2017 FAMILY LIMITED PARTNERSHP

ESTATE PLANNING STRATEGIES

LORMAN EDUCATION SERVICES

July 2017

Presented by:

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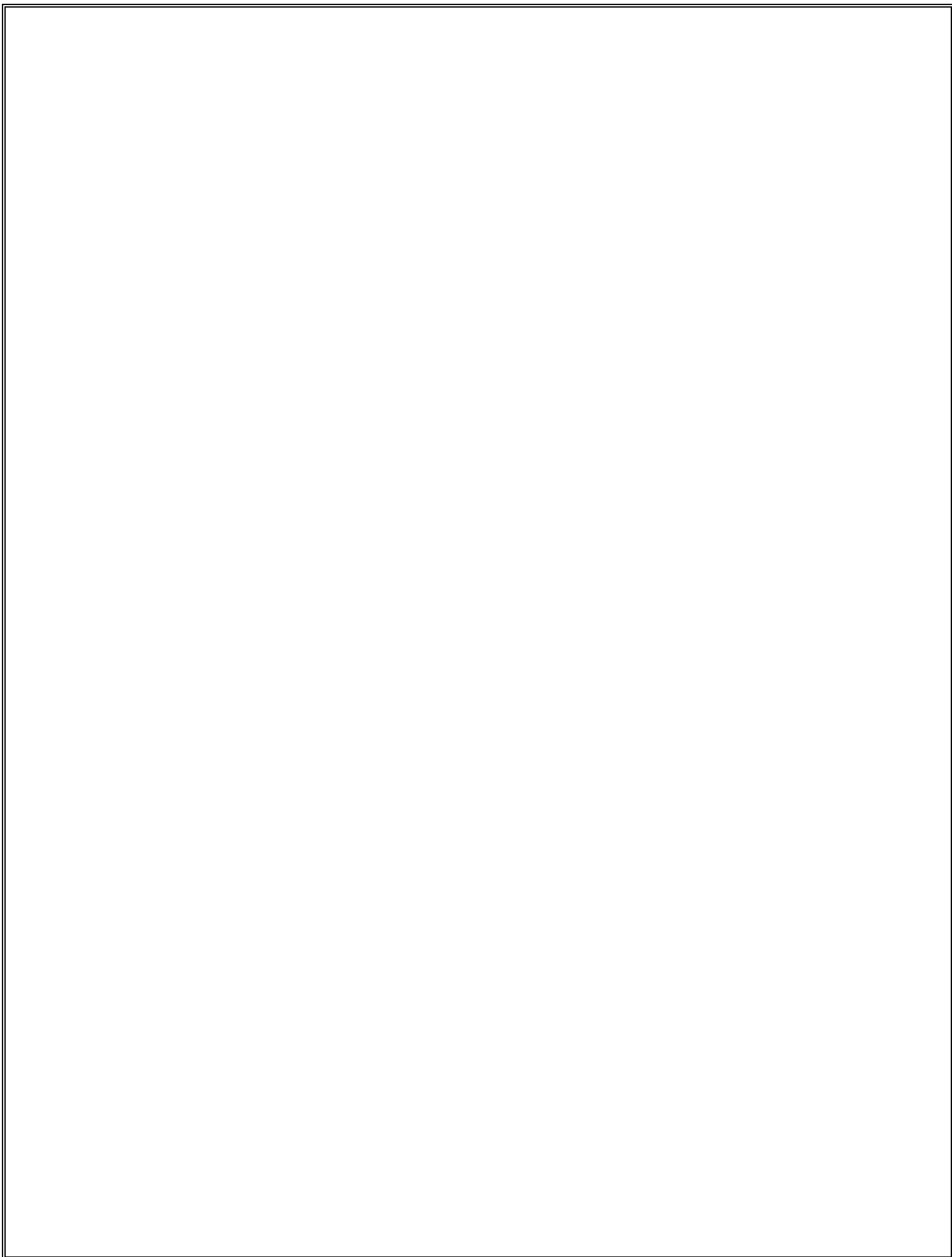

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INTRODUCTION

Cameron L. Hess, Esq., CPA, is Partner with Wagner Kirkman Blaine Klomparens & Youmans LLP and practices in the firm's transaction department in the areas of Taxation, Business Law and Legal Entities. Mr. Hess has over 25 years' experience in assisting individuals and closely held businesses in real estate, construction, manufacturing and service industries. Mr. Hess was formerly with KPMG Peat Marwick's state and local tax practice.

AREAS OF PRACTICE

REAL ESTATE

Mr. Hess represents owners, investors and developers with respect to legal and tax issues connected with real estate acquisition, development and sales. In addition to general real estate law, Mr. Hess advises on leases, loans, Section 1031 exchanges and developer issues (e.g., SB800 compliance, environmental remediation and California Department of Real Estate submittals). Mr. Hess has been counsel involved in one of the largest Sacramento area real estate home builder/developer acquisitions. Mr. Hess chairs the CalCPA Sacramento Chapter Real Estate Committee.

BUSINESS LAW

Mr. Hess works with closely held businesses with respect to general business contracts, acquisitions, financing, sales and owner succession planning. Mr. Hess's practice covers both corporate and pass-through entities (e.g., joint ventures, partnerships, limited liability partnerships and limited liability companies).

NONPROFIT LAW/PLANNED GIVING

Mr. Hess assists nonprofit entities with formation, operation, legal compliance and planned gifting concerns. Mr. Hess advises a number of California nonprofits in special tax areas. Mr. Hess supports the Nonprofit Resource Center as a lecturer and advisor to nonprofits.

FEDERAL AND STATE TAXATION

Mr. Hess represents clients with federal and state tax planning and advocacy, including audit examination, administrative appeals and Tax Court cases. Because of Mr. Hess's background as a CPA, he has been actively involved in complex tax and business cases before the state of California including unitary/combined reporting issues, property, employment and sales taxes. While with KPMG Peat Marwick, Mr. Hess was a manager for the Los Angeles Office of state and local tax practice where, for several years, he practiced exclusively state and local tax planning and controversy representation. Mr. Hess is regularly called upon tax aspects of

financial planning, real estate, business transactions. Mr. Hess was previously a columnist with *Spidell's California Taxletter*.

ESTATE PLANNING

Mr. Hess represents clients with complex estate planning, including irrevocable trusts, life insurance trusts, charitable trusts, granter retained annuity trusts and unitrusts, family limited partnerships and asset protection. Business succession planning has included transition planning, buy/sell agreements and family limited partnerships.

EDUCATION

University of California, Berkeley (B.S. (Accounting), 1980); University of Southern California (M.B.T., 1983); University of Southern California (J.D., 1983). Member: Tax Law Journal. Mortar Board, Honor Society, Beta Alpha Pi, Phi Alpha Delta (Law).

ADMISSIONS

- Admitted to California State Bar, 1984
- Admitted to U.S. Court of Appeals, 9th Circuit, 1984
- Admitted to U.S. District Court, Eastern District of California, 1984
- Admitted to U.S. District Court, Central District of California, 1991
- Admitted to U.S. Tax Court, 1991
- Admitted as Certified Public Accountant, 1988

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American Bar Association (Member 1980-present); State Bar of California (Tax Section); CalCPA - Sacramento Chapter (past President 2001-2002, Chair of Real Estate Committee 1993 to present, Director 1994 to 2006; CalCPA - State (Legislative Liaison State Financial Planning Committee); Sacramento County Bar Association (Member Tax and Business Sections); Past Member: State Bar Committees: Partnerships and Limited Liability Companies Committee (Member 1995-1997); California Manufacturers Association (Corporate Counsel Steering Committee, 1992-1994); Sacramento Metropolitan Chamber of Commerce; Rental Housing Association of Sacramento Valley (Board Member, past President); Easter Seals Superior California (Board Member 2003-2011.)

ACADEMIC ACTIVITIES

Published: Published in *Spidell's California Taxletter*, CCH *Taxes*, *The Tax Executive*, *The California Constructor*, *Los Angeles Lawyer, CSEA Enrolled Agent, SVAA Rental Property Management*, National Business Institute, (Topics include limited liability companies, property taxes, limited partnerships, corporations, city business taxes, employee benefit plans).

Instructor: Lecturer before State Bar of California, Tax Section, Sacramento County Bar (Tax and Business Sections); California Society of Enrolled Agents (SuperSeminars), California Society of Certified Public Accountants, California CPA Education Foundation, Inland Society

of Tax Practitioners, Society of California Accountants, Lorman Education Services, National Business Institute; Adjunct Instructor U.C. Davis (Taxation and Tax Planning for Certified Financial Planners 1998 – 2004); Adjunct Instructor Consumes River College (Intermediate Taxation 2013)

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2017 FAMILY LIMITED PARTNERSHP

ESTATE PLANNING STRATEGIES

By Cameron L. Hess

I. CURRENT REAL WORLD OVERVIEW.

The family limited partnership ("FLP") provides strategic estate planning, enabling not only a reduced transaction cost on family succession, but a conveyance of family values between generations.

The term FLP conjures more a grouping of planning concepts than any particular legal structure, and is used in the context of partnerships, limited liability companies ("LLC"), and like entities, wherein it may be combined with other planning tools. There are several common features with all FLPs:

1. Flow-Through Entity. One is that a conveyance occurs into an entity that has "flow-through" characteristics for income tax purposes (i.e., the entity is essentially not taxable).

2. Conveyance. Two is that there is a degree (partial or complete) of conveyance, present or future, in income/principal from one generation to a younger generation.

3. Asset Protection. Three is the entity is provides a form of asset protection, either with respect to the assets held or to protect one generation from follies of the other generation.

Beyond that, anything can happen. Accordingly, this outline introduces FLPs as a tool, outlining several key relevant legal and tax issues associated with FLPs. In reading this outline, unless specifically intended to explain a type of entity, the term FLP includes the use of LLCs.

Example 1: Simple Gift at Time of Purchase

> Able and Betty Star own several other apartment communities. Their three children, Carla, Dwayne and Edward, are adults. They would like to see their children become involved in apartment ownership, for which has been a good experience, providing income and wealth for their retirement. Able and Betty found a potential new acquisition, High Jinx Apartments and have come to you asking how their children (who have no cash to buy with them) could participate.

Parents have several options. To name just two:

Purchase/Gift FLP Interests. Able & Betty may form a FLP to purchase High Jinx Apartments. They then gift a 10% limited partner interest to each child.

This would be reported as a gift (and no sale if parents are general partners – with respect to debt allocation). If “zero” capital account is credited, the amount of the gift may be close to zero. Carla, Dwayne and Edward as limited partners will be allocated each year 10% of profits/losses, subject to at-risk/PAL/704 limitations. Carla, Dwayne and Edward will benefit from the future appreciation of the buildings.

Gift 30% of Down Payment. Able & Betty may form a FLP wherein each child is already a 10% member. If Able/Betty make the down payment.

If Carla, Dwayne & Edward are credited capital interests, 30% of the down payment will be reported as a gift. There is no rule as to who is the manager. Able & Betty could choose to allow the 3 children to be the managers, if they want that.

II. FLPS FOR BUSINESS AND ESTATE SURVIVAL.

A. FLP as Business Succession Tool

1. Business Succession Concerns. One of the biggest concerns for family business owners is succession planning. Succession planning is something that is individually tailored. This is where the benefit of FLPs is that it provides options. It allows decisions as to who manages, who votes, who holds income rights.

However, the first question to ask is: Does a FLP make sense? Sometimes it plainly doesn’t make sense. If interests and rights are transferred to the next generation, then what comes into play are the nature of each of the members of the next generation – each’s age, maturity, health, interests and capacities. For example, if no one in the next generation has any interest or willingness to own a particular business or investment, or the next generation is divisive, then planning should be cautious in considering a FLP.

Other times a FLP makes sense. If the younger generation is collegial, and there is a level of trust, potential to develop skills, and bona fide interest, then a FLP can work. Likewise, if just one member has an interest, and the group is collegial, a FLP could allow for division between working interest and investment interests. It could also provide for a mechanism to for those who do not want to be part of the group to cash out.

A FLP may help to address estate planning issues of division of assets, where there are no easy solutions.

2. Business/Investment Purpose. Another question is whether there are valid reasons to form a FLP. For many states, it is no longer required that a FLP be limited to enterprises that have a business purpose. In those states, a FLP may exist for investment or succession purposes, such as pooling moneys to allow a family investment portfolio to be professionally managed, by meeting minimum investment values required by professional money managers.

There are also other valid reasons for a FLP – they may be a better structure to resolve differences. While ownership of investments by co-tenancy is simple, it requires generally unanimous agreement and unanimous, simultaneous action to get anything done. By contrast, a FLP can provide for action by majority, and centralize management allowing for effective investment decisions.

If there is one or more in the next generation with the interest in owning or succeeding, then there are advantages to FLPs:

- FLPs may pass ownership interests, but contain terms that retains or passes control either/both by (i) providing for how/who is the designated general partner/manager/operator and (ii) granting different rights among different members in FLP management decisions.
- FLPs have fairly simple administration; FLPs also provide how profits/losses and compensation is provided for.
- FLPs may provide asset protection from creditors (and failed marriages.)

