THE VACATION HOME LLC

ESTATE PLANNING STRATEGIES FOR TRANSFERRING OWNERSHIP OF THE FAMILY CABIN AND (KEEPING IT IN THE FAMILY)

AMERICAN BAR ASSOCIATION

ABA SECTION OF
REAL PROPERTY,
TRUST & ESTATE LAW

19TH ANNUAL SPRING SYMPOSIUM
WASHINGTON, D.C.
MAY 1-2, 2008

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I. **<u>Introduction</u>**

One of the most cherished assets that a family owns is the family cabin, lake home or other recreational home or residence. The family cabin not only has economic value but more importantly it has sentimental value. Therefore, planning for the use and transfer of the family cabin to successive generations must take into consideration these often deep seated emotional feelings and considerations. Each family member has there own view and association with the family cabin. Family members may have grown up at the family cabin, put significant "sweat equity" in the family cabin and view it as "special", and therefore are be more focused and interested in its transfer to the next generation. Often the family cabin has been in the "family" for many generations. Transfer of the family cabin from one generation requires careful planning. Ownership and transfers can take on many forms and each has its benefits and detriments. Ownership can be direct in fee, by tenancy in common, by joint tenancy, or by tenancy by the entireties in some states. Ownership can be indirect, such as a life estate, in trust, or in a family limited partnership or limited liability company. Each of these ownership vehicles will be explored. Finally, an annotated family limited partnership form is included in these materials that can be easily modified to address some of the common issues confronting joint ownership of the family cabin, such as responsibly for routine and extraordinary maintenance costs, personal use, renting to third parties, divorce and creditor and tax issues.

II. **<u>Fee Simple Transfers: Tenancy in Common, Joint Tenancy, Tenancy by the Entireties, Life Estates and Remainder Interests</u>**

A. Fee simple transfers from parents to one or more children, whether as tenants in common, joint tenants with right of survivorship, tenancies by the entireties, or a transfer of a remainder interest with a reserved life estate is simple and familiar to most clients. Some of the pros and cons of these types of transfers and ownership forms are outlined below.

B. <u>Advantages</u>

1. Simple and easily understood by most clients. Most conveyances can be made by deed.

2. Less expensive and costly form of transfer and ownership

3. Discounts for fractional interests may be available. Discounts may not be limited to the cost of partition. See <u>Estate of Baird v. Commissioner</u>, T.C. Memo 2001-258. The adequate disclosure regulations require either an appraisal or other documentation to support the discount claimed to start the running of the three year statute of limitations on assessment. See Treas. Regs. §301.6501(c)-1(f)(2), (3). Also,

Notes and Questions

any discount claimed on the transfer requires the taxpayer to check the "yes" box on the Federal Gift Tax Return (IRS Form 709).

4. Retention of a fractional ownership interest by the parent/grantor allows continued use and occupancy by the parents under most state's laws.

C. Disadvantages

1. Creditor claims. A fractional ownership interest is subject to the claims of children's creditors. This may be particularly troublesome when the donee/children are younger and less financially stable than the parent donor.

2. Divorce. A donee/child with a outright ownership interest in the family cabin (e.g. tenant in common) may expose the property to claims by a spouse in a divorce. Even though the interest in the family cabin was made by gift and is generally considered non-marital property and not subject to division in divorce, martial property may have been used to help maintain the property, such as payment of real estate taxes, maintenance costs or contributions for improvements. The commingling of marital and non-marital property may inadvertently "convert" the property interest to marital property and embroil the family in a fight by an in-law over ownership and use of the family cabin-an event never contemplated by the parent/donor when the gift was made.

3. Partition By "Unhappy Camper". Not all family members are happy campers forever. Disputes can arise, and one or more co-tenants might get disgruntled with the arrangement and want "out". But what if the "ins" don't want to (or more likely, can't afford to) pay off the "outs". Their only recourse of action to "cash out" is to go to court and compel liquidation of the family cabin by a partition action. In most states, a partition action can be brought for any or no reason.

4. Unequal Contributions by Co-Tenants. The financial wherewithal of each co-tenant may be different. Family members may not all have the same level of interest or responsibility. Informal oral financial contribution agreements may break down, resulting in one family member "fronting" most of the costs of maintenance of the family cabin. This can result in heated discussions and dissatisfaction with the arrangement. It may result in a partition action, and/or an accounting to compel contribution for the improvement and maintenance of the family cabin.

