Breaking Developments in Trusts and Estates Law

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Planning Developments for Family Limited Partnerships and Limited Liability Companies

Family limited partnerships have become a valuable and dependable estate planning tool to transfer business property, real estate and other assets to family members. The discussion of family limited partnerships in this memorandum also applies to limited liability companies, as the principles discussed are equally applicable to both. Family limited partnerships provide solutions to a number of business, investment and tax objectives. Several recent court cases appear, however, to impact the potential gift and estate tax benefits offered by family limited partnerships. Further, rumblings from the federal government indicate possible regulatory or statutory changes to reduce or disallow the gift and estate tax advantages from using family partnerships to transfer family wealth.

A. Potential Changes to Federal Statutory and Regulatory Law

One of the advantages of using limited partnerships to transfer family wealth is that the rights and powers of the limited partners to manage or control the entity are defined by state law. For example, a limited partner under state law does not have the power to manage the business affairs of the partnership or the power to cause the partnership to liquidate. One of the byproducts of the legal relationship between limited partners and a partnership is that potential purchasers of the limited partner interest will discount the value of the interest because it does not include the right to manage the partnership. This lack of control often causes limited partnership interests to be less "valuable" to current and prospective partners. The discounts applied to limited partnership interests are commonly referred to as the "lack of marketability" discount and the "minority interest" discount.

Congress enacted Internal Revenue Code ("Code") Section 2704 to limit the use of valuation discounts for gift and estate tax purposes. In general, Code Section 2704(b)(2) provides that when valuing an interest in a family-controlled entity, the existence of a restriction on the right to liquidate the entity will be disregarded. Code Section 2704 also identified certain types of restrictions that would be excluded from the definition of a "disregarded restriction," thus allowing those restrictions to impact valuation. The primary exception was that any restriction imposed by federal or state law would not be disregarded. This exception made it possible to avoid Code Section 2704 by imposing restrictions on liquidation that were no more restrictive than state law.

In 2009, the IRS identified seventeen work projects relating to estates, trusts and gifts in its 2009-2010 Priority Guidance Plan. One of the identified projects was to provide "[g]uidance under Code Section 2704 regarding restrictions on the liquidation of an interest in a corporation or partnership."

In addition, the Department of Treasury issued the General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals (the "Greenbook"), which included a change in law to expand the definition of "disregarded restrictions" under Code Section 2704 applicable to family-owned partnerships, LLCs and corporations. The same proposals were included in the Administration's budget proposal for 2011.

If Congress addresses gift and estate tax reform this year, it is likely that part of the reform would include action to limit the use of valuation discounts in family-owned entities. In the absence of Congressional action, the IRS could issue the Code Section 2704 regulations that it has been working on for a number of years. These statutory or regulatory changes would apply to the valuation of existing family partnerships, LLCs and corporations for gift and estate tax purposes.

With all of these potential changes on the horizon, it is no longer safe to assume that clients with family-owned businesses will be able to claim significant valuation discounts for gift and estate tax purposes.

There is a window of opportunity to review existing family partnerships, LLCs and corporations to ascertain client interest in capturing family entity discounts that exist under current law through lifetime transfers. Possible methods to transfer interests in these entities include:

- **Taxable Gifts**, possibly at the 35 percent gift tax rate in effect for gifts in 2010;
- **Installment Sale to a Grantor Trust**, that could be structured to take advantage of the current low federal rates and to minimize gift and capital gain taxes; and
- **Grantor Retained Annuity Trusts**, that could be structured to transfer much of the future appreciation of the assets to the next generation.

B. Court Cases That Address Gifting in the Context of Family-Owned Businesses and Strategies to Address the Challenges.

Even if some or all of the potential changes discussed above do not come about, the IRS continues to litigate family entity gift and estate tax valuation cases. And, as the cases summarized below demonstrate, the IRS has had success in attacking family entity transfers on several fronts.

1. Annual Exclusion Issues

a. Gifts of Family Partnership or LLC Interest May Not Qualify for Annual Exclusion From Gift Tax Under Code Section 2503(b).

