Avoiding Pitfalls in Designing, Implementing and Operating a Family Entity

57th Annual Estate Planning Seminar
Seattle, Washington
November 2, 2012
Introduction

- Variety of pitfalls
  - Form and substance;
  - Gift, estate and income tax;
  - Expertise, strategy and communication of professionals; and
  - Decisions, mindset and follow-through of client

- Materials and Resources: PowerPoint available at www.landerholm.com/People/T.-Randall-Grove

- Objective: Understand the key considerations in planning, drafting and advising so that client objectives are achieved and the potential pitfalls are avoided
1. Parent and Child each make a contribution and proportionate equity interests of Class A and Class B Units are issued.
2. Parent makes a gift of 60% Class B Units.
3. Value of Class B Units are reduced by 40% discount; Value of gift $600,000 x .60 = $360,000.
4. Value of retained Units also subject to discount.
Legitimate and Significant Non-Tax Purposes

1. Description

- Key to credibility and accomplishing tax objectives
  - §2036(a) exception – “bona fide sale” test
  - Step transaction

- Attributes
  - Non-tax purpose is actual
    - Third parties would do the same thing under similar circumstances;
    - Continues family investment strategy; or
    - Asset protection and preservation
2. Law – Is the non-tax purpose legitimate and significant?

Key cases:

a. *Bigelow* – *Bigelow v. Comm.*, 503 F.3d 955 (9th Cir. 2007), *aff’g* T.C. Memo 2005
   - 9th Circuit case
   - IRS victory because non-tax purposes not “actual” – didn’t use approach that unrelated parties would use

   - Tax court analysis that is most frequently cited
   - One family entity succeeded
   - One family entity failed
Legitimate and Significant Non-Tax Purposes

Key cases: (continued)

   - “Legacy” marketable securities (DuPont family)
   - Perpetuating Investment Strategy is sufficient

   - Protection from divorce

e. *Shurtz* — *Shurtz v. Comm.*, T.C. Memo 2010-21
   - Promote management of timberland
   - Avoid “Jackpot Justice” in Mississippi
# Negative Factor Matrix for Finding an “Implied Agreement” Under IRC 2036(a)(1)

(Cases from 2007 to 2012)*

| 1. Mingling of entity income and personal income. | X | X | X | X | (a) | X | (g) | X | (d) | (d) | (d) | X | (j) | X | (i) | (d) |
| 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 | (a) | X | (g) | X | (d) | (d) | (d) | X | (j) | X | (i) | (d) |
| 3. Disproportionate distributions contrary to entity governing instrument. | X | X | X | (a) | X | X | | | | | | | | | | | |
| 4. Disregard for financial formalities during taxpayer's lifetime. | X | X | | | | | | | | | | | | | | |
| 5. Taxpayer depended on entity distributions during lifetime. | 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 | (f) | X | X | (f) | X | (f) | (f) | (f) | X | X | (f) | (f) | |
| 7. General partners did not actively manage the assets. | 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 | | | | | | |

(a) Upon the death of the primary transferor, a distribution was made from the entity to enable the estate to pay estate taxes; the Tax Court found that the requirements for the exception to Section 2036(a) were satisfied.
(d) Entity formalities were observed and transfers of assets and entity interests were completed. Proportionate interests were received in exchange for assets contributed.
(f) A legitimate and significant non-tax reason motivated the creation of the entity and the transfer qualifies for the exception to Section 2036(a).
(g) Governing instruments were executed but entities were not funded; however, transferor directed funding with specific assets. Contributions by other partners are not subject to "de minimus" test.
(h) Murphy is currently on appeal.
(i) No discounts were used in valuing gifts of FLP interests; most entity formalities followed with several minor exceptions.
(j) High management fee paid to transferors; direct payment of personal expenses; transferor had sole right to amend partnership agreement and sole discretion to make distributions.

