Advantageous Uses of LLCs

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A. Use in Family Wealth Planning and Asset Protection

Using entities such as Family Limited Liability Companies (FLLC) and Family Limited Partnerships (FLP) and even the new Family Limited Liability Limited Partnerships (FLLLP)[1] in family wealth planning provides for:

a. Asset Management

Family wealth planning allows for the orderly management and disposition of business operations, the ownership of a portion of a business, and the ownership of an important asset or assets (e.g. real estate or oil interests).

b. Tax Management

Sound family wealth planning can also result in various tax advantages, including a reduction of estate tax, a reduction of income tax, maximized use of gift tax exclusions, and maximized use of generation skipping transfer tax exemptions. Assets transferred to FLPs or FLLCs are removed from the estate of the transferor during life, reducing its size for estate tax purposes. The transferring of ownership interests to the FLLC or FLP during life provides a second benefit, as such interests are usually transferable at a discount. This is generally accomplished by separating financial, governance, and voting rights of the interest and transferring only the financial and/or governance rights. The value of the interest transferred with the limited powers is discounted, which generates a maximization of the use of gift tax exemptions and/or a maximization of the use of generation-skipping tax exemptions, depending on the generations of the recipients. Lastly, the use of business entities to hold assets also reduces income tax by transferring ownership interests in the income producing LLC during life from family members in

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[1] Using a FLLLP has an added effect of providing liability protection for both general and limited partners. For simplicity's sake, this presentation will address only the FLLC.

higher tax brackets to family members and other beneficiaries who may be in lower income tax brackets.

c. Estate Planning Techniques and Issues

The FLLC is a frequently used estate planning device. However, you will be hard-pressed to find any statute or other authority for family limited liability companies. The closest that you will find in Minnesota is Minn. Stat. § 500.24, which provides for family farm partnerships. The family limited liability partnership, as we know it and use it in estate planning, is simply a limited liability partnership which happens to consist of members of a single family.

Example 1: *John Q. Sample and his real estate empire*:

Mr. Sample is married with four adult children and seven grandchildren. He owns, in joint tenancy with his wife, four 30-unit apartment buildings, and manages and (individually) owns a 50% general partnership interest in four other 20-unit buildings. Sample has five employees. Each of the buildings is separately insured and Sample has a $5 million umbrella insurance policy.

The Plan:

(1) Sample establishes the Sample Family, LLC (SFLLC). Sample then transfers to the SFLLC his and his wife's title to the four 30-unit buildings and his general partnership interests in the four 20-unit buildings in return for a 50% membership interest to each.

(2) Sample obtains appraisals for each of the buildings. He also obtains a valuation for SFLLC.

(3) Sample makes annual gifts of minority interests, in the form of non-voting financial rights in SFLLC, to his adult children and trusts for grandchildren in an amount designed to take advantage of his Annual Gift Tax Exclusion.

(4) Sample obtains an opinion supporting the valuation of the minority interests at a discount on the basis of lack of marketability of the financial rights and lack of voting rights and control.

(5) Sample finally coordinates the SFLLC with a Trust Plan. He and his wife each establish revocable trusts. They then transfer their membership interests to their respective revocable trusts.

Note: Gifting fits into the SFLLC plan as follows:

- Mrs. Sample received a 50% membership interest in SFLLC which resulted in a gift of a portion of Mr. Sample's membership interest. The gift was subject to the 100% marital deduction. This gift was made at a discount for lack of marketability and lack of control, and it had the added benefit of removing assets from Mr. Sample's estate, thereby reducing the assets subject to estate tax.

- The gifts of minority interests of financial rights made to the Sample children and grandchildren allow Mr. and Mrs. Sample to use their combined annual gift tax exclusion up to the maximum of $22,000 per child or grandchild. This method of gifting still allows Mr. and Mrs. Sample to preserve their entire respective gift and estate tax exclusions[2] to use during the remainder of their lifetimes or at death if they wish.

