Estate Tax Law

April 26, 2012

Family Limited Partnerships: Still a Useful Estate Planning Tool

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In previous newsletters, we have discussed the benefits associated with family limited partnerships (see Planning to Pass the Baton: Family Wealth Transfers, September 2011). The recent case of *Estate of Kelly* (March 2012) offers another example of how family limited partnerships can be used in business and estate planning.

In *Estate of Kelly*, Mrs. Kelly was an elderly widow who had succeeded to sole ownership of her family's substantial business and investment holdings. Mrs. Kelly's health was deteriorating and she lacked experience in business and investment matters. With her children willing and able to assist her, Mrs. Kelly formed four limited partnerships and transferred to those partnerships specific properties and investments. Mrs. Kelly also formed a wholly-owned corporation to act as the general partner of each limited partnership, and her children acted as the corporation's officers and directors. In this capacity, the children and grandchildren actively managed the limited partnerships' business and investment interests. Over a number of years, Mrs. Kelly gifted limited partner interests to her children and grandchildren. At the time of her death, Mrs. Kelly had gifted all or a majority of her limited partner interests in three of the four limited partnerships.

Following her death, Mrs. Kelly's children filed her estate tax return and reported only those limited partner interests that Mrs. Kelly had not gifted by the time of her death. The IRS asserted, nevertheless, that Mrs. Kelly's estate should include the value of all the properties and investments transferred to the partnerships, apparently arguing that the partnerships were formed primarily to avoid tax, and that Mrs. Kelly in essence had retained the possession or enjoyment of the properties and investments. As a result, the IRS claimed, her estate owed more than $2,000,000 in additional tax.

The Tax Court agreed with Mrs. Kelly's children, and ruled that her estate should not include the value of the properties and investments transferred to the partnerships. The Tax Court noted that there were legitimate business reasons for creating the limited partnerships, such as protection from potential liabilities, and delegating daily management responsibilities to the children, as corporate officers and directors. Further, the Tax Court observed, even though Mrs. Kelly contributed a considerable portion of her business and investment assets to the limited partnerships, she retained significant liquid funds outside of the partnerships. The funds provided financial support for Mrs. Kelly, and undermined the IRS argument that she was dependent upon, or possessed and enjoyed, the partnership interests or assets.

Although the Tax Court's opinion does not discuss the issue of valuation

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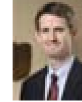

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discounts, one could reasonably assume that the limited partner interests gifted to Mrs. Kelly's children and grandchildren, and the limited partner interests she continued to own at her death, were materially discounted based on lack of control and lack of marketability principles. Please note, however, that President Obama's 2013 Revenue Proposal would eliminate such valuation discounts, effective on the date of enactment. Thus, there may be a limited window of opportunity to apply discount valuations principles in valuing limited partner interests for gift or estate tax purposes.

Despite their many benefits, we have previously noted that family limited partnerships are not appropriate or worthwhile for everyone. Nevertheless, if you own substantial investments or a successful business, and wish to transfer ownership of the investments or business to younger generations, the use of a family limited partnership should be considered.

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