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Family Limited Partnerships

Special Concerns in FLP Planning Where Both Spouses are Living

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If a family partnership is established when both spouses are living, there is a risk that a large portion of the couple's estate tax liability may be accelerated to the first spouse's death. This article suggests possible remedies for this dilemma.

A family limited partnership (an "FLP"),[1] if properly structured and administered, can provide significant tax and non-tax benefits to senior and junior family members in appropriate circumstances. The stakes are raised, however—and the cost-benefit analysis can be drastically altered—where the senior family members are married and desire an estate plan that will defer all federal and state estate taxes until the death of the surviving spouse.

In this common situation, the exercise of restraint in the client's FLP planning may produce a better result for the client's family given the risks posed by Section 2036, which can create "phantom assets" that are included in the gross estate of the first spouse to die, but because they are not "real assets," may be unable to pass to the surviving spouse to qualify for the federal estate tax marital deduction. This mismatch between gross estate values and marital deduction values could produce substantial estate taxes upon the "first death"—in sharp contrast to the client's likely expectation that the marital deduction would shield the husband and wife from federal and state estate taxes until the death of the surviving spouse.

Consider, for example, a limited partnership as to which the date of death net asset value of "Dad's" pro rata share of the entity's underlying assets attributable to transfers made by Dad during his lifetime is $20 million, and for which the "Section 2033 value" of the interests in the entity owned by Dad at his death is $13 million (which assumes a 35 percent aggregate discount for lack of control and lack of marketability). Dad predeceases Mom and there are no adjusted taxable gifts. Assuming that $2 million is used to fund the credit shelter trust (this is the maximum amount that, under present law, can pass estate tax-free for federal estate tax purposes), limited partnership interests worth $11 million would be available to fund the marital deduction trust.[2]

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Consistent with the client's likely expectation, this would produce the result of no federal and state estate tax due upon Dad's death, as survived by Mom.

But what happens if the IRS audits the estate tax return and successfully asserts that Section 2036 applies? In that case, the value of the underlying FLP property that is included in Dad's gross estate would be $20 million, but the aggregate value of the FLP interests that pass to the marital deduction trust and the credit shelter trust potentially remains locked in at $13 million. In effect, there would be a $7 million *phantom asset*, which because it is not a real asset, would appear to be ineligible to fund the marital deduction trust (or any other disposition, for that matter).[3] In this example, that could produce a combined federal and state estate tax liability substantially in excess of $3.5 million on the death of the first spouse to die—not welcome news to beneficiaries who likely expect a zero tax result on the first spouse's death.

To avoid this unhappy result, the executor of the decedent's estate may consider not claiming any discount at all on the FLP interests on the estate tax return. Not only could this avoid a potential phantom asset marital deduction problem, but it would also prevent a possible step-down in basis. But what is there to prevent the IRS from taking the position that the value of the property interests that are available to fund the marital deduction trust should be substantially discounted—as the IRS has previously done[4]—thereby reducing the amount of the marital deduction?[5] Because this issue has not been clearly resolved by the courts in the context of FLPs, it appears that there is nothing to prevent the IRS from seeking to compel this phantom asset problem[6] (not to mention the step-down in basis). This article addresses the Section 2036 "phantom asset" risk in the context of FLP planning and suggests possible strategies to help minimize this risk for existing FLPs where both of the senior generation family members are living. This article also considers a potential framework for inter vivos transfers (via sales to adequately funded irrevocable grantor trusts) of limited partnership or LLC membership interests within estate tax exclusion limits.

Application of Section 2036 to FLPs

Section 2036 has emerged as the IRS's most successful weapon before the courts in disallowing discounts for lack of marketability and lack of a controlling interest that are associated with the use of FLPs. Section 2036 is one of the so-called string provisions of the Code which includes in the decedent's estate property that was transferred during the decedent's lifetime if the decedent retained, either expressly or by an implied agreement, (1) the use or enjoyment of, or the right to the income from, the property or (2) the right to designate, either alone or in conjunction with any person, who will use or enjoy the property or the income from it. The elements for inclusion under Section 2036 are:

(1) The decedent during his or her life made a transfer;

(2) The transfer did not involve a bona fide sale for an adequate and full consideration in money or money's worth; and

(3) The decedent has retained a "*string*."

There are two main types of strings under Section 2036. *First*, there is the Section 2036(a)(1) string, where the decedent has retained the possession or enjoyment of the property transferred to the FLP, or the income therefrom.

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Second, there is the Section 2036(a)(2) string, where the decedent (perhaps through his or her ability to influence or control the general partner, or by serving as the manager of an LLC) has retained the right to designate the persons who will possess or enjoy the FLP property or the income therefrom.

Reg. 20.2036-1(a) provides that the retained right to possess or enjoy the transferred property, or the income from it, does not have to be a legally enforceable right. Accordingly, for Section 2036(a) to apply, the FLP agreement does not have to mandate that Mom or Dad shall receive annual distributions from the FLP of a proportionate share of the entity's income or a specified cash flow. Rather, all that is needed for Section 2036(a)(1) or Section 2036(a)(2) to apply is an *implied agreement or understanding at the time of the transfer*.

For example, assume that Dad transfers to an FLP almost all his wealth, including his house (which, in fact, is what occurred in *Strangi*[7]), and does not retain sufficient assets to live on without receiving distributions from the FLP. In this situation, it is likely that a court will conclude that there was an implied agreement at the time of the transfer that the FLP property will be available for Dad's enjoyment and support. In that case, unless the estate is able to show that the transfers to the FLP qualify for the "bona fide sale exception" (discussed below), the value of the property transferred to the FLP as of the date of the decedent's death (and without any discounts) will be included in the estate.

