Report #5

A complete listing of the proceedings and speakers is available on **the Institute's Web site**

(Monday and Tuesday A.M.)

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This Report contains additional coverage of the Monday A.M. Fundamentals program and coverage of one of the four Tuesday morning general sessions.

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Monday, 1/10/05 - **FLPs and LLCs from A to Z** Louis A. Mezzullo Esq.

Report by Shelly D. Merritt Esq.

Mr. Mezzullo gave a comprehensive presentation on issues relating to family limited partnerships and LLCs. He first addressed what type of entity to use for a family entity. It generally comes down to either a limited liability partnership or limited liability company. For several reasons stated throughout the presentation, Mr. Mezzullo prefers LLCs if the applicable state statute meets certain requirements discussed below.

He pointed out that the nature of the assets affects the type of entity to use. For example, if the client has an active business, it may be preferable to use an S-corporation in order to be able to treat some income as dividend income to avoid the additional 2.9% self employment tax.

Characteristics of an interest in an entity affecting discount on value:
1. Management rights add to value, lack thereof decreases value
2. If a member/partner has the right to require the entity to buy his or her interest at any time, this also adds to value, lack thereof decreases value.
3. If a member/partner can transfer freely, adds to value, lack thereof decreases value.

Tax issues

1. Qualifying a transfer of an interest in an entity for annual gift tax exclusion. Hackle case involved LLC with no steady stream of income. Court held that where donee could not transfer full membership interest to a 3rd party, a gift of the interest doesn't qualify for annual exclusion. To avoid Hackle, Mr. Mezzullo suggests providing in the operating agreement that a member/limited partner can transfer his or her full ownership interest to 3rd party after first offering to the company/partnership (i.e., the transferee receives full membership/limited partnership interest instead of assignee interest). This does not affect discount much, if any, since the membership/limited partnership interest has no voting rights.

2. IRC §2036(a) Issues. Kimbell v. U.S., 244 F. Supp 2n 700, 91 AFTR 2d 2003-585 (N.D. TX 2003) and Estate of E. Stone III, T.C. Memo 2003-309 both held that 2036(a) did not apply to the initial transfer to the partnership since the transfers fell within the bona fide sale exception to

2036(a). Both found non-tax reasons for the entity. He advised that it is best to have other owners own non- deminimus interests in the entity when the decedent dies in order to avoid IRS argument that the only reason the entity was set up was to avoid tax (i.e. where decedent owns almost all LP interest and child owns small GP interest at death).

3. IRC §2036(b): If a transferor retains the right to vote stock that is transferred to an FLP, the value of the stock will be included in the transferor's estate. This is the rule under Bynum. Two options for avoiding this result: 1) With respect to voting rights, provide that all members/partners of the entity can vote the stock in proportion to their ownership interest in the entity, or 2) Have another entity own the right to vote the stock, not the family members.

4. IRC §2701: Provides that if an older family member transfers an interest in an entity to a younger family member and the transferor retains a senior or preferred equity interest, then special valuation rules apply causing the gift value to be increased.

a. Can be avoided if there is only one class of equity interest.

b. If there is more than one class of equity interest and the retained interest is a "qualified payment right," then right can be taken into account in valuing the transfer to the lower generation to decrease value. But, if payments are not actually made, then you have a problem.

5. IRC §2703: Provides that any restrictions (that are not commercially reasonable) on right to transfer an interest in an FLP are ignored when determining the value of the interest.

a. Transfer restrictions typically used in FLPs are generally commercially reasonable because same restrictions would be used with non family members.

b. Several cases have held that §2703 does not apply to disregard the entity altogether.

6. IRC §2704(a): Provides that a lapse of a voting or liquidation right results in a taxable gift if during the transferor's lifetime or in an increase to the estate of the transferor, if at death. For example, if an older family member is a GP and the GP interest is converted upon his/her death to a LP interest, the dimunition in value of the interest is added back.

a. Have a corporation serve as the GP to void application of 2704(a). No death, no lapse.

b. If state law provides that GP's withdrawal causes dissolution of partnership, then this section applies.

c. Will not apply where manager of an LLC dies because death of member in an LLC does not cause dissolution of the LLC. One argument in favor of using LLCs instead of LLP.

7. IRC §2704(b): Applicable Restriction (a limitation on the right of an owner to liquidate his or her interest, if the restriction is more restrictive than state law) is ignored for valuation purposes. There are cases that provide that an Applicable Restriction is only the right to dissolve the entity, not just the member's/partner's interest in the entity.

