

# CURRENT THINKING ON FAMILY LIMITED PARTNERSHIPS

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## ***I. REASONS FOR YOU TO RECOMMEND FAMILY PARTNERSHIPS AND LLCs TO CLIENTS***

### ***A. Non-tax reasons take precedence***

1. Clearly the tax benefits of FLPs and FLLCs (hereinafter referred generically as FLPs) have been responsible for the proliferation of FLPs.
2. However, the non-tax aspects of FLPs are the greatest reasons to tell a client to implement a FLP. Clients continually raise issues with their estate planners which include the need for family unity, professional assistance for family members in managing family wealth, protection of successors from creditors, divorce and predatory litigation, ease of transfer of assets including avoidance of transfer taxes on the transfer of assets which may be owned by a FLP, restricting the transfer of family assets outside the family and power of attorney alternatives including protecting family members with special needs. The FLP can help solve many if not all of these issues.
3. Non-tax reasons should be fully documented and kept in the file. Assume that attorney-client and CPA-client privilege will not be sustained and that IRS will see all of your notes, letters and memos. Assume these facts will be important to a court if it comes to that. These cases are very fact intensive.
4. If there is family discord and particularly if family members hire their own lawyers to represent them, this will be a good fact. See *Estate of Stone v. Commissioner*, 86 TCM 551 (2003).

- B. Tax reasons exist as well. Don't be ashamed of putting that forward as a reason for doing this. It should not be the sole or primary reason.
  - 1. Weigh the benefit of the potential for discounts on transfer during lifetime as well as discounts on what is held at death against the loss of basis step up under IRC Sec. 1014.
  - 2. Where clients are husband and wife using traditional zero estate tax planning on the first death, the death of the first spouse may put you in the position of taking a discount and lower the basis of the asset without an attendant estate tax benefit.

## ***II. TYPE OF ENTITY TO SELECT***

- A. The two choices for family entities of this type are Family Limited Partnerships (FLPs) and Family Limited Liability Companies (FLLCs). Every state now has both types of organizations available to clients.
- B. Differences between the two include the following:
  - 1. The definition of a FLP under the laws of most if not all of the states and under IRS regulations require that the entity be formed with a business purpose. LLCs have no such requirement. While IRS has been able to seemingly impose a business purpose requirement in some cases, it has not been universally accepted. The business purpose requirement is troubling from an academic as well as technical standpoint. In addition, IRS has sanctioned the use of partnerships solely to hold life insurance in private letter rulings. In practice, while IRS likes to see a business purpose in FLP transactions to sustain discounts, there has not been the assertion of any difference between these types of entities by IRS as it relates to business purpose doctrine, although they certainly threatened to do so early on.
  - 2. An FLP must have at least two owners. An LLC may have only one owner. Single owner entities have been used by planners to assert discounts in certain situations where the sole owner died owning not the underlying assets, but only the interest in the LLC.

3. The FLP must have a general partner that is personally liable to the creditors of the entity. The way to fix this issue is to have either a corporate or LLC general partner. Prior to the check the box regulations, this general partner had to meet certain minimum net worth requirements and the entity had to have a preponderance of non-corporate attributes in order to be taxed as a partnership. In 1997, the check the box regulations changed all of that and now it is accepted that a shell corporate or LLC general partner will work and limit the personal liability of the owners. In addition, using an entity to be the general partner will prevent the interruption of activity if a general partner dies. An LLC need not have any owner that is personally liable to the creditors of the entity, even the person(s) responsible for day to day operations.
4. Most states allow a creditor of a FLP to foreclose on the units of the entity and receive value to satisfy a judgment creditor. The operating agreement may make the creditor an assignee owner or require a buyout but the remedy for a judgment creditor is typically not limited to a charging order, as may be the case for an LLC. In Delaware, the sole remedy to a judgment creditor of a member of a LLC is to obtain a charging order (essentially an order of court allowing the creditor to obtain payment from distributions made from the entity to the owner, if and when such distribution is made). Nevada, Oklahoma and Wyoming also have excellent statutes from a creditor protection standpoint. Thus, if asset protection is an issue, and it may be one of the non-tax reasons for formation of the entity, then a LLC formed in one of those states generally will be superior to the FLP or a LLC in another state. You need not be a resident of one of those states to avail yourself of that state's LLC statute.
5. FICA taxation of the income from the entity including payment for the use of capital and for services, is subject to a muddled set of rules. Statutorily, a limited partner under IRC Sec. 1402 is exempt from FICA taxation. A limited partner is by definition someone not involved in management and typically not active in the business. Anecdotally, IRS has attacked contrived plans where a service entity employed limited partners and attempted to disguise compensatory income as distributions to a limited partner, but I know of no reported cases on the subject. LLCs are subject to proposed regulations from 1998 that

were put on moratorium. The moratorium is over but they are still not being utilized. They essentially require any owner that is active for 500 hours or otherwise meets certain requirements that look like active participation or participate in management, to be treated as if they are general partners for FICA purposes. Many practitioners take the view that LLC owners are like limited partners. Some practitioners also use tiered entities to try to make the area less clear and to bolster the anti-FICA argument.

- C. From the standpoint of obtaining discounts on either the transfer of units to others or on the ownership of such units at death, in the states that I have utilized, I see no difference on audit or otherwise.