* Shaded areas are taxpayer victories.
Legitimate and Significant Non-Tax Purposes

3. Credibility Boost

- Financial independence of primary transferors
- Practical independence of each transferor
- Documentation of reasons for non-tax purpose
- Difference in management and/or investment (before and after establishment of entity)
- Prepare business plan for entity and use it for evaluation and decisions in the future
Capitalization of Entity – Potential Recharacterization of Loans

1. Description
   - Contribution of capital to entity
   - Loan to entity by primary transferor
   - Recharacterization of loan to contribution
     - Deemed indirect gift due to increase in equity value for all members; or
     - Ownership dilution (of non-contributing members) from issuing additional entity interests to contributor; and
     - Shift of cash flow from lender to members
   - Occurs if loan is not designed or operated in a businesslike manner

2. Law
3. Scenario
   - Stan and Francine (husband and wife) and their two children, Steve and Haley, own an LLC as 25% members.
   - Stan and Francine loan the LLC $1,000,000 for tenant improvements and receive a low-interest unsecured demand note
   - The LLC makes no payments

4. Solutions
   - Businesslike loan terms – See Rosen case, Exhibit 1, pages 37-38
   - See indirect gift analysis in outline – See pages 16-18
   - Consider loan v. contribution carefully when planning
1. Description

- General non-recognition of income tax rule does not apply if the family entity is an “investment company” following a contribution

- 80% or more is marketable securities or cash

- Exception for:
  - No diversification (identical assets contributed by transferors)
  - Applies to each asset contributed to the entity, each time a contribution is made
Gain Recognition upon Contribution to an Investment Company Partnership §721

2. Law
   - §721
   - Treas. Reg §1.351-1(c)(1) – Definition of investment company

3. Scenario
   - Phillip, Arnold and Willis each make contributions to an LLC; two phases of contributions. See example in outline.

4. Solutions
   - More than 20% of assets are real estate or interests in a closely held active business
   - Contribute identical marketable securities
1. Description
   - If residence is contributed to LLC and the transferor continues to use the residence;
   - §2036(a)(1) applies;
   - Unless the exception to §2036(a) is satisfied ("adequate and full consideration")

2. Law
   - §2036(a)(1)
   - *Disbrow* — *Disbrow* v. Comm., *T.C. Memo 2006-34*
     - Transfer of residence to entity with retained use of residence by transferor — IRS Victory due to non-businesslike approach regarding lease and payments
   - §119(a)
Contributions of Personal Use Property

3. Solutions

- Lease the house for market rate and terms
- Use of property can be compensation for services
- Value of use of farm house will be excluded from income:
  - If user is an employee for §119, and
  - If use is necessary to do her job
  - For the convenience of the employer
Protection from Liability – Arising From LLC Assets and From Personal Creditors of Members

1. Two types of liability protection from an LLC
   - From claims related to assets in the LLC
   - From claims of personal creditors of a member against such member’s LLC interest
     - What happens if a member of LLC files for bankruptcy?
     - Will the bankruptcy trustee be subject to the provisions of the operating agreement?
     - What steps can be taken to make an LLC interest less attractive to a bankruptcy trustee?
2. Solutions

- Consider including the obligations set forth in *Norberg* in the operating agreement so that it qualifies as an executory contract – may be important if members own LLC interests outright
  - Management participation
  - Voting on various matters
  - Additional capital contributions

- Consider gift of entity interest to irrevocable trust

- Obtain advice from bankruptcy counsel regarding effect of executory and non-executory status under particular facts
Indirect Gift – Treated as Gift of (Contributed) Assets, Not Gift of Entity Interest

1. Description

- After entity is formed and funded and members own interests in entity
- Subsequent contribution results in all members receiving proportionate increase in value (based on ownership)
- Transfer is treated like transfer of assets, not transfer of interests
- Failure to adequately document transactions or reflect contribution in transferor’s capital account can result in indirect gift