5. Sale of Family Cabin Restricted. The sale of the family cabin when parents and children own fractional interests, or where the parents retain a life estate and the children own the remainder interest, still necessitates the consent of all co-tenants and fractional owners before a sale of the family cabin to a third party buyer can be

Notes and Questions

completed. On sale of the family cabin before death of the life tenant, the remainderman is entitled to the actuarial value of the interest sold.

6. Income Tax Basis. Any lifetime fractional interest transfer of the family cabin to a child by a parent will result in a carry over income tax basis to the donee. If the cabin were owned entirely by the parent at death it would receive a full step-up in income tax basis at death. Likewise, if the parent transferred a remainder interest and retained a life estate, the family cabin would receive a full step-up in income tax basis at the parents death under IRC § 1014. Of course, with a retained life estate, the full value of the family cabin would be included in the parent's estate under IRC § 2036.

7. Medical Assistance Look Back Period. Transfers of fractional interests in property or transfers of remainder interests in real estate may cause disqualification for medical assistance based on the value of the property transferred for a period of time after the transfer.

8. Waste. If the relationship between the life tenant and the remainderman deteriorates the remainderman's remedy may be limited to a suit for waste against the life tenant. Partition is usually not an option.

III. **Trusts**.

Lifetime and testamentary trusts could own the family cabin. The two most common lifetime trusts would be a revocable living trust and a qualified personal residence trust ("QPRT"). The pros and cons of each will be reviewed.

A. Revocable living trust. Placing the family cabin in the parent's revocable living trust is one option.

1. Advantages.

   a. The family cabin continues to be under the control and direction of the parent/grantor during his or her lifetime.

   b. The real estate transfer to the revocable trust is easily accomplished by deed.

   c. The revocable living trust is a grantor trust for income tax purposes, so any transactions related to revocable trust (e.g. payment of expenses and taxes) is reported/deductible by the grantor the same as if he or she owned the family cabin outright in their individual names.

   d. If the grantor were to become disabled, the successor trustee of the revocable trust

Notes and Questions

would continue to manage the family cabin without interruption or a conservatorship or guardianship proceeding.

e. The grantor determines who his or her successor trustee would be to manage the family cabin in the event of death or disability.

f. Probate avoidance.

g. The parent can be the sole trustee of the revocable trust.

2. Disadvantages

a. The full fair market value of the family cabin will be included in the parent/grantor's taxable estate.

b. The lifetime gifting opportunities are the same as with outright ownership.

c. There is no "transition of ownership" or "succession plan" if the family cabin remains in the parent/grantor's revocable trust.

d. Contributions of funds by children for expenses creates gift tax issues. The revocable trust is not a good vehicle for multiple parties making capital contributions for improvements or for sharing expenses for maintenance.

e. If the grantor become disabled and a successor trustee is appointed, the successor trustee may not have the discretion to keep the family cabin "alive" and well if the grantor needs funds for other reasons (e.g. health, support, etc.). The successor trustee may be forced to sell the family cabin.

f. Creditor protection is limited with a revocable trust.

B. Irrevocable trust-QPRT. A common irrevocable trust for the transfer of a primary or second home, such as a lake cabin, is a qualified personal residence trust ("QPRT"). The pros and cons of the QPRT will be reviewed.

1. Advantages

a. The QPRT allows the grantor to make a gift of the family cabin to children while retaining use and enjoyment for a term of years.

b. The gift of an interest in the family cabin using a QPRT is significantly less that if the gift was made in fee.

Notes and Questions

c. The QPRT allows for gifts of fractional interests, thus further reducing the gift tax cost.

d. The QPRT is sanctioned by the Internal Revenue Code (IRC § 2702) and is a relatively "safe" way of making gifts of interests in the family cabin to children.

e. The QPRT is a grantor trust for income tax purposes, so all deductible costs (e.g. real estate taxes) continue to be deductible by the grantor for income tax purposes.

f. The parent can be the trustee of the QPRT.