Even if the decedent has a retained interest in the FLP's property, Section 2036 can be avoided if the decedent's transfer of property to the FLP qualifies for the "bona fide sale exception." As the Tax Court explained in *Estate of Bongard*, "[i]n the context of family limited partnerships, the bona fide sale... exception is met where the record establishes the existence of [1] *a legitimate and significant nontax reason*[8] *for creating the family limited partnership, and* [2] *the transferors received partnership interests proportionate to the value of the property transferred*.[9] The objective evidence must indicate that the nontax reason was a significant factor that motivated the partnership's creation. A significant purpose must be an actual motivation, not a theoretical justification."[10] By contrast, the bona fide sale exception will *not* be met "where the facts fail to establish that the transaction was motivated by a legitimate and significant nontax purpose."[11]

Guiding principles relevant to FLPs

The following principles emerge from the FLP cases with respect to formation, funding, and administration of the entity[12]:

FLP formation

- There should be a substantial non-tax purpose for establishing the FLP. This can include any of the following: (1) asset protection, (2) a joint investment vehicle for partners or members, (3) the centralized and active management of assets, (4) facilitating an investment strategy that expressly permits the retention of portfolios that are heavily concentrated in particular assets or classes of assets, (5) facilitating the establishment of a voting block through the pooling of partners' or members' voting securities of a particular issuer, (6) facilitating the raising of capital from third parties, and (7) providing a

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mechanism to ensure the submission to arbitration of any intra-family disputes subject to strict confidentiality provisions.

- The FLP's governing documents should provide, among other things, that: (1) the interests received by the participants in the entity will be proportionate to the value of the property that each contributes; (2) the assets contributed will be properly credited to the capital accounts of the transferors; (3) distributions require a negative adjustment in the distributee's capital account;[13] and (4) liquidating distributions will also be made in accordance with capital account balances.[14]

- The decedent's death should not trigger a division or distribution of the FLP assets under the FLP's governing documents.[15]

- Transfers to the FLP generally should be made before Mom or Dad is terminally ill, lest they give the appearance of "testamentary transfers."[16]

- The various family members should have the opportunity to review drafts of the FLP agreement and both negotiate its terms and have input into what assets are to be contributed to the FLP.[17] If feasible, each family member should be represented by separate counsel.[18]

- Following the principles applicable to trusts under Section 2036(a)(2), Mom or Dad should not be the managing member of the LLC or the general partner of the limited partnership, or own any interest in the general partner, and in no event should he or she be able to participate in decisions relating to distributions from the FLP.[19]

- If there is concern that the bona fide sale exception may not be available, Mom's or Dad's transfers to the FLP should be accomplished through an irrevocable grantor trust with an independent trustee, which can help protect against estate tax inclusion under Section 2036(a)(2) based on the Tax Court's 2003 decision in *Strangi*.[20] There, the court held that Dad's ability to join with other equity holders to liquidate or amend the entity is a Section 2036(a)(2) trigger.[21] A taxable gift may be avoided through the retention of a testamentary power of appointment.[22]

FLP funding

- Mom or Dad should have sufficient "outside assets" (i.e., property that is not transferred to the FLP) to live on so that they do not have to rely on distributions from the FLP.[23]

- Personal use assets—such as the family home—should not be transferred to the FLP.[24]

- Property that secures Mom's or Dad's obligations (such as real estate that secures a mortgage or a line of credit) generally should not be transferred to the FLP.[25]

- Although the cases have not uniformly required this,[26] it is generally helpful if there is a genuine pooling of interests involving substantial contributions from younger generation family members.[27]

- The FLP property should be timely contributed to the entity.[28]

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FLP administration

- The administration of an FLP is as important as its structure. As discussed below, the failure of Mom or Dad to observe the formalities of the entity (i.e., respect the entity) can trigger Section 2036.

- Assets contributed to the FLP should be properly credited to the capital accounts of the transferors.[29]

- Distributions from the entity require a negative adjustment to the distributee's capital account.[30]

- All distributions from the FLP should be made pro rata in accordance with the distributee's capital accounts, as properly maintained.[31]

- All FLP assets should be strictly segregated from non-FLP assets, and entity and personal assets must not be commingled.[32]

- The FLP should not pay Mom's or Dad's personal living and medical expenses.[33]

- There should be periodic meetings of the FLP's managers (generally, at least twice a year) to review the entity's investment portfolio and to consider changes in investments.[34] A written memorandum, or minutes, should be prepared to memorialize each meeting, the business that was discussed, and the decisions made by management.

- The FLP's management (at least with respect to decisions concerning distributions and liquidation) should be handled by persons other than Mom or Dad, Mom's or Dad's agent under a power of attorney, or the trustee of Mom's or Dad's inter vivos trust. If there is little or no change in the property's management, the estate will be vulnerable to the Service's argument that the FLP entails a "recycling of value" to obtain valuation discounts for transfer tax purposes.[35]

- Following Mom's or Dad's death, the FLP should not be used to pay the decedent's debts, funeral expenses, estate administration expenses, or specific bequests under his or her will or revocable trust.[36]

The "passing requirement" as it applies to interests in closely held entities

To qualify for the estate tax marital deduction, the value of the interest must be includable in the decedent's gross estate and must "pass" to or for the benefit of the surviving spouse.[37] This "passing" requirement is broadly defined in Section 2056(c) to include interests in property that are acquired by the spouse via will, intestate succession, an inter vivos trust, right of survivorship, or by exercise or in default of exercise of a power of appointment, by dower or elective share, or by contract (such as under an annuity or a beneficiary designation).[38]

An interest is deemed to have passed from the decedent to the surviving spouse if "such interest has been transferred to such person by the decedent at any time."[39] Thus, lifetime transfers includable in the decedent's estate under Section 2036 or 2038 (as in the case of a revocable trust) can qualify for the estate tax marital deduction if the decedent and the donee were married at the time of the decedent's death and the other marital deduction requirements are met.[40]

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If the property passing to the surviving spouse (or to the marital deduction trust) is an interest in a closely held entity, the value of that interest is determined by applying traditional willing-buyer/willing-seller valuation principles.[41] For example, in *Estate of Chenoweth*,[42] a 51 percent interest in the common stock of a close corporation that was bequeathed to the decedent's widow was eligible for a valuation *premium* (thereby increasing the amount of the estate tax marital deduction) to take into account the control element.

