A Fresh Look at Family Partnerships/LLCs and Code Section 2036

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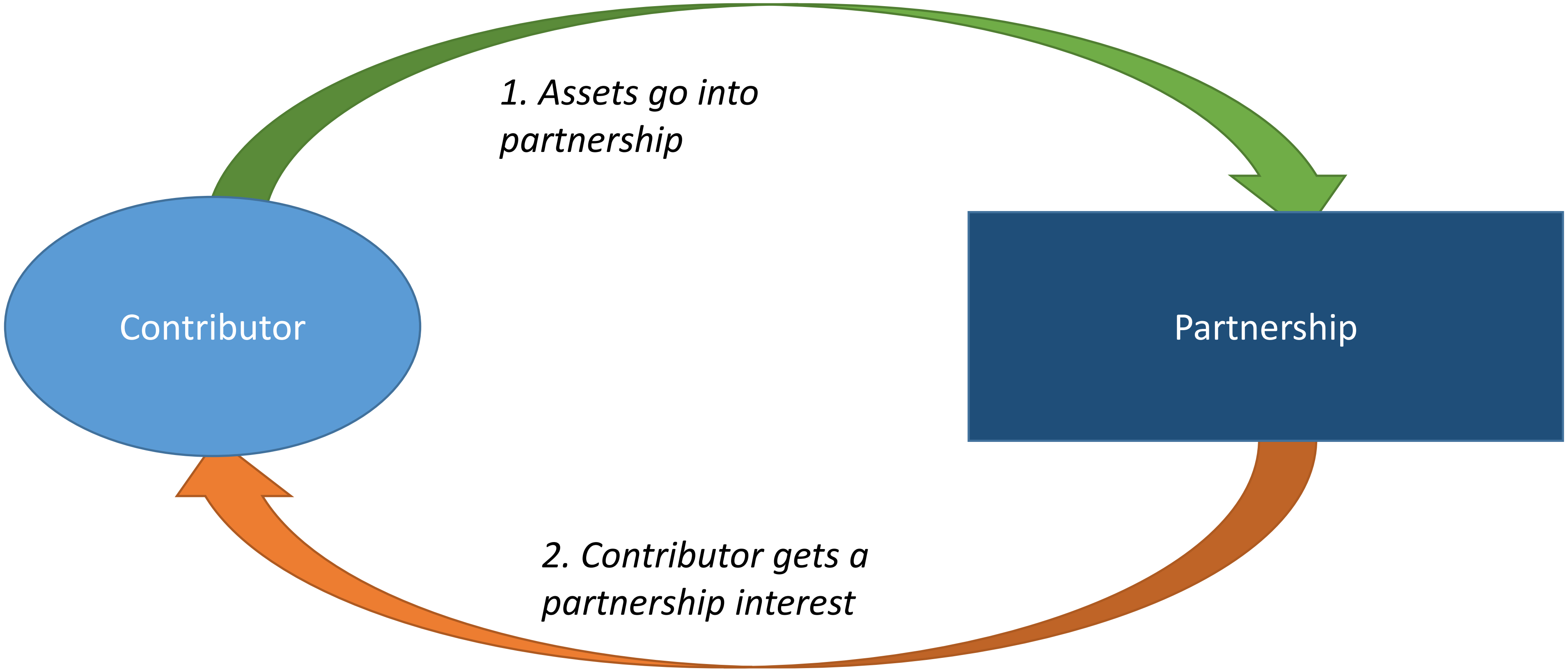
This presentation is not legal or tax advice

General Idea

- Planning with a family partnership, or a holding company, is all about exchanges:
  - One or more individuals put assets (perhaps including other partnership or entity interests) into one family partnership, in exchange for interests in the family partnership
  - This is usually a tax-neutral exchange under IRC 721 (no gain or loss recognized; carryover basis preserved for inside basis of partnership assets and outside basis of partnership interest)
  - Each individual's interest in the family partnership can then be gifted to other family members, perhaps with discounts for lack of control and lack of marketability
- It is this exchange – assets for partnership interest - that creates the headaches we will discuss today

Exchange, Illustrated



Exchange – Balance Sheet Perspective

Before:

Contributor	Assets
Cash	$1,000,000

After:

Contributor	Assets
Partnership Interest	$1,000,000

Partnership	Assets	Equity
Cash	$1,000,000	($1,000,000)

What is a Family Partnership?

- At its broadest level, a family partnership is designed to consolidate family ownership of multiple assets, possibly in multiple classes
- These assets might include, but are not limited to:
  - Real estate (both investment and personal use)
  - Interests in active businesses
  - Investment securities and cash
  - Alternative investments, or passive investments in businesses
- The family partnership may be funded substantially by one family member or one head of family, or may consist of a pooling of assets by multiple family members in the same or different generations

Purposes of a Family Partnership?

- A family partnership has several potential purposes, which may include:
  - Diversification of investment returns, as permitted by tax code
  - ***<u>Ease of transfer of assets from one generation to the next, during life or at death</u>***
  - Restriction of transfer of assets outside of family
  - Shifting of income tax among family members for non-service businesses
  - Liability protection for family assets
  - ***<u>Discounts in value for estate/gift/GST tax purposes when interests are transferred</u>***
- It is this latter purpose which creates the issues we will discuss, especially when the circumstances show this was **<u>a main purpose</u>**

Some Assumptions

- Throughout this presentation, I will use some blanket terms and assumptions, but they may not always reflect reality:
    - I use the term “family partnership” to refer to a tax partnership or disregarded entity where family members hold the majority of interests, even if the entity is organized at a state-law level as a limited partnership or LLC
    - I will focus on one individual who funds the majority of the partnership, either as the “contributing partner” or “decedent,” as the context requires
    - When I use the term “discount,” I will assume a 35% combined discount for lack of control and lack of marketability
    - Given these stipulations, I will assume that ***a benefit*** of the transaction (regardless of whether the benefit was intended) was obtaining this discount either for a gift of partnership interests, the estate tax value of retained partnership interests, or both

Capital Structure

- To understand how we get there, and how the discount is leveraged, you must understand the basic capital structure of a limited partnership (which drives the term family *limited* partnership)
- To have a limited partnership, you must have:
  - At least one general partner, and
  - At least one limited partner
- Note that the income tax treatment of the partnership is irrelevant here, other than the tax-free exchange of assets for a partnership interest, because gift/estate tax tend to focus on *state law* property interests
  - So, a disregarded entity interest could still be subject to discounts if there are multiple owners (such as spousal owners in a community property state)
  - Discounts may even vary by state!
  - But, you must make sure you actually have a state law partnership interest – some states may not let the same person be general and limited partner if they are the only partner

Why Does The Capital Structure Matter?

- State law on limited partnerships universally distinguishes the two types of partners in this manner:
  - General partners are the only partners allowed to manage the partnership, but in exchange they have no liability protection against debts and judgments of the partnership
  - Limited partners get this liability protection, but in exchange they cannot manage the partnership, and often do not have a vote beyond transactions that materially affect the ownership or value of their interest
- Because of this dichotomy, it is the *limited partnership* interest that creates a discount, since a limited partner has no control over the partnership
  - More importantly, even if limited partners hold a majority interest (by percent) of the partnership, discounts can still be claimed because it is the limited partner's lack of control (regardless of percent ownership) that creates the discount
  - The converse also holds true – a control premium may attach to the general partner interest

Can You Do This With Other Entities?