2. Disadvantages

a. There will be estate tax inclusion of the family cabin in the parent/grantor's taxable estate if the parent/grantor dies during the QPRT term. This may result in the waste of gift tax credit.

b. No generation skipping planning can be done with a QPRT because of certain ETIP rules until after the term of the QPRT.

c. At the end of the QPRT term, if the grantor/parent survives, the grantor/parent must rent the family cabin from the QPRT continuation trust and or QPRT individual beneficiaries (i.e. children) at fair rental value. Consider making the continuation trust a grantor trust as well.

d. If the family cabin is sold in a QPRT the net proceeds of sale must be reinvested in a qualifying replacement home or the arrangement must be converted to a GRAT.

e. Successor trustee selection, removal; fiduciary duties-QPRT successor trust. The grantor may retain the power to remove or replace a trustee so long as the grantor can only appoint an individual or corporation which is not a "related or subordinate" party as defined in IRC § 672(c) (See: Rev. Rul. 95-58: grantor's reservation of unqualified power to remove trustee and appoint new trustee (other than grantor) isn't reservation of trustee's discretionary distribution power by grantor that would cause inclusion of trust property in gross estate under IRC §§ 2036 or 2038; retained power wasn't equivalent to power to affect beneficial enjoyment of trust property, and didn't effect completed nature of gift to trust). Consider a trust protector.

Notes and Questions

f. Creditor protection is generally better with an irrevocable trust than with a revocable trust. However the QPRT is a “self-settled trust” under state law (i.e. the grantor has retained an interest in the trust after formation), which may subject the QPRT assets to attachment in most jurisdictions.

g. When IRS interest rates are high the QPRT works better; when interest rates are low (like now) the QPRT is not as attractive.

IV. **<u>Entities</u>**

The family cabin could be placed in an entity, such as a general partnership, an S or C corporation, a family limited partnership (FLP) or a limited liability company (LLC). The primary consideration in placing the family cabin in an entity is whether or not the formation of an entity with a single “personal” asset fulfils a business purpose under state law, and whether or not the personal use nature of the family cabin causes estate tax inclusion under IRC § 2036. The are a number of non-tax and tax reasons for formation an entity to hold the family cabin. Below are some of them.

V. **<u>Non-transfer tax objectives in establishing an entity (e.g. LLC or limited partnership)</u>**

A. <u>Retention of control by senior family members</u>.

1. General partner (donor) continues to control management of partnership affairs (including control over timing and amount of distributions) while gifting equity interests.

2. <u>Limited partners are only passive investors with no management control.</u>

a. Non-participation in management essential to limited liability.

b. Limited partners may vote on various partnership matters without risking limited liability.

(1) Dissolution of partnership

(2) Continuation of partnership

(3) Admission of partners

B. <u>Simplification of annual gift giving</u>

1. Many assets (e.g. real estate or the family cabin) are difficult to value and are not prone to gifts of undivided fractional interests.

Notes and Questions

2. Gifts of limited partnership interests are a simplified way to transfer a fractional interest without any risk of partition and forced sale.

3. Gifts of limited partnership interests generally are present interest gifts thereby qualifying for gift tax annual exclusion. See TAM 9131006 (Apr. 30, 1991), PLR 9415007 (Jan. 12, 1994) and TAM 199944003 (July 2, 1999); But see TAM 9751003 (Aug. 28, 1989) and *Hackl v. Comm.,* 335 F.3d 664 (7^{th} Cir. 2003) *aff'g* 118 TC 14 (March 27, 2002) where gift tax annual exclusion was denied; general partner had complete discretion over distributions of partnership income and could withhold distribution "for any reason." IRS concluded that such power was "extraordinary and outside the scope of a business purpose restriction…"; in addition, significant restrictions were imposed on ability of limited partners to withdraw or transfer interests with no corresponding restrictions on general partner; gift of limited partnership interests was not a gift of a present interest and, therefore, did not qualify for the annual exclusion.

C. <u>Transfer of wealth without negating donee's incentive to be productive.</u>

1. Many clients do not fear the creation of wealth *per se*, but rather that substantial gifts to children and/or grandchildren will hinder their initiative and the incentive to be productive in society.

