WRMarketplace

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TOPIC: Estate of Powell: Is Its Bark Worse than Its Bite for Family Limited Partnerships?

MARKET TREND: Even though recently proposed IRS regulations on the transfer tax valuation of family entities (including family limited partnership ("FLPs")) are at a standstill, the IRS continues to pursue FLPs through the courts. A recent U.S. Tax Court decision may give the IRS yet another technical argument in challenging FLPs, but is its impact on properly formed and administered entities limited?

SYNOPSIS: FLPs are effective legacy planning tools for families seeking to consolidate their assets and investments, engage and educate multiple generations in legacy management, and plan for business succession. If established solely for tax purposes and/or improperly formed and administered, an FLP's creation typically will result in IRS scrutiny and challenge. In Estate of Powell, the U.S. Tax Court's opinion: (1) deemed a limited partner's right to vote (in conjunction with other partners) on an FLP's dissolution as a power to designate the enjoyment of the FLP's assets, (2) considered the general partner's fiduciary duty to the FLP as illusory due to the general partner's relationship as family member and attorney-in-fact of the limited partner, and (3) raised the possibility of double tax inclusion of the value of both FLP interests and its underlying assets in a decedent's estate.

TAKE-AWAYS: At best, the Powell decision represents a win for the IRS against abusive FLP practices, by applying a somewhat novel approach to estate inclusion and

taxation. Regardless, there is no need to panic. The best practices for forming, funding, and administering a FLP for legacy planning purposes, as discussed in WRMarketplace Nos. 13-10 and 17-16, remain largely unchanged and should continue to be followed in successful FLP planning.

MAJOR REFERENCES: Estate of Powell v. Comm'r., 148 T.C. No. 18 (May 18, 2017).

PRIOR REPORTS: 17-16; 13-10.

The recent decision in the U.S. Tax Court case of *Estate of Powell v. Commissioner*, reviewed by 17 Tax Court judges, involved "deathbed" tax planning using an FLP, and resulted in inclusion of the FLP's value in the decedent's estate. Advisors should take note of *Powell* and understand its lessons for avoiding overly-aggressive, poorly-structured FLP plans. But how much should the decision really change the best practices for FLP planning? Perhaps not as much as one may think.

WHAT HAPPENED? BAD FACTS

The following provides a timeline of the FLP planning implemented in *Powell*. Note the short duration between the FLP's creation and funding, the transfer of FLP interests, and the decedent's passing, as it plays a key role:

- Nancy H. Powell ("**decedent**") appointed her son, Jeffrey Powell ("**Jeffrey**"), as her attorney-in-fact under a power of attorney ("**POA**"). The ***POA limited gifts made by the attorney-in-fact to the annual federal gift tax exclusion***.
- On ***August 6, 2008***, while decedent was ill but before her passing, Jeffrey, as general partner ("**GP**"),[1] formed NHP Enterprises, LP ("**NELP**"), which granted the GP unilateral control over partnership distributions.
- On ***August 7, 2008***, decedent was deemed incapacitated by her physicians, allowing Jeffrey to act on her behalf under her POA.
- On ***August 8, 2008***, $10 million of cash and securities was transferred from decedent's revocable trust to NELP in exchange for a 99% limited partner interest ("**LP interest**").
- Also on ***August 8, 2008***, Jeffrey, acting under the POA, assigned decedent's 99% LP interest to a charitable lead annuity trust ("**CLAT**") that paid a charitable annuity to the Nancy H. Powell Foundation during decedent's life and, upon her death, distributed the remainder to trusts for decedent's descendants (*i.e.*, Jeffrey and his brother).
- Decedent died on ***August 15, 2008***, just one week after the funding of NELP and the transfer of LP interests to the CLAT.
- Jeffrey, as executor of decedent's estate, filed a 2008 gift tax return reporting a gift of over $1.66 million, which represented the value of the CLAT's remainder interest, taking into account a ***25% discount for lack of control and marketability of the LP interest***.

