S. Tax Court Judge David Laro, he was informed that Judge Laro was soon to be hearing several cases in Texas related to FLP issues. It would appear that guidance from the Tax Court is forthcoming.

It should be remembered that even though the Tax Court may eventually rule in favor of the taxpayer regarding FLPs, the IRS will continue to challenge the validity of specific valuation discounts. This underscores the importance of obtaining a comprehensive and defensible business valuation of a FLP to justify any discount claimed. Courts are increasingly reluctant to split the difference, when one side presents a well-reasoned and researched appraisal position. Therefore, obtaining the best available appraisal services from tax planning through execution can represent the difference between victory and defeat in tax disputes.

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