

STRUCTURING AND DEFENDING FAMILY LIMITED PARTNERSHIPS

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I. WHY USE FAMILY LIMITED PARTNERSHIPS OR FAMILY LIMITED LIABILITY COMPANIES?

A. Non – tax advantages:

1. Allows continued centralized management of assets after parent dies or is incompetent.
2. Allows older generation to shift management responsibilities to younger generation.
3. Can reduce family fights as to management of assets, since management may be centralized in general partner or manager.
4. Protection of assets from claims of creditors of the partners/members.
5. Better returns for partners since investing a larger amount, rather than each partner investing separately.
6. Can train younger generations in managing and preserving family assets for future generations.
7. Limited partners have no say in the investment or operation of the entity, and no say in distributions to the partners.
8. Can limit the transferability of the partnership interest – keep out undesired owners, such as ex-spouses.
9. Can allow parent to retain control of the management of the assets (but see below for IRS problems).

10. Limited liability for debts of the entity (except for the general partner).
11. Allows gifts of interests in property without having to actually separate ownership – gift of a limited partnership interest rather than an undivided interest in the underlying asset.
12. Amendable.
13. Avoid ancillary probate proceedings on out of state real property.
14. Can provide for means of settling disputes outside of court (arbitration) and payment of attorney fees by losing party.
15. Can maintain confidentiality as to the “real” owners of the underlying assets.

B. Tax advantages:

1. Partnership interests or membership interests may be subject to discounts for lack of marketability and/or minority interest.
2. Effective means of transferring income tax burden by transferring partnership interests to younger generations.

C. Disadvantages:

1. Increased IRS scrutiny – Service views estate tax returns showing family limited partnerships or family limited liability companies (collectively referred to in this outline as “FLP”) as abusive per se.
2. Must follow formalities and FLP organizational documents.

II. IRS ATTACKS

A. Section 2036

Section 2036 deals with retained interests and provides as follows:

SECTION 2036. Transfers With Retained Life Estate

(a) General Rule

The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth) by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death - -

(1) the possession or enjoyment of, or the right to the income from, the property, or

(2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

1. Strangi cases

a. Facts: HORRIBLE!

Substantially all of Mr. Strangi's assets were transferred to the FLP when he was terminally ill. He received a 99% interest as the limited partner and 47% of the ownership of the 1% general partner.

b. Latest case – Fifth Circuit.

In the most recent ruling from the courts (Strangi [Strangi IV], 96 AFTR2d 2005-5230), the Fifth Circuit this year

ruled on the issues raised in the prior Strangi cases, to the detriment of the taxpayer.

The prior rulings held that the taxpayer's estate included the proportional value of the underlying assets of the limited partnership and general partner, rather than the interests in the entities themselves. Thus, no valuation discounts were allowed. This was based on the conclusion by the Tax Court that Mr. Strangi had retained an income interest under Section 2036(a)(1) and that he also had the right to control the dissolution of the entity, causing inclusion under Section 2036(a)(2).

The Fifth Circuit affirmed the Tax Court's prior decision, although it relied on the Section 2036(a)(1) grounds, and did not rely on Section 2036(a)(2).

2. Bona fide sale exception to Section 2036(a).

The courts have held that Section 2036(a) won't apply when the interest in the FLP has been acquired in a bona fide sale for adequate consideration. The Fifth Circuit concluded that when assets are transferred into a partnership in exchange for a proportional interest in the FLP, the adequate consideration requirement will be met, as long as the formalities of the FLP are respected.

“[T]he proper focus therefore on whether a transfer to a partnership is for adequate consideration is: (1) whether the interest credited to each of the partners was proportionate to the fair market value of the assets each partner contributed to the partnership, (2) whether the assets contributed by each partner to the partnership were properly credited to the respective capital accounts of the partners; and (3) whether on termination or dissolution of the partnership the partners were entitled

to distributions from the partnership in amounts equal to their respective capital accounts.”

If satisfied, four objective facts were identified by the court to determine if the contribution was bona fide:

- a. Were sufficient assets retained for the support of the transferor and was there no commingling of assets?
- b. Were the assets actually contributed and ownership transferred to the FLP?
- c. Did the assets transferred to the FLP include assets that require active management?
- d. Were there credible nontax reasons for the formation of the FLP?

The Fifth Circuit relied on the determination of the Tax Court judge on the issue of nontax business purpose. As an appellate court, the court can only reverse the Tax Court’s decision if it is clearly erroneous. Because this issue was tried extensively before the Tax Court, the Fifth Circuit held that the Tax Court’s rejection of rationales for business purpose was not clearly erroneous, and, therefore, upheld the Tax Court decisions. In other tax cases, the rulings as to business purpose may be different. However, we can expect the IRS to aggressively raise the issue of business purpose in future cases and audits.

3. Bongard case.

In Bongard v Commissions, 124 T.C. 95 (2005), the full Tax Court again reviewed the bona fide sale exception to the application of Section 2036. Mr. Bongard (1) transferred stock

of his company to a holding company and then (2) transferred some of the holding company stock to an FLP. The Court found a business purpose in the creation of the holding company (to position the company for a stock offering) but not for the transfer to the FLP.

The Court adopted a two-pronged test for the bona fide sale exception to apply:

“[T]he bona fide sale for adequate and full consideration exception is met where the record establishes the existence of a legitimate and significant nontax reason for creating the family limited partnership, and the transferors received partnership interests proportionate to the value of the property transferred.”

The Court further adopted the position that intra family transactions are subject to a higher level of scrutiny. The Bongard FLP never engaged in any meaningful business activity. The Court found that Mr. Bongard had merely changed the form in which he held his beneficial interest in the stock. The Court found that the full value of the stock owned by the FLP was included in Mr. Bongard's estate without any valuation discount.