- The gifts to the trust for the grandchildren are also an efficient way to make the most of the generation-skipping transfer tax exclusion[3] by transferring appreciating assets at the current discount to subsequent generations.

The gifts affect the valuation of membership interests of SFLLC and the determination of discounts, as they transfer non-voting financial rights only, leading to a lack of marketability and control. The purpose of the discount is to

[2] The gift tax exclusion is $1,000,000.00 and the unified estate tax exclusion varies by year. In 2007-2008 = $2,000,000.00; 2009 = $3,500,000.00.
[3] The GSTT for 2007 is $2,000,000.00 and matches the estate tax exclusion in each year.

create the ability to transfer a larger portion of the financial rights of membership interest. (If the interest transferred is given a 40% discount, a transfer of $22,000 to each child or grandchild is really a transfer of $55,000).

- As for income tax savings, interests transferred to the children reduce the income earned by Mr. and Mrs. Sample on the assets and lessens their annual tax burden. The children are paying taxes on the income that they earn from the acquired assets, but likely at a lower rate than Mr. and Mrs. Sample would have been.

d. Assets Suitable for Transfer to LLC

The following types of property are best suited for transfer to a business entity:

i. Real estate directly owned or owned through other entities.

LLCs work well in real estate developments because they limit the liability of the investors for uninsured and underinsured losses and provide flexibility in management structure. Real estate projects tend to be a single property with early stages of activity, such as financing and often construction.

ii. Closely-held stock

Stock in a closely-held company is also well-suited for transfer to a business entity. Marketable securities may also be used, but they are usually not the best asset to transfer unless there is a non-tax related business purpose for making the transfer.

iii. Oil interests and intellectual property

Oil interests and intellectual property (e.g. patents, trademarks, copyrights) are also well-suited for transfer.

e. Issues Raised by Mixing Property Within LLCs

Different types of assets are subject to different levels of valuation discounts and different types of liability. This is an issue that must be managed carefully when considering which assets to transfer to an LLC.

f. Internal Revenue Service Challenges – There is a catch!

The Internal Revenue Service (IRS) has challenged these family plans, particularly the ability to discount the value of interests transferred, and the taxpayer's characterization of the transfer as a bona fide sale for adequate and full consideration. The IRS's initial challenge was to the valuation of transferred assets to a family owned entity based on I.R.C. § 2703(a)(1) and (2).

IRC 2703(a)(1) provides that for transfer tax purposes, the value of property is determined without regard to "any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property," or "to any restriction on the right to sell or use such property." This rule applies no matter how and where in the corporate documents or express or implied agreements such restriction is created.[4]

i. Exceptions

[4] I.R.C. § 2703(b).

Exceptions to IRC 2703(a)(1) & (2) are listed in IRC 2703(b). This section of the code permits such a restriction to be a factor (and possibly the controlling factor) in valuing an LLC interest. For the exception to apply, the option, agreement, right, or restriction: (1) must be "[a] bona fide business arrangement;" (2) must not be a "device to transfer the property to family members for less than full and adequate consideration;" and (3) must consist of terms "comparable to similar arrangements entered into by persons in an arms' length transaction."[5]

Example 2:

> P, the parent of child C, owns 60% of the interests in the LLC, a limited liability company. C owns the remaining 40% of LLC interests. P gives 20% of her interests in LLC to C. LLC's operating agreement states that a member may not sell his interest in LLC without prior consent of the other members, placing a restriction on the transferability of the interest. Assuming the restriction does not meet the three requirements of Code Section 2703(b), it will be disregarded in determining the value of the transferred LLC interests (i.e., valuation as if P's interest is freely transferable and will not be given a discount for lack of transferability).

Restrictions on liquidation of an LLC that are greater than those provided by state statute might be ignored in valuing an interest under the gift tax valuation rules. I.R.C. § 2704(b).

