ADVANCED ASSET PROTECTION THROUGH FAMILY LIMITED PARTNERSHIPS

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ADVANCED ASSET PROTECTION THROUGH FAMILY LIMITED PARTNERSHIPS

I. Estate Eroders

A. Income, Payroll and Consumption Taxes

B. Transfer Taxes (Estate and Gift Tax)

C. Personal Injury or Property Damaged Caused by You, Your Spouse, Your Children or Your Employees

D. Employee Action

E. Guest Accident at Home or Work

F. Divorce (Yours, Your Children's or Your Grandchildren's)

G. Liabilities Against Joint Owners

H. Liabilities Against Co-Partners

I. Service as Corporate Officer/Director

J. Advisory Board Member

K. Business Operator

L. Property Owner

II. Benefits of Utilizing Family Limited Partnerships

A. Estate and Gift Tax Savings - It is difficult to pass on a very large estate to future generations due to the substantial transfer taxes (estate and gift) imposed. Substantial valuation discounts for estate and gift tax purposes have been obtained for reasons discussed in connection with Sections IV through VIII hereinbelow.

B. Protecting Assets From Future Creditors - If a family member who has transferred most or all of his non-exempt properties to a family limited partnership is unable to satisfy the claim of a future creditor, such a creditor has very limited remedies against the assets held in such family limited partnership, as discussed in Section IX hereinbelow. This limitation on remedies is what makes the family limited partnership an effective asset protective device.

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C. **Simplified Family Transfers** - It is often difficult to transfer undivided interests in multiple assets, such as real properties, securities held in investment accounts, oil and gas interests, etc., amongst the various children, grandchildren or other donees or devisees of a donor. If these assets are placed in a family limited partnership, the resulting limited partner units can be used as "family money" to conveniently gift or devise the equivalent of undivided interests of all of the assets to family members. If the gifts of limited partnership units qualify for the annual exclusion, the same discount methods of valuation discussed in Section VII hereinbelow will apply, so that a greater value can be gifted to family members without potentially incurring a gift tax. If the discounted value of the gift exceeds the annual exclusion, the diminishment of the unified credit can be reduced. Similarly, even if the annual exclusion is found not to apply to such gifts, the reduction of the unified credit can still be diminished. However, while once thought that gifts of family limited partnership interests would routinely qualify for the annual gift tax exclusion, relatively recent developments have indicated otherwise. *See, e.g.*, ***Hackl v. Commissioner***, 118 T.C. 279 (2002), *aff'd* 335 F.3d 664 (7th Cir 2003); TAM 9751003; ***Price v. Commissioner***, T.C. Memo 2010-2 (1/4/10); ***Fisher v. U.S.***, No 1:08-cv-0908-LJM-TAB (S.D. Ind. 3/11/10); *but see*, ***Estate of Wimmer v. Commissioner***, T.C. Memo 2012-187 (6-4-12), where the transfers of limited partner interests qualified, but only because distributions were continuously made to the partners and such distributions could be readily ascertainable.

D. **Protecting Assets Against Failed Marriages** - Many affluent individuals are worried about financial exposure in the event of a divorce involving their children and the possible passage of a substantial portion of the family wealth to a second family. While other protective devices such as prenuptial or postnuptial agreements are often found distasteful, the family limited partnership could provide the necessary protection without even raising the issue. If the wealth of a child consists of limited partnership units acquired by gift (before or during marriage) and, thus, constituting separate property of the child, the wealth of the child can be protected from award to a divorced spouse. Even if the divorce court were to award part of the limited partnership units to a divorced spouse, a properly drafted family limited partnership agreement would provide that involuntary transfers are subject to repurchase options, so that retention of family assets can be maintained by the family.

E. **Revocability** - One major disadvantage of the irrevocable trust, which also has substantial asset protection features, is that it cannot generally be lawfully amended or terminated without participation by a court and, possibly, other parties such as a guardian ad litem for minor children or other incapacitated beneficiaries. The family limited partnership agreement may be amended or terminated if the designated vote of the partners (in a family limited partnership, comprised of family members) can be obtained.

F. **Generation to Generation Retention** - Since a well drafted family limited partnership agreement will contain consent requirements and/or purchase option provisions on the attempted transfer of any partner of his or her partnership units, the assets can be effectually retained in the family for the duration of the partnership.

G. **Reduction of Investment Portfolio Costs** - Families may have many members, as well as trusts set up on their behalf, resulting in costly maintenance of separate

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investment accounts for multiple family member investors. Consolidation of investment accounts in one partnership can greatly alleviate this problem. Using a different financial or money manager for each family member or trust may be prohibitively expensive. There may be a substantial reduction in financial or money manager fees based on various levels of investment. If multiple family member and trust accounts are consolidated into one investment account in the family limited partnership, managed by one financial or money manager, the realization of a substantial reduction of fees can be obtained. On the other hand, many professionals advise that multiple financial managers are necessary to, among other things, achieve more diversification of the various portions of the family's total investment portfolio, outweighing the benefit of reduced fees and other costs.

H. **Flexibility in Portfolio Mix** - Oftentimes, in the irrevocable trust scenario, the trustee is not allowed to use sound portfolio investment principles because of concern of treating either the income beneficiary or the remainder beneficiary unfairly. An income beneficiary's interest increases if the portfolio contains investments generating larger income, usually in the form of dividend or interest income, while a remainder beneficiary's interest is enhanced through investments which appreciate in value. Thus, the division of interests between the income and remainder beneficiaries may produce an inherent conflict. Since sometimes it is better to invest in appreciating securities and sometimes in income producing securities, or a mixture of the two, an investment vehicle that sidesteps fiduciary duties relating to conflicts among different beneficiary classes is desirable. Placement of the investment portfolio in a family limited partnership provides this flexibility.

I. **Retention of Younger Generation Initiative** - An often expressed fear of the older generation is that a substantial transfer of wealth too early stifles the initiative of their children to produce through work. Since retention of management, including the power to make distributions to younger generation limited partners, is a fundamental feature of essentially all family limited partnerships, the older generation can completely control the cash flow to their children and encourage productive work habits.

III. Structure of Family Limited Partnership

A. **Ownership of Units** - While differing fact patterns may dictate other structures, this author often creates a Texas limited partnership, now governed under the Texas Business Organizations Code, with one hundred (100) partnership units, one (1) general partner unit and ninety-nine (99) limited partner units. The predominant spouse (or a revocable trust with such spouse as trustee) contributes one percent (1%) of the marital assets going into the family limited partnership in exchange for the one (1) general partner unit. The predominant spouse contributes forty-nine percent (49%) of the marital assets going into the family limited partnership for forty-nine (49) limited partner units. The non-predominant spouse contributes fifty percent (50%) of the marital assets going into the family partnership for fifty (50) limited partner units. Later, pursuant to an annual gift-giving program, or intermittingly as the spouses may determine, both spouses may gift limited partner units to family members as "family money".

B. Management of the Family Limited Partnership - Sole and exclusive management control of the family limited partnership will be held by the general partner, who is usually the predominant spouse or a revocable trust, relating to which the predominant spouse is the trustee. In the event of marital estates where each spouse has management control over separate significant portions of such estate (and, sometimes, in other circumstances), dual family limited partnerships, where one spouse is general partner of one family limited partnership and the other spouse is the general partner of the other family limited partnership, can maintain proper spousal control of marital assets subject to each spouse's normal management domain. Crucial to asset protection concerns and the attainment of substantial valuation discounts is the ability of the general partner to limit cash distributions to the partners in the general partner's sole discretion. Additionally, for estate and gift tax planning, it may be desirable to have junior family members own the general partner interests to help bolster the arguments for significant estate or gift tax discounts.

C. Transfer Restrictions - Unless there are lack of family harmony concerns, transfers of interests in the family limited partnership should require unanimous or super-majority vote of all of the partners for asset protection reasons. It is this voting control to admit new partners into the partnership, among other things, that provides the difficulty of a creditor in becoming a substituted partner into the family limited partnership. Many practitioners feel that other common restrictions on transferability will meet the "comparability test" under IRC §2703, such as requirement for the consent of only the general partner and/or right of first refusal provisions. Furthermore, many practitioners feel that the normal "permitted transferee" provisions allowing for the admission of related partners upon death or similar events will not cause IRC §2703 concerns.

