MASTERING ESTATE PLANNING ISSUES

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ADVANCED LLC ISSUES IN LOUISIANA

MASTERING ESTATE PLANNING ISSUES[1]

A. Estate Planning Strategies Using LLCs

(a) Estate Planning for Insolvency; Rights of Judgment Creditor

Under the Louisiana default rules, a judgment creditor may apply to a court for an order charging a membership interest of a member with payment of the unsatisfied amount of a judgment with interest. §1331. The statute provides that, to the extent so charged, the judgment creditor shall have only the rights of an assignee of the membership interest. An assignee is entitled to receive such distributions, to share in such profits and losses, and to receive such allocation of income, gain, loss, deduction, credit or similar item to which the assignor was entitled to the extent assigned. §1330A. The statute does not indicate whether the judgment creditor can also proceed to cause

[1] This paper was presented at a seminar sponsored by the National Business Institute in the summer of 2005 entitled "Advanced LLC Issues."

a sheriff's sale of the member's interest but, assuming that the creditor can do so and the default rules on transferability apply, presumably, all that could be sold would be the rights of an assignee unless the members approve the purchaser for admission as a member.[2] Also, note that until the assignee of an interest in a LLC becomes a member, the assignor continues to be a member. See §1332A.[3] This means that a member's interest might be seized and sold at a sheriff's sale by a seizing creditor in which case the creditor, if it purchased the interest at the sheriff's sale, might find itself paying income taxes on profits allocated to the membership interest while the debtor/member continues to vote the membership interest, including votes on decisions such as whether to make distributions. Could the members get together and decide to amend the operating agreement to create different classes of members for purposes of distributions to the prejudice of the seizing creditor? These are among the many questions which will have to be dealt with in the courts.[4]

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[2] In ***Herring v. Keasler***, 563 S.E.2d 614 (N.C.App. 2002), the court granted a charging order, but the court concluded that the North Carolina LLC act did not authorize the forced sale of the interest. The court quoted from the statute to the effect that a charging order entitles the judgment creditor to receive distributions and allocations to which the judgment debtor would be entitled, but does not dissolve the LLC or entitle the judgment creditor to become or exercise any rights of a member. The court's reasoning for finding forced sale was not permitted was that the forced sale of a membership interest to satisfy a debt would "necessarily entail the transfer of a member's ownership interest to another, thus permitting the purchaser to become a member" in violation of statutory provisions that require consent of all members to admit a person as a member.

[3] §1332A reads: Except as otherwise provided in the articles of organization or a written operating agreement: (1) An assignee of an interest in a limited liability company shall not become a member or participate in the management of the limited liability company unless the other members unanimously consent in writing. (2) Until the assignee of an interest in a limited liability company becomes a member, the assignor shall continue to be a member. (Emphasis added).

[4] Note that in a recent Bankruptcy court decision, the court held that a Chapter 7 trustee of an individual debtor who was the sole member and sole manager of an LLC succeeded to the membership interest upon the bankruptcy filing. The court held the trustee acquired the right to control and manage the LLC, which included the right to sell property owned by the LLC. ***In re Ashley Albright***, 2003 Bankr. LEXIS 291 (US KB Ct. for the

Given this statutory framework, there is the potential to use the LLC to affect discounting in the determination of fair market value which would come into play in assessing creditors' rights in several settings, including negotiations with a seizing creditor and in valuation of LLC membership interests for bankruptcy purposes. Simply by virtue of the differences in state law applicable to LLC membership interests such discounts might be greater than minority interest, liquidity and marketability discounts which would be otherwise available if the same thing were done with corporate stock. These same valuation principles and statutory aspects of LLCs carry over into the estate tax area to make LLCs a worthwhile instrument to examine for implementing estate tax planning objectives. [5]

(b) Avoidance of Ancillary Probate Proceedings

The benefits of single member LLCs disregarded for tax purposes makes the LLC an effective tool not only for limiting the liability of the owner from claims arising out of the ownership and management of real property investments, but it also provides the added advantage of avoiding the necessity of ancillary probate proceedings in those states in which the decedent owns real property which is otherwise required if the decedent owns title in his own name. The LLC membership interest is an incorporeal movable.[6] While the title to real property is regulated by the

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Dist. Of CO, 2003).

5 Caution is advised here. As the subsequent discussion of these issues reflects, the tax rules in this area are extremely complicated. For a number of years now, the IRS has been engaged in an all out attack on the transfer tax benefits of family limited partnerships and family limited liability companies. The taxpayers have won many of the early skirmishes in the courts. With each defeat, the IRS has fine tuned its arguments and theories of attack. The service IRS has seen successes in recent years in attacking the use of FLP's and FLLC's used to create discounts in valuation of family owned properties.

6 LSA-Civ. Code art. 473.

law of the situs of the property, the ownership and succession of the incorporeal movable is regulated by the law of the owner's domicile. This also may allow avoidance of state inheritance taxes in the state in which the immovable property is located. The downside of this is that the income from the immovable property may become Louisiana source income subject to Louisiana income tax where it otherwise might not be subject to state income tax if the state in which the immovable property is located does not have a state income tax. Therefore, each case must be evaluated on its individual circumstances.

(c) Transfers of Title

The process of transferring titles to immovable property is simplified greatly by transferring title once into an LLC. Future transfers during the lifetime of the owner or through the succession process can be made with minimal legal documentation requirements.[7]

(d) Limiting Younger Generation's Access to Wealth

While there may be income, gift and estate tax implications to be considered, placing assets into an LLC and gifting LLC interests can be used to facilitate a parent's desire to move property to the next generation yet limit or regulate the children's access to those assets or cash flow generated by them; a very common desire among clients in this area.[8]

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7 Facilitation of post-mortem transfers has been mentioned by at least one court in the tax litigation arena as one of the non-tax purposes for use of a family limited partnership. ***Kimbrell v. U.S.***, No. SA-97-CA-0774-IOG, 371 F.3d 257 (5th Cir. 2000).

8 While the IRS has previously recognized in Technical Advice Memorandum ("TAM") 9131006 and Private Letter Ruling ("PLR") 9415007 that retained investment and distribution authority of the parent/general partner in connection with donations of limited partnership interests did not cause continued inclusion of the interest in the donor's estate, recently the IRS has questioned whether such retained controls might cause inclusion under IRC §2036.

(e) Aggregation of Investments for Management and Continuity

The aggregation of family investments into a single family LLC provides for centralized control, management by family deliberative process and reduced accounting and management expenses. Institutionalization of family communications regarding business and financial affairs can have therapeutic affects including fostering family harmony and. Mechanisms for resolution of disputes may be constructed. It provides a means of maintaining assets under family control by limiting transferability to outsiders without family consent. Without such consent, any transferee of an LLC interest will be merely an assignee unless formally admitted to membership. This can eliminate the possibility of family members having to deal with former spouses in the case of a failed marriage. A parent might retain limited restricted control over transferred membership interests whil promoting gradual development of knowledge and communication about family assets.

(f) Controlling Trust Income

Trusts may be required to distribute all income currently for various reasons. By placing assets in a family limited liability company and donating interests to the trust, income might be retained in the partnership for partnership needs which may avoid the income being treated as "trust accounting income" for distribution purposes.

(g) Use of LLCs to Obtain Discounts in Valuation Through Fractionalization of Ownershi

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In the view of some practitioners, the family limited liability company (“FLLC”) is the “presumptive entity of choice” for estate planning and has replaced the family limited partnership (“FLP”).[9] Among the typical estate planning client's objectives when developing their estate plans are:

(a) Reducing estate and gift taxes;

[9] See Friedman and Sciarrino, "Estate Planning Vehicle of Choice for the 1990's: FLLC or FLP?", Journal of Limited Liability Companies, Warren, Gorham & Lamont, Winter 1997, Vol. 4, Number 3, p. 91.

(b) Managing the transition of control over assets transferred to heirs as part of a program designed to minimize gift and estate taxes;

(c) Retaining the use of assets as a lifetime source of income;

(d) Treating children as equally as possible.[10]

Prior to the advent of the LLC, FLP's were the entity of choice in this arena. Perhaps the primary area of interest is in taking advantage of discounts of as much as 40% - 45% and more that may be available by placing family assets in a properly designed FLP. By placing assets in such an entity, fractional interests can then be transferred by donation. FLP's have thus allowed taxpayers to transfer interests in a limited partnership while retaining significant control over the assets as general partner of the FLP. While allowing ownership interests to be transferred to family members, the FLP also could provide the elder family member with a lifetime source of income from the assets either as a distribution of profits or as reasonable compensation for services rendered, or a combination of the two.

The FLP also accommodated the elder family member's desire to treat his or her children equally by facilitating the fractionalization of ownership interests to be divided evenly among the children. At the same time, if some children are active in the business of the elder family member, those children could be gradually groomed to become general partners in the FLP.

Some of the advantages of the FLP that made it attractive in the estate planning field include the following:

(a) They can be formed easily without adverse tax consequences;

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[10] Id.

(b) They provide children, as limited partners, with protection against creditor's claims;

(c) Restrictions can be placed on family members from transferring family assets held in the form of limited partnership interests to non-family members;

(d) The partnership can be modified by amendment to the partnership agreement as needed to accommodate changing family and business circumstances (a big advantage over irrevocable trusts);

(e) The elder family member's decisions on behalf of the entity may be better insulated in the limited partnership form when compared to the irrevocable trust to the extent the general partner, to some extent, is thought to be protected by the "business judgment rule", while the trustee is subject to the "prudent person rule".[11]

(f) Facilitates transfers of interests in the family assets without complying with onerous notification requirements such as the "Crummey Notice"[12];

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[11] See ***Theriot v. Bourg***, 691 So.2d 213 (La. App. 1st Cir. 1997), writ denied 696 So.2d 1008, recons. den. 701 So.2d 146, and the discussion elsewhere in these materials, Act 1253 of the 1999 Regular Session of the Louisiana Legislature resurrecting the "business judgment rule" and legislating a gross negligence standard of liability for corporate officers and directors and for members and managers in LLCs.

[12] Recent victories by the IRS in attacking FLP transactions have resulted in some practitioners implementing the use in FLPs and FLLCs of powers analogous to the typical "Crummey Power".

(g) Offers attractive tax savings by splitting business income among family members where capital is a material income producing factor in the enterprise.[13]

If structured to serve as an estate planning vehicle, an FLLC may closely resemble an FLP and can provide most of the some of the same benefits. Since the FLLC can be taxed as a partnership, it shares the same flexibility as the FLP in the formation and operation under the partnership tax rules. The clarification and simplification of tax treatment under the Check the Box regulations has enhanced the use of the LLC in this context.

The flexibility in design of the FLLC under state law allows one to design an LLC that will function much like the limited partnership if that is preferred. On the other hand, the flexibility under the statute allows the practitioner greater creativity in the design of the management and operational aspects of the FLLC than one has with the limited partnership. In doing so, one must be mindful of the regulations under IRC §704. Under these regulations, retention of excessive control may have an impact upon whether transfers of membership interests will be respected by the IRS or whether they will be treated as though the elder family member has not really parted with the interest.

With respect to partnerships in which capital is a material income-producing factor, §704(e)(1) provides that a person shall be recognized as a partner for income tax purposes if he owns a capital interest in the partnership, whether or not such interest is derived by purchase or gift from another person. However, a donee or purchaser of a capital interest in a partnership is not recognized as a partner under §704(e)(1) unless the interest is acquired in a bona fide transaction, not a mere sham for tax avoidance or evasion purposes, and the donee or purchaser is the real owner

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13 Friedman and Sciarrino, *supra*, at 92.

of such interest. Reg. §1.704-1(e)(1)(iii). A transfer is not recognized if the transferor retains such incidents of ownership that the transferee has not acquired full and complete ownership of the partnership interest. Transactions between family members are closely scrutinized in a facts and circumstances intensive analysis with some of the factors to be considered including the following:

> (a) Retention of control over the distribution of income in a manner that results in the retention of income in excess of the reasonable business needs of the business;
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> (b) Limitation of the right of a limited partner or member to withdraw from the entity, or to sell an interest, without financial detriment;
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> (c) Holding management controls inconsistent with the normal relationship among partners although retention of voting and business control, such as is common in ordinary business relationships, is not by itself to be considered as inconsistent with normal relationships among partners, provided the donee is free to liquidate his interest at his discretion without financial detriment;
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> (d) Retaining control over assets essential to the operation of the partnership (for instance, through retention of assets leased to the alleged partnership). Regs. §1.704-1(e)(2)(ii).

While in the limited partnership, much of this is governed by the provisions of the statute and the nature of the limited partnership, in the FLLC setting, the drafter would have to pay even closer attention to these matters.

To the extent that valuation freezes might still be accomplished under the provisions of Chapter 14 of IRC, the FLLC might be used in lieu of the family partnership but this determination requires careful analysis of the interaction of state LLC law and the provisions of IRC §§2701-2704. Even where the FLLC is used solely to take advantage of valuation discounts through fractionalization of ownership interests, the LLC Law should also be examined carefully in conjunction with the tax laws, particularly in light of the recent concentrated effort of the IRS to attack the use of this type of

estate planning.

Under traditional valuation methodology, in determining whether valuation discounts such as the minority, liquidity and marketability discounts were appropriate the issue hinged upon the ability of the owner to compel liquidation of the entire partnership, or require the purchase of the partnership interest at its liquidation value. See ***Estate of Harrison***, TCM 1987-8; and ***Estate of Watts***, 823 F.2d 483 (CA-11, 1987). It must first be noted, however, that the fundamental principles of estate and gift tax valuation as applied to FLP and FLLC interests were altered by the provisions of Chapter 14 of the IRC. Sections 2701, *et seq,* provide certain special rules to be applied in the valuation of interests in corporations and partnerships for gift and estate tax purposes.

IRC §2701 is designed to increase the gift or estate tax that a taxpayer incurs when he transfers a residual interest in a family-owned corporation or partnership to a younger generation family member as part of an estate freeze strategy. The value of property transferred by gift or includible in the decedent's gross estate is its fair market value. Fair market value generally is the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. Treas. Reg. §20.2031. Chapter 14 of the IRC (§§2701-2704) contains rules that supersede the willing buyer willing seller standard.

