CURRENT CHALLENGES TO THE FAMILY LIMITED PARTNERSHIP SCHEME FOR ESTATE PLANNING

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With careful planning, taxpayers can avoid IRS attacks on FLPs as estate planning vehicles.

Family limited partnerships (FLPs)[1] have been in "play" as an estate planning tool since at least the mid 1990's.[2] It is almost self-evident that the IRS considers the FLP as a device that has been much abused by taxpayers to depress values and rob the U.S. Treasury of funds to which it believes itself entitled. It is the quintessential device to prevent rich people from paying "their fair share." According to the Service, the FLP is more about achieving a " discount" on the value of the decedent's interest in the entity than about what it should be—a family investment/business succession plan.

Usual IRS attacks on family entities

Suspecting a nefarious objective by estate planners and their clients, the IRS has used a panoply of weapons to challenge the very formation of FLPs, as well as the discounting of the value of assets placed into such entities. Of course, these challenges almost always involve a decedent's estate, although occasionally the IRS may question the value reported on a gift tax return.

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These challenges generally have fallen into the following categories:

- Lack of economic substance.
- Lack of a "bona fide" arrangement (Section 2703).
- Assignee interest only at death (Section 2704(a)).
- Transferor's retain control (Section 2704 (b)).
- Retained life interest (Section 2036).
- Gifts on formation.
- Discounting the FLP interest.
- Step transaction theory.

Lack of economic substance. FLPs that have only readily marketable securities or passive investment assets are prone to attack as lacking a business purpose; at times, the IRS will argue that there is no economic substance to the FLP when entity formalities were not followed. This no longer seems to be an independent basis for attack but, as will be discussed below, is now part of the larger Section 2036(a) attack.

The IRS generally loses "lack of economic substance" arguments. If state law supports the creation of the entity, courts will not limit their utility. Even when a court has suspicions as to the non-tax motives for the creation of the entity, it usually recognizes the economic substance of the entity. Only when the IRS can clearly show that the entity formalities were not strictly followed—either in formation, operation, or making gifts—is the IRS successful.

Economic substance can be greatly enhanced by following the suggestions at the end of this article, which include documenting the business succession objectives of the new family entity, engaging the participation of younger family members, and documenting important business actions.

Section 2703. The operating agreement contains restrictions on the right to transfer underlying property that must be ignored unless the restrictions are (1) "bona fide" arrangements; (2) not a testamentary substitute; and (3) are similar to other arm's-length transactions.[3] The IRS has consistently lost in its attempts to have the entity ignored under Section 2703. Courts, however, will apply Section 2703 in valuation determinations based on transfer restrictions if the restrictions are greater than would be found in arm's-length transactions.[4]

Section 2704(a)—lapsing rights. Under this challenge, the IRS asserts that an operating agreement containing a provision that converts a decedent's or transferee's limited partnership interest to a non-voting, assignee interest only upon death may constitute a taxable transfer under Section 2704(a) as a non-permitted lapsing, liquidating or voting right. The IRS's argument based on Section 2704 (a) was raised for the first time in a 2000 Field Service Advisory (FSA 200049002),[5] but has not yet been addressed by any court.[6]

Section 2704(b). Restrictions on liquidation or withdrawal that are more restrictive than required by state law are to be ignored for valuation purposes when the transferor controls the entity. IRS challenges based on Section 2704(b) generally are ineffective in a properly structured entity, especially when states have changed their laws to make limited liquidation and withdrawal rights the default rule.[7]

Because of the IRS's lack of success in attacking discounts, Treasury has once again proposed that Section 2704(b) be expanded to "modify the rules with respect to discounting."[8] In effect, discounting would be impermissible in the FLP context unless the FLP contained an *active* trade or business. Thus, an FLP with only investment assets would no longer be eligible for minority-interest or lack-of-marketability discounts.

While this matter remains on the Treasury wish list, it was not part of the Fiscal Cliff negotiations in 2011. It could, however, be included in either a broad overhaul of the Code (that both Republicans and Democrats profess to want) or, perhaps more likely, as part of the ongoing fight over Republicans' demand for spending cuts in return for further raising the debt ceiling.

Section 2036. Under Section 2036(a)(1), the gross estate of a decedent will include, at date-of-death value, all assets over which the decedent has retained, by express or implied agreement, the right to control the possession, use or enjoyment. Section 2036(a)(2) separately mandates inclusion of all assets over which the decedent had the right, either alone or in conjunction with others, to designate the person who shall possess or enjoy the property or income thereof. The IRS has met with considerable success in challenging family entities under Section 2036, primarily because it has litigated only the most abusive cases.

In the latest taxpayer loss, *Estate of Liljestrand*,[9] an FLP established seven years prior to death was disregarded, in part because the accountants did not know of, or account for, the FLP's existence for four years after its formation. The Tax Court concluded that the transfer to the FLP was not a bona fide sale for significant non-tax reasons when:

- Only one partnership meeting was held since the partnership's formation, and no minutes were ever kept.
- The decedent failed to treat the partnership as a separate entity, and he used FLP assets to pay personal expenses.

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[1] This article uses the term, family limited partnership or family limited liability company, interchangeably as the FLP.

[2] One of the first Tax Court decisions to address the use of FLPs as an estate planning device was Estate of Schauerhamer TCM 1997-242, which applied Section 2036(a) to cause FLP units previously given as gifts to be included in the decedent's estate.