D. Liquidation Rights - For IRC Chapter 14 purposes, no partner should be given the right to unilaterally liquidate the partnership, including the general partner. Common procedures to prevent the risk of dissolution upon the death, incapacity or other withdrawal of a sole individual general partner, that would subject the partnership to a partnership vote to reconstitute and continue the partnership, would be to provide for the appointment of successor general partners or to include multiple general partners. Successor general partners can conveniently be established by making a revocable trust be the general partner, the grantor and trustee of such trust being the individual who would otherwise serve as general partner. Within the trust document, successor trustees could be provided for.

IV. Estate and Gift Tax Considerations (General)

A. Estate Tax Credit/Applicable Exclusion Amount – The American Taxpayer Relief Act of 2012 ("ATRA"), signed into law on January 2, 2013, made permanent the basic exclusion amount of $5,000,000 per person ($10,000,000 for a married couple), adjusted for inflation for decedents dying in 2013 and thereafter. With the inflation adjustment, the basic exclusion amount is $5,250,000 for 2013 and $5,340,000 for 2014. Other important features of ATRA include: (i) the generation-skipping transfer ("GST") exclusion is also $5,000,000, adjusted for inflation, (ii) the maximum estate tax and GST tax rate has been set at 40% and (iii) the so-called "portability" provision, where the surviving spouse may utilize the

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unused portion of the deceased spouse's estate tax exclusion amount, has been made permanent.

B. Gift Tax Credit/Applicable Exclusion Amount – Starting for transfers made in 2013, ATRA makes the applicable exclusion amount for transfers by gift equal $5,000,000 for each taxpayer ($10,000,000 for a married couple), adjusted for inflation, the same as the estate tax exclusion amount (under a unified estate/gift tax structure).

V. Estate and Gift Tax Considerations (Chapter 14, IRC §§2701 - 2704)

A. Chapter 14, IRC §2701 - IRC §2701 was designed primarily to address the traditional corporate and partnership recapitalizations that seek to "freeze" the value of senior generation interests and shift appreciation to junior generation interests. For example, in the corporate context, the recapitalization was accomplished with preferred stock retained by the senior generation and common stock gifted to the junior generation. IRC §2701 contains special valuation rules that cause certain discretionary distribution rights and liquidation rights (retained through preferred stock, for example, in the corporate context), preserved within the senior "frozen" interests, to be valued at zero so that the transfer value of the junior interest is determined without such considerations and, thus, are assigned a much higher value. However, non-lapsing differences with respect to management and limitations on liability do not create separate classes of interest for this purpose. Treasury Reg. §25.2701(c)(3). Therefore, most practitioners agree that the difference between general and limited partnership interests regarding participation in management and exposure to liability do not create two "classes" of partnership interests for this purpose. In the family limited partnership context, involving so-called "straight up" interests, IRC §2701 should not apply since there are not two classes of interests, with retained special distribution rights or liquidation rights attached to one of such classes.

B. Chapter 14, IRC §2702 - IRC §2702 was designed primarily to address retained interests in trusts and is generally not applicable in the family limited partnership context.

C. Chapter 14, IRC §2703

1. **IRC §2703: In General** – In recent years, IRC §2703 is one of the more common mechanisms used by the IRS to attack family limited partnerships. IRC §2703 contains rules governing the tax impact of certain buy-sell agreements and similar arrangements designed to limit or restrict the value of interests in family-controlled partnerships and corporations. Generally, IRC §2703 provides that the value of any property shall be determined without regard to any contractual restrictions on transferability unless such restrictions are (1) a bona fide business arrangement, (2) not a device to transfer the covered property to members of a decedent's family for less than full and adequate consideration and (3) comparable to similar arrangements entered into by unrelated parties. The IRS has taken the position in recent cases that the entire partnership agreement (and, thus, the existence of the partnership) may be disregarded under this code section and, thus, the value of partnership

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assets attributable to a transferor should be determined without regard to any partnership structure (no discounts).

2. IRC §2703: The Statute – IRC §2703 reads as follows:

SUBTITLE B--ESTATE AND GIFT TAXES (Sections 2001 to 2704)
CHAPTER 14--Special Valuation Rules (Sections 2701 to 2704
Sec. 2703. Certain Rights And Restrictions Disregarded.

Sec. 2703. Certain Rights And Restrictions Disregarded.

(a) General Rule. -- For purposes of this subtitle, the value of any property shall be determined without regard to -

(1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right), or

(2) any restriction on the right to sell or use such property.

(b) Exceptions. -- Subsection (a) shall not apply to any option, agreement, right, or restriction which meets each of the following requirements:

(1) It is a bona fide business arrangement.

(2) It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.

(3) Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction.

(Added Pub. L. 101-508, title XI, Sec. 11602(a), Nov. 5, 1990, 104 Stat. 1388-498.)

3. IRC §2703: The Lead Case – *Estate of Strangi v. Commissioner*, 115 T.C. 478 (2000), *aff'd in part and rev'd in part on other grounds*, 293 F.3d 279 (5th Cir. 2002) (referred to as "*Strangi I*").

In *Strangi I*, the Tax Court rejected the IRS argument that "a right or restriction may be implicit in the capital structure of an entity" by stating:

> "Respondent (IRS) next argues that the term "property" in section 2703(a)(2) means the underlying assets in the partnership and that the partnership form is the restriction that must be disregarded. Unfortunately for respondent's (IRS') position, neither the language of the statute nor the language of the regulation supports respondent's (IRS') interpretation. Absent application of some other provision, the property included in decedent's estate is the limited partnership interest and decedent's interest in Stranco."

The Tax Court goes on to state the following:

> "Treating the partnership assets, rather than decedent's interest in the partnership, as the "property" to which section 2703(a) applies in this case would raise anew the difficulties that Congress sought to avoid by repealing section 2036(c) and replacing it with chapter 14. We conclude that Congress did not intend, by the enactment of section 2703, to treat partnership assets as if they were assets of the estate where the legal interest owned by the decedent at the time of death was a limited partnership or corporate interest. See also *Estate of Church v. United States*, 85 AFTR 2d 2000-804, 2000-1 USTC par. 60,369 (W.D. Tex. 2000). Thus, we need not address whether the partnership agreement satisfies the safe harbor provisions of section 2703(b)."

4. **IRC §2703: Conclusions** – Many practitioners believe that IRS attacks on validly formed limited partnerships based on IRC §2703 will continue to be fruitless (on the IRS' part) under the *Strangi I* rationale that the term "property" cannot refer to the partnership assets, themselves, since such assets are not part of the transferor's estate (the partnership interests are), thus, rendering IRC §2703(a) non-applicable to the valuation of the partnership interests. Many practitioners also believe that an additional IRC §2703(b) argument (not addressed by the *Strangi I* court, since its determination under IRC §2703(a) made an analysis of IRC §2703(b) unnecessary) would also be available by relying on state law regarding the non-assignability of interests without the consent of all partners (unless provided otherwise in the partnership agreement). As to whether other restrictions, such as right of first refusal provisions, will trigger IRC §2703 applicability will need to be determined under the subjective "comparability" rule of IRC §2703(b)(3), in the event a court were to find IRC §2703(a) applicable to the partnership interests, themselves (contrary to *Strangi I*).

A recent contrary case, holding that IRC §2703 disallows consideration of transfer restrictions contained in a limited partnership agreement in determining the magnitude of the lack of marketability discount for family limited partnerships holding primarily marketable securities is *Holman v. Commissioner*, Doc 2010-7656, 105 AFTR2d ¶2010-721 (8th Cir 4/7/10). While being consistent with earlier cases in affirming that the property transferred is the partnership interest, itself, rather than the underlying assets held by the partnership (in this case, publicly traded Dell stock), the majority opinion indicated that typical transfer restriction provisions, such as a right of first refusal, do not meet the bona business arrangement prong of the IRC §2703 test where the partnership essentially holds marketable securities. That is, the majority decision essentially held that "maintaining family control" is a legitimate business purpose for partnership restrictions *only* when the "control" being preserved is the right to manage an operating business or an actively-managed asset. Also, see similarly, *Fisher v U.S.*, 106 AFTR2d ¶2010-6144 (S.D. Ind. 9/1/10), applying the *Holman* majority rationale to a limited partnership holding lake-front real estate for future appreciation. Also, of note, is the *Holman* dissent, which contains a good discussion of authorities indicating that, contrary to the majority decision, "maintaining family control" is a legitimate business purpose even for partnerships holding passively-managed investment assets.

