Fall 2016 Bulletin

CODE SECTION 2036 AND FAMILY LIMITED PARTNERSHIPS (FLP)

The Tax Court used Internal Revenue Code Section 2036(a)(1) to include the entire value of a FLP created by an octogenarian with virtually all of her assets in her estate.

FACTS:

At age 88, two years following a diagnosis of Alzheimer's Disease and literally days prior to her death, Hilde created an FLP with the assistance of her daughter. The entity was funded with cash, marketable securities, and a condominium that comprised virtually all of her assets, which were stipulated to be worth $2.1 million, in exchange for an 86.25% limited partner interest. The children contributed condominiums in exchange for the general partner interests.

As determined by Judge Kroupa, the facts were that Hilde was not involved in the establishment of the FLP and she was only an initial limited partner. Two months passed before any assets were contributed to the Partnership. Two days prior to her death, via a power of attorney, Hilde gave each grandchild a sizable share of limited partner interests with the use of a power of attorney.

After Hilde's death, the IRS sought to revalue the deathbed gifts and include the entire FLP in her gross estate under IRC Sec. 2036. Judge Kroupa expressly found no business purpose for the FLP and held that the investment strategy of the FLP was substantially the same as that when the assets were in Hilde's name. The estate obtained cash to pay estate tax from the Partnership. The estate first argued for a shift in the burden of proof under IRC Sec. 7491; however, Judge Kroupa denied the request, finding that the daughters' testimony was self-serving and more after-the-fact than anything else.

Judge Kroupa expressly found or observed the following:

- The original funding of the FLP was not a sale or exchange for purposes of the exception to IRC Sec. 2036(a)(1).
- The activity inside of the FLP was passive and did not rise to the level of a legitimate business operation.
- The FLP was not a true joint venture.
- The FLP was not operated in accordance with the FLP agreement, (e.g., no meetings were held and the proper books were not maintained).
- The partners did not negotiate or set the terms of the FLP agreement.
- The initial capital contribution was not made until two months after the FLP agreement was executed, with the bulk occurring two days prior to Hilde's death.
- Hilde contributed all of her investment assets, and virtually all of her assets to the FLP, retaining virtually nothing upon which to live, so that she was unable to meet her financial obligations without resorting to FLP assets.
- When she formed the FLP, Hilde was 88 and in poor health.
- The FLP gave little or nothing to Hilde other than tax benefits.
- Hilde retained the right to the assets contributed to the FLP via an implied understanding.
- The FLP was solely a testamentary device.
- Hilde's relationship to her assets did not change after creation of the FLP.

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- The FLP was formed on the advice of counsel.
- One of the daughters essentially stood on both sides of the transaction.

In light of the foregoing, Judge Kroupa ruled in favor of the IRS.

COMMENT:

Judge Kroupa's decision was not surprising. The case adds little to the FLP knowledge base, except to provide yet another example of how NOT to form a family limited partnership or limited liability company. Though FLP's or Family LLC's are formed on a daily basis, it is essential that they are formed properly and are not merely a tax device without any other business purpose or legitimate business operation.

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