- Yes, but you have to be more intentional about the capital structure to mimic the structure inherent in a limited partnership
- LLC
  - Typically broken down into different classes of units, one with voting/management rights and the other with no or limited voting/management rights
- Corporation
  - Typically broken down into voting and nonvoting shares, and possibly preferred and common shares
- Can you have varying capital rights? It depends on the entity, but is not a requirement and may be a detriment
  - For example, an S corporation cannot have more than 1 class of stock by capital right, but can have voting/nonvoting shares with the same capital rights
  - Different capital rights may invoke IRC Section 2701, which causes issues we will not discuss in this presentation

Fair Market Value

- Going back to the beginning, as I noted, this is a transaction driven by the initial *exchange* of an individual's assets for a partnership interest, which we can now fairly characterize as a *limited* partnership interest
- But fair market value (FMV) comes into play – this is the value at which an unrelated willing buyer and willing seller would exchange property, neither being under any compulsion to buy or sell
  - Sometimes, an arms-length standard is used, but not always as we will see as this is impossible in an intrafamily transaction
- We see FMV at two points:
  - The initial exchange of assets for a partnership interest; and
  - The determination of the gift or estate tax value of a limited partnership interest, *or the value of the underlying partnership assets previously contributed by a deceased partner*
- The difference is character and timing

LP Exchange – Balance Sheet Perspective

Before:

Contributors	Assets
Cash	$1,000,000

After:

Contributor	Assets
General Partner (1%)	$10,000 GP Interest
Limited Partner (99%)	***$643,500*** LP Interest*

Partnership	Assets	Equity
Cash	$1,000,000	($653,500?)*

**Assumes 35% combined discount for lack of control and lack of marketability. Where does this discount go? Should it increase value of GP interest? Should it be reflected on books of partnership?*

Questions for Deep Thought

- Is the FMV of the assets contributed to the partnership equal to the FMV of the limited partnership interest received?
- Given the restrictions placed on a limited partner, would a willing buyer pay this equal exchange value for the limited partnership interest, knowing that they have no right to control the partnership or compel distributions from the partnership?
  - This is where discounts come in, and it creates checks-and-balances because it is assumed the seller will try to get top dollar and not just roll over and accept a third party's discounted offer
- But, since FMV is based on a value between *unrelated* parties, do these checks-and-balances change when family members are involved? As we will see, *it depends on the purpose(s) for the family partnership*

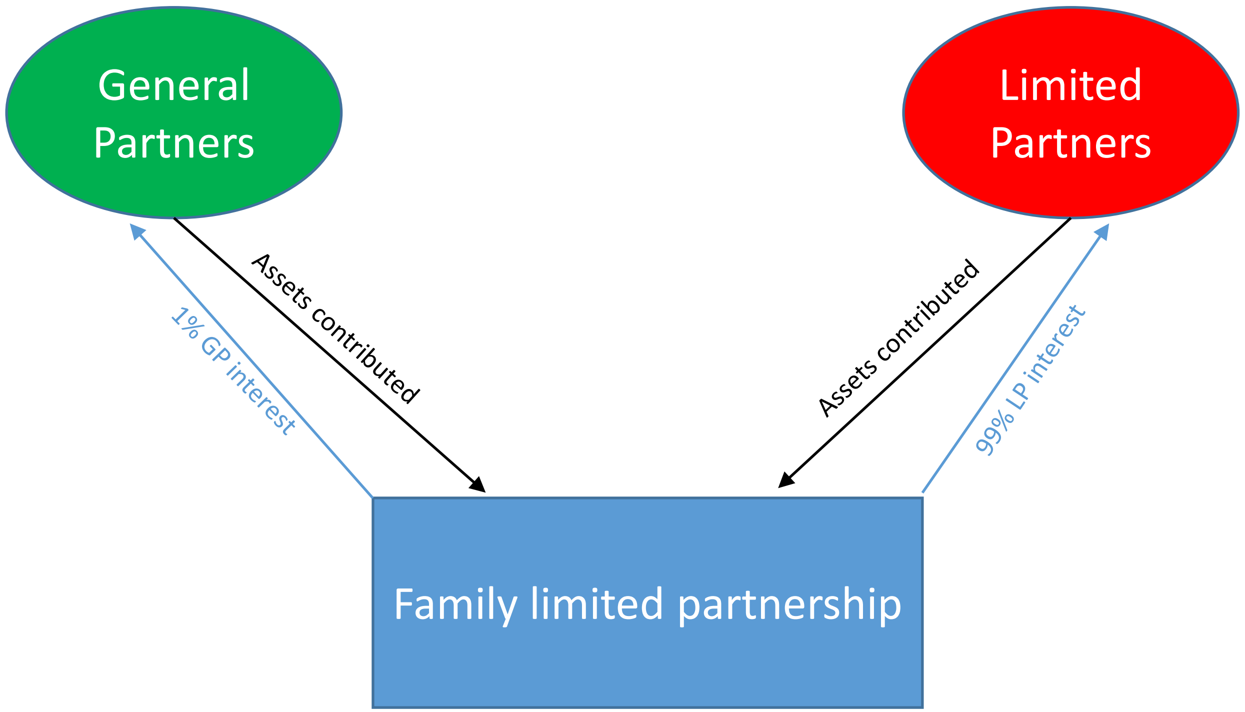
Questions for Deep Thought

"Unless a gift motive is conceded or some secret knowledge is presumed, I am not persuaded that a rational person dealing at arm's length would ever knowingly exchange assets worth $300 for an interest in an entity worth $200, with no right to control the entity or compel a distribution of her share of the entity's assets."

-Judge Halpern, in his dissenting opinion in *Estate of Bongard v. Commissioner*, 124 TC 95 (2005).

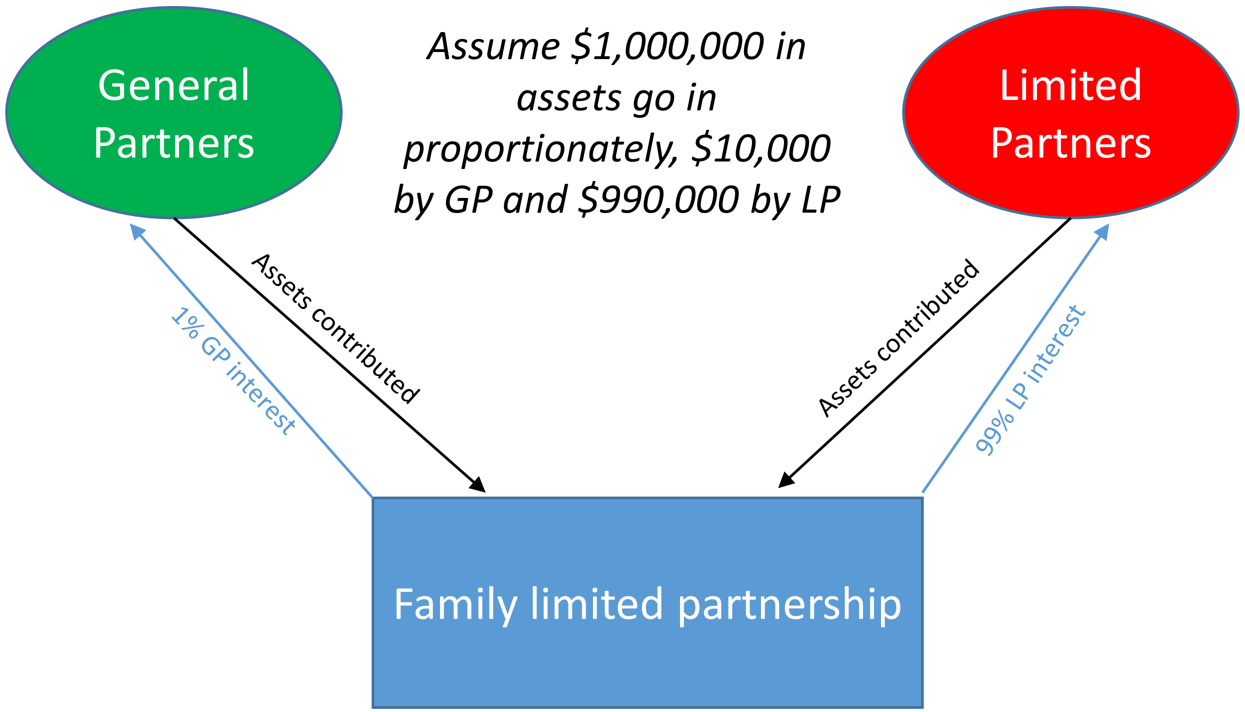
An Illustration of Common Structure

General partners' interests often pass through the estate or through other control structures



Limited partners can then transfer LP interests to other family members

The Value Equation – Family Limited Partnership



But, with 35% combined discounts, the LP interests received in exchange for $990,000 might only have an FMV of <u>$643,500</u>! Will this FMV be respected for estate or gift tax purposes?

