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TAX & TRANSACTIONS BULLETIN

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- Family goals and objectives often include: (a) keep assets within the Family; (b) protect assets from creditors; (c) reduce income and estate tax taxes; (d) resolve Family disputes quickly (avoid intraFamily litigation); and (e) avoid probate and guardianship proceedings.
- A Family Limited Partnership ("FLP") or Family Limited Liability Company ("FLLC") permits a Family to retain control over its assets and ensure the financial security of each family member.
- The FLP also may permit valuation discounts which reduce Estate and Gift Taxes.
- The Family should establish one or more credible non-tax business reasons for the formation of the Partnership.

PROPERLY SETTING UP A FAMILY LIMITED PARTNERSHIP

Many U.S. Families have accumulated significant wealth. Family goals and objectives often focus on preserving this wealth. Specifically, Family goals and objectives often include: (a) keep assets within the Family; (b) protect assets from creditors; (c) reduce income and estate tax taxes; (d) resolve Family disputes quickly (avoid intraFamily litigation); and (e) avoid probate and guardianship proceedings.

A Family Limited Partnership ("FLP") or Family Limited Liability Company ("FLLC") permits a Family to retain control over its assets and ensure the financial security of each family member. The FLP provides unified administration of real estate, marketable securities, and business assets, and ensures continuity of investment and management of Family Assets for the long term. The FLP also may permit valuation discounts which reduce Estate and Gift Taxes. Typically, the Senior Generation contributes most of the FLP's assets.

In a series of recent court cases, IRS has successfully attacked Family Limited Partnerships.[1] IRS typically argues that Code Section 2036(a) precludes a valuation discount, thus requiring Estate and Gift Tax to apply to the full undiscounted value of FLP assets.[2] IRS has lost some cases.[3] Considering the expense of litigation, however, most Families prefer to avoid any IRS challenge at all. An important Family Goal, therefore, is to set up an FLP which discourages any IRS challenge.[4]

[1]IRS has won the following cases: *Estate of Strangi*, 96 AFTR 2d 2005-5230, 417 F3d 468 (CA-5, 2005); *Estate of Bongard*, 124 TC at 126-129; *Turner v. Commissioner*, 94 AFTR 2d 2004-5764, 382 F3d 367 (CA-3, 2004); *Estate of Abraham*, 95 AFTR 2d 2005-2591, 408 F3d 26 (CA-1, 2005); *Hackl, Sr. v. Commissioner*, 92 AFTR 2d 2003-5254, 335 F3d 664 (CA-7, 2003); *Senda*, 97 AFTR 2d 2006-419, 433 F3d 1044 (CA-8, 2006).

[2]IRS uses two (2) main arguments to attack FLPs. The first argument relies on Code Section 2036(a), subjecting the full undiscounted value of FLP assets to Estate Tax. The second argument relies on Code Section 2503(b), subjecting gifts of FLP Interests to Gift Tax (see *Hackl*).

[3]IRS has lost the following cases: *Kimbell v. U.S.*, 93 AFTR 2d 2004-2400 (371 F.3d 257), (CA5), 05/20/2004; *Church*, 85 AFTR 2d 2000-804 (DC Tex., 2000), aff'd on other grounds, 88 AFTR 2d 2001-5323, 259 F3d 193, 2001-2 USTC ¶50571 (CA-5, 2001); *Estate of Stone*, TC Memo 2003-309, RIA TC Memo ¶2003-309; *Estate of Schutt*, TC Memo 2005-126, RIA TC Memo ¶2005-126.

[4]The courts generally recognize two exceptions that will allow a transfer to escape the operation of 2036 (a). Under the first exception, if the transfer is a bona fide sale for full and adequate consideration, then 2036(a) does not apply. See Treas. Reg. §§ 20.2036-1(a), 20.2043-1(1). If the transfer is not a bona fide sale for full and adequate consideration, then the transfer may still be excluded from the estate of the decedent under the second exception, if the decedent did not retain either the (1) possession, enjoyment or rights to the transferred property, or (2) the right to designate the persons who would possess or enjoy the transferred property. *Kimbell v. U.S.* infra*; Estate of Stone v. Comm'r*, infra. The FLP should be structured to fully satisfy both exceptions.