4. Note that Section 2036 is an estate inclusion provision, and does not apply to gifts or a lifetime sale. Therefore, the taxpayer needs to gift or sell as much of the FLP interests as possible during his/her lifetime.
5. Need to avoid an implied agreement to allow the decedent to retain an interest or rights with respect to the property or income therefrom.

B. Present interests.

1. Only gifts of present interests qualify for the annual exclusion for gift tax purposes under Section 2503(b). This Section allows the donor to exclude from taxable gifts the first \$11,000 of gifts **other than gifts of future interests in property** made to any person by the donor during the calendar year. [It is anticipated that this amount will increase to \$12,000 for gifts made in 2006.] In order to qualify as a present interest gift, the donee must be immediately able to use or enjoy the property transferred, or the income from the property transferred.
2. In Hackl v. Commissioner, 118 T.C. 14 (2002), affirmed 335 F.3d 664 (7th Cir. 2003), the Tax Court ruled that gifts of membership interests in an LLC did not qualify for the annual exclusion, based on the restrictive language in the LLC Operating Agreement. Basically, the members could not withdraw their capital contribution, demand a distribution, or transfer their membership interest without the consent of the Manager. The Tax Court ruled that the LLC must prove that the LLC would receive income, that some portion of the income would flow steadily to the donee, and that such portion would be ascertainable. Under the facts in Hackl, the Tax Court ruled that these elements did not exist.
3. A properly drafted Operating Agreement can avoid the Hackl result – provide for a transfer by the member subject to a right of first refusal.

III. DISCOUNTS

- A. In addition to the many non-tax reasons for forming an FLP, many of our clients form an FLP for the valuation discounts available for gift tax

purposes or estate tax purposes. While many cases have dealt with the amount of the discounts, it is clear that the courts will allow valuation discounts, PROVIDED THAT THE COURT RECEIVES RELIABLE AND COMPETENT VALUATION INFORMATION.

B. Therefore, in determining discounts, it is necessary to examine the following elements:

- Operating Agreement
- Size of the interest
- Performance characteristics
- Underlying assets

C. To properly determine the amount of the discount, numerous third party sources must be reviewed, including:

- Public secondary markets for FLP interests
- Restricted stock studies
- IPO studies
- Decided court cases
- Closed end investment companies
- Real estate investment trusts

D. It is best to obtain the valuation study at the time of the gift, rather than when the gift or estate is being audited by the IRS.

E. The recent court cases have shown the following range of discounts allowed by the courts (Hoffman, "Understanding the Fundamentals of

Discounting Using Family Limited Partnerships and Family Limited Liability Companies”, Estate Planning, June-July 2004, 35, 37)

Asset Group	Average Combined Discount
Income Producing Real Estate	25%-35%
Non-Income Producing Real Estate	35%-45%
Publicly Traded Equity Securities	20%-30%
Publicly Traded Fixed-Income Investments	15%-25%
Collectible Paintings/Photography/Auto	40%-50%
Operating Business	45%-65%

IV. STRATEGIES FOR SUBSTANTIATING THE FLP

A. Don't use "family" in the name of the entity –

Not the "Kaplow Family LLC," but either "28400 Associates, LLC" or "Kaplow Mining & Mercantile, LLC."

B. Emphasize non tax benefits in correspondence and in the Operating Agreement.

See list above in Section 1

C. Substantiate the business purpose (non-tax) of the FLP

1. Recite the business purposes in the Operating Agreement
2. Tie into some actual business event compelling the creation of the FLP – not just because the client (or advisor) attended a seminar touting FLP's.

D. Transfer operating assets rather than passive investment assets.

E. Don't have the transferor as the general partner or manager. Try to bring in 3rd party as a manager or co-manager.

- F. Educate the client as to the formalities in operating the FLP – and make sure client follows them!
- G. Have meetings of the members/limited partners (even if they have no vote) and provide periodic financial reports to them. Record minutes of the meetings.
- H. Do not limit the fiduciary duties of the general partners/managers.
- I. The Partnership Agreement should require distributions to be made pro rata in accordance with (i) partner's capital accounts, and (ii) economic realities – and make them accordingly.
- J. Don't create the FLP on the transferor's death bed.
- K. Don't transfer all of the transferor's assets to the FLP – Transferor needs to retain sufficient liquid assets to meet his/her support needs and future estate taxes.
- L. Ensure that fair market value is paid for the use or purchase of any FLP assets.
- M. Do not commingle FLP assets and personal assets. Do not pay the transferor's personal expenses from the FLP. Don't transfer personal use assets to the FLP.
- N. If possible, have the other members of the FLP make a significant contribution of property to the FLP.
- O. Have the Operating Agreement negotiated by all the members or their attorneys.
- P. Title all FLP assets in the name of the FLP.
- Q. Establish a separate bank account for the FLP and make all contributions to, and distributions from, the account.

- R. Avoid all indicia of an implied agreement that the transferor gets all the income.
- S. Make all required state and federal filings – tax returns, LLC updates, etc.
- T. Maintain a proper set of books and records for the FLP.
- U. Have a non-family member (or charity) as a member of the FLP.
- V. Don't unwind the FLP shortly after the death of the transferor.
- W. Obtain timely appraisals.
- X. Don't make gifts of FLP interests shortly after assets are contributed to the FLP.

V. SUMMARY

In summary, run the FLP as a business entity with a legitimate business purpose – not as another bank account of the transferor. Also, make sure that the client understands that there are risks associated with ownership of FLP interests.