### ***III. STATE OF ORGANIZATION***

- A. For asset protection value, see Item II above dealing with Delaware, Nevada, Wyoming and Oklahoma LLC statute.
- B. For non-tax aspects of the entity organization, it is generally thought that using the statute of a state other than the state of residence will be respected by the courts of any state in which an owner is sued and in which the entity is sued. But so far as I know, this has not been tested. It is possible that the laws of the state of residence will be applied regardless of what state's statute was utilized to form the entity. In addition, some judges make new law and so no guarantees are available to clients on this front, we do the best we can.
- C. From the standpoint of obtaining discounts, the general concern about state law centers around the restrictions in the operating agreements as they compare to state law. For example, if the operating agreement prevents a limited partner from withdrawing from the entity without consent of other partners, and if state law allows a limited partner to withdraw without consent, then IRC Sec. 2704 (b) would apply to allow the IRS to disregard the restriction in valuing the units. In Ohio, ORC Sec. 1782.33 after 1994 provides that a limited partner may not withdraw unless the operating agreement allows it. Prior to 1994, the statute allowed a limited partner to withdraw and receive fair value for his interest within 180 days after giving notice of withdrawal unless the agreement provided otherwise. When it became clear that IRS would challenge this restriction under IRC Sec. 2704, Ohio changed its law. Typical restrictions on limited partners and LLC members include the inability to transfer the units, the lack of

ability to vote on most if not all actions taken by the entity and the inability of any one member to cause the liquidation of the entity. IRS advanced the IRC Sec. 2704 theory in *Kerr v. Commissioner*, 113 T.C. 449 (1999) aff'd, 2002-1 USTC Para 60,440 (5<sup>th</sup> Cir.2002) and in *Estate of Harper*, TCM 2002-202, and lost in both cases. The states that I commonly use, Ohio and Wyoming, as well as most others, including Virginia, Georgia and Nevada, generally provide in state law, the same restrictions commonly found in most operating agreements. Where a majority owner wishes to impose restrictions on himself to prevent him from liquidating the entity, for purposes of making a *Graegin* loan or for obtaining discounts in situations where the ownership of the entity has not been given away in any significant amount, the Delaware statute may provide the best result. As discussed below, IRS still asserts the IRC Sec. 2704 argument so there may still be states that are not as taxpayer friendly.

#### ***IV. TAX REASONS TO TRANSFER ASSETS AND THE TAX PROS AND CONS OF DOING SO IN A FAMILY PARTNERSHIP OR LLC***

- A. Apart from the non-tax reasons for forming FLPs and FLLCs, there are income and transfer tax benefits and pitfalls.
- B. Transfer tax benefits include the obvious, the potential to reduce value of the estate of a decedent by making lifetime gifts of limited units at a discount and to discount the value of the interests owned by a decedent on death. IRS calls this “disappearing value.” Practitioners call this fair market value. The range of discounts depends on many factors. Operating businesses are generally seen as providing the vehicle for larger discounts than businesses seen by IRS as merely being a “wrapper” of an entity around a portfolio of stocks and bonds. Some appraisers are comfortable discounting entities made up purely of cash. Others are not. Discounts provided by appraisers can range greatly with the average often falling in the 30-45% range.
- C. Discounts greater than 50% can run afoul of valuation penalties under IRC Sec. 6662(g). The penalty is 20% of the understatement of tax and can be increased to 40% where the understatement is the result of a gross valuation misstatement (IRC Sec. 6662(h). Where an appraiser aids and abets the understatement of tax, penalties under IRC Sec. 6701 may be imposed (only \$1,000) but disqualification of the appraiser to practice before the IRS under Circular 230 is also likely.

- D. The whipsaw of lower basis on the first death with no attendant transfer tax benefit is possible when planning for a married couple. See Section I (b) (1) above.
- E. Similarly, many individuals own assets, particularly real estate, in a FLP in order to be able to transfer ownership, via intra-family sales or by gift, without incurring a transfer tax.
- F. From an income tax standpoint, there are many benefits and pitfalls to watch out for. They include:
  - 1. On formation, if multiple family members contribute assets or services to the entity, and if the assets are made up 80% of cash and marketable securities (expansively defined), and if any contributor's assets consist of 25% or more in one company or 50% or more in 5 or fewer companies, then there will be diversification and the rules of IRC Sec. 721(b) will cause taxation of the gains (without offset for the losses) inherent in the portfolio.
  - 2. Service partners can obtain their interest in the partnership without causing tax. Proposed Regulations under 1.83-3 and 1.83-6 no longer make a distinction between income and capital interests. Instead, the entire transaction is taxable under Section 83 but a pure income interest has no value. A capital interest will be treated similarly to a grant of stock in exchange for services. An interest in both will have aspects of both. The rules of Rev. Proc. 97-23 obsoleted. See Notice 2005-43. If done correctly, there are significant transfer tax benefits without cost available to families using FLPs with service partners. In addition, service partners can have qualified plans on the income earned.
  - 3. The rules of IRC Sec. 704(e) need to be respected in order for a transfer of an interest in a FLP to be respected for income tax. This generally requires payment of reasonable compensation to family members who work in the business and for the use of capital.
  - 4. Family members should be advised to stay in the partnership for some time. IRS will view liquidation of the partnership within the audit period of the estate of a decedent who set it up as indicative of no business reason for having the entity and no non-tax reasons for having one. In addition, a partner who received his interest by gift who

then takes out the assets within a short time may trigger the disguised sale rules of the code causing an income tax detriment on units received by gift. Distributions of cash and marketable securities in excess of basis (which may be low if received by gift), will cause an income tax. If the FLP owns both investment and inventory property (such as developed real estate), the transfer of a non-pro-rata interest in the assets in the partnership can also cause a tax event under IRC Sec. 751 as if “hot assets” were sold.

