

# DISCOUNTING TRANSFER TAXES WITH LIMITED LIABILITY CORPORATIONS AND FAMILY LIMITED PARTNERSHIPS<sup>1</sup>

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## Introduction

It has been suggested that estate and gift taxes are voluntary taxes since careful planning can go a long way to avoiding them. [ Cooper, A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance, 77 Colum.L.Rev. 161 (1977). ] While historically this may have been true, revisions to the Internal Revenue Code over the last several years have made it increasingly difficult to avoid transfer taxes.

Nonetheless, significant planning opportunities do remain. An increasingly popular technique is to structure the ownership of assets so as to reduce their value for transfer tax purposes. This can be done in a variety of ways, including by retaining a qualified retained interest in the property, [ I.R.C. § 2702, Treas. Reg. § 25.2702 et. seq.] by shifting subsequent appreciation in the value of the assets to members of a younger generation, [ I.R.C. § 2701, Treas. Reg. § 25.2701 et. seq.] and by creating an opportunity to claim valuation discounts. This article describes how family limited partnerships ("FLPs") and limited liability corporations ("LLCs") can be used to create valuation discounts.

## Family Limited Partnerships

An FLP is a partnership which is created between family members of a senior generation (parents) and a younger generation (children or grandchildren). The partnership is created when business or investment assets are contributed in return for partnership interests.

Typically, the partnership issues both general and limited partnership interests. The person holding the general partnership interest has the sole authority to manage and control the partnership assets. [ RULPA § 403.] Persons holding limited partnership interests are entitled to assets upon termination of the partnership in proportion to their partnership interests, but have no voice in management. [ RULPA § 604.] In this regard, limited partners are similar to holders of non-voting corporate stock.

A partnership is not considered to be a separate taxpayer for federal income tax purposes. [ I.R.C. § 701.] Rather, all income is taxed to the partners based upon their distributive shares. [ I.R.C. § § 701, 702.] Likewise, any income tax deductions (such as depreciation) flow through to the partners [ I.R.C. § 702.] . A general partner is under no obligation, however, to distribute any of the partnership income (unless the partnership agreement so provides). [ RULPA § 601.]

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<sup>1</sup> This article is current as of October 1995. Please contact Willms, S.C for current information on this topic.

## **Limited Liability Corporations**

In simplest terms, an LLC is an unincorporated business entity which, when properly structured, is taxed in the same manner as a partnership. [ Rev. Rul. 88-76, 1988-2 C.B. 360. See also, Treas. Reg. § 301.7701-2(a).] Ownership of the LLC is represented by membership units. Like a partnership, a combination of voting and non-voting membership units may be issued. However, unlike a partnership, an LLC can shield the personal assets of all of its members from liability for the LLC's debts, just as though they were shareholders of a corporation.

## **Estate Planning with FLPs and LLCs**

The use of FLPs or LLCs has become increasingly popular in recent years because of the tax and non-tax benefits that can result from their use. These benefits include:

1. With an FLP or LLC, it is possible for a person to reduce his or her taxable estate by making annual gifts without surrendering control of the underlying assets. For example, a parent may give non-voting membership units in an LLC to children and still maintain control as the only voting member. To the extent these gifts are sheltered from tax by the unified credit or the annual exclusion, they are tax free. [PLR 9415007; TAM 9131006.] These gifts can qualify for the annual exclusion from the generation-skipping transfer tax as well. [ See I.R.C. § 2642(c).]
2. FLPs and LLCs also allow gifts without having to divide the gifted asset amongst the donees. For example, if an LLC is funded with securities, the investments can continue to be managed as a single portfolio, with children merely receiving an undivided interest in that portfolio.
3. FLPs and LLCs can encourage people receiving gifts to be productive since there is no obligation to distribute income to the donees, unless the operating agreement directs otherwise.
4. FLPs and LLCs can lower income taxes, if the income of the donee is taxed at lower rates than the donor, since a proportional share of the FLP's or LLC's income will "pass through" and be taxed at the donee's lower rate. This is true even for income which is not distributed.
5. FLPs and LLCs may, to some extent, protect the gifts from claims of a donee's creditors or claims of a donee's former spouse in the event of divorce, because in most states a creditor's remedy against the gifted interest is limited to a "charging order" against the interest. [ RULPA § 703; Wis. Stat. § 183.0705 (1993-1994); N.Y. Limited Liability Company Law § 607 (McKinney 1994).]

