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FAMILY LIMITED PARTNERSHIPS

— by Neil E. Harl*

In recent years, family limited partnerships have gained in popularity for various reasons. Much of the popularity has stemmed from perceptions that substantial discounts could be obtained. That feature has drawn the interest of the Internal Revenue Service and has resulted in targeting of family limited partnerships as a tax abuse area. Regulations have been proposed disallowing valuation at less than fair market value.

Challenges to discounts

The idea that family limited partnerships could be created with the sole or primary purpose of obtaining a discount for federal estate or federal gift tax purposes has led to several challenges by the Internal Revenue Service. Although a 1985 Tax Court decision allowed a substantial discount for a family partnership, a 1990 Tax Court case disallowed a valuation discount when the partnership was formed for the sole purpose of reducing federal estate tax. A 1997 Tax Court decision rejected discounts proposed by the estate as producing unrealistically low values.

Beginning in 1997, a series of private letter rulings has challenged family limited partnerships set up with an apparent purpose of depressing values at death or in the event of a gift. In the first of the rulings, a family limited partnership formed two days before death was disregarded by IRS for valuation purposes. In that ruling, IRS observed that the only purpose for the partnership was to depress the value of partnership assets in the decedent's gross estate for the benefit of children. A little over a month later, IRS ruled that a limited partnership formed pursuant to a power of attorney two months before a decedent's death was disregarded by IRS for federal estate tax valuation purposes.

In a letter ruling issued the following month, a partnership formed from assets held in a revocable trust two months before the decedent's death at a time when the taxpayer was incompetent was disregarded for valuation purposes as serving no business purpose and because it was not a bona fide, arm's length business arrangement.

About a month later, IRS ruled that exchange of $400,000 of farmland for a 99 percent limited partnership interest did not result in the claimed 40 percent discount at death 54 days later. In the following year, 1998, IRS ruled that the existence of a family limited partnership would be disregarded when the sole or primary purpose was the reduction of federal estate tax for a transfer within six weeks of death.

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In a 1999 federal district court case in Texas, the only discount allowed to the holder of a 25 percent interest in a family partnership was a 5.4 percent discount to reflect liquidation costs.16

Restrictive agreements in partnership documents

If the only purpose behind the formation of a family limited partnership is to depress asset values, with nothing of substance changed as a result of the formation, any restrictions imposed by the partnership agreement are likely to be disregarded.17 The Internal Revenue Service evaluates such transactions in light of whether the arrangement—(1) was a device to transfer property to a family member for less than adequate consideration and (2) was not the result of arm's length negotiation having a valid business purpose.18

Discounts based on restrictive agreements have been allowed in the past. However, enactment of the "freeze" rules in 1990 has called that line of cases into question.19 In a 1999 Tax Court case,20 the court refused to approve a scheme whereby the use of "assignee interests" were used to transfer interests to children to get around the provision of I.R.C. § 2704(b).21 The court did, in that case, agree that the partnership agreements did not contain an "applicable restriction" within the meaning of I.R.C. § 2704(b) on the grounds that the provision was no more restrictive than state law. Accordingly, a discount for lack of liquidity could be used in computing the value of partnership interests transferred for federal gift tax purposes.22

Conclusion

There is little doubt that IRS has their eye on family limited partnerships. Certainly any use of the concept should be accompanied by a showing of ample business reason for the transaction and should involve a careful assessment of the limitations in I.R.C. § 2704(b).

FOOTNOTES

1 See generally 8 Harl, Agricultural Law § 60.07 (family farm partnerships), ch. 61 (limited partnerships); Harl, Agricultural Law Manual § 7.04 (1999) (limited partnerships).

2 See, e.g., Estate of Watts v. Comm'r, T.C. Memo. 1985-595 (35 percent discount of 15 percent partnership interest for non marketability for federal estate tax purposes).


4 Estate of Watts v. Comm'r, n. 2 supra.

5 See Estate of Murphy v. Comm'r, T.C. Memo. 1990-472.

6 See Estate of Lehman v. Comm'r, T.C. Memo. 1997-392 (value of decedent's interest in limited partnership owning real property determined from discounted cash flow methodology with adjustments).


8 Id.


10 Id.


12 Id.


16 Id.

17 Ltr. Rul. 9730004, April 7, 1997.


20 See I.R.C. §§ 2701-2704, enacted by OBRA, Sec. 11602(a) (1990).

21 I.R.C. § 2704(b); Treas. Reg. § 25.2704-1(b)(1). See Ltr. Rul. 9735003, May 8, 1997 (restrictions imposed in family limited partnership failed to satisfy I.R.C. § 2704(b) exceptions); FSA Ltr. Rul. 9919009, Jan. 13, 1999 (partnership agreement provisions preventing liquidation were an "applicable restriction" under I.R.C. § 2704(b) which was disregarded in valuing transferred partnership interests to extent more restrictive than limitations under state partnership law; 45 percent discount in family limited partnership disallowed).


23 Id.

24 Id.