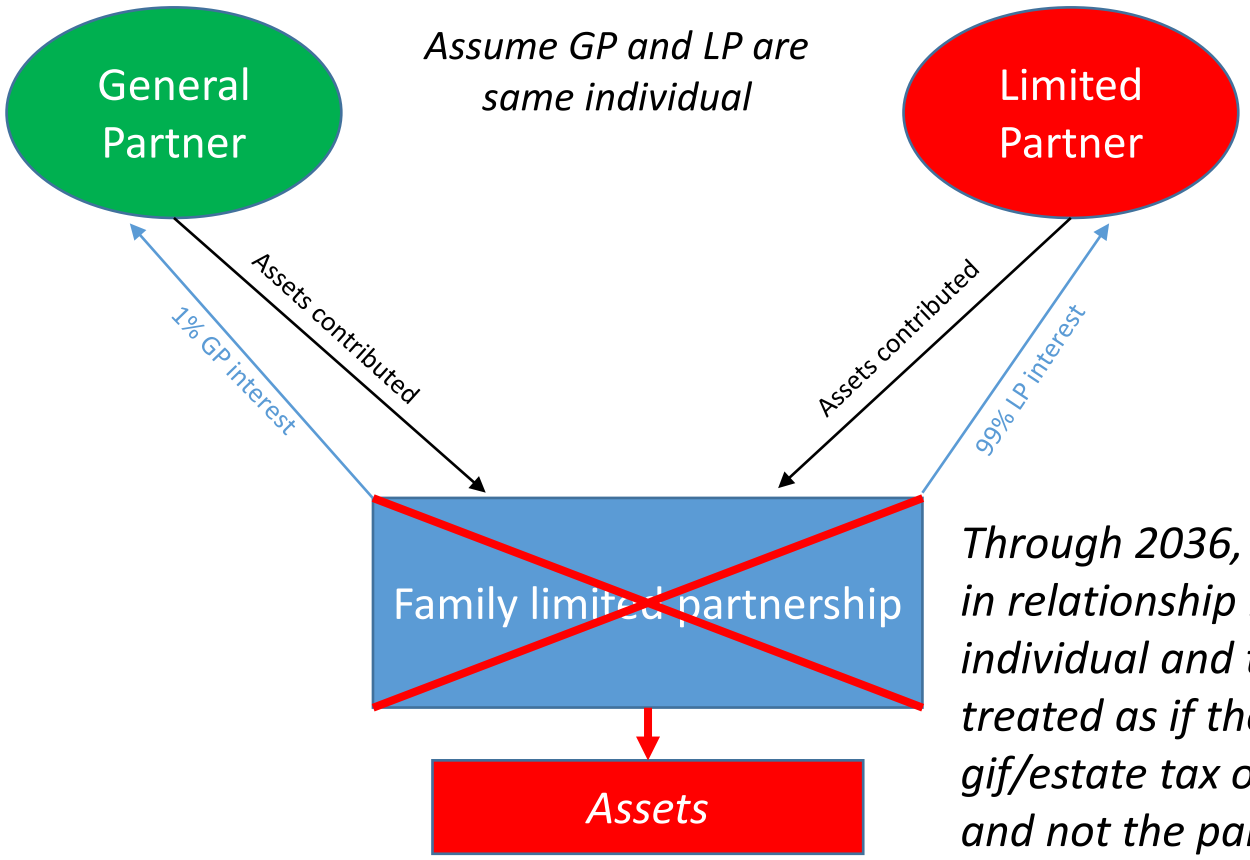
The Issue

- It takes a lot of resources for a taxpayer to establish a discount valuation – you often need a formal appraisal or valuation
- Likewise, if the discount is too large on audit, the IRS has to hire its own valuation experts at great expense
- If things reach the Tax Court level, additional valuations may be required from expert witnesses
- To avoid these discount battles, is there a separate angle of attack which can be used by the IRS? Can they argue that the partnership was a sham?

IRC 2036

- IRC Section 2036 is an angle of attack used by the IRS to completely bypass this issue of the exchange of value and discounts
- Remember that initial exchange I discussed? IRC 2036 gives the IRS a tool to *ignore this initial exchange*, so it is as if the individual decedent who created the partnership (on paper) never actually created it (for gift and estate tax purposes)
  - This allows the IRS to avoid fighting any battle over discounts of LP interests, or control premiums for GP interests
  - Note, too, that subsequent gifts may be treated as this exchange as well – for example if an interest in a single-member LLC is gifted
- I will explain 2036 a bit more, but first here is an illustration…

An Illustration of 2036 Outcome



Through 2036, there is no change in relationship between the individual and the assets – they are treated as if they are still the gif/estate tax owner of the assets and not the partnership interests

2036 Balance Sheet Perspective

Before:

Contributors	Assets
Cash	$1,000,000

After:

Contributor	Assets
General Partner (1%)	$10,000 GP Interest
Limited Partner (99%)	**$990,000 cash***
Limited Partner (99%)	**$643,500 LP interest**

Partnership	Assets	Equity
Cash	$1,000,000	($1,000,000)

**For estate tax purposes, LP is treated as if they never actually gave away cash in exchange for their LP interest. Instead, they are treated as if they still own the cash, or assets subsequently purchased with that cash by the partnership.*

What is IRC 2036?

- Before we get into the technical details, 2036 is part of a series of Code Sections that apply to *disregard lifetime changes* in ownership with respect to a decedent for *estate tax purposes only*
- Essentially, 2036 applies where there is a change in ownership *on paper*, but where the relationship between the decedent and the assets (subject to the change in ownership) does not actually change economically prior to death
- How? We look to situations where the decedent maintains income from, or control over, the assets after the change in ownership, which lasts until death (or three years prior to death)
  - Why 3 years? Because IRC 2035 ignores certain releases of IRC 2036 powers which occurs within 3 years of death

Outcome of IRC 2036

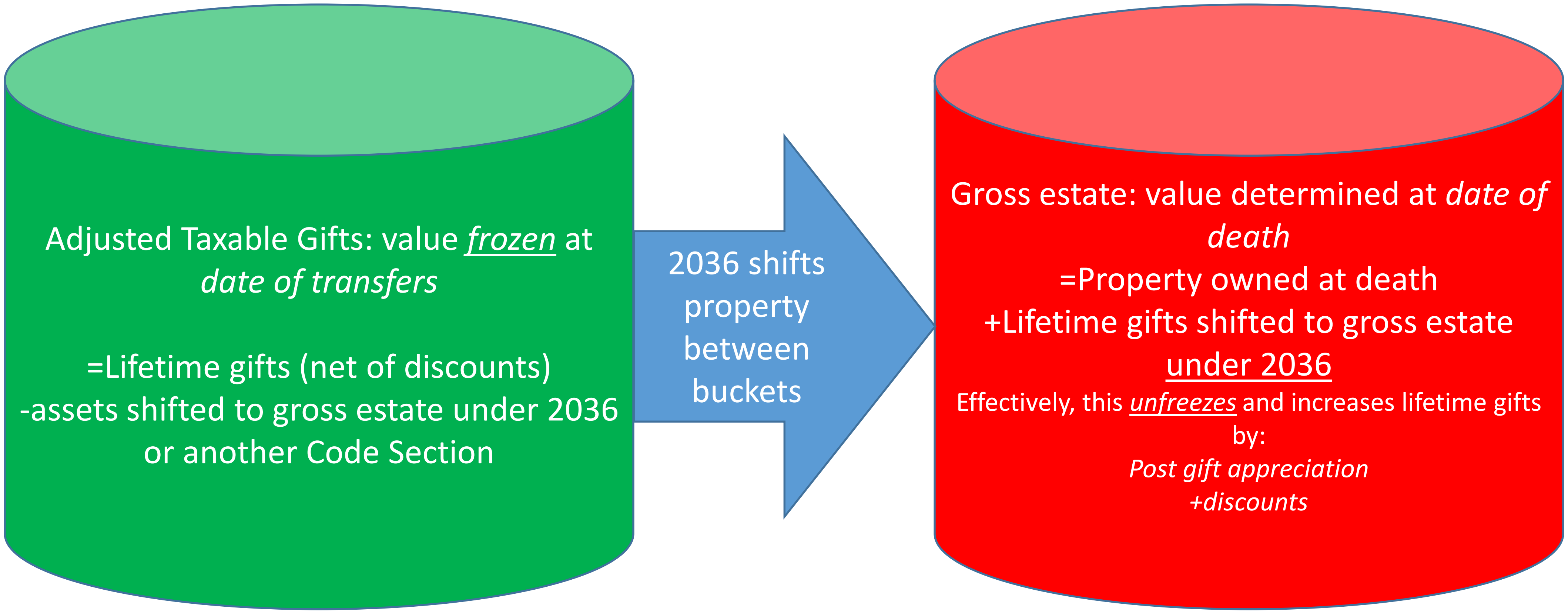
- 2036 is not a gift tax rule – it only applies to *estate tax* at the time of an individual's death
  - But, it often is applied on the heels of a transfer of assets which should have been fully or partially a gift for gift tax purposes
- It is a rule for determining the *estate tax value* of certain assets transferred subject to retained benefit and control during life
- The outcome? Transferred assets are included in the gross estate, at their date-of-death FMV
- The effect? The estate tax base (gross estate) is increased by:
  - Any prior discounts claimed for the FMV after a partnership exchange, and
  - Any growth in the value of the assets which occurred between the date of change of ownership, and the date of death
    - This extends to assets acquired in exchange for the originally contributed assets