**V. CHECKLIST OF ORGANIZATIONAL DOCUMENTS, DECISIONS AND ELECTIONS.**

- A. The formation of a FLP or LLC should include the following documents:
  - 1. Filing of Articles of Organization with the State
    - (a) While a partnership may exist without the filing with the state, a limited partnership or LLC in most if not all states requires filing with the state to be recognized. Non-filing at best creates a general partnership, with generally bad results.
    - (b) Generally requires the selection of a statutory agent inside the state (there are services that do this).
    - (c) Anonymity is generally kept if desired.
    - (d) Name selection and preservation can sometimes cause issues.
  - 2. Filing a Registration to do business with the State
    - (a) If you file the Articles with a state other than the state of residence or if you plan to do business in any other state, you generally must register to do business in that state, otherwise you cannot sue in the courts of the state and in some cases, the consequences could be worse.
  - 3. Preparation of the Operating Agreement
    - (a) In many states (Ohio included), an operating agreement for an LLC is not needed. The state

statute provides the law governing the entity unless an agreement overrides. *Be careful in Ohio however where the operating agreement contravenes the statute. Where the statute does not specifically provide that the operating agreement can override the statute, the statute may override the agreement. See **Holdeman v. Epperson, Case No. 2004-CA-49, Court of Appeals for Clark County, Oh., July 22, 2005.*** Ohio statute provides a member managed LLC, which in family entities is generally not desired. In some states, such as California and New York, an operating agreement is required by state statute. FLPs generally require an agreement. Single member LLC generally don't need an operating agreement in most states but the banks may require it to lend.

- (b) The lack of an operating agreement may be fatal to obtaining discounts on units transferred.
  - (c) Decisions include the choice of fiscal year, tax matters partner in some cases, cash flow distribution decisions, whether to use a qualified income offset or deficit restoration provision to cure loss allocations, the relative rights and obligations of different classes of interest and who will manage the entity and what their title and authority will be.
4. Preparation of certificates or assignments of units evidencing ownership in the entity (see discussion at VI below).
  5. Obtain a federal identification number by filing form SS-4 or doing so on-line. Select a fiscal year. While the SS-4 filing does not bind you to a fiscal year, it is best to select the correct fiscal year with the SS-4 to avoid problems with IRS. If a non-calendar year is selected, a form 8716 must be filed to make the Section 444 election. Later, each year a form 8752 must be filed to make the deposit payment if any.
  6. Keeping regular minutes and having regular meetings
    - (a) IRS does look at whether the entity is run as a business, so regular meetings and keeping the formalities of a business entity can not hurt

- (b) There are excellent non-tax reasons for keeping a complete minute book as well.

## ***VI. ASSIGNMENT OF INTEREST VS. CERTIFICATION***

- A. An assignment of an interest in a FLP or LLC creates an assignee interest. Most operating agreements discuss the rights of an assignee and generally the assignee's rights are less than those of a full partner. Some practitioners believe that an assignee interest is worth less than a full owner and therefore believe that a transfer by assignment carries the potential for greater discounts. An assignee generally will be considered a partner for tax purposes, even if not admitted as a partner. See Rev. Rul. 77-137, 1977-1 CB 178.
- B. A certificated interest (like a stock certificate) is likely the same from a valuation standpoint as an assignee interest. I have found no authority either way on this subject. From an asset protection standpoint, a certificated interest may be better than an assignee interest.

## ***VII. WHAT TO LOOK FOR IN THE OPERATING AGREEMENTS***

- A. Operating agreements are typically drafted by attorneys.
- B. CPAs should look for the following items in an operating agreement:
  - 1. That the effective date of the operating agreement is on or before any transfers of the interests.
  - 2. That if required, a tax matters partner is selected
  - 3. The selection of a fiscal year. Use of a non-calendar year can be advantageous, with only the form 8752 filing each year as additional work.
  - 4. Whether the agreement calls for management by manager or members if it is an LLC. Generally, the family entity is manager managed but can be member managed as well. If a partnership, look at the general partner entity for this aspect.

5. Cash flow distributions should be required of the manager or general partner using a fiduciary duty to distribute excess cash flow and amounts necessary to pay taxes on the flow through of income. This is to help guard against the present interest exclusion attack under the *Hackl*, 2003-2 USTC Para. 60,465 (7<sup>th</sup> Cir. 2003) case.
6. Cash flow distributions should be required to be pro-rata, at least on an annual basis (helps protect against a IRC Sec. 2036 argument on death).
7. The agreement should contain the types of restrictions found in most business deals, including:
  - (a) restrictions on transferability but allowing transfers in the family unit, with transferees being subject to the original restrictions.
  - (b) right of first refusal in the entity or other owners on the purported sale of the units outside of the family unit
  - (c) restrictions on the ability of an owner to withdraw from the entity
  - (d) lack of voting control in the limited units
8. Look closely at the way units are valued for buyout purposes. Look at the appraisal procedure. If discounts are desired, resist efforts to provide a buyout without discounts in certain cases. Make the price the same during lifetime as at death. Consider the cost of getting multiple appraisals. Consider the use of formulas, even in family situations, that use fair market value concepts. The more it looks like a deal that others would enter into, the less IRC Sec. 2703 may apply.
9. Look closely at how units are bought out on death or otherwise so that it does not create a problem for the remaining owners.
10. In case the entity will ever own life insurance, look for a provision that prevents an insured, even one who is a manager, from exercising “incidents of ownership” over the policy owned by the entity.

