

What is a Family Limited Partnership (“FLP”)?

A “family limited partnership” (hereinafter referred to as “FLP”) is, in reality, merely a limited partnership that is formed under the laws of a particular state whereby the FLP partners are related family members. § 620.101-620.186, *Fla.Stat.*, constitute the body of statutory law governing limited partnerships conducting business in the State of Florida and these statutes are cumulatively referred to as the “*Florida Revised Uniform Limited Partnership Act (1986)*”.

FLPs are commonly used to produce favorable estate planning, asset protection planning, business continuation planning, transfer tax planning and income tax planning benefits for family members of different generations. The traditional function of FLPs focused on the creation of a business entity, i.e. the FLP, that would effectively manage business and investment assets that are contributed primarily by transferor senior family members to the FLP so as to accomplish tax and non-tax planning objectives such as: (a) redirecting portions of future FLP income to junior family members; (b) creating valuation discounts for transfer tax purposes, i.e. gift tax, of FLP assets for the benefit of junior family members; (c) protecting family assets from future potential creditors of FLP partners; (d) achieving the intra-generational transfers of family assets to junior family members while doing so at a reduced transfer tax cost; and (e) to facilitate business continuation planning for family business assets.

The creation of FLPs involve the creation of management rights and economic rights with respect to the various interests of the partners. In FLPs, there is one class of partners known as the “general partners” and a second class of partners known as the “limited partners”. The general partners of a FLP retain both management rights and economic rights over the partnership business. General partners are solely responsible for the management of the partnership business and such general partners are the only partners who have the right to vote on issues concerning FLP management. Limited partners, on the other hand, retain the economic rights as provided for in the partnership agreement, but have no inherent management authority or rights with respect to the operation of the partnership business.

Economic rights include the partner’s right to receive allocations of the partnerships distribution of income, losses, deductions and/or credits based upon the agreement of the parties. For purposes of Florida law, see the definitions of “general partner”, “limited partner”, “partner”, “limited partnership”, “partnership agreement”, and “partnership interest” as set forth in § 620.102, *Fla.Stat.*

From an income tax standpoint, a partnership generally is not a taxable entity, but is considered to be a “pass-through” entity (unless “C corporation” income tax status is elected by the FLP pursuant to Check-the-Box Regulations; cf. Reg. § 301.7701-3) wherein all items of income, gain, loss, deduction and credit are “passed through” to each FLP partner based upon the partnership agreement in each calendar year which is reported by the federal partnership return (Form 1065) filed on behalf of the partnership and as reported in each K-1 that is issued to every partner..

It is essential for income tax purposes that a partnership (including all FLPs) must be bona fide and each partnership transaction must be entered into for a subst

In this scenario, the general partners own a small percentage of the partnership, i.e., usually 1% to 5%, while the limited partners own the majority percentage ownership of the partnership. One of the historical objectives of this type of planning structure is to permit senior family members, as general partners, to retain control of the partnership assets while still transferring significant portions of ownership in the partnership to junior family members.

CAVEAT: Retaining control over FLP income and/or designating whom shall enjoy the FLP assets can be considered a “taxable string” to cause inclusion of FLP assets into the estate of the transferor senior family member as per the *Strangi III* case rationale discussed below.

Please beware that as a result of recent case law, most significantly those cases that have been decided concerning the *Estate of Strangi* (see cites to the *Strangi* line of cases identified below), the structure of the FLP and issues concerning senior family member control of management and of the termination of enjoyment of partnership income must be critically scrutinized and re-evaluated in light of the *Strangi* cases that will be discussed later in this article, to-wit: *Estate of Strangi vs. Commissioner, T.C. Memo 2003-145 (“Strangi III”)*; *Estate of Stangi vs. Commissioner, 293 F 3d 279, 89 AFT 2d 2002-2977 (CA-5, 2002) (“Strangi II”)*; *Estate of Strangi, 115 TC 478 (2000, aff’d in part and rev’d and remanded in part, 293 F 3d 279, 89 AFTR 2d 2002-2977 (CA-5, 2002) (“Strangi I”)*.

What are the benefits of using a FLP?

Generally speaking, there are a variety of planning benefits available in using and FLP as an appropriate business entity choice:

1. **Income Tax Benefits:** There are some income tax benefits that are potentially available in using an FLP. By gifting away limited partnership interests to junior family members, partnership income can be legitimately shifted to junior family member who presumably are taxed at a lower marginal income tax rate. Even though income in a limited partnership is typically allocated to percentages of ownership, it is legally permissible to disproportionately allocate income according to business and economic reasons.
2. **Preservation of Family Wealth:** FLPs can prospectively control distributions of family assets in order to preserve wealth for the benefit of the family.
3. **Asset Protection:** FLPs offer a degree of asset protection of family assets for partners.
4. **Estate Tax Savings:** FLPs offer estate tax planning benefits in terms of avoiding probate, providing for a structured plan of management and disposition of family assets and partnership assets may receive the benefit of discount valuations and shift appreciation values to junior generations. CAVEAT: *Strangi III* case rationale discussed herein.
5. **Control of Disposition of Family Assets:** FLPs can prevent interests in family property from passing to non-family members as a result of divorce, death or other events.
6. **Effective Gifting Without Fractionalizing Family Asset Ownership:** FLPs can be used to implement an annual gift giving plan of FLP interests to junior family members from senior family members so as to effectuate transfer tax savings and not fractionalize family asset ownership.
7. **Effective Asset Management:** FLPs can avoid minority owners of family assets from being able to impede the management and disposition of such assets.
8. **Centralized Family Asset Management:** FLPs provide for central management of family assets.

