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# Practical Planning for Family LLCs and LPs

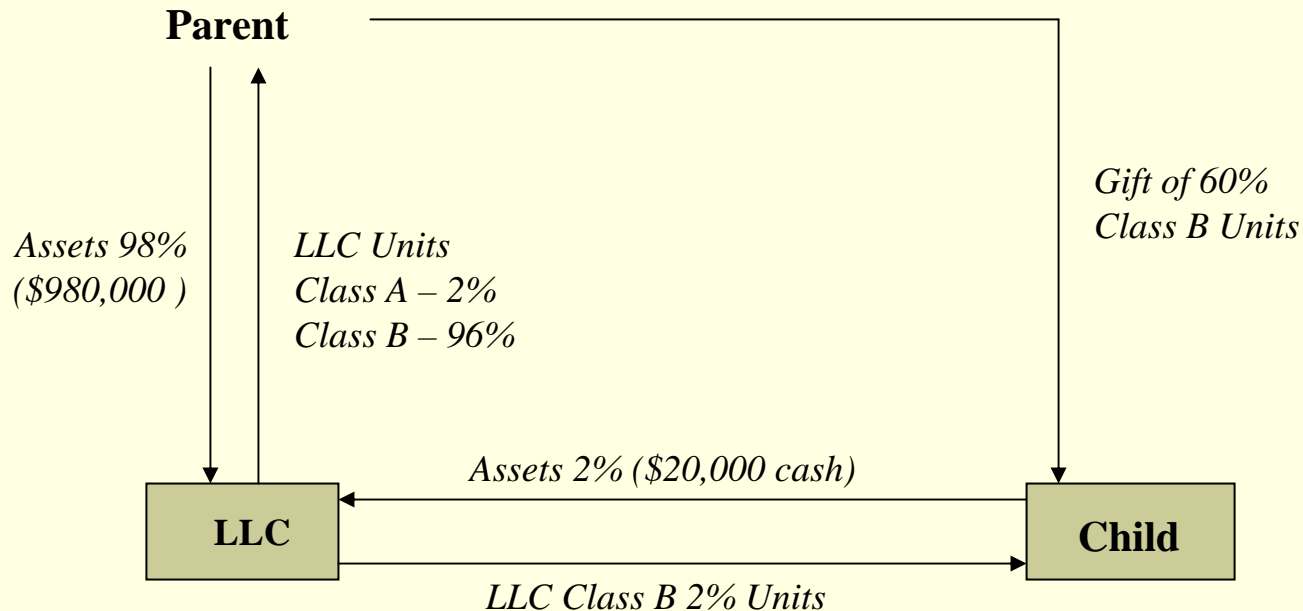
*Designing, Implementing and Operating the  
Family Entity to Avoid a Successful IRS Attack*



# Observations of Family Entity Case Outcomes

Success (probable)		Failure (danger)	
Credible	<ul style="list-style-type: none"> <li>• Real nontax purpose</li> <li>• Before-and-after difference in benefit and control</li> <li>• Reality check on distribution power</li> </ul>	Pig Theory	<ul style="list-style-type: none"> <li>• Death-bed planning</li> <li>• Lacks nontax purpose</li> </ul>
Consistent	<ul style="list-style-type: none"> <li>• Implementation and operation is consistent with nontax purposes and governing instrument</li> </ul>	Perpetuates the Status Quo	<ul style="list-style-type: none"> <li>• All assets in entity</li> <li>• Disproportionate distributions</li> </ul>
Competent	<ul style="list-style-type: none"> <li>• Attorney</li> <li>• Appraiser</li> <li>• CPA</li> <li>• Entity manager</li> </ul> <p>(each fulfill their role)</p>	Procedural Mistakes	<ul style="list-style-type: none"> <li>• Drafting errors</li> <li>• Early gifts</li> <li>• Nonbusinesslike operation</li> </ul>

# Family Entity Strategy Example



1. After the entity is funded and capital accounts reflect contributions, Parent makes a gift
2. After gift is complete, Parent owns 2% Class A and 36% Class B; Child owns 62% Class B
3. Value of Class B Units are reduced by 50% discount; Value of gift  $\$600,000 \times .50 = \$300,000$ ; Value of retained Units also subject to discount
4. Non-tax benefits: management, transfer, limited liability and separate property

# Attacks on Entity Planning Tax Benefits

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- §2036(a)(1)\* – transfer, plus retained benefit (includes “implied” agreement–intra-family transactions with the entity)
- §2036(a)(2)\* – transfer, plus retained control (right to direct benefit without sufficient “constraints”)
- §2038\* – transfer, plus right to amend or revoke
- Valuation issues – extent of discounts under particular circumstances and possible accuracy-related penalties under §6662