An estate freeze is a strategy that had become popular prior to 1990 that has the effect of limiting the estate tax value of property held by an older generation at its value at the time of the freeze and passing any appreciation in the property to a younger generation. Generally, the older generation retains income from or control over the property. Prior to 1990, an estate freeze was

often accomplished by having the parent distribute common stock to his heir while he retained ownership of preferred shares. Since the payout on the preferred stock was fixed, its value generally would not increase as the corporation's profits grow. Under general valuation rules, the value of the common stock for purposes of computing the gift tax was determined by subtracting the value of the retained preferred stock from the full value of the corporation. The preferred stock would be structured so that the full current value of the corporation was represented by the value of the preferred stock resulting in the common stock being left with little or no value as of the date of its transfer to the younger generation. The result was that the value of the retained preferred stock interest was frozen as of the transfer date and any future appreciation in value occurred only in the common stock interest in the younger generation's hands.

Other rights frequently given to the retained preferred interest included a right to: (1) "put" the frozen interest for an amount equal to the liquidation preference of the frozen interest; (2) liquidate the entity and receive assets; and (3) convert the nonappreciating interest into an appreciating interest. If these rights were not exercised in favor of the older generation owner, they might have the effect of transferring wealth to the heirs without being subject to a transfer tax. By not exercising conversion, liquidation, put or call rights in his favor, the preferred interest holder might transfer part or all of the value of such rights to the younger generation common stockholders.

§2701 discourages such tax free transfers by valuing at zero certain discretionary rights that the senior generation preferred interest holder has, on the assumption that he will not exercise them in an arms-length manner. The preferred interest holder's right to receive preferred distributions will be valued at zero unless the corporation is required to pay dividends at a fixed rate at specified times

on a cumulative preferred basis. The "applicable retained interests" to which the §2701 rules apply are stock and partnership interests that have: (1) a distribution right (e.g. a right to receive dividends); or (2) a liquidation, put, call, or conversion right. The distribution right is subject to §2701 only if immediately before the transfer, the transferor and applicable family members (the older generation) control the corporation or partnership. Control requires ownership of at least 50% (by vote or value) of the stock of the corporation.

IRC §2701 does not apply if market quotations are readily available for the transferred stock or partnership interest; nor does it apply to the value of the applicable retained interest if: (1) market quotations are readily available for the retained interest on an established securities market; (2) the retained interest belongs to the same class as, or a class subordinate to, the transferred interest, or (3) the retained interest is proportionately the same as the transferred interest (except for nonlapsing differences in voting rights). Nonlapsing differences with respect to management and limitations on liability do not destroy the proportionality otherwise existing between classes of partnership interests; nor do nonlapsing provisions necessary to comply with partnership allocation requirements of the IRC.

If a transfer by a single individual to a member of his family results in a proportionate reduction of each class of equity interest held in the aggregate by the transferor and the applicable family members (the older generations), then §2701 does not apply.

The following transactions are not transfers subject to §2701: (1) a capital structure transaction after which the transferor, each applicable family member (the older generations), and each member of the transferor's family holds substantially the same interest as before the transaction

(for this purpose, common stock with non-lapsing voting rights and nonvoting common stock are substantially the same); (2) a shift of rights resulting from the execution of an IRC §2518 qualified disclaimer; and (3) a shift of rights from the exercise, release, or lapse of a limited power of appointment (that is not otherwise treated as a transfer for gift tax purposes).

IRC §2703 provides rules relative to buy-sell agreements. Buy sell agreements are commonly used to control the transfer of ownership in a closely held business, to avoid expensive appraisals in determining the purchase price, to prevent the transfer of the business to an unrelated party, to provide a market for the equity interest, and to plan for future liquidity needs. Buy sell agreements have also been used to freeze the value of business interests at a level that is below the fair market value of the assets at death. IRC §2703 gives effect to buy sell and other restrictive agreements in establishing the estate or gift tax value of property only if the conditions of §2703 are met. If these conditions are not met, any option, agreement or other right to acquire or use property for less that the fair market value that the property would otherwise have must be disregarded. Any restriction on the right to sell or use the property must also be disregarded if the three conditions are not met. The agreement is considered for valuation purposes only if: (1) it is a bona fide business arrangement; (2) it is not a device for transferring property to members of the decedent's family for less than full and adequate consideration in money or money's worth; and (3) the terms of the agreement are comparable to similar arrangements entered into by persons in an arms' length transaction.

§2704 of the Code addresses the treatment of certain lapsing liquidation rights and restrictions. Under §2704(a), if there is a lapse of a voting or liquidation right in the entity, and the

individual holding the right before the lapse and members of that individual's family control the entity both before and after the lapse, the lapse is treated as a transfer by the individual who held the voting or liquidation rights before their lapse. The amount of the transfer is the excess of the value of all interests in the entity held by the individual who held the lapsed right immediately before the lapse, over the value of those interests after the lapse.

If there is a transfer of an interest in the entity and if the transferor and his family members "control" the entity immediately before the transfer, §2704(b) requires that "any applicable restriction" be disregarded in determining the value of the transferred interest. Under Reg. §25.2704-2(b), "an applicable restriction is a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under state law generally applicable to the entity in the absence of the restrictions."

> Parent (P) and P's three adult children (C1, C2 and C3) own an entity (E) in the proportions of 40% to P and 20% to each of C1, C2 and C3. E has no debt and its assets have a FMV of $100 if sold by E. An ownership interest in E that does not carry with it the power to require E to liquidate (i.e. a noncontrolling interest) has a value that is 40% less than the amount that would be received by the interest holder if E sold all of its assets and liquidated. This is a marketability/minority discount.
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> If P gives his 40% interest to one or more C's and, under the default rules of state law applicable to E, P has the right to compel payment of liquidation value either by withdrawing from the entity or through his death, then no discount is available in valuing the transferred interest even if the applicable agreement between the parties bars this right to compel liquidation. This is because the restriction in the agreement of the parties is an "applicable restriction" which is more restrictive than the general laws of the state which would otherwise apply, and it is thus disregarded. Additionally, because P's right to compel liquidation lapses upon his transfer of the interest in E, the value of the transferred interest takes into account the liquidation

value.[14]

Prior to the adoption of the Check The Box regulations, in the case of FLLCs, under most state LLC acts, a discount from liquidation value would be difficult to achieve. This was because most LLC acts, as originally enacted, were designed to satisfy the association taxable as a corporation rules (Regs. §§ 301.7701-2, the "Kintner Regulations"). The statutes were drafted to assure that, if the statutory default rules were followed, an LLC would fail to have at least two of the four primary corporate characteristics, thus assuring partnership classification.[15]

The characteristic of continuity of life was obviated by providing, as a default rule under the statute, that the dissociation of a member caused a dissolution, unless the other members voted to continue the LLC. Under Louisiana's LLC Law, all members had a statutory default right of withdrawal and withdrawal or death triggered the dissolution of the LLC absent a vote by the remaining members to continue. Even in the event of such a vote, the withdrawing or deceased member was, under many statutes, including Louisiana's act,
entitled to the "fair value" of his LLC interest.

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[14] See Ives, H. Bryan, III, "Valuation Discounts for Partnership and LLC Member Interests", Journal of Limited Liability Companies, Winter 1994, Volume 1/Number 3, pp. 110-117.

[15] Prior to the Check The Box regulations, an LLC's qualification for partnership taxation was dependent upon application of former treasury regulations known as the "Kintner Regulations". Former Treas. Reg. Section 301.7701-2. The Kintner regulations identified four corporate characteristics which distinguished associations taxable as a corporation from partnerships. Those corporate characteristics were:

i. Continuity of life;
ii. Centralized management;
iii. Limited liability; and
iv. Free transferability of interests.

If more than two of these corporate characteristics were found to exist, the LLC would be taxed as a corporation.

Thus, the issue under many state LLC acts involves an interpretation of this "fair value" right. The state of Arizona amended its LLC statute to protect liquidation value discounts from §2704 by declaring its intention to "clarify" the meaning of fair value so that it is based upon *reasonably anticipated* future distributions from the continuing LLC. Presumably, this was to distinguish such distributions from liquidating distributions. Arizona law goes further in the case of "family controlled limited liability companies" to provide that the statutory distribution right in the case of withdrawal or death is the lesser of liquidation value or value based upon reasonably anticipated rights to continuing distributions, assuming the LLC continues for 25 years.

With the adoption of the Check The Box regulations, many states moved quickly to amend their LLC statutes in order to design the default rules to qualify LLCs formed under those states for these minority discounts under the §2704(b) regulations as well as other advantages which were clarified under the Check The Box regulations. For instance, in 1997, at least 22 states enacted legislation to authorize the single-member LLC, 16 states eliminated the requirement that the articles of organization include the latest date for dissolution, and 14 states eliminated member dissociation as a default event of dissolution.[16]

The state of Maryland is a prime example of this type of state action. That state now permits an LLC to have perpetual existence and has eliminated dissociation of a member as an event of contingent dissolution. Absent a contrary operating agreement provision, an LLC in Maryland now may elect within a reasonable time after a member's dissociation to pay the fair market value of the

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[16] Paul, Marshall B. and Levine, Stuart, "State Statutory Changes Follow Lead of Check-the-Box Regulations," Journal of Limited Liability Companies, Warren, Gorham & Lamont, Winter 1997, Vol. 4, Number 3, p. 132.

interest to the dissociated member which is, unless otherwise provided in a written operating agreement, based on the rights of the dissociated member or successor to share in distributions. The LLC is not, however, automatically obligated to redeem the dissociated member's interest.

With the enactment of new Maryland Code §4A-606.1 and the deletion of the dissociation of a member as an event of contingent dissolution, Maryland intended to give transferors of interests in Maryland family LLCs the maximum ability to discount the value of a transferred LLC interest by minimizing problems under Internal Revenue Code Section 2704(b).[17]

Since Maryland no longer gives the holder of the interest of a dissociated member any right either to demand fair value of the interest or liquidate the entity, §2704(b) presumably will no longer apply to the valuation of LLC interests transferred.

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17 Id. at p. 133.

The state of New Jersey took a slightly different approach. First, except when an LLC has only one remaining member, there is no automatic dissolution after an event of dissociation except when a member resigns. A member who dissociates from the LLC becomes a mere creditor of the LLC.[18] If a member resigns, the default rule requires that the LLC purchase the LLC interest, however, "fair value" for purposes of the purchase price is defined as "the net present value of [a member's] right to share in distributions ... less all applicable valuation discounts." "All applicable valuation discounts" includes discounts for "lack of liquidity, relative size of the holding, absence of any trading market and comparable factors."[19] Therefore, while a member who resigns has the right to "put" its interest to the entity, the statute still allows immunity from attack under Section 2704 because the appropriate discounts are applied when determining the buy-out price.[20]

The 1997 Louisiana legislature repealed the provisions of L.R.S. 12:1334(3) which had formerly provided that a limited liability company was dissolved and its affairs were required to be wound up upon:

> (3) The death, interdiction, withdrawal, expulsion, bankruptcy, or dissolution of a member or the occurrence of any other event which terminates the continued membership of a member in the limited liability company, unless within ninety days after such event, the limited liability company is continued by the unanimous consent of the remaining members or as otherwise provided in the articles of organization or a written operating agreement and, if membership is reduced to one, the admission of one or more members.

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18 N.J. Rev. Stat §42:2B-24.1.

19 Id. §42:2B-39.

20 Paul and Levine, *supra*, at p. 134.

Section 1303 of the act was amended by adding subpart B to read as follows:

> B. Without limiting the grant of powers, rights, and privileges contained in subsection A of this Section, every limited liability company shall have perpetual existence, unless a limited period of duration is stated in the articles of organization.

Section 1325 of the Louisiana statute continues to provide as follows:

> A. If a limited liability company has been constituted for a term, a member may withdraw without the consent of the other members prior to the expiration of the term, provided he has just cause arising out of the failure of another member to perform an obligation.
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> B. A member of a limited liability company not entered into for a term may withdraw or resign from a limited liability company at the time or upon the happening of an event specified in a written operating agreement and in accordance with the written operating agreement. If a written operating agreement does not specify the time or the events upon the happening of which a member may withdraw or resign, a member of a limited liability company not entered into for a term may resign or withdraw upon not less than thirty days prior written notice to the limited liability company at its registered office as filed of record with the secretary of state and to each member and manager at each member's and manager's address as set forth on the records of the limited liability company.
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> C. Except as otherwise provided in this Chapter, on withdrawal or resignation, a withdrawing or resigning member is entitled to receive such distribution, if any, to which the member is entitled under a written operating agreement and, if not otherwise provided in a written operating agreement, within a reasonable time after withdrawal or resignation, the fair market value of the member's interest as of the date of the member's withdrawal or resignation.

Therefore, although the Louisiana legislature did not go as far as Maryland, New Jersey and perhaps some of the other states in making it clear that minority interest

discounting and marketability discounting in the transfer of LLC membership interests would be available for purposes of federal gift and estate taxes, the removal of the provision providing for dissolution of the entity in the event of death, withdrawal or other termination of an LLC interest should be sufficient to qualify an interest in a Louisiana LLC for such discounting under the §2704(b) regulations.

As long as the withdrawing or deceased member cannot compel liquidation of the entity and thus command liquidation value for that member's interest, the determination of "fair market value" for purposes of §1325 of the LLC statute must, consequently, be determined on a going concern basis with all the inherent problems and limitations on transferability, marketability and minority ownership. Nevertheless, as long as the Louisiana legislature leaves to the courts the factors to be applied in determining "fair market value", those seeking to use the LLC as an estate planning tool to facilitate discounting in valuation on the basis of factors such as minority interest, liquidity and marketability may find that the LLC formed under the laws of states such as Maryland and New Jersey provides greater certainty that in a given case, such discounting factors will be applied by the courts.[21]

Under IRC §2036, a decedent's gross estate includes the value of any transferred property or interest in property, in which the decedent reserved or retained an interest for his life, or for any

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[21] This should not be taken as a recommendation that Maryland and New Jersey represent the optimum statutory environment on these issues, but rather, merely illustrative of what some of the other states have done in comparison to Louisiana. Note, however, that in the partnership context, in ***Shopf v. Marina Del Ray Partnership***, 549 So.2d 833 (La. 1989), the Louisiana Supreme Court interpreted the Louisiana Partnership Law provision requiring the payment of the "value" of a retiring partner's interest to require payment of an amount equal to the "fair market value" of the interest and applied a minority discount in valuing the partnership interest. Therefore, there should be little doubt that such concepts should apply in determining fair market value in the LLC context.

period that cannot be measured without reference to his death, or for any period that doesn't actually end before his death. The rule applies to all transfers, whether in trust or otherwise, except for property transferred in a bona fide sale for adequate and full consideration in money or money's worth. Retained interests include retention of: (1) the possession or enjoyment of, or right to income from the property, or (2) the right, either alone or in conjunction with any other person, to designate the persons who will possess or enjoy the property, or its income. To the extent the use, possession, income, or other enjoyment of the transferred property is used to satisfy a decedent's legal obligations during his lifetime (e.g. for support of a dependent), the decedent is considered to have retained or reserved an interest in the property.

