

*Speech on "Business Purpose" as It Relates to
Family Limited Partnerships
Presented to the Chicago Bar Association on
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The ACM decision is important not only in its adherence to the long standing proposition that a transaction motivated solely by income tax avoidance may not withstand judicial scrutiny, but in its analysis of whether the components that support the economic substance of a transaction are sufficient "on a stand alone basis" to justify the transaction.

The issue I want to discuss is whether this "economic substance" or call it "business purpose doctrine" in ACM and similar cases can be exported from the income tax area into the family partnership area.

Family limited partnerships ("flps") these days are being structured to achieve estate and gift tax reductions. This may not be their sole purpose. It may not even be the primary purpose for certain of these partnerships. But it is a substantial reason for the formation of an overwhelming majority of these partnerships. These partnerships may be a problem from the "business purpose" side if a court follows ACM and common law analysis. Not just whether the transaction is motivated solely by tax avoidance, but a weighing of the economic substance of the transaction.

What I want to do is look at the business purpose issue and its relevance to flips both from a technical and a pragmatic perspective. First, the technical perspective.

What Code sections support the IRS's argument, and it is an argument that the IRS is currently making, that an flip without a business purpose is not to be valued on a fragmented or discounted purpose: that the "partnership wrapper" as the IRS refers to it, is to be ignored?

Fortunately, for practitioners, if we look through a whole series of statutes, proposed legislative actions, and recent legislation, we come to the conclusion that this "business purpose" test, as applied to Family Partnerships, is nowhere to be found in Chapters 11, 12, 13 or 14 of the Code. For example, consider the following:

1. Family attribution, that is, treating all family interests as if they were held by one central entity, was proposed in 1987 in a House Bill. It did not pass.
2. Family attribution as a means of valuing interests has been consistently rejected by the Tax Court without any discussion of the need for a "business purpose" in those cases disposing of family assets on a fragmented basis. The TC case Murphy is a rare exception to the Tax Court's consistent rejection of family attribution.

3. In Revenue Ruling 93-12, the IRS specifically rejected family attribution as a means of valuing fragmented transfers for gift and estate tax purposes.

4. In enacting Section 2701 of Chapter 14 of the Code in 1990, which deals with valuation freezes in the partnership context, nowhere is there a requirement that a business purposes exist for the formation of this type of partnership. And the requirements to comply with Section 2701 are complex. Had business purpose been an important objective in the family partnership context, it most certainly should have arisen in the Section 2701 context and rules. 5.

Similarly, in the Section 2704 context, where lapsing rights and applicable restrictions are disregarded for valuation purposes, it would have been extremely easy for Congress to also disregard family partnerships not entered into for sufficient business purposes. Nowhere is this requirement express in the statute or in the legislative history.

6. In the often touted Murphy case, and this is Murphy v. Commissioner, 60 TCM 73, a 1993 case, although the Tax Court held against the family and disallowed discounts, the case is truly not premised on a “lack of business purpose” criterion.

7. In the proposed 701 regs., there was an example of a family

partnership for transfer tax purposes that was not formed for business purposes. This was removed in the final regs., perhaps evidencing a belief by the IRS that it did not believe that it had legislative support to implement this business test?

8. And most importantly, in the four private rulings that I will discuss, although the Service cites business purpose, it's not able to back it up by any statutory references.

So this dearth of legislative and case support would seem to indicate that the IRS would not rely on lack of business purpose as a reason to attack family partnerships, or at least not believe it. But in four rulings this year, the Service has attacked with a vengeance these family partnerships based, among other reasons, on a lack of a business purpose.

Let me quote you the language the IRS has used in these rulings, all of which ignore the partnership structure in valuing the underlying assets, or stated another way, in not allowing discounts.

(1) "The only discernable purpose for the partnership agreement was to depress the value of the partnership assets as the assets pass through the decedent's gross estate."

(2) "It is well established that transactions having no purpose or effect to the transferor other than to reduce estate taxes are disregarded for federal tax

purposes.” Interestingly, on that quote, they cite the Murphy case, which seems to me to be an aberration in the estate tax area.

