Discounts for Partnership and LLC Interests

How to navigate around FLP pitfalls

The current estate tax laws are slated to stay in place until the end of this year. This allows clients to make gifts of up to $5.12 million without incurring any federal gift tax. Due to the large quantity of gifts that this law may prompt during the remaining window, it’s important to understand the field of tax law that governs the gifting of ownership interests in family limited partnerships (FLPs) or family limited liability companies (LLCs). In fact, the large gift tax exemption, coupled with the power of discounting, can allow for huge amounts well beyond this $5.12 million figure to be placed beyond the realm of a taxable estate, assuming there’s no possibility of a later “clawback” of the estate tax due on the gift or estate tax exemption being subsequently reduced.

The passage of the Tax, Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (TRA 2010), which allows for this $5.12 million gift tax exemption (or $10.24 million if an electing donor is married), didn’t contain any restrictions on one’s ability to apply discounted valuations to gifts of FLP interests, even though past bills have been proposed to do just that. Present and future efforts will most likely continue to strive to restrict the discounting capabilities of such interests. For example, in President Obama’s most recent budget proposal, restrictions on the ability to discount FLP interests again were being suggested.

Nevertheless, until any such legislation is passed, the discounting of valuations of FLP interests is still an available strategy.

History
Taxpayers used the FLP as a vehicle to make gifts to family members. There are numerous non-tax reasons for using FLPs in this process. Furthermore, these FLP interests, typically, are appraised at a value that’s significantly less than what the proportional indirect ownership interest in the FLP’s underlying assets would represent.

Taxpayers and their appraisers have, from time to time, claimed extensive discounts exceeding 50 percent. The Internal Revenue Service saw this discounting as an abuse, especially when the FLP appeared to be no more than a “wrapper” for the underlying subject assets, with no apparent reason for the FLP other than to decrease or sidestep any gift tax.

Likewise, the IRS perceived abuse by taxpayers, who would retain a portion of an FLP until death (as opposed to retaining direct ownership in the underlying assets) for purposes that included the goal of decreasing any estate tax exposure.

The Law Now
In the typical scenario, a taxpayer will make gifts of FLP interests to various family members or trusts. The taxpayer often retains a beneficial interest in or control over the FLP.

The IRS has successfully argued that, at the time of the taxpayer’s death, the decedent’s retained interest in the FLP as of the moment before death was sufficient to pull all the FLP assets into his estate. The IRS relies on Internal Revenue Code Section 2036 to support this view.

IRC Section 2036(a) states:

The value of the gross estate shall include the value of all property to the extent of any interest therein of which decedent has at any time made
a transfer (except in the case of a bona fide sale for an adequate and full consideration in money or money’s worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or any period which does not in fact end before his death—

(1) The possession or enjoyment of, or the right to the income from, the property, or

(2) The right, either alone or in conjunction with any person, to designate the person who shall possess or enjoy the property or the income therefrom.

Practitioners try to avoid this section by designing the FLP so that the taxpayer hasn’t retained the interests described in Sections 2036(a)(1) and (2), such as a right to income distributions from the FLP or the right to control the timing of FLP distributions. More conservatively, a practitioner may strive to totally avoid the need to even consider whether Sections 2036(a)(1) and (a)(2) apply by simply meeting the “bona fide sale for an adequate and full consideration in money or money’s worth” exception.

Taxpayers can meet this “bona fide sale for an adequate and full consideration” test if there’s a non-tax motivated purpose for the FLP.

Non-Tax Motivated Purpose

A number of courts have found FLPs to have a non-tax purpose if there’s convincing evidence establishing the taxpayer’s motives for creating the FLP, other than for reasons of reducing or eliminating gift and/or estate taxes.