Example 2 – Management Transition:

Following the prior example, Able and Betty believe Carla is most interested and able to manage the apartments, but they want to give her a trail run. An LLC is formed, where Able/Betty – holding most of the member interests, designate Carla as a co-manager in the LLC.

Warning. While the foregoing works for many businesses and investments, it may not be applicable to "professional" service businesses. In some cases, state laws may preclude a FLP (or LLC) from being used to operate a service enterprise.

3. Sale of FLP Interest vs Direct Sale. In certain cases, such as with investment property, there may be the option to make a direct transfer, then have interests contributed into a FLP, rather than to transfer interests in the FLP. The reason for a direct sale rather than a sale of an interest may deal with certain local state rules. Generally direct transfers possibly may not receive lower discounts for valuation purposes.

4. Buy-Sell Agreements. The transition from one generation to the next generation may be provided by way of buy-sell agreements to the extent that the same provisions might apply to two unrelated persons.

The Service will follow the price set forth in a buy-sell agreement in establishing an estate tax value or in determining that there was no gift, under Code Section 2703, where four requirements are met:

- The price must be determined by the agreement.
- The terms of the agreement must be binding throughout life and death.
- The agreement must be legally binding and enforceable.
- The agreement must be entered into for bona fide business reasons—not as a testamentary substitute designed to pass assets to beneficiaries at less than full and adequate consideration.

5. Valuation/Payment Strategies

a. Valuation. If a FLP can be formed for valid business reasons, the valuation of the interest sold, gifted or inherited may reflect a "discount." The predominant view is that statutory restrictions and restrictions contained in the FLPs agreement limit the value of the interest transferred. On the other hand, a growing minority view is that as a business interest, if viewed at market value, the investor would look to what would be paid for the cash flow. In either event, the value of an FLP interest should be considered to determine the price for a sale or the value for a gift or bequest based on what a willing buyer/seller would agree as the price in an arms-length transaction.

Indeed, whether formed as a FLP or LLC, generally state laws may limit the rights of members, such as restricting the right to compel a sale of the business, a

liquidation of the partnership or to control, possibly restricting voting rights. Frequently the consequence is that the value is "discounted" as compared to the underlying asset value in the partnership.

The benefit of this valuation is that a senior generation may be able to sell or gift a greater portion to the next generation at a lower effective cost, as to the effect on gain from sale or, if the estate is greater than the unified credit amount, from a lesser use of the unified credit amount. This can result in significant tax savings, if the underlying property is not expected to be sold to a third party in the foreseeable future.

6. <u>Senior Level Cash Flow Concerns.</u> For long-term held property the senior level may have a concern in preserving income, while transferring equity and appreciation to the next generation. The use of a sale may allow the opportunity to shift future income to the next generation, but permit the retention of a stream of income though an installment sale, possibly allowing to them capital gains, rather than losing that tax benefit. Currently the effective federal capital gain rate of 23.8 percent (including the 3.8 percent net investment income tax) is significantly lower than ordinary income rates of 35% or higher. This incentivizes the option to transfer property by an installment sale, to convert ordinary income from investment activities into capital gain treatment on the sales proceeds.

The benefit of a sale of a FLP interest is that it allows a fixed cash flow for a period of years. Thereafter, upon full repayment of the note, there is no longer an obligation to make payments to the parents. Therefore, the parents must determine their comfort as to their resources when the note on the sale is paid in full. They must also consider should losses limit available cash, whether the children willing to make capital contributions to meet payment obligations on debt FLP debts.

B. FLP as Estate Reduction Tool

1. <u>Gift/Sale Options</u>. For both moderate and larger estates, the transfer of property from one generation to the next involves options as to whether the transfer is by gift or by sale. The decision whether to transfer by gift or sale involves a matrix of issues, wherein in many cases, a blend of both may provide the ideal result.

a. <u>Use of Gifting</u>. The benefit of making a gift involves the degree of simplicity. Where a senior generation has done very little planning, and an

estate has grown sufficiently large to result in estate taxes, gifting has the benefit of allowing a sizable portion of one's estate to transfer from one generation to another. The considerations to making a gift of a FLP interest include:

i. Gift/Estate Taxes. Greater shelter for appreciating property by fixing unified credit use at a lower value than a transfer at death;

ii. Estate/Income Tax Trade-of. If property is expected to be sold, not retained, shortly after the gift, the resulting income taxes, due to the absence of a step-up may be a distinct disadvantage. In fact, the higher income taxes may outweigh estate tax savings from avoiding estate tax on appreciation

iii. Income Taxes. The effect of a gift of a FLP may transfer with the property, profits to lower tax bracket family members.

> NOTE: The lower tax bracket benefit should not be underestimated. In many cases, the one-time gift provides a significant tax benefit, and is a substitution for annual gift giving, wherein the parents must pay tax on the income before making gifts.

b. Use of Installment Sales. As a general rule, for those planning early, an installment sale has benefits insofar as the senior generation may not be comfortable with parting with cash flow. The use of an installment sale in connection with the transfer of a FLP, can be a powerful tool in estate planning. The benefits of a sale with periodic payments, if qualifying as an installment sale several fold:

i. Cash Flow Protection. An installment sale postpones paying tax on a portion of the taxable gain from the FLP sold, wherein the cash flow may be set, after tax, to roughly match the prior income tax flow over the period of sale.

ii. Partial Inflation Hedge. To the extent that over the term of the sale, a greater portion will be capital gain, having a lower tax rate, rather than interest income, the net after-tax cash flow will modestly increase over time; this provides a partial hedge to inflation for fixed installment payments. Similarly, with a fixed cash flow item, the effective tax may (absent statutory changes) reduce overall taxes due to CPI indexed (or government adjusted) increases to i) lower tax bracket tiers,

ii) the threshold amount on net investment income tax, iii) personal exemptions, iv) phase-outs and, by government action – the AMT exclusion amount.

iii. Step-Up – Depreciation/Interest Deductions. The purchasing family members may qualify for both deductions on the payments, to the extent of interest, and depreciation which reduces the net effective cost of the purchase.

iv. Estate Tax Benefits. For larger estates, an installment sale may be superior to other types of estate "freezes" insofar where a potentially appreciating asset is substituted for a promissory note. In fact, the promissory note, even with arm's length terms, may be discounted for estate tax purposes with respect to value.

(a) Self-Cancelling Installment Notes. In some cases, it may make sense to set up the promissory note as a "self-cancelling installment note (SCIN). The benefit of a SCIN is that the promissory note will be excluded from the estate for estate tax purposes, as it has no value upon the death of the beneficial holder.[1] On the other hand, a SCIN will trigger income tax, generally capital gains, at the time of cancellation. Presently, even with state income taxes, the effective capital gain rate upon cancellation (23.8% - 39% - fed/state combined), will be lower than the current estate tax rate (40%). To have a good SCIN

- There must be a bona fide sale "full and adequate consideration")
- There must be a premium as to the price or interest paid, reflecting the "risk premium" as to the benefit of the termination provision; this may be computed using the actuarial tables provided by the regulations.[2]
- Both the sales agreement and promissory note should include language clearly identifying the cancellation at death and that provision must be irrevocable;

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[1] Estate of Moss v. Com'r (1980) 74 T.C. 1239. In accord is IRS GCM 39503. In the context of a SCIN, any presumption of a gift in certain circuits may be rebutted by documenting that there is a "real expectation of repayment. Estate of Costanza v. Com'r .C. Memo 2001-128. (Reversed and Remanded) (6th Cir 2003).

[2] The Risk Premium may be computed based on comparing the present value of the installment note, to the total present value of each payment, multiplied by the percentage likely to live at each year age. The effect

- The transferor should not retain extensive *control*.
- Interest rate must be at least the Code Section 483 required applicable federal rate.
- The term of the note should be no longer than the actuarial life expectancy of the transferor.

Given the close scrutiny of SCINs when examined, they must be carefully documented to mitigate the risk of the Service challenging the transaction and either disregarding the transaction or finding it to be a gift or an annuity payment (where the interest component will be disallowed.) SCINs should not be used when the health is in such a poor condition that the life expectancy is likely to be significantly shorter than actuarial life expectancy. It is almost never available where there is a terminal illness where the expectancy of death is under one year.

In addition, Section 453(e) will apply, wherein a sale by the purchaser within two years of the initial transfer will require the transferor to recognize the deferred gain immediately.

c. Combined Gift/Sale. With respect to an installment sale, often where the sale is 100% financed, younger generation does not have sufficient equity such that the payments can cover the debt to the senior generation. In fact, as to the purchased portion, even if 100% of the cash flow allocated to the younger generation is used to pay the promissory note, it may be inadequate. As a solution to the foregoing, the senior generation may be able to do a part-gift; part-sale to improve the likelihood that cash flow will be sufficient to cover payments.

Example 3 – Small Gift of FLP.

> Able and Betty Star already own the apartment building, but want to gift interests to their children.
>
> Able and Betty may form a FLP, transfer their interest therein individually as general partners (1%) and their revocable trust as the limited partner (99%). After appraising the apartment at $1.2 million (with no debt), they

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of the computation provides a higher amount due for a SCIN note where the holder is older and/or the term is longer.

each gift $28,000 per child (the annual donee exclusion amount x 2); $96,000 collectively.

A business valuation appraiser determines that the because of a 35% discount for the limited partnership interests, each gift represents a little over a 3.6% interest in the FLP or about 10.8% total combined that the children hold as limited partners.

Assuming that nothing further happens and Able and Betty pass on two years later, the value included in Able and Betty's estate for the FLP might not be 89.2% of the value of the apartments. Each holds 44.6%a non-controlling interest, wherein each estate would be entitled to a valuation discount due to lack of control and possibly discounts for issues in transferability due to transfer restrictions.

Example 4 – Larger Gift of FLP.

Assume the same facts. Able and Betty may increase the gift beyond $28,000 per child either/both i) by gifting using a portion of their unified credit amounts (presently $5.43 million, each) or ii) gifting through an irrevocable trust for the benefit of their children (with the trust for a term of years), wherein the terms of the trust include Crummey Powers granting secondary beneficiaries named, i.e., the spouses and grandchildren, a one-time withdrawal right, as permitted under the *Christofani* decision.[3].

Example 5 – Combined Sale/Gift.

Assume the same facts, but Able and Betty want to preserve some of their cash flow. In making a gift, they may do a projection of cash flow and the term of the installment sale to compute the maximum debt burden amount that the interest transferred can bear. The gift is then determined based on the smallest gift amount required so that the total interest transferred, including the gift can carry the property. For example, with respect to apartment houses, it would not be unusual to see that gift portion may represent from 25-40% of the total FLP interest transferred, the balance being the sale portion.

2. "Freeze Partnership". Another strategy is to adopt the same valuation freezes used with corporate entities, wherein the goal is, possibly without making a large gift, to freeze the value of the retained interest by the senior generation – wherein the senior generation again has an interest in retaining a fixed income interest.

[3] Christofani v. Com'r, (1991) 97 T.C. 74

Here, the FLP partner/member interests consists of two classes – one being a "preferred interest" (also called Class A interest), which has a fixed redemption right, and generally a preferred income right, and a "common interest" (also called Class B interest) which is entitled to appreciation and remaining income. It is not unusual in this structure to see a "reverse-FLP" wherein the senior generation (the parents) hold the limited partner interest (or for LLC, limited voting rights interest) and the younger generation holds the general partner (or for LLC, full voting rights interest.)

The benefit of this structure is that the value of the preferred interests are "frozen", thereby keeping future appreciation out of the estate. In addition, the preferred interest continues to have cash flow, providing continuing support for the senor generation.

One of the complexities of this arrangement involves valuation, wherein the Service closely scrutinizes the allocation of value with respect to a sale or gift of the common interest.

3. Protecting Section 6166.

a. Overview. Where the senior generation remains active in a FLP as managers or the general partner, there may be the opportunity to use Section 6166 to defer estate taxes on the retained interest, to the extent that the value passing to the next generation will be subject to estate taxes at death.

b. Benefits of IRC §6166.

i. If an estate qualifies under IRC §6166, liability for payment of the estate tax attributable to the closely held business interest can be spread out over up to 15 years. Payment terms can be selected by the estate within the maximums allowed.

ii. The maximum deferral allows annual interest-only payments due on each anniversary of the date the estate tax return was due to be filed. Fully amortized principal and interest payments begin on the 5th anniversary of the due date of that return and can continue until the 14th anniversary of that due date. Interest on

the first $1.28 million in taxable value attributable to a closely held business is set at 2%[4]. The remaining amount bears interest at a rate equal to 45% of the annual underpayment rate established under §6621.

iii.

c. Statutory Requirements of IRC §6166. Generally speaking, for an estate to avail itself of IRC §6166, the following 2 requirements must be met:

i. The decedent was, as of the date of his death, a citizen or resident of the United States; and

ii. The decedent's estate includes an interest in a closely held business the estate tax value of which exceeds 35% of the decedent's "adjusted gross estate" – by deducting from the gross estate only those items permitted under §§2053 and 2054, namely, funeral expenses, administration expenses, claims against the estate, unpaid mortgages and indebtedness on property and casualty losses.

