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**ESTATE PLANNING MEMORANDUM**

**TO:** CPAs, Clients & Associates  
**FROM:** David L. Silverman, Esq.  
**DATE:** April 8, 2010  
**RE:** Anticipating Challenges to FLPs and FLLCs

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**A. Introduction**

Possessed of favorable tax attributes and tremendous flexibility, family limited partnerships (FLPs) and family limited liability companies (FLLCs) have proliferated over the past decade and have become an integral part of many estate plans. They can be used to manage a family business, to implement a plan of family succession and can even serve as extremely effective testamentary instruments. Recognized as separate legal entities, FLPs and FLLCs also accomplish formidable asset protection objectives. Their income tax attributes are winning: taxed as partnerships, they are ignored for federal and most state income tax purposes — partnership income flows through to partners or, in the case of an FLLC, to its members. C corporations, by contrast, suffer from double taxation.

While S corporations do not attract double tax and are for the most part taxed as partnerships, they are not taxed quite as favorably as are partnerships and LLCs. Moreover, they are not governed by operating or partnership agreements and accordingly are inherently not as flexible as partnerships or LLCs. Furthermore, in general only a person, certain trusts, or an estate, may own S corporation

stock. If an “ineligible” shareholder acquires S corporation stock (e.g., at the death of shareholder), the corporation will eventually, if not immediately, lose its S corporate status, and will thereupon be taxed as a C corporation. The use of S corporations in estate planning is thus not particularly desirable.

**B. Valuation Discounts and Family Entities**

FLPs and FLLCs (“family entities”) possess extremely attractive gift and estate tax attributes. For transfer tax purposes, various discounts apply to the valuation of FLP or FLLC interests, such that an asset, transformed into a partnership or membership interest when dropped into an family entity, may be worth 10 to 80 percent less than the pre-transfer fair market value of the asset. When sales of such discounted partnership interests are made to “defective” grantor trusts in exchange for a promissory note utilizing favorably modest APR interest rates, a cascade of enticing leverage opportunities may result. In general, real estate and closely held family businesses generate the highest valuation discounts; marketable securities the lowest. Of course, another estate planning objective is accomplished when interests in family entities are gratuitously assigned: future appreciation of the assets, as reflected by the value of the family entity interests, will also be removed from the transferor’s gross estate.

Although at first blush it might appear surprising that real estate worth \$1 million could result in a transfer for gift tax purposes of only \$500,000 (or perhaps \$350,000 if a sale is subsequently made to a defective grantor trust), the economics of the transaction indeed justify the discounts, and courts have repeatedly so held. Thus, a restriction on management rights in the operating agreement produces a “lack of control” discount, and a restriction on transfer rights results in a “lack of marketability” discount. To illustrate, assume a business consisting of unimproved real

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estate in the Adirondacks worth \$1 million is transferred by parent to a family entity, in exchange for all of the partnership interests. Shortly thereafter, parent makes gratuitous transfers of partnership interests to the children. Assume further the operating agreement restricts the ability of the assignee members to manage the company, to vote, or to cause a liquidation. What would an outside buyer be willing to pay for such a membership interest? Probably very little, if anything. For this reason, a discount of at least 50 percent might apply when valuing the interest in the family entity. This translates into substantial transfer tax savings.

If the transferor has fully utilized his entire \$1 million gift tax exemption, the gift tax savings would be equal to the marginal gift tax rate, approximately 40 percent, multiplied by the difference between the asset value and the value of LLC membership interests after applying the discount. In the example, had the transferor instead fractionalized the interest by deeding undivided portions of the real estate to his children, discounts would still be available; however, since each transferee would have the right to bring a partition action to force the sale of the real estate, considerably smaller discounts for gift tax purposes would result. The IRS has kept a wary eye on family entities utilized in estate planning, but has had limited success, at best, in challenging valuation discounts where the family entities have been properly implemented and maintained. Courts have repeatedly asserted that family entities validly created under state law with attributes business persons would not ignore should not be ignored for income, gift, or estate tax purposes.

The Service has fared somewhat better in challenging the family entity discounts where (i) no professional valuation discount appraisal has been obtained at the time of the transfer or (ii) the transferor has retained direct or indirect control or enjoyment of the assets transferred into the family entity. As will be discussed below, courts have handed the IRS complete victories, wiped out any discounts claimed, and even brought the asset back into the taxpayer's estate at his death, where the taxpayer has been sloppy, has used the family entities as merely a personal "bank account," or has

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made a transparent attempt to reduce the size of his gross estate through deathbed transfers clearly having no other purpose.