Examples of non-tax motives include: (1) creating a centralized management of the FLP assets as opposed to all the co-owners having some say as to how the assets are to be managed and/or sold, (2) promoting communications among family members, (3) shifting management of assets that require active management to a manager who has better abilities than the donor, (4) isolating within the FLP the liability and risks associated with the contributed assets, and (5) holding the FLP assets in a manner that prevents the donor-taxpayer’s children from being able to dissipate the assets. This last goal is especially compelling when the children have, in fact, exhibited a propensity to squander assets that they previously owned. In Estate of Murphy, there was supporting documentation (for example, attorney’s correspondence with the taxpayer) that the FLP was formed for the purpose of centralizing the management of various assets into one pot, controlled by the named general partner. The management purpose is also found more easily in cases in which the FLP is funded with the type of assets that require active management (such as a business or real estate). Also, a management purpose can be found in cases in which: (1) actual active management occurs under the FLP; or (2) the FLP has been clearly established as a vehicle under which an investment philosophy will be perpetuated. This latter management purpose is more obvious when there’s evidence that the donor had a strong desire to have the assets in the FLP administered using a very specific management strategy that the general partner has the skills to implement.

In Estate of Miller v. Comm’r, the court gave great weight to the fact that the FLP demonstrated that it had a primary purpose unrelated to tax savings.
obtain benefits from the assets (via annual gifts of FLP interests to those family members), but not to have any power to dissipate the assets. The general partner was to manage the FLP assets using Murphy’s buy-and-hold investment strategy versus making distributions to partners. It should be noted too that Murphy owned only 49 percent of the LLC that served as the general partner of the FLP (which suggests less retained control) and Murphy retained significant assets outside of the FLP (which suggests no expectation to retain a right to distributions from the FLP).

In the *Estate of Schutt v. Comm'r*, the court viewed

the retention of an established investment strategy as a business purpose. This was another example in which the taxpayer desired to create the FLP for the purpose of carrying out his cherished buy-and-hold strategy with investments.

In the *Estate of Miller v. Comm'r*, discounted gifts by the taxpayer weren’t pulled back into the estate, because the court determined there was a non-tax purpose for using the FLP. Valeria Miller (the donor), whose husband predeceased her, was inactive with regard to engaging in any trades of her investments. On the other hand, her husband had a very specific investment strategy that he applied while he was living that involved a charting of the stocks’ price activities.

After her husband’s death, and after Valeria had exhibited very little desire to engage in much trading activity with her investments, Valeria decided to transfer her securities to an FLP in which her son was the managing partner. Once the investments were placed into the FLP, her son substantially changed the investment activity of the FLP assets, as compared to how they were managed while Valeria held title to those investments. The son spent many hours applying the stock charting methodology that he had learned from his father.

The court gave great weight to the fact that the FLP demonstrated that it had a primary purpose unrelated to tax savings. The FLP was a vehicle through which a marked change in investment philosophy was to be applied to its holdings. This non-tax purpose was instrumental in finding that Section 2036 didn’t apply.

The FLP was also designed to allow the general partner to manage the FLP assets more easily under a single vehicle applying one investment strategy, which couldn’t have been accomplished if the donor had made gifts of the underlying assets outright to the various children. In the latter case, the individual children may well have had different ideas about how to manage the assets.

In *Estate of Black v. Comm'r*, the court, likewise, found that an FLP created for the purpose of perpetuating an investment strategy and to prevent the children from dissipating assets met the non-tax motive threshold. The fact that the partnership was created partly for asset protection reasons was another factor that avoided Section 2036 estate inclusion and allowed the ownership interest in the partnership to be discounted in the taxpayer’s estate, saving significant estate taxes. This is in line with *Church*, which also appeared to factor in the asset protection motives as part of the basis for the taxpayer’s ability to meet the crucial non-tax purpose test.

In the *Estate of Shurtz v. Comm'r*, asset protection was again cited as a non-tax purpose. Various family members held timberland under a limited partnership. A few of the family members formed a second FLP to own their interests in the first partnership. This way, distributions could be made by the first FLP pro rata to all its members without exposing distributions to the second partnership to creditors. The second FLP, in essence, kept the charging order protections in place with respect to those distributions. To further support the court’s finding of a non-tax motivation for the formation of this second partnership, the second FLP was also partly funded with undivided interests in additional timberland. The FLP structure facilitated the more...
efficient management of those real estate interests.

In Keller v U.S.,\(^\text{11}\) the court decided that, partly due to the fact that a primary motive for creating the FLP was to protect the underlying assets from the taxpayer's children's divorces, the non-tax reason was met, therefore, Section 2036 didn't apply.