Note: The Adjusted Gross Estate is Determined Prior to the Application of any Charitable or Marital Estate Tax Deduction.

(a) Example: Assume a decedent dies in 2015 with an estate valued at $14.5 million, comprised of (i) $500,000 cash that will be used to pay debts and expenses of the estate, (ii) $8 million of additional cash and marketable securities that will pass to a charity, and (iii) a fifty percent interest in a closely held business – said interest which is valued at $6.5 million, and will pass to the decedent's children. The decedent's estate plan provides that taxes are charged against the assets includable in the decedent's taxable estate.

The 35% test is not applied to the taxable estate of $6.5 million (after the deductions for debts, expenses, and the charitable gift), but to the adjusted gross estate of $14 million (after the deductions for debts and expenses, but before the charitable deduction). Because the closely held business valued at $6.5 million is more than 35% of the adjusted gross estate of $14 million, the decedent's estate would have qualified for §6166 deferral, allowing his executors to defer a portion of the $228,000 in estate taxes.

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[4] IRC §6166 adjusts the amount eligible for the 20% interest rate by inflation. 2015 is $1,470,000. (See IRC §§6601(j)(3) and 1(f)(3).)

d. Closely Held Business Defined. A FLP interest may qualify for Section 6166 if it is treated a closely held business. An interest in a closely held business is defined in §6166(b) as any of the following:

i. An interest as a proprietor in a trade or business carried on as a proprietorship;

ii. An interest as a partner in a partnership carrying on a trade or business, if:

(a) 20% or more of the total capital interest in such partnership is included in determining the gross estate of the decedent, or

(b) such partnership had 45 or fewer partners; or

iii. Stock in a corporation carrying on a trade or business if:

(a) 20% or more in value of the voting stock of such corporation is included in determining the gross estate of the decedent, or

(b) such corporation had 45 or fewer shareholders.

e. Exclusion of Passive Assets. IRC §6166(b)(9) excludes "passive assets" from the estate tax value of an interest in a closely held business used in determining whether the estate qualifies for estate tax deferral and when determining the portion of estate tax that can be deferred pursuant to §6166. A "passive asset" is any asset other than an asset used in carrying on an active trade or business.

i. The IRS has provided that to qualify for §6166 deferral, the business must consist of a manufacturing, mercantile, or a service enterprise rather than the mere management of passive assets.

ii. The IRS has scrutinized whether a decedent's real estate holding will be considered a closely held business for purposes of §6166. If the holdings are considered mere passive investments, they will not be considered a closely held business. If, however, the decedent's activities rise to the level of managing an active business rather than a passive investment, the estate may qualify for §6166 deferral.

Revenue Ruling 2006-34 addresses whether a decedent's interest in real estate will qualify as a closely held business for purposes of §6166. Specifically, the ruling provides that the IRS will consider the following non-exhaustive list of factors:

(a) Whether an office was maintained from which the activities of the decedent, partnership, LLC, or corporation were conducted or coordinated, and whether the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) maintained regular business hours for that purposes;

(b) The extent to which the decedent (or agents and employees of the decedent, partnership, LLC, or corporation);

(1) was actively involved in finding new tenants and negotiating and executing leases;

(2) provided landscaping, grounds care, or other services beyond the mere furnishing of leased premises;

(3) personally made, arranged for, performed, or supervised repairs and maintenance to the property (whether or not performed by independent contractors), including without limitation painting, carpentry, and plumbing; and

(4) handled tenant repair requests and complaints.

Further, the ruling provides 5 examples. In example 4, strip malls were owned and managed through a limited partnership, of which the decedent was a limited partner. The partnership, acting through its general partner, handled the day-to-day operations and management of the strip malls. The activities of the general partner on behalf of the limited partnership included (either personally or with the assistance of employees or agents) performing daily maintenance of and repairs to the strip malls (or hiring, reviewing and approving the work of third party independent contractors for such work), collecting rental payments, negotiating leases, and making decisions regarding periodic renovations of the strip malls. With respect to example 4, the limited partnership's management by a general partner and its employees was imputed to the decedent. (In a prior example, the activities of an independent contractor were not imputed.)

The implication here is that a FLP structure may be more advantageous than other structures to meet the §6166(b)(9)(B)(iii) test. If there is retained a general partner or manager interest by the senior generation in actively managed real estate or a business, the FLP interest may qualify as a closely for §6166 deferral.

C. Advanced Planning

1. GRAT/FLP Combination. An interesting planning tool involves the combined use of FLIPs and GRATS to convey large property interests. FLPs allow substantial discounts for fractional interests. GRATS allow substantial discounts for time value of money concerns.

2. Charitable Planning. Another strategy is the use of interests in a family limited partnership for charitable giving. Where there is a bona fide charitable intent, a FLP may be structured to provide for a charity to have an interest. For example, a charity may be granted a senior preferred interest that would provide the charity with a preferred distribution, subject to available cash flow each year. The concept of this structure would be to provide a fixed income and a fixed principal amount on liquidation wherein the charity would not share in appreciation. As with other charitable contributions, if properly structured and reported, a charitable deduction would be allowed on the gift of the partnership interest.

Charitable giving of a FLP interest involves a number of technical issues. First, under the FLP's agreement will need to permit the transfer. Second, partnership liabilities may present problems. Under Rev. Rul. 75-194, 1975-1 C.B. 80, the IRS the donor's share of partnership liabilities will reduce the gift. But, a greater concern is that certain liabilities may be deemed assumed by the charity, triggering a bargain sale to the donor, including possibly ordinary income from unrealized receivables and substantially appreciated inventory. (Com'r v. Tufts, 461 U.S. 300 (1983).) The charity might also be subject to tax on unrelated business income (UBI) due to underlying debt. Income would also need to be reviewed to determine that it is "investment income" not taxable business income.

3. Life Insurance Planning. One problem that has arisen as of late, particularly with higher estate tax exemption amounts is that there may be existing life insurance policies of considerable value, but which are not needed for the payment of

estate taxes. When funded into an ILIT, a difficulty arises in getting the policy out absent termination of the ILIT itself. Because ILIT provisions cannot be changed without court approval and insurance requires annual payment of premiums, if not paid out of cash value, the time, cost and risks associated with court approval may be an item which may be better if avoided.

One possible strategy would be to have a FLP purchase for fair market value the policy from the ILIT. If the insured holds a nominal 1% limited partner interest in the limited partnership, it is possible that the policy will still qualify for exclusion from income tax under Section 102 under an exception to the transfer for value rule. See §101(a)(2)(B). While the policy itself could not be transferred back directly to the insured, this limited partnership purchase strategy may be viable. Generally, fair market value should approximate cash surrender value. However, if the insured is of poor health, then the IRS may not accept cash surrender value as fair market value.

III. FLP–LIMITED PARTNERSHIPS V. LIMITED LIABILITY COMPANIES

A. What is a FLP?

1. Definition of a Partnership. A voluntary association of two or more persons to carry on a business, as co-owners, for profit.

a. Association of Two or More Persons. Partnerships are voluntary associations. All partners must agree to participate. A person cannot be forced to be a partner or to accept another person as a partner.

b. Carrying on a Business. Mere co-ownership of property (by joint tenancy, tenancy in common, tenancy by the entireties, joint property, community property, or otherwise) does not itself establish a partnership. A business -- trade, occupation, or profession -- must be carried on.

c. Co-ownership of a Business. Co-ownership of a business is essential. The most important factors in determining co-ownership are whether the parties share the business' (i) profits and (ii) management responsibility.

d. Profit Motive. The organization must have a profit motive (even though it does not actually have to make a profit).

i. See Holmes v. Lerner (1999) 74 Cal.App. 4th 442, holding that an express agreement to divide profits is not a prerequisite to proving the existence of a partnership.

2. Limited Partnerships. A limited partnership must have at least one general partner (who manages the business and is liable for partnership debts) and one limited partner (who invests capital but does not participate in management). There are no restrictions on the number of general or limited partners allowed. Any person may be a general or limited partner. A person may be both a general and a limited partner in the same partnership.

a. Admission of New Partners. Once a limited partnership has been formed:

i. New limited partners can be added only upon the written consent of all partners unless the partnership agreement provides otherwise.

ii. New general partners can be admitted only with the written consent of each partner. The partnership agreement cannot waive the right of partners to approve the admission of new general partners.

b. Formation of Limited Partnerships. The creation of a limited partnership is formal and requires public disclosure. The entity must comply with the statutory requirements.

i. Certificate of Limited Partnership. Someone must execute a certificate of limited partnership and file it with the Secretary of State. The certificate must contain:

(a) Name of the limited partnership;

(b) Address of the principal place of business, and the name and address of the agent to receive service of legal process;

(c) Name and business address of each general partner;

(d) The number of general partners' signatures required for filing certificates of amendment, restatement, merger, dissolution, continuation and cancellation; and

(e) Any other matters that the general partners determine to include.

The limited partnership is formed when the certificate of limited partnership is filed.

ii. Defective Formation. Defective formation occurs when (i) a certificate of limited partnership is not properly filed; (ii) there are defects in a certificate that is filed; or (iii) some other statutory requirement for the creation of a limited partnership is not met. If there is a substantial defect, persons who thought they were limited partners can find themselves liable as general partners. Such persons who erroneously but in good faith believe they have become limited partners can escape liability as general partners by either:

(a) Causing the appropriate certificate of limited partnership (or certificate of amendment) to be filed; or

(b) Withdrawing from any future equity participation in the enterprise and causing a certificate showing that withdrawal to be filed.

Nevertheless, the "limited partners" remain liable to any third party who transacts business with the enterprise before either certificate is filed if the third person believed in good faith that the partner was a general partner at the time of the transaction.

iii. Limited Partnership Agreement. The partners of a limited partnership must draft and execute a partnership agreement that sets forth the rights and duties of the (general and limited) partners (including terms and conditions regarding the operation and dissolution of the partnership).

(a) Rights and Duties of Partners. The rights, powers, duties and responsibilities of the partners in a limited partnership are specified in the partnership agreement, CRLPA and the common law. The general partners of a limited partnership have the same rights, duties and powers as partners in a general partnership (1994 Act).

Limited partners can have virtually the same rights as general partners. They have rights to inspect the partnership's books and records and to an accounting. They can assign their partnership interests unless they have agreed otherwise.

(b) Voting Rights. It is good practice to establish voting rights in the partnership agreement.

(c) Share of Profits and Losses. The partnership agreement may specify how profits and losses are to be allocated among the partners. If there is no such agreement, the profits and losses are shared on the basis of the values of the partners' respective capital contributions. A limited partner is generally not liable for losses beyond his or her agreed upon capital contribution.

(d) Other Items/Issues. The partnership agreement should address:

(1) The partnership's name;

(2) The names and addresses of the partners;

(3) The partnership's principal office;

(4) The nature and scope of the partnership business;

(5) The duration of the partnership;

(6) The capital contributions of each partner;

(7) The salaries, if any, to be paid to the partners;

(8) The rights and duties of the partners regarding the management of the partnership;

(9) Limitations, if any, on the authority of partners to bind the partnership;

(10) Provisions for the admission and withdrawal/disassociation of partners, and the terms, conditions, and notices required for withdrawal; and

(11) Provisions for continuing the partnership upon the withdrawal of a partner, death of a partner, other disassociation of a partner, or dissolution of the partnership.

3. Liability of General and Limited Partners. The general partners have unlimited liability for the debts and obligations of the limited partnership. Generally, limited partners are liable only for the debts and obligations of the partnership up to their agreed upon capital contributions.

a. Limited Partners and Management. As a "trade"-off for limited liability, limited partners must give up their right to participate in management. A limited partner is liable as a general partner if his or her participation in the control of the business is substantially the same as that of a general partner (though the limited partner is liable only to persons who reasonably believed him or her to be a general partner).

4. How is a FLP Formed?

a. A partnership agreement is entered into:

i. Individual and trust (Appendix);

ii. Individual and corporation;

iii. Husband and wife;

iv. Etc.

b. Assets are placed into the partnership (the partnership is capitalized).

c. (Limited) FLP interests are gifted to beneficiaries/partners.

B. What is an LLC?

1. General Characteristics. An LLC is a statutory hybrid that is a cross between a corporation and a partnership. LLCs generally provide limited liability to their members (like a corporation) and, at the same time, offer the advantages of one level of tax (like a partnership) without the restrictions placed on S corporations.

a. Formation. LLCs are generally formed upon filing of the Articles of Organization ("Articles").

b. Operation. The internal affairs of the LLC are governed by its Articles, its operating agreement and the applicable state LLC Act – many states have adopted the Revised Uniform Limited Liability Act. The operating agreement looks much like a limited partnership agreement except that the "partners" are referred to as "members" and, in lieu of general partners, the LLC has "managers." Unlike the general partner of a limited partnership, the manager need not own an interest in the LLC. An

LLC can be either "member managed," where all of the members are involved in management decisions, or "manager managed," where management responsibilities are delegated to fewer than all of the members.