# Attacks on Entity Planning Tax Benefits

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- Non-discounted (indirect) gifts of underlying assets – Gift of entity interests prior to completed funding of assets to entity or step-transaction doctrine
- §2703 – ignore certain restrictions on entity interests for valuation purposes
- Gift of a future (not present) interest – not qualify for an annual gift tax exclusion

\*Transfers made to avoid inclusion under §§2036-2038 within three years of death will trigger inclusion under §2035(d)(2)

*See Discounts for Family Limited Partnerships, Appeals Settlement Guidelines dated 10-18-06; Internal Revenue Service UIL No. 2031.01-00 (Search RIA Checkpoint “Appeals Settlement Guidelines for FLPs and FLLCs”)*

# Ten Key Questions in Designing, Implementing and Operating an Effective Entity Strategy

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## QUESTION ONE:

What are the primary facts to look for in determining that an entity is an appropriate strategy?

# Suitability of Entity Planning for the Client

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- A. Assets having significant value (and appreciation potential)
- B. Specific non-tax objectives (management, succession, creditor protection)
- C. Client willingness to treat the entity like a business

“Sole Owner” Approach	“Entity” Approach
• Owner of Assets	• Owner of Entity Interest
• Sole Decision Maker uses “own rules”	• Management Subject to Governing Instrument and State Law
• No Accountability	• Accountability Based Upon Fiduciary Duty and Entity Objectives

# Ten Key Questions in Designing, Implementing and Operating an Effective Entity Strategy

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## QUESTION TWO:

Should a written explanation of the entity strategy be given to the client, including benefits, risks and alternatives, and including a statement of the specific non-tax benefits that are achieved?

- Client understanding
- Credibility with IRS

# Ten Key Questions in Designing, Implementing and Operating an Effective Entity Strategy

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## QUESTION THREE:

Should special steps be taken during the planning process in preparation for possible litigation?

### a) Privileged Information

- Prepare all correspondence/instructions/file memoranda as though it will be “discoverable” by the IRS
- It is easy to inadvertently waive the privilege
- The privilege must be asserted at audit or else it is waived

### b) Qualify for shifting the burden of proof

- Credible evidence that is substantiated
- Cooperation with the IRS

# Ten Key Questions in Designing, Implementing and Operating an Effective Entity Strategy

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## QUESTION FOUR:

How can the entity/plan be designed so that there is the greatest likelihood of qualifying for the exception to Section 2036(a) – bona fide sale for adequate and full consideration?

- What to avoid
- *Kimbell*
- *Bongard*

# Negative Factor Matrix for Finding an "Implied Agreement" Under IRC 2036(a)(1)

	Schauerhammer	Reichert	Harper	Thompson	Kimbell	Strangi-III (3rd cir.) (e)	Stone	Abraham (5th cir.) (e)	Hillgren (1st cir.) (e)	Kimbell (5th cir.) (e)	Bongard (5th cir.)	Bongard (WCB)	Bigelow	Korby (8th cir.) (e)	Schutt	Disbrow	Rosen	Erickson
1. Commingling of entity income and personal income.	X	X	X				X	X										
2. Continuation of pre-entity benefit. Disregard of entity formalities. Nothing changed except legal title. Practical control. Post death payment of expenses/debts of taxpayer and/or his estate.	X	X	X	X	X	X		X	X	(d)	(f)	X	X	X	(f)	X	X	X
3. Disproportionate distributions.	X	X	X	X			(a)	(b)	X			X	X		X	X	X	X
4. Accounting/financial records for the entity prepared after taxpayer's death.	X	X	X					X								X		
5. Taxpayer retained minimal assets after transfers to entity.		X	X	X		X		X	X			X	X			X	X	
6. No significant non-tax or business reason to create entity. Recycling property through partnership form. No pooling of significant assets among partners.	X	X	X	X	X	X		(b)	X	(d)	(f)	X		X	(f)	X	X	X
7. General partners (family members) did not actively manage the assets.	X	X	X	X		X						X				X	X	X
8. Poor health of taxpayer at time of entity formation.	X	X	X	X	X	X	X	X	X	X		X	X	X	X	X	X	X

For Negative Factor Matrix explanation of lettered items, see Exhibit 1 in Practical Planning for Family LLCs and LPs outline, page 33

# How to Fail the “Bona Fide” Test

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## Judge Laro’s “checklist” in *Rosen*