D. Chapter 14, IRC §2704

1. **IRC §2704: In General** – An additional attack of family limited partnerships by the IRS in recent years is under IRC §2704. IRC §2704 (the anti-*Harrison* statute) applies to

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treat a "lapse" of a voting right or liquidation right as a taxable transfer. Thus, if the transferor retained the unilateral power under the partnership agreement to liquidate the partnership or his interest in the partnership, the transferor's partnership interest would be valued at liquidation value (no discounts). Additionally, IRC §2704 provides that certain "applicable restrictions" on a transferor's ability to liquidate the partnership or his interest in the partnership will be disregarded, if, among other things, the "applicable restrictions" are more restrictive than that provided under applicable state law. Thus, if a partnership agreement provides for unanimous vote of all of the partners to liquidate a partnership, but the applicable state's partnership law provides for a 70% vote, a transferor's 75% partnership interest would be valued as if the partnership agreement's restriction on the ability to liquidate were disregarded, treating the 75% partner as if he had the power to liquidate the partnership, notwithstanding the more restrictive provision in the partnership agreement.

2. **IRC §2704: The Statute** – IRC §2704 reads as follows:

SUBTITLE B--ESTATE AND GIFT TAXES (Sections 2001 to 2704)
CHAPTER 14--Special Valuation Rules (Sections 2701 to 2704
Sec. 2704. Treatment Of Certain Lapsing Rights And Restrictions

Sec. 2704. Treatment Of Certain Lapsing Rights And Restrictions.

(a) Treatment Of Lapsed Voting Or Liquidation Rights. --

(1) In General. -- For purposes of this subtitle, if --

(A) there is a lapse of any voting or liquidation right in a corporation or partnership, and

(B) the individual holding such right immediately before the lapse and members of such individual's family hold, both before and after the lapse, control of the entity, such lapse shall be treated as a transfer by such individual by gift, or a transfer which is includible in the gross estate of the decedent, whichever is applicable, in the amount determined under paragraph (2).

(2) Amount Of Transfer. -- For purposes of paragraph (1), the amount determined under this paragraph is the excess (if any) of --

(A) the value of all interests in the entity held by the individual described in paragraph (1) immediately before the lapse (determined as if the voting and liquidation rights were nonlapsing), over

(B) the value of such interests immediately after the lapse.

(3) Similar Rights. -- The Secretary may by regulations apply this subsection to rights similar to voting and liquidation rights.

(b) Certain Restrictions On Liquidation Disregarded. --

(1) In General. -- For purposes of this subtitle, if --

(A) there is a transfer of an interest in a corporation or partnership to (or for the benefit of) a member of the transferor's family, and

(B) the transferor and members of the transferor's family hold, immediately before the transfer, control of the entity, any applicable restriction shall be disregarded in determining the value of the transferred interest.

(2) Applicable Restriction. -- For purposes of this subsection, the term 'applicable restriction' means any restriction --

(A) which effectively limits the ability of the corporation or partnership to liquidate, and

(B) with respect to which either of the following applies:

(i) The restriction lapses, in whole or in part, after the transfer referred to in paragraph (1).

(ii) The transferor or any member of the transferor's family, either alone or collectively, has the right after such transfer to remove, in whole or in part, the restriction.

(3) Exceptions. -- The term 'applicable restriction' shall not include --

(A) any commercially reasonable restriction which arises as part of any financing by the corporation or partnership with a person who is not related to the transferor or transferee, or a member of the family of either, or

(B) any restriction imposed, or required to be imposed, by any Federal or State law.

(4) Other Restrictions. -- The Secretary may by regulations provide that other restrictions shall be disregarded in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor's family if such restriction has the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee.

(c) Definitions And Special Rules. -- For purposes of this section --

(1) Control. -- The term 'control' has the meaning given such term by section 2701(b)(2).

(2) Member Of The Family. -- The term 'member of the family' means, with respect to any individual --

(A) such individual's spouse,

(B) any ancestor or lineal descendant of such individual or such individual's spouse,

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(C) any brother or sister of the individual, and

(D) any spouse of any individual described in subparagraph (B) or (C).

(3) Attribution. -- The rule of section 2701(e)(3) shall apply for purposes of determining the interests held by any individual.

(Added Pub. L. 101-508, title XI, Sec. 11602(a), Nov. 5, 1990, 104 Stat. 1388-498; Amended Pub. L. 104-188, Sec. 1702, Aug. 20, 1996, 110 Stat. 1755.)

3. **IRC §2704: The Regulations** – Treasury Regulations §25.2704-1 and §25.2704-2 reads as follows:

Treasury Regulations
§ 25.2704-1 Lapse of certain rights.

§ 25.2704-1 Lapse of certain rights.

(a) Lapse treated as transfer

(1) In general. The lapse of a voting right or a liquidation right in a corporation or partnership (an "entity") is a transfer by the individual directly or indirectly holding the right immediately prior to its lapse (the "holder") to the extent provided in paragraphs (b) and (c) of this section. This section applies only if the entity is controlled by the holder and members of the holder's family immediately before and after the lapse. The amount of the transfer is determined under paragraph (d) of this section. If the lapse of a voting right or a liquidation right occurs during the holder's lifetime, the lapse is a transfer by gift. If the lapse occurs at the holder's death, the lapse is a transfer includible in the holder's gross estate.

(2) Definitions. The following definitions apply for purposes of this section.

(i) Control. Control has the meaning given it in section 25.2701-2(b)(5).

(ii) Member of the family. Member of the family has the meaning given it in section 25.2702-2(a)(1).

(iii) Directly or indirectly held. An interest is directly or indirectly held only to the extent the value of the interest would have been includible in the gross estate of the individual if the individual had died immediately prior to the lapse.

(iv) Voting right. Voting right means a right to vote with respect to any matter of the entity. In the case of a partnership, the right of a general partner to participate in partnership management is a voting right. The right to compel the entity to acquire all or a portion of the holder's equity interest in the entity by reason of aggregate voting power is treated as a liquidation right and is not treated as a voting right.

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(v) Liquidation right. Liquidation right means a right or ability to compel the entity to acquire all or a portion of the holder's equity interest in the entity, including by reason of aggregate voting power, whether or not its exercise would result in the complete liquidation of the entity.

(vi) Subordinate. Subordinate has the meaning given it in section 25.2701-3(a)(2)(iii).

(3) Certain temporary lapses. If a lapsed right may be restored only upon the occurrence of a future event not within the control of the holder or members of the holder's family, the lapse is deemed to occur at the time the lapse becomes permanent with respect to the holder, i.e. either by a transfer of the interest or otherwise.

(4) Source of right or lapse. A voting right or a liquidation right may be conferred by and may lapse by reason of a State law, the corporate charter or bylaws, an agreement, or other means.

(b) Lapse of voting right. A lapse of a voting right occurs at the time a presently exercisable voting right is restricted or eliminated.

(c) Lapse of liquidation right

(1) In general. A lapse of a liquidation right occurs at the time a presently exercisable liquidation right is restricted or eliminated. Except as otherwise provided, a transfer of an interest that results in the lapse of a liquidation right is not subject to this section if the rights with respect to the transferred interest are not restricted or eliminated. However, a transfer that results in the elimination of the transferor's right or ability to compel the entity to acquire an interest retained by the transferor that is subordinate to the transferred interest is a lapse of a liquidation right with respect to the subordinate interest.

(2) Exceptions. Section 2704(a) does not apply to the lapse of a liquidation right under the following circumstances.

(i) Family cannot obtain liquidation value

(A) In general. Section 2704(a) does not apply to the lapse of a liquidation right to the extent the holder (or the holder's estate) and members of the holder's family cannot immediately after the lapse liquidate an interest that the holder held directly or indirectly and could have liquidated prior to the lapse.