- a. Such an order allows the creditor or former spouse of the donee to receive distributions made with respect to the gifted interest (if any), but they cannot attach the gifted interest itself.
  - b. Because a member of the donee's family will normally control the amount and timing of the distributions, the creditor or former spouse would receive an asset of relatively little value.
  - c. Furthermore, the creditor or former spouse would be treated as the owner of that portion of the gifted interest for income tax purposes. Therefore, former spouses and creditors may be very reluctant to attach the gifted interest and be taxed on income that may not be distributed.
6. The value of gifts of LLC or FLP interests may be discounted to reflect (i) restrictions found in the partnership agreement or operating agreement on the partner's/member's right to compel liquidation, and (ii) the lack of a ready market for the partnership/LLC interests.

Because of the liability protection it affords, an LLC may be preferable to an FLP if the asset to be transferred is an interest in an active trade or business, or an asset that could be the basis for litigation (such as environmental hazards, personal injury claims, and the like).

### **The Availability of Valuation Discounts**

When gifts are made of interests in an FLP or LLC, a fair market value must be assigned to the transferred interests in order to determine the gift tax consequences of the transfer. "The fair market value is the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts". [ Treas. Reg. § 1.170A-1(c)(2); See also, Estate of Bright v. United States, 658 F2d. 999 (5th Cir. 1981).]

There are a variety of approaches that are use to determine the value of a business interest. These include the income approach, the market approach and the asset approach. [ See generally, Wozencraft and Rich, Valuation of Family Limited Partnership Interests, National Business Institute, Inc. (Nov. 1994). See also, Rev. Rul. 59-60, 1959-1 C.B. 237.] A variant of the income approach is known as the discounted cash flow ("DCF"). Under this approach, the cash flow generated by the FLP or LLC interests along with the residual value of the FLP or LLC interests upon liquidation are discounted to their present value using an appropriate rate of return. [ A thorough discussion of the discounted cash flow approach can be found at U.S. Trust Company of New York, Practical Drafting at pg. 4156 - 4165 (R. Covey, ed., October 1995). ] This approach may be appropriate when information on comparable publicly traded companies is not available and the FLP or LLC being valued has a predictable cash flow.

When estimating the cash flow generated to an FLP or LLC interest, the person assigning the value to the FLP or LLC interest should consider the ability of the underlying assets to generate an income stream, the history of cash distributions and the intent of the partners/members regarding distributions. The operating agreement should address these issues.

Once a preliminary value of the donated interest has been ascertained, a determination must be made as to whether that value should be reduced by discounts. In regard to the gift of an interest in a partnership or an LLC, there are two principal discounts that could apply.

First, there is a discount when the interest transferred represents a minority interest. This discount reflects the lack of control of a minority interest holder. When the income approach is used to value the FLP or LLC interest, this discount reflects the inability of a minority interest holder to compel income distributions, unless the operating agreement directs otherwise. Accordingly, this discount may, at least in part, already be accounted for when estimating the cash flow the holder of a minority interest in the FLP or LLC will receive. [ See, e.g. , Estate of Jung v. Comm'r, 101 T.C. 412 (1993).]

The courts have long recognized that a minority discount can be obtained for a transfer of a minority interest to a member of the donor's family even though the donor's family controls the entity. [ See, e.g. , Propstra v. Commissioner , 680 F.2d 1248 (9th Cir. 1982); Estate of Bright v. Commissioner , 658 F.2d 999 (5th Cir. 1981); Estate of Andrews v. Commissioner , 79 T.C. 938 (1982); Estate of Lee v. Commissioner , 69 T.C. 860 (1978), nonacq ., 1980-2 C.B. 1.] Even so, the IRS had, until recently, asserted that minority interest discounts in a family control entity were not appropriate. However, the IRS reversed its position when it issued Revenue Ruling 93-12. [ Rev. Rul. 93-12, 1993-1 C.B. 202, revoking , Rev. Rul. 81-253, 1981-2 C.B. 187.]