In spite of the above benefits, FLPs are not for everyone. First of all, as indicated previously, there must be a bona fide and legitimate business purpose for creating the FLP.

Recently, there have been a number of FLPs created virtually on the deathbed of a senior family member in an attempt to gain valuation discounts and other FLP planning benefits. This strategy will not work from an Internal Revenue Service (“IRS”) estate tax valuation perspective.

FLPs have been created without a bona fide substantial business purpose. FLPs have been created to improperly assign income to junior family members and to effectuate disguised gifts upon creation by senior family members to junior family members. These planning scenarios result in IRS problems since all of these types of scenarios constitute inappropriate uses of the FLP concept. Furthermore, the use of such improper FLP strategies will result in the IRS attacking the structure and seeking tax deficiencies. FLPs are an extremely high risk target for IRS audit. In fact, if you have a taxable estate, you can almost guarantee an audit if one or more FLPs are involved in the decedent’s taxable estate.

Thus, FLPs should only be used where appropriate. Competent legal counsel and accounting advice should be sought by the client when structuring any FLP. FLPs are somewhat complex and costly to set up and operate and, as a result, are not appropriate for every estate planning situations. Due to recent case law, it is critical that the documentation for any FLP be carefully drafted so that the FLP design structure complies with all aspects of federal and state law. In order to obtain desired valuation discounts of FLP interests, it will be necessary in light of the *Strangi III* case that senior family FLP partners relinquish sufficient control over management of the FLP assets and over FLP income in order to avoid an *Internal Revenue Code (“IRC” or “Code”) § 2036* inclusion problem. This is one consideration of many to be contemplated prior to the implementation of any FLP.

Nevertheless, FLPs remains an attractive planning option for the “right” planning circumstances.

What are the estate planning advantages of using a FLP?

First and foremost, FLPs have been used in an estate planning context in order to obtain valuation discounts of FLP interests by fractionalizing the ownership interests of senior family members in the FLP. Valuation discounts have been obtained for FLP interests for lack of marketability and for minority interests. Due to restrictions on transferability of FLP interests by the partners of the FLP, such restrictions have supported the proposition that such interests are less marketable and therefore entitled to a “valuation” discount.

In general, an asset owned outright that is not owned by an FLP, or other business entity, has a greater value than an entity equity interest in an FLP that owns such an asset directly. The valuation discount for a limited partnership interest due to lack of control and lack of marketability is possible because the limited partner has no managerial control over the FLP assets. By legal definition, the limited partner has no managerial control in the partnership business and cannot force a liquidation of the partnership assets in order to obtain his or her pro rata share of the partnership assets.

There are a variety of factors that are outside the scope of this article that relate to the formulation of valuation discounts of FLP interests. Suffice it to say that such valuation discounts can vary based upon certain factors such as the type of FLP assets owned, the amount of debt financing encumbering the FLP assets, the nature of restrictions on transferability of FLP interests that are provided by state law and/or the FLP agreement, the amount of control by senior family members over FLP assets and income distribution and the manner in which FLP cash distributions are determined by the partnership agreement.

The whole issue of the availability of valuation discounts for FLP interests has been shaken by virtue of the recent and successful IRS attacks on FLPs through the application of *IRC* § 2036 in cases such as the *Strangi* line of cases referenced above and other cases such as: *Estate of Schauerhamer vs. Commissioner*, TC Memo 1997-242, *Estate of Reichardt vs. Commissioner*, 114 TC 144, 151 (2000), *Estate of Harper vs. Commissioner*, TC Memo 2002 – 121, *Estate of Thompson vs. Commissioner*, TC Memo 2002 – 246 and *Kimbell vs. United States*, 244 F.Supp. 2d 700 (N.D.Texas 2003).

In the first five U.S. Tax Court cases referenced above, the Tax Court found that the FLPs reviewed in these particular cases involved an expressed or implied agreement or understanding between the decedent and the other partners of the FLP that provided that the decedent (who created the FLP in question) would retain effective enjoyment and economic benefit from the property that had been transferred to capitalize the FLP. In these cases, the IRS applied the *IRC §2036(a)(1)* to legally justify finding that the evidence of partnership formation and operation in each case involved an implied agreement or understanding between the decedent and the other FLP partners to create the effect that the decedent retained a *IRC §2036(a)(1)* power of prohibited lifetime control of the FLP assets. In all of these cases the other partners were members of the decedent's family.

In the *Kimbell* case referenced above, the United States District Court found that the FLP partnership agreement was, in essence, an agreement between the decedent and the other FLP partners that permitted the decedent to retain the economic benefits of the property transferred to capitalize the FLP. The Court found that such retained control by the decedent (who initially formed the FLP) caused inclusion of the value of the FLP assets in the decedent's estate pursuant to the authority of *IRC §2036*. However, in a huge defeat for the IRS, on May 20, 2004, the Fifth Circuit Court of Appeals ruled against the IRS position in the case and against the inclusion of FLP assets into the decedent's estate through the application of *IRC § 2036* (see discussion below).