2. Members and LLC Interests.

a. Nature of Interest in LLC. While an LLC interest is generally considered intangible personal property, a member is limited to the interest itself and has no direct ownership interest in specific LLC assets.

b. Admission of Members. As to the members, admission is generally set out shortly after the time of organization, and thereafter additional persons become members as provided in the Company's operating agreement. If the Articles or operating agreement do not so provide, the unanimous vote of members may be required. Upon an assignment, while the assignee may be entitled to member's share of the profits and losses of the LLC and the right to receive distributions; it does not necessarily include any right to participate in management.

c. Dissociation or Resignation. In many states, a member may not be stopped from dissociation. While the operating agreement may provide for the conditions upon which member may resign or withdraw, the member may dissociate notwithstanding. That action, however, may adversely affect the member's interest.

d. Rights of Creditors. A member has no direct ownership interest in the assets of an LLC that may be reached by his, her or its creditors. However, a member's creditors may reach his, her or its interest in the LLC. A judgment creditor of a member may apply to the court to charge the interest of a member or assignee with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of the interest.

e. Dissolution. An LLC is dissolved and its affairs are to be wound up as specified in the Articles or operating agreement or generally upon a majority in interest of members, unless greater percentage of voting interests specified in Articles or operating agreement. But, on application by or for a manager or member, a court may decree dissolution of an LLC if it is not reasonably practicable to carry on the business in conformity with the Articles or operating agreement.

C. Quick Comparison of Features

1. Flow-Thru Tax. LLCs may be classified as partnerships for federal income tax purposes.

   a. Advantage: None.

2. Limited Liability. The principal advantage of an LLC is the limitation on liability. In the case of a FLP, at least one partner (which may be a corporation or an LLC) must have unlimited personal liability. Further, the limited partners may become liable for the debts of the partnership if they take part in the management of the business. These rules do not apply to participants in an LLC.

   a. Advantage: LLC.

3. Accounting Methods. IRC Section 448(a) provides that C corporations, partnerships with C corporations as partners, or tax shelters must use the accrual method of accounting. The term "tax shelter" is defined as any enterprise other than a C corporation if at any time interests in the enterprise have been offered for sale in any offering required to be registered with any federal or state agency having authority to regulate the offering of securities for sale. The Regulations provide that an offering is required to be registered with a federal or state agency if, under federal or state law, failure to file a notice of exemption from registration would result in a violation of federal or state law.

In the case of a family LLC which is managed by all of its members, a securities qualification or registration will not be required if all members are actively engaged in the management. However, where an LLC is manager managed, it is necessary to file a notice of exemption for securities law purposes. Therefore, it is likely that a manager managed LLC would not be allowed to use the cash method of accounting. Similar restrictions apply to FLPs.

   a. Advantage: Member-managed LLCs.

4. Debt Allocation/Basis. Where debt is not guaranteed by a member, it would seem that the LLC will be treated as having non-recourse debt under the Regulations used to determine outside basis (the basis of a partner in his or her partnership interest). (See Temporary Regulation Section 1.752-1T.) This would mean that all of the members would be eligible to claim a share of the debt for purposes of

computing basis. Because all of the debt would be non-recourse, it would follow that the LLC will have a higher amount of non-recourse deductions than a FLP.

a. Advantage: Unclear. (Who do you represent?)

5. Passive Losses/Material Participation. It appears that only one of the special rules that apply to material participation by a limited partner for passive loss limitation purposes would apply in determining whether a member of an LLC materially participates in a passive activity. For example, under current Regulations, it would appear that the member would have to participate in the activity for more than 500 hours, and would not be able to rely upon any of the other six methods for determining material participation. See Temporary Regulation Section 1.469-5T(e)(1) and (2).

a. Advantage: FLP.

6. Uncertainty in the Law. The laws relating to LLCs in the various states differ. For example, the Colorado LLC is treated as a partnership if the LLC qualifies as a partnership for federal tax purposes. In Florida, the LLCs are treated as C corporations for state tax purposes even if an LLC qualifies as a partnership for federal tax purposes.

In many of the LLC statutes, the entity terminates/ dissolves on the death of a member. The remaining members may continue the entity, but the damage may have been done and the IRS may be able to argue that the decedent's interest must be valued as a percentage of the underlying assets instead of using the discounted value of the LLC/entity.

a. Advantage: FLP.

7. Self-Employment Taxes. Self-employment tax is imposed on net earnings from self-employment. There are some exceptions to the net earnings from self-employment rule, namely, rental from real estate and the gain or loss from the sale of a capital asset.

In PLR 9423018, the Service held that, when a member was actively engaged in the professional business of an LLC, the member would not be treated as a limited partner under Section 1402(a)(13). Similarly, Proposed Regulation Section 1.1402(a)-(18) excludes from the ambit of this tax a member who is not a manager of a family LLC which could have been formed as a limited partnership. (Note that the definition of

manager is any person who is vested with authority to make decisions. This appears broader than simply looking at whether the person has been designated as a manager in the Articles.)

In the case of an LLC, the test for self-employment tax is an all or nothing test. In the case of partnerships, if a person owns general and limited partner interests, only the earnings from the general partner interest are subject to this tax.

Under IRC Section 1402(a)(13), the income or loss of a limited partner other than guaranteed payments under IRC Section 707(c), is not earnings from self-employment.

a. Advantage: FLP.

8. Estate Planning/Valuation. FLPs may have slight estate-planning advantages over LLCs. Unless the members of an LLC provide otherwise in the operating agreement, each member has the right to withdraw from the LLC and become the holder of an economic interest. (Corp. Code § 17252.) A limited partner does not have the statutory right to withdraw from a FLP. (Corp. Code § 15663.) If an LLC member has the right to withdraw and receive fair value for his or her interest, the minority discount that applies when valuing limited partnership interests may not apply when valuing interests in an LLC. (See IRC § 2704(b).)

a. Advantage: FLP?

NOTE: The statutory provisions governing withdrawals in both LLCs and FLPs may be varied by agreement among the members/partners.

9. IRC Section 2704(b). Another technical estate tax advantage FLPs have over LLCs is contained in IRC §2704(b), which provides that a liquidation provision will be ignored where it is more restrictive than the limitations contained under "generally applicable" state law. This provision can be used by the IRS when determining the estate tax for a deceased general partner or LLC member.

If the IRS is successful in asserting that the partnership or LLC is dissolved on partner or member's death, the discount associated with the interest in the FLP or LLC could be substantially reduced. Consequently, in structuring family entities, measures should be taken to ensure the entity will continue after the death of a family member.

Under California law, a limited partnership will not dissolve when a general partner dies if there is another general partner in existence. While an LLC will not be

dissolved upon a member's death, it can be dissolved by a vote of members holding a majority of the membership interests Since the FLP is more difficult to dissolve upon the death of a family member, as contrasted to an LLC, a FLP provides a greater likelihood of preserving any/all applicable valuation discounts, and avoiding the impact of IRC § 2704(b), in cases where one person owns a majority interest.

a. Advantage: FLP.

IV. TAX ISSUES WITH FLPS.

A. Income Tax Reporting.

1. Overview. FLPs and LLCs that do not elect out of partnership reporting generally follow same reporting as other partnerships for federal income tax purposes, including filing a partnership return, federal form 1065 each year. Partnership items are separately stated, to reflect their different character, when allocated to each partner/member’s personal income tax return. On the other hand, there are a number of special rules that may be triggered, such as for example:

a. Recognition of gain on an installment sale to a related person at the time of a subsequent transfer within two years of the original sale (Section 453(e));

b. Recasting capital gains and ordinary income on sales between related persons (Section 1239)

2. Sale to Related Persons. Where an interest in a FLP is sold, the question arises whether the involvement of related parties will have an adverse tax consequence. There are several provisions to be aware of under the Code. First, under Section 453(g) the sale of depreciable property to certain related persons will not qualify for the installment sale method. Nor does the purchaser receive a step-up in basis until amounts are included in the seller’s gross income. The foregoing does not apply if it is shown the sale does not have as one of its principal purposes the avoidance of federal income tax. (Code Section 453(g))

Second, under Section 1239, any gain realized from sale of property between related persons will be taxed as ordinary income where the property would be depreciable to the transferee. (Code Section 1239)

Because the foregoing triggers very harsh results, these provisions need to be reviewed with every transaction. While these provisions are generally thought to not apply to FLP sales, clients should be advised that there is a possible risk if the Service take the position that for FLPs, the underlying assets should be considered subject to these rules if the property is depreciable;[5] it is unclear, however, that Congress intended as to its application to partnerships, but the effect both capital gain and step-up benefits would seem to parallel the limitations of these provisions.[6]

Finally yet importantly on the related party concerns, clients should be advised that under Section 453(e) of the Code any disposition within two years will cause the installment sale to fail.

B. Tax Challenges.

FLPs (and LLCs) have been used for over 75 years (i) to provide for succession of management, (ii) for income tax planning and (iii) for estate/gift tax planning. The challenges made by the IRS to FLPs are not a new event, but rather involve a change in focus and intensity. This arose in part due to mass marketing of FLPs and LLCs in a manner more akin to the sale of snake oil and FLPs with sloppy drafting, and execution resulting in a hard pushback by the Service with a greater number and depth of challenges. Challenges have included issues as to whether gifting/transferring parents really parted with the assets transferred, and whether what was transferred was in fact the FLP or the underlying asset. Valuation issues have repeatedly arisen.

It can be said that the IRS has a degree of discomfort with the use of LLCs and FLPs in estate planning. The potential arguments involve the following: (1) substance

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[5] Section 453(g) defines related parties under Section 1239 discussed below, but includes an interesting twist. The term includes 2 or more related partnerships with cross-reference to Section 707(b)(1)(B) and Section 267(c) of the Code. A logical reading is that the intention was to mandate family attribution rules where there is a sale between two related, commonly controlled partnerships, wherein control could include ownership by immediate family members.

[6] The wording of Section 1239, at least facially, does not appear to apply to FLPs where the all of the partners received their interest by purchase or gift. Under Section 1239, which mandates ordinary income treatment on related party sales between related persons, the definition of related persons includes a sale between (i) a taxpayer and controlled entities, i.e. a 50% or more controlled partnership or corporation and legal entity, and (ii) trusts in which taxpayer or his spouse is a beneficiary (other than a contingent remote beneficiary). Section 1239 also incorporates as related persons provisions of Section 267(b)(3), (10), (11) and (12) (between corporations or a corporation and a partnership) and 267(c) (constructive ownership of stock). Consequently, ordinary income treatment may result on a corporate stock sale between parents and children wherein the children are the sole owners of the corporate entity.

over form, (2) step transaction doctrine, (3) gift on entity formation due to disappearing value, (4) Section 2036 decedent retained control and (5) Section 2703 donor retained interest. As to Section 2703, which deals with gifts with retained interests, the IRS has arguably ignored Committee Reports indicating that Section 2703 was not intended to eliminate the right to minority and transfer discounts created with respect to gifts of interests in entities. (H.R. Conf. Rep. No. 101-964 (1990) at 1137.)

While the IRS tended to go after the more egregious cases, there is growing direction to try to develop case law to support challenges to the use of general partnerships, limited partnerships and LLCs for estate planning purposes, particularly with respect to the use of discounts. The bottom line is any error or factual complexity may bring about IRS scrutiny of a transaction.

1. Step Transaction

a. Holman, Jr. v. Commissioner, 130 T.C 170 (2008).

On November 2, 1999 the taxpayers and a trust for their children transferred Dell stock to a partnership. On November 8th, (six days later) the taxpayers made gifts of limited partnership interests to a custodial account and a trust for the benefit of their children. The Court rejected the IRS's indirect gift argument because the taxpayers satisfied the burden of proving that the Dell stock was contributed to the partnership prior to the transfer of partnership interests. The Court also rejected the IRS's argument that all of the steps were interdependent and served no purpose other than to avoid making gifts of stock.

b. Gross v. Commissioner, T.C. Memo 2008-21.

Eleven days after the formation of a partnership and the transfer of securities to the partnership, the taxpayer made gifts of limited partnership interests to her daughters. The IRS argued that the step transaction should apply to the transfers with the result that the transaction should be treated as a transfer of the securities and not of the partnership interests. The Court rejected the application of the step transaction by reasoning that because of the time between the date of the contribution and the date of the transfer of the partnership interest, the donor bore an economic risk as to the change in value of the

property contributed to the partnership. However in a footnote the Court noted that they might reach a different result if a less volatile asset "such as preferred stock or a long-term Government bond" were contributed to the partnership.

c. Linton v. United States, 638 F. Supp 1277 (2009).

