

10 Things To Remember About FLPs/LLCs

I FISCAL FITNESS: Make sure the FLP/LLC is the right fit in your situation. Most mistakes that are made in the FLP/LLC arena are due to the inappropriate evaluation of the suitability of that entity technique in a particular situation. Simply put, many FLPs /LLCs fail due to improper "fit."

Is your client too old or unhealthy for the FLP/LLC? These are legitimate questions in light of the jurisprudence and rulings. See, e.g., TAM's 9719006, 9723009, 9725002 and 9730004; and *Thompson Est. v. Comr.*, T.C. Memo 2002-246; *Schauerhamer v. Comr.*, T.C. Memo 1997-242; *Reichardt Est. v. Comr.*, 114 T.C. 144 (2000); *Strangi Est. v. Comr.*, 115 T.C. 478 (2000), *affd. in part and revd. in part, sub nom. Gulig v. Comr.*, 293 F.3d 279 (5th Cir. 2002); and *Harper Est. v. Comr.*, T.C. Memo 2002-121.

Will your client follow the rules for FLPs/LLCs? Do your clients understand the importance of following the rules? A perfectly formed and funded FLP/LLC that is imperfectly administered (e.g., non pro rata distributions, commingling, etc.) probably will not work for estate tax purposes. See, e.g., *Schauerhamer Est. v. Comr.*, *supra*; *Reichardt Est v. Comr.*, *supra*; *Harper Est. v. Comr.*, *supra*.

Will your clients pay for follow-up advice? What have you done to educate your clients as to the rules and the risks, and what written proof do you have of your efforts in this regard?

Do your clients need or require this level of complex planning? Can they handle that complexity? Do they understand the tax risks inherent with FLPs/LLCs? Did you consider/offer alternate estate planning techniques to them?

II. THE SUBJECT MATTERS: The type of assets placed into an FLP/LLC make a difference. The assets contributed to FLPs/LLCs can have both tax and non-tax implications. Many clients are drawn to the FLP/LLC for its asset protection qualities. However, people sometimes put liability-prone property into an FLP/LLC with other valuable property, and, by so doing, fail to achieve the asset protection that could have been available had the assets been placed into separate entities to minimize cross exposure.

On the tax side, the wrong mix of marketable securities could cause the entity to be treated as an "investment company" under IRC-Sec:721. The contribution of appreciated property to an FLP/LLC could give rise to considerations of allocation of built-in gain under IRC Sec. 704(c). Property encumbered by debt inside of an FLP/LLC can give rise to a number of tax issues relating to IRC Secs. 704, 705 and 752.

Not only can the financial nature of FLP/LLC property matter, but the percentage of a client's property that is put into an FLP/LLC seems to matter, as well as the nature of that property. In *Harper Est. v. Comr.*, supra. and *Thompson Est. v. Comr.*, supra, the Tax Court applied IRC Sec. 2036 where the decedent had placed virtually all of his or her property into the partnership.

Many practitioners believe that the IRS has a bias against FLPs/LLCs that are entirely or heavily capitalized with marketable securities.

III. AVOID GRAY HEIRS: Avoid the grey area of assignees. One of the biggest areas of uncertainty in the law of FLPs/LLCs pertains to the rights and obligations of assignees of interests in FLPs/LLCs. Accordingly, a well-drafted FLP/LLC agreement should provide for rules pertaining to the rights of assignees and persons who should be admitted as owners (as opposed to being mere assignees) immediately upon adoption of the entity governance documents.

Some clients insist on making assignee-only transfers of FLP/LLC interests to children or other loved ones. It seems fairly clear today that the valuation differential between non-managing interests and assignee interests is marginal. So this is not a very compelling reason for making assignee-only transfers. Where clients insist on assignee-only transfers, it is imperative that the agreement be fashioned to give these assignees some rights, particularly, the ability to avail themselves of the fiduciary duty of the entity managers and be given access to entity financial information. Otherwise, IRC Sec. 2036 could apply to include the date-of-death value of the gifted interests in the donor's gross estate. In drafting for the rights of assignees, one may wish to distinguish between "good" assignees (like loved ones) and "bad" assignees (like creditors).

