An Introduction to Family Limited Partnerships

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A. The Magic—Why we are talking about Family Limited Partnerships and what they can accomplish for our clients?

1. Ability to transfer assets, simply and easily, to a family’s younger generation, and capture subsequent asset appreciation in that younger generation, while allowing the senior generation to retain substantial control over the assets

A family limited partnership allows fractional interests held by individuals or entities to be controlled by the general partner(s). Further, many successful clients fear that substantial gifts to descendants may hinder their productivity and initiative. In particular, clients with a substantial portfolio of stocks and bonds believe that giving a child or grandchild a readily marketable asset would not be doing that child any developmental favors. Most clients believe that no one understands their children better than they do. By creating a family limited partnership and transferring only a limited partnership interest to a descendant, a donor controls the marketability of the wealth transferred because the interest effectively cannot be sold and because the donor can reinvest the partnership’s cash flow rather than making distributions to the partners.

2. Keeping assets in the family

Family partnership agreements often are drafted with certain buy-sell provisions to ensure that the partnership’s assets will stay in the family. Under such provisions, if any partner attempts to assign his or her interest in the partnership to a person outside of the family, the other partners or the partnership itself may acquire that interest on the same terms, or, in the case of a gratuitous transfer, at its fair market value. Secondly, even without buy-sell provisions, no outsider can have any rights as a partner unless all of the
partners admit that outsider as a partner (and can only be an assignee with limited
distribution rights). 1

3. **The pooling of partnership assets may lower operating costs and increase
diversity**

Families often have many members, and often several trusts have been created over time in conjunction with prior gifts. Keeping up with investments for multiple parties can be frustrating and expensive. Consolidating assets into one partnership may solve these condition and management problems. It is easier and cheaper for a partnership comprising assets of several trusts, business entities and individuals to diversify investments because the greater size of its portfolio. Likewise, it is easier and cheaper to diversify across several money managers because larger accounts generally are less expensive on a percentage basis and because minimum size requirements are more easily met. Thus, over time, the pooling of assets will lead to greater value and wealth for all of the partners. For investors who are not concerned with short-term lack of control and marketability, and who wish to realize long-term growth of their assets for themselves and their family, the family partnership is an excellent institutional tool.

4. **Simplification of annual giving**

Many assets are difficult to value and not easily gifted as undivided fractional assets. Rural land and closely held unincorporated business are good examples. Contributing those assets to a family limited partnership, however, allows a donor to assign partnership interests to a descendant with the use of a simple form. A fractional interest is given away by gifting an interest in the partnership; yet there is no immediate risk of partition of the asset, and management of the asset remains consolidated. If a client wishes to transfer part of his limited partnership to his issue, it generally will qualify for the annual exclusion.

5. **May provide some protection against future unforeseeable creditors**

A family partnership may be a flexible vehicle to provide some protection of an individual’s assets from future creditors. The principal remedy of a partner’s creditors is to acquire a “charging order” against the partner’s interest in the partnership. Under many states’ limited partnership laws (including Pennsylvania’s), unless a partner has made a fraudulent conveyance to the partnership or a conveyance deemed to be fraudulent, his or her creditors cannot reach the partnership’s assets. Instead, a creditor may obtain a charging order against the partner’s interest in the partnership, which does not give the creditor any management rights but entitles the creditor only to the partner’s share of partnership distributions (i.e., an assignee’s interest). It should be noted that

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1 A recent case denied the annual exclusion for gifts of LLC interests where it was held that the LLC’s operating agreement “clearly foreclosed the donees’ ability to realize any substantial present economic benefit.” See Hackl v. Comm., 92 AFTR 2d 2003-5254 (335 F3d 664 (7th Cir. 2003).
obtaining a charging order exposes a creditor for the pro rata share of the partnership’s tax liability.

In addition, the partnership agreement may be drafted so that an involuntary transfer of a partnership interest to a creditor or any other third party triggers buy-sell provisions which allow the other partners or the partnership itself to purchase that interest at its fair market value. Since the fair market value of a limited partnership interest is usually much less than the underlying asset value, the creditor effectively is paid with less money, and the family assets are more likely to survive the creditor’s claims. Furthermore, partnership agreements can be drafted to prohibit the pledging of partnership interests for the debts of a partner.

6. **Protect assets against failed marriages**

The risk of a gift to a descendant being awarded to his or her spouse upon divorce can affect an estate plan, and prenuptial or postnuptial agreements may be distasteful or impractical in many situations. In particular, stocks and bonds are very prone to being commingled with assets of the marriage and in community property states effectively might become community property. Limited partnership agreements, however, can be drafted so that gifts of limited partnership interests are protected from the risk of divorce. In Pennsylvania, separate or nonmarital property generally escapes the equitable distribution process. Nonmarital property includes: property a spouse brought into the marriage and kept separate during the marriage, inheritances received during the marriage and kept separate during the marriage, and property excluded by a valid prenuptial agreement. In addition, nonmarital or separate property may include gifts received by just one spouse during the marriage. See 23 Pa.C.S. Section 3501. Many jurisdictions, including Pennsylvania, will not award separate property to a divorced spouse or will limit that award. A partnership provides a convenient means of segregating a descendant’s separate property so that commingling is avoided. In addition, a partnership agreement can provide that an involuntary transfer of a partnership interest required by a divorce court will trigger buy-sell provisions under which the other partners or the divorced partner can buy that interest at its fair market value.

7. **Partnership agreements are flexible**

In comparison to an irrevocable, unamendable trust, a limited partnership is a very flexible arrangement. If all of the partners agree, the partnership agreement may be amended or the partnership may be terminated, and usually all of the partners are family members. By contrast, irrevocable trusts may be difficult to amend, and in order to preserve tax benefits, may not be amended by a beneficiary. As compared to corporations, a partnership requires fewer formalities and may be terminated without the potential adverse tax consequences associated with the termination of a corporation.
8. **Business judgment rule offers flexibility in management**

Most families want to protect the family member who is charged with the responsibility of making investment decisions. In particular, families often want that family member to be protected from the “20/20 hindsight” of a court or jury.

9. **Arbitrate family disputes rather than litigate**

Recent history is replete with examples of highly publicized intrafamily litigation involving the management of family assets. It is extremely difficult to replace a trust beneficiary’s right to sue his trustee with a commitment to binding arbitration: the state law right of a beneficiary to sue his or her trustee in many jurisdictions may not be removed by a trust agreement. Because a partnership agreement is a mere contract, however, it can be written so that all of the partners agree to settle disputes by arbitration. When compared to a jury trial, arbitration is usually preferable, especially in the family context. The publicity associated with family disputes can provide an unfair advantage to the person bringing a lawsuit against the family’s decision maker. With a well-drafted partnership agreement, such publicity can be avoided through the arbitration process and enforced by a confidentiality provision. In addition, an experienced businessperson or financial advisor may serve as arbitrator and fact finder. Thus, where the client determines there is an advantage to arbitration, the partnership vehicle may be superior to the use of a trust in many jurisdictions. Note that in Pennsylvania, trust issues are generally arbitrable, however certain exceptions, such as capacity issues, remain.

10. **Institutionalize communication on financial matters**

The family partnership can help to train younger generations in the management and distribution to the family’s assets.

11. **Potential estate and gift tax savings**

a. **The Valuation of Family Limited Partnership Interests**

i. **Valuation of Interests**

A limited partnership interest is not as liquid or negotiable as the underlying partnership assets. To preserve family ownership, certain restrictions on transfer of limited partnership interests must be included in the Partnership agreement. Such a structure also may increase valuation discounts for gift and estate tax though special valuation rules under Chapter 14 of the Internal Revenue Code of 1986, as amended (“Code”).