This principle has also been applied in reverse to *reduce* the marital deduction where the property funding the marital disposition consisted of a minority interest in a closely held entity. Therefore, in TAM 9050004, the IRS discounted a 49 percent interest in a wholly-owned corporation passing to the marital trust to reflect lack of control. Similarly, in TAM 9403005, the IRS reduced the marital deduction where a non-controlling interest in a closely held corporation that was controlled by the decedent was used to fund a marital trust. Further, in *Estate of Disanto*, [43] the Tax Court held that where the surviving spouse disclaimed a portion of a control block of stock to reduce what she received to a minority interest, the marital deduction would be reduced to reflect a minority interest discount (although the same company's stock was included in the decedent's gross estate at a control premium).[44]

As these authorities demonstrate, a *disparity* can exist between the value of closely held entity interests that are included in a decedent's estate and the value of such interests that are to fund a marital deduction disposition. Where the value for marital deduction purposes will not offset the value included in the gross estate, "phantom value" will be left in the decedent's estate.[45]

In the FLP context, the "phantom asset" marital deduction issue surfaced (although without resolution) in *Bongard*. *Bongard* was a "tiered discount" case— the decedent first transferred shares of stock in an operating company of which he was the CEO and the sole member of its board of directors ("Empak") to a holding company LLC ("WCB Holdings"), and then transferred non-voting LLC membership interests in the holding company to an FLP ("BFLP") in exchange for a 99 percent limited partnership interest. Mr. Bongard's irrevocable trust acquired a one percent general partnership interest in the FLP.[46] Approximately one year after forming the FLP, Mr. Bongard made a gift of a 7.72 percent limited partnership interest to his wife. He died unexpectedly the following year at age 58.[47]

The Tax Court held[48] (1) that Section 2036(a)(1) brought back into the decedent's estate the LLC membership interests in the holding company that the decedent had transferred to the FLP,[49] and (2) that the three-year rule of Section 2035(a) brought back into the decedent's estate the LLC membership interests in the holding company that were allocable to the 7.72 percent limited partnership interest that Mr. Bongard had given to his wife less than a year before his death.

It does not appear from the Tax Court's decision in *Bongard* that an offsetting marital deduction was allowed with respect to any phantom value attributable to the application of Section 2036.[50] In a footnote, the court specifically reserved judgment on the phantom asset marital deduction issue with respect to the limited partnership

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interests that the decedent had given to his wife within three years of his death, stating that the "decedent's estate may be entitled to a [marital] deduction under [section] 2056 for his inter vivos gift of [the LLC membership units in the holding company to his wife] that was pulled back into his gross estate under *Section 2035(a)*."[51] No similar assertion was made by the Tax Court with respect to the additions to the decedent's gross estate caused by inclusion under *Section 2036*.

The decision in *Bongard*—aside from climate facing FLPs in the Tax Court— demonstrating the current judicial leaves unanswered whether phantom assets included in the gross estate under Section 2036 (or Section 2035, for that matter) can be offset by the marital deduction under Section 2056.[52] Consequently, this is a risk that estate planners need to be very much aware of, and where warranted (in the case of existing FLPs), counsel their clients as to appropriate remedies.

Possible solutions to avoid the "phantom asset" marital deduction problem for existing FLPs

What are the possible solutions to avoid the Section 2036 phantom asset marital deduction issue for existing FLPs? Before a married client pursues FLP planning initially, the potential risks and rewards of such planning need to be analyzed carefully. This article discussed earlier the non-tax benefits that FLP planning can provide, depending on the circumstances. The principal transfer tax saving to be derived by a married client from FLP planning is the opportunity for leveraged inter vivos transfers (whether by gifts, or by sales to irrevocable grantor trusts) of limited partnership or LLC membership interests at substantially reduced (i.e., discounted) transfer tax costs.

But at what potential costs are these benefits to be pursued? Because most married couples contemplate deferring all estate taxes until the death of the surviving spouse (at which point there could also be substantially increased estate tax exemptions and lower estate tax rates), *the result of the FLP planning could be to risk accelerating some portion of a married couple's estate tax liability to the death of the first spouse.* Moreover, even if the FLP planning is "successful" in achieving the "baseline" result of no estate taxes at the death of the first spouse, there will still be *adverse income tax consequences.* These adverse income tax consequences include a loss of the step-up in basis of the transferred FLP interests that have not been brought back into the decedent's gross estate, and a substantial reduction (if not a complete loss) of the basis benefits available through the entity's Section 754 election.[53] So in many instances, the best FLP planning advice to a married couple may well be to postpone all FLP planning until after one spouse has died and to use other strategies instead.

If a married client already has an FLP, there are three possible ways to address the phantom asset marital deduction risk: (1) by taking measures to reduce the Section 2036 exposure, (2) by taking measures to cause the value of the FLP interests passing to or for the benefit of the surviving spouse to equal the pro rata net asset value of the underlying entity, and (3) by liquidating the FLP while both spouses are living. These strategies are explained below, followed by an examination of the FLP planning opportunities that may still be available where both spouses are living.

Reducing the Section 2036 exposure for existing FLPs

This article earlier set forth a number of guidelines relating

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to the formation, funding, and administration of an FLP that are also relevant to reducing Section 2036 exposure for existing FLPs. Provided that the senior family member is willing to part with "control"[54] (particularly with respect to distributions), one helpful technique would be to transfer the senior family member's interests in the FLP to an irrevocable grantor trust[55] in which all distribution decisions (as well as decisions about possession or enjoyment of the entity's property) would be controlled by an independent trustee who is not a related or subordinate party to the settlor within the meaning of Section 672(c).[56]

Gift tax consequences would be avoided through the settlor's retention of a testamentary power of appointment, which would render the transfer "incomplete" for gift tax purposes.[57] In addition, because the transfer would be an incomplete gift, Section 2704(a)—which can treat the lapse of certain voting or liquidation rights as a transfer—would not apply (although care must be exercised to limit the potential application of Section 2704(a) upon the decedent's death).[58]

A significant "fly in the ointment" is the three-year rule of Section 2035(a). This section provides that if the decedent dies within three years of transferring property, or relinquishing a right relating to transferred property which would have triggered estate tax inclusion under certain Code sections (including Section 2036) had he died possessing it, then the underlying assets are brought back into the decedent's gross estate. Accordingly, the client's efforts to divest himself of these Section 2036 triggers may fail if he does not survive the transfer by at least three years.

