
SHERRARD
GERMAN & KELLY, P.C.
ATTORNEYS AT LAW

28th Floor, Two PNC Plaza, Pittsburgh, PA 15222
Phone: 412-355-0200 • Fax: 412-261-6221 • www.sgkpc.com

REPORT FROM COUNSEL

SPRING 2006 ISSUE

A LOOK AT RECENT DEVELOPMENTS WITH FAMILY LIMITED PARTNERSHIPS

By Holly McCann, Esquire

The Internal Revenue Service (the "Service") has continually attacked the validity of the use of discounts that are claimed by donors and decedents when assets are transferred to a family limited partnership ("FLP"). Until recently, the Service has had limited success in its attack on these discounts. However, discussed below are some cases where the Service has recently been successful in invalidating valuation discounts claimed on limited partnership interests in such FLPs. In these cases, the Service has relied on Section 2036(a) of the Internal Revenue Code of 1986, as amended (the "Code") to include the fair market value of assets transferred into a family limited partnership by a deceased donor in the donor's estate. The Service's successful attack on these types of partnerships under Code § 2036(a) should cause one to carefully consider the facts and circumstances surrounding the creation of an FLP.

First Circuit Court of Appeals

In the First Circuit, in the *Estate of Abraham v. C.I.R.*, 408 F.3d 26 (1st Cir. 2005), the decedent's estate appealed from a Tax Court determination that was unfavorable to it, where the Tax Court had concluded that the estate must include certain interests in a FLP that were purportedly transferred to the decedent's children by gift and purchase because

the purchase of the decedent's interest by the children was not a bona fide sale for full and adequate consideration and the decedent also retained rights in the income from the total property.

As part of Mrs. Abraham's estate plan, three pieces of commercial rental property were transferred to three FLPs, which were created when Mrs. Abraham was ill, and were made under court order by her guardian. Both Mrs. Abraham and her children were partners in these FLPs. The decree of court that allowed the creation of the FLPs specifically provided that each child, as a limited partner, would receive income from said FLP. However, the partnership agreements did not specifically mention any obligation for Mrs. Abraham's support. After the limited partnerships were created, the limited partners purportedly purchased for fair market value, after applying minority and lack of marketability discounts, proportionate interests in each FLP. While the decedent was alive, her guardian ad litem also made additional gifts of the interest in the FLPs, and paid additional living expenses of the decedent through payments from the FLP.

When Mrs. Abraham died, her executor included in her estate tax return only the value of the percentage interests in the FLPs that were still held by her at her death. However, the Service determined that because (1) the decedent transferred interests in each limited partnership for less than adequate and full consideration and (2) the decedent retained an interest in the assets, then under Code § 2036(a), the fair market value of the FLP assets should be included in the decedent's gross estate.¹ The estate challenged the Service's deficiency notice, rejecting the Service's position, and further arguing that the decedent did not retain a legally enforceable right within the meaning of Code § 2036.

The Tax Court, however, concluded that Code § 2036(a) applied, regardless of the fact that the FLP agreement did not give the decedent a legally enforceable interest in the property--but rather an interest retained pursuant to an understanding or agreement which would come within the purview of Code § 2036(a). The appellate court agreed, and held that the entire value of the assets transferred into the FLPs should be included in the decedent's estate at full fair market value.

Third Circuit Court of Appeals

In *Estate of Thompson v. C.I.R.*, 382 F.3d 367 (3rd Cir. 2004), the decedent and his children transferred securities, cash and real property to FLPs in exchange for proportionate ownership interests in the FLPs. The decedent and his two children served as directors and officers of the 1% corporate general partner. The decedent, then at the age of 98, transferred approximately 94% of his total assets into the FLPs. Loans were also made to family members, but payments were often late or were not paid at all. In addition, the FLPs made distributions of cash and partnership interests to decedent during his lifetime. In particular, while decedent's annual income from two annuities and Social Security totaled approximately \$14,000 each year, at the time that he transferred his assets to the limited partnerships, the decedent had annual living expenses of \$57,202.

On the decedent's death, the Service asserted two alternative theories for including the value of all of the FLP's assets in the decedent's estate. Under the Commissioner's first theory, the FLPs should be disregarded for tax purposes. The second theory relied on Code § 2036(a).

The Tax Court rejected the service's first argument, finding that the family partnerships were validly formed and properly recognized for federal estate tax purposes. However, the court sustained the application of Code § 2036(a)(1) to include the decedent's transferred assets in his estate. The Circuit Court noted that Code § 2036(a)(1) returns a lifetime transfer to a decedent's gross estate if there is an express or implied agreement at the time of transfer that the transferor will retain lifetime possession or enjoyment of, or right to income from, the transferred property. The court found such an implied agreement here, in that the decedent clearly did not retain sufficient assets to support himself for the remainder of his life as was calculated at the time of his transfer.