For gift and estate tax purposes, discounts from the value of the underlying assets on transfers of limited partnership interests may be most likely if a partnership contains actively managed, income-producing business property or real estate. To date certain limited partnership interests in investment partnerships that hold
real estate or marketable securities have nonetheless been receiving valuation discounts. While the IRS is litigating cases where gift and estate tax valuation discounts have been claimed on limited partnership interests, there currently exists precedent that such discounts should apply in appropriate circumstances. Such discounts (which may, for example, approximate 20-40% of underlying asset value) would be attributable to the non-marketability of a limited partnership interest (compared to underlying assets in the Partnership) and the inability of a limited partner, as such, to participate in Partnership investment and distribution decisions. The discounts for lack of marketability generally range between 25-35%, while the discounts for lack of control generally range between 10-15%. Although the IRS has challenged family limited partnerships (and specifically, the discounts associated with the transfer of limited partner interests) in the Tax Court on a number of legal grounds, and the IRS continues actively to do so at both the trial court and appellate court levels, the results of the court decisions to date generally have been pro-taxpayer (see the cases discussed below) when the taxpayers followed entity formalities and did not engage in deathbed transactions. The IRS, however, has yet to concede any of its arguments.

b. Gifting of Family Partnership Interests

i. Limitations on Amount

Tax-free gifting of family partnership interests is limited by the donor’s annual exclusion limit. Pursuant to Code Section 2503(b), a donor may make gifts of up to $11,000 (adjusted for inflation annually) per year to a donee and still qualify for a complete exclusion of the gifts. This amount is doubled in the case of a married donor splitting gifts with a spouse. The exclusion is valid for an unlimited number of donees. The number of gifts is irrelevant as long as the total value for each donee does not exceed the annual exclusion limit. The exclusion shields the gifts from both the gift tax and the unified tax (estate tax) in the total of lifetime gifts and death transfers.

In calculating the impact of a gift towards the donor’s annual exclusion limit, the discounted value is used, NOT the fair market value of the gift.

Example: John gifts an interest to his daughter with a market value of $10,000. If the gift is subject to a 25% discount, this gift will only count $7,500 towards his annual exclusion limit.
ii. Limitations on Timing

As the Internal Revenue Service subjects family limited partnerships to a higher level of scrutiny, some period of time should elapse between the formation of the partnership and any gifting of interests.

To receive the proper discounts, the family limited partnership must have a legitimate purpose; if it is viewed simply as a vehicle for estate tax evasion it will not pass IRS muster.

Thus, any gifting of interests must occur after, and independent of, the partnership creation and its initial funding. Generally, waiting a period of from 6 months to a year is satisfactory to demonstrate that there was no prearranged plan.

Note that arguments employed by the government to recover tax on the transfer of family limited partnership interests depend on estate tax provision 2036(a) which includes in a decedent’s gross estate transferred property over which a decedent retains the right to control the possession or enjoyment of either the property or the income from the property, or the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

Whether an analogous strategy would be available when gift tax is the only issue is an open question.

B. Overview of the Law Governing Partnerships

1. Limited Partnerships are formed by two or more persons, entities, or combination of person(s) and entity(ies), and have at least one general partner and one limited partner.

   a. General Partner: A general partner in a limited partnership has all the same rights and responsibilities as a partner in a general partnership. The general partner must be identified on the Certificate of partnership as well as in the partnership agreement. In contrast to a limited partner, a general partner has more rights and responsibilities, and thus greater liability; a general partner is fully liable for the acts of the partnership.

   b. Limited Partner: It is the existence of a limited partner that makes a general partnership a limited partnership. Limited partners have certain rights and responsibilities under Pennsylvania law that are less expansive than the rights and responsibilities of general partners. However, these rights may be expanded in the partnership agreement. Limited partners may be named in the agreement only: they do NOT have to have their names on the partnership certificate. Liability for limited partners is less than the liability for general partners; a
limited partner is liable only to the extent of its investment in the partnership, unless specified differently in the partnership agreement.

2. Formation. A limited partnership is formed by executing & filing a certificate of limited partnership with the appropriate jurisdiction, for Pennsylvania practitioners, commonly either the Pennsylvania or Delaware Department of State. (See examples contained in Appendix B).

   a. The original general partners MUST be named on the certificate; limited partners do not have to be named.

3. Agreement. Agreement to do business as a limited partnership may be oral or written, but in Pennsylvania certain provisions must be in writing to be binding; otherwise the statutory default provisions will apply.

   a. These provisions include:

   i. Rules governing the admission of additional general partners (See 15 Pa.C.S. Section 8531 (2005));

   ii. Allocation of profits and loses among partners and classes of partners (See 15 Pa.C.S. Section 8543 (2005));

   iii. Distribution of cash or other assets among partners and classes of partners (See 15 Pa.C.S. Section 8544 (2005));

   iv. Rules governing the voluntary withdrawal of a limited partner (See 15 Pa.C.S. Section 8553(a) (2005)); and

   v. Rules governing distribution in kind from partnership (See 15 Pa.C.S. Section 8555 (2005)).

4. Dissolution. Limited partnerships are dissolved:

   a. As specified in the certificate of limited partnership;

   b. As specified in the written partnership agreement;

   c. Upon written consent of all partners;

   d. Upon order of judicial dissolution; or

   e. When no general partners remain (unless all remaining partners agree in writing to continue business or agree to appoint one or more replacement general partners).

5. Dissolution of limited partnership will NOT affect the limited liability of a limited partner.
a. Limited partners will remain responsible for their portion of unpaid liabilities to the extent that they receive assets in connection with dissolution.

C. The Rights, Duties, and Responsibilities of Partners

1. General Partners. General partners have essentially the same rights/duties/responsibilities as partners in a general partnership.

   a. Manage / conduct business of partnership.
   b. Inspect / copy partnership books.
   c. Full liability for activities of partnership.

2. Limited Partners. Limited partners have similar rights, only in a more limited sense.

   a. Right to obtain upon reasonable demand full information regarding the state of the business and the financial condition of the partnership, including copies of all tax returns and all other just and reasonable information.
   b. Right to inspect and copy records the partnership is required to maintain at its registered office / place of business.
   c. These rights are subject to restrictions of the partnership agreement and restrictions based upon the right of general partners to keep certain information confidential for a reasonable period of time. Typical restrictions include aspects such as transferability and participation in management of the partnership.

3. Certain rights are held by both general and limited partners

   a. **Right to share in profits and losses**

      i. As allocated in partnership agreement, or
      ii. If no allocation exists, on the basis of the value of the contributions made by each as stated in the partnership agreement, or
      iii. If these rights are not allocated in the partnership agreement and no value of contribution is stated in the partnership agreement, then on a per capita basis.

   b. **Right of distributions**

      i. Each partner has right to receive distribution of partnership assets:

         1) Upon withdrawing from the partnership, or
         2) Upon the dissolution of the partnership, or
3) When otherwise specified in the partnership agreement.

ii. Distributions are to be allocated in the same manner as profits and losses are to be allocated (see (a.) above).

iii. Exceptions.

1) Partners cannot demand distribution in a form other than cash, except as specified in the partnership agreement.

2) While partners cannot demand distribution in a form other than cash, they may receive distributions in a form other than cash. However, partners are not required to accept a distribution in kind of more than their proportionate share of a particular asset, except as specified in the partnership agreement.

3) A partner generally may not receive any distribution that would reduce the value of partnership assets below its total liabilities, except for liabilities to creditors who have recourse limited to specific assets of the partnership.

D. Discussion of General and Limited Partnership Interests

1. General and Limited partners have the same interests

   a. The interest is a share of the partnership’s profits and losses.

   b. This interest is intangible personal property.

   c. The interest of general and limited partners in a limited partnership is identical to the interest of partners in a general partnership.

2. Assignment of partnership interests

   a. Partners may assign their interest in whole or in part, except as otherwise provided in the partnership agreement.

   b. Assignment of partnership interest does not terminate the partnership.

   c. Assignment entitles assignee to the same right to profits and disbursements of assignor, to the extent of the interest assigned.

   d. If a partner assigns the entirety of his or her interest, he or she ceases to be a partner.

   i. However, an assignee who receives all of a partner’s interest does not become a partner automatically. He or she may become a limited partner:
1) if the assignor has that right through the partnership agreement, or

2) if all other partners consent, or

3) through procedures outlined in the partnership agreement.

E. Limited Liabilities for Partnership Activities

1. Liability for General Partners

   a. General partners in a limited partnership are liable to the partnership and other partners to the same extent as partners in a general partnership.

   b. Specifically all general partners are:

      i. Jointly and severally liable for everything chargeable to the partnership for the wrongful act of a partner and the breach of trust by a partner.

      ii. Jointly for all other debts and obligations for the partnership, but any partner may enter into a separate obligation to perform a partnership contract.

      iii. These liabilities may be changed through the partnership agreement.

   c. General partners in a limited partnership are similarly liable to third parties; however these liabilities CANNOT be modified by the partnership agreement.