**C. Recent Decisions Place a Premium on Careful Planning**

Mistakes made when forming or funding family entities can vitiate any transfer tax savings. For example, father deeds property into an LLC on June 1, and thereupon assigns LLC membership interests to his children on June 5. Articles of organization are not filed in Wilmington until June 10. Under these facts, father has made a gift of land to his children, and only relatively small discounts will be allowed for gift tax purposes. The serious mistake was transferring property to a nonexistent entity. Since the LLC was not formed until after the initial transfer into the (nonexistent) entity was made, the IRS successfully argued in *Shepherd*, 283 F.3d 1258, that father made an indirect gift to his sons of a 25 percent undivided interest in timberland rather than a gift of an interest in a partnership to which the land was transferred. The case underscores the importance of proper documentation and planning when forming family entities.

Assume the previous mistake was not made, but that after making the transfers and prior to filing a gift tax return, father declines to advance the \$5,000 in required fees for a current valuation of the real estate, and for an expert valuation discount analysis of the family entity. Instead, father reads summaries of all of the Tax Court cases of the past five years, and determines that no case with similar facts returned a discount of less than 25 percent. Accordingly, father decides to be “safe,” instructs his accountant to take a 15 percent valuation discount, and asks her to prepare a one or two page valuation discount analysis to be annexed to the gift tax return, as required. If challenged by the IRS, the discount analysis may not fare well in court unless the accountant is experienced in valuation discount analysis. It is not enough that a valuation discount be justified after the fact —

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courts have required that any valuation discount be supported by an expert's appraisal at the time the gift tax return is filed.

On the other hand, if father is prudent obtains the required recent real estate appraisal and expert valuation discount analysis, as his attorney suggests, the discounts claimed, even if on the high side, will be on more solid footing. Thus, the Tax Court in *Estate of Strangi*, 115 T.C. 478 (2000) held that a validly created business entity will not be ignored for gift or estate tax purposes where an expert appraisal is obtained. Assume in the example father invites his children to dinner, and advises them that he is transferring all of his assets to a newly formed FLP in exchange for all of the partnership interests, the vast majority of which he subsequently intends to assign gratuitously to the children. His children assure him that they will take care of him and, true to their word, after the transfers, regular distributions of cash are made from the family entity to father.

If many years later after father's death his estate is audited, the IRS might not only disallow the discounts taken, but might also attempt to bring all of the assets back into the father's estate under IRC § 2036, since it appears that not only was the separate nature of the entity ignored, but that father retained enjoyment of the assets. Even if the children had said nothing at dinner, but had tacitly understood that distributions to father were required, the IRS would argue that an implicit agreement existed. Finally, even there were no implicit agreement, and father asked for and expected nothing, if regular distributions were in fact made to father during his lifetime, the IRS might persist in challenging the bona fides of the transfer tax aspects of the family entity.

#### **D. Potential Application of Section 2036 to Family Entities**

Recently, the IRS has attempted to reign in tax savings resulting from transfers to family entities by invoking IRC § 2036 at the transferor's death. Section 2036 provides that the value of

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the gross estate includes the value of any interest in which the decedent has retained the possession, enjoyment or right to income from property, or the control over who enjoys income from the property. An exception provides that if full consideration is received for the property, Section 2036 does not apply, since in that case the transaction would constitute a sale, rather than a gift.

The likelihood of the IRS successfully invoking section 2036 to return to the decedent's estate assigned interests in family entities to which assets have been transferred was the subject of considerable discussion at the University of Miami Heckerling Institute on Estate Planning in January of this year. Section 2036 would be an especially potent tax weapon for the IRS since, if successfully invoked, the result would be not only to eliminate any valuation discounts claimed, but also to return the assets, and all appreciation on those assets, to the decedent's gross estate. Accordingly, persons contemplating transfers and transactions involving family entities must be vigilant to the potential application of this statute. A consensus emerged at Heckerling that many family entity arrangements were ultimately vulnerable under section 2036 if (i) the separate nature of the entity was not respected; or (ii) the decedent retained control or enjoyment over the transferred assets, either by agreement or by understanding, and even perhaps without any understanding; or (iii) the decedent transferred most of his property to the family entity, and was unable to cover his own living expenses without distributions from the entity.

The IRS raised the section 2036 argument with success in Estate of Harper, T.C. Memo 2002-21. There, the Tax Court held that the value of assets contributed to an FLP should be included in the decedent's estate based upon the (i) commingling of funds; (ii) delay in transferring assets; (iii) disproportionate partnership distributions; and (iv) "testamentary" characteristics of the transfers. Interestingly, the terms of the partnership agreement in Estate of Harper provided that the transfers were complete and unconditional: Harper held only a limited partnership interest; his two children held the only general partnership interests. Yet, the Tax Court nevertheless concluded that

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the “practical effect during the decedent’s life was minimal.” The case starkly illustrates the danger of the transferor retaining either control or receipt of distributions from the family entity, without regard to the existence of any prior agreement and, at the same time, illustrates the importance of respecting the separate nature of the family entity.