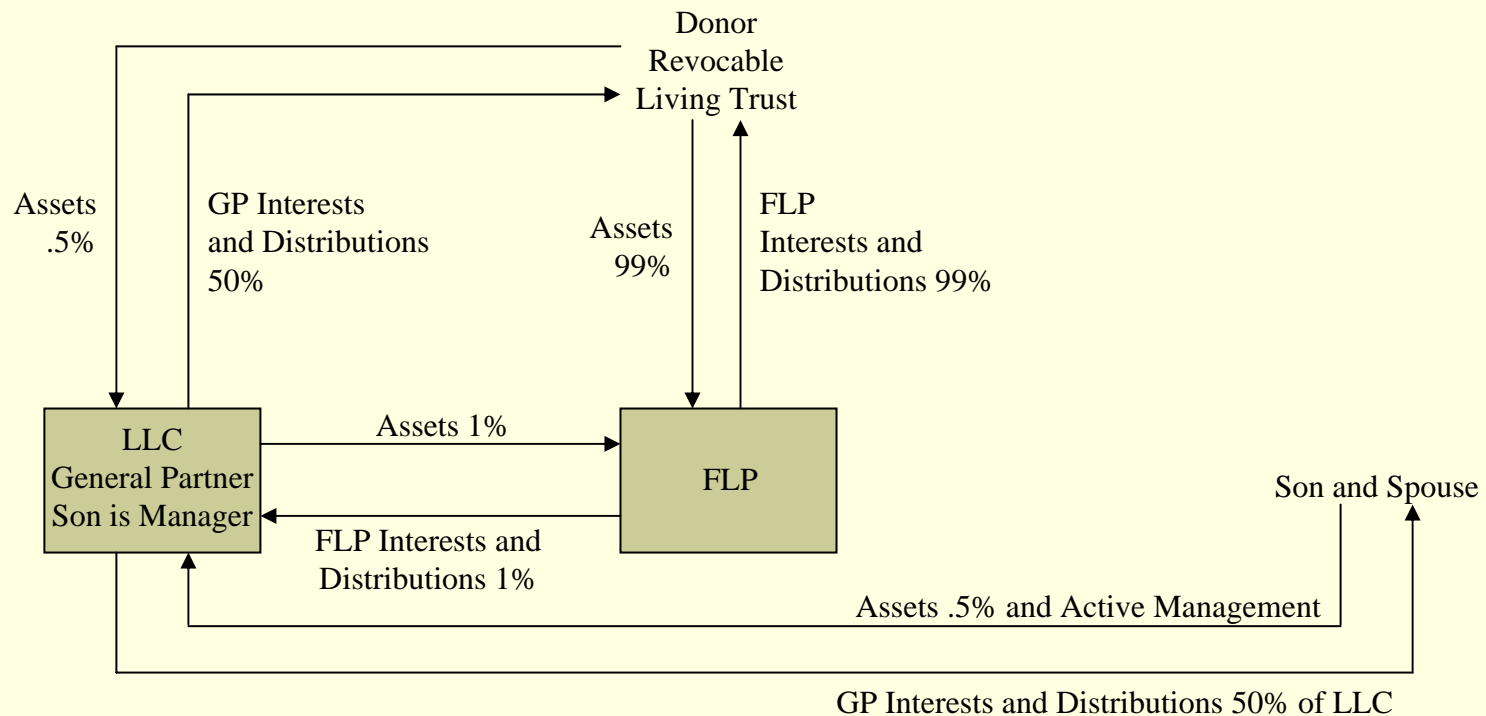
1. No “non-tax” reasons actually motivated the formation of the entity – no functioning business operation or joint venture
2. Not businesslike in capital contribution – capital accounts and issuing entity interests
3. De minimis contribution by children – entity funded solely by transferor
4. No negotiation of terms by partners – general partner “stood on all sides of the transaction”

# How to Fail the “Bona Fide” Test

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5. Transfer of substantially all of transferor’s assets
6. No change in management or benefit
7. Transferor (and the estate) was unable to meet financial obligations without distribution from entity
8. Cash and marketable securities held in a passive manner by entity
9. Advanced age and failing health

# Bona Fide Sale Exception to Section 2036(a) Is Granted in *Kimbell* (5th Cir.)\*



\* Rationale in the *Kimbell* case is based upon an objective approach with “heightened scrutiny” of the intrafamily transaction. The 5<sup>th</sup> Circuit found substantial business and non-tax motives. It is a favorable extension of *Stone*, but not a “safe harbor.”