(B) Ability to liquidate. Whether an interest can be liquidated immediately after the lapse is determined under the State law generally applicable to the entity, as modified by the governing instruments of the entity, but without regard to any restriction described in section 2704(b). Thus, if, after any restriction described in section 2704(b) is disregarded, the remaining requirements for liquidation under the governing instruments are less restrictive than the State law that would apply in the absence of the governing instruments, the ability to liquidate is determined by

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reference to the governing instruments.

(ii) Rights valued under section 2701. Section 2704(a) does not apply to the lapse of a liquidation right previously valued under section 2701 to the extent necessary to prevent double taxation (taking into account any adjustment available under 25.2701-5).

(iii) Certain changes in State law. Section 2704(a) does not apply to the lapse of a liquidation right that occurs solely by reason of a change in State law. For purposes of this paragraph, a change in the governing instrument of an entity is not a change in State law.

(d) Amount of transfer. The amount of the transfer is the excess, if any, of --

(1) The value of all interests in the entity owned by the holder immediately before the lapse (determined immediately after the lapse as if the lapsed right was nonlapsing); over

(2) The value of the interests described in the preceding paragraph immediately after the lapse (determined as if all such interests were held by one individual).

(e) Application to similar rights. [Reserved]

(f) Examples.

The following examples illustrate the provisions of this section:

Example 1

Prior to D's death, D owned all the preferred stock of Corporation Y and D's children owned all the common stock. At that time, the preferred stock had 60 percent of the total voting power and the common stock had 40 percent. Under the corporate by-laws, the voting rights of the preferred stock terminated on D's death. The value of D's interest immediately prior to D''s death (determined as if the voting rights were non- lapsing) was $100X. The value of that interest immediately after death would have been $90X if the voting rights had been non-lapsing. The decrease in value reflects the loss in value resulting from the death of D (whose involvement in Y was a key factor in Y's profitability). Section 2704(a) applies to the lapse of voting rights on D's death. D's gross estate includes an amount equal to the excess, if any, of $90X over the fair market value of the preferred stock determined after the lapse of the voting rights.

Example 2

Prior to D's death, D owned all the preferred stock of Corporation Y. The preferred stock and the common stock each carried 50 percent of the total voting power of Y. D's children owned 40 percent of the common stock and unrelated parties own the remaining 60 percent. Under the corporate by- laws, the voting rights of the preferred stock terminate on D's death. Section 2704(a) does not apply to the lapse of D's voting rights because members of D's family do not control Y after the lapse.

Example 3

The by-laws of Corporation Y provide that the voting rights of any transferred shares of the single outstanding class of stock are reduced to 1/2 vote per share after the transfer but are fully restored to the transferred shares after 5 years. D owned 60 percent of the shares prior to death and members of D's family owned the balance. On D's death, D's shares pass to D's children and the voting rights are reduced pursuant to the by-laws. Section 2704(a) applies to the lapse of D's voting rights. D's gross estate includes an amount equal to the excess, if any,

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of the fair market value of D's stock (determined immediately after D's death as though the voting rights had not been reduced and would not be reduced) over the stock's fair market value immediately after D's death.

Example 4
D owns 84 percent of the single outstanding class of stock of Corporation Y. The by-laws require at least 70 percent of the vote to liquidate Y. D gives one-half of D's stock in equal shares to D's three children (14 percent to each). Section 2704(a) does not apply to the loss of D's ability to liquidate Y, because the voting rights with respect to the corporation are not restricted or eliminated by reason of the transfer.

Example 5
D and D's two children, A and B, are partners in Partnership X. Each has a 3-1/3 percent general partnership interest and a 30 percent limited partnership interest. Under State law, a general partner has the right to participate in partnership management. The partnership agreement provides that when a general partner withdraws or dies, X must redeem the general partnership interest for its liquidation value. Also, under the agreement any general partner can liquidate the partnership. A limited partner cannot liquidate the partnership and a limited partner's capital interest will be returned only when the partnership is liquidated. A deceased limited partner's interest continues as a limited partnership interest. D dies, leaving his limited partnership interest to D's spouse. Because of a general partner's right to dissolve the partnership, a limited partnership interest has a greater fair market value when held in conjunction with a general partnership interest than when held alone. Section 2704(a) applies to the lapse of D's liquidation right because after the lapse, members of D's family could liquidate D's limited partnership interest. D's gross estate includes an amount equal to the excess of the value of all D's interests in X immediately before D's death (determined immediately after D's death but as though the liquidation right had not lapsed and would not lapse) over the fair market value of all D's interests in X immediately after D's death.

Example 6
The facts are the same as in EXAMPLE 5, except that under the partnership agreement D is the only general partner who holds a unilateral liquidation right. Assume further that the partnership agreement contains a restriction described in section 2704(b) that prevents D's family members from liquidating D's limited partnership interest immediately after D's death. Under State law, in the absence of the restriction in the partnership agreement, D's family members could liquidate the partnership. The restriction on the family's ability to liquidate is disregarded and the amount of D's gross estate is increased by reason of the lapse of D's liquidation right.

Example 7
D owns all the stock of Corporation X, consisting of 100 shares of non-voting preferred stock and 100 shares of voting common stock. Under the by-laws, X can only be liquidated with the consent of at least 80 percent of the voting shares. D transfers 30 shares of common stock to D's child. The transfer is not a lapse of a liquidation right with respect to the common stock because the voting rights that enabled D to liquidate prior to the transfer are not restricted or eliminated. The transfer is not a lapse of a liquidation right with respect to the retained preferred stock because the preferred stock is not subordinate to the transferred common stock.

Example 8
D owns all of the single class of stock of Corporation Y. D recapitalizes Y, exchanging D's common stock for voting common stock and non-voting, non-cumulative preferred stock. The preferred stock carries a right to put the stock for its par value at any time during the next 10 years. D transfers the common stock to D's grandchild in a transfer subject to section 2701. In determining the amount of D's gift under section 2701, D's retained put right is valued at zero. D's child, C, owns the preferred stock when the put right lapses. Section 2704(a) applies to the lapse, without regard to the application of section 2701, because the put right was not valued under section 2701 in the hands of C.

Example 9
A and A's two children are equal general and limited partners in Partnership Y. Under the partnership agreement, each general partner has a right to liquidate the partnership at any time. Under State law that would apply in the absence of contrary provisions in the partnership agreement, the death or incompetency of a general partner terminates the partnership. However, the partnership agreement provides that the partnership does not terminate

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on the incompetence or death of a general partner, but that an incompetent partner cannot exercise rights as a general partner during any period of incompetency. A partner's full rights as general partner are restored if the partner regains competency. A becomes incompetent. The lapse of A's voting right on becoming incompetent is not subject to section 2704(a) because it may be restored to A in the future. However, if A dies while incompetent, a lapse subject to section 2704(a) is deemed to occur at that time because the lapsed right cannot thereafter be restored to A.

[T.D. 8395, 57 FR 4250-77, Feb. 4, 1992]

Treasury Regulations
§ 25.2704-2 Transfers subject to applicable restrictions.

§ 25.2704-2 Transfers subject to applicable restrictions.

(a) In general. If an interest in a corporation or partnership (an "entity") is transferred to or for the benefit of a member of the transferor's family, any applicable restriction is disregarded in valuing the transferred interest. This section applies only if the transferor and members of the transferor's family control the entity immediately before the transfer. For the definition of control, see section 25.2701-2(b)(5). For the definition of member of the family, see section 25.2702-2(a)(1).