Nevertheless, there is a potential way out of the three-year rule of Section 2035. This section, similar to Section 2036, contains an exception for a "bona fide sale for an adequate and full consideration in money or money's worth."[59] Hence, a sale (instead of a gift) of the FLP interests to an irrevocable trust (which, to avoid federal income tax consequences, should be a wholly grantor trust) in exchange for a promissory note bearing interest at reasonable commercial terms may provide a solution. Because the trust would be a wholly grantor trust, there would be no realized gain or loss on the sale (or taxable income on the receipt of interest on the note) pursuant to Rev. Rul. 85-13.[60]

There are a number of caveats relating to invoking the bona fide sale exception under Section 2035(d). First, it appears that if "adequate and full consideration" is missed by even one dollar, the bona fide sale exception would not apply.[61]

Second, there is an absence of guidance concerning what is needed to satisfy the bona fide sale exception of Section 2035(d). In this connection, it would appear that the standard handed down by the Tax Court in Section 2036 cases involving FLPs, such as *Bongard*—which considers (1) whether there is a "legitimate and significant nontax reason for creating the family limited partnership" and (2) whether "the transferors received partnership interests proportionate to the value of the property transferred"[62]—is not fully applicable. This absence of guidance is compounded where a sale to an irrevocable trust in exchange for a promissory note is involved.[63] One school of thought says that the grantor trust should be pre-funded—perhaps to the extent of ten percent, or even 15

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percent, of the value of the FLP interests that are purchased by the trustee.[64] But this is only anecdotal—there is no case law, Regulation, or Revenue Ruling articulating a bright-line test.

Third, it is unclear what the face amount and the terms of the promissory note issued by the trustee should be. How much of a discount (if any) should be applied to the limited partnership or LLC membership interests being sold to the grantor trust? Should the interest rate on the promissory note exceed the applicable federal rate? An independent appraisal would be essential here in suggesting reasonable commercial terms (as well as in determining the discount on the FLP interest to be sold), but an appraiser's report provides no assurance that the IRS or the courts will respect the terms of the transaction. Further, what sort of credit support would be reasonable under the circumstances? Would parties in an arm's-length transaction ordinarily require the beneficiaries of the irrevocable trust to issue guarantees to provide credit support in the event that the trustee defaults on the promissory note? And if that were the case, what if the beneficiaries have minimal assets, or are minors (in which case they would lack contractual capacity to issue an enforceable guarantee)?

Fourth, even aside from these valuation and transactional issues, there is uncertainty in the law concerning what constitutes "adequate and full consideration" for purposes of the bona fide sale exception to the three-year inclusion rule of Section 2035. In *Allen*,[65] the Tenth Circuit held that adequate and full consideration for purposes of the predecessor statute to Section 2035 means an amount necessary to restore to the decedent's gross estate the amount that would have been includable had the predecessor statute to Section 2036 applied. Applying this reasoning, the consideration to be paid by the irrevocable grantor trust for the FLP interests purchased from the settlor would have to equal the *undiscounted* value of the underlying property. This, however, could result in a taxable gift *by the beneficiaries* to the settlor. Unless the settlor's spouse is the sole beneficiary of the irrevocable grantor trust (so that the gift tax marital deduction may be available), this is generally an unacceptable result.[66]

Causing the value of FLP interests passing to the spouse to equal the value of the underlying assets

A second (and perhaps more effective) technique to tackle this problem would involve taking steps to cause the value of the FLP interests passing under the decedent's estate plan in a marital deduction disposition to equal the value of the underlying assets. Perhaps the best way to accomplish this would be to provide in the FLP's governing documents (which may need to be amended to allow this) that the holder of the FLP interests that would pass to or for the benefit of the surviving spouse (e.g., the trustee of the QTIP trust) would be able to liquidate the FLP without the consent of any other person.

For example, suppose that the partnership agreement permits liquidation to occur upon the affirmative vote of the general partner and limited partners holding more than two-thirds of the outstanding limited partnership interests. In this situation, the trustee of the QTIP trust—who pursuant to the decedent's estate plan would receive the general partnership interest and more than two-thirds of the limited partnership interests—would be able to liquidate the FLP without the consent of any

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other person. Consequently, there would not appear to be any viable basis for the IRS to argue that the value of the FLP interests passing to the surviving spouse should be discounted.

Liquidating the FLP during the senior generation members' lifetimes

Although the technique discussed immediately above should work to the extent of the marital disposition, in some estate plans the extent of lifetime gifts to family members other than the spouse is sufficiently far along to prevent this technique from eliminating all estate taxes upon the first spouse's death. In that case, if Section 2036 (or Section 2035) is a significant concern, consider liquidating the FLP while both spouses are living. Liquidation of an entity that is treated as a partnership for federal income tax purposes can potentially be accomplished income tax-free, although a thorough analysis would be required to ensure that tax-free treatment is available under the circumstances.[67]

Inter vivos transfers of FLP interests within projected estate tax exclusion limits

Depending on the circumstances, there may be opportunities for fine-tuning FLP planning while both spouses are living to achieve tax and non-tax objectives. Provided that the relevant guidelines for minimizing risk under Section 2036 (as discussed earlier) are scrupulously heeded in the formation, funding, and administration of the FLP, the following considerations may be helpful in developing and implementing a plan that appropriately manages the Section 2036 phantom asset risk by ensuring that the disparity between gross estate values and marital deduction values is kept within estate tax exclusion limits.