# *Kimbell* Assessment of Bona Fide Sale for Adequate and Full Consideration Exception

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## 1. Adequate and Full Consideration

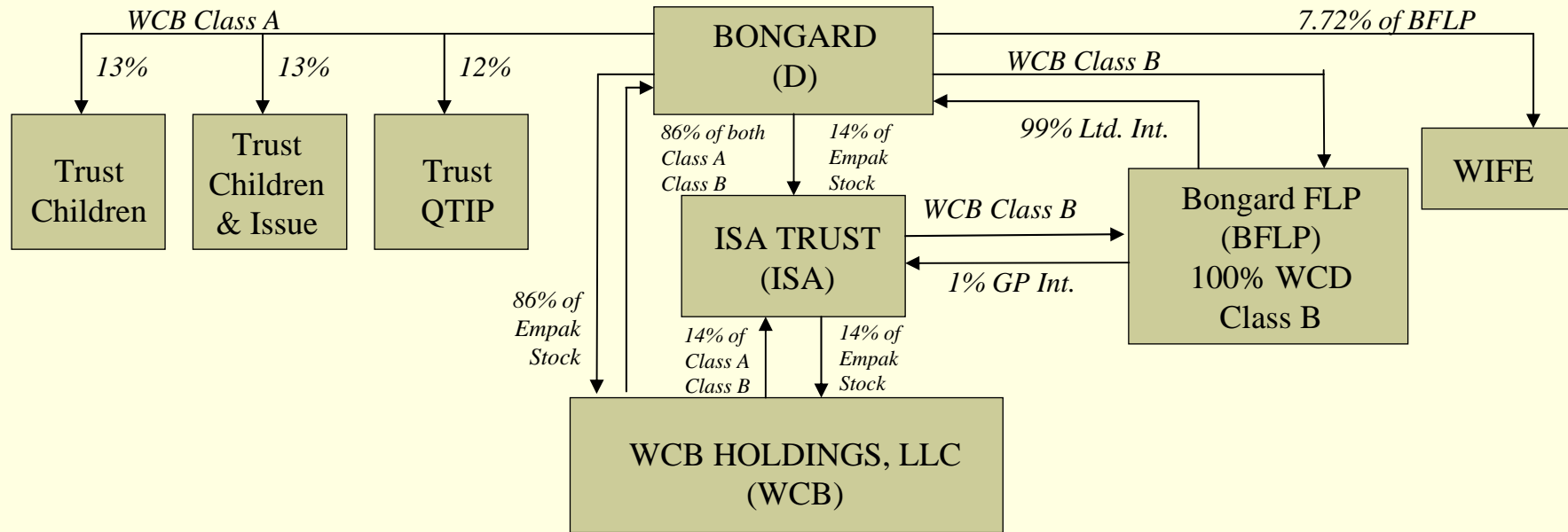
- a. Pro rata entity interests issued for contributions.
- b. Assets credited to partner's capital account.
- c. Distribution upon termination in accordance with capital account.

## 2. Bona Fide Sale

- a. Donor retained sufficient assets for own support.
- b. No commingling.
- c. Entity formalities satisfied in implementation and operation.
- d. Proper funding of assets to entity.
- e. Substantial business or other nontax reasons and significant portion of assets required active management.
- f. Non-tax reasons that cannot be accomplished in a revocable living trust.

# Legitimate and Significant Non-Tax Reason Is the Key to Bona Fide Sale for Adequate and Full Consideration

## Exception to §2036(a) is granted and denied in *Bongard* (Tax Court)



1. WCB was formed to help Empak raise capital, be competitive and manage a stock offering.
2. BFLP was passive – no activities, investments or distributions and D did not utilize the entity for his stated estate planning purpose (no gifts made to children).
3. §§2035 and 2036(a) did not apply to D’s transfer to WCB, but did apply to his transfer to BFLP and his gift of 7.72% of BFLP to his wife.
4. Broad definition of transfer.
5. Legitimate and significant non-tax reason is satisfied if objective evidence shows that the non-tax reason was a significant factor that motivated the creation of the entity.
6. “Practical control” is a basis for finding retained enjoyment under §2036(a)(1).

# *Bongard* (Tax Court): Assessment of Bona Fide Sale for Full and Adequate and Full Consideration

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## 1. Adequate and Full Consideration

- a. Transferors each received an interest in the entity that was proportionate to the assets transferred
- b. Assets contributed were properly credited to respective capital accounts
- c. Distributions from entity resulted in negative adjustment to capital account
- d. Legitimate and significant non-tax business reason satisfies heightened scrutiny regarding “dissipated value”

# *Bongard* (Tax Court): Assessment of Bona Fide Sale for Full and Adequate and Full Consideration

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## 2. Bona Fide Sale

- a. Arms-length transaction is how unrelated parties would structure the transaction
- b. Legitimate and significant non-tax reasons for forming the entity
- c. The pooling of assets
  - i. Capital accounts were properly credited and maintained
  - ii. No Commingling
  - iii. Pro rata distributions

# Ten Key Questions in Designing, Implementing and Operating an Effective Entity Strategy

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## QUESTION FIVE:

Should the client engage in transactions with the entity (living in the home; borrowing money)? What steps should be taken in documenting such transactions if they are necessary?