2. Liability for Limited Partners

   a. Limited partners are liable only to the extent of their investment. Limited partners are not liable for any debt, obligation or liability of the limited partnership, and are not liable for the acts of any partner, agent or employee of the limited partnership.

   b. If an investor, under mistaken belief he or she is a limited partner, later discovers that he or she is a general partner, the investor may limit his or her liability by executing a certificate of limited partnership or by withdrawing from future equity participation.

   c. If a limited partner acts like a general partner and a third party therefore believes the limited partner is a general partner, the limited partner may assume the liabilities of a general partner.
Take Away Points:

- Limited partnerships are just like regular partnerships, except they also have limited partners.

- The specific relationship (i.e. responsibilities and duties) of limited partners MUST be enumerated in the limited partnership agreement.

- Limited partners do not suffer from the same liability concerns as general partners; however the flip side of the same coin (or another benefit depending on how you look at it) is that limited partners generally do not have the same level of duties and responsibilities as general partners. The level of involvement is dictated by the partnership agreement.

F. Current Status of Family Limited Partnerships in Estate Planning

1. Attacks by the Service
   a. Position of Service
      i. The use of family limited partnerships to obtain discounts for estate and gift tax purposes is an area in which the Internal Revenue Service has taken a keen interest.
      
      ii. The following situations appear to give rise to greater scrutiny by the Service:

      1) Limited partnerships formed shortly before death;

      2) Limited partnerships formed where the significant partner or member is incompetent and a power of attorney is used to form the entity;

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2 Many commentators have been perplexed by the role to be played in this context of the Supreme Court’s decision in U.S. v. Byrum. U.S. v. Byrum, 408 U.U. 125 (1972). In Byrum, the Court held that Section 2036 did not apply to transfers of minority interests of stock in a corporation even though the donor retained control, explaining that a majority shareholder owes a fiduciary to minority shareholders. Congress subsequently overruled the narrow result of Byrum with adoption of Section 2036(b); however it is still good law with respect to business entities other than controlled corporations. A corporation will be treated as a controlled corporation if, at any time after the transfer of the property and during the 3-year period ending on the date of the decedent's death, the decedent owned, or had the right (either alone or in conjunction with any person) to vote, stock possessing at least 20 percent of the total combined voting power of all classes of stock. In Strangi, the tax court held Byrum to be inapplicable since among other reasons the notion of a fiduciary duty to oneself is problematic.
3) Limited partnerships composed primarily of cash and marketable securities;

4) Limited partnerships where corporate formalities are not recognized and partners use partnership assets as personal assets; and

5) Limited Partnerships where a partner has contributed all of his or her assets to the partnership. (A partner must hold enough assets outside of the partnership to maintain his or her living expenses.)

G. Recent Case Law (Discussed In Detail Below) Suggests that Practitioners Should Keep the Following In Mind While Structuring Family Limited Partnerships:

- It is vitally important not to intermingle personal assets and partnership assets; partnership assets should not be utilized for the private expenses of partners.

- Partnerships with assets requiring active management are more likely to achieve estate and gift tax discounts. Functional businesses are subjected to various business world stresses that monetary or investment assets are not subjected to. These stresses make the transfer of assets appear less like a mere tax avoidance scheme and give more substance to valuation discounts.

- Partnership interests received by an individual in exchange for assets contributed to a family limited partnership constitute full and adequate consideration only when the partnership’s creation is determined to be for a substantial non-tax reason.

- When contributing assets to a family limited partnership, it is vital to maintain enough assets outside the partnership for self-support.

- A bona fide transaction can still occur despite the fact that family members are on each side of the table.

1. *Strangi v. Commissioner of Internal Revenue* (May 20, 2003)³

   a. Background

   Decedent’s son-in-law, an attorney (“Mr. Gulig”), took over decedent’s affairs in 1993 pursuant to a 1988 power of attorney. In 1994, Mr. Gulig set up a family limited partnership, the Strangi Family Limited Partnership (“SFLP”) after attending a financial planning seminar. Acting under power of attorney,

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Mr. Gulig assigned 98% of decedent’s wealth, including his house, to SFLP in exchange for a 99% limited partnership interest. Mr. Gulig also established Stranco as a corporation to act as general partner; decedent acquired a 47% interest in Stranco and decedent’s children acquired a 53% interest.

The SFLP agreement held that the distributions of assets and proceeds would be made in the sole discretion of the managing partner. The sole managing partner was Stranco (majority owned by the decedent’s children).

However, Stranco’s by laws established Mr. Gulig as the manager of its day-to-day business. Thus Mr. Gulig, who was responsible for the day-to-day management of decedent’s financial affairs, was also in control of the operations of the SFLP partnership.

The family limited partnership was established in early August, 1994; the decedent passed away on October 14th. SFLP had been paying for his maintenance.

Following a tax filing in 1996, the IRS filed a notice of tax deficiency of $2.5 million in estate taxes and $1.6 million in gift taxes, resulting from the government’s conclusion that decedent’s interest in SFLP and Stranco should have been increased in value; the decedent’s estate claimed an interest of $6,560,730 for decedent’s interests in SFLP; the government claimed $10,947,343; the total value of property held by SFLP at time of decedent’s death was $11,100,922.

On remand from the Fifth Circuit, the Tax Court held that the property value should be included to the extent declared by the government in their notice based on the following analysis.

b. Analysis of Section 2036

The government claimed that the value of the property contributed to SFLP and Stranco was includible in the decedent’s gross estate under either 2036(a)(1) or 2036(a)(2) without discount.

i. Section 2036(a)(1)

Section 2036(a)(1) provides for the valuation of property contributed to a partnership based on the extent to which the decedent retained, by express or implied agreement, possession, enjoyment or the right to income.

In this instance, the court noted that the decedent had only $761 in liquid assets available in his checking account. Thus it appeared that everyone expected that SFLP and Stranco would be the primary source of decedent’s liquidity.
In addition, SFLP funds were used to provide extensive medical care for the decedent and to provide funeral expenses, and a source of tax payments for the decedent’s estate.

In light of these facts, the court stated that the SFLP/Stranco arrangement bore greater resemblance to one man’s estate plan than to any sort of arm length joint enterprise. In fact, virtually nothing beyond formal title changed in decedent’s relationship to his assets. Thus, the court found that decedent retained full possession of, enjoyment of, and the right to income from his contributed property within the meaning of 2036(a)(1); the value included in the estate was the full value of the contributed property.

ii. Section 2036(a)(2)

Section 2036(a)(2) mandates the inclusion in the decedent’s gross estate the value of contributed property based on the extent to which the decedent retained the right to designate the persons who shall possess or enjoy the property or its income.

The court in Strangi found that the SFLP/Stranco agreement granted the decedent full power of designation over the property, and again no valuation discount was appropriate.

Specifically, the provisions of the governing documents of SFLP/Stranco provided ascertainable and legally enforceable rights to designate persons who shall enjoy the transferred property and its income.

The SFLP agreement named Stranco managing general partner and gave Stranco sole discretion to determine distributions. The Stranco shareholders, including the decedent through Mr. Gulig, then gave Mr. Gulig the power to delegate the authority through the Stranco management agreement. The end result was that decedent’s attorney in fact had the power to make the distribution decisions of the partnership that had been almost completely funded by the decedent’s assets.

c. Strangi II v. Commissioner of Internal Revenue (August 8, 2005)

On remand, the Tax Court held that Section 2036(a) applied to include the value of the property transferred to the FLPs in the decedent’s gross estate. Fifth Circuit affirmed the Tax Court’s opinion holding that the property in question was included in the decedent’s estate under 2036(a)(1), but that 2036(a)(2) also applied.

Tax Court determined that the estate was not entitled to 2036(a)’s bona fide sales exception to inclusion in gross estate of decedent’s retained interest--holding that even though adequate and full consideration was given in the form of
proportional partnership interest, there was no substantial non-tax business purpose for the transfer, that, therefore, the transaction lacked the essential bona fides required by the statute.


a. **Background**

Ruth Kimbell died on March 25, 1998, leaving her son David as executor of her estate. Just prior to Ruth’s death, David, his wife, and Ruth’s revocable living trust (“The Trust”) joined to form a limited liability company. The Trust owned a 50% interest in the LLC.