2. Gifts of limited partnership interests to junior family members with retained control by donor/general partner over partnership income distributions, coupled with the standard restrictions on withdrawal and assignability, effectively prevent junior family members from relying on ownership interest as sole means of financial stability.

   a. Compare to gifts of marketable assets that may be "cashed-in."

   b. Retained power of donor/general partner to reinvest partnership income and indirect power to affect marketability of limited partnership interest does not cause estate inclusion under IRC §§ 2036(a)(2) or 2038. *See United States v. Byrum,* 408 US 125 (1972) and TAM 9131006 (Apr. 30, 1991); compare *Estate of Strangi v. Commissioner*, 417 F. 3rd 468 (5th Cir. 2005).

D. <u>Lower Operational Costs and Increase Diversity of Investments By Pooling Assets.</u>

1. Number of investment accounts that must be tracked is minimized.

2. Pooling of smaller accounts into a single larger account will generally result in lower investment management fees as larger accounts are generally less expensive on

Notes and Questions

percentage basis. In addition, larger accounts will give access to investment managers with minimum account requirements.

a. Most investment clubs among non-related parties use the partnership format. *See* Rev. Rul. 75-523, 1975-2 C.B. 257 and Rev. Rul. 75-525, 1975-2 C.B. 350

b. Related parties also like forming “investment clubs.”

c. Diversification of assets is also easier with larger asset pools.

E. Protect against the transfer of assets outside the family

1. Most limited partnership agreements contain right of first refusal provisions that give the non-transferring partners and/or the partnership the ability to purchase partnership interests subject to an attempted voluntary transfer to a non-family member.

a. Same terms as attempted sale.

b. Fair market value in the case of a gratuitous transfer.

2. Partnership agreement and state law generally give the transferee of partnership interests only the rights of an assignee. Partner status generally conferred only if remaining partners consent.

F. Provide Creditor Protection

1. Principal remedy for a partner’s “outside” creditors is to receive a “charging order” against the partner’s interest in the partnership. The creditor may not satisfy his or her claim against the partnership’s underlying assets.

2. A charging order does not give the creditor any management or voting rights. The creditor has only the rights of an assignee and is entitled only to the partner’s allocable share of partnership income and loss.

3. To the extent partnership income is allocated proportionately among the partners, but income distributions are not made, the creditor will have a tax burden which must be satisfied from the creditor’s own resources. This often leads to a quick settlement by the creditor for substantially less than the amount owed.

4. Most limited partnership agreements contain right of first refusal provisions that give the non-transferring partners and/or the partnership the ability to purchase partnership interests subject to an involuntary transfer to a non-family member (i.e. a creditor).

Notes and Questions

The purchase of partnership interest at "fair market value" (which should be significantly less than net asset value) often results in creditor receiving less than 100 cents on the dollar.

G. Protection in the event of divorce

1. It is easy to commingle non-partnership interest assets with marital property. It is easier to maintain partnership interests as separate property.

2. Prenuptial and/or postnuptial agreements are complicated, expensive and distasteful.

3. Underlying partnership assets are protected because partners own only a partnership interest, not the partnership's underlying assets.

4. Fair market value of partnership interests takes into consideration minority interest, lack of marketability and lock-in discounts and are therefore less attractive.

5. A transfer of partnership interests incident to divorce is an involuntary transfer which will "trigger" the application of the partnership right of first refusal provisions.

   a. Purchase at fair market value (remember discounts).

   b. Partnership agreement may call for a deferred payout to the ex-spouse with no security interest.

H. Partnership Agreement Provides Structural Flexibility

1. Partnership agreement may be amended and partnership may be terminated.

2. In comparison, an irrevocable trust generally may not be amended or terminated without court approval and the participation of a guardian ad litem if there are minor beneficiaries.

3. Termination of limited partnership requires less formalities than the termination of a corporation and is not fraught with the same potential adverse tax consequences. Repeal of *General Utilities* does not apply to partnerships.

I. Investment Flexibility

1. *Business Judgment Rule* applies to partnerships versus stricter *Prudent Investor Rule* applicable to trusts.

Notes and Questions

2. General Partners are not subject to the same diversification rules applicable to trustees.

3. Ability to follow *Modern Portfolio Theory*

   a. Theory states, in simplified terms, that rational investors should seek to achieve the highest rate of return consistent with their risk tolerance, from whatever source.

   b. Trustees subject to conflict between income beneficiaries (who prefer current income) and remainder beneficiaries (who prefer growth).

   c. Unitrusts (which pay the current beneficiary a percentage of the trust's value) allow trustees to follow the theory. Unfortunately, most trusts are not unitrusts.