To permit the value of the FLP interests held by the decedent at death (and which would pass in a marital disposition) to equal the pro rata net asset value of the entity's assets, the FLP interests passing in the marital disposition would need to be immediately subject to liquidation (without any restrictions) by the holder of such interests (e.g., the trustee of the QTIP trust). For this to occur, the decedent would have to retain until his death a controlling interest in the entity, such as the entire general partnership interest plus the amount of limited partnership (or LLC membership) units that are necessary to secure an immediate liquidation right under the governing documents, and applicable state law, without the consent of any other person. This, in turn, may warrant an amendment to the FLP's governing documents to relax the criteria for liquidation.

The transfer of limited partnership (or LLC membership) interests should take the form of a *sale* to an adequately funded irrevocable grantor trust, which may be done in exchange for a promissory note. By contrast, a *gift* of an interest in the FLP would not enable the transferor to qualify for the bona fide sale exception under either Section 2036 or 2035.[68] In this connection, *Estate of Rosen*[69] demonstrates that where Section 2036 applies, all the underlying FLP property attributable to the decedent's gifts of limited partnership interests—including FLP property attributable to limited partnership interests gifted more than three years before the decedent's death—may be brought back into the decedent's estate under Section 2036(a)(1).[70] In contrast to a *gift*—which, by definition, can *never* constitute a bona fide sale for an adequate and full consideration—a *sale* to an irrevocable grantor trust could

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potentially qualify for the bona fide sale exception to Section 2036.[71]

Assuming a sale to a grantor trust in exchange for a note, it may be desirable to pre-fund the trust with cash gifts equal to approximately 15 percent of the purchase price.[72] The interest rate on the note issued by the trustee should equal or exceed the applicable federal rate (the "AFR") to take into account the trust's credit risk, as warranted, consistent with actual market conditions. An independent appraisal performed by a qualified appraiser would be essential. If the trust is a wholly grantor trust, there would be no realized gain or loss on the sale (or taxable income on the receipt of interest on the note) pursuant to Rev. Rul. 85-13.

The trust generally should have an independent trustee meeting the safe harbor of Rev. Rul. 95-58[73] (i.e., not a related or subordinate party within Section 672(c)(1) or 672(c)(2)) handle all negotiations of the terms of the sale with the transferor.[74]

Because there could still be a Section 2036 (or Section 2035) risk on the sale to the irrevocable grantor trust,[75] *the extent of the lifetime transfers of limited partnership (or LLC membership) interests to the irrevocable grantor trust generally should be capped* at the lower of the federal and state estate tax applicable exclusion amounts, as reduced to take into account other non-marital dispositions and projected appreciation in the value of underlying property interests. The Section 2043 offset for consideration furnished by the trustee in exchange for the FLP or LLC interests (e.g., the face amount of the promissory note) can also be taken into account in determining the amount of this cap on lifetime transfers.[76]

Conclusion

An estate planner should be vigilant regarding the special concerns that are presented in FLP planning where both spouses are living. The notion that such planning can be approached from the perspective of "nothing ventured and nothing gained" is perilously incorrect, and completely overlooks the potential that Section 2036 presents to accelerate a significant portion of the married couple's estate tax liability to the first spouse's death.

In many instances, the risks of FLP planning will not justify the effort, at least while both spouses are living. For existing FLP plans, it is essential that the potential estate tax exposure be carefully reviewed and monitored regularly. This article has suggested techniques that may be available to bring the phantom asset marital deduction risk within estate tax exclusion limits. Through due diligence and by taking appropriate measures, the phantom asset risk can be minimized, and a married client's objective of deferring all federal and state estate taxes until the death of the surviving spouse may yet be achieved.

Endnotes

1 References to "family limited partnerships" include limited partnerships and limited liability companies ("LLCs") (as well as other similar entities) in which family members hold the partnership or membership interests.

2 In New York, which has decoupled its state estate tax from the federal estate tax, the amount of the credit shelter trust in this example generally would be $1 million (which is the lower of the applicable exclusion amounts for federal and New York State estate tax purposes), and the amount of the marital deduction trust would be $12 million.

3 A self-adjusting credit shelter, or marital, formula clause may be ineffective to prevent this result because, as discussed later, the passing requirement of Section 2056(c) may limit the amount of the marital deduction to the *discounted* value of the FLP or LLC interests passing to the

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marital deduction trust.

4 See Estate of Disanto, TC Memo 1999-421, RIA TC Memo ¶99421, 2000-1 USTC ¶47823, 78 CCH TCM 1220 (the value of assets passing to a surviving spouse must take into account minority interests in determining the marital deduction); TAM 9403005 (a minority stock interest that passed to the surviving spouse had to be valued as a minority interest for purposes of the estate tax marital deduction, even though the decedent owned a controlling interest in the corporation); TAM 9050004 (49 percent interest in stock of closely held business passing to QTIP trust should be valued with a minority interest discount); see also Estate of Schwan, TC Memo 2001-174, RIA TC Memo ¶2001-174, 82 CCH TCM 168 (applying this approach in a case involving the estate tax charitable deduction).

5 The failure to step down basis at death under Section 1014 to take into account discounts for lack of marketability and lack of control could also raise a penalty exposure under Section 6662 for the substantial overstatement of the value of the property, and raise issues under a "duty of consistency" if discounts for FLP interests are later claimed by the executor of the surviving spouse's estate. See Akers, "Worth the Effort Even Beyond the Grave—An Update of Post-Mortem Tax Planning Strategies," 37 *U. Miami Heckerling Inst. on Est. Plan*. ¶811.17, at 8-148 (2003).

6 See Estate of Bongard, 124 TC 95 (2005).

7 TC Memo 2003-145, RIA TC Memo ¶2003-145, 85 CCH TCM 1331 *aff' d* 96 AFTR 2d 2005-5230, 417 F3d 468, 2005-2 USTC ¶60506 (CA-5, 2005).

