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Financial Planning

Reports of the Death of the Family Holding Company Have Been Greatly Exaggerated

Recent decisions have made tax planning with family entities a minefield, but one that can be navigated with careful planning

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As a part of any comprehensive financial plan, the use of family limited partnerships and family limited liability companies has become an extremely popular means to achieve the reduction of gift and estate taxes. With the release of several recent Tax Court cases involving such entities, however, questions have arisen as to the continued viability of these planning vehicles.

As a result of these cases, tax planning with LPs and LLCs has indeed become a minefield, but one that can be successfully navigated with careful planning to remove gifted LP and LLC interests from estates while still retaining control of the entity.

Background

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Although taxpayers were victorious in most decisions involving family entities in the 1990s, several critical cases have recently been decided in favor of the Internal Revenue Service. In *Estate of Hackl v. Commissioner*, 118 T.C. 14 (3-27-02), the Tax Court concluded that gifts of membership interests in an LLC that operated a tree farming business did not confer a substantial present economic benefit to the recipients and therefore did not qualify for the gift tax annual exclusion.

The court rejected the argument that an outright transfer of equity is automatically a gift of a present interest. The court held that since the recipients of the gifted membership interests did not have an unrestricted and noncontingent right to the immediate use, possession or enjoyment of property or income from the property, the gifts did not qualify as annual exclusion gifts. This holding was recently affirmed on appeal.

Other recent cases have considered the estate tax impact of family entities owned by a decedent. In *Estate of Harper v. Commissioner*, T.C. Memo. 2002-121 (filed 5-15-02); *Estate of Kimbell v. Commissioner*, 244 F.Supp. 2d 700 (D.C. Tex. 2003); *Estate of Thompson v. Commissioner*, T.C. Memo. 2002-246 (filed 9-26-03); and *Estate of Strangi v. Commissioner*, T.C. Memo. 2003-145 (filed 5-20-03), the IRS was successful in its attempt to impose an estate tax on the underlying assets of the partnership.

Each of these cases applied §2036(a)(1) of the Internal Revenue Code and concluded that where a decedent effectively retained the right to the use and enjoyment of partnership assets, the underlying assets in the entity contributed by the decedent were includable in the decedent's estate, with no valuation discounts available. This held true even where gifts of interests in the entity had been made by the decedent.

Strangi's Alternative Holding

Most startling, however, in the recent *Strangi* case, the Tax Court went one step further. In its alternative holding, it concluded that where a decedent retained the right to participate in decisions regarding the liquidation of the partnership and partnership distributions, the percentage of the underlying assets attributable to the decedent's contribution to the LP were includable in the decedent's estate under §2036(a)(2).

In *Harper*, the court held that the full value of a partnership's assets (with no discounts) was includable in a taxpayer's estate, despite the fact that the taxpayer only owned a 99 percent limited partner interest in the entity. This ruling was based on the fact that the taxpayer had retained the right to the use and enjoyment of the partnership property until the time of his death.

The court held that the partnership was a testamentary vehicle and that there was an implied agreement that the taxpayer would retain the economic benefit of the partnership's assets, holding that this implied agreement caused inclusion under §2036(a)(1), which applies where a decedent retains for life the use, possession, right of income or enjoyment of transferred property.

The only exception to this rule applies in the case of a bona fide sale for adequate and full consideration. The court held that the taxpayer's transfer of assets in exchange for a partnership interest was not a transfer for full and adequate consideration that qualified for the exception.

It is important to note that *Harper* involved a partnership as to which many of the requisite formalities were ignored. For example, the partnership did not have an employer identification number; the assets deemed to be in the partnership were in fact titled in the name of the 99 percent limited partner (a revocable trust) for a period of time; funds of the taxpayer and the entity were commingled; certain personal expenses of the taxpayer were paid out of the partnership; and distributions of income were not made on a pro rata basis.

These facts made it difficult for the taxpayer's estate to argue that there was no implied agreement and to assert that the general partner owed a fiduciary duty to all of the partners.

Comparable facts were present in *Thompson*, which involved the transfer by a decedent of the vast majority of his assets to a limited partnership under which distributions were made to the decedent. The court ruled the underlying partnership assets were includable in the decedent's estate under §2036(a)(1) without any valuation discounts as a result of the decedent's retained enjoyment of partnership assets.