For a long time now, the IRS has been actively attacking FLPs through audits by contesting the percentage of "valuation discounts" applied to the transferred FLP interests. The IRS is now using *IRC § 2036* in order to attack the FLP entity itself in order to eliminate all valuation discounts. The IRS strategy so far has been to attempt to convince the Court that the decedent and/or his or her family members had an implied agreement or understanding that the decedent would retain income or enjoyment of the assets transferred to the FLP until his or her death, thus causing the inclusion of the fair market value of all FLP assets in the decedent's estate due to the application of *IRC § 2036*.

IRC §2036(a) states as follows: "the value of the gross estate shall include the value of all property to the extent of any interest therein which the decedent has at anytime made a transfer (except in case of a bona fide sale for an adequate and full consideration of money or monies worth), by trust or otherwise, under which he obtained 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, property, or (2) the right, either alone or in conjunction with any persons, to designate the persons who shall possess or enjoy the property or the income therefrom."

It will be interesting to see if the mode of IRS attack on FLPs shall change in light of the *Kimbell* and *Strangi III* cases, supra.

What is the typical FLP structure and what assets are typically used to fund the FLP?

The typical FLP scenario involves parents creating a FLP and transferring income producing capital assets into the partnership for the ultimate benefit of their children and grandchildren. A transfer of assets to a FLP is not a gift but a capital contribution to the partnership in exchange for which the parents receive general and limited partnership interests. This exchange is considered a tax-free exchange of assets pursuant to *IRC §721(a)*, unless the "investment company" exception set for in *IRC §721(b)* applies. Beware that the non-recognition rule of *IRC §721(a)* mentioned above will not apply to any gain realized on a transfer to a partnership which would have been treated as an "investment company" under *IRC §351(e)*.

A partnership is an "investment company" for purposes of *IRC §721(b)* if the transfer results in "diversification" and, that after the relevant exchange, more than 80% of the value of the FLP assets transferred are held for investment and consist of "stock and securities" or interest in regulated investment companies or real estate investment trusts. Cf. *Reg. 1.351-1(c)(1);IRC §351(e)(1)*.

Subject to avoiding the partnership being classified as an investment company partnership, the FLP can be funded with business, personal or investment assets.

After the FLP is created and funded, the parents or their controlled entities, typically become the general partners and, either initially or over time, the limited partnership interests are transferred by gift or sale to the parents' children or grandchildren. The general partners usually retain only a small portion of the ownership of the limited partnership while the limited partners own the majority interest. However, the general partners retain the complete responsibility and control of managing the partnership business. Remember that a general partner also is exposed to unlimited liability for any partnership debts. Accordingly, it is prudent to avoid using an individual as a general partner, which would expose that individual to unlimited liability due to partnership activities. Normally, an entity that provides asset protection to the general partners will be used, such as an "S" corporation or limited liability company ("LLC").

Limited partners should have no control over the partnership and have no management rights in the partnership. The estate planning objective of the FLP is to "freeze" asset values and shift ownership of future asset growth from senior family members to junior family members. By virtue of creating a properly structured FLP, the senior family members have discounted the value of their interests in those assets used to fund the FLP, due to the valuation discounts referenced above, and have further created a platform for gift giving of limited partnership interest that will also be subject to valuation discounts for minority interests and lack-of-marketability. Thus, the FLP creates gift-giving leverage.

Do federal and state securities laws apply to FLPs?

Quite simply, a limited partnership interest is considered a "security" under the federal and Florida statutory definitions of "security". *Stowell v. Ted S. Finkle Investment Services, Inc.*, 489 F.Supp. 1290 (S.D. Fla. 1980); §4(2) of the Securities Act of 1933, 15 USC §§ 77(a) et seq.

In order to avoid registration requirements, both Florida and federal law provide for a private placement exemption for the required registration of securities, including the sale or issuance of limited partnership interests. *Reg. D 17 CFR §§ 230.501 et seq; §517.061 (11)(a), Fla.Stat.* Even though a limited partnership interest may not be offered through a public offering, the anti-fraud and civil liability provisions of the *Securities Act of 1933 and Chapter 517, Fla.Stat.* mandate full and fair disclosure of all material information regarding the investment in the FLP do apply.

When the FLP is created, each partner should execute an "investment letter" and a subscription agreement that represents: (a) that the investor is an accredited investor or has such knowledge and experience in financial and business matters that he or she is capable of evaluating the risk and merits of the investments; (b) that the partner understands that an investment involves a high degree of risk and that there is a potential to lose the entire investment; (c) that the investor was given the opportunity to ask questions and receive information from the general partner; (d) that the investor understands that the limited partnership interest have not been registered under the *Securities Act of 1933* ; and (e) that there will be restrictions on transferability of the interest for an indefinite period of time and that the investor is acquiring the interest for his or her own account and not for the account of others and for investment purposes only and not with the present intention to re-sell.

Under *Fla.Adm.Code §3E-500.005*, there are two options for full and fair disclosure necessary for the private placement exemption that apply under Florida law. One option is that the investors are provided reasonable access to and have been furnished with all material, books and records of the issuer, all material contracts and documents relating to the proposed transaction and an opportunity to question the appropriate executive officers or partners of the entity. The second option is to provide an offering circular prior to sale to the prospective investor that provides information as to a specific listing of twenty-eight items referenced therein and required by §517.06 (11)(a)(3), *Fla.Stat.*

What are the required formalities to form a limited partnership in Florida?

