



Litigation Update — Family Limited Partnerships Face New Challenges

Will Family Limited Partnerships (FLPs) survive? Recent Tax Court decisions show that the IRS has continued its intense scrutiny of FLPs and their discounts, with a big push to disqualify them under IRC 2036(a). 2004 brought some interesting decisions:

Stone: A Good Decision

Many consider the *Estate of Stone v. Commissioner* case to be an excellent example of a “good” FLP decision.

In 1996, Eugene and Allene Stone and their children formed five FLPs, and the Stones transferred most of their assets to them. When they died, the Stones’ estate tax returns were challenged by the IRS, which claimed that the asset transfers were not “bona fide sales for full and adequate consideration.”

Relying on good documentation, the estate pointed to several factors indicating that the property was indeed transferred legitimately and at arm’s length. One key fact was that the Stones retained sufficient assets to allow them to maintain their standard of living. In the end, the estate prevailed. The tax court held that the transfers did not constitute a “recycling of value,” which had sealed the decision against estates in several other cases.

Abraham — Fatally Flawed

The case of *Estate of Abraham v. Commissioner* illustrates how the IRS successfully disqualified an FLP due to Section 2036(a) issues. In this case, the guardians of elderly Ida

Abraham created an FLP as part of her estate plan. Her guardian was given sole discretion to use up to 100 percent of the FLP's income to pay Ida's living expenses — a decision the IRS considered antithetical to the intended purpose and spirit of an FLP.

The court concluded that the FLP was “merely a testamentary vehicle employed to shift assets to future generations while maintaining continued right to benefit from the FLP interests transferred.” Chalk up one for the IRS.

Hillgren — Valuation Prevails

Estate of Hillgren v. Commissioner dealt with the case of Lea Hillgren, an active but mentally ill woman who relied on her brother Mark for financial assistance and guidance. Lea's FLP included seven parcels of real estate, four of which were encumbered by a Business Loan Agreement (BLA) between the siblings and ultimately controlled by Mark.

When Lea died, the IRS disallowed the tax discount associated with the FLP, claiming that even though Mark controlled the FLP, the assets were basically used to support Lea. Indeed, crucial FLP paperwork wasn't even filed until after the estate tax challenge began, underscoring the Hillgrens' disregard for the FLP entity.

One interesting twist in the Hillgren case: while the FLP was not considered valid, the BLA was. And because the BLA gave Mark discretion over any sale for 29 years and a 25 percent interest in cash available from the properties, the court determined that these restrictions — similar to the types of restrictions on a valid FLP — reduced the value of property to any willing buyer. The court allowed a significant discount on those properties, and the taxpayer prevailed.

As all of these cases illustrate, FLPs, while still important in estate planning, are under the IRS microscope. Complying with Section 2036(a) is not impossible, but it does require vigilance.

Please feel free to contact us if you have FLP questions. Our FLP and valuation experts will be glad to assist you.

