Family Limited Partnerships: Great Facts – and the Taxpayer Still Loses!

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The value of hiring an Arxis Financial valuation expert is often tied to the ability to authoritatively establish and support control and marketability discounts. Often, this is required in the context of estate and tax planning through family limited partnerships.

However, the IRS continues to challenge the advantageous tax attributes of family limited partnerships (FLP) when minority interests are gifted to family members. Generally, when FLP's are created, assets are contributed to the partnership and limited partnership interests in the partnership are gifted to family members. The advantageous benefits arise due to the discounts applied to the value of the ownership interest for purposes of calculating gift and estate tax. In effect, a 1% interest in the partnership is valued for tax purposes at a value less that 1% of the underlying assets.

Where the FLP is established purely for the tax benefits, the IRS rightfully challenges the validity of the gift/estate valuation. Often, the challenge will be under IRS Code §2703. Under this section, the value of any property transferred by gift is determined without regard to any right or restriction relating to the partnership interest unless the restriction meets each (all) of the following three requirements:

1. It is a bona fide business relationship
2. It is not a device to transfer property to family for less than full and adequate consideration
3. Its terms are comparable to similar arrangements entered into by persons in arms-length transactions

In a recent case that applied this code section (Holman v Commissioner, 130 T.C. No.12, Docket No 7581-04, May 27, 2008) the courts sided with the IRS and the reasons are instructive in how FLP's should be structured and managed to avoid a similar result. In this case the partnership was established by parents for the benefit of their children and substantial amounts of stock were transferred into the partnership. Subsequently, ownership interests were gifted to the children and gift tax returns were filed valuing the stock after discounting them for lack of control and limited marketability. The IRS issued notices on the gift tax returns on the basis of several claims.

The courts ruled in favor of the taxpayer on the question of whether the FLP was valid. However, while the facts of this case seemed strongly in favor of the taxpayers the court opined that the restrictions on transfer of partnership interests in the partnership agreement failed the §2703 test. The result of this was greatly reduced (but not eliminated) discounts.

The following are observations by the court supporting their opinion that are instructive to those contemplating the formation of a family limited partnership:

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- Included in the purpose of the partnership was what the court deemed to be personal (not business) goals. These included goals such as preventing the children from spending the wealth and providing for the education of the children. The court opined that the business purposes of the partnership should have been stated in the restrictive language.
- Since the only partnership asset was common stock the court determined that holding stock was the only purpose of the partnership. Therefore, they found no business purpose. It was not a “closely-held business.”
- In the course of the litigation the records indicated that the parents had a clear, advanced, and well-articulated understanding of the partnership agreements. That seems to have worked against them as the court gave them no benefit of ambiguity in their testimony.
- The dueling experts seem to have caused the court some hesitancy on the third test. The IRS expert said “I couldn’t find anyone who would do this deal...” The taxpayer’s expert testified that the restrictive paragraphs were not out of the mainstream of what one finds in an arm’s length partnership agreement. In response the court seems to have punted, stating that they may agree that the agreement meets the third test but it didn’t matter since it failed the first two.

The Holman case seems to be one of the taxpayer doing everything right and the court determined to find fault with what they did. This was not what is often called a “bad facts” case. The establishment and operation of the FLP appears to have been meticulously planned and executed. The flaws found by the court could be summarized as follows: Describe and operate the FLP as a business and do more with the FLP than simply hold assets.

A knowledgeable valuation expert will be key to successfully presenting and defending FLP valuation and discounts with an eye towards the latest developments such as the Holman case.

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