(b) Applicable restriction defined. ***An applicable restriction is a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction.*** A restriction is an applicable restriction only to the extent that either the restriction by its terms will lapse at any time after the transfer, or the transferor (or the transferor's estate) and any members of the transferor's family can remove the restriction immediately after the transfer. Ability to remove the restriction is determined by reference to the State law that would apply but for a more restrictive rule in the governing instruments of the entity. See section 25.2704-1(c)(1)(B) for a discussion of the term "State law." An applicable restriction does not include a commercially reasonable restriction on liquidation imposed by an unrelated person providing capital to the entity for the entity's trade or business operations whether in the form of debt or equity. An unrelated person is any person whose relationship to the transferor, the transferee, or any member of the family of either is not described in section 267(b) of the Internal Revenue Code, provided that for purposes of this section the term "fiduciary of a trust" as used in section 267(b) does not include a bank as defined in section 581 of the Internal Revenue Code. A restriction imposed or required to be imposed by Federal or State law is not an applicable restriction. An option, right to use property, or agreement that is subject to section 2703 is not an applicable restriction. [Emphasis added]

(c) Effect of disregarding an applicable restriction. If an applicable restriction is disregarded under this section, the transferred interest is valued as if the restriction does not exist and as if the rights of the transferor are determined under the State law that would apply but for the restriction. For example, an applicable restriction with respect to preferred stock will be disregarded in determining the amount of a transfer of common stock under section 2701.

(d) Examples. The following examples illustrate the provisions of this section:

Example 1

D owns a 76 percent Interest and each of D's children, A and B, owns a 12 percent interest in General Partnership X. The partnership agreement requires the consent of all the partners to liquidate the partnership. Under the State law that would apply in the absence of the restriction in the partnership agreement, the consent of partners owning 70 percent of the total partnership interests would be required to liquidate X. On D's death, D's partnership interest passes to D's child, C. The requirement that all the partners consent to liquidation is an applicable restriction. Because A, B and C (all members of D's family), acting together after the transfer, can remove the restriction on liquidation, D's interest is valued without regard to the restriction; i.e., as though D's interest is sufficient to liquidate the partnership.

Example 2

D owns all the preferred stock in Corporation X. The preferred stock carries a right to liquidate X that cannot be exercised until 1999. D's children, A and B, own all the common stock of X. The common stock is the only voting stock. In 1994, D transfers the preferred stock to D's child, A. The restriction on D's right to liquidate is an applicable restriction that is disregarded. Therefore, the preferred stock is valued as though the right to liquidate were presently exercisable.

Example 3

D owns 60 percent of the stock of Corporation X. The corporate by-laws provide that the corporation cannot be liquidated for 10 years after which time liquidation requires approval by 60 percent of the voting interests. In the absence of the provision in the by-laws, State law would require approval by 80 percent of the voting interests to liquidate X. D transfers the stock to a trust for the benefit of D's child, A, during the 10-year period. The 10-year restriction is an applicable restriction and is disregarded. Therefore, the value of the stock is determined as if the transferred block could currently liquidate X.

Example 4

D and D's children, A and B, are partners in Limited Partnership Y. Each has a 3.33 percent general partnership interest and a 30 percent limited partnership interest. Any general partner has the right to liquidate the partnership at any time. As part of a loan agreement with a lender who is related to D, each of the partners agree that the partnership may not be liquidated without the lender's consent while any portion of the loan remains outstanding. During the term of the loan agreement, D transfers one-half of both D's partnership interests to each of A and B. Because the lender is a related party, the requirement that the lender consent to liquidation is an applicable restriction and the transfers of D's interests are valued as if such consent were not required.

Example 5

D owns 60 percent of the preferred and 70 percent of the common stock in Corporation X. The remaining stock is owned by individuals unrelated to D. The preferred stock carries a put right that cannot be exercised until 1999. In 1995, D transfers the common stock to D's child in a transfer that is subject to section 2701. The restriction on D's right to liquidate is an applicable restriction that is disregarded in determining the amount of the gift under section 2701.

[T.D. 8395, 57 FR 4250-77, Feb. 4, 1992, corrected by 57 FR 11264, Apr. 2, 1992]

4. Texas Partnership Statutes on Liquidation and Withdrawal

a. Liquidation of Texas limited partnerships subject to the Texas Revised Limited Partnership Act ("TRLPA") [Generally, limited partnerships formed prior to 1-1-06]:

Sec. 8.01. A limited partnership is dissolved and its affairs shall be wound up only on the first of the following to occur:

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(1) the occurrence of events specified in the partnership agreement to cause dissolution unless within 90 days after the event causing the dissolution, all remaining partners (or another group or percentage of partners as specified by the partnership agreement) agree in writing to continue the business of the limited partnership;

(2*) written consent of all partners to dissolution;*

(3) an event of withdrawal of a general partner, unless:

(A) there remains at least one general partner and the partnership agreement permits the business of the limited partnership to be carried on by the remaining general partner or general partners, and that general partner or those general partners do so; or

(B) within 90 days after the event of withdrawal, all remaining partners (or another group or percentage of partners as specified by the partnership agreement) agree in writing to continue the business of the limited partnership and, to the extent that they desire or if there are no remaining general partners, agree to the appointment, effective as of the date of withdrawal, of one or more new general partners; or

(4) entry of a decree of judicial dissolution under Section 8.02 of this Act. [Emphasis added]

b. Liquidation of Texas limited partnerships subject to the Texas Business Organizations Code ("TBOC") [Generally, limited partnerships formed on and after 1-1-06]:

§ 11.051. EVENT REQUIRING WINDING UP OF DOMESTIC ENTITY. Winding up of a domestic entity is required on:

(1) the expiration of the domestic entity's period of duration, if not perpetual;

(2) a voluntary decision to wind up the domestic entity;

(3) an event specified in the governing documents of the domestic entity requiring the winding up, dissolution, or termination of the domestic entity;

(4) an event specified in this code requiring the winding up or termination of the domestic entity; or

(5) a decree by a court requiring the winding up or dissolution of the domestic entity, rendered under this code or other law.

Acts 2003, 78th Leg., ch. 182, § 1, eff. Jan. 1, 2006.

§ 11.058. SUPPLEMENTAL EVENTS REQUIRING WINDING UP OF LIMITED PARTNERSHIP. An event requiring the winding up of a limited partnership includes, in addition to any event specified in Section 11.051, the following:

(1) ***written consent of all partners to the winding up and termination of the limited partnership*****; and**

(2) ***an event of withdrawal of a general partner*****. [Emphasis added]**

Acts 2003, 78th Leg., ch. 182, § 1, eff. Jan. 1, 2006.

§ 153.501. CONTINUATION WITHOUT WINDING UP. (a) The limited partnership may cancel an event requiring winding up as specified in Section 11.051(1) or (3) if, not later than the 90th day after the event, all remaining partners, or another group or

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percentage of partners as specified by the partnership agreement, agree in writing to continue the business of the limited partnership.

(b) The limited partnership may revoke an event requiring winding up as specified in Section 11.058(2) if:

(1) there remains at least one general partner and the partnership agreement permits the business of the limited partnership to be carried on by the remaining general partners and those remaining general partners carry on the business; or

(2) not later than one year after the event, all remaining partners, or another group or percentage of partners specified in the partnership agreement:

(A) agree in writing to continue the business of the limited partnership in writing; and

(B) to the extent that they desire or if there are no remaining general partners, agree to the appointment of one or more new general partners.

(c) The appointment of one or more new general partners under Subsection (b)(2)(B) is effective from the date of withdrawal.

(d) To approve a revocation under Section 11.151 by a limited partnership of a voluntary decision to wind up as specified in Section 11.058(1), prior to filing the certificate of termination required by Section 153.451, all remaining partners, or another group or percentage of partners as specified by the partnership agreement, must agree in writing to revoke the voluntary decision to wind up and continue the business of the limited partnership.

Acts 2003, 78th Leg., ch. 182, § 1, eff. Jan. 1, 2006. Amended by
Acts 2005, 79th Leg., ch. 64, § 93, eff. Jan. 1, 2006.

c. Withdrawal by limited partners of Texas limited partnerships subject to the Texas Revised Limited Partnership Act ("TRLPA") [Generally, limited partnerships formed prior to 1-1-06]:

Sec. 6.03. A limited partner may withdraw from a limited partnership only at the time or on the occurrence of events specified in a partnership agreement and in accordance with that partnership agreement.

d. Withdrawal by limited partners of Texas limited partnerships subject to the Texas Business Organizations Code ("TBOC") [Generally, limited partnerships formed on and after 1-1-06]:

§ 153.110. WITHDRAWAL OF LIMITED PARTNER. A limited partner may withdraw from a limited partnership only at the time or on the occurrence of an event specified in a written partnership agreement. The withdrawal of the partner must be made in accordance with that agreement.