The important lesson of Estate of Harper is that compliance with formalities is necessary but not sufficient to withstand IRS scrutiny and perhaps Tax Court disapproval where substantially all of the partnership assets are derived from one person. It had been assumed, based upon Estate of Jones, 116 T.C. 121 (2001) and Estate of Strangi, 115 T.C. 478 (2000), that a transferor who received a proportionate interest in the family entity would have received “adequate and full consideration in money or money’s worth,” thus precluding the application of IRC § 2036. Apparently this is not the case. The Tax Court in Estate of Harper observed that Jones and Strangi were not dispositive with respect to the applicability of section 2036, because they “say nothing explicit about adequate and full consideration but do refer to enhancement, or lack thereof, of other partner’s interests.”

**E. Preventing Loss of Tax Benefits**

The benefits and tax savings offered by family entities are significant. While actions taken and formalities observed during initial planning are important, proper maintenance of the entity thereafter is equally vital. Recent cases illustrate entity characteristics which will vex the IRS and cause consternation to the courts — ultimately risking the loss of tax benefits. Existing entities should be examined and, if necessary, steps should be taken to ameliorate deficient operational aspects. A thorough examination should address the following issues:

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- ¶ Determine whether (i) accurate and complete gift tax returns have been filed for all transfers; (ii) capital accounts have been properly maintained; (iii) income tax returns have been filed; and (iv) financial statements have been prepared. The importance of accurately prepared gift tax returns, fortified by expert valuation discount analyses, cannot be overemphasized.
  
- ¶ Determine whether the separate nature of the family entity is being respected, and whether the entity is truly being operated as a business. While some errors may be seal the fate of the family entity for tax purposes if discovered on audit (e.g., the transferor receiving a distribution to take a cruise), the timely correction of other operational errors may lessen the risk that the IRS will succeed in “piercing the veil” of the entity for tax purposes. Howard Zaritsky of Rapidan, Virginia (Tax Planning for Family Wealth Transfers, WGL), counseled at the Heckerling Institute that (i) family entities should maintain minutes and hold regular meetings; and (ii) correspondence should be on company letterhead with the name of the Managing Member printed on the stationery. Mr. Zaritsky also advised attorneys to remind clients and their accountants of the importance of maintenance and periodic review of existing family entity arrangements.
  
- ¶ Be aware that operating agreements should be periodically reviewed and amended. Members should consider restricting the ability of the transferor, as Managing Member, to make distributions to himself or herself. Although it had been assumed that an agreement which held the Managing Member to a fiduciary standard in determining whether to make distributions was adequate, new cases suggest that this

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may not be sufficient it may be necessary to place real restrictions on the amount of cash available for distribution to the transferor parent.

- ¶ Be aware of the potential adverse tax consequences attendant with altering the “default” provisions in state statutes governing family entities. For example, under IRC §2704(b), operating agreements whose restrictions “effectively limit” the ability of the family entity to liquidate will be ignored for purposes of determining the value of the transferred interest if those restrictions are more stringent than under state law. Section 2704(b) could therefore result in the complete loss of valuation discounts. While the default provisions of most state statutes, including New York, attempt to eliminate this risk, one must ensure that terms of the agreement do not unintentionally override the safety net provided by the state statutes, possibly resulting in disastrous federal tax consequences. If after careful review it is determined that a tax-sensitive provision in the state default statute has been disabled, the family entity agreement should be amended to avoid the potential application of IRC § 2704(b).
  
- ¶ Determine whether multiple transferors, rather than just one parent, have made contributions to the family entity. It is generally preferable to have more than one transferor. If intended assignees of gifted interests (generally the children), are without sufficient cash to purchase initial interests, consider having them execute a secured note bearing adequate interest in exchange for a partnership interest.
  
- ¶ Be aware that family entities holding only one asset, or a “basket” of marketable securities, may generate a lower valuation discount and may also be more susceptible to IRS attack. It may be advisable to consider funding a family entity with more than

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one type of asset, especially if aggressive valuations are contemplated. (However, it should also be noted that there are liability risks associated with having multiple assets within one entity, especially multiple parcels of real estate.)

- ¶ Be aware that transferring all or nearly all of one's wealth to a family entity may risk IRS inquiry, since the result of such a transfer would be to necessitate distributions from the entity to support the transferor. Courts have expressly indicated that IRC § 2036 could apply to transfers with a retained interest, express, implied, or merely in fact. If too many assets have been transferred to the family entity, it may be possible for the transferor to purchase some of the assets back from the family entity.
  
- ¶ Ensure that distributions to parent comport with business realities rather than with the needs of the parent. Distributions should not happen to approximate the living expenses of the parent, or the amount of cash required by the parent in the years immediately preceding the formation of the family entity.

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