Retention of the right to vote transferred stock (whether directly or indirectly) in a controlled corporation is considered a retention of enjoyment. For this purpose, a controlled corporation is one in which the decedent (through actual ownership or attribution under IRC §318) owned, or had power to vote (alone or in conjunction with others) stock having at least 20% of the total combined voting power of all classes of the corporation's stock at any time after the transfer of the property and during the three year period ending on the decedent's death.

(h) Valuation Principles Justifying Discounts

In the FLP area, the factors which negatively affect valuation of the limited partnership interests as compared to the fractional interest in outright ownership of assets indicate that a limited partnership interest is worth significantly less than a pro rata share of the liquidation value of the partnership assets. Among the common factors under the Uniform Limited Partnership Act are:

(i) The limited partnership interest has no voice in management, and is therefore analogous to a minority interest in a corporation, for which discounts typically are permitted.

(ii) Limited partners have no rights to underlying partnership assets, but merely own their limited partnership interests.

(iii) A fixed term limited partnership would not permit any limited partner to withdraw from the partnership prior to its dissolution.

(iv) The limited partner has no ability to control cash distributions from the partnership during the continued existence of the limited partnership.

(v) Restrictions on transfer prevent the limited partner from being able to assign his or her limited partnership interests to someone who is not already a partner unless approved by the other partners.

(vi) If the general partner is not required to make a § 754 election, the transferee of a limited partnership interest will be liable for his or her pro rata share of gains, based on the basis of the partnership assets rather than the price paid for the purchased interest.

Characteristics of LLC membership interests which would warrant valuation discounts would include the following:

(i) The transfer of an LLC membership interest without approval of other members to admit the transferee as a member leave the assignee with no voice in management, and is therefore analogous to a minority interest in a corporation, for which discounts typically are permitted.

(ii) LLC members have no rights to underlying company assets, but merely own their membership interests.

(iii) An LLC member in an LLC constituted for a term does not have the right to withdraw and demand fair market value for his interest in the absence of a failure of another member to perform an obligation. While an LLC membership in an LLC constituted without a term under the default rules may afford a member the right to withdraw from the LLC prior to its dissolution, the withdrawing member is entitled only to fair market value of the interest (not liquidation value) which presumably would encompass appropriate discounts for minority interest, liquidity and lack of marketability. A transferee of a membership interest without the consent of the other members results in the transferee having only rights of an assignee. He has no membership rights, including no right to withdraw and demand fair market value of the membership interest.[22]

(iv) The minority member of an LLC has no ability to control cash distributions from the company during the continued existence of the company.

(v) If the member is not required to make a § 754 election, the transferee

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22 §1325A & B speak only in terms of "a member may withdraw." However, note further that under §1332A(2), the transferor member under the default rule retains the membership rights (including right to vote the membership interest) until the assignee is admitted as a member. Querie: whether this is a retained voting right under §2036(b)(1) that will cause the property to be retained in the transferor's estate? Querie: further the effect of using nonvoting membership interests for the transferred interest.

of a membership interest will be liable for his or her pro rata share of gains, based on the basis of the partnership assets rather than the price paid for the purchased interest.

B. Recent Cases Involving Valuation and Related LLC Issues in Estate Planning

a. Valuation of Assignee Interests

Numerous cases have recognized that transferees of partnership interests are merely treated as "assignees", and have acknowledged that the value of the transfer should take into account the limited rights of assignees under state law. There is no reason to think that the same cases would not be applicable to LLC membership interests governed by the Louisiana default rule.

In ***Estate of Watts vs. Commissioner***, 823 F.2d 483 (11th Cir. 1987), *aff'g* 51 T.C.M. 60, the 11th Circuit approved an 85% discount to liquidation values in valuing general partnership interests for estate tax purposes, reasoning that:

> [B]ecause the estate tax is a tax on the privilege of transferring property upon one's death, the property to be valued for estate tax purposes in that which the decedent actually transfers at this death, rather than the interest had by the decedent before death, or that held by the legatee after death. *Propstra* 680 F.2d 1250. ... The Commissioner's argument was based entirely on the notion that the interest transferred at the time of Martha Watt's death was an interest that entitled its own holder to dissolve the partnership, and to liquidate the company. This is not the case.

In ***Estate of McCormick v. Commissioner***, 70 T.C. M. 318 (1995), at issue was the

valuation of general partnership interests that were transferred by gift and upon death of the general partner. The IRS submitted that because a general partner under North Dakota law was entitled to withdraw from the partnership and force a dissolution at any time, the value of the general partnership interest was equal to the partner's pro rata share of the partnership's liquidation value. The taxpayer did not argue that a transferee of the general partner would merely become an "assignee" which should be taken into account under the willing buyer-willing seller test. The taxpayer did argue that even though a general partner has the ability to cause dissolution, the dissolution would not result in an immediate partition of the partnership assets, but would merely cause the partnership to go into a "winding-up mode." The taxpayer argued that this would not enhance the value of a general partner's minority interest. The Court agreed that the dissolution, winding-up and liquidation of the assets of the partnerships being reviewed in that case would be a lengthy process because of the nature of the business and underlying assets. The court concluded that the liquidation values in these partnerships would not be readily available to a holder of a small percentage of the partnerships, and "it is less likely that a willing buyer would purchase any of the interests under consideration for the purpose of liquidating the underlying assets." The court allowed marketability and minority interest discounts of 46%, 38%, 44%, and 54.

In ***Estate of McClendon v. Commissioner***, 96-1 U.S. T.C. 18, 545 (5th Cir. 1996) the Fifth Circuit Court of Appeals highlighted the limitations on the rights of an assignee in valuing a transferred partnership interest. At issue was the sale of a remainder interest in a partnership interest. The IRS argued that the partnership interests were undervalued, and accordingly that the values of the remainder interest were understated. The donor's estate

countered that the interests that were transferred were only remainder interests in "assignee interests" in the partnership, not the actual partnership interest themselves. The Fifth Circuit agreed with the estate's analysis.

In ***Estate of Nowell v. Comm'r***, T.C. Memo. 1999-15, the Tax Court recognized that limited partnership interests passing at death should be valued as assignee interests. The court ruled that the limited partnership interest passing at a decedent's death should be valued as an "assignee interest". Under Arizona law, a partner cannot confer on an assignee the rights to exercise the powers of a partner, unless provided otherwise in the partnership agreement. The partnership agreements specified that the assignee of limited partnership interests in either of the decedent's partnerships would become an assignee and not a substitute limited partner unless, among other things, the general partners consent to the assignee's admission as a limited partner. The court determined that limited partner status is conferred on the transferees of the limited partnership interests only if the general partners consent. The determination of whether the transferees "will be treated as limited partners of the respective partnerships can be made only by taking into consideration whether the remaining general partners will consent to their admission as limited partners, subjective factors that cannot be taken into consideration under the objective standard of the hypothetical seller/buyer analysis. [Citations omitted.] Thus, the limited partnership interests received [by the transferees] must be valued as assignee interests."

In ***Adams v. U.S.***, 213 F.3d 383 (5th Cir. 2000), on remand, 2001-2 USTC ¶ 60, 418 (D.C. Tex. 2001), the 5th Circuit considered the case of a decedent who owned an interest in a Texas general partnership comprised of listed

securities, oil and gas interests and ranch land. The District court allowed no discount for minority, marketability, bad mix of portfolio assets, or uncertainty of assignee rights, based upon its determination that the partnership dissolved at the decedent's death and all of the partners (including the heirs) were entitled to their pro rata share of partnership assets, even though the surviving partners continued the partnership. The Fifth Circuit disagreed, noting that:

> [W]e are firmly convinced that it is anything but 'well- established' that a partner's assignee has the right to receive a 25% share of NAV. We discern a very real possibility that, as a matter of law, the holder of an assignee interest in the partnership could be stuck with an unmarketable interest in a partnership that owns a poorly diversified mix of assets and over which the assignee has no legal control.

The court also recognized that legal uncertainty over the right of an assignee to force a pro rata redemption of his interest "raises the specter of costly litigation in addition to an adverse result" and is a factor that must be considered in valuing the interest for estate tax purposes. When the case was remanded, the district court accepted the estate's expert testimony of 20% minority discount, 10% portfolio discount, and 35% marketability discount (for an overall discount of 53%). The court rejected allowing a additional discount for the legal uncertainly of rights of an assignee, because the

discounts assume that the assignee

would not have rights. Therefore, legal uncertainty is not an additional factor that depresses the price a willing buyer would pay for the assignee interest.

In ***Kerr v. Comm'r*,** 113 T.C. 449 (1999), aff'd, 292 F.3d 490 (5th Cir. 2002), the Tax Court treated the donations as transfers of full limited partnership interests rather than just assignee interests, but concluded that § 2704(b) did not apply to disregard transfer restrictions. The Fifth Circuit affirmed that §2704(b) did not apply (but for a different reason), and did not change the assignee conclusion. Significant discounts were allowed.

In ***Estate of Jones v. Comm'r***, 116 T.C. 121 (2001), the court concluded that the donor gave full limited partnership interests rather than just assignee interests based upon an implication that consent to the transfers would be given by the other partners. Nevertheless, gifts of 16.9% limited partnership interests to four daughters were valued with a 40% lack of control discount and an 8% lack of marketability discount. (The IRS expert appraiser allowed a 38% lack of control discount.)

In ***Estate of Dailey v. Comm'r***, T.C. Memo 2001-263, the court treated the donor as having made gifts of limited partnership interests rather than assignee interests. Still, the court allowed an aggregate marketability and minority discount of 40%. The court did not find either party's valuation experts to be extraordinary, but thought the taxpayer's expert provided a more convincing and thorough analysis.

In ***McCord v. Commissioner***, 120 T.C. 358 (2003), the Tax Court recognized that assignee interests, rather than full-fledged partnership interests, were transferred. The Court distinguished the facts of this case from those in the ***Kerr*** case, where the Tax Court had concluded that in substance partnership interests (not just assignee interests) were transferred. The assignment

restrictions had not been ignored in prior transfers, the assignment document itself did not purport to say that the assigned interest would "constitute a Class B Limited Partnership Interest, " and the parents and their children did not have the ability to formally admit the transferees without the consent of other persons. A small interest had been transferred to a foundation before the large assignment at issue in the case. While the Court recognized the transferred interest as a mere assignee interest, its subsequent discussion of the valuation of that interest made very little (if any) distinction based on the fact that assignee interests rather than limited partnership interests were being valued. The court allowed a weighted minority discount of 15% and a marketability discount of 20%, for an overall seriatim discount of 32%.

b. Additional Discounts Allowed in Recent Cases

Numerous additional cases in recent years have generally allowed substantial discounts, even in partnerships containing marketable securities. See ***Church v. United States***, 85 A.F.T. R 2d 2000-804 (W.D.Tex 2000), aff'd, 268 F 3d 1063 (5th Cir. 2001) (court accepted taxpayer's appraisal when the government failed to offer expert testimony and allowed a 58% discount compared to the value of the contributed assets; ***Estate of Strangi v. Comm'r***, 115 T.C. 478 (2000) ("Strangi I")(court accepted the IRS's appraiser discount of 31%, but made clear that it thought a 31% discount was too high -- subsequent cases have addressed applicability of § 2036); ***Knight v. Comm'r***, 115 T. C. 506 (2000) (court came up with its own discount of 15% for gift tax purposes and disregarded the governments's expert because he determined the "fair value" rather than the "fair market value" of the transferred interest);

Adams v. U.S., 213 F. 3d 383 (5th Cir. 2000), on remand, 2001-2 USTC ¶ 60, 418 (D.C. Tex. 2001) (Texas general partnership comprised of listed securities, oil and gas interest and ranch land; court accepted estates's expert testimony of 20% minority discount, 10% portfolio discount, and 35% marketability discount [for an overall discount of 53%]); ***Estate of Jones v. Comm'r***, 116 T.C. 121 (2001) (for one partnership court allowed only an 8% marketability discount and no lack of control discount [because 51% interest in the partnership could remove the GP]; for second partnership, 40% lack of control discount and an 8% lack of marketability discount [IRS expert appraiser allowed a 38% lack of control discount; ***Estate of Dailey v. Comm'r*** , T. C. Memo 2001-263 (aggregate marketability and minority discount of 40%, partnership consisted of blocks of three publicly traded stocks); ***McCord v. Comm'r***, 120 T.C. 358 (2003) (partnership consisted of marketable securities 65%, real estate partnerships 30%, real estate, oil and gas partnerships, oil and gas interests 5%; minority discounts were assigned for each of the five categories of interest–10% for equities and bonds, 23.3% for real estate partnerships, 40% for directly owned real estate, and 33.5 % for oil and gas, with an aggregate weighted minority interest discount of 15%; marketability discount of 20% [in large part based on the IRS's expert's private placement study]); ***Lappo v. Comm'r***, T.C. Memo 2003-258 (2003) (assets were marketable securities, 19% for real estate, weighted average of 15%; marketability discount for securities and real estate–24%; overall weighted discount of 35.4% [if only securities, discount would have been 30.46%; if only real estate, discount would have been 38.44%]); ***Perracchio v. Comm'r***, T.C. Memo 2003-280 (2003) (partnership assets were marketable securities and cash, money market funds were over 40% of the assets; court determined minority discount factors for five different

classes of the assets (ranging from

a low of 2.0% for cash/money market funds to a high of 13.8% for foreign equities); court allowed a weighted average 6% minority discounts and overall 25% marketability discount [not determined separately for one each particular class of asset], for an overall seriatim discount of 29.5%).