8 Other courts have articulated this portion of the test differently. In *Strangi*, the Fifth Circuit expressed this part of the bona fide sale test as requiring a "substantial business or other nontax purpose." Strangi, 417 F.3d at 479. See also Turner (Estate of Thompson), 94 AFTR 2d 2004-5764, 382 F.3d 367, 2004-2 USTC ¶60489 (CA-3, 2004) (a bona fide sale must provide the transferor with "some potential for benefit other than the potential estate tax advantages that might result from holding assets in the partnership form"). It is unclear whether these differences in language hold any meaningful distinction.

9 The bona fide sale exception has been described as containing two discrete requirements (1) a "bona fide sale" and (2) "adequate and full consideration." Strangi, 417 F.3d at 478. See also Estate of Schutt, TC Memo 2005-126, RIA TC Memo ¶2005-126, 89 CCH TCM 1353.

10 Estate of Bongard, 124 TC 95 (2005) (emphasis and number added, internal citations omitted).

11 *Id*.

12 See Abbin, "A Practical Checklist for Planning with Family Limited Partnerships," 33 EPTL 10 (Oct. 2006).

13 It has been suggested that, if feasible, the partnership agreement should prohibit all distributions during the partnership term. See Gans and Blattmachr, "*Strangi*: A Critical Analyisis and Planning Suggestions," Tax Notes 1153, at 1169 (9/1/03).

14 See Schutt, *supra* note 9.

15 *Id*.

16 See Strangi, 417 F.3d 468.

17 See Schutt, *supra* note 9; Estate of Korby, TC Memo 2005-102, RIA TC Memo ¶2005-102, 89 CCH TCM 1142; Estate of Abraham, TC Memo 2004-39, RIA TC Memo ¶2004-039, 87 CCH TCM 975 *aff' d* 95 AFTR 2d 2005-2591, 408 F.3d 26, 2005-1 USTC ¶60502 (CA-1, 2005); Strangi, *supra* note 16; Estate of Stone, TC Memo 2003-309, RIA TC Memo ¶2003-309, 86 CCH TCM 551 .

18 See Stone, *supra* note 17.

19 See Strangi, *supra* note 7.

20 See Gans and Blattmachr, *supra* note 13, at 1164.

21 In the Strangi appeal, the Fifth Circuit expressly declined to address the Section 2036(a)(2) issue. See Strangi, 417 F.3d at 478 n.7.

22 This renders the transfer "incomplete" for gift tax purposes. See Reg. 25.2511-2(b).

23 See Estate of Rosen, TC Memo 2006-115, RIA TC Memo ¶2006-115, 91 CCH TCM 1220; Schutt, *supra* note 9; Korby, *supra* note 17; Estate of Bigelow, TC Memo 2005-65, RIA TC Memo ¶2005-065; Turner (Thompson), 382 F.3d at 372 n.5; Strangi, *supra* note 7. But see Bongard, *supra* note 6 (the decedent's maintenance of substantial assets outside the FLP did not prevent application of Section 2036).

24 See Strangi, *supra* note 7; Estate of Reichardt, 114 TC 144 (2000).

25 See Bigelow, *supra* note 23; Reg. 20.2036-1(b)(2).

26 See, e.g., Kimbell, 93 AFTR 2d 2004-2400, 371 F.3d 257, 2004-1 USTC ¶60486 (CA-5, 2004) (Section 2036 did not apply due to bona fide sale exception where decedent contributed 99.5 percent of capital to FLP

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entities).

27 See Schutt, *supra* note 9; Church, 85 AF TR 2d 2000-804, 2000-1 USTC ¶60369 (DC Tex., 2000), *aff' d 88* AF TR 2d 2001-5352, 268 F,3d 1063, 2001-2 USTC ¶60415 (CA-5, 2001). Although arising in a slightly different context, it may be helpful to consider Rev. Rul. 87-9, 1987-1 CB 133, as a guideline for evaluating what constitutes significant capital contributions from other persons. See remarks of T. Randall Grove at the 2004 Heckerling Institute on Estate Planning, accompanying a presentation entitled "Designing, Implementing and Operating the Family Limited Partnership to Avoid a Successful Section 2036 Attack." In Rev. Rul. 87-9, the Service concluded that a transfer of non identical assets worth 11 percent of the total contribution of all shareholders at formation is *not insignificant* for purposes of determining whether the investment company exception to Section 721 applies to trigger recognition of gain on transfers of appreciated property to capitalize a corporation. Section 721(b) requires recognition of gain in certain instances where the partnership would be treated as an "investment company" under Section 721 if the partnership were taxed as a corporation.

28 See Korby, *supra* note 17; Schutt, *supra* note 9; Estate of Hillgren, TC Memo 2004-46, RIA TC Memo ¶2004-046, 87 CCH TCM 1008; Estate of Harper, TC Memo 2002-121, RIA TC Memo ¶2002-121, 83 CCH TCM 1641 .

29 See Bongard, 124 TC at 124; Schutt, *supra* note 9; Bigelow, *supra* note 23.

30 *Id*.

31 See Bigelow, *supra* note 23; Korby, supra note 17; Harper, supra note 28.

32 See Bigelow, *supra* note 23; Hillgren, *supra* note 28; Harper, *supra* note 28; Reichardt, *supra* note 24; Estate of Schauerhamer, TC Memo 1997-242, RIA TC Memo ¶97242, 73 CCH TCM 2855. See also Schutt, *supra* note 9 (proper segregation of assets was a factor in concluding that the bona fide sale exception applies).

33 See Bigelow, *supra* note 23; Hillgren, *supra* note 28; Harper, *supra* note 28; Reichardt, *supra* note 28; Schauerhamer, *supra* note 32.

34 See Bongard, 124 TC at 126; Schutt, *supra* note 9.

35 See Strangi, 417 F.3d at 481; Korby, *supra* note 17; Turner (Thompson), 382 F.3d at 379, 381; Harper, *supra* note 28.

36 See Strangi, 417 F.3d at 477.

37 Section 2056(a).

38 See Pennell, 843-2nd T.M. (BNA), *Estate Tax Marital Deduction*, p. A-43 (2004), which provides an excellent discussion of all the marital deduction requirements.

