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Recent TAMs and a Tax Court case illustrate the theories that the IRS is using to challenge family limited partnerships and to cause the partnership to be disregarded in valuing its underlying assets for transfer tax purposes.

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The family limited partnership (FLP) is used by senior family members to facilitate business, succession, and estate planning. In a series of recent private letter rulings, the IRS has continued its attempt to undermine the FLP as a family planning entity because of the IRS's perception that FLPs (as well as certain other pass-through entities, such as limited liability companies (LLCs) and business trusts) are often used for tax avoidance purposes.

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The Service's assault on FLPs seems based on the assumption that anyone who creates an FLP shortly before death is engaged in a sham transaction, which will be treated as a testamentary disposition effective only at death. Although many practitioners may agree with that conclusion, this is not the real issue. The concern is that the sham transaction argument will become entrenched in the law and extended by the IRS to other FLP transactions.

Family and business benefits of FLPs

FLPs have significant business and family planning advantages besides the estate and gift tax benefits arising from the discounting of interests in an FLP. The FLP structure is designed to protect investors from personal liability and to facilitate raising capital, while at the same time preserving control of the enterprise with the entrepreneur.

An FLP has two types of partners: general partners and limited partners. The general partners have management control and unlimited liability. The limited partners have no voice in management and are entitled to receive only such distributions as are declared by the general partners. Limited partners have no personal liability (beyond their capital contributions) with respect to the debts of the FLP. Consequently, limited partners are passive investors, insulated from the actions of the general partners who have a free hand in running the enterprise. The passive investors supply the capital while the success or failure of the venture is in the hands of the general partners.

Maintaining control. If parents transfer some or all of their assets to an FLP, they can avoid problems relating to loss of control and fractional ownership. Because the property is owned by the FLP, the parents—as the general partners of the FLP—will continue to control the assets. Rather than transferring ownership interests in individual properties to their descendants, the parents may transfer FLP limited partnership interests to children and grandchildren. The transferees, as limited partners, have no right to participate in the management of the FLP and have no

control over the FLP's assets. The limited partners' only interest is in the distributions they receive with respect to their limited partnership interests.

Family succession planning. Parents may groom a child or children employed in a family business to take over eventual control. When those children are ready, the parents may easily transfer control by transferring or sharing the general partner interest in the FLP. Such transfer of control is simpler to accomplish if the general partner is a corporation.

Cash flow. The general partner decides when and how much will be distributed to the partners. The general partner has considerable flexibility in determining what should be retained in the business and what should be distributed to the partners. As a practical matter, the FLP should probably distribute sufficient funds to pay the income tax liability on the FLP profits passed through to the partners.

An FLP provides more certainty of cash flow. If, for example, children A and B receive interests in property X, and children C and D receive interests in property Y, their incomes are limited to the performance of their respective properties. If one property has no earnings for several years, while the other is profitable, the children will not be benefited equally. This may strain family relationships. If both properties are transferred to an FLP, the children can be given interests in the partnership. The children will then receive distributions based on the performance of the FLP rather than on the performance of each property.

[1] 1977-1 CB 178.

In recently issued TAMs, the IRS ignored the taxpayer victory in *Estate of Frank*, a Tax Court decision.

Providing for children not in the business. Through ownership of limited partner interests, children who are not employed in the family business may still benefit from distributions on their partnership interests and possibly from redemptions of those interests from time to time, depending on their needs and the FLP's cash flow.

Simplicity of transfer and administration. An FLP introduces simplicity into making transfers. For example, parents may transfer title to real property to the FLP and then give interests in the FLP to their children. If the FLP were not used, a gift of an interest in real estate to the children would require a deed. If the parents wish to make gifts within the $10,000 gift tax annual exclusion, annual deeds are required. Because deeds must be recorded, the result is numerous deeds of record, and the ownership structure is exposed to the public.

The FLP is an umbrella for the family assets transferred to it, and should produce efficiencies in asset administration. When ownership of assets is fractionalized among family members, administration is usually costly and inefficient.