Fifth Circuit Court of Appeals

Finally, in the case of *Estate of Strangi v. C.I.R.*, 417 F.3d 468 (5th Cir. 2005)², the FLPs in question held interests in cash, securities and insurance policies and some commercial real estate. The decedent initially transferred 98% of his assets in exchange for a 99% limited partnership interest in the partnerships. The 1% general partner interests were held by a family corporation in which the decedent was a minority shareholder, along with his children. The decedent was incapacitated and terminally ill when the partnerships were created and he died two months later. Partnership assets were used to pay his personal living expenses, his funeral expenses and the administrative expenses and state and federal transfer taxes of his estate. The decedent and two of his daughters lived rent-free in three residences owned by the partnerships, and one of the decedent's daughters and two of his sons borrowed large amounts of cash from the partnerships, which were never repaid.

In the second round of this case, the Service argued that the existence of the FLPs should be ignored under Code § 2036(a). The Fifth Circuit agreed with the Tax Court that there was an implied agreement at the time of the transfer to allow the substantial and present use of the transferred assets for decedent's use under Code § 2036(a). However, the estate argued that the bona fide sale exception to Code § 2036 applied to exclude decedent's ownership of a limited partnership interest in his estate at his death. The court, however, rejected this argument.

The court concluded that where assets are transferred to a partnership in exchange for a proportional interest therein, the adequate and full consideration requirement would generally be satisfied so long as the formalities of the partnership entity are respected. The court then proceeded to break apart the exception into a "bona fide sale" provision and a "full and adequate consideration" provision. Under such an analysis, the court concluded that a sale is bona fide if, as an objective matter, it serves a substantial business or other non-tax purpose. This caused the court to examine the non-tax objectives of the decedent and his family in forming the FLPs.

In this case, the estate offered five different non-tax rationales for the transfer of assets to the FLPs. These five rationales were: (1) deterring tort litigation by the decedent's former housekeeper; (2) deterring a potential will contest by decedent's children; (3) persuading a corporate executor to decline to serve; (4) creating a joint investment vehicle for the partners; and (5) permitting centralized active management of working interests owned by the decedent. The Tax Court rejected each of these arguments.

What's Left of FLPs After Abraham, Strangi and Thompson

Based on the facts of the cases discussed above, it appears that there may be a significant risk of disallowance if an FLP is created when the decedent is at or close to death, and where all or substantially all of the assets contributed to the limited partnership consist of marketable securities. However, when used in the proper manner and for the proper purposes, FLPs are still valuable estate planning tools. The Service is particularly attuned to such so-called "death bed" FLPs. The taxpayers in the cases described above, who made the contributions to the FLPs, were near death; they contributed almost all of their assets to the FLPs; and their contributions allowed them to achieve discounts for the value of assets held in the FLP when they would not otherwise have been entitled to such discounts. However, with proper planning and under the appropriate circumstances, FLPs can still be considered as one of the many tools that are available for use in business and estate planning for individuals with sizeable estates.

About the Author

Holly S. McCann is an associate attorney with the firm and is a member of the firm's Corporate Services Group. Ms. McCann's practice focuses on the area of corporate, partnership and individual business and tax law, especially relating to small and medium-sized businesses. Ms. McCann is a graduate of the Duquesne University's School of Law.

End Notes

¹Code § 2036(a), Transfers with Retained Life Estate, provides as follows:

(a) General rule

The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death--

(1) the possession or enjoyment of, or the right to the income from, the property, or

(2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

² Remanded to Tax Court for rehearing to determine allowable administrative expenses, including attorney's fees (429 F.3d 1154 (5th Cir. 2005)).

FIRM ANNOUNCEMENTS

JDRF Honors Rob German for Many Years of Service and Leadership

The Western Pennsylvania Chapter of the Juvenile Diabetes Research Foundation International (JDRF) is saluting our firm's managing shareholder, **Robert D. German**, as the "2006 Honoree" at its 14th Annual Rainbow Gala, on April 29.

JDRF is the world's leading charitable funder and advocate of research for Type 1 diabetes. The black-tie event at the Hilton Pittsburgh hotel, one of the area's premier fund-raising events, is expected to generate more than \$820,000 for diabetes research.

Sherrard, German & Kelly, P.C. has strongly supported the JDRF Rainbow Gala since its inception in 1992 and the firm is proud to be the Presenting Sponsor of the 2006 Rainbow Gala.

Rob and his wife, Anne, have been passionate JDRF volunteers since 1988 when their son, Chris, was diagnosed with Type 1 diabetes at age six. Over the years, Rob has held many leadership positions with the local chapter and with the JDRF International organization. He was president of the Western Pennsylvania Chapter from 1994 to 1996 and has served on the JDRF International Board of Directors since 1998. He was elected to a two-year term as Chairman of the Board in 2004.

With over 100 chapters, branches and affiliates worldwide, JDRF has provided more than \$900 million in direct funding to diabetes research since it was founded in 1970.

Congratulations to our friend and partner, Rob German, on his many years of exceptional service to efforts to find a cure for diabetes, on his outstanding accomplishments as Chairman of the Board of JDRF, and on his recognition as the 2006 Rainbow Gala Honoree.