Similarly, in the *Strangi* case, the Tax Court disregarded a family limited partnership for estate tax purposes and included the partnership's underlying assets in the taxpayer's estate with no valuation discounts. The court reached this conclusion using two different approaches.

First, the court held that Strangi had an implied understanding with members of his family that he could use partnership assets as his own; Strangi had placed 98 percent of his assets into the partnership, making it necessary for him to rely on the assets to pay his expenses. This aspect of the *Strangi* argument was consistent with the cases discussed above, all based on §2036(a)(1).

More troublesome, however, was the alternative holding of the *Strangi* court. The court found that the taxpayer's interest in the corporate general partner, which was only a 47 percent interest, provided him with the right to control, together with others, decisions regarding distributions from the partnership and liquidation of the entity. The court ruled that these retained rights, which gave the decedent control over the timing of the partners' enjoyment of partnership assets, caused the partnership's underlying assets to be included in the taxpayer's estate with no discounts under §2036(a)(2). Code §2036(a)(2) applies where the decedent, either alone, or in conjunction with others, retains the right to control the timing of a beneficiary's enjoyment of transferred property.

The Tax Court disregarded the argument by the taxpayer that the general partner was constrained by fiduciary concerns and could not simply exercise control in his favor or in favor of one partner over the other. Many commentators feel that this decision is inconsistent with the Supreme Court holding in *U.S. v. Byrum*, 408 U.S. 125 (1972).

In *Byrum*, the Court considered a decedent's retained right to vote stock and concluded that he owed a fiduciary duty to the other stockholders. The fiduciary duty diminished the decedent's control and prevented the transferred stock from being includable in his taxable estate.

By contrast, the *Strangi* court held that the fiduciary duty owed by the decedent to his family did not sufficiently limit his retained right to vote on liquidation and distribution decisions so as to remove the §2036(a)(2) problem. The *Strangi* court seemed to create a distinction between family and nonfamily situations, stating that the fiduciary duty in an intra-family investment vehicle should be disregarded.

Impact on Existing Family Entities

The recent cases — in particular, the alternative holding in *Strangi* — may prove troublesome for clients with existing LPs and LLCs.

If a family entity is to be continued, the client must be made aware of the importance of observing the formalities of the entity. A thorough review of the financial transactions of the entity should be undertaken to determine whether corrective measures need to be taken on any transactions that were handled improperly and, more important, to make sure that all LP/LLC finances and operations are structured properly in the future.

In general, the family entity should be operated as a business, to the maximum extent possible. In this regard, the importance of keeping accurate books and records cannot be overstated.

The entity should collect all income to which it is entitled and should pay all of its expenses. There should be no commingling of assets and the family entity should not pay any expenses of its owners. Making sure that all distributions made by the entity are being made on a pro rata basis is an important step in establishing the arms-length character of the entity.

It can be helpful to give clients a checklist to assist them in observing the various formalities of the entity. It is important that the partnership agreement be reviewed to determine whether any amendments are necessary, particularly in light of recent case law.

Specifically, it is important to confirm that the client — either as a general partner/voting member or as a limited partner/nonvoting member — not have any right to participate in decisions regarding the entity's liquidation or distributions.

Following a review of the LP/LLC's operations and the partnership/operating agreement, the consequences of the client's retention of interests in the entity need to be evaluated. Although only the retention of a limited partner/nonvoting membership interest may present issues that need to be addressed, it is helpful to explore the more traditional structure (and the one involved in *Strangi)* — the retention by the donor/transferor of a general partner interest or voting membership interest, either directly or through an interest in an entity serving as general partner or voting member.

Wait and See

The first question to be answered is whether remedial measures need to be taken immediately or whether a "wait and see" approach should be adopted.

Since many commentators believe that the alternative holding in *Strangi* is inconsistent with the Supreme Court's decision in *Byrum*, rather than reacting immediately to the *Strangi* court's novel approach to §2036(a)(2), it may be prudent to wait until the completion of the appellate process and until other courts have spoken on the issue.

In certain situations, however, the client and adviser may conclude that steps need to be taken immediately (for example, when the voting owner is elderly or ill).

The next question is whether the family entity needs to be continued or whether it can be terminated. In this regard, both tax and nontax issues need to be evaluated. From the nontax perspective, the distribution of the entity's assets to its owners may be unacceptable to the client.

For example, the client may be concerned about long-term asset protection, which may be jeopardized if the entity's assets are distributed to his children. Alternatively, the client may be unwilling to relinquish the investment advantages of having all family assets consolidated in one entity.