39 Section 2056(c)(4).

40 See Pennell, *supra* note 38, at A-43—A-44.

41 See Reg. 25.2512-3. As discussed later, depending on the circumstances, this can potentially override the decedent's likely objective that the marital deduction prevent the imposition of estate tax. As a corollary, if the disposition to the surviving spouse is inadequately funded, the surviving spouse may be deemed to have made a taxable gift. See Akers, *supra* note 5, ¶811.17, at 8-145 and n.576. This could have disastrous consequences if a QTIP marital deduction trust is involved, because under Section 2519, a surviving spouse who assigns all or any part of a QTIP income interest triggers a gift of the full value of the remainder interest in the trust (in addition to making a gift of the value of the assigned income interest under Section 2511). See Pennell, *supra* note 38, at A-91. In addition, the deemed gift by the spouse could have estate tax consequences upon the spouse's death under Section 2036(a)(1) if the spouse is also a beneficiary of the non-marital or credit shelter trust to which the transfer has been made.

42 88 TC 1577 (1987).

43 TC Memo 1999-421, RIA TC Memo ¶99421, 2000-1 USTC ¶47823, 78 CCH TCM 1220.

44 See also Schwan, *supra* note 4.

45 See Pennell, *supra* note 38, at A-127 n.794.

46 The trust had initially been funded several years before with Empak stock. Mr. Bongard was neither a beneficiary nor a trustee of the trust, although he did retain significant input over what distributions were made by this trust. On six occasions, distributions of Empak stock were made to the trust beneficiaries upon the decedent's request to the trustees. Following each distribution, Empak redeemed the distributed shares for cash. Significantly, in 1998—more than a year after BFLP was created and shortly before Mr. Bongard's death (which occurred in November 1998)—there was a further redemption of Empak stock, which was accompanied by WCB Holdings' redemption of certain membership units that were held by Mr. Bongard's irrevocable trust.

47 At the time of Mr. Bongard's death, BFLP had not performed any activities, and had never

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acted to diversify its assets (i.e., the WCB Holdings membership units) or made any distributions. Mr. Bongard was very wealthy and did not need to rely on distributions from BFLP to maintain his standard of living.

48 The Tax Court also held: (1) that Mr. Bongard's transfer of his Empak stock to WCB Holdings in exchange for non-voting membership units satisfied the bona fide sale exception to Section 2036 because Mr. Bongard had a legitimate and significant non-tax reason for the transfer (i.e., to facilitate a public or private offering of Empak's stock), and (2) that Mr. Bongard's transfer of WCB Holdings membership units to BFLP in exchange for a 99 percent limited partnership interest did *not* satisfy the bona fide sale exception as there was no legitimate and significant non-tax reason for the transfer.

48 According to the court, an implied agreement existed whereby Mr. Bongard retained a Section 2036(a)(1) right of enjoyment in the WCB Holdings membership units that he transferred to BFLP. Without citing any supporting case law, the court stated that this implied agreement was attributable to the fact that the decedent effectively controlled BFLP's investments through his executive positions with Empak and WCB Holdings. Because BFLP had not performed any meaningful functions as an entity, the court also rejected the estate's contention that the general partner's fiduciary duties precluded an implied agreement. Hence, the court concluded that an implied agreement existed that allowed the decedent to retain the enjoyment of the property held by BFLP, and that under Section 2036(a)(1), the decedent's estate included the value of the WCB Holdings membership units held by BFLP at death that was proportionate to the decedent's 91.28 percent limited partnership interest. Bongard, 124 TC at 131. Judge Chiedhi in a blistering dissent, assailed the majority opinion's determination that the decedent, within Section 2036(a)(1), had retained the enjoyment of the WCB membership units that he transferred to BFLP. According to Judge Chiechi, the government had relied only on Section 2036(a)(2)—and not on Section 2036(a)(1)—in attempting to bring back into the decedent's estate the WCB Holdings membership units that he transferred to BFLP, arguing that, under the partnership agreement, the decedent retained the right, in conjunction with the irrevocable trust (the general partner of BFLP) to liquidate BFLP and to amend that agreement. See Bongard, 124 TC at 151 n.5 (Chiechi, J., dissenting). The majority opinion instead recharacterized the government's position as having been brought under Section 2036(a)(1), which involves a completely different set of considerations than the Section 2036(a)(2) analysis.

50 According to the decision, the IRS had issued a notice of deficiency, principally due to its invocation of Section 2036 to bring back into the estate the value of Empak shares that the decedent had transferred to the holding company in exchange for LLC membership interests. The court determined that this transfer was *not* subject to Section 2036 based on the bona fide sale exception.

51 Bongard, 124 TC at 133 n.13 (emphasis added).

52 In Korby, the Tax Court determined that Section 2036(a)(1) applied to cause estate tax inclusion of property that the decedent transferred to an FLP that she had formed with her husband together with their joint revocable trust. The decedent (Mrs. Korby) was survived by her husband, who died approximately five months later. The executor of Mrs. Korby's estate conceded that the marital deduction did not apply to the FLP's assets that were included in Mrs. Korby's estate under Section 2036(a)(1). However, because Mr. Korby died shortly after Mrs. Korby, there may well have been a strategic purpose for this concession to minimize the combined estate tax liabilities of Mrs. and Mr. Korby's estates. In any event, a taxpayer's concession is not tantamount to a court ruling and therefore is without precedential value.

53 If an entity taxed as a partnership makes a Section 754 election, the entity's basis in its assets (the "inside basis") will be adjusted, but only with respect to the transferee partner. The entity will increase its inside basis by the excess of the transferee partner's "outside basis" (which has been stepped up under Section 1014) over his or her share of the entity's inside basis. Alternatively, if the transferee partner's outside basis has been stepped *down* under Section 1014, the entity making a Section 754 election will reduce its inside basis with respect to the transferee partner by the excess of the transferee

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partner's share of the inside basis over his or her outside basis. This adjustment to inside basis affects both the allocation of gains and losses to the transferee partner upon a disposition of an entity asset, and the partner's share of inside basis for purposes of depreciation deductions and distributions. See Donaldson, "Income Tax Aspects of Family Limited Partnerships," 39 *U. Miami Heckerling Inst. on Est. Plan*. ¶1402.4, at 14-14 (2005). Significantly, if the estate tax value of the decedent's partnership interest has been discounted for lack of control and lack of marketability, the disparity between the "inside basis" of the entity's assets and the "outside basis" (which will have been reduced by discounts) of the entity interest acquired from the decedent may be reduced, if not eliminated. In this manner, the valuation discounts can produce an adverse income tax result.

