

AFTER A LONG-AWAITED COURT OF APPEALS DECISION, FAMILY LIMITED PARTNERSHIPS WILL SURVIVE

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FLPs Will Survive ... If They Are Bona Fide

The (*Family*) Limited Partnership (FLP) is a planning device frequently used by physicians to protect assets from third-party and judgement creditors. As such, an often overlooked benefit of FLPs is their value as vehicles of wealth accumulation, management and transfer. The ability to build and conserve assets in FLPs, and to eventually transfer those assets to heirs in ways that are taxably advantageous can be an important function within overall wealth management planning. And, as in any planning strategy that contemplates tax benefits, there are guidelines which should be followed.

Recently, The 5th Circuit Court of Appeals rendered its much-anticipated decision on family limited partnerships as tax planning devices in the case of *Strangi*. After a series of back-and-forth rulings on this controversial case, the Court ultimately ruled against the taxpayer based on unique facts and circumstances. However, the Court's decision has also been instructional, affirming that FLPs are legitimate planning vehicles if they are formed, structured, and operated properly.

The 5th Circuit held that a particular section of the Internal Revenue Code dealing with inclusion of assets in taxable estates will not apply to include the *full* value of assets inside an FLP if the initial transfer of the assets to the FLP was a "*bona fide sale for adequate and full consideration*."

The impact of this and other facts considered in *Strangi* will be felt in cases where valuation discounts are taken on transfers of partnership interests (usually to succeeding family generations), where careful consideration of applicable federal regulations is lacking. Historically, such valuation discounts have been key tax-planning components in wealth transfer planning strategies.

What is "Adequate and Full Consideration"?

In *Estate of Strangi* and *Estate of Kimbell* (a 2004 case), the 5th Circuit held that a transfer to an FLP is for "adequate and full consideration" if: (1) the partnership interest received by each partner is proportionate to the fair market value of the assets contributed by that partner to the partnership; (2) the assets contributed by each partner are properly credited to the partners' respective capital accounts; and (3) on the termination or dissolution of the partnership, the partners are entitled to distributions in amounts equal to their capital accounts.

What Makes A Sale "Bona Fide"?

The answer depends on the set of facts in each case. The 5th Circuit held in another case¹ that for a sale to be "bona fide," there must be a substantial business purpose or other non-tax purpose (i.e., purpose which is not solely intended to reduce taxes) for partnership formation. If the initial transfer of assets to the partnership does not qualify as a bona fide sale for adequate and full

¹ *Kimbell v. US*, 93 AFTR 2d 2004-2400 (5th Cir. 2004)

consideration, particular sections of the Internal Revenue Code² may apply to bring the assets into the gross estate at their full value without any valuation discounts, depending on the facts. In wealth transfer planning, the loss of valuation discounts can have a significant impact on estate taxes.

Retaining Certain Rights In Conjunction With Transferred Assets

In the most recently decided *Strangi* case, the 5th Circuit upheld the Tax Court's determination that Mr. Strangi retained the possession or enjoyment and the right to income from the assets transferred to the partnership. The Court based its holding on the manner in which the partnership was operated and the fact that Strangi transferred virtually all of his assets to the partnership, finding an implied agreement existed between Strangi and the partnership that Strangi retained the right to the partnership assets. As a result, the full value of the assets were included in Strangi's gross taxable estate without any valuation discount.³

Unresolved

What remains unclear is whether partnership assets must be fully included in the decedent's estate if the decedent, in conjunction with others, had the right to designate the persons who could enjoy partnership property or the income generated by the partnership.⁴ Unfortunately, the 5th Circuit gave no guidance on this issue, for which the Tax Court had ruled in favor of the IRS.

FLPs Still Work As Planning Tools

FLPs remain a viable planning option in the appropriate situations, i.e., asset protection, wealth transfer, or planning strategies employing both objectives. In order to satisfy the "bona fide sale for adequate and full consideration" requirement, the taxpayer should document his or her substantial business or substantial non- tax purpose for forming the FLP and operate the FLP in accordance with a properly drafted partnership agreement and in observance of the procedural formalities required of a bone fide business entity.

For a complete list of the procedural do's and don'ts of Family Limited Partnerships or other information regarding asset protection, please email us at:

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² IRC Secs. 2036(a)(1) and 2036(a)(2)

³ IRC Sec 2036(a)(1)

⁴ IRC Sec 2036(a)(2)