J. <u>Minimization and/or Avoidance of Probate</u>

1. Assets held individually (and without a beneficiary designation) are subject to probate.

2. Probate can be avoided by transferring assets to a revocable trust during lifetime, but often this does not occur.

3. Instead, assets could be transferred to a limited partnership, with only a single transfer of the partnership interests needed to the revocable trust to avoid probate.

4. If partnership interests are part of probate estate, privacy concerns are still protected as underlying partnership assets generally need not be disclosed in a probate proceeding.

5. Ancillary probate may be avoided with respect to real property owned in a non-domiciliary state by transferring ownership to a limited partnership.

K. <u>Easier and Less Costly Resolution of Family Disputes</u>

1. Most partnership agreements require arbitration to settle disputes.

2. Arbitration is often less costly than full blown litigation.

3. Confidentiality is more easily preserved.

4. The state law right of a beneficiary to sue his or her trustee may not be removed in

Notes and Questions

many jurisdictions.

L. Avoid Frivolous Lawsuits From Discontented Family Members

1. Partnership agreement may adopt the "English" rule to disputes which requires that the loser pays all costs associated with the arbitration.

2. Charging a trust beneficiary with trust litigation costs is extremely difficult, if not impossible. Furthermore, trustee reimbursement out of trust assets only hurts all trust beneficiaries.

M. Avoid State Death Taxes

1. Partnership interest is an intangible asset, subject only to estate or other death tax in the state of decedent's domicile.

2. *Example*: If a Florida vacation home is owned in a FLP, the need for a Florida probate is eliminated for a Minnesota domiciliary. Also gone are the additional legal and accounting costs. Finally, Minnesota apportions Minnesota estate tax on "real estate" and "tangible personal property" located in Minnesota. A FLP interest (even if the FLP owns Minnesota real estate) is an intangible asset, and is not subject to Minnesota estate tax apportionment.

N. Education of junior family members and the institutionalization of communication

1. Senior family members want to oversee wealth in the hands of junior members to ensure that it is not abused.

2. FLP allows senior family members to educate junior family members regarding: (i) family holdings, (ii) investment philosophies, (iii) business practices, and (iv) family goals regarding the use of wealth for charitable and non-charitable purposes.

3. Forces (and facilitates) communication among family members. They now have something in common – an ownership interest in the family limited partnership.

O. Minnesota law.

1. Minn. Stat. § 322B.10 provides that a LLC may be organized "for any **business** (emphasis added) purpose or purposes.." but does not define the term. Unless otherwise provided in its articles of organization, a Minnesota LLC has a general business purpose. Minnesota's LLC statute in substance is parallel to Minnesota's Business Corporation Act, Minn. Stat. § 302A. The notes to the genesis of the statute

Notes and Questions

state that a "business purpose" means any purpose which is intended to benefit the shareholders of the corporation. Thus a corporation may not operate at a profit, and yet still have a business purpose.

2. Minn. Stat § 321.0104 provides that a limited partnership may be organized "for any **lawful** (emphasis added) purpose". The Uniform Partnership Act of 2001. A partnership is defined under Minnesota law as "an association of two or more persons to carry on as co-owners a business for profit…" This distinction may be important for creditor claims purposes and for estate tax purposes.

3. Minnesota law allows for the formation of a "limited liability limited partnership" (LLLP).

VI. **Transfer tax reasons for forming an entity.**

A. Reduction or Elimination of Estate, Gift and Generation-Skipping Transfer Taxes

1. Estate Taxes

   a. Imposed on fair market value of what passes from the decedent at the time of death.

   b. Current "Applicable Exclusion Amount" is $2,000,000. Applicable Exclusion Amount subject to scheduled increases reaching a maximum of $3,500,000 per person by 2009.

   c. Estate tax is tax inclusive meaning that the funds to pay the estate tax are also subject to the estate tax. In other words, there is a tax upon the tax.