Even though a limited partnership may be in writing or created by oral agreement pursuant to §620.102(9), *Fla.Stat.*, prudence dictates that the limited partnership agreement be in writing since this agreement will govern the conduct and operation of the partnership business.

A certificate of limited partnership must be executed by all general partners to form a limited partnership pursuant to §620.108 and 620.114, *Fla.Stat.*

An affidavit indicating the amount of capital contributed by each partner must accompany the filing of the certificate of limited partnership pursuant to §620.108(1), *Fla.Stat.*

In order to give legal life to the limited partnership, one signed copy of the certificate of limited partnership must be filed with the Florida Department of State. The limited partnership is considered formed at the time the certificate of limited partnership is filed unless a later date is specified in the certificate. There is a filing fee to be paid along with the filing of the certificate of limited partnership that is calculated currently as \$7.00 per \$1,000 of the anticipated amount of the limited partners' capital contributions. The minimum filing fee for an FLP is \$52.50 and the maximum filing fee is \$1,750.00. Please be aware that these fees, as are will all governmental fees, subject to change.

The certificate of limited partnership is required to be amended within 30 days after any new general partner is admitted to the partnership, any general partner withdraws from the partnership, the partnership continues business after the withdrawal of a general partner or the partnership changes its name. §620.109(2)(a), *Fla.Stat.*

If an FLP is dissolved, a certificate of cancellation must be filed with the Department of State. §620.113, *Fla.Stat.*

All domestic limited partnerships authorized to transact business in Florida must file an annual report to renew their certificate of authority on forms provided by the Department of State on or before December 31 of each year.

What are the common elements of a limited partnership agreement?

The name of a limited partnership must contain the word "Limited" or its abbreviation "Ltd." §620.13(1), *Fla.Stat.* The name of a limited partnership may not contain the name of a limited partner unless that limited partner is also a general partner or the business of the limited partnership was carried on under that name before the admission of the limited partner. §620.103(2), *Fla.Stat.*

The FLP agreement normally contains a purpose clause. If it is desirable to limit the scope of authority of the general partners of the FLP, a more specific purpose should be inserted in the agreement.

The term of the FLP is not limited by statute. However, the term must be definite according to §620.108, *Fla.Stat.*

Capital contributions of a limited partner or a general partner may be in the form of cash property, services, promissory note, or other contractual obligation to contribute cash, property or to perform services in the future. §620.135, *Fla.Stat.*

The FLP agreement can provide for the general partners' ability to call all limited partners to make additional capital contributions to the FLP. §620.136(1), *Fla.Stat.* Failure of a partner to make a required capital contribution can result in forfeiture of that partner's partnership interest.

The FLP agreement typically addresses the allocation of profits and losses of the partnership and distribution of cash or other assets to the partners. In the absence of such an allocation agreement, profits, losses and distributions to

partners will be allocated on the basis of the value of their capital contributions to the partnership. §620.137-620.138, *Fla.Stat.* The FLP agreement can provide for a preferred pay-out of cash flow to the limited partners. However, any preferential pay-out of cash flow or other assets must pass the test of *IRC §704* and the accompanying regulations. If preferential allocations of profits and losses do not have “substantial economic effect”, tax problems will result.

The FLP agreement should identify the fiscal year used and the method of accounting used by the partnership. A limited partnership must maintain a registered office where certain partnership records are kept. §620.106(1), *Fla.Stat.* Every domestic limited partnership that owns real property in Florida must maintain a registered office and a registered agent in Florida. §620.192, *Fla.Stat.*

To what extent is a FLP an effective asset protection planning strategy?

FLPs have a limited value as an asset protection strategy. First of all, a general partner is exposed to unlimited liability emanating from the operation of the partnership business. Secondly, personal creditors of a general partner may seize the general partner’s interest or share of partnership income. Typically, the general partner seeks to insulate himself or herself from personal liability by transferring his or her general partnership interest to a subchapter “S” corporation or other entity with limited liability features.

A limited partner has liability to partnership creditors only to the extent of his or her interest in the partnership as far as his or her capital contribution is concerned. Personal creditors of a limited partner may obtain a charging order against a limited partner’s income or foreclose on a limited partner’s interest.

However, a Court does have the power to set aside any partnership interest that was created by virtue of a fraudulent conveyance according to state law.

If real estate is transferred to a FLP, is that transfer subject to the Florida documentary stamp tax?

Unfortunately, it is true that §201.02, *Fla.Stat.* and *Fla.Adm.Code §12B-4.013(10)* imposes a documentary stamp tax on the fair market value of real estate transferred to an FLP.

When will the tax status of an FLP be considered abusive by the Internal Revenue Service?

In January of 1995, the Internal Revenue Service (IRS) adopted the so-called “Anti-Abuse Rules” for partnerships that were published as proposed *Reg. §1.701-2*, as published on May 17, 1994, by the U.S. Treasury. Under this regulation, the IRS can disregard the partnership if the partnership was formed primarily to reduce the aggregate partnership liability in a manner inconsistent with the underlying economic arrangements.

Quite simply, if the only reason for the partnership is to reduce taxes, the arrangement will be considered abusive. For the FLP to avoid being classified as “abusive”, it is necessary that the partnership have a substantial business purpose. In addition, the substance of each partnership transaction must be respected under the substance over form principal and the partnership transactions must accurately reflect the partners’ economic agreement and properly reflect partner incomes.