As mentioned above, in FLPs/LLCs, it is critical that some classes of people be automatically admitted as owners upon adoption of the governance agreements. Unlike corporations, FLPs/LLCs separate financial rights from management rights. If this is not carefully provided for in the governance documents, there could be an unwanted result of some family being held hostage on the outside as mere assignees in an FLP/LLC.

IV. FIDUCIARY - NOT A FOUR LETTER WORD: The "F" (Fiduciary) word is your friend. The thin reed of respect for transfer tax purposes accorded to FLP's/LLC's lies resplendent in the state law fiduciary duty owed by owners. See the U.S. Supreme Court's opinion in *Byrum v. U.S.*, 408 U.S. 125, 33 L. Ed. 2d 238, 92 S. Ct. 2382 (1972). Estate planners cannot over-emphasize to clients the existence and importance of the general partner/manager's fiduciary duty—both in your advice and in the entity governance documents. Yet, in *Kimbell v. U.S.*, Civ. Action No. 7:01-CY-0218-R, 2003 U.S. Dist. LEXIS 523 (N.D. Tex. January 15, 2003), the estate attempted to assert a *Byrum* fiduciary duty argument even though the partnership agreement expressly provided that the general partner owed no fiduciary duty to the partnership or to the other partners.

Once an FLP/LLC is formed and funded, the assets no longer belong to the contributors, and their use of those assets is no longer subject to their whim and caprice! While this should be obvious to estate planners, it is not always either obvious to or desirable by those clients who may be looking at the FLP/LLC not as an estate management and transfer device, but solely as a shell game of sorts. However, the estate planner must strive to weed the latter folks out as poor candidates for the FLP/LLC, as was discussed in No.1 above.

Estate planning advisors also need to pay close attention to the indemnification/hold harmless provisions in the entity governance documents – fiduciary duty is of little importance if the document then essentially forgives all transgressions through indemnification. Too often, we see relaxed statements of fiduciary duty, or overly generous indemnification/hold harmless provisions - some of these clauses are eerily similar to those seen in the go-go tax shelter limited partnerships of the 1980's- where the limited partners indemnified the general partners against their own negligence and other transgressions, including, without limitation, criminal fraud! Avoid these types of clauses. Inclusion of such provisions invites the IRS to apply Code Section 2036.

Consistent with fiduciary duty is access to financial information. It is impossible for an owner to realistically evaluate whether those in charge are fulfilling their fiduciary duties without meaningful access to financial information. This clause is important as well.

V. LEARN TO LISTEN: Input and other rights of non-manager owners are necessary. It is imperative that careful attention be paid to fashioning rights of non-managing members, including, without limitation, accounting/information rights, distributions and voting input on significant or other extraordinary events. This is important for tax and non-tax reasons.

First, these rights protect the non-managing owners, and they act as reminders to those in charge that their control is not without limitations. Admittedly, some clients' penchant for control may be so great as to rule them out as candidates for FLPs/LLCs.

Second, the existence of real rights on the part of the non-managing owners will support the bona fides of their interests, and of transfers of interests to them. Non-managing FLP/LLC owners should be permitted to assign interests in the entity (subject to rights of first refusal and appropriate assignee rights). The managing owners should be required to make distributions of available cash, and the governance documents should provide some requirement that all determinations of whether there is any available cash should be made at least annually, with consequences to the managing owners if that doesn't happen.

If a non-managing owner is not free to assign the economic interests in the FLP/LLC and if the managing owners are not required to make distributions of available cash, then the gift of any such interests may not qualify for the gift tax annual exclusion. See *Hackl v. Comr.*, 118 T.C. No. 14 (2002). However, it also is conceivable that a transfer of such an interest may not be a gift at all (because of the extent of the tie up of the donee's interests), with the result that the donor retained everything to be included in his estate under IRC Sec. 2036.

Granting the non-managing owners input on extraordinary events adds more validity and protection as it serves as a check on the authority of the managing owners and serves to backstop fiduciary duty.