Improving return. Another advantage of the FLP as an umbrella is efficiency in asset investment management. The FLP will have a greater pool of assets than will each family member. This may provide more leverage in diversifying investments and in retaining investment advisors; the expectation is that greater returns may be achieved.

Better family relationships. All the disparate family members have a common interest in the success of the FLP. This may create an atmosphere for enhanced communication among family members.

Asset protection. The FLP is unusual in that its assets are not subject to creditors' claims against a partner. Section 703 of the Revised Uniform Limited Partnership Act (RULPA) limits the remedies of a judgment creditor of a partner-debtor to obtaining a charging order against the FLP interest of the partner. To the extent so charged, the judgment creditor has only the rights of an assignee. An assignee is not a partner and is entitled to receive only distributions to which the assignor was entitled.

Under *Rev. Rul.* 77-137,[1] a creditor with a charging order is treated as a substituted limited partner for federal income tax purposes. This means that the judgment creditor must report as income the distributive share of all partnership items (i.e., income, gain, loss, deduction) attributable to the charged interest. Because of the tax liability, few creditors apply for charging orders.

No ancillary probate. At death, ancillary probate proceedings are required in each state where the decedent owns real property. Ancillary proceedings are not required for personal property. Most states treat partnership interests as personal property even though the partnership may own real property. This avoids ancillary probate.

Estate and gift tax benefits of FLPs

Although the FLP was conceived as a business planning tool, advisors soon discovered that it also provided tax planning advantages.

Valuation discounts for transfers of FLP interests. Use of an FLP may provide a greater valuation discount then might otherwise be available if the underlying assets were instead given directly to the recipient. For example, if parents want to transfer $100,000 equally among their four children, the value of the gift is $100,000.

Under Reg. 25.2512-1, the valuation test is the hypothetical "willing buyer-willing seller" test. That is, the value of property "is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of relevant facts."

Rather than transferring $100,000 cash outright to children (as in the above example), the parents may create an FLP to which they transfer $100,000 in exchange for 99 limited partner interests (representing 99% of the FLP equity) and one general partner interest (representing 1% of the FLP equity). The partnership invests the $100,000 in short-term Treasury bills.

Subsequently, the parents transfer the 99 limited partner interests equally among their four children. The issue that arises is the value of the transfers for gift tax purposes. Is the value of each gift $24,750 or some lesser amount? If the value is a lesser amount, what is the justification for the lower valuation?

Under the willing buyer-willing seller test, each gift has a value that may be considerably less than each partnership interest's pro rata share of the underlying partnership assets. There are three reasons (as follows) why a hypothetical buyer would not purchase the partnership interests based solely on the value of the underlying assets:

The recent case, *Estate of Schauerhamer*, demonstrates the importance of conducting an FLP in the same manner as any other business.

1. *Lack of management participation.* As a limited partner, the buyer would have no control over the investment of partnership assets. Control lies solely with the general partner.
2. *Marketability discount.* There is no market for the limited partner interests. If the buyer needs cash, he would probably not be able to sell such an interest except at a substantial discount.
3. *Minority interest (lack of control).* A limited partner interest represents only a minority interest in the partnership even if the partner owns a majority of the limited interests. It may be difficult to find a buyer interested in acquiring a minority interest in an enterprise, especially if he will have to wait 50 years to cash out.

The IRS has traditionally recognized marketability discounts. *Rev. Rul.* 93-12[2] recognized minority discounts for gifts of interests in family owned businesses.

IRS rulings against FLPs

The IRS has recently issued several private rulings refusing to recognize FLPs established shortly before death. The FLPs in the rulings were created by children of the decedent-parent pursuant to powers of attorney. The IRS takes the position that an FLP created shortly before death is a testamentary disposition effective only at death.

Alternatively, the IRS also argues that: (1) the FLP transaction is itself a restriction on the right to use the property owned by the decedent and is ignored for valuation purposes under Section 2703, and (2) the FLP interests are valued based on their liquidation value rather than their going concern value under Section 2704(b).

