WRMarketplace

An AALU Washington Report

The *WRMarketplace* is created exclusively for AALU members by experts at Greenberg Traurig and the AALU staff, led***by Jonathan M. Forster, Steven B. Lapidus, Martin Kalb, Richard A. Sirus, and Rebecca Manicone.*** **WRMarketplace #17-16** was written by Greenberg Traurig Shareholder Jonathan M. Forster, Greenberg Traurig Associate Ashley B. Sawyer.

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TOPIC: Handle with Care – Eight Lessons from Recent Family Limited Partnership Cases.

MARKET TREND: Despite challenges and recently proposed regulations under IRC §2704, family entities can still play a crucial role in legacy and business succession planning.

SYNOPSIS: Recent cases involving the transfer tax consequences of family entities like family limited partnerships ("FLPs") and limited liability companies ("FLLCs") emphasize that the success of family entities for legacy management requires careful planning in the entity's creation and subsequent administration, including: (1) establishing evidence of non-tax motives, (2) complying with entity formalities, (3) prioritizing business interests in entity operations and management, and (4) ensuring independent and fair treatment of all owners.

TAKE-AWAYS: Despite IRS cases and the proposed IRC §2704 regulations, clients can still use family entities to address both tax and practical issues in their legacy plan. Clients, however, must avoid potential pitfalls in implementation and operation that could expose them and their families to adverse gift and/or estate tax consequences, since even minor or unintentional oversights can serve to undermine FEs created for valid, non-tax reasons. Using existing FLP case law as a road map and working closely with experienced advisors to help implement best practices can help navigate the potential risks and ensure legitimate transactions comply with the applicable rules.

MAJOR REFERENCES: *Est. of Purdue v. Comm'r., T.C. Memo 2015-249; Est. of Holliday v. Comm'r., T.C. Memo 2016-51; Est. of Beyer v. Comm'r., T.C. Memo 2016-183.*

Family entities ("**FEs**"), like FLPs and FLLCs, have become mainstream over the years in planning for business succession, family governance, creditor protection, and legacy management. Intra-family transfers of interests in FEs often generate valuation adjustments for lack of marketability, lack of control, or other voting or liquidation restrictions, allowing for more effective wealth transfers. The IRS, however, consistently scrutinizes FEs used in wealth transfer plans and, last fall, issued proposed regulations under IRC §2704 that attempt to limit "discounts" in the valuation of FE interests for transfer tax purposes (see *WRMarketplaces Nos. 16-33 and 42*). Given significant criticism from numerous tax advisors and legislators though, the fate of these regulations is uncertain.

So, as of now, legacy planning with FEs remains not only viable, but also increasingly attractive for addressing pragmatic planning concerns. Ensuring a successful FE plan and avoiding IRS challenges requires careful management and attention to detail to document proper formation and operation. Heeding the following lessons from recent U.S. Tax Court cases can help, while the attached checklist of best practices provides additional guidance in implementing these lessons.

LESSON #1: KNOW WHERE THE IRS IS COMING FROM

When scrutinizing FEs in transfer tax planning, the IRS looks at the specific facts of each case, typically focusing on the following:

Estate Inclusion. Relying on IRC §2036, the IRS regularly argues for the inclusion of the ***undiscounted value of all the FE's underlying assets***, on the basis that the decedent transferred assets to the FE with a retained right to possess, enjoy, and/or receive income from the assets during life (a "**2036 challenge**").[1] A defense to this argument applies, however, if the objective evidence indicates that: (1) the individual did not retain any rights or interests in the assets transferred to the FE, (2) the transfer occurred pursuant to a bona fide sale, and (3) the bona fide sale was for adequate and full consideration ("**2036 exception**"). The lessons discussed below review actions that can establish (or undermine) that defense.