Second, there is a discount when the interest transferred cannot be easily sold or converted to cash. This discount reflects the fact that because there is no ready market for an interest in a family controlled limited partnership or LLC, a person wishing to sell such an interest may have to accept a lower sale price to attract a buyer. This discount also reflects the fact that the operating agreement can impose significant restrictions on the ability to transfer the FLP or LLC interest to third persons.

It should be noted that minority interest and lack of marketability discounts can also be utilized to reduce estate taxes. For example, if a member of a senior generation makes a series of gifts of minority interests in an FLP or LLC during his or her lifetime, the value of these gifts can be discounted for gift tax purposes. [ Rev. Rul. 93-12 1993-1 C.B. 202; TAM 9449001.] If, as a result of these gifts, the senior generation member owns a minority interest in the FLP or LLC at the time of his or her death, then the minority interest discount will apply also to the valuation of the FLP or LLC interests held by the senior generation partner/member at death. [ PLR 9432001.]

The following characteristics of an FLP should be considered in assessing the amount of the discount claimed for lack of control and lack of marketability. [ Wozencraft and Rich, supra note 13.]

- Nature (limited or general) and size of the interest;
- Level of control exerted over the entity and its assets by the person receiving the interest;
- Potential for distributions and any requirements related to distributions and allocations in the governing instrument;
- Evidence of a ready market for the FLP or LLC interests, if any;
- Nature of the underlying property held by the FLP or LLC, including price volatility, income generating potential and marketability;
- Restrictions found in the governing instrument on the sale and transfer of an interest in the FLP or LLC;
- Terms of the agreement;
- Imminence of liquidation or dissolution;
- Access to information concerning the FLP or LLC and its business activities, and
- Miscellaneous general provisions, including:
  - cash calls
  - voting rights and ability to influence management
  - ability to force dissolution or liquidation

The discounts that apply when gifts of limited partnership interests are made may be offset in part when the general partnership interests are transferred because a control premium may apply at that time. [ See PLR 9436005; Estate of Winkler v. Commissioner , 58 T.C.M. (PH) 231 (1989).] A partial listing of post 1988 cases involving minority interest discounts and the amount of discount allowed can be found in the October 1995 issue of Practical Drafting Magazine. [ U.S. Trust Company of New York, Practical Drafting at pg. 4128-4130 (R. Covey, ed., October 1995).]

## Disallowance of Valuation Discounts

An FLP or LLC governing instrument normally restricts a partner's/member's ability to withdraw from the FLP or LLC, prevents the termination of the FLP or LLC before the expiration of a set term, limits the junior generation's ability to participate in management, and restricts the transferability of partnership interests. As mentioned above, these restrictions can significantly reduce the value of limited partnership interests for transfer tax purposes. Even so, absent careful planning the Internal Revenue Code may disregard these restrictions and hence disallow the discounts claimed when valuing FLP or LLC interests for transfer tax purposes.

I.R.C. §2704(b) provides that if there is a transfer of an interest in an FLP or LLC and the FLP or LLC is controlled by the donor's family, then "applicable restrictions" imposed by the operating agreement are to be disregarded when valuing the gifted interest for transfer tax purposes. [ See also, Treas. Reg. § 25.2704-2(a).] A family limited partnership will be controlled by the donor's family if the donor or his family own at least 50% of the capital or profit interests in the partnership (or, presumably, an LLC), or the donor or his family hold an equity interest as a general partner. [ Treas. Reg. § 25.2701-2(b)(5).] Thus in most cases, where an FLP or LLC is created for estate planning purposes, the possible impact of I.R.C. §2704(b) must be addressed.

