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Assets Transferred to Family Limited Partnership Are Includible in Estate

Document: Estate of Thompson, T.C. Memo. 2002-246 (9/26/02)
Code Section: 2056
Kleinrock's Analysis Section: 759.3

The full date-of-death value of the assets that a decedent transferred to family limited partnerships are includible i his gross estate. Estate of Thompson, T.C. Memo. 2002-246 (9/26/02).

Before the death of their father, Theodore Thompson, his two children, Robert and Betsy, met with a financial adviser concerning the establishment of an estate and financial plan for their father. The financial adviser recommended an estate plan that used family limited partnerships. The adviser recommended using two family limited partnerships with corporate general partners. In promoting this arrangement, the adviser indicated the primary advantages of the program were (1) lowering the taxable value of the estate, (2) maximizing the preservation of assets, (3) reducing income taxes by having the corporate general partner provide medical, retirement, and "income splitting" benefits for family members, and (4) facilitating family and charitable giving. In addition, he stated that the benefits could be achieved while total control of all assets is retained by the directors o the corporate general partner." The adviser indicated that the limited partnership interests were expected to enjoy the benefit of discounting for gift and estate tax valuation purposes. He indicated that a 40 percent discount was a reasonable expectation. Subsequently, the decedent, his children, and the president of the financial advising firm formed two family limited partnerships, with two corporations to serve as the corporate general partners. The decedent contributed to the partnership approximately $1.3 million of listed securities, plus note receivables due from relatives. Before his death, the decedent gifted away part of his interests in the partnerships. The decedent's estate valued his partnership interests by applying a 40-percent combined discount for minority interest and lack o marketability to the partnerships' net asset values. The value of the prior partnership interest gifts were also determined by applying a 40-percent combined discount for minority interest and lack of marketability.

The IRS issued a deficiency notice in which it increased the values of decedent's interests in the limited partnersh and increased the amount of taxable gifts relating to the decedent's lifetime gifts of partnership interests in those partnerships. Thus, the decedent's taxable estate was increased by approximately $1.4 million. The IRS argued fi that the partnerships lacked economic substance and thus should be disregarded for transfer tax purposes. Alternatively, the IRS argued that because the decedent retained the economic benefit and control of the transferr assets, Code Section 2036(a) applied so that the date-of-death value of the assets the decedent transferred to the partnerships was includable in his gross estate.

The Tax Court held that the full date-of-death value of the assets that the decedent transferred to the partnerships was includible in his gross estate. The court was satisfied that the partnerships were created principally as an alternate vehicle through which the decedent would provide for his children at his death and concluded that the decedent retained enjoyment of the property transferred within the meaning of Code Section 2036(a)(1). The cour noted that Code Section 2036(a) does not apply to a transfer that is "a bona fide sale for an adequate and full consideration in money or money's worth." However, the court rejected the estate's contention that the decedent's transfer of his assets to the partnerships fell within this exception. The exception, the court stated, is limited to thos transfers where the transferor has received full consideration in a genuine arm's-length transaction. The exemptio is not allowed where there is only contractual consideration but not "adequate and full consideration in money or money's worth." According to the court, when a family partnership is only a vehicle for changing the form in which the decedent holds his property--a mere "recycling of value"--the decedent's receipt of a partnership interest in exchange for his testamentary assets is not full and adequate consideration within the meaning of Code Section 2036. Thus, the court concluded that, in the instant case, there was no bona fide sale for adequate and full consideration.

With respect to the IRS's argument that the partnerships lacked economic substance and thus should be disregarded for transfer tax purposes, the court held that because the partnerships were validly formed under stat law, they had sufficient substance to be recognized for federal estate and gift tax purposes.

For a discussion of using family limited partnerships for estate planning, see Kleinrock's Analysis and Explanation, Section 759.3.