- *Disbrow* – retained use of house by transferor
- *Rosen* – extensive loans made to transferor

# Ten Key Questions in Designing, Implementing and Operating an Effective Entity Strategy

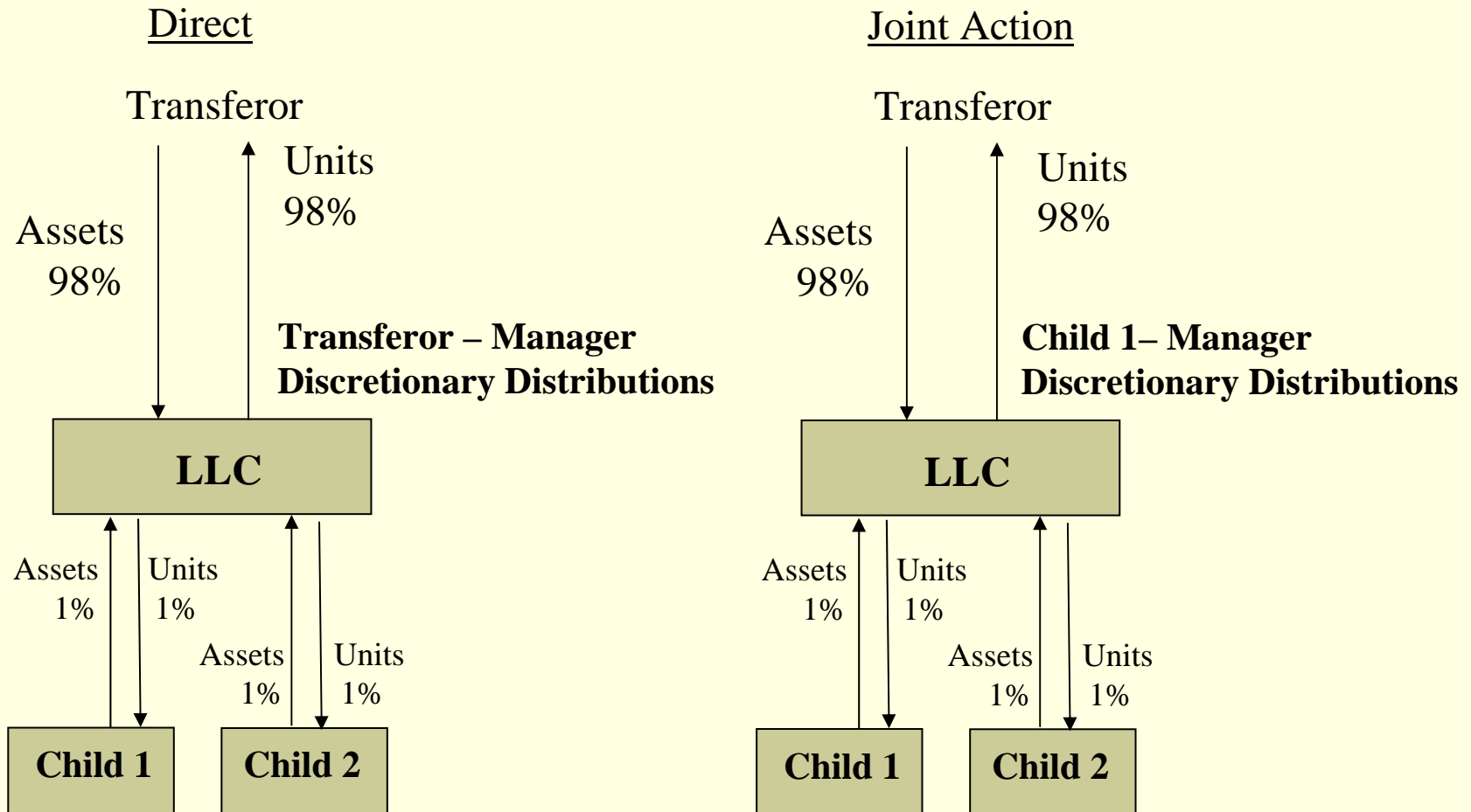
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## QUESTION SIX:

How can an entity be rehabilitated that has a section 2036(a)(2) “retained control” issue or designed to avoid Section 2036(a)(2)?