2. Law – See Exhibit 3, page 40

- **Jones** — *Jones v. Comm.*, 116 T.C. 121 (2001)
- **Senda** — *Senda v. Comm.*, T.C. Memo 2004-160, aff’d 433 F.3d 1044 (8th Cir. 2006)
## Indirect Gift* and Step-Transaction** Factors Matrix***

(Application of Either Approach May Diminish or Eliminate Discounts or Otherwise Undermine Tax-Saving Strategies)

<table>
<thead>
<tr>
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Key:  - means negative factor for taxpayer  
+ means positive factor for taxpayer
3. Solutions

- Multiple owners – entity must issue interests in exchange for contribution if no gift is intended – document subsequent contributions

- Need time separation between entity funding and gifting of interests

- Reflect contribution in transferor’s capital account (see Exhibit 2, page 39)

- Retroactive entries to capital accounts must be done as soon as possible (prior to death of transferor)
1. Description

- Series of steps treated as single transaction for tax purposes if:
  - Integrated in substance (no step had independent significance)
  - Interdependent
  - All focused on particular result

- Step transaction doctrine may be used to eliminate tax benefit from the steps if insufficient substance
2. Law – See Exhibit 3

- **Holman** – *Holman v. Comm.*, 130 T.C. 170 (2008), *aff’d on other grounds* 601 F.3d 763 (8th Cir. 2010).
  Between funding and gifts, the taxpayers experienced economic risk, giving independent significance to steps.

- **Linton** – *Linton v. U.S.*, 630 F.3d 1211 (9th Cir. 2011), *aff’g in part, rev’g in part* 638 F. Supp. 2d 1277 (W.D. Wash. 2009)
  9th Circuit analyzed step transaction doctrine tests in a practical manner and focused on the interdependent test (each individual step is fruitless without completion).

- **Pierre II** – *Pierre v. Comm.*, T.C. Memo 2010-106
  IRS victory when structure of overall transaction generated valuation discounts with no non-tax purpose and no significant separation of time between steps.
Indirect Gift* and Step-Transaction**
Factors Matrix***

(Application of Either Approach May Diminish or Eliminate Discounts or Otherwise Undermine Tax-Saving Strategies)

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Key:  - means negative factor for taxpayer
+ means positive factor for taxpayer
3. Scenario

- Sharon and John form and fund LLC on 9-1-12 with marketable securities
- Gifts of interest in LLC made on 9-2-12 (claimed discount on Form 709)
- How long must the holding period be for the transferors to experience economic risk?
- Were there non-tax purposes for the LLC? If so, is it necessary to have a holding period?
Step-Transaction (Collapse of Interrelated Steps into One Transaction)

4. Solutions

- Determine that the step does not result in a greater tax benefit
- Document non-tax reason/independent significance for forming and funding the LLC
- Allow sufficient time between steps (e.g., formation and gift)
1. Description

- To qualify, gift must be of a present interest
- Gift of interest in LLC is a present interest if:
  - Immediate substantial economic benefit; or
  - Interest is freely transferable

2. Law

- **Hackl** — *Hackl v. Comm.*, 118 T.C. 279 (2002), aff’d 335 F.3d 664 (7th Cir. 2003)
  No present interest because no income distributed and significant restrictions on transfer

- **Price** — *Price v. Comm.*, T.C. Memo 2010-2
  No present interest because no consistent income distributed and significant restrictions on transfer
Annual Gift Exclusion Qualification

  
  There was present interest because:
  
  - Entity generated income
  - Some portion of income flowed to members
  - Income could be readily ascertained

3. Scenario

- Brad and Angie form and fund LLC to hold commercial real estate and they make annual gifts of entity interests to their children and grandchildren

- No consistent income; distribution at discretion of manager

- “Unanimous consent” restriction on transfers
4. Solutions

- Amend operating agreement to require distribution of income
- Provide for put right – can sell entity interest to transferor for 60 days (see Exhibit 4, page 41)
- Allow transfers to third parties subject to limited right of first refusal
1. Description