The Trust and the LLC later formed a family limited partnership (the “Partnership”). The Trust contributed $2.5 Million in cash for a 99% pro rata limited partner interest. The LLC contributed $25,000 for a 1% general partner interest. The end result was that Ruth, through the Trust and the LLC, owned 99.5% of the Partnership. (The estate planning goal was to reduce the estate tax owed by Ruth’s estate by only having Ruth’s interest in the Partnership and LLC included in the estate tax calculation rather than the Partnership’s underlying assets.)

b. **The IRS Audit**

The IRS determined that the value of the assets transferred to the Partnership and the LLC, rather than Ruth’s interest in those entities, was includible in the gross estate under Section 2036(a) of the Code. The estate paid the tax and filed for a refund; the refund was denied, and a lower court found for the IRS on grounds that Ruth’s transfers to the Partnership and the LLC were subject to Code Section 2036(a). Specifically since family members were on each side of the transaction, the transfer was not a bona fide sale.

c. **The Lower Court Decision for the IRS**

The Kimbell family appealed on grounds that the transfer qualified for an exemption to Section 2036(a) as it was a bona fide sale for an adequate and full consideration in money or money’s worth.

The Government claimed, and the lower court agreed, that the sale was not bona fide; it was not conducted at arms length as family members were on both sides of the transaction. In addition, the Government claimed and the lower court agreed that the transaction was not for an adequate and full consideration: the pro rata interest in the partnership was not adequate consideration for the assets she transferred to the partnership.

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d. **The Decision on Appeal: Pro-Family Limited Partnership**

The Fifth Circuit Court of Appeals reversed the lower court decision.

First, the court found that the transaction was in fact for adequate and full consideration. They followed a three-part test to reach this determination.

i. Whether the interests credited to each partner was proportionate to the fair market value of the assets each partner contributed to the partnership;

ii. Whether the assets contributed by each partner to the partnership were properly credited to the respective capital accounts of the partners; and

iii. Whether on termination or dissolution of the partnership the partners were entitled to distributions from the partnership in amounts equal to their respective capital accounts.

The court found that the Kimbell transaction met all of these requirements.

More important was the question of whether or not the transaction was bona fide. The fact that tax planning motives were involved was not the determinative factor; the question instead was whether the sale was a bona fide sale or was instead a disguised gift or sham transaction.

In showing that the transaction was bona fide, the Kimbell family established three crucial facts. First, Ruth had sufficient assets outside of the partnership for personal use; she retained $475,000, more than enough to support her at the age of 96. Second, the assets transferred to the Partnership, specifically oil and gas operations, were actually re-titled to the Partnership. Third, these assets required active management. Therefore the transaction had all the elements of a bona fide sale.5

3. **Turner v. Commissioner** (September 1, 2004)6

a. **Background**

In April, 1993, the decedent was informed by a financial advisor that a family limited partnership could reduce the taxable value of his estate and provide certain other benefits. Shortly thereafter, at age 95, decedent transferred $2.8M in assets – including $2.5M of marketable securities – to two limited partnerships,

5 See also Estate of Schutt v. Comm., TC Memo 2005-126, May 26, 2005 (finding a legitimate non-tax purpose in “‘the furtherance and protection of ***[decedent’s] family’s wealth by providing for the centralized management of his family’s holdings in duPont [sic] stock and Exxon stock during his lifetime and to prevent the improvident disposition of this stock during his lifetime and to the extent possible after his death.’’”).
one formed with his daughter and son-in-law, and the other formed with his son. At the time of the transfers, decedent had annual expenses of $57,202 and an actuarial life expectancy of 4.1 years, but he retained outside of the partnership only $153,000 in personal assets and an annual income of $14,000 from two annuities and Social Security.

Both partnerships made cash distributions to decedent during his lifetime. These distributions were used to make gifts to family members and to cover living expenses. Both partnerships made loans to the decedent’s family members. Interest payments on the loans generally were late or not made, the loans were frequently reamortized, and the partnerships never pursued enforcement action.

The decedent died at age 97 holding $89,000 in liquid assets and a majority interest in the two partnerships. Following decedent’s death, the partnerships sold approximately $700,000 in securities to partially fund bequests in decedent’s Will and to pay decedent’s estate taxes. On decedent’s estate tax return, his estate applied a 40% discount rate to the net asset value of the partnerships for lack of control and marketability. After the discount, and taking into account a couple of modest lifetime gifts of partnership interests, the decedent’s remaining partnership interests were valued at approximately $1.7M.

b. Notice of Deficiency/Tax Court Decision

The IRS issued a notice of deficiency disallowing the claimed discounts on each of the partnerships and increasing the decedent’s taxable estate from approximately $1.7M to approximately $3.2M. The IRS argued two theories for disallowing the claimed discounts:

i. First, that the partnerships should be disregarded for tax purposes, thereby causing the undiscounted value of the decedent’s pro-rata share of the underlying assets to be included in his gross estate; and

ii. Second, and in the alternative, that the full fair market value of the assets transferred to the partnerships by the decedent should be returned to decedent’s gross estate under Section 2036(a)(1) because decedent retained control and enjoyment over the transferred assets during his lifetime.

After the estate petitioned for redetermination, the Tax Court held that:

i. The partnerships were validly formed and properly recognized for federal estate tax purposes; and

ii. Section 2036(a)(1) applies to return to the gross estate the date of death value of decedent’s transferred assets as well as new partnership assets derived from the assets contributed by the decedent;

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The estate appealed.

c. **Third Circuit’s Decision**

The court first considered whether the decedent retained for his lifetime the possession, enjoyment, or the right to income from the property he transferred to the partnerships.

The court started by reciting that (i) Section 2036(a)(1) applies if there is an express or implied agreement at the time of transfer that the transferor will retain lifetime possession or enjoyment of, or right to income from, the transferred property, and (ii) an implied agreement may be inferred from the circumstances surrounding both the transfer and subsequent use of the property;

The court found an implied agreement between decedent and his family that decedent would continue to be the principal economic beneficiary of the contributed property and retain enjoyment of the transferred property for the following reasons:

i. The fact that decedent did not retain sufficient assets to support himself for the remainder of his life supports the inference that decedent had an implied understanding that his children would agree to his requests for money from the assets he contributed to the partnerships, and that they would do so for as long as he lived; and

ii. The transfer by decedent when he was 95 years old of 95% of his assets, in the form of marketable securities, is more consistent with an estate plan (under which a decedent retains enjoyment of his property until death) than an investment in a legitimate business;

The court next considered in two parts whether the bona fide sale exception to Section 2036(a) applied.

**First, was receipt by decedent of partnership interests, “adequate and full consideration” for the transferred assets?**

The court held that there was no transfer for consideration within the meaning of Section 2036 because the decedent’s contributions to the partnerships were merely recycled into a different form but not fundamentally changed. As evidence of this, the court cited the following:

i. The partnerships were not formed to conduct an active business;

ii. There was no pooling of the partners’ assets for investment or other legitimate purposes;

iii. Each partner directly received any income derived from the assets he or she contributed;
iv. The partnerships held the securities contributed by the decedent without any substantial change in investment strategy; and

v. The partnerships did not engage in business transactions with anyone outside the family;

Second, were the decedent’s contributions of assets to the partnerships in return for partnership interests “bona fide” sales.

The court stated that a “bargained-for exchange” (for example, partners with divergent interests) or an “arm’s length transaction” (for example, each partner retains independent counsel) would be evidence of a bona fide sale, but that neither is required. Absent such evidence, heightened scrutiny of intra-family transfers is appropriate to determine whether they are made in “good faith.” The court cited the following considerations in determining whether there is a good faith transfer:

i. Whether the transfer provides the transferor some potential for benefit other than the potential for estate tax advantages; and

ii. Whether the partnership operates a legitimate business;

Because neither partnership in this case conducted any legitimate business operations or provided the decedent with any potential non-tax benefits, the court concluded that the decedent’s transfers were not bona fide sales.

Accordingly, the decision of the Tax Court was affirmed.