Invalid Gifts. For gift tax purposes, the IRS often seeks to invalidate a gift of FE interests, arguing that: (1) the gift is really of the underlying property, which may not be subject to a valuation discount, or (2) the gift does not qualify for the annual gift tax exclusion,[2] which could result in gift tax liability for the year of the gift, or perhaps worse, the unexpected use of more gift tax exemption in the year of the gift, which reduces the exemption available for subsequently reported gifts, potentially resulting in additional gift tax.

Invalid Sales. As valuations of intra-family transfers of FE interests typically reflect valuation adjustments for lack of marketability and control, FEs have been a natural complement to legacy planning with installment sales to grantor trusts. In such transactions, the IRS has focused on whether the note represents bona fide debt with economic substance, as opposed to simply a gift of equity to the trust with a retained interest. If the IRS determines the note is not bona fide, it may classify the entire transfer as a gift, resulting in both gift tax on the transfer and estate tax inclusion of the assets due to the grantor's retained interest (the right to receive note payments).[3]

LESSON #2: PLAN WHILE IN GOOD HEALTH

Courts reviewing 2036 challenges often consider the transferor's age and health at FE funding as a factor in whether transfers to the FE were made solely for transfer tax purposes in contemplation of death. In *Purdue*, the IRS alleged that the respective ages of the taxpayers when they created their FE showed that their planning was testamentary in nature. The court disagreed, however, because both spouses were in good health at the time of funding.

LESSON #3: HAVE SIGNIFICANT, LEGITIMATE, & RELEVANT NON-TAX REASONS

The non-tax reasons for creating a FE are the crux of the bona fide sale element of the 2036 exception and must represent true motivators that incentivized the planning (rather than later-identified justifications). Further, the reasons must relate to, and support, the transferor's circumstances. This analysis is intensely fact-specific, as evidenced by recent cases:

- ***Holliday: Pro-IRS.*** The Tax Court rejected the decedent's non-tax reasons for creating her FE due to lack of relevance to her situation. The court determined that: (1) the decedent did not need protection against the undue influence of caregivers because she personally was not concerned about the issue and her sons (who managed her affairs) visited her regularly, (2) creditor claims were unlikely because she had never been sued, and (3) management of her assets in an FE was unnecessary because her spouse's assets were being successfully managed in trust.

- ***Beyer: Pro-IRS.*** The Tax Court found that the decedent's objectives of maintaining consolidated investments and management succession planning were not adequately supported because they could have been easily accomplished through the use of other planning techniques, such as trusts. Further, non-tax reasons were not enumerated in the 28 purposes for the FLP in the partnership agreement.

- ***Purdue: Pro-Taxpayer.*** Conversely, in *Purdue*, the Tax Court viewed the consolidation of assets into an FE as an acceptable non-tax motive for creating the entity because, previously, the taxpayers' assets had been managed through several accounts held with three different management firms.

It's worth noting that, with clients becoming more focused on practical planning issues, non-tax motivations are moving to the forefront of much FE planning, as FEs can address several concerns simultaneously, including: (1) centralized legacy management and succession, (2) development of a coherent family investment philosophy, (3) family confidentiality and creditor protection, (4) family oversight of the fiscal management abilities of younger generations, (5) asset consolidation in a single entity to prevent fractionalized asset ownership, and (6) pooling of assets for cost-efficiencies, greater diversification, and better access to investment opportunities.

LESSON #4: TREAT FE CREATION & FUNDING AS ARM'S LENGTH TRANSACTION

In 2036 challenges, the IRS consistently argues that a taxpayer "stood on both sides of the transaction" and that there was no meaningful negotiation or bargaining. Accordingly, to better withstand IRS scrutiny, the transaction should be carried out in the same manner as unrelated parties would use. Specifically, the transferor should only receive interests in proportion to the value of the assets transferred to the FE. Which assets, and the interests received, should be carefully valued contemporaneously with the transfer by an experienced and qualified appraiser. Further, if the FE planning involves an installment sale, the economic substance of the note transaction should be documented and all formalities filed (see *WRMarketplaces Nos. 15-09* and *17-13* for a detailed discussion of installment sale considerations). Under *Purdue*, these actions are presumed to be how unrelated parties would act in a similar transaction and should satisfy the 2036 exception requirement of a bona fide sale for adequate and full consideration.

