FAMILY LIMITED PARTNERSHIPS (FLPs) are a popular estate planning tool. However, several recent cases in which the Service has successfully argued that property transferred to FLPs is included in the decedent’s gross estate expose potential traps for the unwary. In particular, FLPs must not be created solely to reduce tax, partnership formalities must be observed, and the decedent must not retain possession, enjoyment, or a right to income from the property post-transfer. The Service has been increasingly successful in using section 2036(a) of the Internal Revenue Code to include assets previously transferred into a FLP when these considera-

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This is the second of a series of articles to be contributed by members of the ABA Tax Section which pair a senior member of the ABA Tax Section with a member selected from the Young Lawyers Forum. Both ALI-ABA and the ABA Tax Section are proud to announce this joint venture, which is led by Sam Braunstein, Council Director, ABA Tax Section, Fairfield, Connecticut.

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tions are not observed. (All section references are to the Code unless otherwise indicated.)

REASONS TO USE FLPS • FLPs can be used to satisfy numerous personal and financial goals of the client. The Service has been successful in attacking FLPs when nontax business or financial reasons for creating them do not exist and the sole reason for doing so is to obtain estate tax discounts for fractional interests in retained FLIP interests.

Some nontax business, financial, and family reasons for using FLPs include:

• **Family Control:** The ability to transfer “assets” to a younger generation without giving up complete control of those assets. The asset transferred is generally the limited partnership interest gifted by the client to the child during the client’s lifetime.

• **Consolidation of Family Investments:** When families have complex investments and holdings, a FLP can allow the family to consolidate those investments to make management more efficient. The courts have referred to this as “pooling of assets.” For example, after the death of a spouse, the surviving spouse might have three trusts, a bypass trust, a QTIP trust, and a surviving spouse’s trust, each of which holds fractional interests in various assets (such as real property). By combining the interests and contributing them to a FLP, the entire interest (for example, a parcel of real property) can be more easily managed and the accounting for profits and losses from that property becomes easier.

• **Creditor Protection:** A creditor of a holder of a limited partnership interest is generally limited to obtaining a “charging order.” For example, in California, that creditor may be able to foreclose on the charging order, but the most the creditor will receive is an assignee interest in the partnership. The creditor, therefore, never becomes a partner or owner of the assets held in the FLP.

• **Divorce Protection:** A limited partnership agreement may include provisions describing how a nonfamily member ex-spouse of a limited partner will be treated upon divorce. For example, the agreement might include buy-sell provisions that require the ex-spouse to sell his or her interest in the FLP to the other partners. This keeps the FLP ownership in the family.

• **Annual Giving:** The owners of FLP interests (generally, the parents) may make annual gifts of limited partnership interests to their children instead of giving undivided interests in the assets held by the FLP. (The Tax Court has, however, held that this reason alone is insufficient to avoid section 2036.)

Note that obtaining discounts for annual gifts or for fractional interests held by the estate alone is not considered to be a sufficient reason to establish a FLP.

SECTION §2036(a) • Section 2036(a) provides that a decedent’s gross estate includes the value of property which the decedent has transferred (other than by bona fide sale for adequate and full consideration) when the decedent has retained possession or enjoyment of or the right to income from the property or the power to designate the persons who shall possess, enjoy, or receive income from the property. The purpose of section 2036(a) is to prevent avoidance of the estate tax by lifetime transfers that are testamentary in nature.

Recent cases use a two-stage analysis for determining whether section 2036 applies. First, was there an express or implied agreement that decedent will retain possession or enjoyment of the property or a right to income? If so, the transfer is within section 2036. Second, was the transfer of property a bona fide sale for full and adequate consideration? If so, then section 2036 does not apply.

The first stage of analysis has two parts: whether the decedent retained possession, en-
joyment, or a right to income from the property and whether there was an express or implied agreement at the time of the transfer to do so. Both parts must be satisfied for the transfer to fall within section 2036. If the decedent retained possession or enjoyment of the property (for example, personal property—such as a painting—is kept in the decedent’s home), then the courts have had little problem finding that section 2036(a) applies to cause inclusion of that property in the taxable estate. However, when the possession or enjoyment is not that obvious, then the courts look for an implied agreement. The courts often find implied agreements when the decedent is left post-transfer with insufficient income and assets outside of the FLP to cover his or her own expenses. For these purposes, possession or enjoyment of property means substantial present economic benefit and can include using the transferred property to secure personal debt, payment of personal expenses by the FLP, and continued residence in the home which was transferred to the FLP. When these events occur, the courts have held that there was an implied agreement to use the partnership property for the benefit of the donor to the exclusion of the other partners.

The second stage of analysis also has two parts: whether the decedent received full and adequate consideration and whether the transfer was a bona fide sale. Full and adequate consideration generally requires that the decedent has received a proportionate interest in the partnership for the property transferred to the partnership and that the formalities of the partnership are respected. For the transfer of property to a FLP to be regarded as a bona fide sale, it must also generally satisfy a substantial nontax purpose.

The cases in which section 2036(a) attacks have succeeded are extremely fact driven, but they offer some clear guidelines for planners.

**Bigelow—Implied Agreements**

In *Estate of Bigelow v. Comm’r*, 89 T.C.M. (CCH) 954 (2005), the Tax Court held that the value of property transferred by the decedent to a FLP was included in her estate because there were implied agreements that the decedent would retain enjoyment and income from the property and no valid nontax reason existed for the FLP’s formation.

Virginia Bigelow was sole owner of her residence. In the early 1990s, Mrs. Bigelow gave each of her three children a 1/175th undivided interest in the property. In 1991, Mrs. Bigelow transferred her interest in her residence to a revocable trust, naming herself and her son as co-trustees. The trust agreement required the trustees to distribute all income to or for Mrs. Bigelow’s benefit and allowed invasion of the corpus for her care, maintenance, or support. Mrs. Bigelow suffered a stroke in 1992 and moved into an assisted living facility. She withdrew a 1.50 percent interest in the residence from her trust and then gave a 0.75 percent interest in the residence to each of her two daughters. In 1994, the trust and Mrs. Bigelow’s children formed Spindrift Associates, a FLP, where the trust was the sole general partner and both the trust and children were limited partners. The trust contributed the residential real property, but $450,000 in debts secured by the property remained in Mrs. Bigelow’s name. After the transfer of the residence to the FLP, Mrs. Bigelow no longer received rental income from the property and, as a result, had insufficient income to pay her living expenses and service the debt. The partnership made payments on the debt directly but failed to properly adjust Mrs. Bigelow’s capital account as required by the partnership agreement. After Mrs. Bigelow’s death, the estate took the position that her gross estate did not include the value of the real property transferred to the FLP because she had not retained possession or enjoyment of it. The Tax