11. Look at the tax appendix to be sure it is up to date.
12. Look for curative allocations in the tax provisions and generally, prevent the use of a deficit restoration provision, or else you may cause unlimited liability.
13. Be sure everyone signs the agreement and if they are signed in counterparts, that the agreement has a counterparts provision.

### **VIII. TRANSFERS OF UNITS BY GIFT OR SALE AND COMBINATIONS WITH OTHER TECHNIQUES**

- A. **Delivery by assignment or certificate of transfer** - A gift by assignment or certificate requires the donor to have the intent to make a gift, actually deliver that gift and the gift must be accepted by the donee or they must be aware of the transfer to them. The unconditional transfer must occur within the calendar year for it to be treated as having been complete in that year. This may be very important with regard to the present interest exclusion. Having the donee sign off as accepting the gift at the bottom of the assignment or deed of gift or the certificate is helpful in proving delivery.
- B. **Formula Gifts** - Since valuation is often difficult, some practitioners use “formula gifts” which self adjust when the valuation is finished. A formula gift essentially says that... “I hereby transfer enough units to equal \$11,000 in value to Mr. X and after the valuation is complete, I’ll know the number of units this represents and I will make the adjustment on the books of the partnership.” IRS believes that a formula gift is not a completed gift. If possible to make a close estimate of the gift value before it is made, it is best to gift an exact amount of units. If not possible, consider making staggered gifts. Either make small gifts during a year and then make the rest after year end when the value is known, or, make this year’s gift in early next year when the values are known and continue to make the gifts in the year after based on actual valuation. See the *McCord*, 120 TC 358 (2003) case for the court’s view on valuation by formula.
- C. **Present Interest Exclusion** – the *Hackl* case, showed us that there is a tension between obtaining discounts and obtaining a present interest exclusion for the gift of units to limited partners. The court in the 7<sup>th</sup> circuit viewed the units as being so restrictive that they did not confer a present right to the use of the property. Conceptually, this is incorrect because the transfer of units is the

transfer of personal property, namely the units, and not the underlying property. Since the limited partners have ownership of the units, how can it be said that they do not have the present right to use the property. But, admittedly, in the *Hackl* case the transferability of the units and the right to cash flow was totally lacking. If the present interest exclusion is important to the donor, then having a fiduciary duty to distribute cash flow, as in VII. B. 5 above should be sufficient to overcome *Hackl*. As a practical matter, IRS is not targeting this issue unless the number of present interests is very large.

- D. **Sale of FLP units** – As noted below in Section XII, IRS’ most potent attack is after death using the principles of IRC Sec. 2036. One of the ways to combat this attack is to sell the units for full and adequate consideration. If the units are easily valued or provide lots of cash flow, a sale of the units to a grantor trust for the benefit of family can transfer a significant amount of value to family, keep cash flowing to the donor and potentially avoid inclusion in the estate. The problem is what is full and adequate consideration. If IRS is successful in challenging the valuation, a sale for lower than the final valuation amount could ruin your attempt to use this exception to 2036. A transfer to a Grantor Retained Annuity Trust (GRAT) in exchange for an annuity is technically not a sale but should qualify for the 2036 exception if done for fair market value. If basis relative to fair market value is high, consider a straight installment sale without any gimmicks, for full and adequate consideration. The sale could be made outright to family members, thereby avoiding other 2036 issues as seen in the *LaFarge*, 73 TC 40 (1979) rev’d 82-2 USTC Para. 9622 (9<sup>th</sup> Cir. 1982), case.
- E. If a GRAT or sale to a grantor trust technique is used, avoid gift splitting in the year of the initial gift as a death of one spouse could cause inclusion in the estate even if the decedent spouse did not make the transfer.

## ***IX. GIFT TAX RETURNS-COMPLIANCE AND THE STATUTE OF LIMITATIONS***

- A. **Generally** – When a taxpayer makes a gift, other than certain charitable, marital and present interest exclusion gifts, it must be reported to IRS via form 706, due at the same time as the personal income tax return of the individual is due. Extensions of time are now available using form 8892 separate and apart from the extension for individual tax returns. Timely filing is now more

important before if opting out of the automatic allocation of GST is desired since that must be done on a timely filed return. Also previously, the filing of a gift tax return did not begin the running of the statute of limitations on valuation of the gift unless a gift tax was paid. The amendment of IRC Sec. 2504(c) for gifts made after December 31, 1996 (IRS regulation makes clear that although the effective date is August 5, 1997, all gifts made in 1997 are considered made after that date) made it so that IRS may not challenge the valuation of a gift after the three year statute of limitations found generally for all types of returns under IRC Sec. 6501. Even if IRS misses the three year statute, they can still successfully attack the discount on the death of the donor if IRC Sec. 2036 applies (see below). Therefore, it usually a good idea to file the gift tax return even if one is not required if stopping an attack on valuation is desired, and it usually is (not to mention the potential malpractice exposure since hindsight is 20/20). Even so, some practitioners advise clients not to file a gift tax return if the plan is to eventually remove the entire value of the FLP from the estate (why put IRS on notice if you don't have to).