McCord, ***Lappo*** and ***Perrachio*** represent a recent trend in the Tax Court cases in determining the minority discount based on the appropriate lack of control discount for each category of assets in the partnership, then calculating a weighted discount based on the proportionate values of the various classes of assets.

c. The IRS Assault on FLP Discounting Strategies

As the popularity of using FLPs to create valuation discounts in the gift and estate tax planning field has grown in recent years, the IRS launched an all out assault on these strategies. After several years of frustration in the courts, the service has recently been met with some success.

(i) Lack of Economic Substance Or Business Purpose.

In the early 1990's, the IRS attacked these cases on the basis that the partnership should be disregarded for estate tax and gift tax purposes because of the lack of economic substance or business purpose. This was essentially a sham transaction argument. The service argued that the partnerships were created without any business purpose and solely for the purpose of generating valuation discounts. The end result, they argued, was that the transfers should be treated as indirect transfers of the underlying partnership assets under a step transaction theory.

The service issued several Technical Advice Memoranda premised on the "sham

transaction" argument to disregard the partnership entirely for estate and gift tax purposes. See TAM 9736004 (LLC), 9735003, 9730004,9725002, 9723009, 9719006. The IRS took the position in these rulings that no limited partnership discounts were applicable because of (1) § 2703, (2) § 2704, or (3) the partnership should be ignored where it is formed for the sole purpose of obtaining a minority discount.

The IRS was soundly defeated on this theory in the Tax Court. For example, in ***Estate of Strangi v. Comm'r***. 115 T.C. 478 (2000), aff'd on this issue sub. nom. ***Gulig v. Comm'r***. 293 F.3d 279 various non-tax motives for creating the FLP were offered in response to the sham transaction argument by the IRS including: (a) to reduce executor and attorneys fees at the decedent's death (by persuading a corporate executor to decline to serve); (b) to insulate the decedent from a tort claim and the estate from a will contest; and (c) to provide a joint investment vehicle for management purposes. The court took a hostile attitude toward the non-tax reasons for the partnership; yet nevertheless concluded that the FLP was validly formed under state law and was therefore recognized for tax purposes. In ***Knight v. Comm'r***. 115 T.C. 506 (2000), the court rejected the IRS argument to ignore the existence of the partnership but did not address non-tax motives. Instead, the court focused on the fact that the partnership and restrictions under the partnership were valid and enforceable under Texas law. The court specifically refused to apply income tax economic substance cases that had been cited by the IRS. In ***Estate of Jones v. Comm'r***, 116 T.C. 121 (2001), the court determined, as a matter of fact, that the partnerships were created to generate valuation discounts, but did not disregard the partnerships. In ***Estate of Dailev v. Comm'r***. T.C. Memo 2001-263, the court concluded that the partnership was validly formed under Texas

law, that it would not be

disregarded for tax purposes and did not even mention business purpose. In ***Estate of Thompson v. Comm'r***. T.C. Memo. 2002-246, the partnership was established under the advice of Fortress Financial Group "as a tool to (1) reduce income tax, (2) reduce the reported value of property in an estate, (3) preserve assets, and (4) facilitate charitable giving" while keeping "total control of all assets" in the directors of the corporate general partner. The court held that the partnerships were valid under state law and that potential purchasers of the assets would not be able to disregard the partnerships. "Thus, the partnerships had sufficient substance to be recognize for Federal estate and gift tax purposes" affd sub nom.. ***Turner, Executrix of Estate of Thompson v. Comm'r***. 94 AFTR2d 2004-5763 (3 Cir. 2004).

The ultimate defeat to the IRS' sham transaction approach came in ***Estate of Dailev v. Comm'r.*** T.C. Memo 2002-301. In an earlier case, T.C. Memo 2001-263, the court concluded that the partnership would not be disregarded for tax purposes. In the subsequent case, the court awarded attorney fees to the estate with respect to the issue of disregarding the partnership. The IRS conceded that it was not substantially justified in maintaining its position that the partnership should be disregarded for tax purposes. After this defeat, the IRS abandoned economic substance argument as a stand alone line of attack. They were nonetheless determined to continue the fight on different grounds. However, as will be seen in ***Kimbell*** and ***Turner*** , *infra*, the IRS would focus on non-tax and business assets in its discussion of the "bona fide sale" leg of the "bona fide sale for full consideration" exception to § 2036.

(ii) Gift On Creation of the Partnership

The IRS next argued that the person who creates the limited partnership with pro rata

contributions by all partners makes a gift to the other partners, to the extent that the limited partnership interest received has a discounted value that is less than the value of assets the person contributed to the partnership. This theory was described in detail TAM 9842003. This argument has so far proved to be a failure in the courts as well.

The gift on creation argument was first addressed by the courts in ***Church v. United States***, 85 A.F.T. 2d 2d 2000-804 (W.D.Tex. 2000), affd, 268 F.3d 1063 (5th Cir. 2001). This was an unpublished opinion in which the sole issue on appeal was effect of failure to file a certificate of limited partnership by the date that the gift was made. The district court in ***Church*** rejected the IRS's gift on creation argument. It reasoned that the decedent's partnership interest was directly proportionate to the contributions of the partners and stated that a taxable gift has to involve a gratuitous transfer. By definition this requires a donee. There was none in this case. "Implicit in the Government's argument is the notion that since the value of Mrs. Church's Partnership interest was less than the assets she contributed, someone must have received a gratuitous transfer of the difference. This was not the case, and never could be in the formation of a business entity in which each investor's interest is proportional to the capital contributed."

Subsequent cases that have addressed this issue have likewise ruled against the IRS. See ***Estate of Strangi v. Comm'r***. 115 T.C. 478 (2000), aff'd on this issue sub, nom. ***Gulig v. Comm'r***. 293 F.3d 279; ***Estate of Jones v. Comm'r***. 116 T.C. 121 (2001); ***Stone v. Comm'r***. T.C. Memo 2003-309; ***Turner. Executrix of Estate of Thompson v. Comm'r***. 94 AFTR2d 2004-5763 (3rd Cir. Sept. 1, 2004).

Although the ***Strangi I*** opinion reasoned that there were no gifts on creation in part

because the parent did not give up control over assets contributed to the partnership, the ***Church***, ***Jones***, ***Stone***, and ***Turner*** cases did not base their conclusion that there were no gifts on creation on any retained control over the partnership assets.

(iii) Application Of §2704(A) -Treatment Of Lapsed Voting Or Liquidation Rights

Section 2704(a) provides that a lapse of voting or liquidation rights is treated as a transfer for gift or estate tax purposes if the individual and "members of the family" control the entity before and after the lapse. § 2704 (a) (1). The amount of the transfer is the value of all interests held by the individual immediately before the lapse (determined as if voting and liquidation rights were non-lapsing) minus the value of all such interests after the lapse. I.R.C. § 2704(a)(2).

Two conditions must be satisfied before § 2704(a) will apply:

(a) Lapse of Voting or Liquidation Right. There must be a lapse of a voting or liquidation right in a corporation or a partnership. § 2704 (a) (1) (A). (The Treasury may by regulations extend this section to the lapse of rights similar to voting and liquidation rights. § 2704 (a) (3). The regulations have reserved § 25.2704.1 (e) entitled "Application to similar rights.") A liquidation right means a right or ability to compel the entity to acquire all or a portion of the holder's equity interest in the entity. Treas. Reg. § 25.2704-1 (a) (2) (v). A voting right includes, for a partnership, the right of a general partner to participate in partnership management. Treas. Reg.§ 25.2704-1 (a) (2) (iv). Because a transferee typically only is an assignee unless the remaining partners consent to the transferee being a substitute partner, a lapse of voting rights typically occurs when a general partnership interest is transferred. This probably will not require that any significant additional value be included because of the manner in which the § 2703 (a) amount is determined. However, a lapse of voting rights could be avoided, as described below.

(b) Control. The individual holding such right immediately before the lapse and a member (or members) of such individual's family must hold, both before and

after the lapse, control of the entity. § 2704 (a) (1) (B).

Example 5 in the final §2704 regulations describes the classic situation in which the voting rights with respect to a general partnership interest in a limited partnership are eliminated by reason the general partner's withdrawal or death. In that Example, D and his two children each own a 3-1/3% general and 30% limited interests in a partnership. Under the agreement, any general partner can liquidate the partnership. The partnership agreement provides that when a general partner dies, the partnership must redeem the general partnership interest for its liquidation value. D's death causes D to lose the power to liquidate his limited partnership interest (because of the provision in the partnership agreement that any general partner could liquidate the partnership). In that situation, D's loss of liquidation right with respect to the limited partnership interest is subject to § 2704(a). See Treas. Reg. § 25.2704- 1(f)Ex. 5.

To avoid §2704(a), one should avoid having a partner with a unilateral right to force the liquidation of the partnership. This can be done by avoiding ever having an individual serve as the sole general partner or LLC member with similar rights. At the death of the general partner, the deceased general partner should have the right to pass his or her general partnership interest (as a general partnership interest and not merely as an "assignee" interest) to another. There would be no lapse of a voting right—because the successor general partner would succeed to the voting rights.

(iv) Section 2704(B) -- Treatment of Transfers Subject to Liquidation Restrictions.

§2704(b) deals with liquidation restrictions. If (1) there is a transfer of an interest in a

corporation or partnership to a family member and (2) the transferor and members of the family control the entity immediately before the transfer, then any "applicable restriction" will be disregarded in determining the value of the transferred interest. § 2704(b)(1).

The statute defines the term "applicable restriction" as any restriction (1) which effectively limits the ability of the corporation or partnership to liquidate, and (2) either the restriction lapses after the transfer, or the transferor or any member of the family, acting alone or collectively, has the power to remove the restriction. § 2704 (b)(2).

The final regulation adds an important limitation that is not in the statute. Under the regulation, an "applicable restriction" is a limitation on the ability to liquidate the entity (in whole or in part) **that is "more restrictive than the limitations that would apply under State law generally applicable to the entity in the absence of the restriction**." Treas. Reg. § 25.2704-2)b). This interpretation preserves fractionalization discounts if the restriction on the authority of the minority interest to obtain the liquidation value of the interest is no more restrictive than state law provides for that type of interest.

Section 2704(b) should not apply in this situation in a limited partnership because the restriction on the <u>limited partner's</u> <u>right</u> <u>to</u> <u>withdraw</u> is not a restriction "on the ability to <u>liquidate</u> <u>the</u> <u>entity</u> (in whole or in part)." Treas. Reg. § 25,.2704-2(b) (emphasis added). (Contrast the "liquidate the entity" language in Treas. Reg. § 25.2704-2(b) with definition of "liquidation right" in Treas. Reg. § 25,2604-1(a)(2)(V) as the "ability to compel the entity to acquire all or a portion of the holder's equity interest.") The Tax Court adopted this general analysis in ***Kerr v. Commissioner***, 113 T.C. 449 (1999). The Fifth Circuit court of appeals affirmed the decision,

but on different grounds - that the family acting alone could not remove

the transfer restrictions. Moreover, even applying § 2704(b) may not add substantial value to the gross estate as compared to the mere inclusion of the limited partnership interest, because under state law the withdrawing partner merely has the right to receive "fair value" for his or her limited partnership interest - not necessarily liquidation value.[23]

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[23] Steve R. Akers, *Family Limited Partnerships under Attack – Is Total Victory Around the Corner?*, TULANE TAX INSTITUTE, October 22, 2004, §IV.D.

The right of a limited partner to withdraw by giving six months notice under §603 of the Revised Uniform Limited Partnership Act does not apply if the agreement specifies "the time or the events upon the happening of which a limited partner may withdraw or a definite time for the dissolution and winding up of the limited partnership." If a limited partnership agreement provides for a limited period of duration (i.e., it provides that the partnership cannot continue beyond a certain date in the future), a limited partner would not have a withdrawal right by giving six months notice, and § 2704(b) would not apply, because a restriction on a limited partner's withdrawing from the partnership would be consistent with state law. The IRS has taken the position that a provision in the limited partnership agreement that the partnership is a term interest may itself be considered as an applicable restriction; e.g., Field Service Advice 199919009 (provision in partnership that it would terminate in 50 years treated as an applicable restriction because it prevented limited partner from being able to liquidate his interest on six months notice).[24] Under this reasoning, if the term provision is disregarded under § 2704(b), the limited partner would have the right to withdraw by giving six months notice under §603 of the Revised Uniform Limited Partnership Act and any provisions in the limited partnership agreement restricting the right to withdraw would be disregarded. No court has adopted that position.[25]

Many states have revised their Revised Uniform Limited Partnership Act versions of section 603 to provide generally as follows:

> A limited partner may withdraw from a limited partnership at

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[24] Compare the Louisiana LLC Law which allows for withdrawal rights unless the operating agreement provides otherwise or the LLC is an LLC constituted for a term.

[25] Akers, *supra*, note 22.

> the time or upon the occurrence of events specified in writing in the partnership agreement.[26]

Therefore, in states that have made this revision, there is no right of a limited partner to withdraw by giving six months notice, whether or not the limited partnership is a term partnership, unless the partnership agreement specifically provides to the contrary.[27]

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[26] Note this is identical to the Louisiana LLC Law provision. See §1325B.

[27] Note, however, that §1325B goes on to provide that "If a written operating agreement does not specify the time or the events upon the happening of which a member may withdraw or resign, a member of a limited liability company not entered into for a term may resign or withdraw upon giving not less than thirty days written notice to the limited liability company at its registered office . . ."

The legislative history of § 2704(b) indicates that there is no intent to remove normal minority or fractionalization discounts. If an individual transfers a minority interest that, under state law, would not have a liquidation power, there is no requirement that the transferred interest be valued at its liquidation value rather than at its going concern value. §2704(b) does not require that transferred assets be valued as if the transferee held a put right. §2704(b) merely requires that restrictions on liquidation that are more restrictive than applicable state law be ignored. If, under state law, the minority interest transferred would not have a liquidation right in any event, § 2704(b) will not impact the transfer.[28]

(v) Possible Application Of § 2703–Disregarding Restrictions On Right To Sell or Use Transferred Property.

Section 2703(a) provides that "the value of any property shall be determined without regard to . . . (2) any restriction on the right to sell or use such property.," [emphasis added]

The IRS has argued that §2703 applies to the underlying partnership property rather than the limited partnership interest. The service recharacterizes the series of transactions (the creation and funding of the partnership and the transfer of the partnership interests) as one integrated transaction. Therefore, the transaction is treated as a transfer by gift or at the decedent's death of the underlying partnership assets, subject to the partnership agreement. Because the partnership agreement imposes restrictions on the right to sell or use those underlying assets, the IRS argues that the restrictions are ignored under §2703(a). Furthermore, the IRS argues that the safe harbor exceptions under §2703(b) do not apply because the transaction is not a bona fide arrangement and

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[28] Akers, *supra*, note 22.

is merely a device to transfer property to members of the donor's or decedent's family.[29]

[29] *Id.* at §IV.E.