LESSON #5: RETAIN ADEQUATE LIFESTYLE CAPITAL

The IRS regularly alleges in 2036 challenges that the taxpayer had an implied agreement or understanding with the FE to retain the enjoyment or income from the transferred assets. The IRS relies on several factors to show that: (1) the taxpayer transferred almost all his or her assets to the FE, and/or (2) the taxpayer continued to use or control the transferred assets post-transfer, which may include:

- Continued use of the assets in the form of non-pro rata distributions to the taxpayer or distributions based on an FE owner's personal needs (rather than business needs);
- Significant distributions to pay for the gift and/or estate tax liabilities of a taxpayer, particularly if the taxpayer no longer holds any FE interests;
- Failure to retain assets outside of the FE sufficient to maintain the taxpayer's lifestyle and obligations; and
- The FE agreement provides an unconditional entitlement to FE owners to receive distributions, even if the taxpayer never needed or received such distributions.

LESSON #6: ENSURE GIFTS OF FE QUALIFY FOR ANNUAL EXCLUSION

Implementing the legacy planning aspects of FEs often requires that a gifted FE interest qualify for annual gift tax exclusion. The IRS may challenge these annual exclusion gifts on the basis that such gifts fail to provide a "present interest"—i.e., they do not provide the recipient ("**donee**") with a current right to the use, possession, or enjoyment of the gifted property or the income therefrom—since the FE agreement may restrict the donee's rights to transfer the interest, deny voting rights, and/or limit distributions. To minimize this exposure: (1) the FE should generate income, (2) some portion of that income should flow to the donee, and (3) the donee's portion of the income should be easily ascertained.

For example, in *Purdue,* the Tax Court found that the taxpayer's gifts of FE interests qualified for the annual gift tax exclusion because the FE's real estate assets produced income from rent, and its publicly-traded securities paid dividends, both of which were ascertainable. In addition, the FE made regular distributions to the owners, which were irrevocable trusts that then made distributions to the trust beneficiaries. Note, however, that if the transferor has not also released all rights and interests in the property of the FE, a gift of an FE interest will fail to qualify for the annual gift tax exclusion.

LESSON #7: RESPECT ENTITY FORMALITIES & ACT LIKE A BUSINESS

The failure to follow entity formalities and to operate the FE as a legitimate, independent business entity often provides the IRS with "low-hanging fruit" to argue that a FE should be disregarded for gift and estate tax purposes. For example, in *Beyer*, actions that delegitimized the validity of the FE included: (1) the failure of the general partner to open a bank account, (2) significant distributions (including for estate tax payments) for the taxpayer although no longer a partner, (3) failure to make pro rata partner distributions, (4) filing partnership returns that failed to recognize the interests owned by all partners, and (5) failure to maintain the partners' capital accounts. The FE's legitimacy is further diminished if it fails to engage in business activities, such as active management and/or trading of assets and investments.

Accordingly, an FE should be legally created under applicable state law and abide by its operating documents. Owners should respect the formalities outlined in the operating documents, maintain books and records with respect to entity property, conduct formal meetings of owners, record meeting minutes, and make pro rata distributions to owners based on standards specified in the operating documents (and based on business, not personal, needs).[4]

LESSON #8: BE PREPARED TO SHIFT THE BURDEN OF PROOF

Typically, when the IRS challenges a FE, the taxpayer has the burden to disprove the IRS's allegations. Under IRC §7491(a), however, if a taxpayer produces credible evidence with respect to any relevant factual issue pertaining to a tax liability proceeding, the burden of proof shifts to the IRS. Thus, a strong, well-documented record of proper FE implementation and operation in a case may help the taxpayer in a 2036 challenge shift the burden of proof to the

IRS. Taxpayers, however, must be prepared to take advantage of this opportunity. For example, in *Purdue,* although the final determination was in the taxpayer's favor, the estate failed to argue or establish during trial that the IRS should bear the burden of proof, potentially making the estate's case more difficult to argue.