- B. Starting the statute of limitations** - in order to start the running of the statute of limitations, a gift must be adequately disclosed in such a way that appraises the IRS of the nature of the gift and the method of determining its value. The disclosure must be included with the gift tax return filed or an amended gift tax return filed with respect to the gift. The adequate disclosure regulation regulations are found at Treas. Reg. Sec. 301.6501(c)-(1)(f)(2) and requires the following:
1. A full description of the property gifted and a description of any property received in exchange.
  2. A statement of the relationship between the donor and donee
  3. If a trust is the donee, the trust's federal identification number, who benefits and a description of the trust terms, or better yet, a complete copy of the trust should be attached to the return.
  4. A detailed description of the method of valuation or an appraisal report. In FLP situations, the regulations (Sec. 301.6501(c)-(1)(f)(2)(iv) provide a safe harbor to meet the description requirements. These include providing the following:

- (a) financial data used in valuing the transferred property including balance sheets and income statements for several years (five would be good) along with explanations for any adjustments made such as calculations of EBIDTA and modified income along with any write-ups of assets to fair market value;
  - (b) a description of any restrictions on the transferred property and how they figured into the valuation;
  - (c) a description of any discounts claimed and what they consist of and how they were determined;
  - (d) a statement regarding the fair market value of the underlying property on a non-discounted basis and the pro-rata portion of the property that was gifted. If the underlying assets are not marketable, then include a full description of how that underlying property was valued including the disclosures in subparagraph (a) above.
5. Appraisal Report Safe Harbor – IRS prefers an appraisal report instead of the disclosures in #4 above for obvious reasons. In some cases, despite the regulations, revenue officers have stated to me that the lack of an appraisal report means that the statute cannot be started. This is a perplexing statement. To meet the appraisal report safe harbor, the appraiser must meet three requirements found in Treas. Reg. Sec. 301.6501(c)-(1)(f)(3)(i):
- (a) The appraiser must hold himself out to the public as an appraiser regularly performing such appraisals;
  - (b) The appraiser must be qualified by background, experience, education and professional memberships to appraise the property involved (and should so state in the report); and
  - (c) The appraiser must not be the transferor, transferee, a family member of either or a person employed by either (and should so state in the report).

In addition, the appraisal report should include the following ten items:

- (1) A description of the appraiser's qualifications, background, experience, education, memberships etc.
- (2) the date of the transfer and the date the property was appraised.
- (3) the purpose of the appraisal
- (4) a full description of the property
- (5) a complete description of the appraisal process employed.
- (6) a description of the assumptions, hypothetical conditions and limiting conditions and restrictions on the property transferred that might affect the analysis, opinions and conclusions of the appraiser
- (7) all information used in determining the value including all financial data used in sufficient detail so that another appraiser can replicate the process.
- (8) the appraisal procedures followed and the reasoning supporting the analysis, opinions and conclusions of the appraiser.
- (9) the valuation methodology utilized, the reason for using that method and the procedure used to determine fair market value
- (10) the specific basis for the valuation.

[Many thanks to Tom Overbey, Esq. of Little Rock, AR for supplying me with the checklist from which this was taken, and paraphrased]

6. In preparing the gift tax return, it is suggested that a checklist of this sort be used for each return prepared. In addition, the preparer of the return should check the appraisal report to be sure it complies with the appraisal safe harbor.

- C. **Other Compliance Matters** – In addition to all of the above, the gift tax return should include:
1. Copies of the family partnership agreement
  2. Copies of any trusts to which transfers are made
  3. Copies of the documents that transfer the interests in the FLP
  4. Check the box on the return showing valuation discounts were taken if they were taken
  5. Include a dissertation of the transactions that took place during the year so IRS can follow what occurred
  6. Include a complete discussion of the law governing the area including a listing of the cases, ruling and other tax law sources that may affect the case.
  7. If any calculations were made to show the value of the transferred and retained interests, such as a transfer to a GRAT, a copy of the printout from Estate Planning Tools or other program doing the calculations should be included.

X. ***IRS ATTACK OF GIFT VALUATION UNDER SEC. 2703, 2704, SHAM TRANSACTION DOCTRINE, SWING VOTE, GIFT ON FORMATION AND FAMILY ATTRIBUTION THEORIES***

- A. If IRS has had its greatest successes in attacking FLPs on death under Sec. 2036, then why would it bother challenging these transfers at the time of the gift? Primarily because they have won only the most egregious cases and so they must challenge them at time of gift as well in order to be sure they give themselves the greatest chances of success.
- B. **Family attribution** – early on, IRS attacked valuation discounts by imposing a family attribution concept saying that a transfer of a minority interest to a family member was not really a minority interest if family members controlled. The leading case on this subject is *Estate of Bright*, 668 F.2d. 999 (5<sup>th</sup> Cir., 1981) where IRS first lost the case and in a series of cases thereafter (*Popstra v. US*, 680 F.2d. 1248 (9<sup>th</sup> Cir. 1982); *Estate of Andrews v. Commissioner*, 79 TC 938 (1982), the losses mounted until IRS announced the abandonment of this issue in Rev. Rul. 93-12.

Notwithstanding this, their main valuation expert as late as the year 2000, at one point was intent on reviving the issue, with no success since then that I can discern.