The IRS has taken the position that even if the partnership interest is recognized as the property transferred, §2703(a)(2) would still apply, and the restrictions imposed under the partnership agreement or state law should be ignored. The IRS reasons that the restrictions that a partnership agreement or state law impose on a limited partner's ability to sell or use the partnership interest trigger the application of §2703(a)(2).[30]

The IRS position, as articulated in the 1997 "sham TAMS" would permit a discount to reflect the fractional interest in any real estate represented by the partnership interest, but would not allow any discount for marketable securities. On the basis of §2703, the IRS has argued that the transfer of property to limited partnerships and transfers of limited partnership interests should be valued without regard to any restrictions under partnership law on the rights of limited partners. In effect, the IRS has argued that the existence of the partnership would be ignored.

Even if the conditions stated in §2703(a) are satisfied, §2703(b) indicates that a safe harbor exception to §2703(a) applies if the "agreement, right, or restriction" meets each of the following requirements:

(1) It is a bona fide business agreement.
(2) It is not a device to transfer such a property to the decedent's family for less than full and adequate consideration in money or money's worth.
(3) Its terms are comparable to similar arrangements entered into by persons in an "arm's length transaction."

Various courts have rejected the IRS's §2703 argument. In ***Church v. United States***, 85 A.F.T.R.2d 2000-804 (W.D. Tex. 2000), aff'd on other issue, 268 F.3d 1063 (5th Cir.2001), the court held that §2703(a) does not apply, because the transfer was of a partnership interest,

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30 *Id.*

not partnership assets, so restrictions on the use of the partnership assets would not be ignored. In addition, the ***Church*** case also found that the elements of the §2703(b) safe harbor existed (bona fide business arrangement, not a testamentary device to transfer property to family members for less than full consideration, and restrictions in the partnership agreement were comparable to similar arrangements entered into by persons in arms-length transactions.

In ***Estate of Strangi v. Comm'r***, 115 T.C. 478 (2000) the IRS made two arguments regarding §2703. It argued first that the partnership interest should be valued without regard to restrictions on the right to sell the interest that are implicit in the capital structure of a partnership. The Tax Court did not directly respond to this argument Second, the IRS argued that the term "property" in §2703 refers to underlying partnership assets, and that restrictions on the right to sell or use those underlying assets by reason of the partnership structure should be disregarded. The Tax Court rejected the IRS's §2703 argument, and stated that the partnership interests (not the partnership assets) were transferred, so restrictions on the use of the partnership assets are irrelevant. Therefore, it reasoned that §2703(a) does not apply, so the court did not have to address the applicability of the §2703(b) safe harbors. (All of the Tax Court judges agreed on the §2703 analysis). This portion of the court's holding was approved by the Fifth Circuit Court of Appeals, ***sub. nom Gulig v. Comm'r***, 293 F.3d 279 (5th Cir. 2002).

A district court has recently held in a summary judgment action that the value of gifts of limited partnership interests must be determined under §2703 without regard to specific transfer restrictions in the partnership agreement. ***Smith v. Comm'r***, 94 AFTR 2d 2004-5627 (W.D. Pa. June 30, 2004). In that case, the partnership agreement contained a provision

setting the price and terms of purchase if the partnership exercises its right of first refusal upon a transfer of a partnership interest. The opinion does not address the price provision, but states that the price could be paid) at the purchaser's election) with non-negotiable notes payable over up to 15 years, with equal annual installments of income and principal, and with interest determined at the long-term AFR.

The gift tax return reported the gift at a value of $1,025,392, and reported $26,243 of gift tax. The appraisal attached to the gift tax return applied a significant marketability discount due to the transfer restriction in the agreement. The IRS disregarded the transfer restriction "thus effectively disallowing the attendant marketability discount," valuing the gifts at $1,828,598, and assessing additional gift tax of $360,803. The case is not totally clear regarding the facts. One possible interpretation from the case is that the only discount taken on the gift tax return was a marketability discount attributable to the restrictive transfer provision, and the IRS totally disallowed the marketability discount. That would be unusual, and perhaps there were also discounts for other reasons that were allowed.

The court held that §2703(a) applies to the restrictive transfer provision contained in the partnership agreement, thus meaning that the restriction would be disregarded in determining the value of the gift unless all of the safe harbor requirements in §2703(b) apply. (The taxpayer argued that §2703(a) only applies to separate buy-sell agreements, and not to restrictions in the partnership agreement itself. The court rejected that argument, because the regulations and legislative history both indicate that restrictions "however created" are covered by §2703.)

The court held that it could not rule in this summary judgment proceeding whether the

safe harbor tests in §2703(b) are satisfied. §2703(b) says that restrictions will not be ignored under §2703(a) if the restriction (1) is a bona fide arrangement, (2) is not a device to transfer property to members of the decedent's family for less than full and adequate consideration in money or money's worth, and (3) has terms that are comparable to similar arrangements entered into by persons in an arms-length transaction. The last two elements involve factual findings that make summary judgment impossible. Factors to be considered in the "device" test "include the transferor's health at the inception of the agreement, significant changes in the business subject to the restrictive provision, selective enforcement of the restrictive provision, and the nature and extent of the negotiations that occurred among the parties regarding the terms of the restrictive provision." As to the last "comparability test," the ***Smith*** opinion suggests a rather strict evidentiary standard (similar to the recent opinion dealing with buy sell agreements in ***Estate of Blount v. Commissioner***. T.C. Memo 2004-116 (May 12, 2004). Both parties in ***Smith*** conceded that it would be inherently difficult to find specific examples of agreements between unrelated parties in this situation. The estate submitted affidavits of two attorneys "who essentially state that restrictive provisions requiring installment payments and charging interest at the applicable federal rate are common in both family limited partnerships and transactions involving unrelated parties." However, the court concluded that "these affidavits merely state opinions that are conclusory in nature and do not constitute evidence sufficient to dispel any genuine issue of material fact as to whether of (sic) the restrictive provision in the Smith FLP agreement meet the test set forth in §2703(b)(3)." (Furthermore, the court suggested that due to procedural failures to disclose the affidavits in discovery, the affidavits might not be admissible at the subsequent trial on the facts.)

This case is not a reversal of prior cases that have rejected the IRS's §2703 argument to disregard FLP's generally under §2703. (The IRS had argued in prior cases that §2703 should apply to give no effect to restrictions on reaching the underlying assets in the partnership. That position was rejected in various prior cases, and the IRS began dropping the argument in cases where its pleadings had included a §2703 claim. E.g., ***Perrachio v. Comm'r***, T.C. Memo 2003-280 (IRS dropped §2703 and gift on creation claims.) In ***Smith***, the court addressed whether transfer restrictions in the agreement should be disregarded in valuing the partnership interest itself (as opposed to just ignoring the partnership and valuing the underlying partnership assets).

As a result of the ***Smith*** case, parties should not anticipate receiving much discount, for gift or estate tax purposes, because of transfer restrictions in a partnership agreement that are more restrictive than what state law generally imposes on partnership transfers. Appraisals should specifically address the amount of discount that is attributable to restrictions imposed by state law on the partners, rather than basing discounts primarily on specific transfer restrictions in the agreement. (This case does not mean that specific transfer restrictions are always disregarded – just that the evidentiary standards to satisfy the §2703 safe harbor may be hard to meet.) Furthermore, §2704 (discussed below) would restrict discounts caused by restrictions on the ability to liquidate the entity (in whole or in part) that are more restrictive than restrictions imposed under state law.[31]

(vi) Treatment of Additional Contributions To Partnership As Direct Gifts to Partners

[31] Id.

If a partner makes an additional contribution to a partnership, the IRS will treat the contribution as an indirect gift of the contributed assets to the other partners, rather than as an increase in value of their partnership interests. Therefore, discounts would be allowed only if undivided interest discounts apply to the assets contributed to the partnership. See TAM 200212006 and TAM 200212006.

Where the steps of a donative transaction have no independent significance, the courts will collapse the individual steps in determining the substance of the transaction. See ***Heyen v. United States***, 945 F .2d 359, 363 (10th Cir. 1991) (characterizing a transfer to third party who then retransferred to son as a transfer to son); ***Griffin v. United States***, 42 F. Supp.2d 700 (W.D. Tex. 1998) (holding that a transfer to spouse who subsequently retransferred the property to a child was in substance a transfer to child by the original transferor); ***Estate of Bies .v Commissioner***, T. C. Memo. 2000-338 (holding that a mother's transfers to daughters-in-law who immediately retransferred property to sons were indirect gifts to the sons); ***Estate of Cidulka v. Commissioner***, T. C. Memo. 1996-149 (finding that a transfer to daughter-in-law who retransferred to son was in substance a transfer to son by the original transferor - "the transitory allocation to Taxpayer's capital account, if such allocation even occurred at all, was merely a step in an integrated transaction intended to pass Taxpayer's contribution to Child 1 and Child 2. This treatment is consistent with the substance of the transaction."

In ***Shepherd v. Comm'r***, 115 T.C. 376 (2000), aff'd 283 F .3d 1258 (11th Cir. 2002), the court characterized the facts as a donor transferring land and bank stock to a general partnership in which the donor held a 50% partnership interest and the donor's two sons each held a 25%

partnership interest. The transfers were allocated to each partner's capital account in proportion to their respective partnership interests. The court rejected the taxpayer's argument that the transfers, to the extent inuring to the benefit of the sons, should be characterized for gift tax purposes as enhancements of the then sons' existing partnership interests, and valued accordingly. In accordance with § 25,2511-1(h)(1), the court held the transfer to the partnership represented indirect gifts to each of the donor's sons of undivided 25% interests in the land and bank stock. The Court of Appeals remarked that this was in contrast to the situation of there is a transfer to a partnership "in which the sons were not partners and then establishing the partnership interests of his sons (which would result in a gift of a partnership interest)."

In ***Senda v. Commissioner***, T.C. Memo 2004-160, parents created two partnerships, naming their children as the holders of very small interests (0.10% LP interest for each of three children). They later contributed MCI WorldCom stock to the partnerships. The parents argued that after the contribution of the stock to the partnerships, they gave their children substantial limited partnership interests. There were no records or other reliable evidence that the parents contributed the stock to the partnerships before they made a gift of partnership interests reflecting the stock to the children. While the parents argued that their capital accounts were increased by the amount of their contributions of stock to the partnerships before the gifts were made of the limited partnership interests, the court found no evidence of this.

Estate of Jones v. Commissioner, 116 T.C. 121 (2001), was written by the same judge (Judge Cohen) who wrote the Senda opinion. This case dealt with the creation of two different partnerships where the parent contributed land in return for limited partnership interests

reflecting the value of the land. Later the same day the parent made gifts of limited partnership interests in the partnership to children. The children were partners when the partnership was originally created, but their initial partnership interests were proportionate to their initial contributions. Even though gifts were later made that same day, the court still respected the subsequent transfers as transfers of partnership interests rather than as undivided interests in the underlying assets.

(vii) Additional Contributions to Corporations Treated as Proportionate Indirect Gifts to Other Shareholders.

Treas. Reg. § 25.2511-1(h)(1) contains an example treating an additional contribution to a corporation as an indirect gift of the contributed assets to the other shareholders, to the extent of their proportionate interests in the corporation. The courts have upheld this analysis for additional contributions to corporations. ***Heringer v. Comm'r***, 235 F .2d 149 (9th Cir. 1956) (transfer of farm land to a family corporation of which the donors were 40% owners were gifts to the other shareholders in the amount of 60% of the fair market value of the land); ***Stinson Estate v. U.S.*** 214 F .3d 846 (7th Cir. 2000) (decedent's cancellation of indebtedness owed to decedent by a closely held corporation owned by decedent's five children and two grandchildren constituted a gift of cash to the seven shareholder-children and grandchildren of the corporation); ***Estate of Bosca v. Comm'r***, T. C. Memo. 1998-251 (father's transfer to a family corporation of voting common stock in exchange for nonvoting common stock was a gift to each of his two shareholder-sons of 25% of the difference between the value of the stock transferred and the value of the stock received); Rev. Ru. 71-443, 1971-2 C.B. 338 (allowing a gift tax marital deduction for a portion of the property transferred to a corporation

in which donor's spouse owned 46% of the stock); ***Kincaid v. United States***, 683 F .2d 1220 (5th Cir. 1982) (transfer of ranch to a closely held corporation represented a gift of 33% of the value of the ranch to each of the shareholders to the extent of their interests in the corporation); ***Georgia Ketteman Trust v. Comm'r***, 86 T.C. 91 (1986) (transfer of property to closely held corporation in exchange for a note of lesser value was gift to the other shareholders to the extent of their interests in the corporation); See also ***Estate of Hitchon v. Comm'r***, 45 T.C. 96 (1965) (parent's transfer of stock to a family corporation was a gift by parent of a 25% interest to each of his three shareholder-sons for purposes of determining the sons' basis in the stock under § 1015).

(viii) Avoiding Indirect Gift Treatment

If contributing to an existing partnership in which the children are already partners, ***Estate of Jones*** suggest that additional contribution of assets to the partnership must be treated as a contribution in return for additional interests in the partnership to that contributing partner. Careful and meticulous documentation should be made of the additional percentage interest allocated to the partner and the resulting increase in that partner's capital account all occurring before the donation of the additional partnership interests to the children. A separate instrument should document the subsequent gift of limited partnership interest.

(ix) The Annual Exclusion and Gifts of Partnership & LLC Interests

Prior to the ***Hackl*** decision, *infra*, IRS rulings had concluded that gifts of limited partnership interests qualified as gifts of present interests for purposes of the annual gift tax exclusion (if the limited partnership interest was assigned directly to a donee or to a trust with Crummey powers. See PLR 9415007, TAM 9131006. These rulings were premised on the

distinction between the general partner's powers and a trustee's discretionary power to distribute or withhold trust income or principal and relied heavily upon the fact that the donees had the right at any time to sell or assign their interests, subject to a right of first refusal.