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[5] *See* Treas. Reg. § 25.2703-1(a) and Treas. Reg. § 25.2703-1(b). *See also* Priv. Ltr. Rul. 9736004

Example 3:

> P owns an 80% interest and P's children, A and B, each own a 10% interest in LLC, a limited liability company. LLC's operating agreement requires the consent of all the members to liquidate LLC. Under the state law that would apply in the absence of the restriction in the operating agreement, the consent of members owning 70% of the total company interest would be required to liquidate LLC. On P's death, P's interest in LLC passes to P's other child, C. Assuming that A, B, and C (all members of P's family), acting together after the transfer, can remove the restriction on liquidation, P's interest is valued without regard to the restriction (i.e., as though P's interest is sufficient to liquidate the partnership) pursuant to IRC § 2704(b).

IRS challenges to discount valuation have been defeated time and time again.[6] Consequently, the IRS has chosen since 2003 to focus on the validity of the transaction in the first place under IRC § 2036.

ii. I.R.C. § 2036 or the "Sham Transaction"

The purpose of Section 2036 is to include in a deceased taxpayer's gross estate any inter vivos transfers that were testamentary in nature. *Bongard, Est. Wayne C.*, 124 T.C. No. 8 (2005) (citing *United States v. Grace's Estate*, 395 U.S. 316, 320 (1969)).

[6] *See Kerr v. Comm'r*, 113 T.C. 449 (1999), *aff'd*, 292 F.3rd 490 (5th Cir. 2002); *Knight v. Comm'r*, 115 T.C. 506 (2000); *Estate of Strangi v. Comm'r*, 115 T.C. 478 (2000), *aff'd in part, rev'd in part, and remanded*; *Estate of W.W. Jones II v. Comm'r,* 116 T.C. 121 (2001), *Estate of Dailey v. Comm'r,* 82 T.C.M. 710 (2001).

According to the *Bongard* court, Section 2036(a) generally provides that if a decedent makes an inter vivos transfer of property, other than a bona fide sale for adequate and full consideration, and retains certain enumerated rights or interests in the property which are not relinquished until death, the full value of the transferred property will be included in the decedent's gross estate.

The IRS takes the position that the formation of LLCs for estate planning purposes lacks "substance" and that many of these entities are formed as purely testamentary acts. Therefore, the IRS seeks to have the entity disregarded for transfer tax purposes and included in the estate of the transferor when he or she dies. The IRS has been aggressive in pressing this argument, particularly on deathbed transfers.

In such cases, the court will ask the following questions in determining if an asset should be included in the gross estate:

- Was the transfer made during the taxpayer's lifetime?
- Did the taxpayer:
  - retain an interest in the property transferred;
  - retain the right to enjoy the property or retain the right to receive income from the property;[7] or
  - retain the right to designate (either alone or in conjunction with any person) the person(s) who shall possess or enjoy the property or the income produced from the transferred property?[8]
- Was the transfer a bona fide sale for adequate and full consideration in money or money's worth?

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[7] I.R.C. § 2036(a)(1)
[8] I.R.C. § 2036(a)(2)

1) Retained Interest

The transfer of assets during lifetime is generally not a difficult thing to determine. As a result, the main challenges surround the issues of retained interest and bona fide sale for adequate and full consideration. The IRS has argued that, under IRC § 2036(a), a decedent has retained control by only gifting non-voting interests and retaining voting interests for themselves. The IRS has found that an interest can be retained by express or implied agreement between the parties, as well as by possession or enjoyment of the assets transferred or the right to enjoy the income produced by the assets. Less obvious, retained interest occurs when the transferor keeps a direct or indirect right to determine who shall enjoy the property or the income it produces. Each situation must be examined on its particular facts, but interests are often included in the gross estate of the deceased taxpayer when the transferor retains any control over any individual who has the power to determine who receives distributions from the entity, including general partners or managers.

Another red flag involving estate inclusion under Section 2036 is the transfer of "all or nearly all" of the taxpayer's assets to a FLP or FLLC. The IRS considers this to be evidence of an implied agreement of control over the assets by the taxpayer. A FLP or FLLC is a feasible idea only for those taxpayers who can afford to transfer only assets that they do not necessarily need for their own use and support.

iii. Solution?