VI. FUTURE SHOCK: Consider the impact of generational "fan out" of ownership on governance of the FLP/LLC. This is one of the biggest challenges to drafting an FLP/LLC, but it usually is swept under the rug of expedience. Utilizing governance documents prepared for unrelated owners as guides for FLP/LLC documents causes the estate planner to never even

consider the unique governance issues engendered by the expected change in ownership expected in the context of family estate planning. It doesn't take much "generational fan out" in order to create significant logistical governance problems for the FLP/LLC, particularly if meetings are required and quorums are set rigidly.

Is it appropriate to consider assigning rights by defined "families" (usually each child and his or her descendants and assignees would constitute a "family"), either at the FLP/LLC management level (such as having each "family" select its own manager) or, even at the FLP/LLC owner level (where each "family" votes the interests of all members as a block instead of individually)?

Should each family be given a right to assign its FLP/LLC interests into a separate entity for holding, with the new entity to vote the interests formerly held by the "family." Should the well-crafted FLP/LLC prescribe a manner of division of the FLP/LLC, and even triggering events for that to occur?

VII. VOTE EARLY AND OFTEN: Watch for and coordinate the amount of required votes. The required votes for events in FLP/LLC governance agreements must be carefully coordinated with the ownership shares of the owners, both before and after significant transfers of entity interests. This can have both tax and non-tax implications.

For example, suppose the FLP/LLC agreement provides that 2/3 of the owners by interests can dissolve the entity, and an owner holds more than that prescribed percentage. At that owner's death, the interest will be entitled to a relatively small discount for lack of marketability. Recall, for instance, that in *Jones v. Comr.*, 116 T.C. 121 (2001), the Tax Court determined that no discount for lack of marketability was appropriate for a gift of a limited partnership interest because the partnership agreement gave the donated partnership interest, by virtue of its size, the effective right to dissolve the partnership.

IX. DIFFERENT STROKES FOR DIFFERENT FOLKS: It is important to carefully consider the number and types of FLPs/LLCs that a client may need. One of the more subjective challenges in FLP/LLC design is deciding how many entities the client should have. This challenge has tax and non-tax aspects. In some situations, the client should set up separate entities for different descendants. In other situations, the nature of the underlying property informs the number: property that is susceptible to liability often should be kept separate from other property.

IX. DON'T KEEP IT ALL IN THE FAMILY: Protections against family informality are critical. Despite all of an estate planner's best efforts and exhortations, families may still act over the kitchen table with their FLPs/LLCs in a manner that may call the separate existence of the FLPs/LLCs into question.

For instance, families sometimes make non-pro rata distributions or engage in disparate timing of pro rata distributions. Drafters should anticipate this reality by considering treating these distributions as "interim" and providing for preferential "makeup" distributions and charging interest at the IRC Sec. 7872 rate on "interim" balances that exceed \$13,000.

Additionally, transfers by sale of 50% or more of FLP/LLC interests could result in a technical termination of the FLP/LLC for tax purposes pursuant to IRC Sec. 708. This may or may not pose any adverse tax consequences, but it should be anticipated and cut off.

In some circumstances, it may be prudent to provide additional rights (and obligations) upon certain family assignees who are not automatically admitted as owners. This can be a particularly helpful provision where there are transfers to trusts in which spouses of family members have interests, e.g., QTIP trusts, etc.

In considering allocations of income and distributions of cash, it is important to be very cautious before instituting any scheme that is other than a straight allocation and distribution along percentage ownership lines. Any preference could subject the FLP/LLC to the Balkan provisions of IRC Sec. 2701. While there are situations in which estate planners may want to use IRC Sec. 2701, the application of that section should be a consciously desired result. The only real way to avoid application of IRC Sec. 2701 is to make all FLP/LLC interests the same in quality.

Sometimes, clients desire distribution preferences in the form of "guaranteed payments" pursuant to IRC Sec. 707. This should be used very carefully as there is potential exposure under IRC Sec. 2036, especially if the amount of the guaranteed payment just so happens to equal anywhere close to the amount of income that the property generated when contributed to the FLP/LLC. For example, in *Harper Est. v. Comr.*, supra, the donor received a guaranteed payment on the making of a gift of partnership interests. The Tax Court held that IRC Sec. 2036 applied.