In TAM 9751003, however, the IRS held that donations of limited partnership interests to 35 different donees over three years did not constitute present interest gifts and did not qualify for the annual exclusion. The IRS pointed to the fact that the partnership agreement gave the general partner (a corporation owned by the donor) complete discretion in deciding what funds to distribute from the partnership, including the discretion to retain funds "for any reason whatsoever," and concluded that this provision was extraordinary and outside the scope of a business purpose restriction. It noted that this provision "effectively obviates the fiduciary duty ordinarily imposed upon a general partner, and clothes the general partner with the authority to withhold income for reasons unrelated to the conduct of the partnership. The IRS interpreted the agreement as prohibiting the donee limited partners from assigning their interests and thus, the gifted limited partnership interests "lacked the tangible and immediate economic benefit required...for a present interest in property."

Recently, the Tax Court and Seventh Circuit Court of Appeals have determined that gifts of member interests in an LLC did not qualify for the gift tax annual exclusion. ***Hackl v. Comm'r***, 118 T.C. 279 (2002);aff'd, 335 F .3d 664 (7th Cir. 2003). In ***Hackl***, the donor spouses formed an LLC and made what they thought were annual exclusion joint gifts of member interests to their 8 children, their 8 spouses and to 25 minor grandchildren. Thus there were 41 donees in all and therefore 81 donations totaling over $800,000.00 and the gift tax deficiency at issue was over

$600,000.00. Availability of the annual exclusion was the only issue in the case. The LLC was invested in tree farming. The assets of the LLC constituted land with little or no existing merchantable timber and thus, the LLC was not expected to produce any significant cash flow for many years. Mr. Hackl was named as the initial manager with to serve until his resignation, removal, or incapacity. He had the power to name a successor manager during his lifetime or by his will. The manager was empowered to "direct that the Available Cash, if any, be distributed to the Members, pro rata in accordance with their respective Percentage Interests." No member had the right to withdraw except as approved by the manager. A member desiring to withdraw could offer his units for sale to the Company, and the manager would have exclusive authority to accept or reject the offer and to negotiate terms. The agreement waived the right to have any company property partitioned ,embers could not sell their interests except with the manager's consent, which consent could "be given or withheld, conditioned or delayed as the Manager may determine in Manager's sole discretion."

Similar to "assignee" rights under the Louisiana LLC Law, the operating agreement provided that if a transfer was made in violation of the agreement, the transferee would have no opportunity to participate in the business affairs of the entity or to become a member, but the transferee would only be entitled to receive the share of profits or distributions which otherwise would have inured to the transferor. Members had no power to require dissolution of the LLC.

Section 2503 (b)(1) provides that "gifts (other than gifts of future interests in property)" qualify for an annual exclusion. Under the regulations: ""Future interest" is a legal term, and includes reversions, remainders, and other interests or estates, whether vested or contingent,

and whether or not supported by a particular interest or estate, which are limited to commence in use, possession, or enjoyment at some future date or time. The term has no reference to such contractual rights as exist in a bond, note (though bearing no interest until maturity), or in a policy of life insurance, the obligations of which are to be discharged by payments in the future. But a future interest or interests in such contractual obligations may be created by the limitations contained in a trust or other instrument of transfer used in effecting a gift." Reg. § 25.2503-3.

The Tax Court held that gifts of the membership interests did not constitute present interest gifts and did not qualify for the annual exclusion. It held that outright transfers of equity interests in a business or entity do not automatically qualify as a present interest. The court quoted a U.S. Supreme Court case, providing that the donee must not only have vested rights, he must have the right presently to use, possess or enjoy the property and noted that these terms are not words of art "...but connote the right to substantial present economic benefit." (quoting ***Fondren v. Comm'r***, 324 U.S. at 20-21.

The court went through a two-step alternative analysis noting that the donee must have "an unrestricted and noncontingent right to the immediate use, possession, or enjoyment (1) of property or (2) of income from property, both of which alternatives in turn demand that such immediate use, possession, or enjoyment be of a nature that substantial economic benefit is derived therefrom." The court found the donees in this case did not have "use, possession, or enjoyment" of the property itself within the meaning of § 2503(b). It held that the exception in the regulations for contractual rights in a bond, note or insurance policy was not applicable, quoting ***Estate of Vose v. Comm'r***, T.C. Memo. 1959 - 175, vacated and remanded on another

issue, 284 F .2d 65 (1st Cir. 1960): "The regulations were 'designed to cover notes and bonds which, although perhaps not containing all of the attributes of negotiable instruments, are at least definitely enforceable legal obligations payable on a day certain and immediately disposable by the obligee." (emphasis added.)

The court was impressed that the rights granted in the operating agreement did not afford substantial economic benefits to the donees. The court was concerned with restrictions in the operating agreement, including (1) the absence of the ability of the donees presently to access any substantial economic or financial benefit, (2) the restrictions on unilaterally withdrawing the capital account, (3) any member desiring to withdraw could only offer units to the company and the manager had the authority to accept or reject the offer, (4) no donee acting alone could effectuate a dissolution, and (5) the agreement prevented a donee from selling his interest to third parties without obtaining the consent of the manager. The court concluded that the effect of this was that "for all practical purposes, [the Agreement] bars alienation as a means for presently reaching economic value."

Thus, the court held the donees did not have "use, possession, or enjoyment" of the income from the property within the meaning of § 2503(b). The court reviewed the three-part test described in ***Calder v. Commissioner***, 85 T.C. 713, 727-728 (1985) noting that in order to satisfy this test, the taxpayer must prove "(1) That the trust will receive income, (2) that some portion of that income will flow steadily to the beneficiary, and (3) that the portion of the income flowing out to the beneficiary can be ascertained." The parties in ***Hackl*** did not expect income to be produced for about six years, and even if the partnership produced income, there was no requirement that any

of the income would be distributed to the donees.

The Seventh Circuit affirmed the holding of the Tax Court that the transfer of LLC interests in ***Hackl*** did not qualify for the gift tax annual exclusion as a gift of a present interest It held the gift of the LLC interests was not a present interest within the "plain" meaning of § 2503(b)(1). The court commented that a transfer of all legal rights held by a donor to a gift does not automatically constitute a present interest. It referred to ***Stinson Estate v. U.S.***, 214 F .3d 846 (7th Cir. 2000) where it had held that the forgiveness of a corporation's indebtedness was a future interest because the shareholders could not individually realize the gift without liquidating the corporation or declaring a dividend. The court said that "In this case, Treeco's operating agreement clearly foreclosed the donee's ability to realize any substantial present economic benefit...Treeco's restrictions on the transferability of the shares meant that they were essentially without immediate value to the donees." The Hackls protested that Treeco was set up like any other limited liability company and that its restrictions on the alienability of its shares were no different than those common in closely held companies. The court responded that "While that may be true, the fact that other companies operate this way does not mean that shares in such companies should automatically be considered present interests for purposes of the gift tax exclusion."

It was clear form the court's comments that it was the degree of the limitations on the ability of a member to derive economic benefit from the membership interests that made the difference here. It would certainly seem that if the restriction on transfer was only premised on a right of first refusal, the result might have been different.

It should be noted that the terms of the LLC operating agreement in **Hackl** are very similar to the terms provided by state law for many FLPs. Accordingly, the case would appear

to apply to gifts of limited partnership interests under many FLPs. The taxpayers did not make the argument that the gift of the LLC interest should qualify as a present interest to the extent of the value of an "assignee" interest. The Tax Court acknowledged that the donees could transfer a mere "assignee" interest without approval. It would seem that at least the value of an assignee interest should constitute a present interest. The court acknowledged that "if the transfer was made in violation of the Agreement, the transferee would be afforded no opportunity to participate in the business affairs of the entity or to become a member; rather, he or she would only be entitled to receive the share of profits or distributions which otherwise would have inured to the transferor." Therefore, there was no prohibition against selling an "assignee" interest.[32]

IRS private rulings suggest there is no requirement to receive income currently from property in order for the gift to be a present interest–as long as the interest can be sold immediately. Gifts of non-dividend paying stock have been found by the IRS to qualify for the annual exclusion if there are no restrictions on transferability of the stock. TAM 9346003.

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[32] *Id.* at §IV.G.

In light of the ruling in ***Hackl***, in structuring these transactions, it should be made clear that general partners and LLC members are subject to fiduciary duties with respect to distributions, and donees should have a right to sell their interests subject to a right of first refusal. Some practitioners may give donees the right to sell interests that could become "full-fledged" substitute limited partners or LLC members, subject only to a right of first.[33]

Note, however, that the court in ***Hackl*** stated that permitting the donees to sell their interests, alone, does not assure annual exclusion treatment because the extreme lack of marketability of interests may raise questions about whether the right is by itself sufficient to produce a present interest. ***Hackl*** has been criticized on the fact that the agreement gave the donee/initial manager the authority to appoint his successor as manager. However, parents often like to retain the ability to control who will become the successor general partner or managing member. Allowing for the right to pass the general partnership interest as a general partnership interest should obviate arguments by the IRS that there is a § 2703(a) lapse of a voting right.

Some practitioners are giving the donees a Crummey withdrawal power with respect to gifts of limited partnership interests or LLC membership interests. This is designed to enable the donees to withdraw the fair market value of property equivalent to the annual exclusion amount for a limited period of time after each gift. If limited to the right to withdraw only the "fair market value" of their interests, this type of provision should not have a significant impact on the amount of discount allowed in valuing the interests.

In this writer's view, the ***Hackl*** decision is an demonstration of the old axiom that "the pigs

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33 *Id.*

get fat and the hogs get slaughtered." The lesson to be learned is that even with conservative restrictions on the rights of members and limited partners, significant savings from these strategies may be obtained.

(x) The Bona Fide Sale for Adequate and Full Consideration Exception to § 2036.

Section 2036(a)(1) or (a)(2) only applies if the decedent has "made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth)."

In ***Church v. United States***, 85 A.F.T.R.2d 2000-804 (W.D. Tex. 2000), aff'd, 268 F .3d 1063 (5th Cir. 2001), an FLP was created two days before the decedent's death. The decedent had cancer, but evidence indicated that the decedent did not know she would die so soon after the FLP was created. The decedent's family conveyed its 57% interest in a ranch to the FLP. The decedent owned 62% of that 57% interest. The decedent also transferred $1 million of securities to the FLP. The court concluded that there must be a gratuitous donative transfer for §§ 2036 or 2038 to apply. Because no gratuitous transfer occurred in the creation of the partnership, §§ 2036 and 2038 did not apply.

Cases involving FLPs have analyzed separately the two required elements in the §2036 exception: (1) a bona fide sale, and (2) adequate and full consideration. Prior cases, outside the FLP context, have also applied this same two-part analysis. E.g., ***Wheeler v. U.S.***, 116 F .3d 749 (5th Cir. 1997)

In ***Estate of Reichardt***, 114 T.C. 144 (2000), the court stated that "A bona fide sale is an arm's-length business transaction between a willing buyer and a willing seller," and rejected the

taxpayer's position that "the decedent sold the transferred property to the partnership in exchange for partnership interests as consideration," citing the district court opinion in ***Wheeler v. United States***, 96-1 USTC ¶60,226 (W.D. Tex. 1996) (value of homestead is included in decedent's gross estate under § 2036(a) in part because there was no bona fide sale among family members). The Tax Court in ***Reichardt*** did not point out that the Fifth Circuit Court of Appeals specifically reversed that reasoning of the district court.

The regulations do not articulate a separate bona fide test, but merely require that the transaction be in good faith. Treas. Reg. §§ 20.2036-1(a) & 20.2043-1 ("To constitute a bona fide sale for an adequate and full consideration in money or money's worth, the transfer must have been made in good faith, and the price must have been an adequate and full equivalent reducible to a money value.") Having other partners (even family members) and having negotiations in the structure decisions would help meet this requirement.[34]

The interpretation that the "bona fide sale" requirement means there must be an arm's length transaction has been restated in various subsequent Tax Court and district court cases. E.g. E.g. ***Estate of Harper***, T.C. Memo 2002-121; ***Strangi v. Comm'r***, T.C. Memo 2003-145; ***Thompson v. Comm'r***, T.C. Memo 2002-246, aff'd sub nom., ***Turner, Executrix of Estate of Thompson v. Comm'r***, 94 AFTR .2d 2004-5763 (3rd Cir. 2004); ***Kimbell v. U.S.***, 91 A.F.T.R.2d 2003-585 (N.D. Tex. 2003), rev'd 93 A.F.T.R.2d 2004-2400 (5th Cir. 2004).

In ***Stone v. Comm'r***, T.C. Memo 2003-309, the IRS offered a good example of what satisfies the bona fide test. In that case, five separate limited partnerships were created in April

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34 *Id.* at §V.D.

1997 primarily to resolve ongoing disputes and litigation among Mr. And Mrs. Stone's four children (that generated legal fees of between $2 and $3 milllion). The children had considered using partnerships to settle the litigation since the time that an initial settlement agreement was signed in 1994. The plan was for each child to serve as a co-general partner of one of four of the FLPs holding specific assets. The remaining assets of the Stones, other than assets that they would retain for their living expenses, would be held in the fifth partnership, and all four children would join in managing that partnership. Negotiations continued, and Mr. and Mrs. Stone agreed to the plan to use partnerships in April 1996, primarily in order to resolve the ongoing disputes among his children. Mr. Stone's attorney prepared drafts of partnership agreements and the four children and their attorneys made suggestions for various changes, many of which were made. The partnerships were formed (but not funded) in October 1996. Mr. Stone found out in March 1997 that he only had months to live. The Stones asked their accountants to perform detailed cash flow analyses to enable them to determine what assets they should retain to be able to provide their total monthly cash flow of between $12,000-$15,000. Mr. and Mrs. Stone, although still legally competent, were no longer taking part in the active management of their assets. By March 1997, the parties decided what properties would be transferred to each partnership. On April 8, 1997 Mr. Stone made some gifts of undivided interests in specific properties to the children, and on April 9 the parents and the children (using undivided interests that had been given to them the day before) funded the five partnerships. Mr. and Mrs. Stone died in 1997 and 1998 respectively, claiming an average of 43% valuation discounts.

The court stated that the partnerships were created as a result of arm's length negotiations

in which each member of the Stone family (including the parents) was represented by his or her own independent counsel. The transfers to the partnerships "were

motivated primarily by investment and business concerns relating to the management of certain of the respective assets of Mr. Stone and Mrs. Stone during their lives and thereafter and the resolution of the litigation among the children." The court observed that there was more than a mere change of form. The five partnerships had economic substance and operated as joint enterprises for profit through which the children actively participated in the management.

