

**FLPs: AFTER *STRANGI, STONE, and KIMBELL***

Louis A. Mezzullo  
McGuireWoods LLP  
Richmond, Virginia

August 3, 2004

A. The Benefits of Using FLPs and FLLCs

1. Transfer Tax Benefits

a. Discounts

- (1) Lack of Control.
- (2) Lack of marketability.
- (3) Others: portfolio mix, capital gain liability.

b. Example

- (1) Client holds \$1,000,000 of IBM stock, wishes to give child \$100,000 of the stock. If gift of stock to child or in trust for benefit of child, value of gift is \$100,000.
- (2) If client transfers stock to an LLC and gives child a 10% interest, the value of the gift may be less than \$100,000 because of discounts.

2. Non-tax benefits

- a. Limited liability for owners – not a real concern if all the assets are passive investments.
- b. Provides for the orderly management of the family's business and non business assets.
- c. Assets in entity protected from owner's creditors.
- d. Greater diversification.
- e. Lower investment and management costs.

- f. Easier to transfer interests – simple deed of gift.
- g. Protect assets from spouses – either at divorce or at death.
- h. Educate younger family members concerning investments.
- i. Avoid ancillary administration and possibly state inheritance taxes.
- j. Could incorporate succession planning – one child named as successor manager.

B. IRS Response

- 1. Initially, IRS' position was that lack of control discounts were not appropriate in a family controlled entity – see Rev. Rul. 81-253, 1981-2 C.B. 187.
- 2. IRS' position was rejected by the courts. *See, e.g., Propstra v. U.S.*, 680 F.2d 1248 (9<sup>th</sup> Cir. 1982); *Estate of Bright v. U.S.*, 658 F.2d 999 (5<sup>th</sup> Cir. 1981); *Estate of Andrews v. Commissioner*, 79 T.C. 938 (1982).
- 3. In 1993, the IRS reversed its position; family control did not affect lack of control discounts. Rev. Rul. 93-12, 1993-1 C.B. 202.

C. IRS Challenges to the Use of Entities to Depress Value

- 1. Sham transaction.
- 2. Step transaction.
- 3. I.R.C. § 2703 – to disregard the entity.
- 4. I.R.C. § 2703 – to disregard restrictions on transferability and liquidation.
- 5. I.R.C. § 2704(b) -- to disregard applicable restrictions.
- 6. Gift on formation.
- 7. Challenge the amount of discount.

D. Courts Reject IRS Challenges

- 1. Validly formed entity cannot be disregarded.
- 2. I.R.C. § 2703 applies to restrictions on interests in an entity imposed by agreements, not intended to disregard the entity itself.

3. Restrictions were commercially reasonable and not disregarded under I.R.C. § 2703.
4. Restrictions were not applicable restrictions under I.R.C. § 2704(b) – only a restriction on the right to cause a liquidation of the entity was an applicable restriction or the consent of an unrelated party was required to remove the restriction.
5. There was no gift on formation if the capital accounts of the contributors reflected the fair market value of the property contributed.
6. Courts sustained taxpayer's discounts if experts were creditable and appraisals based on the facts in the case and rejected IRS' experts if not creditable.

E. IRS Finds New Arrows in its Quiver

1. I.R.C. § 2036(a) – The value of the gross estate shall include the value of all property to the extent of any interest therein of which the 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 for 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 persons who shall possess or enjoy the property or the income therefrom.
2. Treas. Reg. § 20.2036-1(a) – An interest or right is treated as having been retained or reserved if at the time of the transfer there was an understanding, express, or implied, that the interest or right would be conferred [on the decedent].
3. Eight cases held that the decedent, in connection with transfers of property to an FLP, had retained the right to the income from the transferred assets under an implied agreement, based on the facts in the cases. *Estate of Schauerhamer v. Commissioner*, T.C. Memo. 1997-242; *Estate of Reichardt v. Commissioner*, 114 T.C. 144 (2000); *Estate of Thompson v. Commissioner*, T.C. Memo. 2002-246; *Estate of Harper v. Commissioner*, T.C. Memo. 2002-121, *Kimbell v. U.S.*, 2003-1 USTC ¶ 60,455 (N.D. Tex. 2002); *Estate of Strangi v. Commissioner*, T.C. Memo. 2003-145 (*Strangi*,

*II*); *Estate of Ida Abraham*, T.C. Memo 2004-39; and *Estate of Lea K. Hillgren*, T.C. Memo, 2004-46.

4. Two of these cases also held that the decedent had retained the right to designate the persons who would possess or enjoy the transferred property or income from the transferred property. *Kimbell v. U.S.*, 2003-1 USTC ¶ 60,455 (N.D. Tex. 2002) and *Estate of Strangi v. Commissioner*, T.C. Memo. 2003-145 (*Strangi, II*).
5. A recent case, *Estate of Stone v. Commissioner*, T.C. Memo. 2003-309, held that I.R.C. § 2036(a) did not apply because of the bona fide sale exception.
  - a. Seven of the eight earlier cases involving 2036(a) had held that the exception did not apply, based on a two prong analysis:
    - (1) the transfer had to be a bona fide sale, which meant an arm's length transaction; and
    - (2) the transfer had to be for an adequate and full consideration in money or money's worth.
  - b. In *Stone*, the court found that there was a bona fide sale because the contributors' capital accounts reflected the fair market value of the contributed assets, distributions were based on the relative capital accounts of the partners, and the donee/children actively managed the partnership property after the formation.
6. Finally, the Fifth Circuit reversed the Tax Court's decision in *Kimbell*, holding that the bona fide sale exception applied because the decedent received a pro rata partnership interest and the transaction was not a sham or disguised gift.

F. Where Do We Stand Today?

1. As a result of *Kimbell* and *Stone*, FLPs and FLLCs that are properly structured and operated should continue to provide an efficient means of transferring wealth to younger generations.
2. The implied agreement argument under I.R.C. § 2036(a)(1) can be avoided by:
  - a. refraining from making non-pro rata distributions to the owners, especially the transferor;
  - b. refraining from commingling the entity's funds with personal funds;

- c. keeping accurate books reflecting the operative agreement and the entity's operations, beginning as soon as possible after the entity is formed;
  - d. encouraging the general partners or managing members to actively manage the assets in the entity;
  - e. complying with all of the formalities imposed by state law;
  - f. complying with the operative agreement in every respect or amending the agreement to reflect changes in circumstances;
  - g. ensuring that assets transferred to the entity are retitled to reflect the new owner;
  - h. not transferring assets that the transferor will continue to use personally, such as his or her residence; and
  - i. not transferring so much of the older family member's assets that he or she cannot continue to live in his or her accustomed manner without distributions from the entity in excess of distributions that would be considered normal for the type of assets held by the entity.
3. The transferor should not be treated as possessing a legally enforceable and ascertainable right under I.R.C. § 2036(a)(2) if the following facts exist:
- a. The transferor never had the right, either alone or in conjunction with any other person, to designate the persons who will receive the income from the transferred property; or
  - b. Other owners have more than a de minimis interest in the entity and the fiduciary duty of the transferor as the general partner or managing member has not been waived.
4. Based on *Stone* and *Kimbell*, the bona fide sale exception may apply if:
- a. Capital accounts reflect the fair market value of the contributed property;
  - b. Other owners have more than a de minimis interest;
  - c. There is active management of the assets after the creation and funding of the entity; and

- d. There are non-tax reasons for the creation and funding of the entity.

\\TAX\196079.2