[3] Section 2703(b)

[4] Holman, 130 TC 170 (2008), aff'd 601 F.3d 763, 105 AFTR 2d 2010-1802 (CA-8, 2010) (restrictions ignored because entity was formed solely to hold Dell stock, and was not a bona fide business).

[5] FSA 200049002. FSAs are non-binding, non-precedential guidance to IRS auditors.

[6] In Estate of Reichart, 114 TC 144 (2000), the IRS raised Section 2704(a), but the court failed to reach the issue

[7] See e.g. Kerr, 113 TC 449 (1999). In Holman, *supra* note 4, the IRS abandoned reliance on Section 2704(b) at trial.

[8] The Treasury Department's "General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals" (popularly called the "Greenbook") was released on 5/11/09. At pages 119-23, three revenue-raising proposals are described under the heading "Modify Estate and Gift Tax Valuation Discounts and Make Other Reforms."

[9] TCM 2011-259.

- The transfer was not for good and adequate consideration.
- The interests credited to each partner were not proportionate to the fair market value of the assets contributed by the partner.
- The assets contributed by each partner were not properly credited to their respective capital accounts.
- The court found "especially significant that [the FLP] failed to maintain capital accounts upon formation of the partnership in 1997 and used neither the values established in the...appraisal nor the fair market value of the real estate to establish the value of each partner's [FLP] interest."

Having concluded that the transfer was not a bona fide sale for adequate and full consideration, the court found that the decedent retained the possession or enjoyment of, or the right to income from, the property he transferred to the FLP when:

The IRS has consistently lost in its attempts to have the entity ignored under Section 2703.

- The decedent used partnership assets to pay personal expenses.
- Although the decedent retained some assets outside the FLP, he lacked sufficient funds outside of the FLP to maintain his lifestyle and to satisfy his future obligations.
- The decedent transferred nearly all of his assets to the FLP.
- The decedent's relationship to the assets remained the same before and after the transfer.
- The FLP served as an alternate vehicle through which the decedent was able to provide for his children at his death.
- Under the FLP, the decedent was guaranteed a preferred return of 14% of the value of his Class A limited partnership interest, i.e., to $43,400. The appraisals estimated the FLP's annual income would equal $43,000. The guaranteed return was indicative of an agreement to retain an interest or right in the contributed property.

In *Estate of Stone*,[10] a case in which the taxpayer emerged victorious, the decedent and her husband owned large tracts of undeveloped woodlands. After construction of a dam, the woodlands abutted the resulting lake and, as a family asset, took on new importance as a potential development project. The decedent wanted to give portions of the land each year to her children and, on advice of counsel, formed an FLP as a more convenient and efficient way to make gifts.

Essential ingredients of the FLP were:

- The FLP placed substantial restrictions on transferability by limited partners. The general partner (the decedent) had considerable power to decide on distributions. The general partner could be dismissed only on a vote of two-thirds of the limited partners.
- Between 1997 and 2000, the decedent retained only 2% of the LP units and all the general partner units.
- During the term of the FLP, two of the children divorced and, in each instance, some of the woodland property was taken out of the FLP and transferred to the former spouse to ensure that the former spouse would not be a member of the FLP. However, the quitclaim deeds executed by the former spouses were not to the FLP, but to the spouse.
- There was no development of the woodlands. The FLP had a bank account, but it was closed after a couple of years. The FLP's only expense was property taxes, which the decedent paid from his personal funds.

The IRS argued that the transfers to the FLP fell within Section 2036 because it was not a bona fide sale for adequate consideration and the decedent retained an interest or right to the property or income of the property transferred. The Tax Court rejected the IRS claims and upheld the FLP. The transaction met the bona fide sale exception because the transaction had significant nontax motives. The court listed the factors to be considered in determining nontax motives:

- The decedent standing on both sides of the transaction.
- The decedent's financial dependence on distributions from the FLP to maintain lifestyle.
- The commingling of partnership funds with funds used for personal activities.
- The failure to transfer title to the property to the FLP.
- The discounting of the value of the units received versus the underlying value of the property transferred to the FLP.
- The decedent's age and physical condition at the time of creation.

The court again noted that there are two prongs in determining whether the bona fide sale exception exists:

1 Whether the transaction qualified as a bona fide sale.

[10] TCM 2012-48.

[11] Citing Estate of Bongard 124 TC 95 (2005).

[12] TCM 2012-73.

2. Whether the decedent received adequate and full consideration.

The court noted that while gift-giving is not a valid business purpose for the establishment of an FLP, in this case, there were other motives as well, such as creation of a "family asset" to be managed by family members. The court also found that the decedent received fair value for the property contributed to the FLP.

In the children's divorce proceedings, the court did find that the formalities of the FLP were not respected. However, it found other factors to support the bona fide sale exception:

- The decedent neither transferred all her assets to the FLP nor was she dependent on the FLP to maintain her lifestyle.
- Title to the woodland property had been placed in the FLP.
- Although the decedent was over age 70 when the FLP was formed, she lived for more than seven years and her husband was still alive at the time of the trial in 2011.
- There was no discounting of the value of the partnership interests.
- The Court distinguished *Estate of Liljestrand*, noting that, while the decedent was on both sides of the transaction and controlled the FLP, "[t]he transaction is arm's length when mutual and legitimate and significant nontax reasons exist for the transaction and the transaction is carried out in a way in which unrelated parties to a business transaction would deal with each other."[11]

In *Estate of Kelly*[12] (another taxpayer win), the decedent was actually incompetent when the FLPs were created; the plan was approved by the probate court to further her desire to have her estate equally divided among children when changes in asset values since the date of execution of the will would have resulted in unequal distributions of value to her children. One of the FLPs contained a quarry where the issue of personal liability had been a continuing issue.