But wait you say, “If I give up control of the entity and I give away all my limited partnership or membership interests, haven’t I made a gift that cannot be discounted?” Why, yes you have.

The solution then is to split the limited partnership or membership interest into financial and non-financial interests or voting and non-voting interests so that not all members have control over the limited partnership or LLC. This will affect the value of the interest and allow a discount to be taken for gifting purposes. *Beware though* – the taxpayer should always be careful to transfer at least some of the voting interests along with the financial interests, even if the taxpayer maintains the majority of the voting interest.

- *U.S. v. Byrum*, 408 U.S. 125 (1972) – The Supreme Court approved of an arrangement by which the transferor transferred his 71% stock in three different companies to an irrevocable trust benefiting his children, while retaining the voting rights of the stock. The Court found that, even though the transferor retained the voting rights of the stock, the decision on who would receive possession, income, and enjoyment from the stocks belonged to the independent trustee.
- *Estate of Strangi v. Comm’r*, 417 F.3d 468 (5th Cir. 2005) (“Strangi II”) – The Fifth Circuit affirmed a Tax Court holding that assets transferred to an FLP were to be included in the decedent’s estate under I.R.C. §§ 2036(a)(1) and 2036(a)(2). The court found that, unlike *Byrum*, the deceased taxpayer had retained “possession and control” of the assets during his lifetime. This finding was based

largely on the fact that the enormous amount transferred, 98% of the transferor's assets, left the transferor with not enough assets to provide for himself and suggested that the transferor and the family members had an implicit agreement that the assets would remain available to the transferor at his disposal. The court closely scrutinized all of the non-tax rationales advanced by the estate and rejected them all as "factually implausible."

- *Thompson v. Comm'r*, 382 F.3d 367 (3rd Cir. 2004) – Similar to *Strangi II*, the Third Circuit based its decision to affirm the tax courts ruling that the transferred assets would be included in the decedents estate on the fact that the vast amount of the estate transferred inter vivos suggested an implicit agreement that the transferees would agree to any requests by the transferor for money.
- *Kimbell v. United States.*, 371 F.3d 257 (5th Cir. 2004) – The court approved of a transaction where the decedent transferred assets to a trust that, in turn, transferred the property into an FLP in exchange for a 99% interest in the FLP. In exchange for $25,000, the remaining 1% was owned by an LLC owned by the decedent, her son, and her son's wife. The court noted that, although transactions between family members might be subjected to closer judicial scrutiny, such transactions can be bona fide, so long as they are supported by adequate and full consideration. The court held that the transaction was bona fide finding that the FLP had actual possession, partnership formalities were adhered to, the transferor retained sufficient assets (unlike *Thompson* and *Strangi II*), some of the assets were active business assets, and there were legitimate non-tax based reasons (protection from

liability, potential for greater growth by pooling, more centralized management) for transferring the money to the FLP.

2. Valuation Discounts - Bona Fide Sale for Adequate and Full Consideration - Additional Hurdles

1. Introduction

A bona fide sale requires both a good faith, arm's length transaction and "an exchange resulting from a bargain."[9] Where a transaction does not appear to be motivated by legitimate business concerns, no transfer for consideration within the meaning of Section 2036(a) has taken place.[10]

The following factors are taken into account in determining whether a bona fide sale has occurred: 1) the taxpayer's standing on both sides of the transaction;[11] 2) the taxpayer's financial dependence on distributions from the partnership;[12] 3) the partners' commingling of partnership funds with personal funds;[13] and 4) the taxpayer's failure to actually transfer the property to the partnership.[14]

2. FLP Litigation – "Pin the tail on the donkey"

a. Introduction

In examining the legitimacy of FLPs, courts often decide cases based on an intensive scrutiny of the facts. This makes such decisions inherently unpredictable. What is clear is that a taxpayer should pay close attention to the structure, form, and

