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Family Entities Continue as Viable Planning Tool

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Two recently-litigated taxpayer victories underscore the continuing viability of family entities (family limited partnerships or LLCs, or FLPs) as an estate planning tool. These entities serve the purpose of organizing management and control of family assets, and at the same time typically generate estate and gift tax discounts on transferred shares of the entity. Although the Obama Administration proposed earlier this year that the discounts generated by family entities should be reduced or eliminated, these cases indicate that current law still respects the advantages, both tax and non-tax, that can be achieved through these entities.

Keller v. U.S.

In *Keller v. U.S.*, the decedent was a widow with substantial investment assets. She was described as "an impeccably shrewd businesswoman and frugal heiress." According to the court's findings of fact, after one of her daughters went through a lengthy and expensive divorce, she became concerned with protection of the family's assets and interests. She sought the advice of longtime accountants for the family for planning methods to "consolidate and protect family assets for management purposes and to make it easier for these assets to pass from generation to generation." In response, the decedent's advisors suggested that she form a family limited partnership.

Through a series of meetings in 1999, the decedent and her advisors hammered out a plan to contribute a bond portfolio worth $250 million to a family limited partnership. To this end, the decedent signed a partnership agreement and expressed a desire to fund the partnership with the bond portfolio. However, she died unexpectedly before the partnership was formally funded. The decedent's executors filed an estate tax return reporting the full value of the bond portfolio on her estate tax return, but then filed a claim for refund, stating that the value of the partnership interests should be included at a 47.5% discount. The IRS denied the claim for refund, arguing that IRC §§ 2036 and 2038 invalidated the transfer of assets to the partnership for estate tax purposes.

The court found in favor of the taxpayer. Under Texas state law, the court found that "the intent of an owner to make an asset partnership property will cause the asset to be property of the partnership … This is the case whether or not legal or record title to the property has yet been transferred." Since Texas law considered the partnership to be validly created and funded, the court then found that there had been a bona fide sale for full and adequate consideration of the bond portfolio to the partnership. This finding excepted the transfer of assets from IRC §§ 2036 and 2038. Key to the court's finding was the fact that the partnership had a "legitimate business purpose": divorce protection and administration of family assets. The court found that any tax advantages to the partnership were "merely incidental." The court was also impressed with the substantial planning and documentation which went into the formation of the partnership. This proved to the court that the transactions and formation of the partnership were "real, genuine, and not feigned."

The result of this taxpayer victory was a tax savings of approximately $40 million.

Pierre v. Commissioner

In *Pierre v. Commissioner*, 133 T.C. No. 2 (2009), a mother formed a limited liability company (LLC) of which she was the sole member. Several months later, she transferred $4.25 million in cash and marketable securities to the LLC. Several days after the transfer of assets, she made a gift of part of her interest in the LLC to two trusts set up for the benefit of her children. On the same day as the gift, she sold the remainder of her interest in the LLC to the two trusts in exchange for a note. The amount of the gifts and sales were calculated using a 30% discount, although there was a mistake in the appraisal of the underlying assets which resulted in an effective 36.55% discount.

The IRS audited the gift tax return filed in connection with the transfers. The IRS concluded that, because single-member LLCs are disregarded for federal tax purposes, the transfers were transfers of the underlying assets of the LLC, not interests in the LLC itself. IRS therefore denied the application of any discount, and assessed additional gift taxes on the transfers.

The Tax Court found that the LLC was a validly-existing entity for state law purposes, and that state law determined property rights for purposes of estate and gift taxation, not federal law. As a result, the court dismissed the IRS's arguments that the LLC should be disregarded. However, the court reserved judgment as to whether the step transaction doctrine would apply to the transfers, and this part of the opinion has not yet been issued.

Conclusion

Family entities, both limited partnerships and LLCs, provide many advantages, both tax and non-tax, to families desiring to preserve and manage wealth. As the *Keller* and *Pierre* cases demonstrate, the courts uphold those entities which are legitimately and diligently formed. To discuss planning opportunities utilizing a family entity, contact one of the Firm's tax attorneys.