The general partner was a corporation, owned 100% by the decedent, but managed by her children. The management fee was a fixed percentage of the assets of the various FLPs; while there could have been distributions to the decedent, none were made to her as the shareholder of the corporate general partner. Nonetheless, the IRS claimed that payment of any management fee to the entity was an impermissible retention of control in the property, thereby implicating Section 2036(a).

As to the partnerships, the IRS contended that they lacked any business purpose and the transfers were not for full value. The IRS asserted that the decedent retained the right to control distributions through the corporate general partner. The IRS assessed a $2 million deficiency.

The Tax Court rejected the IRS arguments, concluding that:

- The estate plan was not principally motivated by estate tax savings. However, the probate court approved the plan in part on the assertion in the pleadings that nearly $3 million in estate tax would be saved if the court approved the plan.
- There were significant issues of potential personal liability with respect to the real estate, especially the quarry, and there were significant nontax reasons to place active real estate in an entity for purposes of management.
- The decedent received fair value for her interests in the various FLPs, and the capital accounts of her interest properly credited her for all the property contributed.
- The decedent's subsequent gifts of FLP units were properly valued and reflected in Forms 709 filed for the three years prior to death. Thus, only the LP interests in several of the FLPs she continued to own at death were required to be included in her estate for estate tax purposes.
- All formalities of the various entities were respected.
- Most importantly, the decedent did not contribute all her assets to the FLPs, retaining more than $1.1 million in liquid assets to pay all her personal needs, thereby negating any assertion that she needed FLP assets to maintain her lifestyle or pay personal expenses. Neither the FLP nor the corporate manager paid any of the decedent's personal expenses.
- There was no Section 2036 issue in the payment of the management fee when the fee was commercially reasonable and, in fact, services were rendered by the managers as contemplated by the management agreement.

Thus, the court concluded that the IRS's assertion that there was an implied agreement to retain an interest in the assets or income of the various FLPs was without basis.

Gifts on formation. At the time of formation of the entity, the decedent made a gift of assets because, in taking back only discounted LP units and giving up control, it is an inherent transfer at less than full value. The IRS has consistently lost the argument that a gift necessarily occurred on creation and funding because of discounts in the value of entity units when the entity was properly created and all other formalities followed.

Discounting the FLP interest. The IRS regularly contests claimed valuation discounts greater than 30% to 35%. It does not generally challenge discounts less than 20%, but seems to be trying to limit discounts to minority interests discounts and to eliminate any consideration of discounts for lack of marketability. However, FSA 200049003 concedes that it might not be able to do so:

Courts hate valuation discount fights. From time to time, the Tax Court threatens to hold entirely for one side or the other. In most cases, however, the court finds some middle ground. Valuation discount cases are highly fact specific, and usually arise in the context of a gift tax return. Discounts have been limited to as little as 15%[13]

Valuation discounts are almost always allowed to some extent if the entity is not ignored on some other grounds.

In Keller,[14] the Fifth Circuit affirmed a district court decision that an estate was entitled to an estate tax refund of $115 million for the discounted value of an FLP that was created during the decedent's lifetime but not fully funded until after the decedent's death. The Fifth Circuit concluded that the FLP was "deemed" to be funded as of the decedent's date of death under applicable state law (Texas), when the "intent of an owner to make an asset partnership property will cause the asset to be the property of the partnership."

The decedent and her husband created joint revocable trusts. Following her husband's death, the decedent was advised that creating an FLP would provide additional protection for her family's assets. The decedent decided to create and fund an FLP with approximately $250 million of cash and bonds, but did not actually transfer the funds to the FLP during her lifetime. The decedent's advisors, working under the impression that the FLP had not been funded, advised the estate to sell $147.8 million of bonds to pay the federal estate tax due.

A year later, one of the decedent's advisors attended a seminar and learned that under Texas law the FLP may have been considered to have been funded at the time of the decedent's death. As such, the estate proceeded to complete any formalities associated with creating and funding the FLP. Because the bonds were deemed to be FLP property, the advisors retroactively structured the sale and payment of estate tax as a loan from the FLP to the estate in exchange for a promissory note payable to the FLP, effective as of the date of the loan.

In addition to the discount allowed in valuing the FLP interest owned by the estate, the Fifth Circuit found that the interest payable to the FLP under the promissory note from the estate was a properly deductible expense of the estate. This determination was made by distinguishing a holding by the Tax Court under similar facts in *Estate of Black*.[15]

Unlike in *Estate of Black*, the estate in *Kelly* did not have to redeem FLP units to satisfy the loan because it had sufficient other illiquid assets to repay its debt to the FLP. As a result, the interest payable to the FLP was properly deductible by the estate. The Fifth Circuit also rejected the IRS argument that the loan should be ignored because the entities—the estate and the FLP—were under common control and little more than a pretense.