4. *Bongard v. Commissioner* (March 15, 2005)\(^7\)

a. **Background**

In 1980, Wayne Bongard formed a company called Empak, Inc., which designed, developed, and marketed certain products for the semiconductor and data storage industry. Bongard was the sole shareholder in Empak until 1986. At that time, he contributed 15% of his stock to a trust (the “ISA Trust”) he created for the benefit of his children and his stepdaughter. At all times, Bongard was a member of the Empak board of directors (most of the time in question he was the sole director). Bongard was the CEO of Empak. Empak never paid dividends.

**ISA Trust.** Initial co-trustees were a Mr. Bernards, an accounting consultant for Bongard’s prior employer, and a Mr. Welter, an Empak employee. For a brief period, Mr. Bernards resigned and was replaced by Bongard’s son, however, following the son’s resignation as co-trustee, Mr. Bernards was re-appointed.

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\(^7\) See *Estate of Bongard*, 124 TC 95, 2005 WL 590670.
**WCB Holdings.** WCB Holdings was an LLC formed in January 1996. On December 28, 1996, Bongard and the ISA Trust contributed to WCB Holdings all of the Empak stock each owned in return for four classes of interests in WCB Holdings (one class of voting interests (Class A governing) and three classes of nonvoting interest (Class A financial, Class B governing, and Class B financial)).

**BFLP.** On December 29, 1996, Bongard contributed to the Bongard Family Limited Partnership (BFLP) all Class B interests that he owned in WCB Holdings. At the same time, the ISA Trust contributed to BFLP a portion of its Class B interests in WCB Holdings. In exchange for these contributions, Bongard received a 99% limited partnership interest, and the ISA Trust received a 1% general partnership interest.

**Gifts.** In late 1996, Bongard created three new trusts (one for his children [for which Bernards and Bongard’s son served as co-trustees], a second for his children and other issue [for which two Empak employees served as co-trustees], and a third for the benefit of his wife [Bongard's brother and friend served as co-trustees]). On March 15, 1997, Bongard contributed approximately 26% of the Class A interests in WCB Holdings in equal share to the trusts for the benefit of his descendants and 12% of the Class A interests in WCB Holdings to the trust for his wife’s benefit. These gifts reduced Bongard’s personal voting power in WCB Holdings to less than 50%. Finally, on December 10, 1997, Bongard gave his wife a 7.72% limited partnership interest in BFLP (the only gift of a BFLP partnership interest).

**Estate Tax and Audit.** Mr. Bongard died unexpectedly on November 16, 1998. The estate reported a federal estate tax liability in excess of $17 million when it filed its return, based on reported values of approximately $4.2 million and $41 million for the estate’s Class A interests in WCB Holdings and limited partnership interests in BFLP, respectively.

The IRS issued a notice of deficiency and determined that all of Bongard’s Empak shares transferred to WCB Holdings were includable in his estate by reason of Sections 2035(a) and 2036(a) or (b). The Service increased the gross estate by more than $96 million and assessed a tax deficiency of almost $53 million.

b. **Bona Fide Sale Exception under 2036(a) and (b)**

Prior cases have separately analyzed the two elements of the exception 1) a bona fide sale and 2) adequate and full consideration in money or money’s worth. The majority in Bongard, however, in considering each of the two elements applied the same standards in determining whether each element was satisfied. The test they employed: 1) is there “a legitimate and significant nontax reason for the creation of the LLC and BFLP,” and 2) are the LLC and BFLP interests received by the transferors proportionate to the value of the property contributed to the LLC and BFLP.
For the nontax reason to be “legitimate and significant,” objective evidence must demonstrate that the reason was “true . . .[and did not] merely clothe transfer tax savings motives.”

Similar to *Kimbell*, the Court considered factors that did not show a nontax reason to be legitimate and significant as follows:

i. A decedent “standing on both sides of the transaction”;

ii. The decedent’s financial dependence on distribution from the BFLP;

iii. The commingling of BFLP assets with a partner’s personal assets;

iv. The decedent’s failure to transfer the purportedly contributed property to the BFLP.

The LLC passed this test because the Court determined that it was formed to generate additional outside capital and assist Empak with a liquidity event such as an initial public offering. The second prong was met because Bongard and the Trust received proportionate units in the LLC for the Empak shares they contributed.

The BFLP, on the other had, did not pass this test. The Court determined that there were no nontax reasons for the FLP’s formation, noting that the BFLP: did not engage in business-like transactions, made no distributions, never invested or diversified its assets, and developed no formal investment plan.

The Court went on to hold that the decedent retained enjoyment of the property transferred to the BFLP to the extent the transfer did not qualify for the bona fide exception where “practical control” was retained over the property transferred to the BFLP. The acquiescence of some parties, including trustees who were neither related nor subordinate employees, in redemptions initially proposed by Mr. Bongard was enough for the Court to decide “practical” if not legal control existed. Of particular significance, the Court disregarded several other factors that other courts have noted in support of the validity of BFLPs: 1) Bongard was not the BFLP’s general partner, 2) Bongard did not need the BFLP assets to maintain his lifestyle, 3) Bongard did not commingle his personal assets with the BFLP’s assets, and 4) Bongard received no distributions from the BFLP.
A. Basic Estate Planning Principles

1. Key Sections of the Internal Revenue Code

a. Section 2033 of the Internal Revenue Code states that “[t]he value of the [decedent’s] gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death.” This includes items of speculative value, such as unresolved legal claims and contingent claims.

i. Valuation. Valuation is critical in the estate tax. Much of sophisticated estate planning involves the engineering of valuation reduction, for example, by interposing entities in a chain of ownership, such as placing property in a partnership or corporation. Valuation discounts are usually associated with interests in a limited partnership or minority interests in a closely held business. Discounts result from lack of marketability and lack of control.

Example: M (mother) has marketable securities, cash and real estate worth $100. She transfers this property to a limited partnership in which C (child) is the general partner having a 1% interest in the capital and profits of the partnership. M is the sole limited partner with a 99% interest in the profits and capital of the partnership. M's interest in the partnership may be worth $70 or less because of the difficulty she would have in selling partnership interests.

Example: F (father) is the sole owner of a small business. Over time he gives shares of stock to his adult children, until he eventually owns less than 50% of the business. Upon his death the value of the shares owned by his estate will be discounted because F lacked control over the business at the time of his death.

b. Chapter 14 and Other Tax Hurdles to Valuation Discounts

i. Chapter 14.

1) Enactment. In 1990, Congress dealt with perceived valuation abuses by the adoption of new Chapter 14, consisting of Sections 2701, 2702, 2703, and 2704. The rules under Chapter 14 modified the valuation of specific retained rights in corporations and partnerships (Section 2701), the valuation of split temporal interests in property (Section 2702), the effect of buy-sell agreements and options upon value (Section 2703), the transfer tax consequences of lapsing rights (Section 2704), and the gift tax statute of limitations (Section 6501(c)(9)). In 1992, the Service issued final regulations under Chapter 14.

2) The specific application of Chapter 14 to partnerships is as follows:
(a) Section 2701 values certain rights retained by the donor at zero (these applicable retained interests are defined as either a put, call, conversion, or liquidation right or, in a controlled entity, a distribution right other than a qualified payment right);

(b) Section 2703 disregards certain value-fixing provisions in partnership, operating, and co-owner agreements (any option, agreement, or other right to acquire or use property at a price less than the fair market value of the property, or any restriction on the right to sell or use such property); and

(c) Section 2704 treats the lapse of a voting, liquidation, or similar right as a deemed gift.

3) With most limited partnerships, the troublesome provision under Chapter 14 will be Section 2704.

4) If the planner avoids creating two classes of partnership interests (other than a general partnership interest and a limited partnership interest with the only difference between the two interests being management rights and liability), Section 2701 should not present a problem.

5) Because most of the restrictions on partnership interests that provide valuation discounts are similar to restrictions contained in partnership agreements among unrelated parties, Section 2703 should not present a problem (assuming the partnership is formed for valid business reasons).

6) On the other hand, Section 2704, presents a mine field, particularly where the planner is trying to avoid a gift upon the formation of the entity. 2704(a) treats a lapse of a voting or liquidation right as a transfer for gift or estate tax purposes if the individual holding the right and members of the individual’s family control the entity both before and after the lapse. Although it is difficult, it is possible to avoid the pitfalls of Section 2704 and also not have a gift upon the creation of the entity. This requires, however, careful planning and drafting.