54 Experience suggests that many (if not most) clients are unwilling to do this.

55 See Gans and Blattmachr, *supra* note 13, at 1164.

56 The IRS has incorporated the Section 672(c) standard of independence into the transfer tax arena in such pronouncements as Rev. Rul. 95-58, 1995-2 CB 191 (concerning the removal and replacement of trustees), and Rev. Rul. 2004-64, 2004-27 IRB 7 (concerning the gift and estate tax consequences of grantor trust status).

57 See Reg. 25.2511-2(b).

58 See Mezzullo, *Family Limited Partnerships and Limited Liability Companies*, 812-2nd T.M. (BNA), pp. A-28—A-29 (2005).

59 Section 2035(d).

60 1985-1 CB 184. To ensure treatment as a wholly grantor trust, it may be desirable to override any Crummey powers of withdrawal under the trust instrument during the year of sale to eliminate any uncertainty concerning the extent (if any) to which such powers may cause the beneficiary of an otherwise grantor trust to be taxed as the "owner" of some portion of the trust's capital gains under Section 678. See Sections 671, 678(a), and 678(b).

61 The consideration furnished offset under Section 2043 would, however, be available in that case to reduce the amount of the inclusion under Section 2035 or 2036. See Abraham, 408 F.3d at 39; Allen, 8 AFTR 2d 6055, 293 F2d 916, 61-2 USTC ¶12032 (CA-10, 1961) (applying the predecessor statute to Section 2043). As Professor Jeffrey N. Pennell has observed, this may produce an unsatisfactory result because the amount of the consideration furnished offset under Section 2043 appears to be frozen in value as of the date that the consideration was furnished and does not take into account subsequent appreciation in the value of the assets transferred through date of death (or the alternate valuation date).

62 Bongard, 124 TC at 118 (emphasis added) (internal citations omitted).

63 See generally Mulligan, "Sale to an Intentionally Defective Irrevocable Trust for a Balloon Note—An End Run Around Chapter 14?," 32 *U. Miami Heckerling Inst. on Est. Plan*. ¶15-1 *et al*. (1998).

64 See, e.g., Mulligan, *supra* note 63, ¶1507.1 at 15-32 (indicating that ten percent pre-funding of the irrevocable trust should be adequate); Abbin, "[S]he Loves Me, [S]he Loves Me Not—Responding to Succession Planning Needs Through a Three-Dimensional Analysis of Considerations to Be Applied in Selection from the Cafeteria of Techniques," 31 *U. Miami Heckerling Inst. on Est. Plan*. ¶1300.1, at 13-9 (1997) (also suggesting that ten percent pre-funding of an irrevocable trust should be adequate).

65 8 AFTR 2d 6055, 293 F2d 916, 61-2 USTC ¶12032 (CA-10, 1961).

66 See Gans and Blattmachr, *supra* note 13, at 1167.

67 Exposure to income tax on liquidation could occur under Sections 704(c)(1)(B), 737, 731, and 752(b). For an excellent summary of the partnership income tax rules relevant to FLPs, see Donaldson, *supra* note 53, ¶14-1 *et al*.

68 See Abraham, 408 F.3d at 37 n.13.

69 TC Memo 2006-115, RIA TC Memo ¶2006-115, 91 CCH TCM 1220.

70 The Rosen decision provides in relevant part: "Petitioners next argue that the Court, if we conclude that the assets are includable in decedent's gross estate under section 2036(a)(1), must exclude from those assets the portion thereof that relates to the limited partnership interest that decedent transferred by gift more than three years before her death. We disagree…. Decedent continued to possess and enjoy the transferred assets up until her death. Accordingly, section 2036(a)(1) includes those assets in her gross estate." Rosen, TCM 2006-115, 2006 WL 1517618, at *25 *accord* Abraham, 408 F.3d at 41; Bigelow, *supra* note 23. See

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also Bongard, 124 TC at 131-32 (Section 2035(a) brought back into the estate the value of the entity's property that was proportionate to the value of the limited partnership interests that the decedent gave his wife less than three years before his death, and that would have been included in his estate under Section 2036 had such gift not been made).

71 Moreover, even if the bona fide sale exception were unavailable, some (albeit potentially incomplete) relief could still be obtained through the consideration furnished offset under Section 2036. See Abraham, 408 F.3d at 39.

72 Alternatively, it may be possible to reduce the level of the trust's funding if the trust beneficiaries (other than minors) execute guarantees and have sufficient assets to provide such level of credit support that an independent third party would deem sufficient. The law is unclear whether giving a guarantee constitutes a gift by the guarantor if the guarantor does not receive a fee for the guarantee (perhaps based on what a bank would charge as a letter of credit fee). See Ltr. Rul. 9113009 (taking the position that the guarantee was a gift), *withdrawn by* Ltr. Rul. 9409018.

73 1995-2 CB 191.

74 See Mulligan, *supra* note 63, at ¶1505.1, at 15-21—15-22 ("Although it is possible for the grantor to serve as trustee of the [intentionally defective irrevocable trust ("IDIT")] without causing the IDIT to be included in the grantor's estate…, naming another party as trustee to effect an IDIT promissory note sale clearly enhances the bona fide arm's-length appearance of the transaction.").

75 This would particularly be the case if death occurred within three years of the sale, under Allen, which involved the predecessor statute to Section 2035.

76 See Abraham, 408 F.3d at 39; see also Allen (involving the predecessor statute to Section 2043).

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