The court noted that, after the sale of the bonds to the FLP, the bonds were no longer estate assets. After realizing (after the fact) that the estate had sold off FLP assets, the estate was forced to rectify its mistake. Lacking liquid assets, it borrowed money from the FLP. The court refused to collapse the estate and FLP to functionally the same entity simply because each entity was controlled by substantially similar (although not identical) persons.

Step transaction theory. This theory posits that the gifts of the LP units are tantamount to gifts in the assets contributed to the entity—and thus the entity should be ignored. The IRS has not been successful in asserting indirect gifts when the formalities of the entity are followed in formation and funding as well as making gifts. However, when the gifts of LP units were made the same day the entity was formed and funded—or even where the gifts were made prior to the completion of formation formalities, the IRS has met with some success.[16]

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[13] Knight, 115 TC 506 (2000).

[14] 104 AFTR2d 2009-6015, *aff'd* 697 F.3d 238, 10 AFTR 2d 2012-6061 (CA-5 2012).

[15] 133 TC 340 (2009).

[16] Compare Senda, TCM 2004-160, *aff'd,* 433 F.3d 1044, 97 AFTR 2d 2006-419 (CA-8, 2006) with Holman, *supra* note 4. There were no indirect gifts when FLP units were given as gifts five days after formation of FLP.

[17] 142 F.2d 824, 32 AFTR 750 (CA-4, 1944),

[18] TCM 2012-88.

The value adjustment clause

Because of the 1944 decision of the Fourth Circuit in *Procter*, taxpayers had no hope until recently of seeking to adjust the value of gifts of FLP partnership units if, after audit, the IRS challenged the valuation and determined that the units had a higher per unit value than that reflected on the gift tax return.

Procter.[17] In *Procter*, the following language was set forth in the gift and assignment document:

> The settlor is advised by counsel and satisfied that the present transfer is not subject to Federal gift tax. However, in the event it should be determined by final judgment or order of a competent federal Court of last resort that any part of the transfer in trust hereunder is subject to gift tax, it is agreed by all the parties hereto that in that event the excess property hereby transferred which is decreed by such Court to be subject to gift tax, shall automatically be deemed not to be included in the conveyance in trust hereunder and shall remain the sole property of Frederic W. Procter free from the trust hereby created.

Thus, the transaction would be partially unwound if a court determined that the transaction was a taxable gift.

The Tax Court did not object to the arrangement, but the Fourth Circuit rejected the notion that the transaction could be effectively unwound if it found the transaction was indeed subject to gift tax. The court found such a provision to be against public policy:

> In the first place, [the provision] has a tendency to discourage the collection of the tax by the public officials charged with its collection, since the only effect of an attempt to enforce the tax would be to defeat the gift. In the second place, the effect of the condition would be to obstruct the administration of justice by requiring the Courts to pass upon a moot case. If the condition was valid and the gifts were held subject to tax, the only effect of the holding would be to defeat the gift so that it would not be subject to tax. The donor would thus secure the opinion of the Court as to the taxability of the gift, when there would be before the Court no controversy whatever with the taxing authorities which the Court could decide, the only possible controversy being as to the validity of the gift and being between the donor and persons not before the Court. In the third place, the condition is to the effect that the final judgment of a Court is to be held for naught because of the provision of an indenture necessarily before the Court when the judgment is rendered. It should be remembered that it is not possible to obtain a declaratory judgment from a federal Court as to whether the gift in question is subject to the gift tax.

While there have been several cases sanctioning adjustment clauses in the context of a remainderman charity, for the most part, all attempts by taxpayers to readjust a gift transaction depending on the scrutiny of the IRS have met with failure, irrespective of the method employed to rescind the gift or to require the donee to make a payment for the "excess value."

Wandry.[18] Recently, the Tax Court has set forth a path for adjusting the value of the gift of FLP units if a challenge to the discount claimed is successfully challenged by IRS on audit. In *Wandry*, a couple established an FLP and embarked on a program of making gifts of FLP interests annually. Their estate planning attorney advised them that (1) the number of FLP units equal to the desired value of their gifts on any given date could not be known until a later date when a valuation of the FLP's assets could be made, (2) all gifts should be given as specific dollar amounts rather than specific numbers of membership units, and (3) all gifts should be given on December 31 or January 1 of a given year, so that a midyear closing of the books would not be required. Based on this advice, the following formula clause was used to set the amount of the annual transfers:

> Although the number of Units gifted is fixed on the date of the gift, that number is based on the fair market value of the gifted Units, which cannot be known on the date of the gift but must be determined after such date based on all relevant information as of that date. Furthermore, the value determined is subject to challenge by the Internal Revenue Service (IRS). I intend to have a good-faith determination of such value made by an independent third-party professional experienced in such matters and appropriately qualified to make such a determination. Nevertheless, if, after the number of gifted Units is determined based on such valuation, the IRS challenges such valuation and a final determination of a different value is made by the IRS or a Court of law, the number of gifted Units shall be adjusted accordingly, so that the value of the number of Units gifted to each person equals the amount set forth above, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or a Court of law.

Consistent with the transfer documents, the gift tax returns reported total gifts of $1,099,000, and the schedules supporting the gift tax returns reported net transfers from each spouse of $261,000 and $11,000 to their children and grandchildren, respectively. The schedules, however, described the gifts to the children and grandchildren as percentage interests in the FLP (not specific dollar amounts). The couple's accountant had derived these percentage interests based on an appraisal valuing a 1% interest in the FLP. The IRS audited the couple's 2004 gift tax returns and determined a deficiency based on the percentage interests listed in the schedules to each spouse's gift tax returns.