7) Appendix A of this handout explains 2701, 2703, and 2704 in greater detail.
2. Other Tax Hurdles

a. Present Interest Requirement and Annual Exclusion

i. To obtain the annual exclusion of $11,000 / $22,000 under Section 2503(b), the donee must have a present interest in the property transferred by the donor.

ii. If a limited partner cannot require the partnership to purchase his or her interest, the donee must obtain a present interest in the property through another mechanism. If the limited partner has the unrestricted right to transfer his or her interest, the entity will have the corporate characteristic of free transferability of interest. This may cause the entity to be classified as a corporation for federal income tax purposes resulting in “double taxation.”

iii. The present interest requirement should be met if the donee as a limited partner has the right to assign his or her interest in the entity notwithstanding that the transferee would be a mere assignee and would not have the right to participate in the management of the partnership.

iv. In Technical Advice Memorandum 9131006 and Private Letter Ruling 9415007, the Service ruled that a donee of a limited partnership interest had a present interest because the donee could have assigned his or her partnership interest subject to the right of first refusal set forth in the partnership agreement. The fact that a limited partner could freely transfer his or her right to distributions should not cause a partnership to have the corporate characteristic of free transferability of interest.8

b. Sections 2036(a)(2) and 2038(a)

i. If an individual transfers property and retains the right to control the possession or enjoyment of the property or the income from the property, the property is included in the gross estate of the decedent under Section 2036(a)(2). If a donor retains the right to alter, amend, revoke, or terminate the enjoyment of gift property, the property is included in the donor’s gross estate under Section 2038(a).

ii. Where the donor is the sole general partner and transfers a limited partnership interest by gift, the question arises whether that is a transfer with a retained life estate under Section 2036(a)(2) or revocable under Section 2038(a). Because a general partner has a fiduciary duty to the other partners, there should not be a retained interest within the meaning of either Section 2036(a)(2) or 2038(a).

8 See supra note 1.
iii. The Service ruled in Technical Advice Memoranda 8611004 and 9131006, and in Private Letter Rulings 9310039, 9332006, and 9415007, that Section 2036(a) did not apply where the decedent was the sole general partner and transferred limited partnership interests. However, these decisions are called into question by the cases discussed above.

iv. If the partnership agreement negates the fiduciary duty of the general partner (for example, by containing an indemnity clause), the transfer may not be protected and may be included in the donor’s estate under Sections 2036(a)(2) or 2038(a).

v. If the limited partnership holds more than 20 percent of the stock of a closely held company, the general partner’s right to vote the stock may cause the stock transferred by the general partner to a limited partnership to be included in the general partner’s gross estate under Section 2036(b).

vi. One way to minimize this risk is to use voting and non-voting common stock and transfer the non-voting stock into the entity. Another method is to allow the partners to vote all stock in proportion to each partner’s interest in the partnership.

3. Application of Tax Fundamentals to Family Limited Partnerships

a. Transferor and transferee MAY be family members

For estate and gift tax valuation purposes, the Service will not aggregate all voting power held by family members for purposes of determining whether the transferred interests should be valued as a part of a controlling interest. Consequently, a minority interest discount would not be disallowed solely because a transferred interest, when aggregated with interest held by family members, would be part of a controlling interest. This would be the case whether the donor held 100% or some lesser percentage of the interests immediately before the gift.

b. Identity of other partners IS relevant

The identity of other owners of a business, exclusive of the transferor and transferee, and their expected actions, can have a negative impact on the valuation of a transferred ownership interest just as well as it can have a positive impact. For example, adding a nonfamily member (such as a charitable organization) as a limited partner may lend credence to restrictions set forth in the partnership agreement upon the withdrawal of a limited partner or upon liquidation (unanimous consent), since the family members, either alone, or collectively, would not have the right to such actions.
c. State law is important in determining property rights inherent in a transferred partnership interest

Under a typical partnership agreement, which states that the terms of the agreement govern, limited partnership interests may be transferred only after certain approvals by other partners. To acquire all of the rights of a transferring limited partner, the transferee must be admitted by all the other partners and must agree in writing to be bound by all provisions of the FLP agreement. Further, no limited partner has a unilateral right to withdraw from the FLP and thereby “cash in” his or her interest. Thus, a limited partner could only “cash in” with the consent of all the other partners.

Therefore, a very relevant fact for consideration by a hypothetical willing buyer of a limited partnership interest is that hypothetical willing buyer’s assessment of whether the other partners would admit the buyer into the partnership as a partner or an assignee. It is clearly more relevant to consider the “assignee” rules under the applicable state’s partnership law because only very rarely would a hypothetical willing buyer consider it likely that all of the other partners would admit the buyer into the partnership as a partner. Other relevant considerations in connection with determining the gift or estate tax value of a transferred partnership interest are the liquidation restrictions and voting restrictions.

d. Application of Discounts

Most ownership interests in family limited partnerships are worth less than liquidation value when valued by the income approach or net asset value approach.

**Minority Interest.** The primary reasons for a discount for a minority interest are that most of the cash flow generated within a limited partnership is reinvested instead of being distributed to the partners and that a buyer generally does not obtain management control, much less liquidation control. A buyer who obtains liquidation control would pay a higher price for access to the retained cash than a buyer who does not acquire liquidation control would pay for the low distributable yield.

An investor in other types of investments may have an expectation for current income of cash distributions. Even in the case of privately held businesses, income derived from the operating surplus or gains from the sale of assets are sources of cash that provide an owner with an economic benefit which the secondary market can use as a basis for pricing the security. In contrast, an investor in a FLP is aware that current income, if any, could well be (and typically is) only enough to cover his or her portion of the tax liability allocable from the partnership’s taxable income. The general partner of the FLP in all likelihood has little motivation or requirement to sell assets and generate a return of capital to an investor.
The magnitude of the minority interest discount depends on, among other things, the level of distributions from the partnership to the partners, the financial risk associated with the partnership’s assets, and the terms of the partnership agreement. Because control premiums have been studied in the corporate takeover context, the inverse relationship of a minority interest discount to a control premium gives experts an accurate base from which to determine a minority interest discount. A minority interest discount for an assignee’s rights attributable to a partnership interest often is in the range of 20% to 40%.

**Non-Marketability.** A discount for lack of marketability results from the lack of any organized secondary market for FLP interests. Removing the most obvious vehicle for liquidity from a security with relatively undesirable investment attributes is virtually unforgivable from the perspective of a third party.

The magnitude of the marketability discount often is determined by reference to sales of restricted stock of publicly traded companies. Because of several independent studies, experts confirm a range of restricted stock discounts from 30% to 45%. Another source is the comparison of the sale of a minority block of stock in a closely held corporation to the value of the same block of stock after the corporation “goes public.” Such studies have revealed discounts ranging from 42% to 74%.

Substantial discounts are appropriate even if the only assets of the entity are passive investments such as undeveloped real estate, stocks, bonds, and cash. As to such assets, in general, valuation experts and courts allow for a minority interest discount in the range of 10% to 20% (similar to closed-end investment funds) while still allowing for the normal range of marketability discounts.

CAVEAT: Minority and lack of marketability discounts vary widely and predictable patterns are not always easy to discern.
Section 2701 – Overview

1) Section 2701 provides special valuation rules to determine the amount of any gift when an individual transfers an interest in a partnership to a family member.

2) Before Section 2701 applies, the following requirements must be met:

   (a) an individual must transfer an interest in a corporation or partnership to a member of the transferor’s family; and

   (b) the transferor or an applicable family member must hold an applicable retained interest (basically a controlling equity interest).

3) Section 2701(e)(1) defines a member of the transferor’s family as a spouse, descendants, descendants of a spouse, and spouses of any such descendants.

4) Section 2701(e)(2) defines an applicable family member as a spouse, an ancestor, an ancestor of a spouse and spouses of ancestors. Section 2701(b)(1) defines an applicable retained interest as either a put, call, conversion, or liquidation right or, in a controlled entity, a distribution right other than a qualified payment right. Under Section 2701(a)(3), an applicable retained interest is valued at zero.