In a series of five TAMs issued in 1997, the IRS disregarded FLPs and an LLC established shortly before death, denying any discounts and treating the transferred assets, for valuation purposes, as owned by the decedent.[3] The IRS characterized the transactions as shams.

- In TAM 9719006, the FLP was created two days prior to the decedent's death, when all life support had ended.
- In TAM 9723009, the FLP was set up less than two months before death when the decedent was 90 years old.
- In TAM 9725002, the decedent was involved in an auto accident that left him incapacitated. The FLP was established two months before death.
- In TAM 9730004, the FLP was created approximately a month after the decedent was diagnosed with terminal cancer. Death occurred by the end of the calendar year.
- In TAM 9736004, an LLC was created less than two months before death.

[2] 1993-1 CB 202. See also Rev. Rul. 59-60, 1959-1 CB 237; Rev. Rul. 83-20, 1983-2 CB 170; IRS Valuation Guide for Income, Estate and Gift Taxes, Lesson 8; Moore, TCM 1991-546.

[3] TAMs 9719006, 9723009, 9725002, 9730004, and 9736004.

Single testamentary transaction. According to the IRS, the formation of the FLP (or LLC) and the transfer of the FLP interests at death should be treated as a single testamentary transaction. This argument is based on the Tax Court's decision in *Estate of Murphy.*[4] There, Mrs. Murphy transferred—just prior to her death—a 1.76% interest in a family corporation to her children. This transfer reduced her ownership in the corporation from 51.41% to 49.65%. The purpose of the transfer was to eliminate a control premium for her interest in the corporation and to allow her estate to claim a minority interest discount. The Tax Court held that the sole purpose of the transaction was to reduce estate tax. The court found the transaction was a sham and denied any discount.

Relying on *Murphy,* the above TAMs concluded that the creation of the FLPs and LLC served no purpose other than tax avoidance and that they would be disregarded for valuation purposes. The creation of the FLP, the transfer of property, and all related transactions would be considered as a single testamentary disposition, effective at death rather than when the FLP was created.

What the IRS ignored in the TAMs (as did the court in *Murphy*) is that there is no foundation in the Code or Regulations for such an argument. There is not even a mortality rule applicable to transfers, other than with respect to the valuation of annuities and term and life interests (e.g., GRATs and GRUTs).[5]

The IRS also ignored the favorable Tax Court decision in *Estate of Frank.*[6] In that case, two days before the decedent's death, his son—acting under a power of attorney—transferred shares of the family business from the decedent to the surviving spouse. The transfer reduced the decedent's ownership position from control (50.3%) to a minority position (32.1%). The interest would therefore be valued as a minority interest rather than as a control interest.

The IRS argued substance over form, sham transaction doctrine, and tax avoidance motives. The court, however, respected the transfer, rejected the IRS arguments, and did not include the transferred shares in the decedent's estate.

Applicability of Section 2703. Section 2703(a)(2) provides that the value of transferred property is determined without regard to any restriction on the right to sell or use the property. In the TAMs, the taxpayers contended that the "property" transferred was the decedent's partnership interest. The Service ruled, though, that the "property" transferred was the underlying assets used to fund the partnership. According to the IRS, the creation of the FLP and related transactions constituted one integrated transaction (i.e., the transfer at the decedent's death of the underlying assets, subject to the partnership agreement). The IRS concluded that any reduction in value of the underlying assets was to be disregarded under Section 2703(a)(2).

There is no support for the IRS position. The only property that the statute could refer to is the partnership interests. No agreement or restrictions existed before the property was transferred to the FLP.

The Committee Reports pertaining to Section 2703 are clear that the section is directed to provisions in buy-sell agreements designed to reduce the value of property. The Senate Committee Report states:

> The bill provides that the value of property for transfer tax purposes is determined without regard to any option, agreement or other right to acquire property at less than fair market value or any restriction on the right to sell or use such property. . . .