At trial, the IRS alleged that the couple was liable for the deficiency amount because (1) the gift descriptions, as part of the gift tax returns, are admissions that they transferred fixed FLP percentage interests to the donees; (2) the FLP's capital accounts control the nature of the gifts, and the FLP's capital accounts were adjusted to reflect the gift descriptions; and (3) the gift documents themselves transferred fixed FLP percentage interests to the donees. The IRS further argued that the formula clause created a condition subsequent to the completed gifts and was void for federal tax purposes as contrary to public policy, citing *Procter.*

The Tax Court quickly dispensed with the IRS's first two arguments.

First, the court noted that the description of the gifts on the gift tax return was consistent with the gift tax documents transferring a specific dollar amount of FLP interests. Second, regarding capital accounts being adjusted related to specific percentages, the court determined that the adjustments in the capital accounts were "tentative" and subject to change once final values were determined. Therefore, it concluded that the capital accounts did not control the nature of the gifts by the couple.

The court next addressed the validity of the valuation adjustment clause. It first took note that other federal courts have held that formula clauses were valid to limit the value of a completed transfer.[19] The court then reviewed its opinion in *Petter* regarding its examination of *Procter* and other cases, to draw a distinction between a "savings clause," which a taxpayer may not use to avoid gift tax, and a "formula clause" (in the form of a definitive value), which was valid to limit the value of the assets transferred.

> A savings clause is void because it creates a scenario in which the taxpayer tries to take property back. On the other hand, a formula clause is valid because it merely transfers a fixed set of rights with uncertain value. The difference depends on an understanding of what the donor was trying to transfer.

The *Wandry* court reasoned that as of the date of the transfer, each donee was entitled to a predefined FLP percentage interest expressed through a formula. The transfer documents do not allow the petitioners to take property back. Instead, the documents correct the allocation of FLP membership units among the taxpayers and the donees because the appraisal of the FLP understates the FLP's value. Therefore, the court ruled that the formula clauses were valid.

The court next addressed the public policy concerns expressed in *Procter.* It concluded that there was no well-established public policy against formula clauses. The court reasoned that the IRS's role is to enforce tax laws, not merely to maximize tax receipts. Additionally, the court pointed to mechanisms outside the IRS audit that exist to ensure accurate valuation reporting, especially the fact that the members of the FLP had an interest in ensuring that they were allocated their fair share of profits and not allocated any excess losses.

The IRS originally filed a notice of appeal of the decision—which would have gone to the Fifth Circuit—but then withdrew the appeal. On 11/13/12, the IRS issued a notice that it will not acquiesce to the decision, indicating that in future cases with similar facts it will contest any valuation formula as being tantamount to a savings clause.

Hackl and its progeny: tension between present interest treatment and valuation discounts.

There is no question that two of the principal reasons that have spurred the growth of FLPs are the ability (1) to discount the value of assets placed into the partnership and/or the partnership units from the underlying value of the partnership assets and (2) to leverage the annual exclusion gifts by the use of discounted values.

As discussed repeatedly, the IRS has never reconciled itself to the notion that assets lose value when placed inside an FLP. Much to its consternation, the Tax Court and, for the most part, federal appellate courts have rejected the IRS's underlying premise. It is only when the IRS has been able to convince courts that a partnership is defectively formed, structured, or operated that the entity is either actually or effectively disregarded for purposes of valuation discounts.

The IRS, however, may have finally hit on a new strategy to defeat one of the principal benefits of the FLP—forcing the partnership to be structured in a way that will either qualify gifts of partnership units as gifts of present interest or qualify the units for large discounts; in no event will the FLP be allowed to be structured to qualify for both.

Annual exclusion gifts require that the gift be a "gift of a present interest," It has long been

[19] Estate of Christiansen, 130 TC 1 (2008), *aff'd,* 586 F.3d 1061, 104 AFTR 2d 2009-7352 (CA-8, 2009); Estate of Petter, TCM 2009-280, *aff'd,* 653 F.3d 1012, 108 AFTR 2d 2011-5593 (CA-9, 2011); and McCord, 461 F.3d 614, 98 AFTR 2d 2006-6147 (CA-5, 2006).

[20] Crummey, 397 F.2d 82, 22 AFTR2d 6023 (CA-9, 1968); Rev. Rul. 73-405, 1973-2 CB 321.

[21] 18 TC 279 (2002).

[22] Hackl, 335 F3d 664, 92 AFTR 2d 2003-5254 (CA-7, 2003).

[23] TCM 2010-2.

held that one cannot make a gift of an interest in trust and have that gift qualify as a gift of present interest. The rationale is simple. Assets placed in trust do not allow the beneficiary immediate access to or control over the asset.

One exception is for trusts that contain proper withdrawal rights by the beneficiary—the *"Crummey"* rule.[20] However, see TAM 953200, which held that a trust beneficiary does not have present interest if he or she waives the right to receive notice of transfers to trust. Thus, if a taxable gift were to be made, the donor would (1) have to use a portion of his or her lifetime gift exclusion and (2) be required to file a gift tax return with respect to such gift.