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[9] *Mollenberg's Etate v. Comm'r*, 173 F.2d 698, 701 (2d Cir. 1949).
[10] T.A.M. 200432015 (March 10, 2004); *see also Estate of Harper v. Comm'r*, 83 T.C.M. 1641 (2002).
[11] *Estate of Hillgren v. Comm'r*, T.C. M. 2004-46;
[12] *Estate of Thompson v. Comm'r, supra*; *Estate of Harper v. Comm'r, supra*;
[13] *Estate of Thompson v. Comm'r, supra*,
[14] *Estate of Hillgren v. Comm'r, supra*.; *See also Estate of Austin Korby*, T.C.M. 2005-103

operation of their family limited partnership or family limited liability company, and to ensure that the entity acts like a “real” business.

b. Case Law

In *Estate of Bongard v. Comm’r*, 124 T.C. No. 8 (2005), the assets transferred into an FLP were included in the estate of the decedent taxpayer.

The facts in *Bongard* involve two transfers. Over the course of several years, Mr. Bongard explored ways to position his business entity, called Empak, for a corporate liquidity event. One idea proposed by his business advisor and was the formation of a single holding company for all stock of the company owned by Bongard’s family. He formed an LLC and transferred his business interest in Empak to the LLC. In so doing, he created Class A and Class B membership units, each having governance and financial rights. Only Class A governance units had voting rights.

The Commissioner argued that the creation of the LLC did not occur as the result of an arm's-length transaction, and consequently, was not a bona fide sale. However, the court indicated that although intra-family transactions are subjected to a higher level of scrutiny, this heightened scrutiny is not an absolute bar.

If the court could find 1) a legitimate and significant non-tax reason for the transfer, and 2) that the transferors received partnership interests proportionate to the value of the property transferred, it would be upheld as a bona fide sale. The court noted that the reasons presented had to be actual motivations, and not just post hoc theoretical justifications.

After a close examination of the facts, the court concluded that the decedent and the trust had mutual legitimate and significant nontax reasons for forming the LLC.

Specifically, the court found that the fact that the transfer was meant to pave the way for a corporate liquidity event was a legitimate non-tax reason. In addition, the court found that the facts that 1) Mr. Bongard was in good health when he made the transfer, and 2) he was relying on the advice of professional business advisors made it unlikely that the transfer was testamentary in nature. Finally, it held that the terms of the transfer were reasonable, and that Mr. Bongard had received a share of partnership interests proportionate to the amount he contributed. The elements of the bona fide sale exception having been met, the court found this first transfer to be legitimate.

However, the case did not end there. Bongard subsequently transferred all of his Class B interests in the LLC to an FLP in exchange for 99% of the limited partnership interests.[15] One year later, Bongard gifted to his wife a 7.72% limited partnership interest in the FLP. He then died unexpectedly eleven months after the gift. Unlike the original transfer of assets, this subsequent transfer of Class B interests was found not to be a bona fide sale.

The estate still contended that the FLP was motivated by significant non-tax concerns.[16] In addition, arguing that the later transfer fit in the bona fide sale exception, the estate asserted that both the transferor and the transferee were "adequately and independently represented," and that all partnership formalities were complied with.

For its part, the IRS claimed that the new FLP was "simply a paper transaction designed to facilitate the distribution of family wealth both before and after death while

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[15] This seemingly redundant transfer was made as part of a complex effort to encourage outside investment in Empak.

[16] The non-tax reasons cited by the estate included: 1) providing another layer of credit protection for Mr. Bongard; 2) facilitating his post-marital agreement with his ex-wife; and 3) to make gifts. Importantly, the court held that a "significant" non-tax must have been an actual motivation, and not just a theoretical justification.

leaving decedent's lifetime control of Empak unimpaired." In support of this, the IRS noted that from its inception until Mr. Bongard's death, the new family limited partnership did not perform any activities, never acted to diversify its assets, or to make any distributions. The court agreed with the IRS, and essentially adopted its analysis in full.