X. TAXING ISSUES: Don't forget the income tax issues of FLPs/LLCs. Years ago, the income tax rules relating to partnerships permitted all sorts of flexibility and asset transfers. In fact there was so much flexibility that the rules invited and elicited abuse. The result was a tightening of rules.

Code Section 704(e) has always provided some restrictions on FLPs/LLCs in which capital is not a significant income producing factor. However, the rules relative to distributions of marketable securities have been tightened, as have the rules pertaining to allocations of items of FLP/LLC income, gain, loss, deduction and credit. Other changes pertaining to transfers of property out of a partnership have increased the risk of a taxable event under IRC Secs. 707(a)(2) and 737. There are other income tax issues discussed earlier.

The bottom line: the FLP/LLC cannot be set up to just comply with estate tax rules; the income tax rules are very important.

From Steve Leimberg's Estate Planning Newsletter, March 26, 2003

THE TEN COMMANDMENTS OF FLPs/LLCs:

With all due respect to the Deity (and to the Moonglows), what follows are a set of rules for clients who desire to set up FLP's/LLC's that they should keep like the Ten Commandments:

- I. Thou shalt respect thine own agreement.
- II. Thou shalt immediately retitle all property contributed to the FLP/LLC.
- III. Thou shalt act as a fiduciary and resist the penchant for over-control.
- IV. Thou shalt not make non pro rata distributions.
- V. Thou shalt not commingle assets or income.
- VI. Thou shalt contemporaneously and accurately account (IRS doth not like after- the- fact adjusting entries).
- VII. Thou shalt not covet thy FLPs/LLCs property.
- VIII. Thou shalt keep personal use and liability prone property out of thy FLP/LLC.
- IX. Thou shalt get quality appraisals of both FLP/LLC assets and any FLP/LLC interest to be gifted.
- X. Thou shalt batten thy hatches. The IRS is not a big fan of FLPs/LLCs.

This communication may not be used and is not intended or written to be used and cannot be used, by you for the purpose of avoiding penalties that may be imposed on you by the Internal Revenue Service.

MHK

MORRIS, HALL & KINGHORN, P. L. L. C.
A Premier Estate Planning Law Firm

For over forty years, the attorneys at Morris, Hall and Kinghorn, P.L.L.C. have been providing quality estate planning documents for our clients. Helping our clients protect their assets for those that they love has been our goal from the very beginning. We are recognized throughout the Southwest for our expertise in educating individuals about the importance of proper estate planning. We do this through various speaking engagements and seminars; and further, we keep our clients up-to-date through constant communication, complimentary reviews and phone calls and more advanced seminars.

At MHK, we focus on protecting families from the expense and delay of probate, providing long-term care planning options and minimizing tax consequences. We also implement the basic and advanced estate planning strategies for clients and assist in administering clients' estates upon death or disability. As we do no other law other than estate planning, our focused practice allows us to answer the complex questions and concerns consumers have about estate planning.

Morris, Hall, and Kinghorn is staffed with experienced attorneys and paralegals, trained in the complex areas of probate, trust, elder law, life care planning and tax law. The aim of our law firm is to help you, our client, understand the basic principles of estate planning, its importance and why each individual needs a plan. We have helped thousands of individuals secure their assets and eased the mind of them and the families left behind. By taking advantage of the services that MHK has to offer, you can be assured that your legacy and your family will be protected.

If you would like a current schedule of seminars in your area or would like a consultation with an attorney, please visit www.morristrust.com or call toll free 888.222.1328.



MEMBER OF THE
AMERICAN ACADEMY OF
ESTATE PLANNING ATTORNEYS



MEMBER OF THE NATIONAL
ACADEMY OF ELDER LAW
ATTORNEYS

This Academy Report reflects the opinion of the American Academy of Estate Planning Attorneys. It is based on our understanding of national trends and procedures, and is intended only as a simple overview of the basic estate planning issues. We recommend you do not base your own estate planning on the contents of this Academy Report alone. Review your estate planning goals with a qualified estate planning attorney.

The American Academy of Estate Planning Attorneys is a member organization serving the needs of attorneys committed to providing their clients with the best in estate planning. Through the Academy's comprehensive training and educational programs, it fosters excellence in estate planning among its members and helps them deliver the highest possible service to their clients.