- Section 2035 3-year rule is triggered if the transferor’s control is eliminated (transfer or amend agreement)
- *Byrum* – 1972 Supreme Court Case
- *Strangi II* – 2003 Tax Court Memo Case

# Section 2036(a)(2) Right To Designate\*



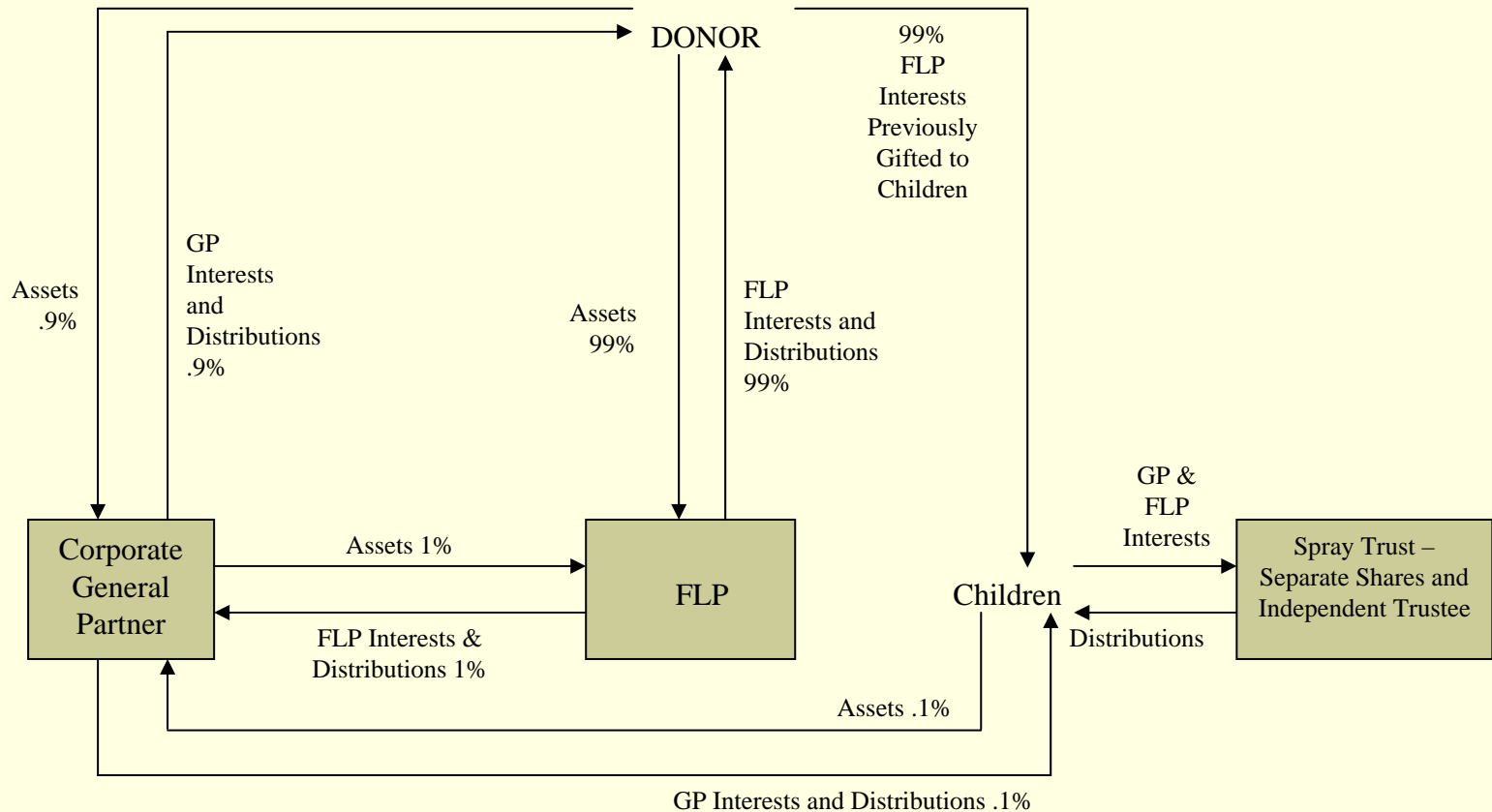
\*The right to designate is not in effect for Section 2036(a)(2) purposes if it is subject to sufficient “constraints.”