The regulation lists seven factors which may indicate that the partnership abuses the partnership tax rules:

1. The aggregate tax liability is less than if the partners personally owned the assets.
2. The aggregate tax liability is less than if the purportedly separate transactions are integrated and treated as steps in a single transaction.
3. One or more partners needed to achieve the claimed tax results have only a nominal interest in the partnership.
4. Substantially all partners are related to one another.
5. Partnership items are allocated in compliance with the literal language but results are inconsistent with the intent of the regulations..
6. The partners contributing property to the partnership substantially retain its benefits and burdens.
7. The benefits and burdens of partnership property are substantially shifted to the distributee partner before or after the property is actually distributed to the distributee or a related party.

Is an interest in a limited partnership which is not publicly traded subject to the state intangible tax?

No. *§199.185(1)(c), Fla.Stat.*

Under what conditions can a gift of a limited partnership interest fail to qualify for the annual gift tax exclusion provided for in Code §2503(b)?

In *TAM 9751003*, the IRS ruled that gifts of limited partnership interest made by the donor failed to confer upon the donee the substantial present economic enjoyment requirement under *Code §2503(b)* for a present interest and as a result these gifts did not qualify for the gift tax annual exclusion provided for in that code section.

In the facts of this case, the IRS took position that the partnership agreement gave the general partner complete discretion over distribution of income and authorized the general partner to retain funds for any reason whatsoever. Accordingly, the IRS held that such a provision negates any fiduciary duty ordinarily imposed upon a general partner and as a consequence the income component of the limited partnership interest failed to require, at the time of the gifts, that there be a steady and ascertainable flow of income to the donee/limited partner. The income component, therefore was not a present interest within the meaning of *Code §2503(b)*. In order to avoid this result, the partnership agreement should provide that the general partner's discretion regarding distribution of income is subject to a fiduciary duty to the limited partners.

In *TAM 975 1003*, the IRS further determined that the capital component was not a present interest due to the existence of restrictions in the limited partnership agreement that prohibited limited partners from assigning their interest, withdrawing from the partnership or receiving a return of capital contributions until the partnership is terminated.

Is the distributive share of any item of income from an FLP to a limited partner subject to self-employment tax?

Under *IRC §1402(a)(13)*, the distributive share of income for an FLP to a limited partner is not considered within the definition of net earnings from self-employment income and therefore not subject to self-employment tax, except for guaranteed payments under *IRC §707(c)*.

Can an FLP act as an alternate entity to own life insurance?

Interestingly enough, an FLP can serve as an alternative planning strategy to an irrevocable life insurance trust (ILIT). An FLP can provide some advantages not available in an ILIT. FLP's can provide the insured greater control over the policy, are not subject to the Crummey withdrawal power requirements and may provide flexibility not possible in an ILIT. If the insured is a general partner, only the discounted value of his or her interest in the partnership will be included in his or her estate. *Rev. Rul. 83-147; IRC §2033, Reg. Sec. 20.2031-3*. An FLP that owns only life insurance is considered a valid partnership under *IRC §7701. Pvt.Ltr.Rul. 9309021*.

How has the Strangi line of cases affected FLP planning?

The *Strangi* cases, supra, have radically altered FLP planning and have given everyone who has created or intends to create a FLP to pause and give some serious thought as to the viability of the FLP concept in light of the *Strangi* cases.

In *Strangi III*, the U.S. Tax Court held that the full fair market value of assets owned by a FLP were includable in the decedent's taxable estate, as of the date of death, thus totally ignoring the FLP entity valuation discounts, due to the decedent's retained interests as to FLP distributions of FLP income (or other FLP assets) and as a result of the decedent's control over transferred FLP assets. This holding was based upon the application of IRC Sections 2036 (a)(1) and (a)(2), which has been the latest and most successful avenue of Legal attack of FLPs by the IRS.

This ruling has sent shock waves through the FLP planning world and shivers through attorneys, CPAs and clients alike who have, or intend to create, FLPs. The *Strangi III* case compels the review of existing FLPs in light of the *IRC § 2036* theory of IRS attack against FLPs and has consequently imposed a new prism of required analysis for prospective FLPs considering the application of the *Strangi III* rationale.

First, we shall review the *Strangi III* case reasoning in this article and then we will consider what remedial or alternate planning options may exist to address the FLP planning implications of *Strangi III*.

IRC § 2036(a)(1) provides that a decedent's estate is to include the full fair market value of all property transferred by a decedent during his or her lifetime to a trust *or otherwise* wherein the said transferor decedent has retained "the possession or enjoyment of, or the right to income from" from such transferred property for his or her life. The statutory term "enjoyment" essentially means the retention by the decedent

The facts involved in the *Strangi III* case are as follows.

Albert Strangi (referred to as “Strangi” or the “decendent”) was a wealthy businessman who had four children from a first marriage and two stepchildren from a second marriage. Strangi developed a serious brain disorder in 1993. Previously, in 1988, Strangi had given his son-in-law, Michael J. Gullig, a power of attorney to act on his behalf. Mr. Gullig was an attorney. In July of 1990, Strangi executed a Will that devised the residue of his estate to his four children if his wife predeceased him. Mrs. Strangi died five months later.

As Strangi’s health declined, Mr. Gullig became closer to him and Mr. Gullig assumed a position of Strangi’s closest advisor and confidant.