In *Hackl*,[21] the IRS convinced the Tax Court that the restrictions placed on limited partnership units, which were inserted into the operating agreement to increase the ability to discount the value of the units, were so burdensome that the gift of the units was neither a gift of a present interest of partnership income nor a gift of present interest in the assets of the partnership and its capital. Thus, gifts of units may have been entitled to a large discount claimed in valuing the gifts, but the gifts nonetheless did not qualify as gifts of a present interest. The gifts were greater than the lifetime "exemption," so the taxpayer donor faced tax, penalties, and interest because no gift tax returns had been timely filed.

The Seventh Circuit affirmed the Tax Court, holding that the gifts, while outright, were not gifts "of a present interest."[22] According to the appellate court, the LLC's operating agreement foreclosed the donees' ability to realize any substantial present economic benefit.

According to the Tax Court, under the Code, a gift is a gift of a present interest if the donee receives an unrestricted and non-contingent right of immediate use, possession, or enjoyment of property or income from property. The court dismissed the argument that a partnership unit was property that was itself entitled to immediate use and enjoyment by the donee.

First, the court noted that there was no right by a member to use the underlying assets of the entity; thus there was no present interest in the assets of the entity. Second, the restrictions which the Court found unusual showed that there was effectively no present interest in the membership units:

- First, the ability to sell a member interest was hampered by a right of first purchase, the terms of which were favorable to the other members; second, there was a restriction stating that any transferee of a unit without the consent of the manager became a mere assignee (not a member).
- The possibility that a shareholder could sell shares without the manager's approval to a transferee who would not have any membership or voting rights could hardly be called a substantial economic benefit.

One could argue that the court confused present interest analysis with valuation analysis. The existence of the restrictions might well make the units less valuable but should not affect present interest determinations.

Next, the court determined whether there was a gift of a present interest in the income of the member units. In doing so, it employed a three-part test:

1. Was there a receipt of income by the members?
2. Was the income a steady flow to the members?
3. Was that flow of income predicable enough to impart value?

Because the LLC did not make distributions in the first five years of operation, the court ruled that the donee recipients of the member interest received no enjoyment of income from the property.

The court's insistence that, unless the units passed to the donees are receiving immediate income distributions, they lack immediate economic benefit is devoid of reality and in fact wrong. Carried to its logical conclusion, this position says that only a portfolio of investment-grade fixed income securities has economic value at any given point in time.

Price. [23] Most commentators were of the view that *Hackl* was an aberration, the result of unusually stringent restrictions contained in the operating agreement, and would have no lasting impact. That turns out not to be the case, however. In *Price*, the IRS again was able to successfully challenge present interest treatment for gifts of LP units in an FLP, thereby subjecting such gifts to transfer tax liability.

The FLP agreement, formed under Nebraska law, contained very standard provisions:

- The general partner had the sole ability to determine what cash to distribute and in what amounts distributions would be made to the limited partners.
- The limited partners could not compel any withdrawal of their capital accounts or distributions of cash or property from the FLP.

- The limited partners could not compel dissolution of the FLP except on a supermajority vote.
- The limited partners could not sell their LP units to a third party without first offering the interests to the general partner and the other limited partners and then only at the price called for by the buy-sell provisions contained in the FLP agreement.
- A transfer of an LP interest gave the recipient only "assignee" status and not that of a substituted limited partner.
- The general partner made periodic cash distributions to the limited partners. Although not expressly stated, the opinion suggests that the distributions were made in order to pay the income taxes on the partners' allocable share of FLP income. There is no explanation why there was no cash distribution in 1997 or 2001. (It may have been, for instance, that there was no tax liability in either of those years, but it simply is not known.)

The entitlement to a discount and the amount of the discount were not issues in the case, suggesting that the IRS did not attack either. Attacking the claimed discount would have undercut the IRS's argument that the LP units lacked immediate economic benefit.

The court articulated the standard by which to evaluate an LP interest in a FLP for the "present interest" analysis. It rejected the notion that merely because there was an unconditional gift of the equity interest in an entity, such as with an LP interest, the transfer qualified as a present interest gift. Instead, it held that, for the gift to be a present interest, the taxpayer must "establish that the transfer in dispute conferred on the donee an unrestricted and non-contingent right to immediate use, possession, or enjoyment (1) of property or (2) of income from property. Both of these alternatives in turn demand that such immediate use, possession, or enjoyment be of a nature that substantial economic benefit is derived therefrom."

The court determined that the restrictions on alienability set forth in the Price FLP agreement effectively gave no substantial economic benefit to the limited partners in the property, i.e., the LP units themselves. It then applied the second test—whether the donees enjoyed immediate use and enjoyment of the income of the property transferred. The court stated that in order to meet this alternative test, the taxpayer would have to show that:

1. The FLP would consistently generate income.
2. Some portion of that income would flow to the LP units
3. The portion of the income flowing can be "readily ascertainable."

The Court was compelled to concede that the FLP clearly had income and could expect to have income annually from its income-producing real estate and stock portfolio. However, the court found that the FLP agreement neither compelled the flow of income to limited partners nor established a mechanism by which the amount that did flow was "ascertainable". Instead, distributions were at the sole discretion of the general partner.

The court flatly rejected the argument that the general partner had a fiduciary duty to make distributions as being without any basis but further noted that, if such a duty existed, it had been violated. In several of the years at issue, no such distributions had been made. Therefore. the Court concluded that none of the gifts of LP units qualified as gifts of a present interest.