5) If Section 2701 is applicable to a transfer, the value of the transferred interest is determined under the subtraction method. Under this method, the amount of any gift is determined by starting with the aggregate value of the family-held interests in the entity and subtracting the equity interest retained by applicable family members based on the special valuation rules. The value of the transferred interest will be increased when the value of the applicable retained interest is reduced under the special valuation rules.

Section 2701 - Interests of the Same Class

1) Section 2701 does not apply if the retained interest is of the same class of equity as the transferred interest.

2) Under Treasury Regulation (“Regulation”) Section 25.2701-1(c)(3), an equity interest is of the same class if the rights are identical to the rights of the transferred interest, except for “non-lapsing differences with respect to management and limitations on liability.”

3) With most limited partnerships that are used as gift vehicles, the only differences between a general and a limited partnership interest are management and liability. Accordingly, Section 2701 should not present a significant hurdle in most planning situations.

4) If a parent creates a family limited partnership, with the parent as the general partner, and the parent transfers a limited partnership interest to a child, the question is
whether the parent as a general partner has retained an applicable retained interest so that Section 2701 will apply.

5) In Private Letter Ruling 9415007, the Service addressed this issue. The Service ruled that as a general partner the donor retained rights to distributions that were of the same class as the limited partnership interests that the donor transferred. Thus, the donor did not retain distribution rights, there were no applicable retained interests, and Section 2701 did not apply to the transaction.

6) Accordingly, a transfer of a limited partnership interest by a general partner is not subject to the special valuation rules of Section 2701 if the only differences between the interests transferred are management and liability.

7) The draftsman of the limited partnership agreement may avoid Section 2701 by not creating two classes of equity. Failure to avoid Section 2701 will result in the limited partnership interests being valued much higher than under traditional valuation methods.

Section 2703 – Overview

1) Section 2703 provides, in part:

The value of any property shall be determined without regard to:

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

b. any restriction on the right to sell or use such property.

2) Regulation Section 25.2703-1(a)(3) provides that a “right or restriction may be contained in a partnership agreement” and may be implicit in the capital structure of an entity.

3) The value of an interest in a limited partnership for estate, gift, and generation-skipping transfer tax purposes is determined without regard to any restriction relating to the property unless the restriction falls within one of the exceptions to Section 2703.

4) Under Regulation Section 25.2703-1(b)(1)(ii), the right or restriction must not be a device to transfer property to “the natural objects of the transferor’s bounty.” Similarly, Regulation Section 25.2703-1(b)(3) defines members of the transferor’s family to include any “individual who is a natural object of the transferor’s bounty.”

Exceptions to Section 2703

1) Section 2703 does not apply to any option, agreement, right, or restriction:

a. That is a bona fide business arrangement;
b. That is not a device to transfer property to members of the decedent’s family for less than full and adequate consideration in money or money’s worth; and

c. The terms of which are comparable to similar arrangements entered into by persons in an arms’ length transaction.

2) According to Regulation Section 25.2703-1(b)(2), each of these three requirements must be independently satisfied before a right or restriction will meet this exception.

3) If more than 50 percent in value of the property subject to the right or restriction is owned directly by individuals who are not members of the transferor’s family, a right or restriction is considered to have automatically met each of the three requirements. The property owned by the non-members of the transferor’s family must be subject to the same rights and restrictions to the same extent as the property owned by the transferor.

4) According to Regulation Section 25.2703-1(b)(3), members of the transferor’s family include the persons described in Section 25.2701-2(b)(5) (controlled entity) and any individual who is a natural object of the transferor’s bounty.

5) The Regulations define a similar arrangement as one that could have been obtained at a fair bargain among unrelated parties in the same business dealing with each other at arms’ length. A right or restriction is considered a fair bargain if it conforms with the general practice of unrelated parties under negotiated agreements in the same business. The problem is in determining what unrelated parties in the same business do in agreements.

Impact of Section 2703 on Limited Partnership

1) It is the partnership entity that creates the significant discounts. Thus, before the Service can be successful in using Section 2703 to limit discounts, the Service must apply Section 2703 to the transfer of property to the partnership and not to the transfer of a partnership interest. Section 2703 applies to restrictions placed on the use of property. If the restrictions in a partnership agreement on the use of a partnership interest are disregarded, there should not be a significant reduction in the available discounts. On the other hand, there could be a significant reduction in the available discounts if the partnership entity were ignored.

2) If Section 2703 is applicable to restrictions on liquidation, a strong argument can be made that most restrictions found in limited partnership and operating agreements used in estate planning come within the exception under Section 2703(b). That argument should be successful for partnerships created for business purposes. Otherwise, the test under Section 2703 of not being a device to transfer property to family members for less than full and adequate consideration may not be met.
3) Section 2703 applies to any right or restriction created or substantially modified after October 8, 1990. Until this area is clarified, the careful practitioner would avoid substantially modifying any grandfathered partnership or operating agreements.

Section 2704(a) – Overview

1) Under Section 2704(a), a lapse of a voting or liquidation right is treated as a transfer for gift or estate tax purposes if the individual holding the right and members of the individual’s family control the entity both before and after the lapse. Section 2704(a) catches the individual who tries to get rid of a voting or liquidation right, while Section 2704(b) catches the individual who restricts liquidation rights.

2) Two requirements must be met before Section 2704(a) applies:

   a. there is a lapse of any voting or liquidation right in a corporation or partnership, and
   b. the individual holding such right immediately before the lapse and members of such individual’s family must hold, both before and after the lapse, control of the entity.

3) The amount of the gift or increase in the gross estate is the excess, if any, of the value of all interests in the entity owned by the holder immediately before the lapse (determined immediately after the lapse as if the lapsed right were nonlapsing) over the value of such interests immediately after the lapse (determined as if all such interests were held by one individual).

4) Regulation Section 25.2704-1(a)(2)(v) defines a liquidation right to be the ability to “compel the entity to acquire all or a portion of the holder’s equity interest in the entity, including by reason of aggregate voting power, whether or not its exercise would result in the complete liquidation of the entity.”

5) The Regulations make a distinction between voting rights and liquidation rights. Regulation Section 25.2704-1(a)(2)(iv) provides: “the right of a general partner to participate in partnership management is a voting right. The right to compel the entity to acquire all or a portion of the holder’s equity interest in the entity by reason of aggregate voting power is treated as a liquidation right and is not treated as a voting right.”

Section 2704(a) and Death of General Partner

1) Under Regulation Section 25.2704-1(c), a lapse of a voting right or a liquidation right occurs at the time a presently exercisable voting or liquidation right is restricted or eliminated.

2) Example 5 under Regulation Section 25.2704-1(f) illustrates a partnership that is caught by Section 2704(a). In that example, Decedent and Decedent’s two children, A and B, are partners, with each owning a 3 1/3 percent general partnership interest and a 30 percent limited partnership interest. The partnership agreement provides that when a
general partner withdraws or dies, the partnership must redeem the general partnership interest for its liquidation value. Under the partnership agreement, any general partner can liquidate the partnership. A limited partner cannot liquidate the partnership and a limited partner’s capital interest will be returned only when the partnership is liquidated. A deceased limited partner’s interest continues as a limited partnership interest. Decedent dies, leaving his limited partnership interest to his spouse. Because of a general partner’s right to dissolve the partnership, a limited partnership interest has a greater fair market value when held in conjunction with a general partnership interest than when held alone. Section 2704(a) applies to the lapse of the Decedent’s liquidation right because after the lapse, members of Decedent’s family could liquidate Decedent’s limited partnership interest. Accordingly, Decedent’s gross estate includes an amount equal to the excess of the value of all Decedent’s interests in the partnership immediately before Decedent’s death (determined immediately after Decedent’s death but as though the liquidation right had not lapsed and would not lapse) over the fair market value of all Decedent’s interests in the partnership immediately after the Decedent’s death.

3) Section 2704(a) applies to the lapse of a liquidation right. Under the laws of most states, a general partner has the ability to liquidate a partnership. Thus, if the planner wants to avoid Section 2704(a), no individual partner should have the unilateral right to liquidate the partnership.

4) This can be accomplished by numerous ways. First, there can be more than one individual general partner and a majority of the general partners are required to liquidate the partnership (this type of provision could be an applicable restriction). Secondly, the general partner could be a corporation. Third, the partnership agreement could require that the partnership may not be terminated unless all partners’ consent and there are nonfamily members as partners in the partnership. Fourth, the general partner is allowed to transfer the partner’s general partnership interest to a permitted assignee.