Hankle Wins Cyber Squatting Case

On March 16, 2006, Judge Terrence McVerry for the United States District Court for the Western District of Pennsylvania issued a non-jury verdict in favor of a mortgage company represented by Sherrard, German & Kelly's senior trial lawyer, **James Hankle**, in one of the first cyber squatting cases ever tried to verdict in Pittsburgh under the Anti-Cyber Squatting and the Consumer Protection Act ("ACPA").

The case dealt with one mortgage company's illegal conduct in registering an Internet domain name identical to another mortgage company's name with a bad faith intent to profit from the use of that registration. Mr. Hankle was successful in arguing during trial that his client's name was a trademark that was distinctive and therefore qualified for protection, that there was a likelihood of confusion, and that the registration of the domain name by the other company was for illegal purposes. The client was awarded a permanent injunction against the violating company from using the client's name in the future, the transfer of the Internet domain name from the violating company to the client, as well as statutory damages, attorneys' fees and costs.

Privacy and Information Security Seminar

Information Security and Privacy issues have become the hottest topics in the beginning of this new millennium, and Sherrard, German & Kelly is helping clients and other interested persons to stay abreast of these rapidly developing areas. On February 23, 2006, Shareholder **Edward G. Rice** co-presented in a Privacy and Information Security seminar, through the Pennsylvania Bar Institute, held in Pittsburgh. Mr. Rice presented the newest developments in information security law to a full house of attendees. If you would like individualized counsel on any privacy or information security matter, please contact Mr. Rice at 412-355-0200, or email him at egr@sgkpc.com.

Springer Elected President of Financial Industries Network

SGK attorney **Eric Springer** has been elected President of the Board of Directors of the Financial Industries Network. He has served as a Board Member for the past 7 years. The Financial Industries Network is a non-profit organization of executives and other senior-level managers from a variety of regional companies and banking and finance-related industries, as well as accountants, investment advisors, securities brokers, tax consultants, business consultants, attorneys, and other professionals. The group meets quarterly to network and discuss issues involving corporate and personal finance. SGK will be a Gold Sponsor of its upcoming dinner event to be held on May 25th at the Duquesne Club, featuring guest speaker Dennis Yablonsky, Secretary of the Pennsylvania Department of Community & Economic Development.

New Members

The firm is pleased to announce that **Joseph M. Wymard** has joined the firm's Litigation Services Group. Mr. Wymard's practice is focused on the valuation of closely held businesses incident to divorce and complex domestic litigation matters. Mr. Wymard has been a sole practitioner and brings 40 years of divorce expertise to this firm where he is now available to attend to the needs of our existing corporate clientele with regard to divorce. Mr. Wymard received his law degree in 1960 and his bachelor of arts degree in 1957 from the University of Pittsburgh.

The firm is also pleased to announce that **John G. Harshman** has joined the firm as an associate in the firm's Litigation Services Group. Mr. Harshman's practice has focused on

complex domestic litigation including divorce, property division, support and custody matters. Mr. Harshman also serves as counsel for the Policemen's Relief and Pension Fund for the City of Pittsburgh and is responsible for the review and approval of Domestic Relations Orders. Mr. Harshman has spent the last decade in practice with Mr. Wymard. Mr. Harshman received his law degree in 1991 and his bachelor of arts degree in 1987 from the University of Pittsburgh.

New Shareholders

The firm is pleased to announce that attorneys **Susan J. Messer** and **Edward G. Rice** have been elected shareholders.

Ms. Messer joined the firm in 1999 and was named a Director in 2003. As a member of the firm's Corporate and Financial Services Groups, her practice includes corporate law, mergers and acquisitions, and commercial real estate transactions. Ms. Messer earned a B.A. from Duquesne University in 1989 and received her J.D. from the University of Pittsburgh School of Law in 1992. She is a member of the American, Pennsylvania and Allegheny County Bar Associations.

Mr. Rice was with Sherrard, German & Kelly from its inception through 1998 and rejoined the firm in 2004 after six and a half years as Associate General Counsel for Buffalo, N.Y.-based M&T Bank. As a member of the firm's Financial Services and Litigation Groups, his practice focuses on banking, real estate, contracts and commercial litigation. Mr. Rice holds a B.S. in industrial engineering from the Pennsylvania State University and a J.D. degree from the Duquesne University Law School. He is admitted to the Bar in Pennsylvania and New York and is a member of the American, Pennsylvania, Allegheny County, and Erie County (N.Y.) bar associations.

Bashaw Named to Executive Committee

Bob Bashaw has been elected to join the firm's Executive Committee. He was also appointed to the Board of the Three Rivers Arts Festival and named to the Board of Directors of the Mountain Playhouse, a non-profit theater located in the Laurel Highlands, Somerset County, Pennsylvania.

Recent Transactions

We recently represented an engineering and HVAC contractor in the simultaneous divestiture of a division and the sale of its remaining assets. We served as counsel to a local contract manufacturer in the sale of its assets to a financial buyer, including an option to purchase the company's related real estate holdings.