- C. **Sham transaction doctrine** – IRS is particularly disturbed by transfers made by power of attorney on behalf of a donor that is not able to do so on their own and also transfers made on deathbed. In similar cases, the IRS was able to successfully argue in *Estate of Murphy v. Commissioner*, TC Memo 1990-472 that a transfer 18 days before death to reduce the ownership of a decedent below 50% was a testamentary transfer and therefore was disregarded, but in a case of almost the exact same facts, *Estate of Frank*, TCM 1995-132, IRS was rebuked by the Tax Court. Similarly, in *Church v. Commissioner*, 2001 USTC Para. 60,369 (W.D. Texas, 2000), aff'd 2001-2 USTC Para. 60,145 (2001) and in the *Strangi* line of cases, the sham and form over substance doctrines were rebuked. Generally the partnership is respected if validly formed under state law and except in extreme deathbed cases, the sham transaction doctrine has had little success.
  
- D. **Swing Vote** – discounts are usually based on lack of control and lack of marketability of the units transferred and sometimes on those retained. The lack of control discount can be negated even for minority interests if the interest is large enough to have swing vote attributes. An example of swing vote is where three siblings each own 33.3% of a family entity. While each is a minority interest, each has the power to control the entity if one of the other owners sides with them. Therefore, it may have more control than would be attributed to it if it could not by itself control the entity. IRS has asserted the swing vote theory in TAM 9436005 and *Estate of Winkler* TCM 1989-231. IRS was successful in *Winkler* and so it is important to try to plan around this issue although in practice, it is rarely seen.
  
- E. **Gift on Formation** – IRS has asserted that if there are discounts on the transfer of limited interests in a FLP, there must be a gift on formation. If the donor puts \$1,000 into an entity and takes back a general partner interest worth \$10 (1%) and a limited interest worth \$990 (99%) and immediately thereafter transfers the limited interests claiming a value of \$643.50 (a 35% discount), then \$346.50 has “disappeared.” This disappearing value must be a gift (so says the IRS). But, IRS has lost this argument several times, mainly because the elements of a gift do not exist (i.e. donor, donee, transfer, acceptance) and because the book capital accounts of the owners reflect fair market value after the transfer and therefore, there is no real disappearing value. See *Church v.*

*Commissioner*, infra and *Strangi v. Commissioner*, 115 TC 35 (2000). See also the concurring opinion in *Thompson v. Commissioner*, TCM 2002-246, aff'd, 382 F 3d 367 (3<sup>rd</sup> Cir. 2004). IRS relies on *Estate of Trenchard v. Commissioner*, TCM 1995-121 to support its argument.

- F. **2703 Issues** - Chapter 14 consists of four sections that impact valuation on transfers during lifetime. If a transfer is to a member of one's family, in a transaction that has donative intent (not a sale for full and adequate consideration), then the Chapter 14 rules will apply. Section 2703 is designed to limit the technique often used which allowed family members who own the same entity to enter into a buy/sell agreement or option agreement, which restricts the transfer of ownership interest and sets a price which may be lower than fair market value. Under pre-Chapter 14 law, if the value in the agreement represented a fair value at the time it was entered into, was binding during lifetime and at death and was not a "device" to transfer wealth to a family member, then the value was respected for transfer tax purposes. Chapter 14 added a fourth requirement for agreements entered into after October 8, 1990 and those substantially modified after that date. The fourth requirement is that the agreement be one that is comparable to similar arrangements entered into by persons in arms length transactions. IRS has also stated that transferring a nominal interest to a third party and entering into such an arrangement will not be sufficient. In *Estate of Church*, infra, IRS lost that argument. The western district of Texas federal court considered the argument and ruled that Section 2703 was not intended to be applied in the partnership context. In *Strangi*, the court concluded that Section 2703 was not intended to include the underlying assets of the partnership in the value of the property transferred and as long as the entity is validly formed under state law, section 2703 should not apply to the underlying assets. Another reason why IRS' argument should fail is that the family entity operating agreement is in fact similar if not exactly the same as many of the tax shelter and investment agreements entered into by investors who are not related. The restrictions on transferability and the rights of first refusal are at least as restrictive in the normal public investor deals as they are in the operating agreements of the family partnership or LLC. Save your old tax shelter partnership agreements as proof. For a contrary view, see *Estate of Smith*, (W.D., Pa., 2003)..
- G. **2704 Lapsing Restrictions issues** – Section 2704 has two provisions related to the valuation of interests transferred in family controlled entities among family members. The first part

(subsection a) will treat the transfer of a voting right or liquidation right by one family member to another under the terms of the agreements related to a corporation or partnership as a gift. Therefore, you cannot depress the value of an interest in a FLP by placing a temporary restriction on the ability to vote or liquidate an entity which lapses later, for gift valuation purposes. The restriction will be ignored. This overrules the case of *Estate of Daniel Harrison*, TCM 1987-008. This applies to transfers and agreements substantially modified after October 8, 1990. The second part (subsection b) will disregard any restriction on the right to liquidate an entity if the entity is controlled by the transferor and his family before the transfer, is more restrictive than state law provisions and either will lapse after the transfer or may be removed by the transferor and his family acting alone or together. Most state laws provide now that restrictions on liquidation are equivalent to those provided in most operating agreements. Thus the 2704(b) issue should be moot. IRS lost this argument in *Kerr v. Commissioner*, 113 TC 449(1999), aff'd 2002-1 USTC para. 60,440 (5<sup>th</sup> Cir. 2002) and in *Estate of Harper*, TCM 2002-202. In *Knight v. Commissioner*, 115 TC 506 (2000), IRS argued that the operating agreement stated a term at which point the entity would end (50 years) and that this was an applicable restriction that would lapse, requiring disregard of the restriction in the agreement. The court rejected that argument as well. IRS continues to press these arguments and as a defensive measure, it may be best in the operating agreement to provide that the entity may only be liquidated on a unanimous vote of all owners (whether voting members or not) and that the entity will exist in perpetuity unless unanimously agreed. But not having these provisions is nothing to worry about at this time.