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PROPERLY SETTING UP A FAMILY LIMITED PARTNERSHIP (cont'd)

The recent case *Kimbell v. United States* provides a blueprint to properly set up a Family Limited Partnership.[5] In that estate tax case, the Fifth Circuit Court of Appeals listed various criteria used to determine whether a transfer of assets to a family-controlled limited partnership is respected, so that the family member-transferor is treated as owning discounted limited partnership interests (and not owning the undiscounted underlying assets). ***Kimbell*** **and related rulings teach that the following Steps are essential to properly set up a Family Limited Partnership:**

1. The Senior Generation should relinquish all control and management of the Partnership assets.[6]

2. The Partnership should be structured[7] as a limited liability company (LLC).[8]

3. The Partnership Interests credited to each partner are proportionate to the fair market value of the assets each partner contributed to the Partnership.

4. The assets contributed by each partner to the Partnership are properly credited to the respective capital accounts of the partners.

5. On termination or dissolution of the Partnership, the partners are entitled to distributions from the Partnership in amounts equal to their respective capital accounts.

6. Each transferor[9] retains sufficient assets outside the Partnership for his own support.

7. There is no commingling of Partnership and personal assets.

8. All Partnership filings and formalities are timely satisfied.

9. The assets contributed to the Partnership are actually assigned to the Partnership.

[5]*Kimbell v. U.S.*, 93 AFTR 2d 2004-2400 (371 F.3d 257), (CA5), 05/20/2004.

[6]The Junior Generation exclusively should control and manage the FLP assets. [*see* 2036(a)]. [Note: control may be held in an Irrevocable Generation Skipping (GST) Trust with a Junior Generation family member as Trustee. Under this arrangement any control premium should be exempt from Estate Tax and Generation Skipping Tax.]

[7]The terms "LLC", "Partnership", and "FLP" are used interchangeably in this Article, since each refers to essentially the same entity for income tax purposes. "Partnership Agreement" and "Operating Agreement" are also interchangeable, as are "Partner" and "Member".

[8]The LLC enjoys the following advantages which make it an optimal entity for an FLP: (i) the LLC shields its owners from both inside liability and outside liability; (ii) the LLC is generally classified as a partnership for Federal income tax purposes; (iii) most State statutes generally permit single member LLCs; and (iv) most State statutes generally permit LLCs with different classes of membership. [Note: The LLC should ensure that it is classified as a partnership for Federal income tax purposes. Under the check-the-box rules which classify entities for federal tax purposes, LLCs are entities that are not mandatorily classified as corporations. Accordingly, the default classification of a multimember business entity organized as an LLC is a partnership and the default classification of a single member business entity organized as an LLC is a disregarded entity. Reg § 301.7701-3(b)(1)(i); Reg § 301.7701-3(b)(1)(ii). Moreover, to achieve additional protection, the LLC may be set up as a "Preferred-Common LLC" ("Preferred LLC"). Preferred partnerships are explicitly authorized by Federal Statute (i.e. Code Section 2701). The Preferred partnership therefore rests within a legal safe harbor, and may offer less audit risk.]

[9]Especially the Senior Generation.