On the same date, January 22, 2003, (i) Mr. Linton transferred real property, cash and municipal bonds to an LLC that was formed in 2002 (ii) Mr. Linton transferred a 50% interest in the LLC to his wife, (iii) Mr. and Mrs. Linton created trusts for each of their four children and (iv) Mr. and Mrs. Linton transferred 90% of the interests in the LLC to the trusts. The Court found that because the gifts were made simultaneously with the contribution of property to the LLC that the taxpayers made indirect gifts if interests in the property contributed. The Court distinguished the holdings in Holman and Gross because there was no delay between the funding and the gifts. Therefore the taxpayers could not show the "volatility necessary to establish a real economic" risk that would result from a delay. Also the Court applied Treasury Reg. Section 25.2522-1(h)(1) which provides that if a contribution is apportioned among the other partners' capital account the contribution is treated as an indirect gift to the other partners.

d. Heckerman v. United States, 104 AFTR 2d 2009-5551.

On facts similar to Linton, the taxpayers transferred mutual funds to an LLC and on the same day assigned 49.6% of the membership interests to trusts for their children. They claimed a discount of 58% on their gift tax returns. The Court found that there was an indirect gift and applied the step transaction to eliminate the discounts in valuing the gifts.

e. Pierre v. Commissioner, 133 T.C. 24 (2009).

The taxpayer created a single member LLC and then transferred $4.25 million in cash and marketable securities. Eleven days later, the taxpayer created irrevocable trusts for the benefit of her son and granddaughter. The next day, the taxpayer transferred by gift a 9.5% membership interest to each trust and sold a 40.5% membership interest to each trust.

The Court held that the transfer of interests in a single member LLC should not be treated as a gift and sale of the underlying assets even though a single member LLC is disregarded for tax purposes.

f. Pierre v. Commissioner, T.C. Memo 2010-106.

The issues this time were (1) whether the step transaction doctrine applied to aggregate the gifts and the sales made to each trust and (2) if they were aggregated, what discount applied for the lack of control. The Tax Court applied the step transaction doctrine for the following reasons:

- The gifts and sale occurred on the same day in the time it took to sign four documents.
- The taxpayer intended to transfer her entire interest in the LLC.
- The transaction was structured to avoid gift tax liability.
- The original document included records reflecting gifts of 50% interests.

In applying the step transaction the Court treated the transaction as a single transfer of two 50% interests. However, the result was a mere reduction of the discount for lack of control from 10% to 8%. The Court allowed a lack of marketability discount of 30% resulting in an aggregate discount at 37%.

g. Bigelow v. Com'r., No. 05-75957, 2007 U.S. App. LEXIS 22030 (9th Cir. Sept. 14, 2007), aff'g, T.C. Memo. 2005-65. The U.S. Court of Appeals for the Ninth Circuit has ruled that a family limited partnership (FLP) failed to achieve the desired estate tax valuation discounts. The decedent established a revocable trust to which she transferred her residence. When she moved to a nursing home, the trust exchanged the residence for an investment property. To pay off the existing mortgages on the residence, the trust obtained a $350,000 loan and a $100,000 line of credit, both of which were secured by the investment property. Later the decedent and her children created an FLP and transferred the investment property (then worth $1.4 million) to it in exchange for partnership interests. The decedent remained personally liable on the loan and line of credit. The FLP made the $2,000 monthly loan payments for the decedent. But, most of the net rental income was used to pay the decedent's living expenses, which increased after her insurance coverage ended. Upon her death, the estate took a 37 percent minority interest and marketability discount to her remaining FLP interest, but IRS said the FMV of the investment property rather than the discounted FLP interest was included in the estate under I.R.C. §2036(a)(1), and the Tax Court agreed.

On appeal, the Ninth Circuit affirmed. The court found an implied agreement between the decedent and her children that she would continue to retain income and economic benefit from the transferred property. In addition, the transfer was not a bona fide sale for full consideration. The main problem, the court determined, was that the loan and line of credit were not transferred to the FLP with the investment property. It didn't matter that the estate was liable to make the loan payments on the decedent's behalf. Also, a transfer of the investment property would have impoverished the decedent if there had not been an implied agreement that the FLP would supplement her income. The FLP also failed to follow partnership formalities. But, the court rejected the IRS contention that inter-vivos transfers of real property to an FLP are can never satisfy the bona fide sale exception to I.R.C. §2036(a). Ultimately, the court said that there must be a significant and legitimate non-tax purpose for the transfer.

With the opinion, the Ninth Circuit has followed several significant FLP cases concerning the application of I.R.C. §2036(a) to FLPs and the need for a non-tax purpose for the entity's creation.

h. Estate of Rector v. Com'r (2007) 2007 TC Memo 2007-367. In Estate of Rector v. Com'r, the decedent formed a FLP with herself and her trust, it was not funded for three months and only the decedent contributed property. Management and ownership remained relatively unchanged after the transfer. The only assets transferred were cash and marketable securities. The decedent's remaining assets were insufficient to support her and therefore one-half million of the FLP's assets were delved into to provide for the decedent's health and care, said amounts which were far in excess of the FLP's income. The FLP had no business plan. Limited partnership interests were gifted to the sons in 1991 and 2001. The Tax Court found that the FLP failed under Section 2036(a), wherein the FLP lacked any business purpose, there was an implicit understanding that the decedent retained control over the entirety of the FLP, enjoying all income and powers and that the transfer was, based on the facts, the transfers were not made in good faith and the children did not engage their own counsel in the development of the agreement.

i. Mirowski v. Com'r. (February 27, 2008) TC Memo 2008-74. In this case, the taxpayer won. This is a case where taxpayer did almost everything

right, but unexpectedly died within one month of the completion of the formation of the FLP. First, Anna Mirowski was competent, had substantial wealth and had been considering a FLP for almost two years. The family was already engaging in joint meetings as to management of investments and the value of unique asset developed by her husband that appreciated considerably after his death. She had a history of making gifts.

The IRS challenged arguing that the FLP failed. The Tax Court disagreed, and made an extensive finding of facts, concluding that (i) the initial transfer into the LLC qualified as a bona fide sale under 2036(a) and 2038(a) following Bongard. Further, there was a significant non-tax reason and the transfers were proportionate to value. There were legitimate non-business reasons. Ms. Mirowski retained sufficient assets. The partnership managed assets separately. They rejected that the IRS had to have an active trade or business as a bona fide exception requirement. The health problem was also unexpected. The LLC's payment for estate taxes was not a factor as it was unexpected; she was not expected to die. Not relevant as it did not appear that estate taxes had to be paid any time soon.

On the gifted interest, there was not found to be a failure there. The news that she died quickly meant they would look at what rights were retained in the partnership. Document was not ignored and there were no distributions like a "check book" to Ms. Mirowski. Document provided no such rights and she used no such rights. As a result the 2036(a) attack did not arise here, there was no implied life estate.

The IRS tried other attacks, but they did not work.

j. Future of the Step Transaction Doctrine in Estate Planning. The reasoning of more recent cases could be easily extended - "nothing of independent significance occurred." between the gift [and sale] transactions."

- Do you have to establish nontax purpose to avoid integration of the multiple steps.
- What are the consequences? In Pierre they were insignificant.

2. Annual Exclusion Gifts

a. Price v. Commissioner, T.C. Memo 2010-2.

In 1997, Mr. Walter Price formed Price Investments, LP of which Walter's Living Trust was the 1% general partner and his and his wife's living trusts were each 49.5% limited partners. Partnership assets originally consisted of stock of Mr. Price's company Diesel Power Equipment Company ("DPEC") and three parcels of commercial real estate leased under long term leases to DPEC. In 1998, the partnership sold its DEPEC stock and invested its sale proceeds in marketable securities.

During 1997-2002 both Mr. and Mrs. Price made gifts of limited partnership interests to their children. For three of the years, the Prices reported taxable gifts on their gift tax returns after deducting the annual exclusions. During the years 1997-2002 the partnership made distributions in four of the years. The issue before the Court was whether the gifts qualified for the annual exclusion under section 2503(b). The IRS contended that under the holding of Hackl the gifts did not constitute gifts of present interests.

The Tax Court examined the terms of the partnership agreement to determine whether the donees obtained the immediate use, possession or enjoyment of the transferred partnership interest and concluded that the partnership agreement does not permit the donees to access any substantial economic benefit from the transferred property. The Court relied largely upon a restriction in the partnership agreement that provided that unless all partners consented, the donees could only transfer the partnership interest to another partner or to a partner's trust. Further, any transfer would be subject to an option to purchase which gave the partnership or the other partners the right to purchase the interest under the terms of a complicated valuation process.

Relying upon Hackl, the Court stated that in order to show the gifts of the partnership interests afforded the donees the right to immediately use, possess or enjoy the income, the taxpayer must show the following:

1. That the partnership would generate income at or near the time of the gifts.
2. Some portion of that income would flow steadily to the donees.
3. The portion steadily flowing to the donees can be readily ascertained.

In holding against the taxpayer, the Court noted that while the partnership could be expected to generate income at or near the time of the gifts and while there were distributions made in four of the six years, there were no distributions in two of the years.

The Court also noted that profits of the partnership were to distributed at the discretion of the general partner except when otherwise directed by a majority interest of all of the partners. Further, the partnership agreement stated that annual periodic distributions to the partner were secondary in importance to the partnerships primary purpose of achieving a long term return in respect to its investments. Thus, the Court held that the gifts did not qualify for the annual exclusion under section 250.3(b).

b. Fisher v. U.S., 105 AFTR 2d 2010-1347.

The Fishers formed a limited liability company whose principal asset was a parcel of undeveloped land on Lake Michigan. In each of 2000, 2001 and 2002, the Fishers transferred 4.762% membership interest in the LLC to each of their seven children. They filed gift tax returns for the transfers and paid gift tax. Upon audit, the IRS asserted a deficiency which the Fishers paid and then sued for a refund in District Court.

The issue in this case was whether the gifts qualified for the annual exclusion under section 2503(b), The Court provided little analysis to support its conclusion that the transfer of partnership interests were transfers of future interests in property and therefore not subject to the annual gift tax exclusion under section 2503(b), The Court merely noted that the transfer restriction in the operating agreement prevented the donees from transferring their interest in exchange for immediate value unless the transfers were to one of the family members. Thus the Court concluded that based upon these conditions it was impossible for the donees to presently realize a substantial economic benefit.

3. Section 2703

a. Holman Jr. v, Commissioner 601 F. 3d 763 (8th Cir, 2010).

The three-part test of section 2703 (b) provides a safe harbor to the provision of section 2703(a) disregarding certain restrictions for purposes of valuation, To qualify for the safe harbor, a taxpayer must meet the following three part test:

- The restriction must be a bona fide business arrangement.
- The restriction must not be a device to transfer proper1y to members of the decedent’s family for full and adequate consideration.
- The terms must be comparable to similar arrangements entered into by persons in an arms' length transaction.

The taxpayer and his wife transferred Dell stock to their family limited partnership, They made gifts of their limited partnership interests in 1999, 2000 and 2001 claiming discounts for lack of control and lack of marketability of 49.25%, The IRS contended that the appropriate discount was 25% because of the application of section 2703 arguing that the restrictions on transfer and other buy-sell provisions in the partnership agreement should be disregarded.

The partnership agreement included provisions restricting transfers to family members and providing for the purchase of interests assigned in violation of the terms of the partnership agreement at a price that was below that proportionate net asset value attributable to the interest assigned.

At the trial in Tax Court, the IRS expert testified to discounts lower than the 28% initially proposed by the IRS resulting in discounts of 22%, 25% and 16.25% in 1999, 2000 and 2001, respectively.

The Tax Court ruled for the IRS and the taxpayer appealed to the Eight Circuit which ruled in a split decision.

i. Dissenting Opinion. In the dissenting opinion, the Eight Circuit considered that the partnership was formed to:

- Maintain family control over family assets.
- Coordinate investment management.
- Protect family assets from future creditors and other third parties.
- Educated the children as to wealth management.

E. Legislative History:

The Joint Committee on Taxation citied Estate of Bischoff v. Commissioner, 69 T.C. 32 (1977) for the proposition that maintaining family control is a legitimate business purposes for buy-sell agreements even when the control being preserved is a right to receive income from investment assets.

The maintenance of control is a business purpose even if the interest being sold is a limited partnership interest in a holding company.

The Senate Finance Committee cited Bischoff for the proposition that continuation of family ownership is a legitimate business purpose for buy-sell agreements even when the control being preserved is the right to participate as a limited partner.

Estate of Amlie v. Commissioner, T.C. Memo 2006-76 also cited the Senate Finance Committee Report:

> The committee believes that buy-sell agreements are common business planning arrangements and that buy-sell agreements generally are entered into for legitimate business reasons that are not related to transfer tax consequences. Buy-sell agreements are commonly used to control the transfer of ownership in a closely held business, to avoid expensive appraisals in determining purchase price, to prevent the transfer to an unrelated party, to provide a market for the equity interest, and to allow owners to plan for future liquidity needs in advance.