In August of 1994, Mr. Gullig attended a Fortress Financial Group (“Fortress”) seminar on FLPs. Mr. Gullig then formed a Texas FLP named the Strangi Family Limited Partnership (“SFLP”) with a corporate general partner (“STRANCO”) utilizing Fortress forms. Mr. Gullig then capitalized SFLP with 98% of Strangi’s assets valued at \$9,876,929 in exchange for a 99% limited partnership interest for Strangi. The assets transferred consisted of mostly cash and securities, but also included real estate, Strangi’s residence, an annuity, receivables and other business interests in partnerships. Mr. Gullig bought a 47% interest in STRANCO for Strangi with the balance of STRANCO being purchased by Mrs. Gullig and her three siblings. STRANCO contributed \$100,333 to SFLP in exchange for a 1% general partner’s interest in SFLP. Later, on August 18, 1994, the Strangi children transferred a 1% interest in STRANCO to the McLennan Community College Foundation (“MCCF”). On October 14, 1994, Strangi died. Since September of 1993, Strangi had required 24/7 home health care by nursing services and he needed a housekeeper since he could not care for himself. SFLP funds were used to pay for personal living expenses of the decedent and after Strangi’s death, SFLP funds were used to pay for the decedent’s debts, funeral expenses, probate administrative expenses, fund a specific devise to the decedent’s sister and to pay for estate taxes of \$3,187,800.

Strangi’s estate tax return represented the following:

1. Gross estate value was \$6,823,582.
2. A 33% discount was taken for lack of marketability and lack of control of SFLP.
3. Decedent’s SFLP interest was valued at \$6,560,730 and his interest in STRANCO was valued at \$24,551.
4. The fair market value of the SFLP assets were \$11,100,922 at the time of death.

After audit, the IRS contended that Strangi’s SFLP interest should have been valued at \$10,947,343 and his STRANCO interest should have been valued at \$53,560.

In the *Strangi I* case, the Tax Court ruled against the IRS position that was based upon the contentions that SFLP was not a valid FLP under state law and that *IRC § 2703* applied. The IRS sought leave to amend its answer to include a *IRC § 2036* argument and the Tax Court denied the request as untimely. The IRS appealed to the Fifth Circuit and the Court remanded the case to the Tax Court with instructions to consider whether *IRC § 2036* applies and to explain why the IRS motion to amend was denied in more detail. This decision is referred to as the *Strangi II* case. Upon remand, the Tax Court rendered the *Strangi III* decision.

In *Strangi III*, the Tax Court found that Mr. Gullig acted on behalf of Strangi with his full authority and thus Strangi maintained sole discretion over the FLP assets. The Tax Court found that Strangi maintained (through an implied agreement with Mr. Gullig) control over distribution of FLP income and assets while retaining possession and enjoyment of the assets he transferred to fund SFLP. This triggered the application of *IRC § 2036(a)(1)*. In such finding, the Tax Court listed the following facts: (a) Strangi transferred most of his assets (98%) to SFLP; (b) Strangi continued to live in his residence that was transferred to SFLP; (c) Rent was accrued but not collected for use of the residence; (d) SFLP assets were used to pay for Strangi’s personal expenses; (e) the entire plan was testamentary in nature.

The Tax Court also held that *IRC § 2036(a)(2)* applied to the facts of the case since Strangi retained the right to designate who shall possess or enjoy the property transferred by Strangi to fund SFLP. The Tax Court found that Strangi retained the authority, either alone or through his attorney, to control SFLP distributions and to terminate the FLP and, accordingly, the decedent could control the enjoyment of the assets transferred to SFLP.

As a side issue, the Tax Court held that the transfers by the decedent to SFLP were not to be considered a bona fide sale thus not subject to the exception provided for in *IRC Section 2036(a)(2)* that states that said Code Section does not apply in the case of a bona fide sale for adequate consideration in money or money's worth. cf. *Estate of Jones v. Commissioner*, 121 T.C. 116 (2001); *Estate of Church v. United States*, 268 F. 3d 1063 (2001).

The Tax Court said that *IRC § 2036(a)(2)* is applicable in the *Strangi* case due to the fact that Strangi had the legally enforceable right, directly or indirectly, to control SFLP distributions and Strangi, as the sole limited partner, had the legally enforceable right to join with the general partner of SFLP to cause a termination and liquidation of the partnership.

The Tax Court held that the case of *U.S. v. Byrum*, 408 U.S. 125 (1972) did not apply to prevent inclusion.

It is fair to say that due to the application of the *Strangi III* case rationale, other entities such as corporations and LLCs would be subject to the same *Strangi* case reasoning. From an entity planning perspective, it can be speculated that if a client forms a FLP (or other entity) and that client retains control over distribution of entity assets or can control, directly or indirectly, the power to liquidate the entity, then you can expect the IRS position to be that any assets transferred to capitalize said entity by the client will be sought to be included back into the client's estate upon death pursuant to the *IRC § 2036 (a)* position successfully argued in the *Strangi III* case. The *Strangi III* case can be interpreted to also mean that FLP units previously gifted away will *de facto* be included in the decedent's estate since the underlying FLP asset values will be included in the transferor's estate. The bottom line lesson of *Strangi III* may well be that if the transferor decedent holds the authority or power, either alone or with another, to control or participate in FLP asset distribution or liquidation decisions, expressly or impliedly, then *IRC § 2036 (a)* shall operate to cause inclusion of all underlying FLP assets that were transferred to the FLP as valued as of the date of the transferor's death. Ouch indeed! See discussion in article, *Strangi: A Critical Analysis and Planning Suggestions* by Mitchell M. Gans and Jonathan G. Blattmachr, *Tax Analysis Special Report, Tax Notes* © September 1, 2003.