WHAT WENT WRONG? RETAINED RIGHTS

IRS Challenges. The IRS challenged this FLP plan based on the following:

Gift Tax. The IRS claimed that the estate owed over $2.9 million in federal gift tax based in part on the argument that the remainder interest passing to decedent's descendant under the CLAT was significantly undervalued, since decedent was terminally ill at the time of transfer.

Estate Tax. The IRS asserted an estate tax deficiency of $5.9 million, arguing for inclusion of the undiscounted value of the LP interests or NELP assets in decedent's estate because:

- **Retained Right to Enjoy Property (IRC §2036(a)(1))**. Decedent, as limited partner, retained a right to possess, enjoy, or receive income from the property transferred to NELP.
- **Retained Right to Designate Enjoyment of Property (IRC §2036(a)(2))**. Decedent retained a right, in conjunction with her sons as owners of NELP, to designate who could enjoy NELP's property due to a limited partner's right to vote on partnership liquidation.
- **Retained Right to Revoke or Alter (IRC §2033/2038(a))**. Alternatively, decedent retained the LP interests in her estate because neither her POA nor state law authorized the gift to the CLAT, making the gift either (1) void, such that the LP interests never passed from her estate or (2) voidable by decedent, so that she retained the right to change, revoke, or terminate the transfer.[2]
- **Transfer within 3 Years of Death (IRC §2035(a))**. Within three years of her death, decedent gifted property, terminating her retained powers in such property under IRC §§2036 or 2038 that otherwise would have caused inclusion in her estate.
- **No Bona Fide Sale.** The exception to inclusion under IRC §§2036(a) or 2038 for the bona fide sale of property in exchange for adequate and full consideration ("**bona fide sale exception**") did not apply because (1) decedent's estate failed to show a significant nontax purpose for NELP's creation and (2) due to the valuation discount, decedent's transfer of property in exchange for the LP interests was not for full and adequate consideration.

Taxpayer Response. Although the bona fide sale exception is one of the most common defenses against FLP estate inclusion under IRC §2036(a), the taxpayer stipulated that this exception did **not** apply and **did not** challenge the IRS's argument that decedent could control enjoyment of the NELP assets under IRC §2036(a)(2). The taxpayer simply asserted there was no estate inclusion because the decedent did not own the LP interest when she died.[3]

THE OUTCOME? ESTATE INCLUSION

It is worth noting that the participating Tax Court judges appear to have seen the case as “aggressive deathbed tax planning,” which should cause estate tax inclusion. As the majority opinion involves a somewhat unique approach to estate tax inclusion, however, it raises the question of whether the court extended its reasoning to find a legal basis for inclusion.

Gift Validity. The Tax Court agreed with the IRS that the gift of the LP interests to the CLAT was either void or voidable because the decedent’s son exceeded his authority as agent under her POA, resulting in inclusion of the LP interests in decedent’s estate.[4]

- ***Why It Matters:*** Placing restrictions on the authority of an attorney-in-fact under a power of attorney or a trustee under a revocable trust to make gifts can impact estate planning opportunities in the event of an individual’s incapacity. For greater flexibility, clients who have larger estates, are charitably-minded, and/or own certain types of assets (e.g., closely-held businesses) may want to grant their fiduciaries broader gift-making authority that specifically addresses this type of planning.

3-Year Inclusion Rule. The majority opinion also analyzed the outcome if the CLAT gift had been valid, in which case, it determined IRC §2035(a) would apply to include the value of the transferred LP interests in decedent’s estate, as the gift was made within three years of her death and the LP interests otherwise would have been includible under IRC §2036(a)(2) (see below).[5]

- ***Why It Matters:*** “Death bed” planning solely for tax purposes is rarely successful. Giving away property in which a decedent previously retained certain rights or powers (such as the right to income, to revoke or amend, to designate or change the recipient, etc.)[6] keeps the possibility of estate inclusion open for three years, post-gift. This makes the ability to rely on the bona fide sale exception to estate inclusion critical, particularly for FLP planning, which, in turn, necessitates the FLP’s creation for legitimate and significant non-tax reasons and its proper administration, including compliance with all business formalities.