Effect of Gifts

- Keep in mind that IRC 2036 is not a gift tax rule – it can apply even if all limited partnership interests are gifted away or sold by a decedent during life
  - *2036 powers do not cause a gift to be incomplete, unless the powers rise to the level of a retained nonfiduciary power of appointment*
- But, you should also keep in mind that the estate tax base *still includes lifetime gifts* – the difference is the value used
  - Lifetime taxable gifts are subject to estate tax using date-of-gift values
  - Gift tax paid within 3 years of death is subject to estate tax
  - Assets in the gross estate are subject to estate tax at date-of-death values (or the alternate valuation date, 6 months after date-of-death)
- The effect and intent of gifting limited partnership interests is *freezing* the value of the underlying partnership assets (through the interest received in exchange) at their discounted value for estate tax purposes

IRC 2036 - Effect

The effect of IRC 2036 is to unwind this value freeze, by including previously-gifted property in the gross estate at its date-of-death fair market value when the donor dies



IRC 2036 – When Does It Apply?

- 2036 has essentially two prongs in this context, found under 2036(a)(1) and 2036(a)(2) – we will refer to them as the (a)(1) and (a)(2) tests
- These tests look to powers and rights retained directly or indirectly after property is transferred by a decedent
  - <u>What is the (a)(1) test</u>? The retained possession or enjoyment (i.e. use) of property, or the right to receive income from property
  - <u>What is the (a)(2) test</u>? The right, *alone or in conjunction with another person*, to designate who might receive income from the property, or possess or enjoy the property
- BUT, if these powers and rights are present, they are ignored if the original exchange was a *bona fide sale for adequate and full consideration in money and money's worth*

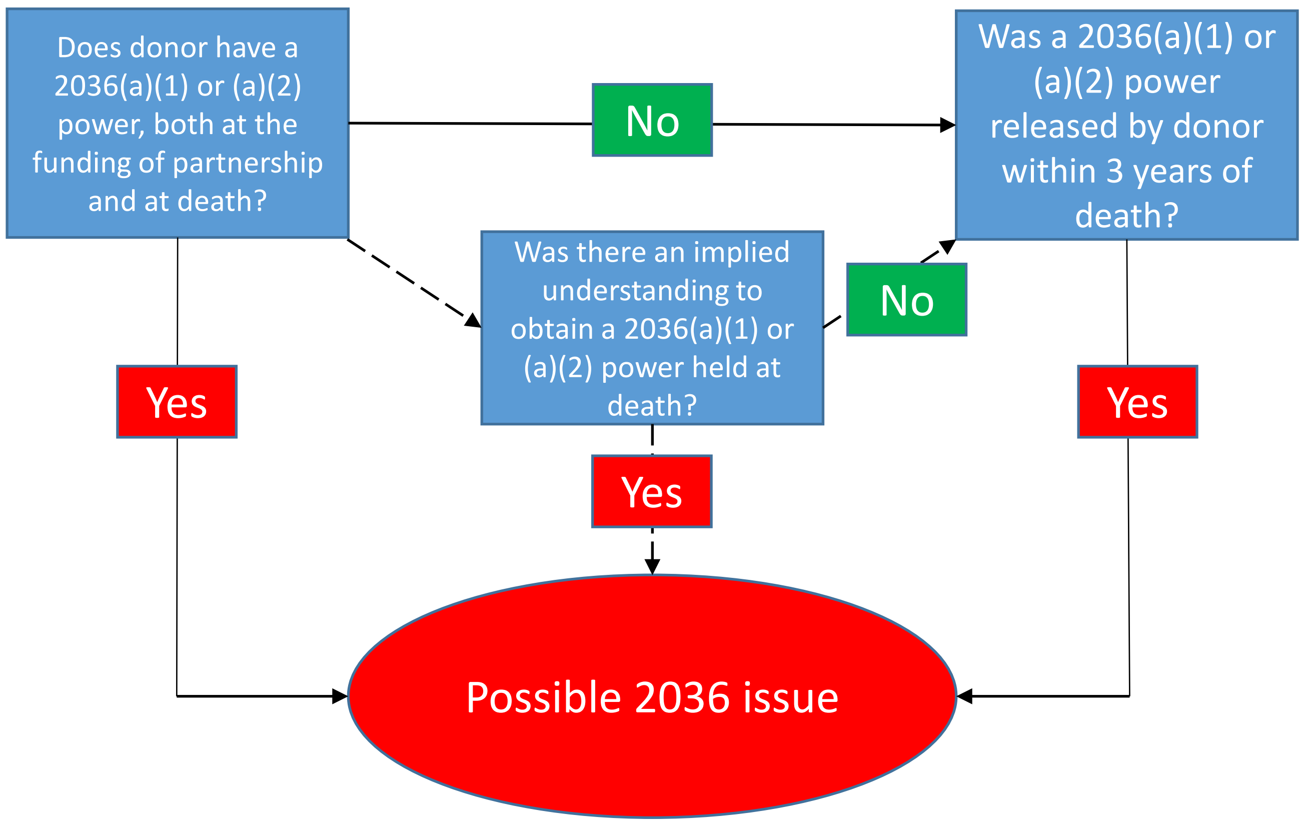
But Wait?

- Doesn’t a partnership interest, in and of itself, provide both income and control? Indeed, as we will see, these are conclusions of the cases out there
- But, as we will see, the income and control *of a partnership interest* is not enough by itself to fail 2036 – we need *stuff* added
- And, we can often claim a bona fide sale due to the exchange of partnership interests for contributed assets – to fail this test, we again need *stuff* added
- The cases in this area are mostly about the *stuff* that has to get added in, to either:
  - Fail the bona fide sale tests; or
  - Have a retained (a)(1) or (a)(2) power under 2036
- And, does it come as a surprise that the same *stuff* might apply in both areas?