Acts 2003, 78th Leg., ch. 182, § 1, eff. Jan. 1, 2006.

5. IRC §2704: The Lead Case – *Kerr v. Commissioner*, 113 T.C. 449 (1999), *aff'd on other grounds*, 292 F.3d 490 (5th Cir. 2002) (the Tax Court decision referred to as "*Kerr I*" and the 5th Circuit decision as "*Kerr II*"). In *Kerr I*, the Tax Court held that IRC §2704 did not apply because the provisions of the partnership agreement regarding liquidation and withdrawal were no less restrictive than applicable state law (Texas law). In *Kerr II*, the 5th Circuit, in affirming the ruling of the Tax Court, ruled that IRC §2704 did not apply because of the existence of a third party partner (a 501(c)(3) entity-The University of Texas) that could, through its vote, prevent the liquidation of the partnership. As the 5th Circuit made its determination on such basis, it did not address (or approve or disapprove) the Tax Court's rationale for holding that IRC §2704 did not apply.

6. **IRC §2704: Conclusions** – Many practitioners believe that IRS attacks under IRC §2704 of validly formed Texas limited partnerships following the Texas statutes on liquidation and partner withdrawal will continue to be fruitless (on the IRS' part) based on the favorable wording of the Texas limited partnership laws. Many practitioners believe that liquidation rights of a general partner provided under state law do not trigger applicability of IRC §2704, or that provision for entity, multiple or successor general partners eliminates this issue. Some practitioners feel that there must be some third party limited partner, such as a charity, to avoid concerns that the family will be treated as one unit for determining liquidation rights, since a partnership may be liquidated under state law by unanimous vote of all partners. Additionally, it appears that the IRS' attention has been shifted to IRC §2036(a) (discussed below) due to a string of recent successes in various recent cases.

VI. Estate and Gift Tax Considerations (IRC §2036(a))

A. **IRC §2036(a): In General** – The primary area in which the IRS has experienced success in connection with challenges to family limited partnerships involved situations where the taxpayers failed to respect the integrity of the entity in various ways. In these cases, the courts have used IRC §2036(a) to bring a value of the partnership assets back into a decedent's estate as a retained life interest.

B. **IRC §2036(a): The Statute** – IRC §2036(a) reads as follows:

SUBTITLE B--ESTATE AND GIFT TAXES (Sections 2001 to 2704)
CHAPTER 11--Estate Tax (Sections 2001 to 2210)
SUBCHAPTER A--Estates of Citizens or Residents (Sections 2001 to 2058)
PART III--Gross Estate (Sections 2031 to 2046
Sec. 2036. Transfers With Retained Life Estate

Sec. 2036. Transfers With Retained Life Estate

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

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

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

C. IRC §2036(a): The Key Recent Cases

1. ***"Schauerhamer"***: *Estate of Schauerhamer v. Commissioner*, T.C. Memo 1997-242, 73 T.C.M. 2855 (1997)

2. ***"Reichardt"***: *Estate of Reichardt v. Commissioner*, 114 T.C. 144 (2000)

3. ***"Church"***: *Church v. United States*, 85 A.F.T.R.2d 804 (W.D. Tex. 2000), *aff'd without published opinion*, 268 F.3d 1063 (5th Cir. 2001) (per curiam), unpublished opinon available at 88 A.F.T.R.2d 2001-5352 (5th Cir. 2001)

4. ***"Harper"***: *Estate of Harper v. Commissioner*, 83 T.C.M. 1641 (2002)

5. ***"Thompson"***: *Estate of Thompson v. Commissioner*, 84 T.C.M. 374 (2002), *aff'd*, *Turner, Executrix of the Estate of Thompson v. Commissioner*, No. 03-3173 (3rd Cir. 9/1/04)

6. ***"Strangi II"***: *Estate of Strangi v. Commissioner*, 85 T.C.M. 1331 (2003)

7. ***"Stone"***: *Estate of Stone v. Commissioner*, 86 T.C.M. 551 (2003)

8. ***"Kimbell"***: *Kimbell v. United States*, 371 F.3d 257 (5th Cir. 2004), *rev'g* 244 F.Supp.2d 700 (N.D. Tex 2003)

9. ***"Abraham"***: *Estate of Abraham v. Commissioner*, 87 T.C.M. 975 (2004)

10. ***"Hillgren"***: *Estate of Hillgren v. Commissioner*, 87 T.C.M. 1008 (2004)

11. ***"Bongard"***: *Estate of Bongard v. Commissioner*, 124 T.C. 8 (2005)

12. ***"Bigelow"***: *Estate of Bigelow v. Commissioner*, T.C. Memo 2005-65 (3/30/05)

13. ***"Korby"***: *Estate of Korby v. Commissioner*, T.C. Memo 2005-102 and 2005-103 (5/10/05)

14. ***"Disbrow"***: *Estate of Disbrow v. Commissioner*, T.C. Memo 2006-34 (2/28/06)

15. ***"Schutt"***: *Estate of Schutt v. Commissioner*, T.C. Memo 2005-126 (5/26/05)

16. ***"Rosen"***: *Estate of Rosen v. Commissioner*, T.C. Memo 2006-115 (6/1/06)

17. ***"Erickson"***: *Estate of Erickson v. Commissioner*, T.C. Memo 2007-107 (4/30/07)

18. ***"Gore"***: *Estate of Gore v. Commissioner*, T.C. Memo 2007-169 (6/27/07)

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19. ***"Mirowski"***: *Estate of Mirowski v. Commissioner*, T.C. Memo 2008-74 (3/26/08)

20. ***"Hurford"***: *Estate of Hurford v. Commissioner*, T.C. Memo 2008-278 (12/11/08)

21. ***"Jorgensen"***: *Estate of Jorgensen v. Commissioner*, T.C. Memo 2009-66 (3/28/09), *aff'd*, No. 09-73250 (9th Cir. 5/4/11)

22. ***"Miller"***: *Estate of Miller v. Commissioner*, T.C. Memo 2009-119 (5/27/09)

23. ***"Keller"***: *Estate of Keller v. Commissioner*, No. V-02-62 (S.D. Tex. 8/20/09)

24. ***"Shurtz"***: Shurtz Estate v. Commissioner, T.C. Memo 2010-21 (2/3/10)

25. ***"Jorgensen"***: Jorgensen Estate v. Commissioner, No. 09-73250 (9th Cir. 5/4/11)

26. ***"Turner"***: Turner Estate v. Commissioner, T.C. Memo 2011-209 (8-30-11)

27. ***"Liljestrand"***: Liljestrand Estate v. Commissioner, T.C. Memo 2011-259 (11-2-11)

28. ***"Stone"***: Stone Estate v. Commissioner, T.C. Memo 2012-48 (2-22-12)

29. ***"Kelly"***: Kelly Estate v. Commissioner, T.C. Memo 2012-73 (3-19-12)

D. IRC §2036(a): The Key Factors From Recent Cases

1. Failure to transfer title of assets to partnership

   Hillgren (real estate), *Gore, Hurford*

2. Intra-family loans not respected

   Thompson, Jorgensen, Turner

3. Commingled partnership and personal funds

   Schauerhamer, *Reichardt*, *Harper*, *Abraham*, *Bigelow, Gore, Hurford*

4. Disproportionate partnership distributions

   Harper, *Bigelow, Jorgensen, Liljestrand*

5. Payment of personal/estate expenses from partnership funds

   Strangi II, *Hillgren*, *Bigelow*, *Rosen*, *Erickson, Jorgensen, Liljestrand*

6. No maintenance of separate records for partnership and non-partnership funds (inadequate partnership records)

   Schauerhamer, *Hillgren, Gore, Jorgensen*

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7. Inconsistent positions taken on tax returns

Hillgren, Jorgensen

8. Personal use of principal residence contributed to partnership without adequate rent payments

Reichardt, *Strangi II*, *Disbrow*

9. Implied agreement of family members to make distributions to decedent if needed

Reichardt, *Thompson*, *Strangi II*, *Abraham*, *Bongard*, *Bigelow*, *Korby*, *Erickson, Miller*