TAKE-AWAYS

Despite IRS cases and the proposed IRC §2704 regulations, clients can still use family entities to address both tax and practical concerns in their legacy plan. Clients, however, must avoid potential pitfalls in implementation and operation that could expose them and their families to adverse gift and/or estate tax consequences, since even minor or unintentional oversights can serve to undermine FEs created for valid, non-tax reasons. Using existing FLP case law as a road map and working closely with experienced advisors to help implement best practices can help navigate the potential risks and ensure legitimate transactions comply with the applicable rules.

FAMILY ENTITIES ("FE") – BEST PRACTICES CHECKLIST

YES	NO
• Have a significant, legitimate, and relevant non-tax reason for forming the FE. Set out these reasons in the FE agreement and use as a guide in FE administration. • Properly execute and file all FE formation documents and state annual disclosures as required by state law. • Have a formal FE agreement signed by each founding owner, who ideally has separate representation. • Obtain a separate taxpayer identification number for the FE. Must be used to conduct FE business. • Properly fund the FE. Title assets contributed to the FE in the FE's name on a timely basis. • Ensure owners' FE interests are proportionate to value of contributions (obtain appraisals to support values). • Ensure that only authorized individuals (general partner, manager) manage the FE and act on its behalf. • Adhere to FE agreement protocols in making FE investments and distributions. • Make pro rata distributions of FE income. Contributions to capital (*i.e.*, capital calls) by owners also should be proportionate to ownership interests. • Open a separate bank account for the FE that is used for FE deposits, expenses, and distributions to owners. • Use FE letterhead to conduct FE business. The FE also should have its own email account for FE business.	• Do not comingle FE assets/accounts with those of other owners or persons. • Do not allow owners to transfer almost all personal assets to the FE. Each owner should retain sufficient assets to maintain his or her standard of living for his/her anticipated lifetime. • Do not permit owners to have personal use of FE assets. Any use of FE real property should be pursuant to a formal lease between the owner and the FE and should be for fair market value. • Do not let the FE pay personal expenses of owners, or allow partners to personally pay FE expenses. The FE also should not pay an owner's estate taxes or administration expenses, but the FE can make loans for these purposes with appropriate documentation and interest. • Do not make gifts of FE interests immediately after creation of the FE. Ideally, a significant period of time will pass between the formation and gifts. • Do not ignore formalities of associated planning (e.g., installment sales to grantor trusts).

FAMILY ENTITIES ("FE") – BEST PRACTICES CHECKLIST	
YES	**NO**
• Hold regular owner meetings and retain minutes. • Keep FE activities and owners' personal lives separate. • Maintain proper books and records. • Timely file federal gift tax returns that adequately disclose gifts or other transfers of FE interests to start statute of limitations running. • Timely file FE income tax returns and issue K-1s.	

DISCLAIMER

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NOTES

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[1] IRC §2036(a). *See e.g., Holliday*. Despite taxpayer's gift of limited partner interest to an irrevocable trust during her life, the court found that there was no bona fide sale when taxpayer transferred property to the FLP, thus the full undiscounted value of all property transferred by taxpayer to the FLP was includible in her estate.

[2] *Purdue*.

[3] If the IRS re-characterizes an installment sale to a trust as a contribution to the trust with a retained right to receive payments pursuant to the note, the transaction would fall under Code §2702, dealing with the valuation of retained interests for gift tax purposes. Since the retained interest would not represent a qualified annuity interest (as under a GRAT), the installment note would be valued at $0, resulting in a gift of the entire value of the asset sold. The estate tax inclusion also arises under Code § 2036, as a transfer of property by the grantor with a retained interest.

[4] In *Purdue,* FE members met regularly to discuss accounts and assets, ratify prior distributions, approve annual cash distributions, and meet with advisors on investment and planning strategies. The FE transferors did not attend any of these meetings.