There are four other recent Tax Court cases (*Estate of Schauerhamer v. Commissioner*; *Estate of Reichardt v. Commissioner*; *Estate of Harper v. Commissioner*; *Estate of Thompson v. Commissioner, supra*) and one U.S. District Court case (*Kimbell v. United States, supra*) that dealt with *IRC § 2036* inclusion issues and involved findings of express or implied agreements or understandings between decedent transferors to FLPs and other partners wherein the decedent transferor retained "enjoyment" or "economic benefit" from assets transferred to the FLP.

In the *Schauerhamer*, *Reichardt*, *Harper* and *Thompson* decisions, the Tax Court found that an implied agreement or understanding existed between the decedent transferor and the other FLP partners that resulted in the decedent transferor retaining lifetime control of FLP assets that was prohibited by *IRC § 2036 (a)(1)*.

In *Kimbell*, the trial court found that the actual partnership agreement at issue provided: (a) limitless discretionary power for the decedent transferor to determine FLP distributions of FLP assets; (b) authority to remove the general partner at the decedent's whim; (c) that the general partner of the FLP had no fiduciary duties to the other partners; and (d) that the decedent transferor dictated possession and enjoyment of FLP assets. Such agreement terms triggered the application of *IRC § 2036(a)* to cause inclusion of FLP assets. However, the Fifth Circuit Court of Appeals recently vacated the trial court's decision that rejected the IRS attack in this case based upon the above Code section and remanded the case back to the trial court.

Another point raised by the above cases involves the application of the holding of the case, *United States v. Grace*, 395 U.S. 316(1969), that stands for the proposition that *IRC § 2036 (a)* applies to transfers that are "testamentary in nature". cf. *Ray v. United States*, 762 U.S. 1361, 1362 (9th Cir. 1985); *Guyann v. United States*, 437 F. 2d 1148, 1150 (4th Cir. 1971).

The estate planning implications of the *Strangi III*, *Kimbell* and other "2036" cases referenced above seem to indicate that where a transferor senior family member creates a FLP and retains any express or implied authority or powers that result in transferor control over FLP income or assets, then inclusion of the FLP assets will occur in the transferor's estate at his or her death.

However, this is not to say that there are no positive FLP cases that have been recently decided. cf. *Estate of Stone v Commissioner*, T.C. Memo 2003-309; *Wheeler v. Commissioner*, 116 F. 3d 749 (5th Cir. 1997). In *Stone*, the Tax Court agreed with the taxpayer position that relied upon the “bona fide sale and adequate exception” contained in *IRC § 2036(a)* in a FLP scenario.

What about the Kimbell case and its application to FLP planning?

As indicated above, the Fifth Circuit Court of Appeals on May 20, 2004, vacated and remanded the the *Kimbell* case, supra, to the trial court to determine values of certain assets and proceedings consistent with the Fifth Circuit’s ruling that *IRC § 2036(a)* did not apply in the case. Let’s review this decision since it was a big IRS defeat on the FLP inclusion issue.

First, let’s look briefly at the facts of the *Kimbell* case. At first blush, the facts did not look good for the taxpayer since the factual scenario involved a “deathbed” FLP. Mrs. Kimbell formed a Texas FLP at the age of 96 just two months prior to her death. The FLP was owned as follows. The 1% FLP general partner was a LLC that was 50% owned by Mrs. Kimbell’s revocable trust and 50% owned by the decedent’s son and daughter-in-law. The 99% limited partner’s interest was owned 100% by Mrs. Kimbell’s revocable trust. The decedent’s revocable trust contributed \$2,534,225.80 for a 99% limited partner’s interest and the LLC contributed \$25,342.26 in cash for a 1% general partner’s interest in the FLP. The assets contributed by the decedent’s revocable trust consisted of over 80% of liquid assets, i.e. cash, marketable securities, and family note receivables.

The federal district court held that all FLP assets were includable in the decedent’s estate pursuant to *IRC § 2036(a)(1) and (2)*, as contended by the IRS.

The Fifth Circuit disagreed with the trial court and reversed holding that Mrs. Kimbell’s transfers of assets to the FLP constituted “bona fide sales for full and adequate consideration”, thus fell within the bona fide sale exception under *IRC § 2036*. In essence, the court said that Mrs. Kimbell exchanged her assets for partnership interests of roughly equivalent value and that the objective facts of the case indicated that the transaction was “bona fide” or genuine. The court said that the test for adequate and full consideration as set forth in the *Estate of Stone* case, supra, was satisfied by the taxpayer in *Kimbell*, to-wit: (1) whether the interests credited to each of the partners was proportionate to the fair market value of the assets each partner contributed to the partnership; (2) whether the assets contributed by each partner to the partnership were properly credited to the respective capital accounts of the partners, and; (3) whether on termination or dissolution of the partnership the partners were entitled to distributions from the partnership in amounts equal to their respective capital accounts.

The Fifth Circuit found that there were five important facts that supported the holding that the transfer of assets to the FLP by *Kimbell* constituted a “bona fide sale”, to-wit:

- (1) Sufficient assets outside the FLP were retained by Mrs. Kimbell for her support
- (2) There was no commingling of of Mrs. Kimbell’s personal and FLP assets
- (3) Partnership assets were transferred to the FLP and the FLP maintained requisite statutory formalities.
- (4) FLP assets required active management (13% of assets transferred to FLP were oil and gas working interests).
- (5) There were non-tax reasons for transfer.