Decedent Retained Right to Designate Enjoyment. Most estate inclusion cases involving FLPs have been decided on whether the decedent retained the right to possess, enjoy, or receive income from the property transferred to the FLP.[7] Here, however, the Tax Court majority opinion found that estate inclusion resulted from decedent’s ***retained right to designate who could enjoy the NELP property***;[8] based on:

- **Ability to Dissolve the FLP.** Decedent, as a 99% limited partner in NELP, had the right in conjunction with other partners (her sons) to vote to dissolve the FLP. This right enabled her to direct who would enjoy the NELP property, particularly as the vast majority would likely re-vest in her name as owner of a 99% LP interest.[9]

- **Imputed Rights of General Partner.** Decedent's son, Jeffrey, was her attorney-in-fact and also, as GP, had unilateral control over partnership distributions under the partnership agreement. As such, the majority opinion reasoned that the fiduciary duties that Jeffrey owed to the FLP were "illusory" because:
  - The duties that Jeffrey owed to NELP were almost entirely owed to decedent herself since she owned the 99% LP interest;
  - Jeffrey, as decedent's son and attorney-in-fact, would not have acted in a way that would prejudice her interests; and
  - NELP was owned solely by related family members, operated only as an investment vehicle, and conducted no meaningful business. "Intrafamily fiduciary duties within an investment vehicle simply are not equivalent in nature to the obligations created" under an entity with unrelated owners.

  Thus, Jeffrey's powers over partnership distributions as GP, if retained by decedent at death, would give her a right to designate enjoyment of NELP's assets.[10]

➢ ***Why It Matters:***

1) Advisors have long recommended that clients minimize their participation in the control of FLPs, specifically avoiding ownership of GP interests or holding management powers, either directly or as controlling owner of another entity. Retention of only LP interests seemed safe; however, *Powell* holds that retention of an LP interest may cause inclusion if the limited partner retains voting rights with respect to the FLP's dissolution. If clients initially hold LP interests in a FLP, they may want to eliminate the limited partners' voting rights with regard to dissolution. Note, if existing FLP agreements are amended to this effect, clients should understand a three-year window remains for potential estate inclusion thereafter.

2) If a client owns LP interests in a FLP, a conservative approach would avoid naming persons related and subordinate to the client (e.g., parents, descendants, siblings) or the client's attorney-in-fact under a personal power of attorney as GP. Having an irrevocable trust with an independent trustee own the GP interest may help.

<u>Getting Whipsawed - Potential for Double Inclusion</u>. Prior Tax Court opinions addressing the value for estate inclusion in FLP cases under IRC §2036 generally have included the undiscounted value of the property transferred to the FLP, ***not*** the value of the retained partnership interest. The majority opinion in *Powell*, however, takes a different approach to calculating the value that should be included in the decedent's estate, providing that the total value for inclusion is (1) the value of LP interest deemed includible in the estate ***as of the date of death*** plus (2) the value of the FLP assets ***as of date of death*** but offset by the value of the LP interest received upon the ***date of the initial transfer of property to the FLP***.

- ***Why It Matters:*** The *Powell* formula works when there is no change in the value of the assets held by the FLP, but it may result in overinclusion or under-inclusion for estate tax purposes if the FLP assets experience any appreciation or loss.

  Example 1 – No Change: On February 1st, decedent contributes $5 million in assets to FLP and receives LP interests valued at $3.75 million (applying a 25% discount). Decedent passes on March 31st. The FLP's assets are still valued at $5 million, and the LP interest at $3.75 million. The value includible in decedent's estate under the *Powell* approach is **$5 million**: $3.75 million of LP interest + $1.25 million of FLP assets ($5 million - $3.75 million offset for value of LP interest when received).

  Example 2 – Appreciation: Same facts as Example 1, except decedent passes on December 31st, when the FLP's assets have increased in value to $10 million and the LP interest has correspondingly doubled in value to $7.5 million. Now, the value includible in decedent's estate under *Powell* equals **$13.75 million**: $7.5 million of LP interest + $6.25 million of FLP assets ($10 million - $3.75 million offset for value of LP interest when received). Note that only $10 million would be includible if the FLP was simply disregarded and its assets included in the decedent's estate.