Therefore the Holman partnership agreement serves the legitimate business purpose of protecting pm1nership assets from unrelated parties.

Holman's partnership expert testified as follows:

> Partnership agreements contain [transfer] restrictions because persons who join together as partners generally desire a high degree of certainty as to who their partners are and will be, especially where they establish the entity with commonly-shared investment goals and the intention that the entity be closely held. They want the ability to limit who may become their partner without their agreement that such person may take a place at the table.

The Tax Court made the factual determination that the partnership agreement restrictions were designed principally to protect family assets from dissipation by the Holman daughters - clearly a non-tax purpose.

Overall, the argument was that the partnership agreement restrictions are "bona fide business arrangements" because they were not created for the primary purpose of avoiding taxes, and they served the following legitimate business purposes: (l) maintaining family control over the right to participate as a limited partner; (2) maintaining family control over the right to receive income from the partnership's investment assets; (3) protecting partnership assets from creditors and potential future ex-spouses; and (4) preserving the partners' fundamental right to choose who may become a partner.

ii. Majority. The majority believed that the question of whether the agreement was entered into for bona fide business reasons and not as a testamentary substitute is a question of fact. The majority focused on the focus of the

Tax Court as to Mr. Holman's testimony in which he failed to identify any current or planned activity by the partnership other than holding passive investment assets without a clearly articulated investment strategy.

> There is no requirement for an "operating business nexus." But under these facts there is no business, active or otherwise. The taxpayers have not presented any argument or asserted any facts to distinguish their situation from the use of a partnership to hold a pass book savings account, as interest bearing checking account, government bonds or cash.
>
> Although there may be a bona fide business purpose associated with investment related activities, in the context of a partnership that hold only an insignificant fraction of stock in a highly liquid and easily valued company, with no stated intention to retain that stock or invest according to any particular strategy, the restrictions in the partnership agreement do not constitute a bona fide business arrangement.

iii. Compare Section 2036. Section 2036 provides an exception for a bona fide sale for full and adequate consideration. In Estate of Schutt v. Commissioner, T.C. Memo 2005-126, the transfer of publicly traded stock was found to have a legitimate business purpose as a result of a buy and hold investment strategy. However Schutt was distinguished in the Estate of Erickson v. Commissioner, T.C. Memo 2007-107, stating that where a family limited partnership is just a vehicle for changing the form of the investment in the assets, "a mere asset container." The court ruled there was no significant non tax purpose.

b. Fisher v. U.S., 106 AFTR 2d 2010-6144

The operating agreement included certain restrictions on transfer, including a fairly standard right of first refusal. However, the right of first refusal permitted transfers to any of the Fishers descendants.

The issue raised was whether the value of the property gifted should be determined without regard to the right of first refusal. A district court in Indiana, citing Holman, held that there was no evidence that the Fishers had an investment strategy that was advanced through the LLC and that there was no ongoing investment in the property to increase its commercial value. This will be another example of a mere asset container ("MAC"). Accordingly, the Court concluded that the restrictions on transfer did not

constitute a bona fide business arrangement for purposes of section 2703(b) and therefore the value of Property transferred should be determined without regard to this restriction.

4. Other Case Decisions.

a. General Partnerships – The Shepherd Decision. In 1997 and 1998, the IRS began to identify its challenge to the use of FLPs and issued a number of technical advisory memorandums (TAMs) all challenging the use of FLPs (and LLCs) for estate planning purpose. These initial early arguments were based on Section 2703, wherein the IRS argued that any restriction on transfer would be disregarded as no such restriction existed under state law. The Fifth Circuit rejected this approach, in 2001 in Church v. US (5th Cir 2001) 268 F.3d 1063.

On the other hand, the IRS found itself more successful in looking at the structure of the formation of a family partnership in disallowing any discount in value for an interest in a family limited partnership. In Shepherd v. Com'r, (11th Cir 2002) 2002 USTC Par. 60,431, the Eleventh Circuit affirmed a Tax Court decision involving gifts of partnership interests holding real estate. In this decision, the courts found that there was no discount since the transaction involved gifts of transferred real property rather than gifts of partnership interest.

The transaction by the donor was intended to be straight forward. Donor had formed the Shepherd Family Partnership on August 1, 1997. He owned 50 percent and his two sons each owned 25 percent. Each put in a nominal amount, proportionate to their interests. On the same day that the contributions of capital were made, the donor and his wife each deeded their timberland to the partnership, but the deeds were not recorded until August 30, 1991. On August 2, 1991, the sons signed the partnership agreement. On September 9, 1991, shares of stocks were transferred to the partnership by the donor.

The donor then claimed a gift was made in 1991 of partnership interests to his sons and therefore, the gifts should be entitled to a 33.5 percent valuation discount to reflect lack of marketability and minority interests.

The Tax Court cited numerous problems with the foregoing transaction. One problem was that at the time of the gifts the transfer of the property to the partnership had not been completely formed since the sons had not even signed the partnership agreement

until the next day. Because there cannot be a partnership of one person, the partnership did not exist at the time of the transfer. J.C. Shepherd v. Com'r (2000) 115 TC 376.

b. Limited Partnerships – The Strangi Decision. This then lead to a string of decisions involving two issues (i) a bona fide transfer for value and (ii) retention of incidents of control. For example, in Strangi v. Com'r. (5th Cir 2002) 293 F.3d 279, the Fifth Circuit upheld a somewhat favorable Tax Court ruling that highlights some of the risks inherent with the use of a family limited partnership (or LLC).

This case involved the decedent who had roughly $10 million in assets as of 1993. The decedent's estate planning attorney, Mr. Gulig, had previously married the decedent's former wife many years earlier and continued to have an excellent relationship with the decedent. During 1993, decedent was diagnosed with a slow, debilitating condition and Mr. Gulig ultimately took over the decedent's affairs under a power of attorney.

During August 1994, after attending a course on family limited partnerships, Mr. Gulig assisted the decedent with estate planning and formed a limited partnership and a corporate general partner. The corporation was owned by Mr. Gulig, the decedent's former wife, and her children who contributed cash and promissory notes totaling about $100,000. The corporation owned 1 percent in the limited partnership.

Concurrently, about $9.9 million in decedent's real estate, securities, insurance, annuities and partnership interests were contributed on his behalf to the limited partnership in exchange for 99 percent interest. About two months later, the decedent died of cancer. On the decedent's return, substantial discounts were reported due to minority interest and transferability restrictions with respect to the limited partnership interest held by the decedent at his death.

In a 9 to 5 decision, the Tax Court upheld the family limited partnership as validly formed. Strangi, (2000) 105 TC 478. The Tax Court rejected claims as to the validity of the family partnership. The Tax Court noted that there were control issues under Section 2036, but that the IRS had not timely pursued this argument. While the Tax Court rejected the large discounts claimed, it allowed the IRS discounts of 8 percent for minority interest and 25 percent for marketability discounts.

This decision was then upheld by the Fifth Circuit which reiterated that mere suspicion and speculation about a decedent's estate planning and testamentary objectives will not cause an agreement to be disregarded unless there is evidence that the agreement is not enforceable or would not be enforced by the parties. Therefore, the partnership agreement changed the legal relationships between decedent and his heirs and creditors. Potential purchasers of decedent's assets would not disregard the partnership. As the tax court stated, "[r]regardless of subjective intentions, the partnership had sufficient substance to be recognized for tax purposes.

Unfortunately, the Fifth Circuit overturned the Tax Court's decision to refuse to allow the IRS to amend its pleadings to assert that partnership assets were includible in decedent's estate under Section 2036.

c. LLCs – the Hackl Decision. Hackl v. Com'r, (2002) 118 TC. No. 14, affd (Seventh Cir. 2003) _______ U.S.T.C. ______. In the following year, the Seventh Circuit affirmed the Hackl decision. In Hackl, the Tax Court agreed with the IRS that gifts of the nonvoting ownership interests in an LLC made by the taxpayer to his children were not gifts of a present interest, but were transfers of a future interest. As a result, the $11,000 annual gift tax exclusion was not allowed.

In Hackl, the Mr. Hackl owned tree farming operations that he had acquired in 1995. Mr. Hackl decided to form a separate entity to operate the LLC and formed an LLC for that purpose. The Operating Agreement created 40,000 voting units and 450,000 nonvoting units. In addition, under the Operating Agreement he appointed himself as the sole manger to serve for life with the right to name a successor during his lifetime or by will. It further provided that as manager had sole authority to decide distributions out of available cash and so long as he personally was the named manager, he had sole authority to approve any withdraw of a member and he alone as manager could decide to dissolve the LLC.

In light of the level of control that Mr. Hackl retained, the Tax Court found that notwithstanding the gifts of nonvoting LLC interests, the children's right to enjoy the gift of the nonvoting LLC interests did not represent a present interest insofar as Mr. Hackl retained substantial control. Therefore, no annual gift tax exclusion was allowable under Section 2503(b).

An interesting nuance of this case was that the taxpayer in Hackl may have been the source of his own undoing here. Not only was the Operating Agreement onerous, but the taxpayer agreed with the IRS that the value of the LLC units should not differ between voting and nonvoting interests and apparently that a gift did occur.

C. RESTATEMENT OF IRS POSITION – IRS Audit Technique Guide - FLPs

1. Partnership—Audit Technique Guide—Chapter 11—Family Partnerships (12-2002).

a. Introduction. In the 2002, the IRS updated its audit guide, confirming the current suspicion by the IRS as to the use of FLPs. While involving a bit of a misstatement, the IRS states that the original focus of FLPs was to split income among family members. This is only partly true as to the fact that early income tax cases from the 1930s and 1940s predated the focus on inheritance taxes since World War II. For decades, aggressive use of FLPs had been curtailed by (i) statutes preventing abuse[7] and (ii) basis/tax shelter rules wherein any "overuse" perceived by the IRS had been curtailed in 1986. The IRS is also partly incorrect in further indicating that the change in taxation to tax children at their parent's income tax rates was a further curtailment. Most FLPs have always been established for adult children.

During the 1990s, however, the IRS states that it became aware of the use of FLPs to reduce estate and gift tax and revised its guide. However, the IRS starts its discussion by citing an income tax decision, reciting the Supreme Court cases in Lucas v. Earl, 281 U.S. 111 (1930). That income tax case involved whether Guy Earl could effectively assign half of his compensation income from the practice of law in 1921 and 1922 by contract to his wife. The validity of the contract was not questioned, but the Court held that the "fruits cannot be attributed to a different tree from that on which they grew."

The IRS's transition from here to estate tax issues in its guide is very tricky. In its audit guide, going back to Lucas, the IRS states that after Lucas, subsequent taxpayers

[7]FLPs have a number of statutory limitations on the income tax side and therefore have always required careful planning. For example, a sale of property by a family member to a related FLP may disqualify capital gain recognition on capital and Section 1231 assets. Statues since 1981 have prohibited churning in to take accelerated depreciation methods. Other rules are in place to eliminate perceived problems.

attempted to use the partnership provisions in lieu of a bare contract to attempt to divert income to family members and others to reduce transfer, i.e. estate and gift taxes. With the decline in income tax rates the principal focus (by the IRS) in this area has become transfer tax avoidance, i.e. estate and gift taxes.

i. Issue A: Income Shifting Using Family Partnerships. On the income tax side, the IRS identifies in its audit guide IRC section 704(e). While Section 704(e) was enacted specifically to family partnerships, the IRS audit guide endeavors to discredit the heading "family partnerships" and does a pretty poor job in at least one area to explain its terms to an auditor. Unfortunately, this is very important insofar as the discussion relates directly to the issues as to how reporting should be done by an enrolled agent wherein the auditor is given poor guidance.[8]

The IRS does correctly identify, however, that, Subsection (e)(1) provides that if any "person" acquires an interest in a partnership from any other "person" by purchase or gift, and if capital is a material income producing factor, then the person will be considered a partner whether they acquired the interest by purchase or gift. It provides a "safe harbor" with respect to partnerships in which capital is a material income-producing factor.

What this means for purposes of reporting on a family limited partnership is that on nonservice partnerships, generally a family member with a 10% interest is entitled to an allocation of income so long as the issue as to compensation to a "working partner" has been adequately covered elsewhere.

Subsection (e)(2) is only one-half covered in the audit manual. What is omitted is that the partner receiving an interest by gift is entitled and reports in income his or her allocable share, except as to "excess" allocations. Excess allocations arise in a failure to (i) provide for compensation for a service partner or (ii) an allocation of income greater than his or her capital account. The manual merely states that a donee's share of partnership income must be reduced to the extent of the donor's reasonable compensation for services rendered to the partnership, giving no guidance as to when an allocation will be honored.

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[8] Section 704(e) actually dates back to its initial enactment in 1951 under the 1939 Internal Revenue Code.