The court further indicated that Mrs. Kimbell did not retain sufficient control over the FLP assets via the general partner LLC due to her having only a 50% interest in the LLC and her son had sole managerial control over the LLC.

The Strangi II case is pending before the Fifth Circuit with briefs to be filed soon. The saga continues.

What are some problems to be alert to when creating or operating FLPs in light of recent case law?

There are a variety of problematic FLP factual scenarios that are critical to identify and address when creating or operating an existing FLP such as:

1. The FLP agreement and related documents should be drafted (and filed if required) in accordance with controlling state law.
2. Avoid transferring the majority of transferor's assets to the FLP and avoid transferring personal assets, i.e. residence, personal auto, etc., to the FLP.
3. Avoid pre-packaged form FLP agreements, ex. The Fortress Financial Group forms as used in *Strangi* case. Utilize competent legal counsel to plan and draft FLP documents.
4. Avoid giving controlling FLP powers over income and FLP assets to transferor senior family members that are violative of *IRC § 2036* that cause inclusion of FLP assets in transferor's estate as per *Strangi III* case rationale.
5. Avoid giving transferor senior family members sole discretion to control, remove and replace the FLP general partner.
6. Avoid FLP creation where transferor is in poor health, very elderly or terminally ill.
7. Avoid nullification of general partner's fiduciary duties to limited partners in the FLP agreement.
8. Use "IRS defensible" business valuation of FLP interests gifted away.
9. Avoid the transferor's personal use of FLP assets that disregard the legal integrity of the FLP. Clearly separate management of FLP assets from personal assets.
10. Have a true business purpose for the FLP.
11. The FLP should achieve planning objectives other than transfer tax reduction and accomplishing testamentary transfers to junior family members.
12. Avoid implied control agreements where transferor retains power to directly or indirectly control FLP income distributions or enjoyment of FLP assets.
13. Avoid giving transferor first option to receive FLP income or asset distributions.
14. Comply with annual state law filing requirements for the FLP and adhere to keeping required FLP books and records. Keep separate FLP bank accounts and avoid commingling of funds.
15. Avoid disproportionate FLP distributions to senior family members for personal living expenses, medical expenses, personal family gifts, loans to junior family members and providing free use of FLP assets to senior family members.
16. FLP assets should always be titled in FLP name.
17. Beware of senior family member control of FLP assets via indirect means or through implied agreements with junior family members.

18. Senior family member majority ownership of FLP continues with few or no transfers of FLP interests until death.
19. FLP is administered more like trust than business entity.
20. FLP formalities are disregarded. FLP partners not compensated for services rendered to FLP nor is adequate return on FLP investment occurring. Avoid disproportionate partner distributions that do not correlate with economic realities.
21. Avoid “off the shelf” boilerplate FLP documents sold by FLP promoters.
22. Avoid creating FLP for very sick, mentally incompetent or very elderly senior family member; especially “deathbed” FLPs.
23. Tax avoidance should not be the sole reason for the FLP. There must be legitimate non-tax, business reasons for forming the FLP. Do not transfer most of senior family member’s assets into the FLP. Do not capitalize FLP with only cash and securities.
24. Have all partners represented by competent legal counsel and CPAs so that all legal and tax ramifications of the FLP can be discussed by the partners prior to setting up the FLP.

What FLP planning strategies can be employed to avoid the effect of the Strangi III case?

The *Strangi III* case discussed above rests upon the applicability of *IRC §’s 2036(a)(1) and (2)*. Therefore, pursuant to the effect of said statutes, the FLP structure must not create a right on the part of the senior family member transferor to: (a) retain the right to income, possession or enjoyment of the FLP assets; or, (b) retain the right to designate possession or enjoyment of FLP assets. Set forth below are suggested strategies that may be used to avoid *Strangi III* inclusion issues. CAVEAT: Do not view these suggested tactics as Gospel; get your own independent legal and tax advice that fits your case.

In order to avoid the *IRC § 2036(a)(1)* inclusion problem: (1) Significant personal assets should be maintained outside the FLP for the benefit of the transferor; (2) Personal assets should not be transferred to the FLP; (3) Other FLP partners, i.e. junior family members, should contribute capital to the FLP; (4) The general partner should not be (nor directly or indirectly controlled by an entity or implied agreement with the transferor) the transferor senior family member; (5) Gifts of FLP interests by transferor senior family members to junior family members should regularly occur to avoid testamentary characterization by IRS; (6) The FLP should be operated as a real business with the intent to earn a profit.

In order to avoid *IRC § 2036(a)(2)* inclusion problem: (1) Do not make the primary transferor senior family member the general partner (or have him or her control the general partner); (2) Avoid implicit or implied agreements that cause the primary transferor to retain control of FLP assets, either directly or indirectly; (3) Transfer FLP units to trust that has independent trustee; (4) As a remedial tactic, have the primary transferor make gifts (or sell) of FLP units to relinquish control; (5) Reorganize the FLP into two or more FLPs in order to divide assets between the partners and therefore address control issues; (6) Amend the FLP agreement to avoid problematic terms that cause inclusion; (7) Sell or gift FLP units to eliminate control problem.