Tax Ct: FLP Declared Invalid
All FLP assets found to be included in decedent's estate

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The United States Tax Court, in Estate of Lockett v. Commissioner, (April 25, 2012) recently found that all of the assets of an initially valid Family Limited Partnership ("FLP") were includable in the gross estate of the decedent, after finding that the FLP participants had failed to maintain the FLP's existence.

The Lockett family executed an FLP operating agreement for an Arizona limited liability limited partnership, which named Mrs. Lockett's two sons as general partners, and herself, Trust A (a trust in which she had a right to withdraw principal and a general power of appointment), and her two sons as limited partners. Thereafter, only Mrs. Lockett and Trust A actually contributed assets to the FLP. The record indicates Mrs. Lockett's frail health and an effort to engage in tax planning, but mainly disinterested and disjointed actions on the part of her heirs and advisors. Her sons' contributions as general and limited partners were never determined, and after its creation they had no actual involvement with the FLP or its activities, nor did they transfer any property to the FLP. Prior to her death, Mrs. Lockett terminated Trust A (which had been made a limited partner of the FLP) and appointed the assets to herself. The partnership agreement provides that the partnership would dissolve upon all of the interests owned by a single partner.

Following her death, the IRS issued a Notice of Deficiency on grounds that the FLP was never a business operated to derive a profit, or alternately, that, as Mrs. Lockett's two sons had failed to become partners, the FLP dissolved upon the voluntary termination of Trust A, then the only other partner in the FLP.

The Court found that the making of investments, the sale of real estate, and the making of loans to family members was sufficient to constitute operating a business for profit. As to the issue of the failure of the sons to become partners, the estate argued that under Arizona law, general partners are not required to make capital contributions to acquire an interest in a partnership. The tax court dismissed this argument, noting that the FLP agreement explicitly required partners to contribute capital in exchange for their interests. Conceding that Mrs. Lockett's sons had not contributed cash or property to the FLP, the estate then argued that her sons had instead acquired a partnership interest in the FLP in exchange for performance of services, or, alternatively, by gift from Mrs. Lockett. Neither son had any direct involvement in the FLP's investment activities, and so the estate could only argue that the sons' requisite "service" to the FLP was their agreement to serve as general partners in the partnership agreement. The Court instead found only evidence that the FLP was managed by its attorneys, accountants and financial advisor, and not by the sons. The court was also unable to discern any intent by Mrs. Lockett to confer partnership interests to her sons by gift.

Amendments to the FLP appeared to support Mrs. Lockett owning 100% of the FLP, and no interest owned by the sons. Neither the U.S. 1065 for the FLP, the Lockett sons' U.S. 1040's, nor Mrs. Lockett's own individual returns supported any ownership by the sons, whether by gift or otherwise, until after her death.

The Court also examined whether several transfers made by the FLP to family members were loans, as claimed, or gifts, citing the general rule that transfers to family members are presumptively gifts absent a showing that the party making the transfer had expectations of repayment and intended to enforce the debt. The Court was persuaded where it found loan treatment of the transfers by the FLP's accountant, who had prepared notes (both signed and unsigned) and amortization schedules, booked the transfers as loans, and reported them as such, coupled with demands for repayment.

As the FLP dissolved when no association of two or more persons existed, the decedent held 100% of legal and beneficial interest in the assets of the FLP at death. This case is perhaps one of many case studies in how not to set up and operate a FLP.