IRC 2036 – Testing Period

- This retained benefit or control (the *stuff*) is usually tested at two points:
  - At the time of the initial change in ownership, and
  - At the later of death, or release of the retained benefit or control within 3 years of death
- But, failing the first prong is not fatal - if the IRS can show that, from the time of the initial change in ownership, there was an *express or implied understanding* to get back benefit or control at a later date, then 2036 can apply
  - This essentially adds a third testing point which *relates back* to the original change in ownership – this is the *stuff* that applies to an (a)(1) or an (a)(2) power
- If we have only a right of benefit or control that exists at death (or is released within 3 years of death) over assets previously owned by the decedent, this is covered more under IRC 2038 (which complements 2036) and which is not the focus of most cases in this area

IRC 2036 – Testing Period Illustrated



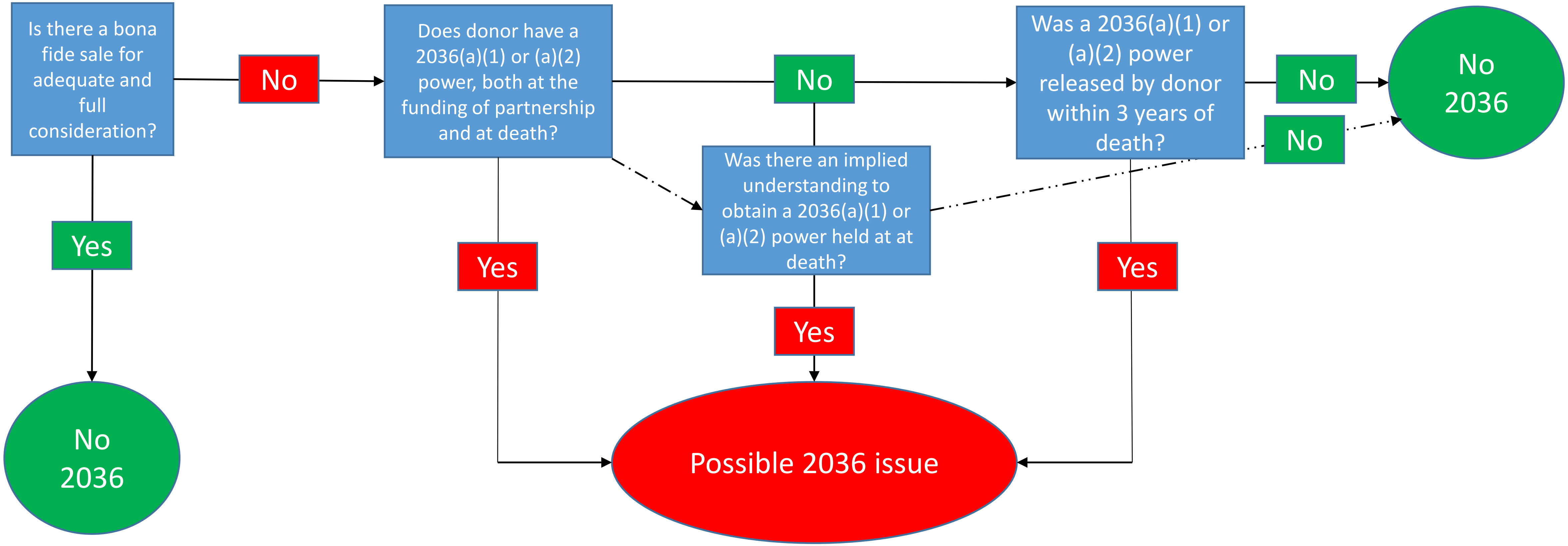
IRC 2036 – Key Cases

- In this presentation, I will not explain some of the key cases in this area, but will cite their principles where important
- Two key cases, *Powell* and *Strangi*, will have their principles peppered in throughout our discussion of 2036 without citation
- Other cases will pop up, such as *Byrum*, *Bongard*, *Thompson*, and others

IRC 2036 – Bona Fide Sale Exception

- For 2036 to apply, there usually has to be a full or partial gift as noted above
- Because of this, there is one important exception – 2036 does not apply if there is a *bona fide sale for adequate and full consideration in money or money's worth*
- Theoretically, this means if the FMV of the assets transferred to the partnership is less than or equal to the value of the partnership interest received, there is no 2036 issue
  - In other words, a change in ownership that does not deplete the gross estate should avoid 2036
- But, since a discount seems to be manufactured in the process of creating a family limited partnership, which does deplete the gross estate, does this mean there can never be a bona fide sale?
  - This is where that *stuff* comes in again, but first we turn our attention to our flowchart

IRC 2036 – Bona Fide Sale Qualifier



IRC 2036 – Bona Fide Sale

- There are several cases that have broken down the bona fide sale requirement, but it generally has two prongs:
  - A bona fide sale
  - Adequate and full consideration
- The mere existence of an equal or proportionate exchange, or an exchange that does not deplete the gross estate, is not enough to meet the requirements
- Instead, courts have taken things a step further to explore the intent and purpose behind the family partnership – this is the *stuff* we have been talking about

Intro to the *Stuff*

- The *stuff* deals with the facts and circumstances surrounding the family partnership, both in how it is established and how it is operated
- And, while the FMV of a partnership interest is determined at date of death, there can even be *stuff* after the date of death that affects the application of 2036
- Even if you do everything right in creating the partnership, the *stuff* surrounding not just the partnership, but also the situation and conduct of individual partners, can trigger 2036
- We will now look to some cases that examine this *stuff*

IRC 2036 – *Bongard* Case

- In *Estate of Bongard v. Commissioner* (2005), the Tax Court extrapolated on the first requirement – a bona fide sale – and explained that:

"[T]he bona fide sale exception is not applicable where the facts fail to establish that the transaction was motivated by a legitimate and significant nontax purpose."

- So, to have a bona fide sale, you must show that the creation and funding of the family partnership has a legitimate and significant nontax purpose

IRC 2036 – Nontax Purposes

- There are a variety of nontax purposes, such as (cases not cited):
  - Limited liability protection for creator(s) of partnership (this cannot be a significant purpose, especially if there are no claims being threatened)
  - Greater financial growth for family wealth by pooling assets
  - A centralized and more economical management structure for family assets
  - Avoiding fractionalization of family assets
  - Keeping a business in the family or promoting family harmony
- But, as you can imagine, these nontax purposes are driven by facts and circumstances, and there are some trends that improve optics:
  - The contributed assets actually require active management
  - The contributed assets are the type that can generate tort liability for the owner(s)
  - Actual liability claims have been threatened
  - The contributing partners have sufficient assets after the partnership is funded to maintain their pre-contribution lifestyle, or even to pay the taxes on transfers of partnership interests
  - The administrative costs would be lower than for individual, trust, or fractional ownership

IRC 2036 – At Arm's Length?

- Can an exchange between family members ever be a bona fide sale, when the waters can be muddied with a gift motive?
- The answer is yes, but the scrutiny of the transaction is heightened
  - There is no arms length requirement – this conclusion has been supported by cases such as *Thompson* and *Morrissette II*
- This gets more to a "sham" type of argument, which can apply if:
  - Partnership formalities are not observed
  - Family members don't participate in the negotiation, formation and/or operation of the family partnership
    - Be careful from an ethical perspective – who do you represent?
  - The same person is on both sides of the partnership formation
  - Other family members don't actually pool assets - instead there is unilateral funding

IRC 2036 – Adequate Consideration

- As noted above, the existence of a discount makes the question of adequate consideration tricky
- But, the most-cited case in this area tends to be *Kimbell v. U.S.* (2004)
- This case supported the proposition that a discount does not prevent adequate consideration, so long as the partnership interests are “proportionate” to the FMV of the assets contributed by all partners
- Consideration does not have to be monetary – *Kimbell, Thompson,* and *Morrissette II* stood for the proposition that intangible consideration such as “family harmony” can fill the discount gap and override the “heightened scrutiny” set forth in the last slide

IRC 2036 – Adequate Consideration

- Some cases before *Bongard* attempted to combine the two prongs of the bona fide sale test, and reached the conclusion that there could never be adequate consideration where there was a mere "recycling of value"
  - This usually applied where there was unilateral funding, instead of a genuine pooling of assets
- This theory was later questioned and rejected in cases such as *Thompson* and *Powell*

Recycling of Value

Before:

Contributor	Assets
Cash	$1,000,000

After:

Contributor	Assets
Partnership Interest*	$1,000,000

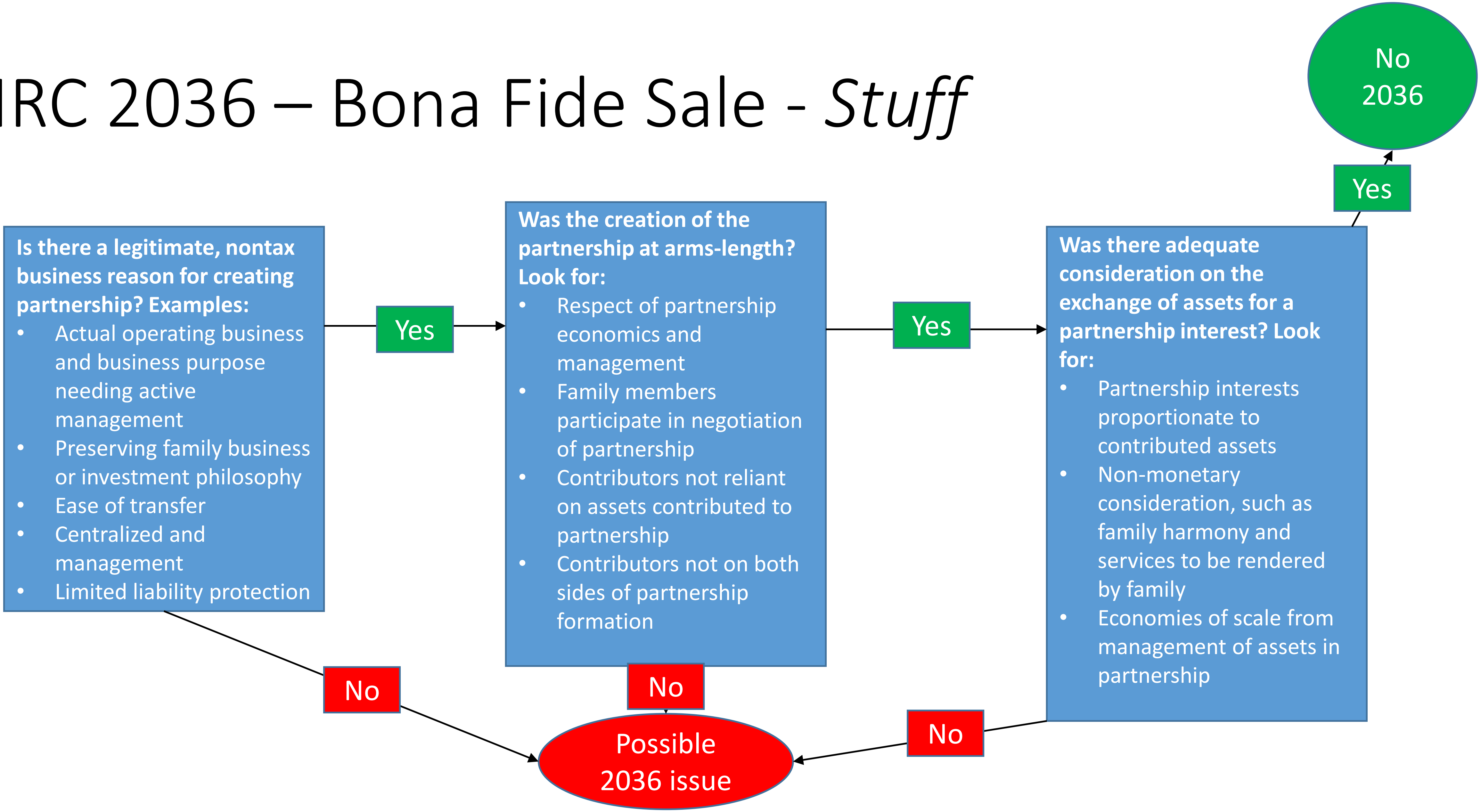
Partnership	Assets	Equity
Cash	$1,000,000	($1,000,000)

**while subsequently rejected, courts using this theory essentially treated the partnership interest as a sham, even if it was valid under state law, because it was just a proxy for owning the contributed assets (cash in this example)*

IRC 2036 – Bona Fide Sale - Conclusion

- Overall, it helps if there is are actual business or management operations being conducted, in which family members actually participate
  - Contrast this with passive management by a third party
  - ***When there is a contribution to an active business enterprise, adequate consideration may even be presumed (see TAM 200432015)***
- Check for intangibles, such as:
  - Family disharmony which the family partnership attempts to assuage
  - Specialized management or services of family members that cannot be found elsewhere, such as investment philosophies
- And, there is some alignment between veil-piercing issues, and the requirements in this context
  - Respect the partnership, from both an economic and management perspective, and maintain the right records

IRC 2036 – Bona Fide Sale - *Stuff*



Did You Know…

- …that often the *stuff* that makes you fail the bona fide sale test is going to be the same stuff that leads to an express or implied understanding of a retained 2036(a)(1) or (a)(2) power?

IRC 2036 – Express or Implied Understanding

- Assuming you fail the bona fide sale test, you must circle back to the question of retaining powers of benefit or control from the time of a partnership exchange through death
- Earlier, I mentioned these two testing times, and how a lack of retained benefit or control after the initial partnership exchange can be nullified if such benefit or control is later obtained
- To show this, the IRS must prove a contemporaneous understanding, either express or implied, to obtain benefit or control before death (more *stuff*)
  - More often than not, retained benefits and control are implied and not explicit
  - But, an *express* understanding can be found (regardless of partnership terms) if, for example, the contributing partner is on both sides of the partnership exchange (in an individual or fiduciary capacity)
- This goes back to the importance of following partnership formalities, especially as relates to distributions and maintenance of capital accounts

IRC 2036 – So No Distributions?

- Does this mean a partner who contributes capital cannot receive any distributions? Not necessarily. There tend to be extenuating circumstances which we will explain
- But, recall that contributing partners may also retain a general partner interest, which gives them management rights (which usually includes the right to declare distributions)
- Limited partners may also have a vote when a return of their capital is involved, such as a liquidation of the partnership (which often requires the consent of limited partners)
- As we will see, retained 2036 rights or powers are usually *implied* or *express* based on circumstances or conduct – they come into play when the distribution formalities are, or are likely to be, disregarded
  - Contrast this with express rights to income, or to vote on liquidation – these may not be enough by themselves without *stuff* as noted above

IRC 2036(a)(1) - Benefits

- As mentioned above, the (a)(1) test comes into play when a contributing partner has one or both of the following:
  - The right to possession or enjoyment of property contributed to the partnership
  - The right to income from property contributed to the partnership
- Note that this is a fine line – it is not the right to income from the partnership, but the right to possession, enjoyment, or income from *property contributed to the partnership*
- And, as noted, this becomes more of an *implied* outcome of conduct and circumstance

IRC 2036(a)(1) - Circumstance

- Often, when circumstance is involved, we see a situation where it appears that the contributor will have no choice but to continue to benefit from *property contributed* to the partnership
- How? By contributing most of their property to the partnership, or putting themselves in a situation where the partnership is their *primary* source of income
- This doesn't mean you can't rely on partnership income – this is why I emphasized *primary* above
  - Instead, will you need a return of partnership *capital* to satisfy debts and expenses, including anticipated estate tax liability?

IRC 2036(a)(1) - Circumstance

- Circumstance also looks to asset mix, which can counterbalance this test of reliance
- Where the partnership conducts active business operations that generate income, this is less of an (a)(1) circumstance than a contribution of cash or securities
- Similarly, the contribution of illiquid investments with a deferred return could also mitigate the assumption of retained benefit
- Question – does the partnership bear a greater resemblance to a business, or to an investment or retirement account?