Although the taxpayer in *Bongard* appeared to follow all of the correct procedures, (crossing every 't,' and dotting every lower-case 'j'[17]) in the end, the government still succeeded in applying Section 2036(a).

According to *Bongard*, the bona fide sale for adequate and full consideration exception is met where the record establishes the existence of a legitimate and significant non-tax reason for creating the family limited partnership, and the transferors received partnership interests proportionate to the value of the property transferred. The objective evidence here did not indicate that a non-tax reason was a significant factor that motivated the creation of the second family entity.

Korby – Bongard Returns … The outcome of *Bongard* is echoed in *Estate of Austin Korby*, T.C.M. 2005-103. In that case, Mr. Korby formed "Korby Properties, a Limited Partnership" ("KPLP") with the help of his estate lawyer. He did this without the involvement of his four sons, who were each to be 24.5% owners through trusts and who each signed the KPLP agreement. Mr. Korby alone decided which of his and his wife's assets would be contributed to KPLP and the terms of the KPLP agreement. He also determined that the living trust would receive management fees as general partner, and whether the limited partners would receive any distributions.

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[17] Indeed, Mr. Bongard followed to the letter the advice of a group of highly-regarded tax and estate attorneys.

The Court held that Mr. and Mrs. Korby used KPLP in an attempt to insulate all of their income-producing assets from the estate tax. As a result, the same reasoning as Bongard was applied, and the transfer of assets to KPLP was found not to be a bona fide sale for full and adequate consideration.

Strangi II and *Turner* – Be Respectful, Taxpayer.

In the *Strangi II* and *Turner* cases cited above, Section 2036(a) would not have applied if there had been a bona fide sale involved. These cases indicate that a taxpayer must respect the discount entity he or she is creating, or the government will not respect it for tax purposes. Creating an entity such as a FLP or FLLC as a means of estate tax avoidance is only as reliable as the client's ability and willingness to respect the underlying entity. After all, it is hard to expect the government or the courts to respect an entity that the client did not.

In cases such as *Strangi II, Thompson, and Harper,* the government was able to force inclusion of property that had been transferred by decedents into family LLPs because their history of dealing with those entities, and the properties transferred to them, represented a complete relinquishment for tax purposes.

En Garde, *Bongard*! *Schutt* and *Stone* - In *Estate of Schutt v. Comm'r*, TC Memo 2005-126, the decedent and two of his children created the Schutt Family Limited Partnership. On behalf of himself and the two children, the decedent contributed land, securities, and cash to the partnership. In return for these contributions (or deemed contributions), the partners received units in the entity representing the following interests:

Mr. Schutt - 5-percent general partnership interest and 82.112-percent limited partnership interest;

Son - 1-percent general partnership interest and 5.444-percent limited partnership interest;

Daughter - 1-percent general partnership interest and 5.444-percent limited partnership interest.

Thereafter, the decedent began making annual gifts of limited partnership interests, intended to qualify for the exclusion under Section 2503(b), to certain of his children, their spouses, and his grandchildren. The court held that the decedent's desire to prevent sale of core holdings in business trusts in the event of a distribution to beneficiaries was 1) real; 2) a significant factor in motivating the creation of family entities; 3) appreciably advanced by formation of the business trusts; and 4) was unrelated to tax ramifications.

Further, the decedent was not financially dependent on distributions from the family entities, retaining sufficient assets outside of the business trusts amply to support his needs and lifestyle. Nor was the decedent effectively standing on both sides of the transactions.

Representatives of the business trusts thoroughly evaluated the business trust proposals, raised questions, offered suggestions, and made requests. Some of those suggestions or requests were accepted or acquiesced to; others were not. Such a scenario bears the earmarks of considered negotiations, not blind accommodation. There is no prerequisite that arm's-length bargaining be strictly adversarial or acrimonious.

Each participant in the *Schutt* LP received an interest proportionate in value to its respective contribution. The capital contributions made were properly credited to each transferor's capital account, and distributions required a negative adjustment in the distributee's capital account. Liquidating distributions would also be made in accordance with capital account balances. Therefore, the transfers in *Schutt* were excepted from inclusion in decedent's gross estate under Section 2036(a).