The Conference Committee Report states:

> The conferees do not intend the provision governing buy-sell agreements to disregard such an agreement merely because its terms differ from those used by another similarly situated company. The conferees recognize that general business practice may recognize more than one valuation methodology, even within the same industry. In such situations, one of several generally accepted methodologies may satisfy the standard contained in the conference agreement.

Section 2703 business purpose argument misplaced. Some of the assets held by the FLPs included a personal residence and marketable securities. The IRS stated that there was no business purpose when an FLP holds a personal residence and marketable securities. The business purpose test applies under the exception to Section 2703(a), set forth in Section 2703(b). If the exception applies, Section 2703(a) does not apply and a restriction on the right to sell or use property is given effect for valuation purposes.

Three requirements must be met for the exception of Section 2703(b) to apply: (1) the restriction must have a bona fide business

[4] TCM 1990-472.
[5] Reg. 25.7520-3(b)(3).
[6] TCM 1995-132.

purpose; (2) it must not be a device to transfer property to the natural objects of the transferor's bounty for less than full and adequate consideration; and (3) its terms must be comparable to similar arm's-length transactions.

It is unlikely that a family transaction could ever meet all three requirements. Practitioners recognize that Section 2703 will usually apply and any rights or restrictions in the agreement will be ignored, but this does not mean that the FLP is ignored. It may mean that the discounts will not be as great as they would be if the restrictions were taken into account, but the usual marketability and minority interest discounts should continue to apply. The existence of publicly traded securities in an FLP results in a smaller discount than when the FLP owns hard-to-value assets.

This does not mean, as the IRS statement may have been intended to imply, that there is no business purpose to creating FLPs holding residences and marketable securities. As discussed earlier, there are any number of valid business purposes for creating such FLPs.

The Service has recognized that its argument based on Section 2703 is weak, if not invalid, inasmuch as it recently conceded the Section 2703 valuation issue in the case of *White v. Comm'r,* which was docketed in the Tax Court.

Applicability of Section 2704. In the TAMs, the IRS also argued that Section 2704 applied to the transaction. Generally, the purpose of Section 2704 is to require that a family-controlled entity be valued, for gift and estate tax purposes, based on its liquidation value rather than as a going concern. Entity agreements usually restrict the ability of a partner or stockholder to liquidate or withdraw from the firm.

Despite the challenges by the IRS against family limited partnerships, these entities should continue as viable planning vehicles.

An FLP agreement typically provides that limited partners are prohibited from withdrawing from the FLP until its stated termination date, usually 50 years. Under Section 2704(b), such a restriction is ignored in valuing the FLP interest if the restriction is more onerous than applicable state law would provide.[7] If the provision in the agreement is less restrictive than state law, Section 2704 does not apply, and the restriction in the agreement is not ignored in valuing the partnership interest.

For example, if state law provides that a limited partner may withdraw from the FLP on six months' notice (the typical provision), then the 50-year waiting period in the FLP agreement is more restrictive than state law, and constitutes an applicable restriction which is ignored for valuation purposes.

A recent letter ruling illustrates the importance of the state law exception. In *Ltr. Rul.* 9710021, a husband and wife created a Business Trust under state law which was classified by the IRS as a partnership for federal income tax purposes. The Business Trust was structured like a limited partnership: the husband and wife owned a 1% (Class A) management interest, and the other interests (Classes B and C) were passive interests intended to be owned by other family members.

In the ruling, applicable state law provided that a business trust has perpetual existence. The Business Trust agreement specified that the Trust would terminate 12/31/2045 or 12/31/2055, depending on certain circumstances. Accordingly, the provision in the Trust agreement was less restrictive than state law because the specified date of 2045 or 2055 was a shorter period of time than perpetual existence.

Applicable state law also provided that the death, incapacity, dissolution, termination, or bankruptcy of a beneficial owner did not result in the termination of a business trust. Therefore, the Trust's agreement was less restrictive than state law because it provided for termination of the Business Trust on the withdrawal of a Class A (manager) owner.