Non Tax Reasons for Having FLP

1. Limited liability to members/partners

2. Retention of control
3. Continuity of life
4. Restrictions of transferability
5. Use as management company for other business entities
6. Restrictions on management and voting rights
7. Protecting assets from liability
8. Protecting assets from owner's creditors (creditors can only get charging order, if creditor goes after interest, becomes assignee and must pay tax on income attributable to interest). Keep property as separate property for marital property purposes.
9. Dealing with recalcitrant family members. Provide for arbitration in agreement, payment of legal fees if challenge, etc.
10. Desirable tax characteristics: (Very important to convey to clients that entity is not all about taxes)

a. Partnership tax treatment
b. No restrictions on ownership (s-corps have restrictions)
c. No restrictions on capital structure
d. Tax Free formation - tax free incorporation more complicated than formation of partnership. Corporation - owners transferring assets to form corporation must own at least 80% after formation.
e. Tax free contributions
f. Tax free withdrawals
g. Basis step up. Partnerships are allowed to make 754 election to step up inside basis on assets owned by partnership. Corporations can't do this. Downside to FLP planning, children have lower basis due to gifts (carryover basis) and discounts on parents' deaths. (See examples in appendix)

Formation of Entity Issues

1. If have validly formed partnership, can make gifts from the very beginning immediately after formation.
2. If put something like a vacation home into the entity, it may be better to put into an LLC if the state LLC act does not require it to have a business for profit. A partnership is by definition a business of more than one person for profit.
3. Investment Company Issues. Causes recognition of gain upon transfer to entity of appreciated property to entity.
4. Contributions of property subject to liabilities can cause gain.
5. Family partnership rules - Capital must be income producing factor and donee must have economic interest in partnership/LLC. If don't satisfy these rules, income of partnership is reallocated to the senior family members.

Income Tax Issues When Dissolving or Making Distributions from Entity

1. Generally, a partner only recognizes gain in connection with a distribution from the partnership to the extent that any money (marketable securities are treated as money) distributed exceeds his or her basis in the partnership. There are several exceptions to the general rule.
2. Exception: If appreciated property is contributed to a partnership and then distributed to another partner within 7 years, donor must recognize the built in gain on the property. Same is true if other property is distributed to the donor partner within 7 years.

Drafting Issues

Provisions in agreement to focus on:
Allocation of profit and loss
Allocation of distributions
Restrictions on transfers
Events causing dissolution
Voting and management rights

1. Need to know default provisions in state statute. IRC §2704(b): If agreement is more restrictive than default rules, then have applicable restrictions.
2. Articles of Organization should provide the following:

a. Provide whether member or manager managed. (Recommends manager managed)
b. That there is only one operating agreement and it can only be amended by percentage set forth in Articles. Want this in the Articles so that a non-managing member has no apparent authority to bind LLC and also to defeat the argument that the members/partners have an oral agreement that is part of the operating agreement. Some states permit oral amendments to operating agreements and some states allow more than one operating agreement.
c. Everything else should go in the operating agreement.

3. Contributions and Distributions

a. Senda and Shepherd cases held that a contribution of property to a partnership/LLC by parents which resulted in an increase in value of children's ownership, was a transfer of the property to the children rather than to the entity. Make sure that additional membership interests are first given to the contributing partner/member (i.e., credited to the contributing partner's capital account) and then transfer the membership interests to the children by assignment.
b. Should provide in the agreement that consent of all members/partners is required before founding (or any other) members can make capital contributions to entity. Generally don't want one owner to be able to increase his or her interest without the consent of the other members.
c. Provide for capital calls in the agreement. May make it more difficult to sell interests. In addition, can possibly be a way of getting rid of a disruptive member.
d. Provide that non pro-rata distributions in kind can only be done with consent of person receiving distribution.
e. Permit transfer of interest by member/limited partner only after offering to the company or other members to purchase at price 3rd party willing to buy for.
f. Agreement should allow member/limited partner to sell full interest to 3rd party after giving right of first refusal to company and/or other members/partners to avoid Hackle issue.
g. Dissolution and Liquidation. Watch out for 2704(b), look at state law. Agreement cannot be more restrictive.
h. If concerned about spouses owning interests in the entity, provide in the agreement that a transfer can be made to a trust for benefit of spouse but not outright to spouse. This will allow gifts of interests to a QTIP.
a. Custodial gifts. Provide in the agreement that upon attaining age 21, custodial interests can be transferred to the child and that such a transfer is not a prohibited

transfer under the agreement.