IRC 2036(a)(1) - Conduct

- Conduct is fairly cut-and-dry – here are some examples:
  - A partner contributes a residence to a partnership, but continues to occupy and use it rent-free – this shows retained possession or enjoyment
  - A partner has the partnership pay their bills directly, or on-demand – this shows retained possession or enjoyment, or retained income
  - A partner receives disproportionate distributions of partnership income or capital – this shows retained possession or enjoyment, or retained income
  - Distributions are later recast as unsecured loans, with self-serving loan documents, which the contributing partner *may not have the means to repay*
- The overall consideration here is whether the partner has truly changed their relationship to the property being contributed to the partnership – if not, it is more likely that retained benefit will be implied
- And, even if the partners ratify these benefits, it shows a prearranged plan to retain benefits, especially if partners are family members, because it is assumed partners would not act against their own economic interests
  - Even a failure to contest such distributions by family members may be enough

IRC 2036(a)(1) – Conduct and Dynamics

- Do family members feel like they can say no? It doesn't matter what the partnership agreement says
- Keep in mind, sometimes, the *stuff* that comes into play here stems from testimony of family members in a Tax Court case
- "I wouldn't have said no to my dad if he needed extra money from the partnership." Well, guess what? This simple statement can create a 2036(a)(1) right
- Family dynamics matter more than you think, and can tip the scales either way

IRC 2036(a)(1) – Income Rights

- But, regardless of implied rights, there is one issue that appears to be both unresolved, and dangerous, in the many cases in this area
- That issue? That the express right to receive income from your partnership interest, even if in the discretion of a general partner, triggers the (a)(1) power
- *Strangi* determined that this was the case, but *Thompson v. Commissioner* (3rd Cir. 2004) found that the mere right as a partner to receive income was not enough
- So what is enough?
  - Remember the splitting hairs analysis – there is a difference between partnership income, and income generated by assets contributed to the partnership…

IRC 2036(a)(1) – Income Rights

- The issue with income rights popped up in *Strangi* because of the general partner's status as the decedent's attorney-in-fact
- *Thompson* clarified that this only happens when the decedent themselves, through an attorney in fact, can obtain partnership income with no restrictions, and in fact the attorney in fact may have a superseding fiduciary duty to *make sure* the income is distributed!
- Recall that you need an *express* or implied understanding, and in this context, the courts have equated an *express* reservation of partnership income (by sitting on both sides) with the (a)(1) right to income
- Presumably, income shouldn't be an issue, even if the decedent was the general partner – *Thompson* notes that even where the income distributions are "all but guaranteed" this shouldn't matter
  - As we're going to see, this is an issue that bled over into retained control and conflicting fiduciary duties…

IRC 2036(a)(2) - Control

- Under the (a)(2) test, retained control is a bit more tricky
- But, to start, there is one overall qualifier – the right alone, *or in conjunction with others*, to control income, possession, or enjoyment of property contributed to the partnership
- Again, though, I want to remind you – this has to do not with control of the partnership, but with control of *property contributed to the partnership* by the individual who has or shares control
- But this means it does not matter if a contributing partner shares power with other partners, or lacks majority control – the mere power to act with others is enough

IRC 2036(a)(2) – Fiduciary Duties

- As a segue from the distinction of partnership control versus property control, it is important to note that official management of any entity may be subject to fiduciary duties
- For example, a general partner has to act in the best interests of the limited partners, and majority interest partners may have a duty not to oppress minority interest partners
- The key case in this area is *U.S. v. Byrum* (1972), in which the retained right to vote the majority of stock was not deemed to be an (a)(2) power
    - The IRS tried to claim that the voting rights could allow the decedent to name directors and have them distribute all income to him
    - But, the U.S. Supreme Court disagreed, noting that fiduciary duties of directors would prevent such an abuse

IRC 2036(a)(2) – Fiduciary Duties

- *Byrum*, however, had some interesting facts that are distinguished in creating the presumption of director- and shareholder-level fiduciary duties (more *stuff*):
  - Minority shareholders who were *unrelated*
  - An active business enterprise, subject to market forces, to be supported by income and reserves before dividends could be declared
  - An independent trustee of the trusts over which the decedent maintained voting control, who would intervene to determine if dividends to the trust would be distributed or accumulated
- Overall, what cases after *Byrum* have concluded is that the fiduciary duty argument may not work within an *intrafamily investment vehicle*
  - And, this is consistent with other holdings – fiduciary duties are usually ignored in cases of general powers of appointment held by a decedent, or acting as trustee of a trust to which a decedent contributes property, unless limited by an *enforceable* ascertainable standard

IRC 2036(a)(2) – Fiduciary Duties

- Extrapolating on intrafamily fiduciary duties, there are some other interesting tidbits to note:
  - If a partnership distribution right is held by an attorney-in-fact for the contributor of property, and the attorney-in-fact creates the partnership on the decedent's behalf, the fiduciary duties of the attorney-in-fact may override the partnership-level duties under the (a)(2) test (and may make the income right become an (a)(1) right)
  - Regardless of *Byrum*, if a corporation is the GP of the partnership, the same look-through analysis of fiduciary duties and roles of family members may apply
  - Fiduciary duties may not matter when the decedent can act with family members to retain control, even as a limited partner, because the weight of case law may imply an understanding to act in concert under the *right circumstances* (especially when family members do not contribute their own assets)
    - Note that this does not create a presumption of family voting attribution – this requires the *stuff* of an express or implied understanding to retain control

IRC 2036(a)(2) – Liquidation Rights

- Which brings us to perhaps the main right which has become the focus of cases – the LP vote to liquidate the partnership, resulting in a return of capital
- This is common in most partnerships, where liquidation usually requires the consent of some or all limited partners
- This right is not enough by itself, but is invoked when there is also a retained right (directly or indirectly) to direct distributions from the partnership
  - Recall this generally arises where the decedent is on both sides of the transaction, especially where an attorney-in-fact is involved
- This is also circumstantial, as follows

IRC 2036(a)(2) – Liquidation Rights

- Some of the circumstances which have included the liquidation vote in the (a)(2) rights include:
  - Decedent holding a 99% LP interest in a partnership;
  - The decedent's attorney-in-fact acting as GP; and
  - The attorney-in-fact creating the partnership.
- These factors again invoke the superseding fiduciary duties of the attorney-in-fact to the decedent, while also assuming that since the decedent was the only partner at formation, the attorney-in-fact would act in the decedent's (and not the partnership's) best interest

IRC 2036 - Conclusion

- As noted above, there is some crossover in *stuff* counted in determining a bona fide sale for adequate consideration, and in determining the retention of an (a)(1) or (a)(2) right
- *Powell* and *Strangi* seem ominous, but the central issue in both from a 2036 perspective was the fact that an attorney-in-fact created the partnership in both cases
  - If you remember nothing else, remember that the fiduciary duties of the attorney-in-fact to the principal supersede any fiduciary duties owed by the attorney-in-fact to other partners
  - This again creates the *stuff* leading to retained benefit or control

IRC 2036 – What is Included?

- Remember that 2036 is a rule that includes the *contributed property* in the gross estate
- But, remember the fruit of the initial exchange – the partnership interests received
- If you fail the bona fide sale test due to inadequate consideration, does this mean you double-count the relinquished assets and consideration received in exchange?
  - After all, there is still a state law partnership interest included in the gross estate, and 2036 does not mean we can ignore its existence
- The answer is no…

IRC 2043 - Intro

- This is where IRC Section 2043 comes into play
- This Code Section subtracts, from the gross estate, the exchange consideration received for assets pulled back into the gross estate
- Thus, for example, if property contributed to a family partnership is included in the gross estate, you get to subtract the value of any partnership interest from the amount to be included in the gross estate (to the extent that partnership interest was received in exchange for the included property)
- But, the question is at what value?

What is Included?