Mirowski\(^\text{12}\) and Bongard\(^\text{13}\) provide good examples of how an FLP or LLC meets the business purpose test. For example, consolidating assets under one entity's ownership to increase the marketability of assets or to increase investment opportunities can be helpful facts. Having language in the governing documents, which defines the standards for the entity to make distributions, may also be helpful to better protect against the possibility of a Section 2036 argument. These distribution standards should be stated in sufficiently ascertainable terms.

Other Helpful Facts

Other helpful facts to suggest a bona fide transaction include the existence of actual negotiations among the partners in the formation of the FLP as to what provisions are to be included in the FLP agreement. This was mentioned in Estate of Korby v. Comm'r.\(^\text{14}\)

Also, having multiple partners pool their money together in forming the FLP better avoids Section 2036. However, this pooling factor isn't, in and of itself, any guarantee that Section 2036 won't apply.\(^\text{15}\)

If Test Not Met

If a taxpayer fails to meet the “bona fide sale” exception to Section 2036's estate pull-back provisions, he may still be able to avoid having the FLP assets pulled back into the taxable estate. Section 2036(a) will cause inclusion only if the taxpayer, up until the time of death (or generally within three years of death), retained interests as described in Sections 2036(a)(1) or 2036(a)(2).

A word of caution here. Even if one is comfortable that a non-tax purpose can be shown, it may be advisable to create the FLP in a way that still better avoids Section 2036's retained power provisions in case the IRS concludes no business purpose was established. This is especially true for cases in which the FLP holds mostly marketable securities. Nevertheless, one should always try to limit these FLP transactions to cases that truly do have a non-tax purpose. Not only does this better avoid the application of Sections 2036(a)(1) and (2), but also, it's valuable if the taxpayer dies within three years of making transfers.\(^\text{16}\)

To avoid the provisions of Sections 2036 and 2038, the taxpayer needs to relinquish certain controls and benefits relating to the FLP.

Miller demonstrated that someone other than the donor taxpayer was truly managing the FLP. The court viewed that fact as evidence that the taxpayer retained no control over the FLP assets, which further thwarted

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the IRS' arguments that the taxpayer retained control to such an extent that it would pull the assets back into her estate.

In general, the controls and benefits to avoid include a retained right to the income from the FLP\(^\text{17}\) or the right (alone or in conjunction with another) to designate who will enjoy the property or income.

A taxpayer should also avoid retaining any right to withdraw assets from the FLP. In Estate of Jorgensen v. Comm'r,\(^\text{18}\) the taxpayer's ability (via an implied agreement) to withdraw assets contributed to causing the FLP assets to be included in his taxable estate. The court in Estate of Murphy v. Comm'r came to a similar conclusion.\(^\text{19}\)

Although not technically an expressed retained right,
if a taxpayer funds the FLP with most of his assets and, therefore, doesn’t keep enough out of the FLP to cover his personal expenses, including his own anticipated estate taxes, one can assume a retention of rights over the FLP assets.

In Strangi, the taxpayer was diagnosed with cancer. Strangi’s son-in-law (as Strangi’s agent) then formed a Texas FLP. Strangi owned only a minority interest in the corporate entity that served as the general partner of the FLP. Nevertheless, the FLP assets were pulled back into Strangi’s estate under Section 2036. A contributing factor to the IRS’ successful Section 2036 argument was Strangi’s reasoning for owning only a minority interest in the FLP was to avoid having control to retain a right to distributions and other Section 2036 powers. Although Strangi failed in that attempt, other cases involved taxpayers who attempted to avoid the same retained powers by not holding any management powers. Instead, those taxpayers owned only a limited partner interest. The question is whether that’s enough to avoid Section 2036(a)(2)’s pull-back provisions, which are triggered when a limited partner, in conjunction with the other partners, has control over the FLP assets The court in Strangi cited Section 2036(a)(2), stating that it brings assets back into an estate if the taxpayer retained the right, either alone or in conjunction with any person, to designate the person who shall possess or enjoy the property or the income therefrom. Therefore, Strangi suggests that such a limited partner will have estate inclusion under that section. The court viewed the taxpayer’s ability, in conjunction with the other partners, to liquidate the FLP as a Section 2036(a)(2) power. However, keep in mind that Strangi retained control and ownership over almost the entire FLP. Moreover, that case involved other “bad facts.” As mentioned above, Strangi’s agent managed the general partner. Therefore, a different fact pattern in which the donor doesn’t control the general partner through an agent could be distinguishable from Strangi. Also, the Section 2036(a)(2) analysis in Strangi was dicta, because the court already concluded that Section 2036(a)(1) was sufficient in and of itself to include all the FLP assets in Strangi’s estate. The court, therefore, never had to make a ruling on the Section 2036(a)(2) component.