2. Gift Taxes

   a. Imposed on fair market value of what passes from the transferor at the time of the transfer.

   b. $12,000 per year annual exclusion for gifts of present interests under IRC 2503(b).

   c. Husband and Wife may "split" gifts under IRC §2513 allowing for an annual tax-free transfer of $24,000 per donee.

   d. Gift tax annual exclusion is subject to inflation adjustments in $1,000 increments.

Notes and Questions

e. Best to follow the advice of the late Mayor Daley from Chicago: "Gift early and gift often."

f. Under current non-unified system of estate and gift taxation, applicable lifetime gift tax exclusion amount (currently $1,000,000) may be used to offset the gift tax on otherwise taxable gifts (those in excess of the annual exclusion amount).

g. Gift tax is tax exclusive. The funds used to pay the gift tax are not also subject to gift tax.

h. Lifetime gifts remove not only value of gifted property from the estate, but also the post-gift appreciation.

i. Minnesota and some states do not have a gift tax.

B. <u>Meaning of Fair Market Value.</u>

1. Definition of "fair market value" for estate and gift tax purposes"

a. "Price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts" Regs. §20.2031-1(b) and Regs. §25.2512-1.

b. Question of fact-burden generally rests with the taxpayer.

c. Standard is an objective test using hypothetical buyers and sellers. The identity and the intentions of the property recipient are irrelevant.

(1) See *LeFrak v. Commissioner*, 66 TCM (CCH) 1297, 1299 (1993)

(2) See also *Propstra v. United States*, 680 F.2d 1248 (9th Cir. 1982); *Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. 1981) (en banc); and *Estate of Lee v. Commissioner*, 69 T.C. 860 (1978).

d. Family relationships are ignored.

(1) IRS is not entitled to aggregate transferred interests with other interests held either by the donor or the donee.

(2) See *Propstra* and *Estate of Bright.*

Notes and Questions

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(3) IRS conceded this issue in Revenue Ruling 93-12 (1993-1 CB 202).

(4) IRS considered a gift of 100% of stock in a closely held business by a father to his five children and determined that each block of 20% should be valued separately and was entitled to a minority interest discount.

2. Pre-Discount Value of a Family Limited Partnership.

a. Greater of "going concern value" and "liquidation value."

(1) "Going concern value" is determined by capitalizing the partnership's past and projected net earnings.

(2) "Liquidation value" (or net asset value) is determined by totaling the fair market value of all partnership interests and reducing the gross by all partnership liabilities.

(3) For an operating business, there is a presumption that the enterprise will continue and not be liquidated. As a result, income available to the buyer will be a more important factor.

(4) FLPs are largely asset based so its value is more directly tied to the fair market value of the underlying partnership assets.

C. Availability of Valuation Discounts.

1. Minority Interest Discount.

a. Critical factor is lack of control.

(1) Limited partner has no control over distributions.

(2) Limited partner has no control over day-to-day operations.

(3) Not easy for the limited partners to remove the general partner.

(4) Limited partner has almost no ability to compel liquidation of partnership and realize a pro rata share of the net asset value of the partnership.

(5) Limited partner cannot withdraw from a term partnership and redeem his partnership interests. In Minnesota, a limited partner cannot withdraw unless the partnership agreement permits withdrawal.

Notes and Questions

(6) Limited partner cannot transfer "management rights" (i.e. voting rights) without the approval of the remaining members. Transferee is merely an assignee.

(7) Limited partner must pay taxes on allocable share of partnership income even if income is not distributed.

b. Case law has consistently rejected theory of "family attribution" in determination of applicability of minority interest discounts.

(1) See *Estate of Bright v. United States*

(2) Family attribution is inconsistent with willing buyer-willing seller test.

c. IRS conceded family attribution issue in Revenue Ruling 93-12.

d. However, IRS may have restricted benefits of minority interest discount by application of "swing vote" premium.

(1) Gifts of partnership interests may be valued at a premium where circumstances would permit a donee to join with another to form a majority or to refrain from joining and effectively retain veto power.

(2) TAM 9436005 (May 26, 1994)

(3) *Estate of Winkler v. Commissioner*, 57 TCM (CCH) 373 (1989)

(4) Can occur in Family Limited Partnerships:

(i) If there are multiple general partners

(ii) If the limited partners have substantial voting rights.

e. The size of the minority interest discount varies from situation to situation and court to court. In general, minority interest discounts allowed by courts range from 20 percent to 60 percent. However, in *Knight v. Commissioner,* 115 TC 36 (November 30, 2000), the Tax Court limited the combined discount for minority interest and lack of marketability to 15%.

f. Get a well-documented appraisal.