# Family Entity Section 2036(a)(2) Assessment Based on Strangi II

	Weak					Strong				
	1	2	3	4	5	1	2	3	4	5
1. <u>General Fiduciary Duty</u>										
a. Meaningful interest owned by independent party.										
b. Meaningful interest subject to independent oversight.										
c. Other circumstances or governing instrument provisions that elevate the probability that fiduciary duty will be enforced.										
2. <u>Economic and Business Realities</u>										
a. Nontax and economic objectives.										
b. Going business/active investment/change from pre-entity approach.										
c. Periodic monitoring and businesslike operation of entity.										
3. <u>Distributions and Liquidation</u>										
a. Donor is restricted from making discretionary distributions.										
b. Donor may not participate in decision to liquidate.										

# Existing Family Entity With Transfers by Children to Trust

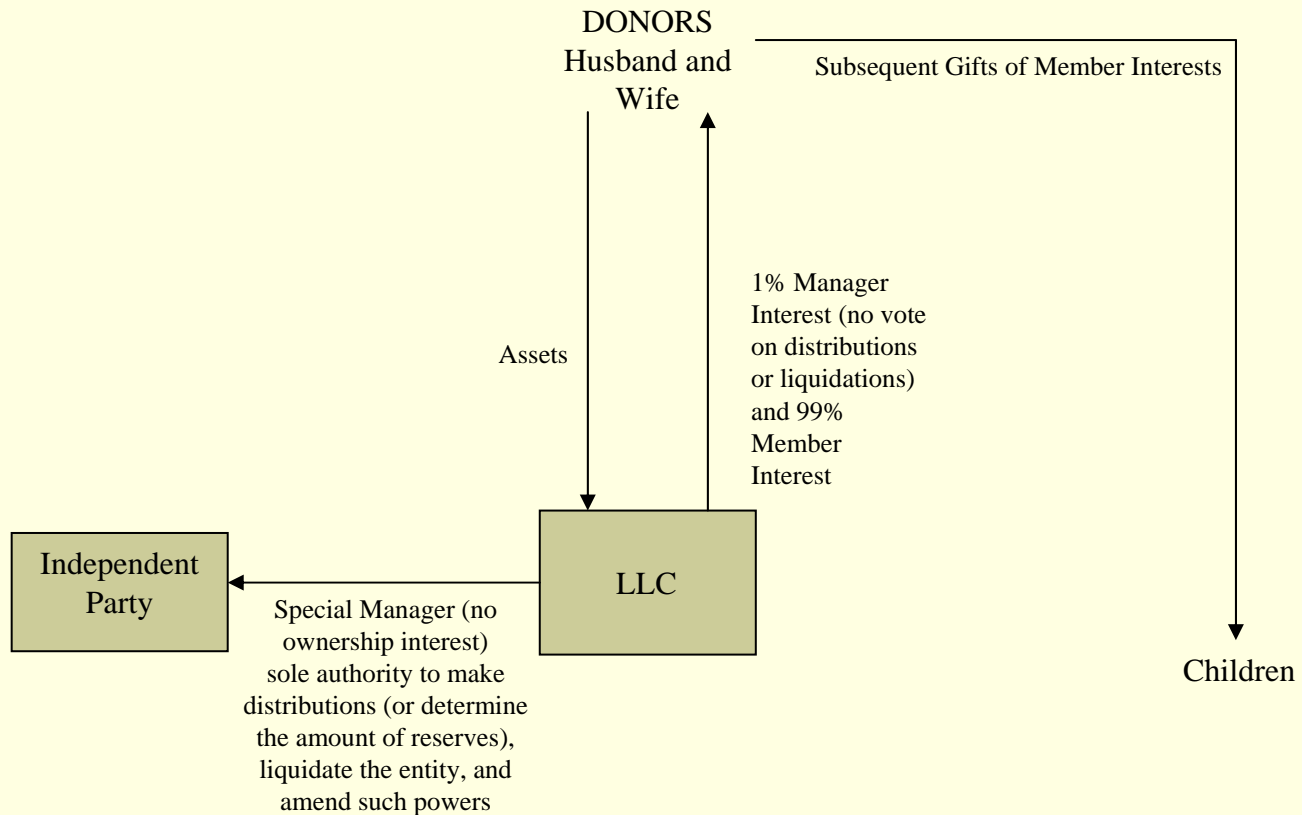
Section 2036(a)(2) Arguably Does Not Apply\*



\* Independent distribution and oversight adds accountability to Donor's fiduciary duty.