The IRS ruled that because the restrictions under state law were more restrictive than those in the Business Trust agreement, the restrictions in the agreement were not to be ignored for valuation purposes.

Some states' laws provide that limited partners may not withdraw from the partnership unless the agreement permits them to do so. Such states include California, Delaware, Florida, Georgia, and South Dakota. If the FLP agreement mandates that a limited partner may not withdraw for a term of 50 years, such a provision is less restrictive than state law and the provision may not be ignored under Section 2704(b). Practitioners concerned about Section 2704(b) may want to form FLPs in one of these jurisdictions.

In the recently issued TAMs involving the creation of FLPs when death was imminent, the FLP agreements contained withdrawal provisions that were more

[7] Reg. 25.2704-2(b).

restrictive than applicable state law. Therefore, the partnerships would be valued based on the ability of the partner to withdraw from the partnership as permitted by state law (usually upon six months' notice), rather than the longer period (i.e., 50 years) specified in the partnership agreements. This essentially permits the IRS to value the partnership interest based on its greater liquidation value rather than its going concern value. But, as stated in the Conference Committee Report explaining Section 2704:

> These rules do not affect minority discounts or other discounts available under present law. The conferees intend that no inference be drawn regarding the transfer tax effect of restrictions and lapsing rights under present law.

This statement is confirmed by Example 8 to the Conference Committee Report:

> Mother and Son are partners in a two-person partnership. The partnership agreement provides that the partnership cannot be terminated. Mother dies and leaves her partnership interest to Daughter. As the sole partners, Daughter and Son acting together could remove the restriction on partnership termination. Under the conference agreement, the value of Mother's partnership interest in her estate is determined without regard to the restriction. Such value would be adjusted to reflect any appropriate fragmentation discount.

Disregarding the entity

A recent Tax Court case demonstrates another avenue of attack used by the IRS against FLPs. In *Estate of Schauerhamer*,[8] the court held that the value of the FLP's assets was included in the transferor's estate because she deposited all the FLP's income into her personal checking account. The decedent in *Schauerhamer* was diagnosed with cancer in November 1990. On 12/31/90, she created three FLPs, one for each of her children. The decedent and one child were the general partners of that child's partnership.

The initial capital of each FLP was $100, which was deposited in an FLP checking account. The decedent transferred a one-third interest in some of her business assets to each FLP on 12/31/90 and 11/5/91. She made 33 annual exclusion gifts of $10,000 partnership interests on 12/31/90 and again on 1/1/91. She died on 12/13/91. The decedent deposited all the income of the FLPs into her own checking account, which was used to pay personal and FLP expenses. No accounting was ever made.

Section 2036(a)(1) provides that a decedent's gross estate includes the value of all property transferred (for other than full and adequate consideration) during lifetime where the decedent retained for life the possession or enjoyment of the property or the right to the income from the property. The court in *Schauerhamer* noted that the term "enjoyment" refers to the economic benefits from the property.

The court held that the retention by the decedent of the income from the property after it had been transferred to the FLPs constituted the requisite "enjoyment" that would cause the transferred property to be included in the decedent's estate. The facts of the case established that there was an implied agreement among all the partners that allowed the decedent to continue to enjoy the transferred property as if nothing had changed.

Schauerhamer illustrates the importance of conducting an FLP in the same manner as any other business. There was a total failure by the family members to respect the formalities (such as a separate partnership bank account) of the FLP arrangement. It would not have mattered if the entity had been a corporation, business trust, or LLC. If the FLPs had been properly managed, the result should have been favorable to the estate. There was nothing improper in forming the FLPs; the fault was in the execution of the plan, not its creation.