Circular 230 Final Regulations - Requires limited scope opinions if attorney so much as mentions tax issues relating to partnerships etc. (i.e., attorney should provide in writing that he/she is not giving an opinion on 2036(a) etc).

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Tuesday, 1/11/05 - Asset Protection Other Than Self-Settled Trusts Steven J. Oshins Esq.

Reported by Gene Zuspann Esq.

This presentation will focus on Trusts - and particularly Beneficiary Controlled Trusts (BCT)

A BCT is a trust in which the primary beneficiary is the sole trustee or is a co-trustee and has the power to replace the other trustee.

The BCT usually includes a special power of appointment that allows the primary beneficiary to eliminate interference by remote beneficiaries. It waives the Prudent investor standard. If a support trust, it must include a spendthrift provision.

Steve discussed support interests vs discretionary trusts. The support trust allows creditors to attack the trust because of rights of beneficary to go to court and enforce the support standard.

There are 4 exception creditors on support trusts under the Restatement
(Trusts) 2nd

He discussed several cases involving discretionary trusts and the inability of a creditor to force the trustee to pay funds from the trust for the claim against the beneficiary. He also mentioned a case that allowed the IRS to obtain payment from a support trust.

Steve suggests that the trusteeship be broken up - use two trustees. The primary bene is the investment trustee and he/she would select the other trustee. The bene/trustee has the power to remove and replace the other trustee.

Dynasty Trusts - if the BCT makes sense for one generation, shouldn't it also make sense for multiple generations. The client does not need immense wealth, "such as the Gettys, the Rockefellers and the Blattmachrs." It often makes sense to use a dynasty trust that retains the client's assets in trust for several generations to protect the beneficiaries and to allow the trust to grow.

Inheritor's trusts - a BCT dynasty trust with discretionary powers. The client sets up the trust and the parents change their estate plan to pour the client's inheritance into the trust rather than outright to the client.

Opportunity shifting - the shifting of income or wealth from the client to others. A third party (the parent) creates the trust with some 'seed'
money and the client uses the seed money to create an entity to acquire or start-up a business. This is a third party trust rather than a self-settled trust and allows creditor protection for the client even though the trust is later worth a substantial amount. It can allow the client to avoid many issues in a

divorce. The client only owns a small share of the entity.
Discretionary trusts - generally creditor proof because there is no standard of distribution. Steve only discussed the UTC for a few moments. He refers the audience to the materials written by the UTC committee and his materials. There are a number of concerns being voiced about the UTC from many people in the country, and Steve concludes that there are issues with the UTC that need to be addressed.

In 12 states, a remainder interest in a trust is marital property. In those states, a dynasty trust could be used to avoid the problem.

Charging orders - pg 66. Corporations do not have the advantage of charging orders but LLCs and partnerships do. A charging order gives the creditor only the rights of an assignee. The law varies on this issue from state-to-state. The materials include a list of cases from different states.

Steve discussed the Ashley Allbright case (a Co bankruptcy case) which held that a singe member LLC does not get the benefit of a charging order.

Disclaimers and existing creditor problems. The Drye case (pg 86) held that a disclaimed inheritance qualified as a property right under IRC §6321 and allowed the IRS to recover its tax lien. Steve believes that disclaimers still work against many creditors.

Tenancy by the entirety - there is now a case (the Craft case) that holds that for federal law purposes, the TBTE will not protect the debtor. However, the TBTE still works in states where it is applicable.

Our on-site local reporters who are present in Miami this year are Gene Zuspann Esq. of Zuspann & Zuspann in Denver, Colorado, Shelly Merritt Esq., a solo practitioner in Boulder, Colorado, Connie T. Eyster Esq. of Hutchinson, Black & Cook LLC in Boulder, Colorado, Jason Havens Esq. of Havens & Miller PLLC in Dustin, Florida, Bruce Stone of Goldman, Felcoski & Stone, PA of Coral Gables, Florida, Herbert L. Braverman Esq. of Walter & Haverfield LLP in Cleveland, Ohio, and Jeffry L. Weiler of Benesch, Friedlander, Coplan & Aronoff LLP of Cleveland, Ohio. The editor again this year will be Joseph G. Hodges Jr. Esq, a solo practitioner in Denver, Colorado who is the Chief Moderator of the ABA-PTL List.

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