Subsection (e)(3) is also only partially stated. What the statute says is that a "purchase" is treated the same as a "gift" for purposes of this section and that states that family means spouse, ancestors and descendants or trusts set up for their benefit. The audit manual reverses the order and fails to note that (e)(3) is limited as to Section 704.

For an enrolled agent, all of the foregoing is important for income tax reporting to understand. First, is to determine whether the allocations will be respected to the other family members. That means making reasonable inquiry as to whether there is a service partner and whether there are guaranteed payments to assure adequate compensation. It also means that "special allocations" need to be carefully reviewed wherein they may not be allowed, except as to statutory special allocations.

If there is no issue, the allocation of profits and losses within a FLP are governed by the same rules as those for non-family partnerships.

(a) Capital Is Not a Material Income-Producing Factor. In its audit guide, the IRS goes on to explain that partnership income arises from services, capital or both. If capital is not a material income producing factor, and a partner performs no services, partnership income is allocated to the partner who performs the services. Lucas v. Earl, and IRC section 704(e)(1) and (2).

(b) Capital Is a Material Income Producing Factor. The IRS further identifies that a determination of whether the interest was acquired by purchase or gift must first be made. If the partner is a family member, the purchase from another family member is treated as though it was acquired by gift. The IRS correctly states the current position, by avoiding any inference with respect to the right to a "step-up" in basis. Rather, the IRS addresses the issue of allocations. In particular, to be considered a partner for the purpose of receiving income allocations, the partner must be an owner in substance, and not just form. Treas. Reg. section 1.704-1(e)(2) describes the basic tests for ownership based on all the facts and circumstances. The following factors indicate that the donee is not a bona fide partner:

(1) Donor retains direct control: This can be achieved through restrictions on distributions, rights to sell or liquidate, or retention of control over the assets of the business and retention of management powers inconsistent with normal (arm's length) relations among partners.

(2) Donor retains indirect control: The donor may control a separate entity that manages the partnership. The management entity may place restrictions that limit the ownership interest of the donee.

(3) Donee does not participate in the control and management of the business, including major policy decisions. The degree of participation may indicate whether the donor has actually transferred an interest to the donee.

(4) Partnership distributions actually are not actually made to the donee. If they are, the donee does not have full use or enjoyment of the proceeds.

(5) The partnership conducts its business in the manner expected of a partnership. For example, it has a separate bank account, follows local law for business operations and treats the donee in the same way any other partner would be treated.

(6) Other facts and circumstances may indicate the donor has retained substantial ownership of the interest transferred.

Treas. Reg. section 1.704-1(e) also addresses the issue of trustees as partners, ownership by minor children, and the use of limited partnerships. In the case of a limited partnership interest, does the limited partner have the right to sell, transfer, and liquidate without substantial restrictions? Does the donee-limited partner have the same rights as unrelated limited partners? The IRS identifies that:

If the donee is not a bona fide partner the income must be allocated to the real owner of the partnership interest.

If the donee is a bona fide partner the donor still must be reasonably compensated for services rendered to the partnership and the donee's share of partnership income must be in proportion to donated capital. If these conditions are not met, there is reason to change the allocation.

In the audit guidelines the IRS concludes that reducing income taxes by shifting income is not as important as it once was due to the reduction in tax rates and changes in rules for taxing unearned income of children. Income tax savings may contribute to the overall success of a family partnership set up to reduce transfer taxes as illustrated below.

Issue B: Family Partnerships and Transfer Taxes. IRS audit guidelines indicate a greater concern as to compliance with estate and gift taxes imposed on the transfer of property at death or the gifting during lifetime by a decedent or donor, respectively.

The following example illustrates the use of valuation discounts and the unified transfer tax system. For purposes of this illustration, the taxpayer is considered to split each transfer with his own spouse and to make each annual gift to the donee and the donee's spouse.

Example 2:

Fred Donor operates a successful retail sporting goods store worth $1,000,000. He has made all the money he needs and wants to pass the business to his two children and minimize the transfer taxes. He transfers the business to an LLC and begins making gifts of 10 percent each year to the donees. Upon his death in 6 years, his remaining 40 percent interest is included in his gross estate.

The gifts are discounted for lack of marketability and control. Lack of marketability applies to securities which are not publicly traded. A minority interest has a lower fair market value since it has no control over management or distributions.

	Percent Transferred	**Value**	**Value After Discount**	**Total Exclusions with Gift Splitting**	**Taxable Gift or Inheritance**
1	10%	$100,000	$60,000	$40,000	$20,000
2	10%	$100,000	$60,000	$40,000	$20,000
3	10%	$100,000	$60,000	$40,000	$20,000
4	10%	$100,000	$60,000	$40,000	$20,000
5	10%	$100,000	$60,000	$40,000	$20,000
6	10%	$100,000	$60,0000	$40,000	$20,000
Death	40%	$400,000	$240,000	0	$240,000
Totals	100%	$1,000,000	$600,000	$240,000	$360,000

It is important to note that after consideration of gift splitting, the annual exclusion, and the lifetime unified credit, transfers of partnership capital and any claimed discounts must be very substantial in order to justify a referral to Estate and Gift.

b. Examination Techniques. To address concerns, the IRS identifies examination techniques. For example, where the partnership is engaged in an active business, auditors are asked to examine of family members are compensated for services they perform for the partnership.

Auditors are also asked to carefully examine any allocations that are not proportionate to capital accounts when family members are partners. They must be based in that case on actual services provided.

Where younger family members' allocations are purportedly based on services, the same audit techniques used in corporate excess compensation cases can be used. However, since the tax effects are much smaller in the partnership context, you may not want to pursue the issue unless the amounts involved are substantial before pursuing this issue.

Where substantial gifts with significant claimed discounts are present the case should be referred to the Estate and Gift Tax group.

c. Issue Identification. On the income tax side, the IRS auditor is expected to consider the following:

i. Does the partnership contain the word "Family" in the name? Do the Schedules K-1 indicate a family relationship, such as same last names, trusts or same addresses?

ii. How long has the partnership been in existence? Was it formed by the transfer of an existing business?

iii. Is the partnership engaged in a trade or business, or is it an investment partnership? Is capital a material income-producing factor?

iv. Does the return or partnership agreement show the recent addition of a related partner or an increase in capital of a younger family member? Does the Schedules K-1 indicate a transfer of capital from one family member to another?

v. Are there disproportionate allocations of income to family members? Are those providing services to the partnership adequately compensated?

d. Documents to Request.

i. Partnership Agreements including any amendments.

ii. Copies of any gift tax returns filed with respect to the transfer of any partnership interest or capital.

iii. Calculations regarding any disproportionate income allocations

e. Interview Questions.

i. Are any of the partners related by blood or marriage?

ii. Were any interests in the partnership acquired by gift?

iii. Were any interests acquired by purchase from a family member?

iv. How are income allocations calculated?

f. Supporting Law.

Lucas v. Earl, 281 U.S. 111 (S CT 1930). This case established the principle that the "fruit of the tree" must be taxed to the tree on which it grew.

g. Resources.

h. Treas. Reg. section 1.704-1(e)(1) and (2).

D. Family Limited Partnerships - Appeals Settlement Guidelines.

1. Overview. Several years ago, the IRS recently Appeals Settlement Guidelines for Family Limited Partnerships and Family Limited Liability Companies. The guidelines addressed four issues:

a. Whether the fair market value of transfers of family limited partnership or corporation interests, by death or gift, is properly discounted from the pro rata value of the underlying assets;

b. Whether the fair market value at date of death of Code section 2036 or 2038 transfers should be included in the gross estate;

c. Whether there is an indirect gift of the underlying assets, rather than the family limited partnership interests, where the transfers of assets to the family limited partnership (funding) occurred either before, at the same time, or after the gifts of the limited partnership interest were made to family members;

d. Whether an accuracy-related penalty under section 6662 is applicable to any portion of the deficiency.

2. Valuation/Discounts. As to the issue of valuation/discounts the guidelines noted that the United States Tax Court had in three cases McCord v. Commissioner, 120 T.C. 358 (2003); Lappo v. Commissioner, T.C. Memo 2003-258 and Peracchio v. Commissioner, T.C. Memo. 2003-280 allowed combined discounts of 32%, 27%, and 29%, respectively. That is the good news. However, the news may even be better as it must be remembered that McCord was reversed and the discounts claimed by the estate were upheld by the 5th Circuit. See Succession of McCord v. Commissioner, 461 F.3d 614 (5th Cir. 2006). In addition, in its guidelines the IRS tries to distinguish Estate of Kelley v. Commissioner, T.C. Memo. 2005-235 were the Court approved of a combined discount of approximately 35%. Thus, the discounts allowed by the Courts may even be higher than the discounts referred to by the IRS in its settlement guidelines.

3. Section 2036. As to the issue of section 2036, the IRS recognized that the issue will come down to whether the taxpayer retained a sufficient interest in the property or whether there was a bona fide sale for full and adequate consideration. It should be noted that the decision in Estate of Bongard v. Commissioner, 124 T.C. 95 (2005) was entered on September 7, 2006 and it appears that no appeal was filed. For an interesting discussion as to the issues surrounding section 2036 we recommend the following three part articles: August, Dawson, Maxfield, and Pollingue, *The IRS Continues its Section 2036 Assault on FLPs* – (Part 1 through Part 3), Business Entities (WG&L).

4. Gift on Formation. As to the issue of gift on formation, the good news is that the argument is not nearly as broad as originally advocated by the IRS. Rather, the argument is being limited to those arguments raised in Shepherd v. Commissioner, 115 T.C. 376 (2000).

5. Penalties. As to the impositions of penalties, the IRS's position may be disturbing to some practitioners. In the Appeals Coordinated Issue Settlement Guidelines Issue, the IRS relies on Long Term Capital Holdings v. United States, 330 F. Supp.2d 122, 199 (D. Conn. 2004), aff'd 2005 U.S. App. LEXIS 20988 (2005). Long Term Capital is a tax shelter case wherein the Court imposed on 40% penalties where the

Court found that the tax opinion was not timely received and the law firm did not conduct sufficient due diligence in discerning the validity of the taxpayer's factual representations. It is interesting that the IRS is citing to tax shelter cases when analyzing the reasonable cause exception as it applies to estate tax issues. The days of relying on the planner's advice and the planner not performing any subsequent due diligence may have come to an end.

E. FLP Eratta.

1. Self-Employment Tax and LLCs. A continuing area of uncertainty has been the application of the limited partner exception to self-employment tax for LLCs. The recent Norwood decision indicates member run LLCs probably will not avoid self-employment tax with respect to inactive members.

a. Regulations Remain Uncertain. Unfortunately, there has been no new guidance on the limited partner exception under Code Section 1402(a)(13). That section says that, except for guaranteed payments for services, a limited partner's share of partnership income is not subject to self-employment tax.

In 1994, the Service tried by proposed regulations to specifically address LLCs. Under 1994 proposed regulations, an LLC member was treated as a limited partner if (1) he or she lacked the authority to make management decisions (the "management test") and (2) the LLC could have been formed as a limited partnership ("LP") rather than an LLC in the same jurisdiction (the "limited partner equivalence test").

As many practitioners found, the 1994 proposed regulations were unworkable. 1997 proposed regulations were issued to treat an LLC member as a limited partner (and thus would not be subject to the self-employment tax) unless he or she:

i. Has personal liability (as defined in Section 301.7701-3(b)(2)(ii)) for the debts or claims of the partnership by reason of being a partner;

ii. Has authority (under the law of the jurisdiction in which the partnership is formed) to contract on behalf of the partnership; or

iii. Participates in the partnership's trade or business for more than 500 hours during the partnership's taxable year.

While Congress postponed any action on the proposed regulations to July 1, 1998, there has been no Congressional guidance. The Treasury Department us apparently hesitant to finalize its proposed regulations leaving LLCs without guidance.

b. Norwood v. Commissioner. In Norwood v. Commissioner, T.C. Memo 2000-84, a general partner tried to argue that his distributive share of the partnership's trade or business income was not subject to self-employment taxes under Section 1401 due to the limited partner exception under Section 1402(a)(13) since his involvement was passive. This argument was not far-fetched insofar as many general partnership agreements limit authority to the "managing general partner." The Tax Court, however, held that regardless of whether the taxpayer's participation in the partnership was passive or active, the taxpayer was a general partner and the determination of that partner's control should be determined under sate partnership law. Thus, the general partner was ruled not eligible for the limited partner exception.

c. Observations. As to whether certain members of an LLC qualify under the limited partner exception, the Norwood decision is consistent with the policy of the 1997 proposed regulations to the extent that a state law authority to contract is sufficient to be thrown out of limited partner treatment. Consequently, members in member-managed LLCs would be treated as general partners.