If the taxpayer is solely a limited partner, then one way to stay within a safer fact pattern would be to have all distribution and liquidation powers held solely by a third-party general partner. Furthermore, the donor shouldn’t hold the power to remove or discharge the general partner at any time and appoint himself or a subordinate as the general partner to avoid the donor being considered as having the powers of the general partner. Thus, look to the FLP provisions, as well as state law, to determine if a majority of partners can remove the general partner. Colorado, for example, has no such statutory provision.

Even though there may be an argument to avoid Section 2036(a)(2), the fact that Strangi and subsequent cases haven’t fully closed this issue leaves some uncertainty in the planning strategies. Therefore, the safest way to avoid Section 2036 altogether would be for the donor to not own any interest in the FLP and not be a manager of the entity’s assets. Instead, the donor should select an independent manager.

For clients who insist on retaining ownership and management control, consider Mirowski, in which the court provides a detailed roadmap as to how Section 2036 and 2038 concerns can be minimized, even in a situation in which the donor of FLP or LLC interests retains a majority ownership interest in the FLP/LLC, as well as serving as general partner/manager of the FLP/LLC.
Here are the favorable facts in Mirowski: Anna Mirowski formed an LLC and owned 100 percent of the interests as its sole member. She had a business purpose for the initial formation. The LLC was funded with patents and a license agreement. The LLC operated partly to manage ongoing litigation involving the patents. This purpose required some active management. This non-tax purpose successfully avoided any Section 2036 issues with the initial transfer of assets to the LLC.

Anna then gifted 48 percent of the LLC interests to trusts for her daughters. She retained the remaining 52 percent.

The operating agreement contained the following crucial provisions:

1. Anna only held rights to the LLC assets if the LLC dissolved. She would receive 52 percent of the liquidation proceeds. Any liquidation required the unanimous consent of the members.
2. She owed fiduciary duties under state law (Maryland) in the performance of her manager role.
3. She could sell the LLC assets (other than in the ordinary course of business) only with the unanimous consent of the members. Such a sale was referred to as a “capital transaction.” The court opinion recites the operating agreement’s definition of a “capital transaction.”
4. She couldn’t admit any new members without the members’ unanimous consent.
5. She could allocate profits, losses and capital proceeds only in accordance with the members’ ownership percentages, pro rata. “Capital proceeds” carried with it a specific definition in the operating agreement.
6. She was required to distribute the “cash flow” (again, specifically defined in the operating agreement) of the LLC among the members within 75 days following the end of each tax year of the LLC.24 She could also (as a majority owner) make such distributions currently during each year.
7. Any involuntary withdrawal (for example, death) of a member would cause the LLC to dissolve unless the remaining members elected to continue the LLC.
8. A manager can be removed only upon an affirmative vote of a majority of the members.

After considering all the above provisions that directed the manager’s powers with such specificity, leaving very little discretion to the manager in dealing with the LLC assets, the court concluded that Anna retained no Section 2036(a)(1), 2036(a)(2) or 2038 powers.25 This case, therefore, provides guidance as to how a client who wishes to retain management control and a majority ownership interest in an FLP or LLC can design the entity to minimize having the assets inside the entity included in the client’s taxable estate.

Mirowski and Estate of Kelly26 both involved entities that were initially funded for non-tax purposes. Therefore, it’s not clear whether these two cases would have had the same result if the original funding of the entity hadn’t met the non-tax motivated tests (and therefore hadn’t met the “bona fide sale for an adequate and full consideration in money or money’s worth” exception to Section 2036). The literal reading of Section 2036 should still allow for the taxpayer-favorable result as to the gifting of FLP interests, so long as the donor had relinquished any Section 2036(a)(1) and (a)(2) rights to the gifted FLP interests for at least the previous three years.