## ***XI. OPERATION AND MANAGEMENT OF THE ENTITY***

- A. The best way to lose the tax benefits that may be available from using a family partnership or LLC is to set one up and then either not follow through or disregard the entity. It is not sufficient to merely set one up. It must be run and managed correctly. There also should be coordination among the professionals. This can be costly but so is the consequence of not getting the desired result. Here are examples of what not to do.
  - 1. *Estate of Schauerhemer v. Commissioner*, TCM 1997-242. Taxpayer violated the partnership agreement terms. Revenues deposited to the personal bank account of the donor. Partnership revenues used to pay for personal

expenses of the donor. It also didn't help that taxpayer formed the entity shortly after being diagnosed with cancer.

2. *Estate of Reichert*, 114 TC 144 (2000). Taxpayer transferred all of his assets to the partnership except personal effects, an auto and a small amount of cash. He was the only one who signed partnership checks, continued to live in his residence which was owned by the partnership and did not pay rent. It also did not help that taxpayer formed the entity shortly after being diagnosed with cancer, same as Schauerhemer.
  3. *Thompson v. Commissioner*, TCM 2002-246, aff'd, 382 F 3d 367 (3<sup>rd</sup> Cir. 2004). Taxpayer transferred almost all of his assets to the partnership. Distributions from the entity were disproportionate to ownership interest (in violation of the agreement) and based on personal needs. Distributions from the partnership closely tracked gifts to kids in two of the tax years.
  4. *Estate of Lea K. Hillgren*, TCM 2004-46. Taxpayer failed to re-title the assets into the name of the partnership and otherwise failed to respect any of the partnership formalities. Many accounting irregularities and post-mortem problems as well indicated that there really was no partnership.
  5. Other similar cases include *Kimbell v. US*, 2003-1 USTC Para 60,455 (ND Texas 2002) reversed later on other grounds, *Estate of Harper v. Commissioner*, TCM 2002-121, *Estate of Strangi v. Commissioner*, TCM 2003-145 and *Estate of Ida Abraham*, TCM 2004-39.
- B. IRS asserts that a business purpose must exist for the partnership to be respected. They do not respect that which is merely a "wrapper" and so they want you to demonstrate that there is a reason for the use of the partnership form and that there is a real business being operated. They will ask what duties and actions are being taken that were necessary to form the entity and that are different from what was taking place before the entity was formed. Documentation of regular meetings and discussions including sharing financial information and decision making is helpful but generally is defensive only. IRS will make a lot of the lack of these things but will give little credit for having them in place. Still, having them can be persuasive if you ever go into court or even to higher administrative levels within the service.

- C. IRS is hostile to FLPs made up of investment assets only including cash, marketable securities and net lease real estate. This does not mean they are correct. The business purpose and formal operating entity concepts are not universally accepted and IRS has lost some cases that in their eyes can be seen as egregious (*Kimbell* for example). In addition, placing personal use assets in a FLP is dangerous from a tax standpoint not to mention the loss of tax benefits on the sale of a principal residence.
  - 1. But placing operating assets and investment assets into the same entity has its income tax pitfalls as well. See the discussion above.
  
- D. Follow the operating agreement explicitly. If there are deviations, amend the agreement to comply with what is being done. Do not make non-pro rata distributions. Do not commingle personal and business assets. Hire an accountant to do the books and present financial statements to the owners. Give more than a nominal interest to others, and actively manage the assets. Pay family members who perform services for the entity, a fair amount of compensation.

## ***XII. IRS AUDIT AFTER DEATH – SEC. 2036***

- A. The crux of IRS attack in recent years is that the taxpayer retained actual or implied control over the assets inside the FLP which causes all of the assets in the FLP, not just the percentage owned by the decedent at death, to be included in the gross estate at the fair market value at date of death. This negates the discounts previously taken, negates the transfers made during lifetime so the opportunity to transfer appreciation out of the estate is lost but on the flip side, if the assets have gone up in value, the basis of the assets will step up to date of death value, giving the taxpayer a benefit in part to offset the detriment of losing the argument.
  
- B. The benefits of this approach to IRS include:
  - 1. If the gift tax return for the transfer is outside the statute of limitations, the IRS gets another stab at it on death, giving them a reprieve from auditing every gift tax return.
  
  - 2. Sloppy taxpayers have routinely lost cases, giving the IRS a potent weapon.

- C. But the issue is complex and very fact intensive. And taxpayer counterarguments are significant. The case decisions are inconsistent and make creating hard and fast rules difficult.
- D. IRC Sec. 2036 will cause inclusion of transferred assets in the estate of a decedent if the transferor retains a life interest in the property transferred. The elements of the section, all of which must be present, are:
1. A transfer by the decedent
  2. of an interest in property
  3. made for less than full and adequate consideration
  4. coupled with the retention by the transferor of the right to income from the property or the possession or enjoyment of the property or the right (either alone or in conjunction with others) to designate who may enjoy the property or income therefrom
  5. For the life of the transferor or for any period that is not ascertainable without reference to the death of the transferor or for any period that does not in fact end before the death of the transferor.
- E. In addition, the relinquishment of an interest that would have been included in the estate of the transferor within three years of death of the transferor, will cause inclusion of the property in the transferor's estate under IRC Sec. 2035.
- F. Where the taxpayers do not observe formalities or where personal use assets are transferred to the entity which are still used personally by the transferor, it is a rather easy matter to assert an implied agreement to retain a life interest in the property. The cases in Section XI above are indicative. Other recent cases of this type include *Estate of Korby v. Commissioner*, TCM 2005-102; *Estate of Bigelow v. Commissioner*, TCM 2005-65. All of these cases have bad facts, many discussed the bona fide sale exception and distinguished these cases from those where a bona fide sale may exist.
- G. Where the formalities are respected, taxpayers have fared better. Here are IRS and Taxpayer arguments and potential counterarguments:

1. IRS: Retention of the right to vote is the retention of the right to control the use and enjoyment of the underlying property. Taxpayer: Several arguments can be made. The *Byrum* case was not overruled by the enactment of IRC Sec. 2036(b) and so this argument falls. In addition, majority owners have a fiduciary duty to minority owners that constrains them from acting in their own best interests and state law prevents the majority owner from taking the entity assets or use them personally to the detriment of the minority owners. IRS might counter that *Byrum* involved a trustee with an independent fiduciary duty. Cases to read on this subject include the *Strangi II* decision, *Byrum* and *Estate of Cohen v. Commissioner*, 75 TC 1015 (1982).
2. Taxpayer: the transfer of assets to the partnership in exchange for partnership interests is a transfer for full and adequate consideration because the net worth of the transferor has not diminished as a result of a transfer, as would be the case in a gift situation. A transfer for full and adequate consideration is a complete defense against a 2036 argument. IRS: there can be no transfer for full and adequate consideration if the transaction is between a person and himself (as is the case with a transfer by one person in exchange for almost all of the interests) and if there is no arm's length dealing. IRS argument is supported in *Harper*, *Thompson*, *Strangi II*. Taxpayer argument is supported by the cases above finding no gift on transfer (by inference) and *Kimbell* (the appellate court decision). Taxpayer should also argue that a transfer for full and adequate consideration is not dependent on a business purpose nor is an arm's length transaction required in the determination that the exchange was for full value. The courts have strained to get around this argument where the taxpayer has not respected the formalities.
3. Taxpayer: where there is family discord an arm's length transaction occurs and section 2036 does not apply. IRS: family discord should have no bearing on the 2036 analysis. Taxpayer argument is supported by *Stone*. This is the only case on point but many cases have negated even statutory requirements in other areas of law, such as the *Haft* case in pre-1982 family attribution case under Section 302.

***XIII. WHAT EFFECT WILL CIRCULAR 230 HAVE ON OUR ADVICE IN THIS AREA***

- A. Circular 230 governs the practice by CPAs, attorneys, enrolled agents, certified appraisers, enrolled actuaries and certain others before the IRS. Violations of the rules are punishable by public censure, being barred from practice before the IRS, penalty and fines.
- B. In an attempt to stop the proliferation of tax shelters and the reliance by taxpayers on questionable opinions of tax practitioners for penalty abatement, IRS amended or enacted sections 10.33, 10.34, 10.35, 10.36, 10.37 and 10.52 of Circular 230. All of these sections provide new and complex rules that must be complied with for written advice given to clients on tax issues. Written advice includes letters, emails, post it notes, writings on cocktail napkins and the like, as well as formal tax opinion letters.
- C. The new rules create four categories of transactions:
  - 1. Those involving Listed Transactions and Reportable Transactions
  - 2. Those where the Principal Purpose is Tax Avoidance (PPTs)
  - 3. Those where a Substantial Purpose is Tax Avoidance (SPTs)
  - 4. All others
- D. At present, there are no estate planning techniques in the truest sense that are Listed or Reportable Transactions. FLP transactions are not listed or reportable.
- E. It is unclear whether estate planning advice will be classified as PPTs or SPTs but it will be hard to say that estate planning advice does not have as a substantial purpose, the reduction of tax. That is the nature of it. It is unclear whether the advice will be seen in the context of the overall planning including how assets are to be transferred on death or if each separate aspect of estate planning will be viewed alone.
- F. If the advice is seen as a PPT, then the covered opinion rules found in Sec. 10.35 must be followed and no written advice that is not overly formal and analytical will meet the rules. In addition, if the

advice is on a subject that is innovative where there is no authority, it may be hard for practitioners to give good planning advice that meets the rules. Advice on PPTs cannot be given in the affirmative on matters that are not supported by authority even with caveats or disclaimers. This type of advice may have to be given orally, which will make our clients uncomfortable.

- G. If the advice is seen as a SPT, we would be wise to put a disclaimer on every piece of written advice that states clearly that this advice is not given for penalty abatement and the client may not rely on it for abatement of penalty. In fact, such a disclosure is wise on all written communication to all clients on all matters except where the client is specifically requesting an opinion to use for penalty abatement.
- H. All firms will need to read Section 10.36 and set up “best practices” within the firm to be sure that no advice is released from the firm without it being reviewed using standard procedures designed to provide quality control. In addition, procedures should be implemented where communication with clients is clear about the purpose of the advice, its limitations and expectations. Expect more guidance in the future.
- I. This could be an advantage to practitioners in many cases. Clients should not be told that there will be no penalties on FLP transactions merely because we recommended it and they should be reminded of this fact in our advice (written or oral) to them in the future.
- J. There is a lot of uncertainty in this area as of now. IRS has asked us to trust them that routine advice on day to day transactions that are not abusive is not what they are after. Be careful.