10. Insufficient assets outside of the partnership for decedent to support himself

Thompson, *Strangi II*, *Hillgren*, *Korby*, *Rosen, Turner*

11. Absence of business activities (no legitimate business concerns) (no non-tax reason)

Thompson, *Rosen*, *Erickson, Gore, Jorgensen, Miller, Turner, Liljestrand*

12. Management of the partnership assets handled the same as before partnership formation

Reichardt, *Bongard, Gore, Turner, Liljestrand*

13. Delay between formation and contribution of assets

Harper, *Rosen*, *Erickson, Gore*

14. Contributing partner solely responsible for the partnership's business activities

Harper, Turner

15. No arm's length agreement

Harper, *Thompson*, *Korby*, *Rosen, Gore, Jorgensen*

16. Taxpayer favorable cases

Church, *Stone*, *Kimbell*, *Schutt*, *Mirowski*, *Keller, Shurtz*

VII. Estate and Gift Tax Considerations (Valuation Discounts)

The Treasury Regulations to IRC §§2031 and 2512 provide the general rule that the hypothetical "willing buyer/willing seller" test applies in valuing assets for estate and gift tax purposes. In addition, the IRS has promulgated Rev. Rul. 59-60, 1959-1 C.B. 237, which specifically addresses the valuation of closely-held business interests, and under Rev. Rul. 68-

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609, 1968-2 C.B. 327, such rules were extended to such business interests not held in corporate form, such as partnerships. When applying these general rules affecting the valuation of closely-held business interests, it is desirable that the "discounted cash flow" approach be applicable, rather than "liquidation valuation." In the family limited partnership context, the discounted cash flow evaluation method (based upon the expected return to a hypothetical buyer based upon the cash flow to be received from the partnership interest) usually results in a lower value because (i) for valuation purposes, it is likely to be assumed that substantially all cash flow of the entity will be reinvested internally in the business or in partnership investments and (ii) under a properly structured family limited partnership, the owner of a limited partnership interest has no assurance regarding minimum (or any) distributions.

In the typical family limited partnership context, a discount for minority interest should also be applicable. A discount for minority interest reflects the holder's lack of control over management and voting and is relevant for valuation purposes, since a minority interest holder cannot influence management, compel distributions or force liquidation. Because of this lack of control, potential purchasers are less willing to buy a minority interest. In the past, the IRS has strongly advocated against applying a minority discount to interests in family-owned entities, using a "unity of ownership" theory. However, the IRS has backed off this position in Rev. Rul. 93-12, IRB 1993-7, February 16, 1993, which holds that the factor of "corporate control" in the family, when a donor transfers shares in a corporation to the donor's children, is not considered in valuing the transferred interests for purposes of IRC §2512. The ruling goes on further to state that the IRS will follow past case law (including, ***Bright*** and ***Lee***) in not assuming that all voting power held by family members may be aggregated for purposes of determining whether transferred shares should be valued as part of a controlling interest.

Perhaps the most important discount applicable in the family limited partnership context is the marketability discount. This discount reflects the absence of a readily available market, in comparison to a publicly traded entity, and the resulting lack of transferability.

In the past much concern has been expressed about the applicability of discounts with respect to family limited partnerships holding solely, or primarily, marketable securities. *See*, ***Dalley Estate v. Commissioner***, T.C. Memo 2001-263 (10/3/01) for a relatively recent taxpayer victory involving a family limited partnership whose assets consisted solely of marketable securities [the Court allowed a 40% discount]. Also, we should note the 1/8/03 comments of Mary Lou Edelstein, national family limited partnership coordinator for IRS appeals. Ms. Edelstein announced the following IRS voluntary settlement positions for valuation discounts for family limited partnerships not constituting "death bed" partnerships: (i) 35% to 40% discounts for family limited partnerships holding "active" assets and (ii) 25% to 30% discounts for family limited partnerships holding "passive" assets.

Presumably due to the relatively recent IRS victories under IRC §2036(a), the IRS has issued updated "Appeals Settlement Guidelines", authored by Ms. Edelstein and dated October 20, 2006, issuing new settlement guidance and guidelines (actual percentages redacted).

In summary, valuation planning with the family limited partnership involves turning "pretty" assets into "ugly" assets by "transforming" them into nonliquid, fractionalized, nontransferable entity-owned assets. Thus, the family limited partnership involves the organizing of an individual's assets so that the critical focus of valuation is turned away from the underlying "pretty" assets and toward the partnership interest itself, with its restricted attributes regarding voting rights, cash flow, transferability and nonliquidity.

VIII. Estate and Gift Tax Considerations (Partnership Anti-Abuse Rules)

On May 12, 1994, the IRS issued certain controversial proposed regulations regarding partnership abuse situations (the "Partnership Anti-Abuse Rules"). These proposed regulations were very vague and could theoretically impact essentially any tax partnership. Notwithstanding such, no specific mention within such proposed regulations was made of family limited partnerships. On October 13, 1994, an IRS official, when directly asked whether the Partnership Anti-Abuse Rules were directed toward family limited partnerships, responded that such was not the case.

On December 29, 1994, the IRS issued final regulations regarding the Partnership Anti-Abuse Rules. These regulations included two examples regarding family limited partnerships that cast some doubt as to the valuation discounts obtainable in some circumstances. Less than thirty (30) days later, on January 23, 1995, the IRS issued Announcement 95-8 retracting the Partnership Anti-Abuse Rules' applicability to family limited partnership situations and specifically deleting the two family limited partnership examples from such regulations. Finally, on April 13, 1995, the amendments referred to in Announcement 95-8 were implemented in the final Partnership Anti-Abuse Rules. Accordingly, the valuation discount availability existing under current tax law is not affected by such rules.

IX. Asset Protection

A. Limited Exclusive Remedy - The key to the asset protection feature afforded by family limited partnerships is the exclusive remedy of creditors of a partner (but not of the partnership) with respect to collection against the partnership interest of a debtor partner. This remedy is commonly referred to as a "charging order" remedy (as opposed to, for example, a "turnover order" remedy). TRLPA §7.03(c) and TBOC §153.256. A "charging order" gives the judgment creditor only a right to the cash distributions attributable to the partner's interest (*when and to the extent declared by the general partner*) and a right to inspect partnership records. The judgment creditor who holds the charging order does not become the owner of the interest or a substitute partner under the properly drafted family limited partnership agreement.

TRLPA §7.03(c) and TBOC §153.256 were amended effective September 1, 2007 to clarify that the "charging order" remedy is the sole remedy for a judgment creditor with

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respect to the limited partnership interest of a debtor partner. Prior law and the amended statutes are provided below.

TRLPA §7.03 (effective prior to 9-1-07) reads as follows:

Sec. 7.03. (a) On application to a court of competent jurisdiction by a judgment creditor of a partner or of any other owner of a partnership interest, the court may charge the partnership interest of the partner or other owner with payment of the unsatisfied amount of the judgment, with interest, may then or later appoint a receiver of the debtor partner's share of the partnership's profits and of any other money payable or that becomes payable to the debtor partner with respect to the partnership, and may make all other orders, directions, and inquiries that the circumstances of the case require. To the extent that the partnership interest is charged in this manner, the judgment creditor has only the rights of an assignee of the partnership interest.

(b) The partnership interest charged may be redeemed at any time before foreclosure or, in case of a sale directed by the court, may be purchased without a dissolution being caused:

(1) with separate property of any general partner, by any one or more of the general partners; or

(2) with respect to partnership property, by any one or more of the general partners whose interests are not charged, on the consent of all general partners whose interests are not charged and a majority in interest of the limited partners, excluding limited partnership interests held by any general partner whose interest is charged.

(c) The remedies provided by Subsection (a) of this section are exclusive of others that may exist, including remedies under laws of this state applicable to partnerships without limited partners.

(d) This section does not deprive any partner of the benefit of any exemption laws applicable to that partner's partnership interest.