- Certain contractual rights and restrictions will be disregarded when determining value for transfer tax purposes;
- Unless three-part “bona fide business” exception is satisfied

2. Law

- §2703(a): Any option, agreement for acquiring entity interests or restriction on right to use or sell is disregarded when establishing value
- §2703(b):
  - Bona fide business arrangement
  - Not a device to transfer to family for low price
  - Terms are comparable to third party arrangements
Certain Restrictions Disregarded for Valuation Purposes – §2703

- Treas. Reg. §25.2703-1(b)
  - §2703(b) test is deemed met if over 50% of owners are non-family
  LLC not involved in a bona fide business

3. Solutions

- Instruct appraiser to not consider the formula price in the operating agreement or restrictions on transfer unless §2703(b) tests are satisfied
- Use fair market value in buy/sell agreement, taking applicable discounts into account
1. Description

- If major gifts are made when transferor has insufficient cash flow
- If the value of retained assets diminish in an extraordinary way after the gift is made
- Risk of excess compensation or disproportionate distributions from entity when over gifting has occurred

2. Law


Disproportionate distributions to transferor (personal expenses and to fund annual gifts)
3. Scenario

After forming and funding LLC and making gifts and a “reversal of fortune,” Donald has insufficient cash flow to sustain his lifestyle.

4. Solutions

- Redeem (or sell to family) all or a part of transferor’s entity interest
- Gifts from transferees to transferor
- Gifts must not be done on a consistent basis and not equal to distributions or else §2036(a) will be implicated
Washington Real Estate Excise Tax on Entity Interest Transfers

1. Description
   - Transfers of controlling interests in entities within 12 months can trigger the Washington real estate excise tax (REET)
   - Tax is assessed on 100% of real estate value
   - Transfers by gift (transfer for no consideration) are exempt
   - Debt secured by real property is deemed to be consideration

2. Solutions
   - Utilize gift exemption
   - If consideration involved, transfer 49% or less in a 12-month period
1. Description

- Transfer assets and retain income or use of transferred asset
- Legal right or implied agreement
- Implied agreement factors – See Exhibit 5, pages 43-44
  - Disproportionate distributions
  - Commingling of entity assets and income with transferor’s assets and income
  - Using entity assets for personal purposes
  - No significant change after entity is formed and funded
2. Scenario

- Tim and Jill form and fund an LLC and later make a gift of a 20% interest to each of their three children
- When LLC cash flow substantially increased, Tim and Jill used broad discretionary authority in the operating agreement to make disproportionate distributions
- Only distributions to children were for payment of income tax
3. Solutions

- Disproportionate distributions – if same year
  - Repay excess distributions
  - Make equalizing distributions
  - Treat as redemption to extent of disproportionate interest

- If disproportionate distributions are “old and cold”
  - Start making proportionate distributions
  - Wait out the §2035(a) three-year period

- Satisfy exception to §2036(a) by
  - Bona fide sale
  - For adequate and full consideration
  - In money or money’s worth
1. Description

- Right to direct who enjoys property or receives income
- Alone or in connection with others
- Causes transferred assets to be included in transferor’s estate
- Retention of typical managerial control over transferred property does not trigger §2036(a)(2)
- However, retained authority to make discretionary distributions triggers §2036(a)(2), unless
  - Objective standard
  - Other reality check
2. Law

- **Strangi** — *Strangi v. Comm.*, T.C. Memo 2003-145, on rem’d from *Gulig, Rosalie v. Comm.*, 293 F.3d 279 (5th Cir. 2002), aff’g in part and rev’g in part 115 T.C. 478 (2000)
  
  Tax Court found that §2036(a)(2) applied

- **Turner** — *Turner v. Comm.*, T.C. Memo 2011-209
  
  Transferor retained right to direct income

- **Byrum** — *U.S. v. Byrum*, 408 U.S. 125 (1972)
  
  US Supreme Court case that provides excellent analysis and planning strategy
Negative Factor Matrix for Finding an “Implied Agreement” Under IRC 2036(a)(1)