No FLP discount for high interest notes

In another recent TAM involving an FLP created shortly before death, the IRS ruled that the decedent's limited partnership interests could not be discounted because the FLP's assets consisted of high yielding notes. In TAM 9735003, Father died on 12/22/93. On 11/1/93, Son, as trustee of Father's revocable trust, and Daughter-in-law, as trustee of a marital trust created under the will of Father's deceased spouse, created an FLP. Daughter-in-law was the general partner, and the two trusts were the limited partners.

The IRS did not rely on its imminent death/sham transaction argument. Instead, the Service concluded that the high-yielding notes owned by the FLP could not be discounted. Father's revocable trust (which was a limited partner in the FLP) owned beneficial interests in an investment trust (X Trust), which made loans to an unrelated partnership (Y Partnership). The Y Partnership invested primarily in derivative securities. The loans to the Y Partnership from the X Trust were evidenced by promissory notes accruing interest at 14% if

[8] TCM 1997-242.

paid quarterly, and 15% if paid annually.

On the estate tax return, Father's estate discounted his interest in the FLP by 55%, based on an appraisal that compared the publicly traded per unit selling prices of three partnerships engaged in investing in derivative securities. The appraisal determined that units in these partnerships traded at approximately 45% of their asset value because of the high risk related to investing in derivatives.

The IRS rejected the estate's appraisal in its entirety, ruling that the appraisal based on the publicly traded partnerships would be appropriate for valuing interests in the Y Partnership but not the FLP. The IRS reasoned that the high risk of holding the Y Partnership notes was offset by the high interest rate paid on the notes. Therefore, a discount was not appropriate, and the face value of the notes was the discounted FMV of the notes. Accordingly, the FLP interest could not be discounted to take into account the value of the underlying derivative securities.

Although the details of the appraisal are not furnished in the TAM, the IRS may be correct that the appraisal is not appropriate since it values the equity interest rather than the debt interest. On the other hand, the appraisal was for the purpose of valuing the FLP interests, not the assets owned by the FLP. The TAM ignored this difference.

The IRS's position was not based on expert opinion, but only on the opinion of the author of the TAM. The valuation issues in TAM 9735003 are factual issues that will be decided by a court based on expert testimony.

Even if the FLP did not exist, the notes must still be valued for estate tax purposes. Whether a further discount is permitted because of the FLP structure is a separate issue. Even assuming the notes are valued at par, the estate is nevertheless entitled to a marketability discount. This point was not discussed in the TAM.

The interest rate is only one factor in determining value. The TAM found the interest rate to be total compensation for the risk. Apparently, the IRS believed that these notes would sell in the open market at par.

The IRS rejected the notion that anyone would invest $325,000 in Y Partnership notes worth $146,250 (based on a 45% discount), while at the same time accepting the same discount for an equity investment in the Y Partnership. It appears that the author of the TAM was substituting his or her risk tolerance for that of the investor.

Judicial valuation of notes

A 1996 case shows the procedure for valuing notes that are not publicly traded. In *Smith*,[9] the decedent owned a note with an unpaid principal balance of more than $3.4 million and an interest balance of more than $4.1 million due to be paid for the remaining term of the note ($7.5 million total). The estate's appraiser set the FMV of the note at $3,552,222, while the IRS appraiser determined the value to be 4.3 million, a difference of $747,778. Although both appraisers used a similar valuation methodology, based on the publicly traded debt of the issuer of the note, they used different discount rates.

The court accepted the estate's valuation because the estate's appraiser demonstrated that the differences between the estate's note and the publicly traded debt of the issuer justified additional discounts. Several of the differences were based on the fact that the estate's note did not have any of the protection (e.g., protection in the event of default) afforded to the publicly traded debt.

Conclusion

FLPs and LLCs are structures that may be used to further business and family planning objectives while at the same time providing gift and estate tax benefits through the application of marketability and minority interest discounts. Despite challenges by the IRS, these entities should continue as viable planning vehicles. The recently issued imminent death TAMs should be limited to their special factual situations. ■

[9] 923 F. Supp. 896, 77 AFTR2d 96-1164, 96-2 USTC ¶60,222 (DC Miss., 1996).