Notes and Questions

2. Lack of Marketability Discount.

   a. Reflects the lack of a ready market for the transferred partnership interests.

   b. Factors mentioned above make partnership interest undesirable.

   c. IRS claim that lack of marketability discount should not apply to partnerships rejected because a partner may withdraw has been rejected.

      (1) See *Moore v. Commissioner*, 62 TCM 1128 (1991)

      (2) Note: Limited partner in Minnesota limited partnership may not withdraw from a partnership absent authorization in the partnership agreement.

   d. Similar to minority interest discounts, the size of the lack of marketability discounts will vary from situation to situation and from court to court. Generally, these discounts range from zero to 40 percent.

   e. Get a well-documented appraisal.

      (1) See *Estate of Joseph R. Cloutier v. Commissioner*, 71 TCM (CCH) 2001 (1996) where court rejected claim for lack of marketability discount because the taxpayer's report (only 3 pages long and contaed bald assertions) did not even provide a review of the basic information necessary to render an opinion on valuation.

3. "Lock-In" Discount

   a. Reflects inability to withdraw from partnership

   b. Rationale:

      (1) FLP usually has few partners who have no incentive or obligation to purchase the interests of a partner who wishes to sell.

      (2) FLP assets usually produce little income.

      (3) Partnership agreement imposes restrictions on transferability and often requires consent to admit a substitute partner.

D. Family Cabin and Estate Tax Law-IRC § 2036

Notes and Questions

1. Entity pays personal expenses.

    a. The family cabin may be viewed by the Service as a personal use asset and highly suspect. See *Estate of Reichardt*, 114 TC No. 9 (2000) and *Estate of Schauerhamer*, TCM 1997-242; partnership income used for personal expenses of the decedent; partnership and personal funds were commingled; partnership income used for personal expenses of the decedent.

2. Inappropriate funding-personal use asset.

    a. The entity should not be funded with personal use assets – especially the primary transferor's homestead. What about the family cabin? See *Estate of Korby v. Comm.,* TCM 2005-102; *Estate of Bongard v. Comm.,* 124 TC No. 8 (2005); *Turner v. Comm.,* 3rd Cir., No 03-3173 (September 1, 2004), *aff'g Estate of Thompson v. Comm.,* TCM 2002-246; *Estate of Lea K. Hillgren v. Comm.,* TCM 2004-46; *Estate of Strangi v. Commissioner*, 417 F. 3rd 468 (5th Cir. 2005); *Estate of Reichardt v. Comm.*, 114 TC 144 (2000); and Estate of Schauerhamer *v. Comm.*, TCM 1997-242; *Bigelow v. Commissioner*, 100 AFTR2d 2007-xxxx (9^{th} Cir. September 14, 2007)

3. Income producing assets.

    a. The family cabin does not generally produce income. Therefore, it might be a good idea to fund the family cabin partnership with other income producing assets in order to avoid any issues with the gift tax annual exclusion. *Hackl v. Comm.,* 335 F.3d 664 (7^{th} Cir. 2003) *aff'g* 118 TC 14 (March 27, 2002).

E. Family Cabin LLLP

    1. If a family cabin is to be put in a entity, given the business purposes strictures in Minnesota law for a corporation or LLC, the limited partnership appears to be the best option. When the limited liability limited partnership election is made, the LLLP acts like a LLC in all regards.

VII. Modifications to entity agreement to accommodate the family cabin situation

A. Family cabin maintenance provisions[1]

    1. Routine maintenance

[1] Many of these sample provisions are from the cabin forms file in the ACTEC webpage.