PROPERLY SETTING UP A FAMILY LIMITED PARTNERSHIP (cont'd)

10. At least some of the assets contributed to the Partnership require active management (e.g. an active business, operating real estate, or working interests in oil and gas properties).[10]

11. The Partnership Agreement should provide that each donee-partner who receives a gift of a Partnership Interest may immediately monetize that Interest, to ensure the gift is a present interest qualifying for the annual gift tax exclusion.[11]

12. The Partnership Agreement should provide that if a General Partner becomes "bankrupt," then such General Partner shall immediately forfeit all authority and his Interest shall be converted into an assignee Interest.[12]

13. The Partnership Agreement should provide that each Member and Manager is prohibited from participating in the exercise of any incident of ownership with respect to a policy of insurance held by the Partnership which insures that Member's or Manager's life.[13]

14. The Family should establish one or more[14] of the following credible non-tax business reasons for the formation of the Partnership that cannot be accomplished under the existing ownership structure:[15]

    a. Create legal protection from creditors, and eliminate personal liability.[16]

[10]The absence of any Partnership assets which require active management is not necessarily fatal. The core requirement is that the Family can demonstrate one or more credible non-tax business purposes for creating the Partnership. See *Estate of Schutt*, TC Memo 2005-126 (Senior Generation transferred solely publicly-traded marketable securities to the FLP in order to impose a buy-and-hold strategy on younger family members; held to be a valid nontax purpose). [Note: Schutt involved two (2) Delaware Business Trusts each classified as a partnership for Federal income tax purposes. The family intentionally established two (2) separate Delaware Business Trusts. A block of shares in solely publicly-held corporation A was transferred to Delaware Business Trust #1. A block of shares in solely publicly-held corporation B was transferred to Delaware Business Trust #2. The family employed this strategy to avoid recognition of precontribution gain upon formation under the investment company rules of Code Section 721(b).]

[11]Code Section 2503(b). See *Hackl, Sr. v. Commissioner*, 92 AFTR 2d 2003-5254, 335 F3d 664 (CA-7, 2003). Specifically, the donee-partner must have the present ability to access any substantial economic or financial benefit that might be represented by the ownership units. *Hackl* states that there are at least two strategies to create this present ability, and thus to qualify gifts of partnership interests for the annual exclusion. The first strategy is to provide the donee with the right to unilaterally withdraw from his capital account. This withdrawal right could provide the donee with a right to withdraw cash from the partnership up to the value of the annual exclusion (or twice the annual exclusion for spousal split-gifts), and would be similar to the Crummey withdrawal right already approved by IRS for gifts to Irrevocable Trusts. The second strategy is to provide the donee with the right to sell his partnership interest to 3rd parties. [Note: The Tax Court in *Hackl* prefers and endorses the first (1st) strategy. See *Christine M. Hackl*, 118 TC 279 (03/27/2002)].

[12]The assignee interest would have the economic rights of the bankrupt person, but would have no voting authority on any matter.

[13]In a situation involving an irrevocable life insurance trust where the insured is trustee, the policy proceeds are included in the insured's taxable estate. However, an insured may be a member of an LLC that owns insurance on his life without causing the policy proceeds to be included in the insured's taxable estate, provided the LLC is also the beneficiary of the policy. *Estate of Knipp v. Commissioner,* 25 T.C. 153 (1955), *acq. in result*, 1959-1 C.B. 4, *aff'd on other issues,* 244 F.2d 436 (4th Cir. 1957); Revenue Ruling 83-147; PLRs 9843024 and 200214028.

[14]The Family should establish as many as possible non-tax business reasons for the Partnership.

[15]The non-tax business reasons for the formation of the Partnership should be: (1) explicitly stated in the written Partnership Agreement and accompanying initial documents; and (2) confirmed by the objective facts.

[16]An LLC helps to protect the owner's assets from liability. Observe that there are two distinct forms of liability. First, there is the liability of the owner for the debts and obligations of the entity ("inside liability"). Second, there is the risk that the owner's equity interest in the entity will be subject to attachment by the owner's personal creditors ("outside liability"). The LLC shields its owners from both inside liability and outside liability. The LLC is therefore an optimal vehicle for achieving limited liability. The LLC, however, does not guarantee limited liability, since it is always possible that a court may permit a creditor to pierce an LLC veil.