(Cases from 2007 to 2012)*

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<th>Factor</th>
<th>Erickson</th>
<th>Gore</th>
<th>Rector</th>
<th>Mirovski</th>
<th>Hartford</th>
<th>Jorgensen</th>
<th>Miller-1</th>
<th>Keller</th>
<th>Malkin</th>
<th>Murphy (b)</th>
<th>Black</th>
<th>Shurtz</th>
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<td>(g)</td>
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<td>(d)</td>
<td>(d)</td>
<td>(d)</td>
<td>(d)</td>
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<tr>
<td>Nothing changed except legal title. Practical control. Post death payment of expenses/debts of taxpayer and/or his estate.</td>
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<td></td>
<td>(a)</td>
<td>(g)</td>
<td>(j)</td>
<td>(i)</td>
<td>(d)</td>
<td></td>
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</tr>
<tr>
<td>3. Disproportionate distributions contrary to entity governing instrument.</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>(a)</td>
<td>X</td>
<td>X</td>
<td></td>
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<tr>
<td>4. Disregard for financial formalities during taxpayer's lifetime.</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td></td>
<td>X</td>
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<tr>
<td>5. Taxpayer depended on entity distributions during lifetime.</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
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<tr>
<td>6. No significant non-tax or business reason to create entity. Recycling property through partnership form. No pooling of significant assets among partners.</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>(f)</td>
<td>X</td>
<td>X</td>
<td>(f)</td>
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<td>X</td>
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<td>(f)</td>
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<tr>
<td>7. General partners did not actively manage the assets.</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
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<tr>
<td>8. Poor health of taxpayer at time of entity formation.</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
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</tbody>
</table>

(a) Upon the death of the primary transferor, a distribution was made from the entity to enable the estate to pay estate taxes; the Tax Court found that the requirements for the exception to Section 2036(a) were satisfied.

(d) Entity formalities were observed and transfers of assets and entity interests were completed. Proportionate interests were received in exchange for assets contributed.

(f) A legitimate and significant non-tax reason motivated the creation of the entity and the transfer qualifies for the exception to Section 2036(a).

(g) Governing instruments were executed but entities were not funded; however, transferor directed funding with specific assets. Contributions by other partners are not subject to “de minimus” test.

(h) Murphy is currently on appeal.

(i) No discounts were used in valuing gifts of FLP interests; most entity formalities followed with several minor exceptions.

(j) High management fee paid to transferors; direct payment of personal expenses; transferor had sole right to amend partnership agreement and sole discretion to make distributions.

* Shaded areas are taxpayer victories.
3. Solutions

- Include a special manager for making distributions and dissolution decisions; or
- Require an objective formula be used for distributions; amend operating agreement as needed
- Authorize transferor to remove the special manager and require that another special manager be appointed
3. Solutions (continued)

- Transferees each establish an irrevocable grantor “buffer trust” and transfer entity interests to it
  - Appoint independent trustee with authority to sprinkle or accumulate income
  - The independent trustee creates a “buffer” between the retained authority of the manager/transferor to make distributions and the benefit of the beneficiary
- In Byrum, this approach addressed the §2036(a)(2) issue (See Exhibit 6, page 45, for “buffer trust” diagram)
Special LLC Design to Promote Businesslike Operation and to Protect From IRS Attacks

- Shift of equity ownership
- Retention of management control
- Gift tax value of transferred LLC units is significantly discounted

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**Smith Property LLC**

**John and Jane**

(fair market value of property)

$_____________

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**Special Manager**

______________

Special Manager (no ownership interest)
sole authority to make distributions and liquidate the entity

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**Trusts for Children**

Independent Trustee

Discretionary distributions

---

**Assets**

2% Class A Units (control) 98% Class B Units (equity) and manager compensation at fair market rates

---

**Children**

LLC Units

---

**LLC**

2% Class A Units 98% Class B Units