Note that Section 2036(b) will pull back any closely held stock placed into an FLP if the contributor of the stock retains the right to vote those shares (for example, as a general partner would typically be able to do).

Gifting vs. Estate Issues
My discussion above focuses on the estate tax side. The non-tax purposes described may be more strictly...
applied to discounts to the value of FLP interests gifted during one's lifetime. It may be that, not only does the motivation need to be non-tax driven, but also there must be an actual active business component to the FLP or LLC. For example, in *Fisher v. U.S.*, the LLC interests that were gifted received no valuation discount benefit from the restrictions set forth in the FLP agreement. The LLC held some undeveloped land. There was a lack, however, of any active measures being taken to enhance the commercial value of the land. Since this didn't rise to the level of being an active business, Section 2703 was cited as the authority to disregard any restrictions contained in the LLC's operating agreement.

The same rationale was applied in *Holman v. Comm'r*. In *Holman*, a non-tax purpose for the FLP was to keep the children from spending the money. But, this doesn't rise to the level of being a business purpose. The same holds true for any motive to retain a particular investment strategy or to provide asset protection. Therefore, in *Holman*, the court allowed no discount that would have stemmed from any provisions set forth in the FLP agreement that restricted the transfer of FLP interests.

Claimed Valuation Discounts
In determining whether Section 2703’s business purpose test will be met (this also applies to the business purpose test in connection with the “bona fide sale” exception to Section 2036) for purposes of allowing claimed discounts in valuation, the court will also look at other facts that may suggest that such other factors were prevalent. For example, if transfers are made very soon before the anticipated death of the donor, the court is less likely to conclude that a business purpose or bona fide sale existed.

**IRS Scrutiny**
If the taxpayer has established a business purpose for the formation of the FLP, and, therefore, avoids Section 2703 arguments, he isn't completely out of the woods. Even though the restrictions in the FLP agreement would then be factored into determining the appropriate discount, the IRS may still challenge whether the discount claimed is excessive. The IRS’ arsenal includes Section 2704(b), which allows the IRS to ignore any liquidation restrictions in the FLP agreement that are more restrictive than what state law would otherwise impose.

Some court cases have discussed the definition of the term “liquidation restrictions.” The liquidation restrictions contained in an FLP agreement are disregarded for valuation purposes, but only to the extent those provisions are more restrictive than the governing state law.

Courts have also held that restrictions on a partner’s right to withdraw from an FLP isn’t a restriction on a liquidation right.

It may nevertheless be advisable to form an FLP in a state that has law in place that will not allow a partner to withdraw, unless the FLP agreement allows otherwise.

Assuming the taxpayer clears the Sections 2036, 2703 and 2704(b) trilogy, the IRS can still challenge the degree of discount claimed. The taxpayer typically relies on an appraisal to support any claimed valuation discount. The IRS can present its own appraisers’ expert testimony to discredit the appraisal supplied by the taxpayer.

**Factors Supporting Discounts**
An FLP interest can be discounted to a greater extent when the interest represents less than a controlling interest in the FLP. The greater the control, the more likely there will be a lower discount. For example, in *Jones*, which was a gift tax case, the interest transferred to the donee was insufficient to provide the donee with the power to replace the general partner, which allowed for a higher discount.

This control factor equally applies to a retained FLP interest in an estate tax case. Under Section 2704(a), if a general partner dies holding dissolution powers over
the partnership, then not only is the general partner’s estate at risk of receiving little discount on the general partner interest, but the same risk applies as to the limited partner interests that the same general partner owned at the time of death. This result can be avoided by ensuring that the decedent didn’t have any unilateral power to dissolve the FLP.

Deemed Gift on Formation
The IRS has argued that when a FLP is funded, followed close in time by gifts of the FLP interests, the gifts were, in substance, a gift of the underlying assets. As such, no discount was allowed.

The IRS has lost this argument if the value of the underlying asset valuations could significantly swing up or down between the time the FLP was funded and the later gifts being made. For example, in Linton v. U.S. and Heckerman v. U.S., the courts disallowed discounts because funding of the FLP and the gifting of interests in the same FLP occurred on the same day. The gifts were valued as if there was a transfer of fractional interests in the underlying assets instead of a transfer of interests in the FLP.