PROPERLY SETTING UP A FAMILY LIMITED PARTNERSHIP (cont'd)

b. Keep the pool of capital together in one (1) entity in order to:

i. Ensure the assets will compound and continue beyond the Senior Generation's lifetime (rather than be subdivided by distributions to subsequent generations).

ii. Achieve centralized management which reduces administrative costs by keeping all accounting functions together.

iii. Avoid costs of recording transfers of real estate as properties are passed from generation to the next.

iv. Assist the Senior Generation to preserve the assets as separate property of their descendants, by protecting assets from the divorcing spouse of a descendant.

v. Assist the Senior Generation to impose its financial/management strategy on younger family members.

c. Create a management succession plan for the Partnership assets, in the event of death/disability of the initial manager.[17]

d. Create a dispute resolution plan providing that all disputes be resolved through mediation or arbitration to avoid intra-family litigation.[18]

In setting up the FLP, the Family must choose between two (2) types of Family Limited Partnerships. The first type is a "straight FLP." In a straight FLP each family member participates proportionately in the growth of assets. There is no explicit federal tax law endorsing or sanctioning a straight FLP. Thus, straight FLPs may be attacked by IRS.

The second type is a "preferred-common FLP" ("Preferred FLP"). The Preferred FLP freezes the value of assets held by the Senior Generation. In a Preferred FLP, Mom and Dad do not participate proportionately in the growth of assets. Thus, Mom and Dad reduce their estate tax by limiting the value of their assets. Preferred FLPs are explicitly authorized by Federal Statute.[19] The Preferred FLP therefore rests within a legal safe harbor.[20] The Preferred FLP may offer less audit risk to Mom and Dad, and may be a conservative method to reduce family taxes.

The Preferred FLP has at least two classes of equity: (1) Preferred Equity; and (2) Common Equity. The Preferred Equity is entitled to an annual cash flow payment,[21] but does not otherwise participate in the growth of underlying assets. The Common Equity is not entitled to any annual payments, but does participate in the growth of underlying assets. Mom and Dad typically desire to own Preferred Equity, since the Preferred Equity (a) pays a guaranteed annual cash stream similar to a bond, and (b) may reduce Mom and Dad's estate tax liability.

[17]The written Partnership Agreement should contain a management succession plan.
[18]The written Partnership Agreement should contain procedures for alternative dispute resolution ("ADR").
[19]Code Section 2701.
[20]Code Section 2701; IRS Regulations 25.2701 et seq.
[21]The Preferred Equity's annual cash flow payment is also referred to as the "Priority Return."
[22]Regulation 25.2701-1(a)(2); 25.2701-3.

PROPERLY SETTING UP A FAMILY LIMITED PARTNERSHIP (cont'd)

There are several key Operational Rules for Preferred FLPs. First, the Preferred Equity must have a value equal to the assets contributed for the Preferred.[22] Second, the total value of all Equity less the value of the Preferred Equity equals the value of the Common Equity.[23] Third, the value of the Common Equity may be reduced by discounts for Minority Interest and Lack of Marketability.[24] The Preferred PLP is also subject to additional Operational Rules.[25]

Example – Preferred Family Limited Liability Company ("PLLC"):
Parent and Child decide to set up an FLP. The FLP will be structured as a Preferred Family Limited Liability Company ("PLLC").[26] Child will be sole Manager of the PLLC with exclusive authority to manage its assets. Child has extensive experience in managing rental real estate. The Operating Agreement provides that Grandchild (followed by several individuals) is successor Manager. Each named successor Manager is experienced in managing rental real estate. Parent can never be Manager.

Parent contributes $1,000,000 in rental real estate to the PLLC for a Preferred Equity Interest with a $1,000,000 dissolution preference and a 7.5% net-cash-flow preference. Child contributes $1,000,000 in a diversified portfolio of marketable securities for all Nonpreferred/Common Equity Interests.[27]

The Operating Agreement and accompanying capital accounts clearly demonstrate that: (1) the Partnership Interests credited to each partner are proportionate to the fair market value of the assets each partner contributed to the Partnership; (2) the assets contributed by each partner to the Partnership are properly credited to the respective capital accounts of the partners; and (3) on termination or dissolution of the Partnership, the partners are entitled to distributions from the Partnership in amounts equal to their respective capital accounts.