In *Estate of Stone v. Comm'r*, T.C.M. 2003-309 (2003), the Stone family created five independent FLPs. Each member of the Stone family was represented by his or her own independent counsel and had input into the decision-making as to how each of the five partnerships was to be structured and operated and what property was to be transferred to each such partnership. The Stone family understood that Mr. and Mrs. Stone would not be bound by any agreements that the children were able to reach as a result of the children's negotiations and that Mr. and Mrs. Stone would make the ultimate decision as to which, if any, of their respective assets to transfer to each of the five partnerships.

The court rejected the Commissioner's assertion that the decision to create the five FLPs was not motivated by legitimate business concerns. The Estate successfully proved that the partnerships were formed to resolve significant intrafamily disputes among the Stones' children with regard to the Stones' assets. When combined with the fact that each of the new FLPs had economic substance, the court found this to be enough to fit the bona fide transfer exception.

Therefore, the court held that the respective transfers of assets by the Stones to each of the five FLPs, as well as respective transfers of assets by the other partners to each such partnership, were bona fide, arm's-length transfers.

c. 2007-2008 Case Law Update

Two cases of note were decided in 2007 and 2008 regarding FLPs. One of these cases represented a victory for the IRS and the other a significant win for the taxpayer.

The Ninth Circuit joined the Third, Fifth, and Eighth Circuits in weighing in on the application of §2036 to FLPs. Bigelow v. Commissioner, 100 AFTR2d 2007-xxxx (9th Cir. September 14, 2007), affg, T.C. Memo 2005-65[18]. The Ninth Circuit upheld the Tax Court finding that §2036 caused the inclusion of all partnership assets in the decedent's gross estate without a discount[19]. The Ninth Circuit decision is not surprising and generally does not plow new ground[20]. The facts of an implied agreement for retained enjoyment of the assets contributed to the partnership were strong[21]. The court focused on the lack of purported non-tax benefits to find that the bona fide sale for full consideration exception did not apply[22].

What is significant about the Bigelow case is the startling "requirement" for the full consideration exception to §2036[23]. The opinion literally says that there must be more than just transfers to the partnership for a proportional number of units of the partnership, and that there "must" be a "genuine pooling" of assets — which would seem to require significant contributions by other partners[24]. However, the reasoning in the next several

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[18] Synopsis of *Bigelow v. Commissioner*, Steve R. Akers, ABA eReport, October 2007.
[19] *Id.*
[20] *Id.*
[21] *Id.*
[22] *Id.*
[23] *Id.*
[24] *Id.*

pages of the opinion refers to other factors (primarily the absence of non-tax benefits) in addressing the bona fide transfer for full consideration exception to §2036[25]. In fact, there were no significant contributions by other partners in that case, but the court made no mention of that as a reason to refuse application of the full consideration exception[26]. Planners probably will not drastically change their planning for family limited partnerships to urge strongly that clients have other family members make substantial contributions to the partnership in light of this troublesome statement in the opinion — which the court itself did not seem to apply[27].

The case of Mirowski v. Commissioner, T.C. Memo 2008-74, (filed March 26, 2008), may be the most significant taxpayer win in the FLP controversy to date. The Tax Court found significant non-tax reasons supporting the creation of an LLC (owned by the Decedent and trusts established by the Decedent for her three (3) daughters) to hold and manage certain investment assets, namely certain patents relating to an an electronic device known as the automatic implantable cardioverter defibrillator (ICD) to monitor and correct abnormal heart rhythms invented by Decedent's late husband, and securities investment accounts with Goldman Sachs established through investment of the proceeds from the ICD patent royalty payments, such that the assets transferred to the LLC were not includible in Decedent's estate under any of IRC §2036(a), 2035 or 2038. IRS loses challenge to $14,243,208.37.