Before:

Contributors	Assets
Cash	$1,000,000

After:

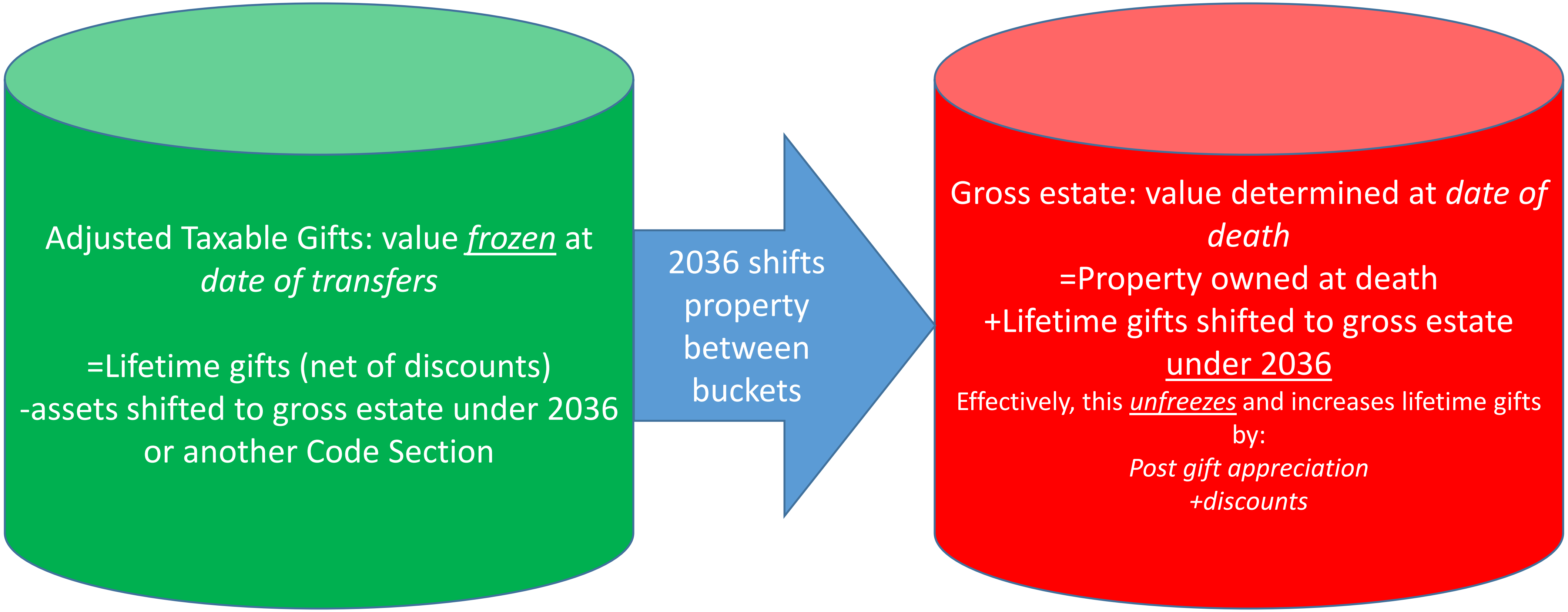
Contributor	Assets
General Partner (1%)	$10,000 GP Interest
Limited Partner (99%)	**$990,000 cash***
Limited Partner (99%)	**$643,500 LP interest**

Partnership	Assets	Equity
Cash	$1,000,000	($1,000,000)

**As we will find out, we don't necessarily net out this double-inclusion but we look back to the initial exchange...*

IRC 2043 - Background

To understand 2043, it is helpful to again understand value freezes and their effect on the estate tax base, which consists of two buckets – the gross estate, and adjusted taxable gifts



IRC 2043 - Operation

- 2043 applies where:
  - Property is included in the gross estate under IRC 2035-2038, or 2041
  - There is no bona fide sale
  - However, there was consideration received, even if not adequate
- In such a case, all you include in the gross estate is the positive difference between:
  - The FMV of the property pulled back into the gross estate, over
  - The value of the consideration received
- This relates back to our discussion of the initial "exchange," but the question is what *value* is used for the consideration received

IRC 2043 – Value Consideration

- The intent (as set forth in *Powell*) of 2043 is to only apply to the extent there is depletion of the gross estate
  - Recall again, under the *Bongard* test, if the only depletion of the gross estate is the discount, there is a bona fide sale as long as there is a significant and legitimate nontax purpose
- But, *Powell* clarifies that the value of consideration received is the value as of the date of transfer (i.e., the gift tax value)
- To put it more plainly, from our prior illustration:
  - Relinquished property subject to 2036 gets the red bucket value
  - Consideration received for the relinquished property gets the green bucket value (i.e., the value it had at the time of the initial exchange)

IRC 2043 – Effect

- The overall effect is the addition to the gross estate of the discount claimed, plus post-transfer appreciation of the property being included in the gross estate and any annual exclusions claimed
- The reclaimed discount under 2043 is referred to in *Powell* as the "doughnut hole"
- BUT THERE IS A CATCH – what if the decedent no longer owns the partnership interest at death?
  - This was another tension solved by *Powell* – the consideration received does not have to be included in the gross estate, since we use the value of consideration at the date of the *initial exchange*
  - *Powell* also rejected some prior holdings that implied that the partnership interest would not be valid consideration under 2043, as a mere "recycling of value" when there is no pooling of assets, because the question of "pooling of assets" relates more to a significant nontax reason that the adequacy of consideration

IRC 2036 and 2043 – Conclusion

- The key point that tends to get lost here is that it does not matter whether partnership interests are gifted
  - In fact, a number of cases have revolved around the claim of a discount for *estate* tax purposes, in especially egregious circumstances (like the retention of a 99% LP interest at death)
- Even if there are gifts, 2036 *relates back* to when the partnership was funded, to include the decedent's *capital contributions* in the gross estate but <u>at date-of-death FMV</u>
  - To state it differently, 2036 relates back to the exchange which created the *discount*
  - If the initial exchange did not create the discount (such as the creation of a single-member LLC), any subsequent gifts may be the point at which we start the clock on 2036
- And, where 2043 is involved, it also *relates back* to the time of the exchange to subtract the initial value of the partnership interests received in the exchange (regardless of whether or not still owned by the decedent at death) from the 2036 value of the capital contributions, but <u>at date-of-exchange FMV</u>

Bringing it Home

- Themes tend to emerge, and the many cases in this area are littered with *stuff* that tends to show abusive transactions
- Here are some key points to remember to avoid the *stuff*:
  - Plan early – deathbed transfers, especially if done through an attorney-in-fact, tend to fall short, especially if the partnership assets do not require active management
  - Respect the partnership – veil-piercing factors also have utility in the arena of 2036 and family partnerships
  - Pool assets – when there is one substantial contributor to a family partnership, it is harder to claim a nontax reason, and the IRS could also collapse steps to treat donee partners as receiving undiscounted gifts of assets and then contributing to the partnership (see *Shepherd*)

Bringing it Home (Continued)

- Here are some more key points to remember:
  - Active management – While you don’t necessarily need an active business or participation by the partners, it helps if there is a need for active management
  - Avoid trust optics – When the contributing partner maintains trust-like rights to income, and the return of capital, these increase 2036 risk – can the business needs of the partnership be equated with an ascertainable standard?
  - Consider outside owners – Having outside, unrelated owners with more than nominal equity increases the possibility that fiduciary duties would foreclose the application of 2036
  - Articulate a purpose – When creating the partnership, it helps to document the nontax purposes for creating the entity, and possibly to quantify them (for example, what is the scope of liability exposure you wish to avoid? What are the cost savings in management expenses?). But, make sure operation of the partnership reflects these purposes

Bringing it Home (Continued)

- Here are some more key points to remember:
  - Make proportionate distributions – Document the partnership's income, create resolutions to declare distributions to *all* partners, and avoid preferential distributions to the contributing partner
  - Leave contributor solvent – Avoid contributing so much of the contributing partner's assets that it is likely that such partner, or the partner's estate, will rely primarily on the income of the partnership
  - Don't pay funeral expenses – A number of courts have cited the payment of funeral expenses, estate taxes, or other expenses of the contributing partner's estate, from partnership capital as a factor in applying 2036 principles
  - Beware other economic benefits – Avoid other economic benefits, like rent-free use of partnership property by the partners, or the use of partnership property to secure debts of a partner

QUESTIONS?

- Send questions* and topic suggestions to griffin.bridgers@gmail.com
  - *Please note that I cannot give tax or legal advice*