If I.R.C. §2704(b) applies, the gifted interests will have to be valued for transfer tax purposes as if the donee could withdraw from the FLP or LLC at any time and receive fair market value for his or her ownership interests. However, assuming the FLP or LLC is controlled by the donor, a restriction on a partner's right to withdraw will be disregarded under §2704(b) only if it constitutes an "applicable restriction." [ Id.] An applicable restriction is one which is more restrictive than the limitations that would otherwise apply under applicable state law and which can be removed by the transferor or any member of his or her family. [ Treas. Reg. § 25.2704-2(b).]

### State Law Exception

Treas. Reg. §25.2704-2(b) states that a restriction that is less restrictive than those that would apply under state law will not be an applicable restriction under §2704(b). However, the Code itself says that the restriction must be "imposed" under state law in order to avoid application of §2704(b).

### LLCs

It is very important to carefully select the state in which an LLC is to be established if valuation discounts are to be claimed because the state laws governing limited liability corporations vary significantly from state to state. Some state LLC statutes permit members of an LLC to withdraw their contributions from the LLC at any time but hold the members liable for damages if the withdrawal is in violation of the operating agreement. Other states provide that the members may withdraw their contributions at any time unless the

operating agreement provides otherwise. Further, many states allow the operating agreement to specify the amount the withdrawing member is entitled to receive upon withdrawal in violation of the operating agreement or the damages recoverable in the event of a withdrawal that violates the operating agreement.

### Partnerships

Under the Revised Uniform Limited Partnership Act, a limited partner does not have a right to withdraw from a partnership if the partnership agreement provides that the partnership is to continue for a stated term. Accordingly, as in the case of an LLC, while most states allow a partnership to restrict a limited partner's right to withdraw when a partnership is for a specified term, many states do not actually impose this restriction. Therefore, caution must be exercised when selecting the appropriate state as the place for creation of the partnership in order to avoid this pitfall.

### Family Control Exception

Another way to avoid application of I.R.C. §2704(b) is to have the partnership agreement or LLC operating agreement restrict an interest holder's right to withdraw, to provide that restrictions found in the agreement can only be removed with the consent of all persons holding an interest in the FLP or LLC, and, further, to arrange for a non-family member to hold an interest in the FLP or LLC. In this event, the restriction could not be removed solely by members of the family, and, accordingly, the restriction would not constitute an "applicable restriction." [I.R.C. §2704(b)(2)(B)(ii).] Note, however, that state law could invalidate such a restriction. Therefore, careful consideration should be exercised when selecting the state whose laws will govern the operation of the LLC or FLP.

The term "member of the family" is defined by §2704(c)(2). Basically it means a spouse, lineal descendent, sibling or spouse of a lineal descendent or sibling. [Treas. Reg. § 2704-2(b); I.R.C. § 267(b).] In this regard, it is important to note I.R.C. §2704(c)(3) applies "family attribution rules" to the application of certain aspects of I.R.C. §2704. However, it seems clear that those attribution rules apply solely for the purpose of determining who holds an interest in the partnership and not when determining who "members of the family" actually are.

### **Business Purpose Doctrine**

An important issue that must be addressed when using a partnership or an LLC to effectuate lifetime gifts is whether the partnership has a demonstratable business purpose, [I.R.C § 2201.] I.R.C. §7701 and the regulations issued thereunder make clear that for a partnership to be respected for tax purposes, it must have an objective to carry on activities as a venture for profit. [Treas. Reg. § 301.7701-3.]

In numerous court cases, the IRS' has attempted to rely on the lack of a business purpose for creating the FLP or LLC as a basis for denying valuation discounts. While the IRS has

been largely unsuccessful in these attempts, it is prudent nonetheless to make sure that a valid business purpose for the FLP or LLC can be demonstrated and well documented.

### **Conclusion**

Valuation discounts create tremendous opportunities for reducing both gift and estate taxes. FLPs and LLCs can be very effective ways to take advantage of these discounts. However, absent careful planning, Chapter 14 of the Internal Revenue Code can result in the disallowance of these discounts. Accordingly, extreme caution must be exercised in connection with both the provisions of the applicable governing agreement itself as well as the provisions of governing state law if the claimed discounts are to withstand IRS scrutiny.