In general, the annual exclusion is available for gifts of present interests in property. Treas. Reg. 25.2503-3(a). Under that regulation, a present interest in property is defined as an unrestricted right to the immediate use, possession or enjoyment of the property or the right to the income from property.

In *Price v. Commissioner,* T.C. Memo 2010-2 (January 24, 2010), the Court determined that gifts of interests in a family partnership did not qualify for the gift tax annual exclusion because the partners could not sell or liquidate their partnership interests without the unanimous consent of the other partners, and the partnership agreement did not require regular distributions to the partners.

In *John W. Fisher v. United States*, 105 AFTR 2d 2010-1347 (U.S. District Court, Southern Dist. of Indiana, March 11, 2010), the taxpayer transferred interests in an LLC to family members. The taxpayer, as manager of the LLC, held discretionary control over distributions by the LLC. The LLC agreement allowed the members to transfer their rights to profits and distributions subject to a right of first refusal. The Court concluded that the transfers did not qualify as tax free annual exclusion gifts because the recipients did not receive a substantial present economic benefit in the LLC interests. The Court identified two primary factors in support of its conclusion: (i) the manager retained discretionary control over LLC distributions; and (ii) the members' rights to freely market or liquidate the interests were subject to a right of first refusal. Thus, the recipients did not have either the right to income from the LLC interests or the right to liquidate or sell the LLC interest. The same rationale could apply to gifts of corporate stock and partnership interests subject to similar transfer and liquidation restrictions.

The decisions in *Price* and *Fisher* are consistent with the earlier Tax Court decision in *Hackl v. Commissioner,* 118 TC 279 (2002) *affd sub nom* 225 F3d 664 (7th Cir. 2003). With respect to a gift of an interest in a partnership or other entity, the recipient must have, at the time of the gift, either the right to sell or liquidate his or her interest or the right to the income from the interest. For these reasons, the conclusions reached in the *Price, Fisher* and *Hackl* cases are also consistent with the requirements for the annual exclusion from gift tax as set forth in Code Section 2503(b).

b. Strategies for Maximizing the Likelihood of Qualifying Transfer of a Partnership Interest as a Present Gift.

There are several possible methods to qualify a partnership interest to be a present interest gift. One solution is to draft the partnership agreement to cause the partnership interest (or assignee interest if the assignee is not admitted as a partner) to be freely transferable. The interest can grant the new partner the ability to require the partnership to purchase his or her partnership interest for its fair market value (referred to as "put right"). The put right can be drafted to continue indefinitely or to expire after a reasonable amount of time. The second method is to permit the new partner to sell his or her interest free of any restrictions for a limited period of time following the transfer. If the partner receiving the interest can liquidate it or sell it for fair market value, then the new partner should be deemed to hold a present interest in the partnership eligible for the annual exclusion. The well-established guidelines developed in connection with

Crummey withdrawal powers (with respect to notice of the right and reasonable exercise period) should be relevant to define the time frame and scope of a put right or unrestricted sale right.

The partnership interest will be treated as a present interest if the new partner has the right to the immediate use, possession or enjoyment of the income from the interest. This part of the present interest definition is harder to apply to partnership interests because of the management structure of a partnership. In *Hackl*, the Tax Court concluded that the taxpayer must show that the partnership was income producing at the time of the gift, that the partnership would make regular distributions of the income to the donee partners and that the distribution of income can be readily ascertained. In general, this means that the distribution of income or cash from the partnership must be required rather than discretionary and that the distribution be generally definable. An analogy can be made to the definition of "income" as defined for trust accounting purposes.