Parent retains sufficient assets outside the PLLC for his own support.[28] There is no commingling of PLLC and personal assets. All PLLC filings and formalities are timely satisfied. The assets contributed to the PLLC are actually assigned to the PLLC through various recorded deeds and account transfers.

The Operating Agreement states one or more of the following credible non-tax business reasons for the formation of the Partnership which are confirmed by the objective facts:

A. Protect assets from creditors.

[23]Regulation 25.2701-3(a).
[24]Regulation 25.2701-(3)(b)(4)(ii).
[25]For instance, the discounted value of the Common Equity must be greater than or equal to 10% of the value of all Equity plus the total debt owed by the partnership to family members. Code Section 2701(a)(4); Regulation 25.2701-3(c). Also, the Preferred Partnership Agreement should specify that the Preferred Priority Return may be paid either in cash or in-kind assets.
[26]See PLR 200114004; PLR 200138028.
[27]To achieve maximum protection from creditors, the PLLC should: (1) hold the rental real estate in a subsidiary single member LLC which is a disregarded entity ("Subsidiary Single Member LLC #1); and (2) hold the diversified portfolio of marketable securities in a second subsidiary single member LLC which is a disregarded entity ("Subsidiary Single Member LLC #2). This format protects the marketable securities from liabilities/risks of the rental real estate. This type of creditor protection is known as "horizontal liability protection" or "avoiding cross collateralization." [Note: If the rental real estate itself consists of multiple properties, then additional Subsidiary Single Member LLCs may be used to own each respective property.]
[28]Child should also retain sufficient assets outside the PLLC for his own support.

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PROPERLY SETTING UP A FAMILY LIMITED PARTNERSHIP (cont'd)

B. *Keep the pool of Family capital together in one (1) entity in order to:*

1. *Ensure the assets will compound and continue beyond the Senior Generation's lifetime (rather than be subdivided by distributions to subsequent generations).*
2. *Achieve centralized management which reduces administrative costs by keeping all accounting functions together.*
3. *Avoid costs of recording transfers of real estate as properties are passed from generation to the next.*
4. *Assist the Senior Generation to preserve the assets as separate property of their descendants, by protecting assets from the divorcing spouse of a descendant.*
5. *Assist the Senior Generation to impose its financial/management strategy on younger family members.*

C. *Create a management succession plan for the assets, in the event of death/disability of Child.*

D. *Create a dispute resolution plan providing that all disputes be resolved through mediation or arbitration to avoid intra-family litigation.*

Although there is no guaranty, careful completion of all above Steps tends to discourage an IRS challenge. The Partnership may enable the Parent and Child to claim valuation discounts which reduce Estate and Gift Taxes.

Economically, if the value of the PLLC's assets doubles to $4,000,000 after one year, Parent's Preferred Interest would have a right to ultimate dissolution proceeds of $1,000,000 and to a $75,000 net-cash-flow preference. At most, then, Parent would have a right, either on a current or deferred basis, to $1,075,000 of the PLLC's $4,000,000 of assets. All other economic rights and appreciation inure to the benefit of Child. On a liquidation basis, Child would have a right to $2,925,000 of the $4,000,000 of PLLC assets, or almost three times Child's initial investment, although the present value of Child's Common Equity Interests would be much less than that (assuming that Child, acting alone, does not have the right to dissolve the PLLC).

In contrast, if the value of the PLLC assets declines by 50% to $1,000,000 during the first year, Parent, as the holder of the Preferred Equity Interests, will have a current or deferred claim to all $1,000,000 of the PLLC's assets. The $1,000,000 decline in value will be borne almost entirely by Child's Common Equity Interests, although Parent's net-cash-flow preference also will be at risk. On a liquidation basis, Child's interest is worth zero ($0.00).

Edited by William B. Fox, B.A., J.D., LL.M. Tax