The Fifth Circuit has followed the traditional approach of just requiring an actual transfer for full and adequate consideration to satisfy the exception, and not applying a special test for intrafamily transactions.[35] In ***Wheeler v. U.S.***, 116 F .3d 749 (5th Cir. 1997), there was a sale of a remainder interest for the full actuarial value of the remainder interest. The Fifth Circuit noted that all parties agreed that, for gift tax purposes, the value of the remainder interest was its actuarial value. The court cited three U. S. Supreme Court cases (***Merrill v. Fahs***, ***Estate of Sanford v. Commissioner*** and ***Commissioner v. Wemyss***) supporting that the phrase "adequate and full consideration" must mean the same thing in both the gift and estate tax statutes; however, the court also observed that the sale of a remainder interest for its actuarial value would not deplete the seller's estate. The Fifth Circuit specifically rejected the application of a separate strict "bona fide" test. It recognized that the "bona fide" qualifier means that the transfer and consideration must not be illusory or a sham. Beyond that, the term may merely mean that commercial transactions that are not literally for full consideration may still qualify for the exception, under the rationale of the gift tax to avoid transforming every bad bargain into a gift by the losing party. In any event, the court clearly rejects a bona fide test that is more restrictive for intrafamily transfers:

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35 *Id.*

> Accordingly, the term 'bona fide' preceding 'sale' in § 2036 is not, as the government seems to suggest, an additional wicket reserved exclusively for intrafamily transfers that otherwise meet the Treasury Regulations' valuation criteria. The government implicitly assets that the term 'bona fide' in section 2036(a) permits the IRS to declare that the same remainder interest, sold for precisely the same (actuarial) amount but to different purchasers, would constitute adequate and full consideration for a third party but not for a family member. This construction asks too much of these two small words. In addition to arguing that 'adequate and full consideration' means different things for gift tax purposes than it does for estate tax purposes, the government would also have us give 'bona fide' not only a different construction depending on whether we are applying the gift or estate tax statute, but also different meanings depending upon the identity of the purchaser in a section 2036(a) transaction. We do not believe that Congress intended, nor do we believe the language of the statute supports, such a construction." Id.

More recently, the Fifth Circuit has addressed the §2036 exception in an FLP case where the IRS argued that the partnership assets should be included in the decedent's estate without a discount under §2036. ***Kimbell v. U.S.***, 93 A.F.T.R.2d 2004-2400 (5th Cir. 2004) rev'g. 91 A.F.T.R.2d 2003-585 (N.D. Tex. 2003). That case concluded that the exception applied to the creation of an FLP, so that the partnerships assets were not includible directly in the estate under § 2036(a)(1). The district court applied § 2036(a)(1) and (a)(2), but the case was reversed by the Fifth Circuit based on the full consideration exception to § 2036.[36]

The facts in ***Kimbell*** involved a decedent who at age 96 formed an FLP. He retained a 99% limited partnership interest. An LLC held the 1% general partner interest. The LLC was owned 50% by the decedent, 25% by her son, and 25% by her daughter-in-law. The son was

[36] *Id.*

manager of the LLC. The decedent died two months after creating the partnership. The partnership had a term of 40 years (which the court noted was when the decedent would have been 136 years old. The partnership agreement provided that 70% in interest of the limited partners could remove the general partner. The partnership agreement also provided that the general partner "will not owe a fiduciary duty to the partnership or to any partner." The estate reported the value of the limited partnership interests on the estate tax return at a discount. The IRS assessed additional taxes, which the estate paid and filed an action seeking a refund.

The estate and the IRS both filed motions for partial summary judgment, as to the application of § 2036(a) to the transfer of assets to the partnership. The district court upheld the IRS's motion for partial summary judgment and held that § 2036(a) applied, and that the full consideration exception to § 2036 did not apply. It found that the decedent retained the rights to possession of the economic benefits of the property [§ 2036(a)(1)] and the right to designate who would benefit from the income of the property [§ 2036(a)(2)]. The district court believed that there was no need in this case to search for an implied agreement, because the decedent had the right under the agreement to remove the general partner at any time and appoint herself as the general partner. As the general partner, she could then control distributions. The estate contended that even if the decedent were the general partner, she still would not have sufficient powers to require inclusion under §2036 because her powers would be held in a fiduciary capacity, pointing to the Supreme Court holding in ***U.S. v. Byrum***, 408 U.S. 125 (1972) that § 2036 did not apply to a decedent who retained voting interests in several corporations. The district court reasoned that "Byrum ... was expressly overruled by

Congressional enactment of § 2036(b). Furthermore, even if Byrum were applicable, the partnership agreement expressly provides that the general partner will not owe a fiduciary duty to the partnership or to any partner."

The district court's statement that §2036(b) overrules the Supreme Court's discussion in ***Byrum*** that fiduciary retention of powers does not trigger § 2036 has been criticized by many as being simply incorrect. Section 2036(b) merely holds that retaining voting powers over transferred stock causes estate inclusion. The court made no attempt to analyze how §2036(b) specifically applies to fiduciary powers held by a decedent in a limited partnership. That aspect of the opinion has been strongly criticized.[37]

The Fifth Circuit Court of Appeals, based on the full consideration exception to §2036, reversed the district court, but did not directly address the § 2036(a)(1) issue. The court rejected the district court's conclusion that "bona fide" means arm's length and that intrafamily transactions cannot meet the bona fide sale requirement. The court looked to Wheeler v U.S., 116 F .3d 749 (5th Cir. 1997), which is the only Fifth Circuit case (and the only circuit level case cited to the court) addressing the bona fide sale for full and adequate consideration exception to § 2036. The basic requirement is: "whether the transferor actually parted with the...interest and the transferee actually parted with the requisite adequate and full consideration." The court noted that although the requirement receives "heightened scrutiny" in intrafamily transfers, just because transfers occur between family members does not impose an additional requirement that is not set forth in the

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37 *Id., Citing* Korpics, For Whom Does *Kimbell* Toll–Does Section 2036(a)(2) Pose a New Danger to FLPs 98 J. TAX'N 162 (March 2003).

statute to be “bona fide.” The court felt the

absence of negotiations is not a compelling factor, particularly when the exchange value is set by objective factors. It concluded that the issue under ***Wheeler*** is whether "the sale...was, in fact, a bona fide sale or was instead a disguised gift or a sham transaction."

The district court opinion in ***Kimbell*** teaches that one should be sure that the decedent does not have the unilateral power to remove and replace himself as the general partner. Also, the agreement should provide that the general partner owes fiduciaries duties to the partnership and to the other partners.[38]

Under the regulations, a transaction is a bona fide sale if it is made in good faith. Reg. § 20.2036-1(a), 20.2043-1(a). The decedent's subjective intent and the presence of tax planning motives do not prevent a sale from being bona fide if it is otherwise real, actual, or genuine. However, "[a] transaction motivated solely by tax planning with no business or corporate purpose is nothing more than a contrivance without substance that is rightly ignored for purposes of the tax computation."

The bona fide sale standard should be able to be summarized as a sale in which the decedent/transferor actually parted with her interest in the assets transferred and the partnership/transferee actually parted with the partnership interest issued in exchange. When the transaction is between family members, it is subject to heightened scrutiny to insure that the sale is not a sham transaction or disguised gift. The scrutiny is limited to the examination of objective facts that would confirm or deny the taxpayer's assertion that the transaction is bona fide or genuine.

The Fifth Circuit in ***Kimbell*** concluded by saying:

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38 *Id.*

> [T]here is no contention that the transfer did not actually take place. The assets were formally assigned to the Partnership and Mrs. Kimbell was actually credited with a pro rata interest. There is no evidence that partnership formalities were ignored or that Mrs. Kimbell used Partnership assets for personal expenses. Finally, applying the heightened scrutiny applicable to transactions between family members, we are satisfied that the taxpayer has established through objective evidence recited above that the transaction was not a disguised gift or sham transaction. The ... taxpayer's ... substantial business reasons ... were strongly supported by the nature of the business assets (undivided working interests in oil and gas properties) conveyed....

Under the court's analysis the bona fide sale requirement is satisfied if there is at least some degree of non-tax purpose.[39] This should be taken with a certain degree of caution given that the court also said: "A transaction motivated solely by tax planning with no business or corporate purpose is nothing more than a contrivance without substance that is rightly ignored for purposes of the tax computation. See Gregory v. Helvering, 293 U.S. 564, 469 (1935)."

The Tax Court applied § 2036(a)(1) to include partnership assets in the decedent's estate in ***Estate of Thompson v. Comm'r***, T.C. Memo 2002-246. This holding was affirmed in ***Turner, Executrix of Estate of Thompson v. Comm'r***, 94 A.F.T.R.2d 2004-5763 (3rd Cir. September

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39 *Id.*

1, 2004). Among other things, the court held that the "bona fide sale for adequate and full consideration" exception to §2036(a) did not apply yet went out of its way to emphasize the importance of having legitimate non-tax business purposes for creating the partnership in applying the bona fide sale for adequate and full consideration exception to § 2036(a).

In ***Turner***, the decedent formed FLPs with each of his two children. The decedent formed the two FLPs in April 1993, one with himself and his son, and one with himself and his daughter's husband. The decedent was the 95.4% limited partner of one and a 65.27% limited partner of the other. Both FLPs had a corporate general partner (about a 1% interest), and the decedent held slightly less than one-half of the outstanding stock of the corporation that served as the general partner. These partnerships were created as part of a Fortress Plan package that touted the following advantages: (1) lowering the taxable value of the estate, (2) maximizing the preservation of assets, (3) reducing income taxes, and (4) facilitating family and charitable giving. The FLP with the daughter's husband consisted primarily of marketable securities. The partnership initially was funded with about $1.376 million. Later in the year the partnership was created, the partnership invested $186,000 in a modular home construction project which the court acknowledged was a "legitimate business transaction."[40] Over a year after the partnership was created, the daughter contributed a parcel of land adjacent to her residence and contributed her interest in a real estate partnership to the FLP. The partnership was amended retroactive to its creation to allocate to each partner gains and losses attributable to the real estate contributed by the partner. The partnership made loans, but only to family members and interest payments were often late or not paid at all.

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40 *Id.*

The FLP with the decedent's son consisted of marketable securities and a note receivable contributed by the decedent, and mutual funds and a ranch property (used by the son as his primary residence) contributed by the son. The son paid rent for using the ranch as his residence, and the only business activity was that mules were raised on the property (but at a loss).

The decedent, at age 95, transferred $2.8 million to the two FLPs, retain $153,000 in personal assets. The court found that the decedent retained assets that would cover 3 ½ years of living expenses, but had a life expectancy of 4.1 years when the FLPs were created.

The Third Circuit concluded that there was no bona fide sale, but for different reasons than suggested by the IRS and Tax Court. The court disagreed with the position of the IRS and the Tax Court that a bona fide sale requires arm's length bargaining between the transferor and an unrelated third party, although an arm's length transaction is "highly probative" to the inquiry. Noting the heightened scrutiny in family transactions, the court said: "We are mindful of the mischief that may arise in the family estate planning context.... But such mischief can be adequately monitored by heightened scrutiny of intra-family transfers to family limited partnerships." The court distinguished the facts of this case from other cases (***Harper*** and ***Strangi***) when the decedent or the decedent's attorney-in-fact planned the entire partnership structure.[41]

The court observed that the relevant regulation to § 2036 requires a "good faith" transfer, and that the Fifth Circuit in ***Kimbell*** interpreted this to require that the decedent actually parted with the transferred interest. The Third Circuit interpreted "good faith" to require the existence of non-tax benefits:

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41 *Id.*

> A 'good faith' transfer to a family limited partnership must provide the transferor some potential for benefit other than the potential estate tax advantages that might result from holding assets in the partnership form. Even if all the 'i's are dotted and the t's are crossed,' a transaction motivated solely by tax planning and with "no business or corporate purpose ... is nothing more than a contrivance....As discussed in the context of 'adequate and full consideration' objective indicia that the partnership operates a legitimate business may provide a sufficient factual basis for finding a good faith transfer. But if there is no discernable purpose or benefit for the transfer other than estate tax savings, the sale is not 'bona fide' within the meaning of § 2036.

The court determined that the "bona fide" requirement does not require an arm's length transaction (although the existence of an arm's length transaction would likely satisfy the test.) The court said that heightened scrutiny will be applied in intra-family transactions (similar to the ***Kimbell*** analysis) and concluded that the "bona fide" requirement means there must be a "good faith" transaction, which the court interprets as meaning there must be non-tax reasons for the transaction. The court gave various statements of this requirement, "some potential for benefit other than the potential estate tax advantages," "business or corporate purposes," "a

legitimate business may provide a sufficient factual basis," "discernable purposes or benefit for the transfer other than estate tax savings."[42]

(xi) "Adequate and Full Consideration" Component of §2036.

[42] *Id.*

The Tax Court has generally held that the receipt of limited partnership interests in return for the transfer of assets to the partnership is not "adequate and full consideration" even though the court has held on various occasions that the creation of the partnership does not result in a "gift on creation" for gift tax purposes.[43] This appears to some to be inconsistent with the Tax Court's statement in ***Estate of Friedman v. Comm'r***, 40 T.C. 714, 718-19 (1963) that "[t]he phrase 'an adequate and full consideration in money or money's worth,' common to both the estate and gift tax statutes here pertinent, is to be given an 'identical construction' in regard to each of them." The Tax Court reasons that "full and adequate consideration" does not exist where there is merely a "recycling" of value through partnership or corporate solution.[44] The court first explained its "recycling" reasoning in ***Estate of Harper v. Comm'r***, T.C. Memo 2000-202, stating that there is a mere "recycling" where there is no change whatsoever "in the underlying pool of assets or prospect for profit, as, for example, where others make contributions of property or services in the interest of true joint ownership or enterprise." Various Tax Court cases have applied this analysis. See ***Estate of Harper***, T.C. Memo. 2002-121 (distinguishing ***Harrison*** and ***Church*** because in those cases other partners made contributions not de minimis in nature and the partnership was a vehicle for genuine pooling of interests); ***Estate of Thompson***, T.C. Memo. 2002-246 (transfer not made for legitimate business concerns, not transferred into a valid functioning business enterprise, and no true pooling of assets because each partner is allocated income attributable to assets by him or her), aff'd sub.nom., ***Turner, Executrix of Estate of Thompson v. Comm'r***, 94 A.F.T.R.2d

43 *Id.* at §V.E.