2. Limitations on Minority/Lack of Marketability Discounts.

In *Holman Jr. v. Comm.,* 105 AFTR 2d 2010-1802 (8th Cir. April 7, 2010) *aff'g* 130 TC 170 (2008), the taxpayer created a family partnership to own stock in Dell and made gifts to his children of partnership interests over several years. The partnership agreement included a laundry list of the partnership's intended non-tax purposes. The Tax Court focused on the fact that the partnership held only Dell stock. The evidence presented at trial by the taxpayer was limited to assertions that the partnership was necessary to maintain ownership and control of the Dell stock. The Tax Court noted that the partnership in this case did not engage in any business, did not hold shares in a closely-held business, and that the testimony did not establish a non-tax business purpose. The Tax Court concluded that the transfer restrictions and right of first refusal rights could be disregarded under Section 2703. The Tax Court, however, allowed the gifts to be treated as gifts of partnership interests (as compared to gifts of the Dell stock).

The Eighth Circuit agreed that there was ample support for the Tax Court's conclusion that the transfer restrictions were not a bona fide business arrangement because the taxpayers' predominate purposes were estate planning, restricted wealth transfer and tax reduction, and therefore should be disregarded. The Eighth Circuit did confirm the minority interest and lack of marketability discounts allowed by the Tax Court, which differed for each year but ranged in aggregate between 17 and 26 percent.

In *Suzanne J. Pierre v. Comm.*, 133 TC No. 2 (August 24, 2009), the taxpayer created a single member LLC, transferring cash and marketable securities. Twelve days later, the taxpayer created two trusts, transferring a 50 percent interest in the LLC to each trust by gifting 9.5 percent and selling 40.5 percent to each trust in exchange for a promissory note. The gifted and sold shares were valued pursuant to an expert appraisal, applying discounts for lack of marketability and minority interest. The IRS asserted that, because a single member LLC is a "disregarded entity" for certain federal tax purposes under the "check-the-box" regulations, the transfers by the taxpayer should be characterized as a transfer of the underlying assets of the LLC, and not of interests in the LLC subject to discounts for lack of marketability and minority interest, and valued accordingly. The Tax Court held for the taxpayer, reasoning that state law has always defined the interests and rights of the parties, and federal tax law has then determined the tax consequences of those interests and rights. The Court found that, under state law, the assets in the LLC belonged to the entity and were not the taxpayer's to give, and therefore the transfer was a transfer of LLC interests and was subject to discounts. In a separate opinion, *Suzanne J. Pierre v. Comm.*, TC Memo 2010-106 (May 13, 2010), the Tax Court addressed the argument of the IRS that the step transaction doctrine should apply to the transfer of LLC interests to the trusts, so that the transfer should be valued as gifts of 50 percent interests in the LLC to the trusts, to the extent the value of these gifts exceeded the value of the promissory note, rather than as separate transfers of the 9.5 percent interests by gift and the 40.5 percent interests by sale. The Tax Court held for the IRS, finding that the gift and sale occurred simultaneously and that there was "nothing of a tax-independent significance" to the two transactions, that they were planned as a single transaction, and that the multiple steps were used solely for tax purposes. The result of this finding was that the transfer of a 50 percent interest, as opposed to separate transfers of the 9.5 percent and 40.5 percent interests, affected the minority discount applicable to the transfer (based on expert testimony, the Tax Court reduced the applicable discount from 10 percent to 8 percent). The lack of marketability discount remained the same.

In summary, courts have continued to hold that transfers of interests in family limited partnerships are to be valued as transfers of interests in a business entity, and not as transfers in the underlying assets held by the entity. While these holdings are beneficial to clients in that they leave open the opportunity to claim lack of marketability and minority interest discounts when transferring interests in the entity, it is also important for clients to be aware that a "standard" discount level for the transfer of interests in a family limited partnership cannot be assumed. Rather, the particular facts surrounding the formation and operation of the entity in question, as well as the facts related to the transfer of interests in the entity, will significantly impact the value of the discounts to be applied. The family limited partnership must have a legitimate business purpose, unrelated to any tax planning or testamentary motives. The entity's business purpose must relate to the assets it holds, and the entity must be managed and operated to carry out this business purpose. Finally, the limited partnership operating agreement must be carefully drafted to address the argument that the transferor has retained control over transferred interests in the family limited partnership and that the transfers of interests qualify for the $13,000 annual gift tax exclusion.

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