If the nontax issues can be overcome, the tax consequences of terminating the family entity must be evaluated. The first step is to determine whether the tax planning objectives will still be achieved if the LP or LLC is terminated. This will generally be the case if significant transfers of limited partner interests had been made. It is also important to consider whether an immediate termination of the family entity would make it more difficult to sustain valuation positions taken as to recent gifts of interests in an LP or LLC and whether the ability to make leveraged gifts of interests in the future will be affected.

If it still makes sense to consider a termination of the family entity, the income tax consequences of a distribution of assets from the entity to its owners need to be analyzed. There are a number of complex provisions that are involved. Although a thorough explanation of those issues is beyond the scope of this article, a few general concepts are set forth.

The primary income tax concern is the potential imposition of a capital gains tax as a result of the family entity's liquidation. This would only occur to the extent that the fair market value of the family entity's assets exceeds their tax basis.

If the family entity constitutes an "investment partnership," the entity can be terminated without any gain recognition if more than seven years have elapsed since the entity was funded. (Depending on the particular facts, an earlier termination may or may not result in gain recognition.) In general, an investment partnership is an LP or LLC in which substantially all the assets have always consisted of cash, cash equivalents and investment assets.

If the family entity does not constitute an investment partnership, the distribution of cash and marketable securities could generate a capital gains tax regardless of when the distribution occurs.

If the fair market value of assets contributed to the LP or LLC exceeded their tax basis, a liquidation of the family entity within the first seven years of funding could result in gain recognition regardless of the nature of the assets involved.

Three-Year Rule

Assuming that the tax and nontax hurdles can be overcome, the client may elect to proceed with a distribution of the family entity's assets and the termination of such entity. This may not, however, immediately eliminate the estate tax inclusion problem under *Strangi* because of the three-year rule set forth in §2035.

Under the three-year rule, if a decedent makes a transfer of an interest in property or relinquishes a power with respect to property during the three-year period prior to death, any assets which would have been included under §2036 had the interest not been transferred or the power not been relinquished will be includable in the decedent's estate.

While it is unclear whether a liquidation of the family entity constitutes a relinquishment by the general partner or voting member (the voting owner) of a power to control assets, there is clearly a risk that the IRS would make that argument.

If the LP or LLC is to be continued, the donor/transferor must divest himself of any general partner interest or voting membership interest (a voting interest) or any interest in an entity serving as general partner to avoid the adverse tax impact of the *Strangi* alternative holding.

This may be unacceptable to many clients; they may be simply unwilling to relinquish control. This means that under the current state of affairs, the full value of the family entity would be potentially subject to estate tax inclusion under *Strangi*.

If the client is willing to explore a transfer of the voting interest, decisions need to be made as to the recipient of such interest and the structure of the transfer.

As to the identity of the recipient, several alternatives exist. If a married couple is involved and one spouse was the sole transferor, he or she could transfer the voting interest to his or her spouse. Another approach would be to transfer the voting interest to one or more children. A third alternative would be to designate an appropriate third party who could either receive the interest directly or serve as a trustee of a trust for the benefit of the client's family.

The transfer of the voting interest can be accomplished either by gift or by sale. A gift of the voting interest is clearly subject to the three-year rule. If, however, the voting interest is transferred via a sale for full and adequate consideration, the three-year rule can be avoided. Ideally, the consideration should be an independent one, furnished by the purchaser.

The difficulty arises in determining

the amount that constitutes full and adequate consideration within the meaning of the exception set forth in §2035(d). There are several cases, including *U.S. v. Allen*, 8 AFTR 2d 6055, that suggest that the full and adequate consideration requirement is satisfied only if the consideration is equal to the full estate tax inclusion amount.

In the context of an LP or LLC, this would mean that the exception would be available only if the voting owner sold his interest — which could represent 1 percent of the equity — for an amount equal to 100 percent of the underlying value of the family entity's assets, a somewhat distorted result.

It would seem more appropriate for the voting interest being sold to be independently valued, taking into account the control features of the interest, thereby causing a premium to be added to the interest's value.

In fact, the *Allen* case and its progeny were rejected by the Third and Fifth U.S. Circuit Courts of Appeals in *Estate of D'Ambrosio v. Commissioner*, 78 AFTR 2d 96-7347, and *Wheeler v. United States*, 80 AFTR 2d 97-5030.