Key points to take from this case include the following:

- LLC's operating agreement placed restrictions on what the Decedent, as majority

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[25] *Id.*
[26] *Id.*
[27] *Id.*

member and general manager, could do with the assets owned by the LLC and in regard to distributions made by the LLC.

- Additionally, the Tax Court referenced state law provisions as to fiduciary obligations owed by the manager to all members as another check on the Decedent's control of LLC assets.
- Decedent initially received a 100% interest in the LLC in exchange for the assets transferred to the LLC, and Decedent's capital account was properly credited for each of the transfers into the LLC, leading the Tax Court to the finding that the transfers were for adequate and full consideration.
- The Tax Court explicitly rejects the IRS' claim that the *Bongard v. Commissioner* case stands for the proposition that facilitation of lifetime gifting as a significant nontax reason for forming and funding a family LLC or a family partnership.
- The Tax Court further rejects the IRS' contention that the activities of the LLC had to rise to the level of a "business" under the Federal income tax laws in order for the exception under Section 2036(a) for a bona fide sale for an adequate and full consideration in money or money's worth to apply.
- Decedent retained over $7.5 million of assets outside of the LLC. The approximate value of the assets transferred to the LLC was over $60 million. The retention of significant assets outside of the LLC appeared to be another significant factor in the Tax Court's analysis.

Both the Bigelow and Mirowski cases are consistent with past cases in that bad facts (i.e. implied agreements as to use of assets, transferring substantially all assets to the FLP such that the transferor could not maintain his/her lifestyle without the use of

FLP assets, and the like) typically result in IRS-friendly decisions, while good facts (i.e., significant non-tax reasons for establishing the FLP, retention of an appropriate amount of non-FLP assets by the transferor) typically result in a victory for the taxpayer.

3. Use in Asset Protection

If they are used properly, FLLCs and FLPs can be effective asset protection and risk management tools. They not only provide for liability protection, but they also manage risks that may not be insurable, such as employment risks. FLLCs and FLPs also allow for relatively easy gifting of ownership interests to others, thereby placing the interests beyond the reach of creditors/plaintiffs. They can reduce the chance of personal liability and the inherent risk on various transactions and investments as well. However, the valuation issues outlined above are at the heart of asset protection cases, and can potentially sink an otherwise sound FLP plan.

4. Creating an FLP – Practice Pointers[28]

1. Include some operating business or real estate investment in the partnership.
2. Create the partnership well before death.
3. Run the partnership as though the partners were strangers.
4. When a partner (existing or new) contributes property to the partnership, allocate the value of the contributed property to the capital account of the contributor.
5. Use different trusts as partners, particularly after the death of the first spouse. This will make it easier to fractionalize ownership.

[28] This list is adapted from one created by Keith Schiller, and published in Steve Leimberg's Estate Planning Newsletter #881 (October 17, 2005).

6. Document the partnership’s business purpose.
7. Keep discounts within amounts that are less likely to draw audit attention, particularly in tough cases.
8. Leave the decedent with enough liquid assets apart from the partnership to continue living their established lifestyle.
9. Have annual partnership meetings.
10. Review the general ledger and cash to make sure that it is being used for business purposes.
11. When possible, have each partner contribute capital to the partnership, not relying exclusively on gifts of partnership interests.
12. After the death of the first spouse, make sales – not gifts – of partnership interests.
13. Advise clients of the risks and potential rewards of using FLPs in their estate planning.
14. Make sure to file partnership tax returns.
15. After death, report the decedent’s interest, when applicable, as an assignee interest and include that reference on the K-1 forms.
16. Avoid the inadvertent voting of an assignee interest after death, or the decedent’s successor may be considered to have received a partnership interest.
17. Try to avoid making distributions, before or after death, to meet the personal obligations of a partner or the liabilities of a decedent’s estate.

18. Keep in mind that in the course of estate tax examinations, the IRS may seek copies of planning documents, drafts, and other communications. Work product and attorney-client privileges may need to be asserted in audit, or they will be waived.

19. In the planning process, attempt to avoid circulation of documents to third parties which may cause waiver of protections and privilege.