Fisher.[24] Following *Hackl* and *Price*, a district court in *Fisher* concluded that the transfers of interests in a family LLC to children were transfers of future interests in property and, therefore, not subject to the gift tax exclusion under Section 2503(b)(1).

Estate of Wimmer.[25] In *Estate of Wimmer*, the issue before the Tax Court was whether gifts of limited partnership interests made between 1996 and 2001 qualified for the federal gift tax annual exclusion under section 2503(b). The Court held that the gifts did qualify. This was the first taxpayer victory after *Hackl* and *Price*.

In 1996, the decedent formed the George H. Wimmer Family Partnership, L.P. under California law. In 1997, the partnership was reorganized under Georgia law which statutorily imposed a fiduciary duty on the general partner to act in the best interests of the partnership and other partners. The Wimmers were the initial general partners and limited partners.

The partnership agreement generally restricted transfers of partnership interests and limited the instances in which a transferee could become a substitute limited partner. The transfer of limited partnership interests required, among other things, the prior written consent of the general partners and 70% in interest of the limited partners.

[24] 105 AFTR2d 2010-1347 (DC Ind., 2010).

[25] TCM 2012-157.

When the partnership was formed, its assets consisted of publicly-traded and dividend-paying stock. No additional funding of the partnership occurred, and the partnership never held any assets other than the publicly-traded stock and dividends received therefrom. The partnership's primary purpose was to increase family wealth, control the division of family assets, restrict nonfamily rights to acquire such family assets and, by using the annual gift tax exclusion, transfer property to younger generations without fractionalizing family assets.

Partnership profits were allocated to the partners according to their proportional partnership interests. All distributions of net cash flow were also shared among the partners in proportion to their partnership interests. Distributions had to be made in cash pro rata.

The partnership agreement, as amended, provided that the primary source for distributions was distributable cash derived from partnership income. The partnership made distributions to the limited partners in 1996, 1997, and 1998 for payment of federal income tax. Beginning in February 1999, the partnership continuously distributed all dividends, net of partnership expenses, to the partners. Dividends were distributed when received and in proportion to partnership interests. In addition to dividend distributions, limited partners had access to capital account withdrawals and used such withdrawals for, among other things, paying down their residential mortgages.

The Court noted, as it did in *Price*, that the donees, in receiving the limited partnership interests, thereby obtained use, possession, or enjoyment within the meaning of Section 2503(b). However, to qualify as a gift of present interest, there must be a present interest in either the limited partnership interests or the income from those interests.

The court quickly concluded that the donees did not receive unrestricted and non-contingent rights to immediate use, possession, or enjoyment of the limited partnership interests themselves because of the restrictions on transferability. It then considered whether the donees received such rights in the income. In order to satisfy the right to income test, the estate was required to prove that:

1. The partnership would generate income.

HOW WOULD YOU RULE?

In January 2013, Meg purchased her home for $300,000. To finance her purchase, she signed a document described as a "mortgage note," promising to pay her mother $300,000 plus interest in return for a mortgage loan. The mortgage note provided that Meg would pay monthly interest at the rate of 4.5% and that the full principal of the note was due and payable in 2043.

Meg and her mother also signed another document entitled "mortgage." The document provided that Meg was indebted to her mother in the principal sum of $300,000 and further provided that Meg mortgage granted, conveyed, and assigned the property to her mother. The document was not notarized or recorded. Can Meg deduct the interest she paid her mother in 2013 as home mortgage interest?

Solution: No. *DeFrancis*, TC Summary Opinion 2013-88.

Section 163(h) prohibits an individual taxpayer from claiming a deduction for personal interest paid or accrued during the tax year. An exception to that rule in Section 163(h)(2)(D) permits individuals to deduct qualified residence interest. Under Section 163(h)(3)(A), qualified residence interest is any interest paid or accrued during the tax year on acquisition indebtedness or home equity indebtedness secured by the qualified residence of the taxpayer. A qualified residence includes a taxpayer's principal residence, so Meg's home passes that test. Under Section 163(h)(3)(B), however, "acquisition indebtedness" means any debt that is secured by the residence. Meg's mortgage was not recorded or otherwise perfected, and under Temp. Reg. 1.163-10T(o)(1), that means her debt was not "secured" and the interest she paid to her mother was not qualified residence interest.

BULLETPROOFING FLPS

Taxpayers should carry out the following actions to overcome IRS attacks on their FLPs:

1. **Use " formal" LLC or LLP documents—particularly for the operating agreement.**
2. **Use a manager-managed LLC with senior family members (SFMs) not in control of the manager.**
3. **Require junior family members (JFMs) to contribute their own assets for proportionate interests in the LLC.**
4. **Provide for succession of management in the younger generation (the sooner, the better).**
5. **Do not transfer substantially all of the SFM's assets; and do transfer some assets requiring management. Leave the home out. The SFMs should have a base level of support outside of the FLP.**
6. **Do not forget to transfer title to the assets and get insurance on the assets.**
7. **Do not comingle personal assets and FLP assets.**
8. **Follow the operating agreement for all distributions, which must be proportional to ownership interests.**
9. **Perform record keeping as it would be performed for any enterprise.**
10. **Prepare management reports to all members at least annually. Emphasize the "business" aspects of the FLP.**
11. **Better yet, have an annual meeting of the members in a "comfortable" place where time can be taken to update all members on family matters and feuds. Take minutes of the meeting. The meeting is deductible to the LLC and members can bring their professional advisors.**
12. **Remember for "disjointed" families, an FLP might not be the best idea.**

2. Some portion of that income would flow steadily to the donees.
3. That portion of the income could be readily ascertained.