TRLPA §7.03 (effective as of 9-1-07) reads as follows:

SECTION 143. Section 7.03, Texas Revised Limited Partnership Act (Article 6132a-1, Vernon's Texas Civil Statutes), is amended to read as follows:

Sec. 7.03. RIGHTS OF JUDGMENT CREDITOR. (a) On application [~~to a court of competent jurisdiction~~] by a judgment creditor of a partner or of any other owner of a partnership interest, the court may charge the partnership interest of the judgment debtor to satisfy the judgment [~~partner or other owner with payment of the unsatisfied amount of the judgment, with interest, may then or later appoint a receiver of the debtor partner's share of~~

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~~the partnership's profits and of any other money payable or that becomes payable to the debtor partner with respect to the partnership, and may make all other orders, directions, and inquiries that the circumstances of the case require~~]. To the extent that the partnership interest is charged in this manner, the judgment creditor has only the right to receive any distribution to which the judgment debtor would otherwise have been entitled in respect [~~rights of an assignee~~] of the partnership interest.

(b) A charging order constitutes a lien on the judgment debtor's [~~The~~] partnership interest [~~charged may be redeemed at any time before foreclosure or, in case of a sale directed by the court, may be purchased without a dissolution being caused:~~

[~~(1) with separate property of any general partner, by any one or more of the general partners; or~~

[~~(2) with respect to partnership property, by any one or more of the general partners whose interests are not charged, on the consent of all general partners whose interests are not charged and a majority in interest of the limited partners, excluding limited partnership interests held by any general partner whose interest is charged~~].

(c) The entry of a charging order is the [~~remedies provided by Subsection (a) of this section are~~] exclusive remedy by which a judgment creditor of a partner or of any other owner of a partnership interest may satisfy a judgment out of the judgment debtor's partnership interest [~~of others that may exist, including remedies under laws of this state applicable to partnerships without limited partners~~].

(d) This section does not deprive any partner or other owner of a partnership interest of the benefit of any exemption laws applicable to the judgment debtor's [~~that partner's~~] partnership interest.

(e) A creditor of a partner or of any other owner of a partnership interest does not have the right to obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the property of the limited partnership.

TBOC §153.256 (effective prior to 9-1-07) reads as follows:

§ 153.256. CHARGE IN PAYMENT OF JUDGMENT CREDITOR. (a) On application to a court by a judgment creditor of a partner or other owner of a partnership interest, the court may:

(1) charge the partnership interest of the partner or other owner with payment of the unsatisfied amount of the judgment, with interest;

(2) appoint a receiver for the debtor partner's share of the partnership's profits and other money payable or that becomes payable to the debtor partner with respect to the limited partnership; and

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(3) make other orders, directions, and inquiries that the circumstances of the case require.

(b) To the extent that the partnership interest is charged in the manner provided by Subsection (a), the judgment creditor has only the rights of an assignee of the partnership interest.

(c) The partnership interest charged may be:

(1) redeemed at any time before foreclosure; or

(2) in case of a sale directed by the court, and without constituting an event requiring winding up, purchased:

(A) by one or more of the general partners with separate property of any general partner; or

(B) with respect to partnership property, by one or more of the general partners whose interests are not charged, on the consent of all general partners whose interests are not charged and a majority in interest of the limited partners, excluding limited partnership interests held by a general partner whose interest is charged.

(d) The remedies provided by Subsection (a) are exclusive of other remedies that may exist, including remedies under laws of this state applicable to partnerships without limited partners.

Acts 2003, 78th Leg., ch. 182, § 1, eff. Jan. 1, 2006.

TBOC §153.256 (effective as of 9-1-07) reads as follows:

SECTION 125. Section 153.256, Business Organizations Code, is amended to read as follows:

Sec. 153.256. PARTNER'S PARTNERSHIP INTEREST SUBJECT TO CHARGING ORDER [~~CHARGE IN PAYMENT OF JUDGMENT CREDITOR~~]. (a) On application [~~to a court~~] by a judgment creditor of a partner or of any other owner of a partnership interest, a [~~the~~] court having jurisdiction may[~~:~~

[~~(1)~~] charge the partnership interest of the judgment debtor to satisfy the judgment [~~partner or other owner with payment of the unsatisfied amount of the judgment, with interest;~~

[~~(2) appoint a receiver for the debtor partner's share of the partnership's profits and other money payable or that becomes payable to the debtor partner with respect to the limited partnership; and~~

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[~~(3) make other orders, directions, and inquiries that the circumstances of the case require~~].

(b) To the extent that the partnership interest is charged in the manner provided by Subsection (a), the judgment creditor has only the right to receive any distribution to which the judgment debtor would otherwise be entitled in respect [~~rights of an assignee~~] of the partnership interest.

(c) A charging order constitutes a lien on the judgment debtor's [~~The~~] partnership interest [~~charged may be:~~

[~~(1) redeemed at any time before foreclosure; or~~

[~~(2) in case of a sale directed by the court, and without constituting an event requiring winding up, purchased:~~

[~~(A) by one or more of the general partners with separate property of any general partner; or~~

[~~(B) with respect to partnership property, by one or more of the general partners whose interests are not charged, on the consent of all general partners whose interests are not charged and a majority in interest of the limited partners, excluding limited partnership interests held by a general partner whose interest is charged~~].

(d) The entry of a charging order is the [~~remedies provided by Subsection (a) are~~] exclusive remedy by which a judgment creditor of a partner or of any other owner of a partnership interest may satisfy a judgment out of the judgment debtor's partnership interest [~~of other remedies that may exist, including remedies under laws of this state applicable to partnerships without limited partners~~].

(e) This section does not deprive a partner or other owner of a partnership interest of a right under exemption laws with respect to the judgment debtor's partnership interest.

(f) A creditor of a partner or of any other owner of a partnership interest does not have the right to obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the property of the limited partnership.

SECTION 145. The changes in law made by this Act to Sections 101.112 and 153.256, Business Organizations Code, Article 4.06, Texas Limited Liability Company Act (Article 1528n, Vernon's Texas Civil Statutes), and Section 7.03, Texas Revised Limited Partnership Act (Article 6132a-1, Vernon's Texas Civil Statutes), apply only to the rights of a judgment creditor of a judgment rendered on or after September 1, 2007. The rights of a judgment creditor of a judgment rendered before that date are governed by the law in effect when the judgment was rendered, and the former law is continued in effect for that purpose.

SECTION 146. This Act takes effect September 1, 2007.

B. Phantom Income - Although the judgment creditor is not assured of receiving any distributions from the family limited partnership, once he obtains a charging order, he is nonetheless required to pay federal income taxes on the income of the partnership in proportion to the interest encumbered by the charging order. Rev. Rul. 77-137, 1977-1 C.B. 178. Thus, the judgment creditor is immediately exposed to "phantom income", without the ability to force cash distributions to pay for such liabilities.

C. Fraudulent Transfers - It must be noted that the "charging order" remedy is only an exclusive remedy if the transfers of property to the family limited partnership are not fraudulent transfers. If such transfers are found to be fraudulent, they may be set aside and subject to the claims of the affected creditors under various remedial laws, including, the Uniform Fraudulent Conveyances Act and applicable bankruptcy laws.

D. Settlement Leverage - The practical effect of transferring assets into a family limited partnership, not in violation of fraudulent transfer rules, is, at the very least, increased leverage in obtaining a favorable settlement with a judgment creditor. A judgment creditor faced with the uncertainty of being able to obtain the underlying assets of value and, at the same time, incurring "phantom income" increases a debtor's negotiating power tremendously.

X. Use of Limited Liability Companies in Texas

Historically, the limited partnership structure was preferred over the limited liability company structure for estate planning in Texas due to the Texas franchise tax, which applied to limited liability companies, but not to partnerships (including limited partnerships).

However, with the new Texas margin tax generally applying also to limited partnerships, equal consideration can now be given to limited liability company structuring. Notwithstanding such, estate planning activities that would qualify as passive activities (i.e., investment in marketable securities and investment in raw land) under the new Texas margin tax law should still be generally structured as limited partnerships in order to qualify as passive entities, which are still exempt from the Texas margin tax.

XI. Conclusion

Under current law, family limited partnerships can provide significant benefits as an advanced estate plan. Significant transfer tax reduction is obtainable, assets can be preserved against future creditors and interfamily transfers from generation to generation can be protected.

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Note: Treasury Regulation excerpts contained in this handout may not be the latest versions of such regulations, as they may change from time to time. The reader should consult the latest versions of the Treasury Regulations before relying on the excerpts contained herein.

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