  Example 3 – Depreciation: Same facts as Example 1, except decedent passes on December 31st, when the FLP's assets have decreased in value to $2.5 million and the LP interest has correspondingly decreased in value to $1.875 million. Now, the value includible in decedent's estate under *Powell* equals only **$1.875 million**: $1.875 million of LP interest + $0 of FLP assets ($2.5 million - $3.75 million offset for value of LP interest when received).

  While the *Powell* formula did not affect the tax result for this estate, eight judges in agreement did note the possibility for "double inclusion" in an FLP with appreciated assets.

WHAT TO DO NOW?

Continue with Best Practices. While the *Powell* court applies somewhat novel reasoning in its decision, the outcome is not surprising. Creating FLPs solely for tax purposes likely will not achieve the desired tax objectives. Thus, as has long been the case, FLPs should be used to accomplish practical, non-tax legacy planning objectives, including developing a coherent family investment strategy, providing consolidated asset management, preventing fractionalization of family assets like real estate over time, educating junior family members and providing them with opportunities to become responsible legacy stewards in a controlled and guided setting, etc. Successful legacy planning with FLPs requires proper funding, implementation, and administration in compliance with the best practices discussed in *WRMarketplace Nos. 13-10* and *17-16*. Apart from considering additional restrictions on the voting rights of limited partners, the *Powell* decision largely leaves these best practices unchanged.

Learn from Powell – FLP Don'ts. *Powell* is a good opportunity to review practices that clearly should be avoided in FLP planning, which include:

- **DON'T make gifts of FLP interest immediately after creation of the FLP.** Ideally, a significant period of time will pass between the formation and gifts.
- **DON'T give the transferor the right to control FLP distributions, liquidations, or dissolution, directly or indirectly (e.g., power held by a person related or subordinated to the transferor).** Such control can be viewed as a retained power to possess the FLP assets or control their enjoyment.
- **DON'T use an FLP for solely for tax planning, near death or otherwise.** A FLP must be created for, and serve, a legitimate, non-tax purpose.
- **DON'T allow a partner to transfer all or almost all assets to the FLP.** Each partner should retain sufficient assets to maintain his or her standard of living for life.
- **DON'T allow partners to have personal use of FLP assets**. Any use of FLP property should be pursuant to a formal lease or rental agreement between the partner and the FLP and should be for fair market value.
- **DON'T allow the FLP to pay personal expenses of partners or allow partners to personally pay FLP expenses**. The FLP should not make disproportionate distributions to any partner to cover personal expenses.

TAKE AWAYS:

At best, the Powell decision represents a win for the IRS against abusive FLP practices, by applying a somewhat novel approach to estate inclusion and taxation. Regardless, there is no need to panic. The best practices for forming, funding, and administering a FLP for legacy planning purposes, as discussed in *WRMarketplace Nos. 13-10 and 17-16*, remain largely unchanged and should continue to be followed in successful FLP planning.

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NOTES

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[1] This interest was initially funded with two unsecured promissory notes made by Jeffrey and his brother,
[2] If void, the LP interests would have remained in decedent's estate, includible for estate tax purposes under IRC §2033. If voidable by decedent, estate inclusion would have occurred under IRC §2038(a) due to decedent's retained power to change the enjoyment of or to alter, amend, revoke or terminate the transfer of property.

[3] As discussed herein, however, since the LP interests were transferred to the CLAT within 3 years of decedent's death, there would be estate inclusion under IRC §2035(a) if any of IRC §§2036 or 2038 applied.

[4] Includible as assets of the gross estate under IRC §2033.

[5] *See* IRC §2035(a). If an individual makes a transfer of any interest in property or relinquished a power with respect to any property, during the three-year period prior to the individual's death, and the value of the transferred property would otherwise have been included in the individual's gross estate under IRC §§2036-2038 or 2042, the value of the transferred property or interest is includible in the individual's taxable estate.

[6] Specifically, rights and powers described in IRC §§2036-2038 and 2042.

[7] *See* IRC §2036(a)(1).

[8] *See* IRC §2036(a)(2).

[9] *See also Estate of Strangi v. Comm'r*, T.C. Memo. 2003-145 (2005).

[10] *See Id.*