That being said, significant valuation fluctuations have been found to be possible even when the gifting of the FLP interest occurred within days or a few months of the funding of the FLP. There doesn’t need to be an actual swing in values, just the potential for such a swing.

Formalities Respected
To avoid having the IRS and courts disregard the very existence of the FLP, observe entity formalities including: (1) the tenant should pay rent for the use of the FLP assets (the lack of that observation was a detriment to the taxpayer in Strangi); (2) the general partner should keep books and records for the entity; (3) the parties should make sure title of the assets transferred to the FLP reflect the FLP as the new owner; (4) the parties should avoid any commingling of personal and FLP assets; (5) the general partners should make sure all distributions are made on a pro rata basis; and (6) the FLP should have at least two partners.

Annual Gift Tax Exclusion
On a related topic, a gift of an FLP interest to qualify for the annual exclusion from federal gift taxes, the recipient must obtain an immediate present interest (as described in Section 2503(b)) to the economic benefits (that is, access to the property or to the income therefrom) of the gift. Take the case of Hackl v. Comm’r, in which the court determined that the donee of FLP interests didn’t acquire a present interest.

In Price v. Comm’r, the general partner had control over the timing of the distributions to be made by the FLP, a partner couldn’t withdraw from the FLP until the FLP dissolved and a partner couldn’t sell or transfer his interest. The case suggests that if there’s a desire to use the annual gift tax exclusions, the partnership agreement (same goes for LLC agreements) should contain at least one of the following important provisions:

1. The donee partner must be allowed to freely sell or otherwise transfer his interest in the partnership, allowing for the new partner to be admitted as a full-fledged partner. A right of first refusal isn’t necessarily an impediment to the ability of the partner to be able to sell an interest freely, per Private Letter Ruling 9415007 (Jan. 12, 1994). However, in Fisher, it was considered an impediment because the other members’ right to acquire the interest due to their right of first refusal wasn’t on substantially equivalent terms as the sale terms with the third party. In Fisher, the other members could buy the interest with a 15-year note.

2. The donee partner must have a right to at least a certain ascertainable amount of distributions annually (for example, such partner’s entire pro-rata portion of the income or enough to pay income taxes on his share of partnership income).

In PLR 9751003 (Aug. 28, 1997), the IRS said that if the general partner can restrict the ability of a donee to enjoy the rights or powers described above, this will result in the disallowance of any annual exclusion against the taxable gift.

In the Estate of George H. Wimmer, gifts were made of limited partner interests. The partnership agreement contained transfer restriction provisions. The partnership, however, owned assets that produced dividend income on a steady basis. It also routinely made
distributions to the limited partners. Given these facts, the court held that the gifted partnership interests qualified for the annual gift tax exclusion.

It should also be emphasized that the general partner must be required to exercise any discretion he may have within the boundaries of his fiduciary obligations to the partners.

IRC Section 2035
If an individual transfers assets to an FLP in exchange for an ownership interest in the FLP, that individual most likely holds Section 2036/2038 powers over the FLP assets. Any subsequent gift of interests in the FLP would then potentially be subject to Section 2035’s 3-year pull back rule if the FLP was determined to have no significant business purpose. In other words, when someone who makes a gift of an FLP interest dies within three years after the gift, such gift is pulled back into the taxable estate pursuant to Section 2035(a).

One solution to avoid this pull back is to form a specially designed LLC (as opposed to a limited partnership) that would be used in connection with any contemplated gifting. The LLC would be wholly owned by the one member who created it. This member could also hold management powers over the LLC. The operating agreement for the LLC would designate a special manager who’s the sole person who holds the power to make distributions, to amend the operating agreement and to terminate the LLC. The special manager would be a person who’s not subordinate, subservient or related to the LLC’s sole member. The member can retain a power to replace the special manager, but only with another person who’s not subordinate, subservient or related to the LLC’s sole member.

The above-described LLC is designed to allow the sole member to fund the LLC with assets, without resulting in the sole member holding powers over the LLC assets that would cause the LLC assets to be includible in the member’s taxable estate under Section 2035(a). If the member later decides to gift away all the LLC interests to family members in a manner that enjoys valuation discounting for gift tax purposes, that member may do so, even while continuing to serve as a manager who makes investment, buy and sell and other asset management decisions regarding the LLC assets. One added component, however, would be advisable.