44 *Id.*

2004-5763(3rd Cir. 2004); **Kimbell v. U.S.**, 91 A.F.T.R.2d 2003-585 (N.D. Tex. 2003) (99% partner, "only a recycling of value"), rev'd, 93 A.F.T.R.2d 2004-2400 (5th Cir. 2004); ***Strangi v. Comm'r***, T.C. Memo 2003-145 (over 99% of assets, mere recycling of value where no contributions by others "of property or services in the interest of a true joint ownership or enterprise").[45]

In ***Stone v. Comm'r***, T.C. Memo 2003-309, Judge Chiechi rejected the "mere recycling" approach that the Tax Court had employed in its previous FLP cases addressing §2036. The court reasoned that the initial transfers to the partnerships by Mr. and Mrs. Stone were not gifts to the other partners. Subsequent transfers to the partnerships by the decedent and other partners were made in exchange for respective partnership interests "that were adequate and full equivalents reducible to a money value." The opinion detailed that the partnership interests were proportionate to the values of assets contributed, that the assets transferred by each partner were property credited to capital accounts, and that upon termination or dissolution, the partners were entitled to distributions equal to their respective capital accounts.

The IRS argued that the partnership interests received by the Stones did not constitute adequate and full consideration after taking into account appropriate discounts in the values of the partnership interests. The court rejected this argument with strong language about the IRS's attempt effectively to sidestep the fair consideration exception test in all transfers to entities:

> Respondent's argument in effect reads out of section 2036(a) the exception for "a bona fide sale for an adequate and full

[45] *Id.*

> consideration in money or money's worth" in any case where there is a bona fide , arm's length transfer of property to a business entity (e.g., a partnership or a corporation) for which the transferor receives an interest in such entity (e.g., a partnership interest or stock) that is proportionate to the fair market value of the property transferred to such entity and the determination of the value of such an interest takes into account appropriate discounts. We reject such an argument by respondent that reads out of section 2036(a) the exception that Congress expressly rejected when it enacted that statute. Respondent's argument about the discounted values of the partnership interests at issue also ignores the fact that each of the Five Partnerships was created, funded, and operated as a joint enterprise for profit for the management of its assets in which there was a genuine pooling of property and services.

The Fifth Circuit's approach to the adequate and full consideration requirement in ***Kimbell*** is well represented by the following comments from the court:

> We would only add to the Tax Court's rejection of the government's inconsistency argument that it is a classic mixing of apples and oranges: The government is attempting to equate the venerable "willing-buyer-willing seller" test of fair market

value (which applies when calculating gift or estate tax) with the property test for adequate and full consideration under § 2036(a). This conflation misses the mark: The business decision to exchange cash or other assets for a transfer-restricted, non-managerial interest in a limited partnership involves financial considerations other than the purchaser's ability to turn right around and sell the newly acquired limited partnership interest for 100 cents on the dollar. Investors who acquire such interests do so with the expectation of realizing benefits such as management expertise, security and preservation of assets, capital appreciation and avoidance of personal liability. Thus there is nothing inconsistent in acknowledging, on the one hand, that the investor's dollars have acquired a limited partnership interest at arm's length for adequate and full consideration and, on the other hand, that the asset thus acquired has a present fair market value, i.e., immediate sale potential, of substantially less than the dollars just paid–a classic informed trade-off.

. . .

The proper focus therefore on whether a transfer to a partnership is for adequate and full consideration is: (1) whether the interests 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 partnership, and (3) whether upon termination or dissolution of the partnership the partners were entitled to distributions from the partnership in amounts equal to their respective capital accounts. [Stone] at 580. The answer to each of these questions in this case is yes. Mrs. Kimbell received a partnership interest that was proportionate to the assets she contributed to the Partnership. There is no question raised as to whether her partnership account was properly credited with the assets she contributed. Also, on termination and liquidation of the Partnership, the Partnership Agreement requires distribution to the Partners according to their capital account balances.

(xii) Importance of Formalities in §2036

Section 2036(a)(1) provides that the gross estate includes the value of property that was transferred by the decedent (except a transfer that is a bona fide sale for an adequate and full consideration) under which he has retained for his life the possession or enjoyment of, or the right to income from the property. Various cases have applied § 2036(a)(1) in situations where the parties did not follow appropriate formalities. The courts reasoned that the failure

to recognize partnership formalities evidences an intent to ignore the partnership and grant the decedent access to the partnership assets as needed.[46]

In ***Estate of Schauerhammer v. Comm'r***, T.C. Memo. 1997-242, the party who set up the FLP continued to receive and have all the income from the FLP deposited into her personal bank account up to the time of her death. The IRS argued that § 2703 applied, and that the restrictions under the partnership agreement and partnership state law constituted restrictions "on the right to sell or use property." The court held that § 2036(a)(1) applied, and the property in the partnership was included directly in the decedent's estate because the decedent continued to enjoy the benefit directly of property that she had transferred to the partnership and partnership formalities were ignored.

In ***Estate of Reichardt v. Comm'r***, 114 T.C. 144 (2000), the decedent and decedent's revocable trust formed a FLP. A revocable trust was the sole general partner. The decedent and two children were co-trustees (but the facts showed that the decedent acted alone in making all decisions on behalf of the trust). The decedent transferred to the FLP his residence, and all of his other property except his car, personal property and some cash. The court held that §2036(a)(1) applied because the decedent and his children had an implied agreement that the decedent retained for his lifetime the right to the income from all of the real property that the partnership had when the decedent died. In concluding that § 2036(a)(1) applied, the court looked to the fact that the decedent commingled partnership and personal funds; deposited some partnership income in his personal account; used the partnership's checking account as his personal account; conveyed his

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[46] *Id.* at §VI.

personal residence to the partnership and continued to live

in the residence without paying rent; and his relationship to the assets remained the same after he transferred them to the partnership.

In another ***Church v. United States***, 85 A.F.T.R.2d 2000-804 (W.D. Tex. 2000), aff'd., 268 F .3d 1063 (5th Cir. 2001), however, many formalities of creating and funding the partnership were not followed yet the district court recognized the partnership and refused to include the partnership assets in the estate under § 2036. The court's many findings included: (1) the FLP had bona fide business purposes and was not a sham for estate tax purposes, (2) the decedent did not have the unilateral right to alter, amend, revoke, or terminate the partnership, (3) there was no express or implied agreement that the decedent could continue to use, possess or enjoy partnership property, or retain the right to the income from partnership property within the meaning of § 2036; in addition, the court concluded that there must be a gratuitous donative transfer for §§2036 or 2038 to apply, and because no gratuitous transfer occurred in the creation of the partnership, §§2036 and 2038 do not apply; (4) Section 2703(a) does not apply, because the transfer was of a partnership interest, not partnership assets, so any restriction on the use of the partnership assets would not be ignored; in addition, the court found that the elements of the §2703(b) safe harbor existed (bona fide business arrangement, not a testamentary device to transfer property to family for less than full consideration, and restrictions in the partnership agreement were comparable to similar arrangements entered into by persons in arm's length transactions); and (5) there was no gift on creation of the partnership. The court accepted taxpayer's appraisal (the government offered no expert testimony) with a 58% discount compared to the value of the contributed assets. The Fifth Circuit Court of Appeals affirmed the decision; however, the IRS only appealed a narrow

issue–whether the failure to file the certificate of limited partnership by the date of the gift was determinative.

In the initial Tax Court decision in ***Strangi v. Commissioner***, 115 T.C. 478 (2000), which is sometimes referred to as ***Strangi I***, the full Tax Court recognized the partnership for tax purposes, and rejected the IRS's gift on creation and § 2703 arguments. The court also refused to rule on the §2036 issue because of procedural defects in the manner in which the IRS raised the issue. The Fifth Circuit affirmed the Tax Court, except as to the §2036 procedural issue and remanded the case to the Tax Court for consideration of the §2036 issue. ***Gulig v. Comm'r***, 293 F.3d 279 (5th Cir. 2002). This is the remanded Tax Court case to consider the §2036 issue. T.C. Memo 2003-145, which is sometimes referred to as ***Strangi II***.

The facts in ***Strangi II*** are that an FLP was created with a corporation as 1% general partner and decedent as 99% limited partner. The corporation was owned 47% by the decedent and 53% by family members. The FLP and the corporation (and the decedent's interest in them) were created on behalf of decedent by his son-in-law, who was acting for decedent under a durable power of attorney. The decedent died about two months after creating the FLP. After his death, the FLP distributed funds to the estate for estate taxes, distributed funds to the children and extended lines of credit to them, and advanced funds to the estate to post bonds with the IRS and Texas. The taxpayer presented facts at trial indicating that the partnership was formed in large part as a method of avoiding likely family litigation that was anticipated following the decedent's death. The Tax Court gave little weight to those facts.

98% of decedent's wealth was contributed to partnership and corporation A 99%

limited partnership interest was retained by decedent. The 1% general partner was a new corporation owned 47% by decedent and 53% by decedent's children. The children subsequently gave 1% to a foundation. The corporation entered into a management agreement with the decedent's son-in-law (who was also decedent's attorney-in-fact under the power of attorney) to manage day-to-day business of the corporation and the partnership–which the court interpreted to include making all distribution decisions. The partnership agreement provided that income, after deducting certain listed expenses "shall be distributed at such times and in such amounts as the Managing General Partner, in its sole discretion, shall determine, taking into account the reasonable business needs of the Partnership (including plan for expansion of the Partnership's business)."

Various distributions were made to or for decedent or the decedent's estate (including home health care, medical expenses of a health care provider, funeral expenses, estate administration expenses, debts of decedent, specific bequests, and estate and inheritance taxes).

The holding of the court was that §2036(a)(1) applied to the corporation and partnership created by decedent. The circumstances that generally suggest an implicit retained interest under §2036(a)(1) included: "transfer of the majority of the decedent's assets, continued occupation of transferred property, commingling of personal and entity assets, disproportionate distributions, use of entity funds for personal expenses, and testamentary characteristics of the arrangement."[47]

Formalities recognizing the entity were followed. The relative dearth of liquefied as

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[47] *Id.*

opposed to "liquefiable" assets reflect that the partnership and the corporation would be the primary source of decedent's liquidity. The decedent continued physical possession of his residence. The partnership charged rent to the decedent, but the court observed that the fact that the rent was merely accrued and not actually paid until over 2 years after decedent's death reflects that the rent was not arm's length.

The court concluded that "accounting entries alone are of small moment in belying the existence of an agreement for retained possession and enjoyment." While pro rata distributions were made to all partners, because interests held by others were de minimus, "a pro rata payment is hardly more than a token in nature." The court found that actual distributions reflected "a conclusion that those involved understood that the decedent's assets would be made available as needs materialized." It was noted that the partnership/corporation arrangement had more testamentary characteristics than a joint investment vehicle for management of assets. Factors supporting this conclusion included the unilateral nature of the formation, the fact that contributed property included the majority of decedent's assets, and the decedent's advanced age and serious health condition. "[T]he crucial characteristic is that virtually nothing beyond formal title changed in decedent's relationship to his assets." The children did not have a meaningful economic stake in the property during decedent's life and made no objections or concerns when large sums were advanced to decedent or his estate.

This case is presently on appeal to the Fifth Circuit Court of Appeals. The §2036 full consideration exception should be a focal point in the appeal, in light of the Fifth Circuit's earlier ***Kimbell*** decision.

In ***Estate of Abraham v. Commissioner***, T.C. Memo 2004-39., the court applied

§2036(a)(1), in a situation where the partnership was created by a guardianship, with the guardianship court approving the creation after it found that the ward's living arrangements would be maintained. A guardianship was opened for the ward (later the decedent in this estate tax case) in 1993. Her children had contested her deceased husband's will, which was resolved by a settlement agreement. Guardians for the ward obtained court approval to establish an estate plan for the decedent and to make gifts. The plan called for the creation of three FLPs, with funds being reserved for the ward's support, and for annual exclusion gifts and sales of limited partnership interests. Pursuant to the plan, the ward's guardians created three different FLPs. The decedent had three children, and the plan was that each child would end up with certain interests in one of the three FLPs. The decedent transferred real estate interests into the FLP. The 1% general partner of each FLP was a corporation owned by revocable trusts for the decedent. Guardian ad litems for the decedent served as president of the respective corporations.[48]

The initial limited partnership interests in the two FLPs for the decedent's daughters were 98% to decedent and 1% to the respective daughter (each daughter was deemed to have contributed about $9,000 to "her" partnership). In the third FLP for the son the limited partnership interest was 99% to decedent. In the same month the FLPs were created, the daughters each purchased about 27% limited partnership interests (in their respective partnerships) from decedent for about $160,000. (The percentage interests were based on an appraisal of the underlying real estate and the application of a 15% minority discount and a 25% marketability discount by a business advisor [not a professional appraiser].) On various

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[48] *Id.*

later occasions, each daughter purchased additional limited partnership interests in "her" partnership in return for cash paid to the partnerships (not to the decedent). About 3 months after the son's partnership was created, the son was "given" a 30% limited partnership interest in settlement of his claims against decedent's estate. Various annual exclusion gifts of limited partnership interests were made to the respective children and their families.

The partnership agreements and the plan approved by the guardianship court made clear that the decedent's living arrangement would be maintained in "status quo" and that the children would not receive any distributions until the guardian ad litem overseeing each partnership determined that a reserve for her support had been maintained. The children testified that there was an arrangement that their mother's needs would be provided for out of the partnership, even out of their partnership funds if the mother's partnership funds were not sufficient.

The court held the facts were clear that the partnerships were created with the express retention and a clear understanding that all of the partnership assets (even including assets attributable to gifted interests) would be used first as necessary for decedent's support. Even the subsequent purchases by the daughters were made in part to get cash to their mother for support. The retention issue was found especially suspect by virtue of the fact that the partnership was being created by a guardianship court, and guardian ad litems are looking out exclusively for the ward's best interests.[49]

The court did not address whether the initial transfer of assets to the FLPs in return for all interests in the partnerships was a transfer for full consideration. If so, arguably §2036

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49 *Id.*

would apply only as to subsequent transfers of interests that were not supported by full consideration.