5) In avoiding the lapse of a liquidation right under Section 2704, the planner must be careful to avoid a gift upon the formation of the entity.

6) Section 2704(a) does not apply to a transfer of an interest that results in the lapse of a liquidation right if the rights with respect to the transferred interest are not restricted or eliminated. Thus, under Section 2704(a) the transfer of a sufficient number of shares in a corporation to lose voting control is not a lapse. See Reg. Section 25.2704-1(f), Example 4.

7) If a transfer results in the elimination of the transferor’s ability to compel the entity to acquire an interest retained by the transferor that is subordinate to the transferred interest, the transfer is a lapse of a liquidation right with respect to the subordinate interest. See Reg. Section 25.2704-1(c)(1).

8) If a limited partnership interest is treated as a subordinate interest within the meaning of Section 2704(a), there may be a lapse within the meaning of Section 2704(a) when the decedent gives up a general partnership interest.
Section 2704(a) - Transfer of Partnership Interests

1) A general partner has the right to participate in management of the partnership, which a limited partner does not. If the general partner in a limited partnership transfers a portion of his or her partnership interest to a member of the family and under the partnership agreement the transferred partnership interest is converted to a limited partnership interest, Section 2704(a) applies. The general partner would have made a gift under Section 2704(a) equal to the value of the general partnership interest given away by the general partner.

2) A limited partner does not have the right to cause the liquidation of a limited partnership by the partner’s withdrawal. Because a gift of a limited partnership interest should not involve a lapse of a voting or liquidation right, Section 2704(a) should not apply and the value of the gift should be the value of the limited partnership interest.

3) As long as the limited partnership agreement permits the continuation of the limited partnership after the withdrawal of the general partner and there are two or more general partners, Section 2704(a) should not apply. It is unclear whether this provision would be treated as an applicable restriction under Section 2704(b).

Section 2704(a) - Default Rules and Term Partnerships

1) Section 2704(a) applies to the lapse of a right to liquidate. The determination of whether a family has the ability to liquidate an entity is determined by reference to the state law “generally applicable to the entity.” See Reg. Section 25.2704-1(c)(2)(i)(B).

2) The laws of some states provide more restrictive rights on the power of a limited partner to withdraw than others.

Section 2704(a) - Nonfamily Members as Partners

1) One method of avoiding Section 2704(a) is to prevent the transferor’s family from having the ability to liquidate the partnership. Regulation Section 25.2704-1(c)(2)(i)(A) provides that Section 2704(a) does not apply to the lapse of the liquidation right to the extent that the transferor and members of the transferor’s family cannot immediately after the lapse liquidate an interest that the transferor held directly or indirectly and could have liquidated before the lapse.

2) Adding a nonfamily member (such as a charitable organization) as a limited partner or member may prevent the application of Section 2704(a).

3) If the limited partnership agreement or operating agreement requires the unanimous consent of all partners or members before the withdrawing partner or member would be entitled to receive value for his or her interest, the family could not remove the restriction immediately after an interest in the entity had been transferred to another family member, the restriction would not be an applicable restriction, and Section 2704(a) should not apply.
4) This restriction, however, may be subject to Section 2703 if it is not a common business practice to have such a restriction. If Section 2703 is applicable, the restriction will be disregarded for transfer tax purposes.

Section 2704(b) – Overview

1) Under Section 2704(b), certain restrictions on liquidation called “applicable restrictions” are disregarded when valuing an interest in a partnership for transfer tax purposes, thereby increasing the value of the transfer.

2) An applicable restriction is a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the state law generally applicable to the entity in the absence of the restriction.

3) A restriction is an applicable restriction only to the extent that either the restriction by its terms will lapse at any time after the transfer, or the transferor (or the transferor’s estate) and any members of the transferor’s family can remove the restriction immediately after the transfer. Section 2704(b) only applies if the transferor and members of the transferor’s family control (as defined under Section 2701) the entity immediately before the transfer.

4) The ability to remove the restriction is determined by reference to the state law that would apply but for a more restrictive rule in the governing instrument. The fact that a family-governing instrument could override the state’s default rule restricting a limited partner’s or member’s withdrawal right should not be treated as an applicable restriction.

5) If an applicable restriction is disregarded under Section 2704(b), the transferred interest is valued as if the restriction did not exist and as if the rights of the transferee are determined under the state law that would apply but for the restriction.

Section 2704(b) - Restrictions Subject to Section 2703

1) An option, the right to use property, or agreement that is subject to Section 2703 is not an applicable restriction. Thus, it appears that a restriction that satisfies the exception under Section 2703 that the restriction is based on common business practices should not be disregarded under both Section 2703 or Section 2704(b).

Section 2704(b) – Partnership Termination

1) Under Regulation Section 25.2704-2(b), an applicable restriction is a limitation on the ability to liquidate the entity that is more restrictive than the limitations that would apply under the state law generally applicable to the entity in the absence of the restriction. Thus, selecting a state law that provides restrictions on termination and the withdrawal of a limited partner will avoid Section 2704(b).
**Section 2704(b) - Nonfamily Member as a Partner**

1) A method of avoiding Section 2704(b) is to have a nonfamily member (such as a charity) as a partner and require under the partnership agreement that the consent of all partners is required to terminate the partnership. Assuming the nonfamily member is recognized as a partner, this should prevent the application of Section 2704(b).
APPENDIX B

PENNSYLVANIA DEPARTMENT OF STATE
CORPORATION BUREAU

Entity Number

Certificate of Limited Partnership
(15 Pa.C.S. 8511)

Name

Document will be returned to the name and address you enter to the left.

<table>
<thead>
<tr>
<th>Address</th>
<th>City</th>
<th>State</th>
<th>Zip Code</th>
</tr>
</thead>
</table>

Fee: $125

Filed in the Department of State on ____________________

____________________________________________________
Secretary of the Commonwealth

In compliance with the requirements of 15 Pa.C.S. Section 8511 (relating to certificate of limited partnership), the undersigned, desiring to form a limited partnership, hereby certifies that:

1. The name of the limited partnership/limited liability company is:
   ______________________________________________________

2. The (a) address of the limited liability company’s initial registered office in this Commonwealth or (b) name of its commercial registered office provider and the county of venue is:

   (a) Number and Street | City | State | Zip | County
   __________________________ |

   (b) Name of Commercial Registered Office Provider | County
   ____________________________________ |
3. The name and business address of each general partner of the partnership is:

<table>
<thead>
<tr>
<th>Name</th>
<th>Address</th>
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<tbody>
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4. Check, and if appropriate complete, one of the following:

- The formation of the limited partnership shall be effective upon filing this Certificate of Limited Partnership in the Department of State.

- The formation of the limited partnership shall be effective on: _______ at _______.

<table>
<thead>
<tr>
<th>Date</th>
<th>Hour</th>
</tr>
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</table>

5. The specified effective date, if any, is:

<table>
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<tr>
<th>month</th>
<th>date</th>
<th>year</th>
<th>hour, if any</th>
</tr>
</thead>
</table>

IN TESTIMONY WHEREOF, the undersigned general partner(s) of the limited partnership has (have) caused this Certificate of Limited Partnership to be executed this

_______ day of __________, 200_.

________________________
Signature

________________________
Signature

________________________
Signature
CERTIFICATE OF LIMITED PARTNERSHIP

OF

[COMPANY]

The undersigned, desiring to form a limited partnership pursuant to the Delaware Revised Uniform Limited Partnership Act, 6 Delaware Code, Chapter 17, do hereby certify as follows:

I. The name of the limited partnership is ________________________.

II. The address of the Partnership's registered office in the State of Delaware is 2711 Centerville Road, Suite 400, Wilmington, County of New Castle 19808. The name of the Partnership's registered agent for service of process in the State of Delaware at such address is ________________________.

III. The name and mailing address of each general partner is as follows:

<table>
<thead>
<tr>
<th>NAME</th>
<th>MAILING ADDRESS</th>
</tr>
</thead>
</table>

IN WITNESS WHEREOF, the undersigned have executed this Certificate of Limited Partnership of [COMPANY], as of ____________________, 2001

By: _______________________

General Partner

Name: ______________________