If the voting interest owned by the client is a controlling interest, the client should consider selling fractional interests so that each interest being sold is not a controlling interest. This will likely reduce the value of the interest sold and therefore would reduce the purchase price. It would also seem to be prudent to arrange for an appraisal of each interest being sold and then arrange for the sale to be undertaken at the appraised value.

Planning in the Future

The IRS has made it clear that it intends to scrutinize and challenge LPs and LLCs implemented for tax planning purposes, particularly with respect to entities consisting of only marketable securities and cash. Nevertheless, the family entity remains a viable entity for tax and nontax purposes as long as careful attention is paid to the structure and operations of the entity.

First, to protect clients from the application of §2036(a)(1), it is imperative that the structure of the entity be respected. A federal tax identification number (EIN) should be obtained and assets properly titled using the entity's name and EIN.

The voting owner should open up an account in the name of the entity at a bank or financial institution, and each owner should contribute his proportionate share of the initial capital of the entity into the account so that the entity is properly capitalized and each owner can justify his percentage interest in the entity.

It is critical that the individuals creating the LP or LLC retain sufficient assets in their names so that they will not need to rely on the assets in the family entity to pay living expenses.

The voting owner should retain an accountant to prepare and file tax returns and maintain the books and records for the entity. Records of all entity transactions should be carefully maintained and provided periodically to the accountant. Distributions from the entity should be made consistently, with the direction in the partnership/operating agreement. Most often, this means that owners should each receive a pro rata portion of any distributions from the entity.

If the client plans to make annual exclusion gifts of entity interests, the partnership or operating agreement should give owners the right to withdraw their share of the income generated by the entity annually. This increases the likelihood that gifts of interests in an entity will qualify as gifts of present rather than future interests.

Observing the formalities of the entity and avoiding §2036(a)(i) should be relatively easy. The more difficult task is to avoid estate tax inclusion under §2036(a)(2). In this regard, it is imperative that the client creating the entity does not retain any direct or indirect control. This means that the client should not own any voting membership or general partner interest — even a minority voting interest — either directly or indirectly through an interest in a corporate general partner.

Clients should be cautioned that the retention of any control (directly or indirectly, express or implied) could result in a successful attack by the IRS under §2036(a)(2).

The voting owner should be the only party managing the day-to-day operations of the LP or LLC. Limited partners and members who are not managers should not assume a management role. The partnership/operating agreement should preclude the limited partners (or nonvoting members) from participation in decisions regarding entity distributions or liquidation.

Additionally, nonvoting owners should not have the right to participate in decisions regarding the amendment to the partnership or operating agreement.

Clients unwilling to establish an entity and gift interests therein without the retention of control should either wait until the courts have spoken further on this issue, consider alternative estate planning techniques or proceed at their peril.

Alternatively, control can be retained while still avoiding the §2036(a)(2) pitfall if the owners are, in effect, selling their assets in exchange for entity interests. If the contribution of assets to the entity can be characterized as a bona fide sale, §2036 does not apply.

To qualify under the bona fide sale exception, establishing a business purpose behind the entity's creation is important. The income tax consequences of pooling of assets in an LP or LLC by various individuals must, however, be carefully considered. This structure should permit older generation owners to retain control over decisions in connection with a family entity.

Another possible structure involves the transfer of assets by one spouse to an entity owned and controlled by the other spouse. For example, a wife can contribute assets to an entity owned by her husband. Although the wife may contribute virtually all (if not all) of the assets allocated to the entity, she would not own an interest in the entity.

The gift by the wife to her husband through the entity will qualify for the marital deduction and will not generate any gift tax consequences. Since the husband did not fund the entity, §2036 is arguably inapplicable. The husband should not be deemed to have retained control over assets that did not originate from him. Therefore, the husband should be able to retain complete control over the entity, giving away non-voting interests in the entity, without estate tax inclusion of the underlying assets.

Clearly the safest alternative under existing law is for the client creating the family entity to designate someone else as the voting owner (such as children or a trust for children) and to retain *no* control over the entity (directly or indirectly, express or implied).

Until this issue is revisited in the anticipated appeal of *Strangi*, any other structure creates a greater level of vulnerability for the use of the family entity as a tax planning tool. In fact, even the recommended structure provides no guarantee as to tax consequences.

Since entities being used for tax and estate planning purposes will likely be more closely scrutinized in the future, careful attention must be paid to the structure and implementation of the entity. In certain cases, the client may be forced to make some difficult decisions. ■