(3) “The transaction in this case lacks any indicia of an arm’s length bona fide business transaction.”

(4) “Even assuming arguendo that there was some legitimate business purpose for these transactions, the facts evidence that the transaction, including the formation of the limited partnership, was contrived primarily for the purpose of artificially versus naturally reducing the value of the decedent’s gross estate in order to reduce the estate tax liability.” Now, that was for a partnership whose purpose was creditor protection.

(5) For a partnership whose purpose was to purchase, maintain, manage and invest partnership assets, the Service held that the transaction had “no purpose or effect to the transferor other than to reduce taxes” and was to be disregarded for tax purposes.

These four letter rulings are 9719006, 9723009, 9725002 and 9730004. We may disagree whether the Service is correct in requiring a business purpose for these partnerships, but these rulings do provide two guidance arrows:

1. Structuring a partnership with bad facts, as were these facts in the rulings, is going to trigger IRS scrutiny and absolutely no sympathy from the court.

If these cases get to the court with bad facts, I think the court is going to import the ACM doctrine into the transfer tax area and perhaps interpose a business purpose requirement on these family partnerships. They may not have to, because there may be other ammunition to attack these from a transfer tax perspective.

2. Stating a business purpose and having a business purpose are two different things. These rulings all stated business purposes, but as we will discuss in a second, very few had business purposes.

For example, is there a business purposes in a 90 year old widower transferring \$1 million of marketable assets into a family partnership in which he gives up control? We may argue that the business purpose is centralized management, but that individual can have management of marketable assets by an investment advisor without giving up control, so there is no business purpose in this instance.

Is there a business purpose for an individual to contribute 99% of equity into a partnership and give up control, whatever their age? No, not really.

Is there a business purpose for four adult family members to pool their marketable assets to invest in one centralized fashion? There may be.

Is there a business purpose for husband and wife, both medical doctors, to form a partnership for creditor protection purposes? There may be.

So each situation must be viewed on its own, and a legitimate business purpose developed. Even if we don't believe in a business purpose test as applied to transfer tax principles, these rulings indicate that we better have one or we are going to have a pretty rough fight on audit.

Now let's look at the facts in these four rulings. . . . because they are pretty egregious facts. The IRS says these are legitimate cases, but these facts are so bad that it's difficult for me to believe these are true cases.

1. PLR 9719006 - Two days before the decedent's death a family limited partnership was formed. At the time the decedent was terminally ill. If this isn't bad enough, at the time the partnership was formed, decedent had been removed from life support.

2. PLR 9723009 - The decedent, age 90, formed the partnership and died 2 months later. I don't know about you, but if I reach age 90, my focus is going to be on eating meals and philosophizing about the meaning of life, not forming partnerships. Well, in actuality, the decedent didn't form the partnership. The son signed the partnership pursuant to a power of attorney given to him by the decedent.

3. PLR 9725002 - The decedent was incapacitated but, that did not prevent the decedent's agent pursuant to a power of attorney from entering into the partnership. The decedent died within 2 months of forming the family partnership.

4. And perhaps the worst of all is PLR 9730004 - In that ruling the decedent was diagnosed with terminal cancer but still implemented a partnership for "long-term investment purposes" and died within 2 months of the formation. What was worse here is that his son, who was an attorney, formed the partnership as the decedent's "agent." The IRS had a good time with this because they cited the son, the attorney that formed the partnership, as the author of "An article on the use of Family Limited Partnerships as Estate Planning Vehicles." The decedent's six purposes for forming the partnership coincided, the IRS noted, exactly with the six non tax business reasons given in the article for creating family limited partnerships.

These facts are funny and really cause you to wonder if they are true. But we can't be forming family partnerships with these kinds of facts. On the other hand, there are quite a variety of non tax reasons which are extremely important in the family partnership area. One which I haven't cited, that I hope is not written about, is the avoidance of Sections 2036(a) and 2038. In the partnership context, this is extremely attractive to my clients and it's a huge non-tax reason for forming partnerships versus making gifts to trusts.

So act with care and I think you can avoid the "business purpose" problems with regard to the family limited partnership.