2. FLPs for Personal Residences. Presently, it is probably not a good idea to use a family limited partnership to own a personal residence, other than possible a vacation home owned by several family members. The issue with personal residences being held by a partnership is several. First, there is the issue as to whether under Section 121 a personal residence will qualify for exclusion of gain if held for personal use. While a private letter ruling was issued in the 2000-year which indicated "yes", Section 121 would be allowed, it was quickly revoked. (PLR 200004022; PLR 200119014) In California, it is uncertain whether the changes to limited partnership law with the enactment of the Uniform Limited Partnership Act of 2006, effective January 1, 2008, will change that result.[9]

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[9] Under ULPA 2006, limited partnerships may be formed for any reason, wherein the limited partnership (unlike a general partnership) is no longer required to be entered into for a "business for profit". The change was argued to be beneficial to estate planners.

V. CONCLUSION.

While the IRS has a degree of discomfort with the use of LLCs and FLPs in estate planning, their use will continue to be protected where they are properly formed and used. While not a complete checklist, the following should be considered:

1. Properly Selected Funding. A FLP or LLC should not be funded with a parent's personal residence or substantially all personal property. The parent should have substantial assets outside of the FLP and they should be adequate to provide for support.

2. Non-Tax Purpose. There should be a substantial non-tax purpose for the formation of the FLP and LLC. The facts should verify that purpose. Purposes that are legitimate, but must be proven that the FLP or LLC made a difference (and the absence would not achieve that purpose) would be:

a. A pooling of funds to obtain better opportunities – there must be a better opportunity and other family members must contribute their own money in substantial amounts;

b. A transition in management – there must in fact be a transition of management.

3. No Excess Distributions. Once formed, distributions from partnership must be normal and ordinary, e.g., proportionate to the member's capital accounts.

4. Some Transfer of Control. The other family members, as limited partners or LLC members must have some, albeit limited, rights of control. This would include the right to remove the general partner, the right to appoint additional general partners or something else. An interesting aspect as to control includes the extent as to the other partners' involvement in the drafting and formation of the limited partnership, which depending on the circumstances may be favorable where there was a joint participation in drafting and unfavorable if just the parents or only the children were involved.

5. Distributions Are Made or Expected. Limited partners, if not entitled to a substantial "minimum distribution" should in fact have in the partnership

agreement a "standard" that creates a fiduciary obligation for the general partner to make distributions. Conversely, the general partner cannot have exclusive, absolute right to determine the distributions made.

6. Partnership Agreement Signed First! The partnership agreement should be signed prior to funding.

7. FLP/LLC In Fact Created. The FLP or LLC should be treated as legally existing prior to any transfer of realty. This is more than merely filing a Certificate of Limited Partnership and signing of a limited partnership agreement. A FLP must have at least two owners or it is not a partnership. Sometimes each member must contribute a small amount of cash in proportion to their interests and open a bank account to help prove existence. If done incorrectly, then estate planning may fail.

8. Funding Promptly Occurs. The FLP should be quickly funded – except for reasonable delay.

9. No Expectation of Imminent Death. It is better if the original owner is not expected to die shortly.

10. The Partnership Should Conduct Affairs Independently. A FLP need not keep minutes of meetings of the general or limited partners, but it should act as an independent organization. That means compliance with any local statutes, maintaining its own bank accounts, having its own insurance, recognizing partner/member rights to distributions.

Partnership - Audit Technique Guide - Chapter 11 - Family Partnerships (12-2002)

INTRODUCTION

The original focus of Family Partnerships was to split income among family members. With the reduction in marginal tax rates, the emphasis has shifted to exploiting Family Partnership to reduce estate and gift tax.

One of the earliest, and most often cited, Supreme Court cases is **Lucas v. Earl**, 281 U.S. 111 (1930). The question presented was whether Guy Earl could effectively assign half of his compensation from the practice of law in 1921 and 1922 by contract to his wife. The validity of the contract was not questioned, but the Court held that the "fruits cannot be attributed to a different tree from that on which they grew." This has come to be known as the "Fruit of the Tree Doctrine" and has found application in many areas.

Subsequent taxpayers attempted to use the partnership provisions in lieu of a bare contract to attempt to divert income to family members and others. If successful, this stratagem would not only reduce income and employment taxes, it would completely circumvent transfer taxes. With the decline in income tax rates the principal focus in this area has become transfer tax avoidance.

ISSUE A: INCOME SHIFTING USING FAMILY PARTNERSHIPS

IRC section 704(e) is titled "Family Partnerships" but only one subsection applies to family members. Subsection (e)(1) provides that if any "person" acquires an interest in a partnership from any other "person" by purchase or gift, and if capital is a material income producing factor, then the person will be considered a partner whether they acquired the interest by purchase or gift. It provides a "safe harbor" with respect to partnerships in which capital is a material income-producing factor.

Subsection (e)(2) applies in the case of partnership interests acquired by gift. It provides that a donee's share of partnership income must be reduced to the extent of the donor's reasonable compensation for services rendered to the partnership.

Subsection (e)(3) is the one applicable to family members only and for this purpose, family means spouse, ancestors and descendents or trusts set up for their benefit. It provides that partnership interests purchased from family members shall be treated as if created by gift.

Capital Is Not a Material Income-Producing Factor

Partnership income arises from services, capital or both. If capital is not a material income producing factor, and a partner performs no services, partnership income is allocated to the partner who performs the services. **Lucas v. Earl**, and IRC section 704(e)(1) and (2).
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Capital Is a Material Income Producing Factor

A determination of whether the interest was acquired by purchase or gift must first be made. If the partner is a family member, the purchase from another family member is treated as though it was acquired by gift. To be considered a partner for the purpose of receiving income allocations, the partner must be an owner in substance, and not just form. Treas. Reg. section 1.704-1(e)(2) describes the basic tests for ownership based on all the facts and circumstances. The following factors indicate that the donee is not a bona fide partner:

1. Donor retains direct control: This can be achieved through restrictions on distributions, rights to sell or liquidate, or retention of control over the assets of the business and retention of management powers inconsistent with normal (arms length) relations among partners.

2. Donor retains indirect control: The donor may control a separate entity that manages the partnership. The management entity may place restrictions that limit the ownership interest of the donee.

3. Donee does not participate in the control and management of the business, including major policy decisions. The degree of participation may indicate whether the donor has actually transferred an interest to the donee.

4. Partnership distributions actually are not actually made to the donee. If they are, the donee does not have full use or enjoyment of the proceeds.

5. The partnership conducts its business in the manner expected of a partnership. For example, it has a separate bank account, follows local law for business operations and treats the donee in the same way any other partner would be treated.

6. Other facts and circumstances may indicate the donor has retained substantial ownership of the interest transferred.

Treas. Reg. section 1.704-1(e) also addresses the issue of trustees as partners, ownership by minor children, and the use of limited partnerships. In the case of a limited partnership interest, does the limited partner have the right to sell, transfer, and liquidate without substantial restrictions? Does the donee-limited partner have the same rights as unrelated limited partners?

If the donee is not a bona fide partner the income must be allocated to the real owner of the partnership interest.

If the donee is a bona fide partner the donor still must be reasonably compensated for services rendered to the partnership and the donee's share of partnership income must be in proportion to donated capital. If these conditions are not met, there is reason to change the allocation.

Reducing income taxes by shifting income is not as important as it once was due to the reduction in tax rates and changes in rules for taxing unearned income of children. Income tax savings may contribute to the overall success of a family partnership set up to reduce transfer taxes as illustrated below.
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ISSUE B: FAMILY PARTNERSHIPS AND TRANSFER TAXES

Estate and gift taxes are imposed on the transfer of property at death or the gifting during lifetime by a decedent or donor, respectively. The rates are graduated starting at 18 percent and rising to 55 percent on amounts over $3 million. The tax is imposed on the fair market value of the property involved, that is, the price a willing buyer and willing seller would agree upon.

A "unified credit" is provided to each taxpayer that reduces the actual amount of tax payable. The same amount of credit applies for both gift and estate taxes. The credit shelters a certain amount of otherwise taxable transfers. The equivalent amount of total property that is sheltered from tax by the unified credit is currently $675,000; that amount will rise to $1,000,000 by 2006. For this purpose "total property" applies to taxable gifts during lifetime and the remaining taxable estate at death.

For estate tax purposes prior taxable gifts are added to the value of the estate and the credit (plus any prior gift tax paid) is subtracted again. Gifts, and estate devises to spouses are fully deductible.

For gift tax purposes a married donor may elect to treat any gift as made one-half by each spouse. Because each donor is allowed an annual exclusion of $10,000 per donee, gift splitting can result in a substantial amount of gifts being sheltered from taxation even before the use of the available unified credit.

Example 11-1

Fred Donor gives $50,000 in cash to his married daughter and her husband. He elects to "split" the gift with his own spouse, Mary. Fred is considered to have given $12,500 to child and $12,500 to child's spouse; Mary is considered to have done the same. Fred and Mary are each entitled to a $10,000 annual exclusion for each of their two gifts. (They need to file separate gift tax returns. Gift tax returns are required to be filed by the

donors, not the donees, and there are no joint returns.) As a result, Fred has a $5,000 taxable gift and Mary has a $5,000 taxable gift. The resulting tax on each donor's $5,000 taxable gift is now sheltered by any remaining lifetime, unified credit.

In the past, an Estate and Gift Tax Attorney was permitted to examine and adjust all gifts made during a decedent's lifetime unless a gift tax had actually been paid. In that case the statute of limitations would run 3 years after the filing or due date as in the case of income tax returns. The Code was amended in 1997 to provide that (generally) the filing of a gift tax return would start 3-year statute of limitations regardless of whether the taxable gifts were fully sheltered by the unified credit. If the Service did not propose changes within that period, the numbers could not be adjusted later, for example, during the examination of an estate tax return. This provision has created an added burden on E&G Attorneys to take a harder look at gift tax returns.

The following example illustrates the use of valuation discounts and the unified transfer tax system. For purposes of this illustration, the taxpayer is considered to split each transfer with his own spouse and to make each annual gift to the donee and the donee's spouse.

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Example 11-2

Fred Donor operates a successful retail sporting goods store worth $1,000,000. He has made all the money he needs and wants to pass the business to his two children and minimize the transfer taxes. He transfers the business to an LLC and begins making gifts of 10 percent each year to the donees. Upon his death in 6 years, his remaining 40 percent interest is included in his gross estate.

The gifts are discounted for lack of marketability and control. Lack of marketability applies to securities which are not publicly traded. A minority interest has a lower fair market value since it has no control over management or distributions.

	Percent Transferred	Value	Value After Discount	Total Exclusions With Gift Splitting	Taxable Gift or Inheritance
1	10%	$100,000	$60,000	$40,000	$20,000
2	10%	$100,000	$60,000	$40,000	$20,000
3	10%	$100,000	$60,000	$40,000	$20,000
4	10%	$100,000	$60,000	$40,000	$20,000
5	10%	$100,000	$60,000	$40,000	$20,000
6	10%	$100,000	$60,000	$40,000	$20,000
Death	40%	$400,000	$240,000	0	$240,000
Totals	100%	$1,000,000	$600,000	$240,000	$360,000

It is important to note that after consideration of gift splitting, the annual exclusion, and the lifetime unified credit, transfers of partnership capital and any claimed discounts must be very substantial in order to justify a referral to Estate and Gift.

Examination Techniques

Where the partnership is engaged in an active business, determine that family members are compensated for services they perform for the partnership.

Carefully examine any allocations that are not proportionate to capital accounts when family members are partners. They must be based in that case on actual services provided.

Where younger family members' allocations are purportedly based on services, the same audit techniques used in corporate excess compensation cases can be used. However, since the tax effects are much smaller in the partnership context, you may not want to pursue the issue unless the amounts involved are substantial before pursuing this issue.

Where substantial gifts with significant claimed discounts are present the case should be referred to the Estate and Gift Tax group.

Issue Identification

1. Does the partnership contain the word "Family" in the name? Do the Schedules K-1 indicate a family relationship, such as same last names, trusts or same addresses?

2. How long has the partnership been in existence? Was it formed by the transfer of an existing business?

3. Is the partnership engaged in a trade or business, or is it an investment partnership? Is capital a material income-producing factor?

4. Does the return or partnership agreement show the recent addition of a related partner or an increase in capital of a younger family member? Do the Schedules K-1 indicate a transfer of capital from one family member to another?

5. Are there disproportionate allocations of income to family members? Are those providing services to the partnership adequately compensated?

Documents to Request

1. Partnership Agreements including any amendments.

2. Copies of any gift tax returns filed with respect to the transfer of any partnership interest or capital.

3. Calculations regarding any disproportionate income allocations

Interview Questions

1. Are any of the partners related by blood or marriage?

2. Were any interests in the partnership acquired by gift?

3. Were any interests acquired by purchase from a family member?

4. How are income allocations calculated?

Supporting Law

Lucas v. Earl, 281 U.S. 111 (S CT 1930). This case established the principle that the "fruit of the tree" must be taxed to the tree on which it grew.

IRC section 704(e) which provides rules consistent with **Lucas** for testing the allocation of partnership income, particularly where family members are partners.

Resources

Treas. Reg. section 1.704-1(e)(1) and (2)