# New Family Entity with Special Manager

Section 2036(a)(2) Does Not Apply



# Design of Entity to Satisfy State Law and Tax Law Requirements

A. Capital Structure	
<ul style="list-style-type: none"><li>• Pro rata equity interests</li></ul>	<ul style="list-style-type: none"><li>• Avoids gift on formation and Section 2701</li></ul>
B. Distribution	
<ul style="list-style-type: none"><li>• Legally enforceable standard or third party discretion for distributions</li></ul>	<ul style="list-style-type: none"><li>• Avoids Section 2036(a)(2)</li></ul>
C. Term of Existence	
<ul style="list-style-type: none"><li>• Perpetual existence and unanimous consent for amendment</li></ul>	<ul style="list-style-type: none"><li>• Avoids IRS reduction of discounts</li></ul>

# Design of Entity to Satisfy State Law and Tax Law Requirements

<b>D. Withdrawal Restriction</b>	
<ul style="list-style-type: none"><li>• No withdrawal from entity</li></ul>	<ul style="list-style-type: none"><li>• Satisfies Section 2704(b) and supports discounts</li></ul>
<b>E. Transferability of Interests</b>	
<ul style="list-style-type: none"><li>• Entity interests transferable after right of first refusal or other restrictions comparable to third-party arrangements</li></ul>	<ul style="list-style-type: none"><li>• Avoids Section 2703 disregard of restrictions and qualifies transfers as “present interests”</li></ul>
<b>F. Management Authority and Fiduciary Duty</b>	
<ul style="list-style-type: none"><li>• Management powers, accountability, and fiduciary duty should be comparable to third-party arrangements</li></ul>	<ul style="list-style-type: none"><li>• Avoids Section 2036(a)(2)</li></ul>

# Ten Key Questions in Designing, Implementing and Operating an Effective Entity Strategy

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## QUESTION SEVEN:

Can an independent party play a significant role in “safeguarding” the plan from a Section 2036(a) attack?

- a) Provide a “reality check” regarding distribution, liquidation and special powers
  - Special manager
  - Trustee for donees
- b) Provide follow-up to assure that the entity implementation and operation is properly executed

# Ten Key Questions in Designing, Implementing and Operating an Effective Entity Strategy

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## QUESTION EIGHT:

What is the most common problem in a) implementing the entity and b) operating the entity?

# Compliance – Procedure Issues

A. ESTABLISHMENT AND INITIAL OPERATION	Target Date	Progress	Completion
1. Execution and Filing (if needed) of Formation and Governing Instruments			
2. Funding of Entity			
3. Special Funding Issues <ul style="list-style-type: none"> <li>• Real Estate</li> <li>• Consent of any Existing Creditors</li> <li>• Marketable Securities/Investment Company Rules</li> <li>• Debt in excess of Basis</li> </ul>			
4. Communication with Other Professionals and Delegation of Responsibilities			
5. Establish Entity Bank Accounts and Financial Procedures			

# Compliance – Procedure Issues

A. ESTABLISHMENT AND INITIAL OPERATION	Target Date	Progress	Completion
6. Initial Entity Capital Accounts and Financial Records			
7. Gifting of Entity Interests <ul style="list-style-type: none"> <li>• Documents</li> <li>• Delivery</li> </ul>			
8. Appraisals (Prior to Date of Gift) <ul style="list-style-type: none"> <li>• Assets</li> <li>• Discount</li> </ul>			
9. File Initial Tax Returns (Income; Gift)			
10. Documentation of Party/Entity Transactions			
11. Follow up meeting prior to end of initial tax year to deal with adjustments, rescission and other Section 761 issues			

# Ten Key Questions in Designing, Implementing and Operating an Effective Entity Strategy

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## QUESTION NINE:

What steps can be taken in order to “separate” the funding of the entity and the gifting of entity interests to assure that the “step transaction” doctrine does not apply? (*Senda* case)

- Don't make final decision regarding gifts until after funding is completed
- A reasonable period of time must pass following funding (objective evidence) prior to gifting

# Ten Key Questions in Designing, Implementing and Operating an Effective Entity Strategy

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## QUESTION TEN:

What safeguards should be implemented so that the operation of the entity will be effective?

# Compliance – Procedure Issues

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## A. Periodic Monitoring

1. Use of entity bank accounts
2. Distributions made in accordance with governing instrument
3. Business plan progress and update
4. Documentation/recording of additional capital contributions and issuance of additional entity interests
5. Documentation/appraisal/reporting of gifts
6. Documentation/valuation of entity/party transactions
7. Minutes of entity actions
8. Filing of returns (income, gift)
9. Filing of state annual licensing reports

# Compliance – Procedure Issues

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## B. After Death of Transferor

1. Avoid distributions from entity (or redemption of entity interests) to pay taxes or administrative expenses
2. Continue to operate the entity

C. Delegate “follow-up” responsibilities to professional advisors to assure that steps occur

D. Depending upon circumstances, annual meeting with attorney and/or CPA or trustee may be the best practice