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Latest 'Bad Facts' FLP Case Emphasizes Poor Planning, Operations

***Estate of Liljestrand v. Commissioner*, T.C. Memo 2011-259; 2011 Tax Ct. Memo LEXIS 251 (Nov. 2, 2011)**

After retiring in 1978, a doctor exchanged his interest in a Hawaiian hospital for several real property holdings, including condominiums and a shopping center in California, a warehouse in Oregon, a Florida strip mall, and a medical building in Arizona. Just about six years later, the doctor formed a revocable trust to hold the real property, naming his eldest son as trustee and also paying him to manage the property.

FLP to ensure son's employment. By 1996, the doctor wanted to plan his estate on behalf of all his four children, but also wanted to make sure that his eldest son kept his position managing the real estate businesses, in which none of his siblings showed an interest. In addition, he was concerned that if he gifted the property while it remained in trust, then local (Hawaiian) law would allow his other children as beneficiaries to seek judicial partition of the property and oust him as manager.

To alleviate these concerns, an estate planning attorney suggested that the father form a family limited partnership (FLP), funded with the trust-owned properties. In 1997, the FLP was formed, naming the father as the 99.8% general partner and giving the son a small Class A limited partnership (LP) interest. Within six months, the father transferred all his real property investments, appraised at roughly $6 million, to the FLP.

Over the next two years, he gifted Class B LP units to four trusts established for each of his grown children. Since the father had contributed all but his personal residence to the FLP, the FLP made disproportionate distributions, larger than those provided by the partnership agreement, to pay his living expenses and debts as well gifts to his grandchildren. Then in 2008, the IRS assessed a $2.6 million deficiency, based on including the entire fair market value of the father's real estate holdings in his estate pursuant to IRC Section 2036(a), and the taxpayer petitioned the court for a determination of liability.

FLP asserts three business purposes, which the court rejected. The court also found several "bad facts" that indicated the FLP transfers were not bona fide sales. For example, the FLP failed to follow "even the most basic of partnership formalities," including keeping regular books and meetings, making proportionate distributions, and refraining from paying the father's personal expenses and the son's debts. The father also stood on "both sides of the transaction" in funding and forming the FLP, without any evidence that he held "arm's-length" negotiations with the other partners or created the FLP to fulfill anything but his own objectives. Based on the totality of these facts, the court concluded that the father did not have a legitimate, nontax reason for transferring his assets to the FLP, which were thus were not "bona fide" sales.

The court also considered the estate's claims that the father did not retain possession of the FLP assets during his lifetime—but the bad facts of its formation, funding, and operations undermined these arguments as well. Although the father retained some assets outside of the partnership, they were not enough to maintain his lifestyle or satisfy his future obligations, including payment of his estate taxes.

Lastly, the "partnership served primarily as a testamentary device through which [the father] would provide for his children at his death," the court held. Taking this feature in light of all the other factors in the case, the court included the full, fair market value of the FLP assets in the father's gross estate, pursuant to Section 2036, and denied the estate's petition to not pay the $2.6 million in tax deficiencies.