The court found that the estate satisfied the first prong. On each date the partnership made a gift of a limited partnership interest, the partnership expected to generate income.

The limited partners not only received annual distributions but also had access to capital account withdrawals to pay down residential mortgages, among other reasons. Intent notwithstanding, because the donees had no other source of income, distributions of partnership income to the trustee were necessary to satisfy the donees' annual federal income tax liabilities. The Court noted that, unlike the taxpayers in *Hackl* and *Price*, the decedent, in his fiduciary capacity as general partner of the partnership, made distributions each year at issue and was required to do so.

With respect to the third prong, the court found that the portion of income flowing to the limited partners could be readily ascertained when:

- The partnership held publicly traded, dividend-paying stock and was thus expected to earn dividend income each year at issue.
- Because the stock was publicly traded, the limited partners could estimate their allocation of quarterly dividends on the basis of the stock's dividend history and their percentage ownership in the partnership.

On the basis of these specific facts and circumstances, the court found that the limited partners received a substantial present economic benefit sufficient to render the gifts of limited partnership interests' present interest gifts on the date of each gift. Accordingly, the gifts qualified for the annual gift tax exclusion under Section 2503(b). Note that the case did not discuss discounting. The sole issue was whether the gifts qualified for present interest treatment. The IRS stipulated to the values—it is not known whether the value reflected a discount.

Avoiding "gift of present interest" attacks

It is clear that if one wishes to avoid the pitfalls of *Hackl* and *Price*, the FLP agreement must contain suitable provisions to insure that the gift is one of a present interest in either the LP units themselves or in the income attributed to the LP units. Some (or all) of the following provisions should be included in the FLP agreement if the interest in the property is to be treated as a gift of a present interest:

- A limited partner must be able to demand withdrawal of at least his or her capital account without undue limitations.
- A limited partner must be given the unfettered right to sell or assign the LP interests to anyone at any price, and the purchaser must be allowed to become a substituted limited partner.
- A limited partner must have some ability to compel dissolution of the FLP. This right presumably could be subject to substantial restrictions such as a ruling by a court that dissolu-

tion is in fact in the best interest of all partners and would have no adverse tax consequences. An attorney's fees provision awarding fees to the prevailing party in any such dissolution action would further inhibit the exercise of this "dissolution right."

Note that in *Wimmer*, the court expressly found that the restrictions on transferability were sufficient to deny present interest treatment in the partnership units themselves. Obviously, inclusion of any of these suggestions in the operating agreement would seriously affect the amount of discount applied to the gift.

Alternatively, if the present interest is to be predicated not on the property interest of the LP unit themselves but on the income interest arising from the ownership of the LP units, it would be prudent to include the following provisions in the FLP agreement:

- A limited partner must be given the right to obtain his or her capital account or receive payments equal thereto without undue impediment.
- The general partner must be obligated to distribute some portion of profits to the LP units at least annually.
- The general partner must have an obligation to tie the distributions to some ascertainable formula.

Although the court did not articulate how the formula is to be measured, presumably a percentage of taxable income would suffice. The inclusion of these provisions should not dramatically affect the amount of discount, if carefully crafted, because the property interest of the LP units themselves remain subject to substantial restrictions.

Conclusion

It is clear that the IRS is continuing and, in some instances—such as with the use of Section 2036—increasing its attacks on FLPs and their equivalents. The IRS can be expected to continue to litigate the most abusive cases in hopes of developing a body of law that will severely limit the FLP's utility.

As noted, increased attacks on the legislative front to severely limit or even eliminate the ability to discount in FLPs can also be expected. These will almost certainly include resurrecting the Treasury proposal to eliminate or severely limit the discounting of partnership unit values.

While there have been a number of recent taxpayer victories, it is increasingly difficult to reconcile the decisions of the Tax Court. One gets the uncomfortable feeling that the court reaches a decision based on some gut feeling and then spends pages of the opinion justifying its result. It is very difficult to articulate a coherent rationale as to why the taxpayer in *Estate of Liljestrand* should lose and those in the *Estate of Kelly or Stone* should prevail.

It remains to be seen if the IRS will finally relent on the issue of valuation adjustment clauses approved in *Wandry*. As matters now stand, it certainly is worth the effort of trying to take advantage of the decision in formulating gifts of FLP interests or other difficult-to-value assets. It may be that with the preservation of the $5 million estate and gift tax exemption, the IRS will focus on matters more likely to produce tax revenues rather than arguing over valuation adjustment clauses.

Even when the IRS cannot attack the original formation, funding, and original discounting of FLPs, it has now made making gifts of LP interests far more complicated, requiring taxpayers, in effect, to elect between claiming annual exclusion benefits or claiming substantial discounting in the value of limited partnership units, notwithstanding the taxpayer victory in *Wimmer*.

Note, however, if the FLP units are to be sold—such as to a defective grantor trust—and not given as gifts, there is no need to attempt to limit the discounting in order to qualify for the annual exclusion. The constraints placed on gifts of partnership units in order to qualify for the annual exclusion are irrelevant to sales transactions. Indeed, properly structured sales escape the most potent weapons that the IRS has to attack transfers of interests in FLPs, namely Section 2036. This section applies only in the context of transfers for less than full and adequate consideration.