Single member LLCs achieve little or no asset protection for the member in most states. The member could run up personal debt and leave the LLC assets as the likely target that creditors would seek for repayment. This fact alone can be viewed as a retained power that the member has over the LLC assets. Such a retained power could trigger Section 2035(a)’s 3-year taxable-estate pull-back rule, even if the member had no debt. Therefore, the LLC should be formed under the laws of a state that protect such single member LLCs from creditors (for example, Wyoming or Nevada), or better yet, be formed in an offshore jurisdiction (for example, Cook Islands or Nevis) whose laws would protect the LLC assets. This would help avoid this application of any Section 2035(a) pull back.

Once Section 2035(a) is avoided, any subsequent gifts of FLP interests also won’t be subject to the 3-year rule.

What the Future Holds
The highly fact-driven case law that exists in this area makes it difficult to get a clear reading of what planning will pass IRS scrutiny and court analysis. As new cases and laws come down the pike, hopefully the planning advice that practitioners can provide will become easier. The fear lingers, however, that as more law is created in this area, many more additional questions may be raised. Chances are, in my opinion, that Congress and/or the Treasury will eventually pass legislation that will curtail the usefulness of FLPs in the estate-planning context.

Endnotes
1. The “clawback” refers to the possibility (although many planners consider this to be remote) that making use of the $5.12 million gift tax exemption this year can be “recaptured” as an additional tax at a later date (for example, as an estate tax upon the donor’s death) at a time that the exemption from such tax has been decreased to a lower amount.
4. Estate of Murphy, ibid.
5. See Estate of Stone v. Comm’r, T.C. Memo. 2012-48, which involved undeveloped woodlands in a partnership. Also, for other examples, see Kimbel, supra note 2 and Estate of Mirowski v. Comm’r, 95 T.C.M. (CCH) 1277 (2008). Recently, a case that found the requisite active management for quarries and other...
real estate established a non-tax purpose. See Estate of Kelly, T.C. Memo 2012-73. For a situation involving only passive investments and failure to meet the active management prerequisite, see Estate of Clyde W. Turner, Sr., et al. v. Comm’r, T.C. Memo. 2011-109. These facts led the court to find no non-tax purpose for the FLP, and therefore Internal Revenue Code Section 2036 was applied to pull the assets back into the donor’s taxable estate.


10. Charging order protections refer to the inability of a creditor of a partner to reach into the partnership for payment of the partner’s debt. Instead, the creditor must wait until a distribution is made to the partner.


14. Estate of Kirby v. Comm’r, 471 F.3d 848 (8th Cir. 2006).


16. See Internal Revenue Code Section 2035.


20. See Estate of Miller v. Comm’r, supra note 7, in which this fact pattern resulted in bringing certain later gifts back into the taxpayer’s estate. Also for a similar situation, see Strange Estate v. Comm’r, 115 T.C. 478 (2000), aff’d in part, rev’d and rem’d in part, 295 F.3d 279 (5th Cir. 2002), and with respect to the IRC Section 2036 argument, T.C. Memo. 2003-145, and the Fifth Circuit’s affirmation, 417 F.3d 468 (5th Cir. 2005). See also, Kimbell supra, note 2.

21. Strange, ibid.

22. See Treasury Regulations Section 20.2036-1(b)(3).

23. Supra note 12.

24. This is somewhat curious, in that this sounds like a retained right to limited liability company (LLC) assets (which is the prohibited retained right that Section 2036(a)(1) addresses). However, it’s not a retained right to the assets attributed to the portion of the LLC that she had gifted away. Her right to distributions pertains only to her 52 percent ownership interest.

25. See also Estate of Kelly, supra note 5, which is consistent with this view.

26. In Kelly, ibid., the decedent taxpayer owned a corporation that was the general partner of the partnership. Nevertheless, the court concluded that Section 2036(a)(1) didn’t apply. The taxpayer retained enough assets outside of the partnership to meet her financial obligations.


29. See, e.g., the death-bed transfer cases of Strange supra note 20 and Murphy supra note 3, under which Section 2703 impeded the achievement of any discounts.