Notes and Questions

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a. *Example*. Each partner may engage contractors for, and expend funds of the partnership for, or be reimbursed under the partnership agreement for, routine maintenance of the family cabin subject to an aggregate limit of $5,000 per year. Routine maintenance consists, by way of example and without limitation, of the following:

(1) house cleaning,

(2) window washing

(3) lawn mowing

(4) leaf raking

(5) cleaning gutters

(6) removing grapevines and weeds

(7) removing garbage

(8) spring and fall cleanup

(9) shoveling snow off of roof

(10) plowing snow from driveway

(11) putting out and taking in dock and boats

(12) piano tuning

(13) spring and fall opening and closing of plumbing

(14) annual check of septic tank and cleaning

(15) emergency repairs and routine inspections and maintenance by plumbers

(16) heating and cooling contractors and other repairmen

(17) minor repairs to dock, boats and other properties of the family cabin

2. <u>Ordinary reoccurring operating expenses</u>.

a. *Example.* Each partner may expend funds of the partnership for, or be reimbursed under the partnership agreement for, ordinary and necessary reoccurring operating

Notes and Questions

expenses such as the following:

(1) real estate taxes

(2) insurance

(3) utilities

(4) mortgage payments

3. Contractor provision/primary managing partner

   a. *Example*. Competitive bidding is not required for engagement of any contractors for routine maintenance. In order to prevent duplication of effort, and for purposes of the partnership's books and records, each partner shall promptly report (i) all engagements of contractors to [JOHN SMITH, MANAGING PARTNER], who shall keep a record thereof, and (ii) all expenditures of funds for the account of the partnership to [JOHN SMITH, MANAGING PARTNER], who shall keep a record thereof. Such reports may be oral and, in emergency situations, need not precede the engagement or expenditure. [JOHN SMITH, MANAGING PARTNER], shall have primary responsibility for property maintenance relating to the family cabin. [JOHN SMITH, MANAGING PARTNER], shall have primary responsibility for payment of bills relating to the family cabin

4. Extraordinary Maintenance.

   1. *Example*. The partners shall consult with one another from time to time regarding the extraordinary maintenance requirements of the family cabin, which include, by way of example and without limitation:

      a. exterior and interior painting

      b. roof repair

      c. replacement of furnace

      d. air conditioning equipment or kitchen appliances

      e. repair or replacement of stairway to lake or dock other than minor or emergency repairs and other than seasonal putting out and taking in of dock

      f. replacement of windows and doors except glass in broken windows

Notes and Questions

g. garage repair or replacement

h. alteration of driveway

i. disposal or replacement of boats or boat motors or acquisition of boats or boat motors

j. alteration or repair of retaining walls or deck other than minor or emergency repairs

k. power washing and staining deck

l. landscaping

m. cutting of trees except (1) pruning (2) emergency situations

n. redecorating

o. remodeling

p. replacement of furniture or draperies.

All extraordinary maintenance items require approval by vote or written consent of the partners holding at least a majority of the outstanding interest in the partnership. No vote or written consent shall be taken without prior notice pursuant to the partnership agreement and prior consultation of all partners. Each approval shall specify the nature and scope of the task, the maximum amount of funds of the partnership authorized to be expended, and whether a particular contractor is to be hired or competitive bids are to be solicited. No such approval shall require the partnership to expend funds in excess of funds available to the partnership pursuant the terms of the partnership agreement.

B. <u>Personal use of family cabin</u>

1. *<u>Example</u>* Maximum personal use of the family cabin by the partners and their families and guests, and by individual beneficiaries of any trusts that are partners and their families and guests, at the same or different times, is encouraged, and, except as otherwise provided herein, such personal use takes precedence over all other use. The partners shall consult from time to time regarding the schedule of personal and rental use and shall use their best efforts to establish a schedule of personal use for the next rental season no later than Christmas of each year, which shall be maintained by Managing Partner. Rental uses for the following season shall not be scheduled prior to Christmas of each year without prior consultation of each partner. Any requests for personal use subsequent to Christmas of each year shall still take precedence over any

Notes and Questions

rental use that has not yet actually been scheduled with a particular renter. Rental use that has actually been scheduled with a particular renter takes precedence over personal use. For this purpose, "scheduled" means that the partnership or any partner has provided an assurance to a particular prospective renter that the family cabin will be available to that person during a particular time period, which assurance need not be in the form of a legally binding rental agreement. Partners (and individual beneficiaries of any trusts that are partners) and their families and guests generally will not pay rent, utilities or cleaning costs to the partnership in respect of their personal use of the family cabin, all such costs being generally for the account of the partnership. However, (i) partners (and individual beneficiaries of any trusts that are partners) and their families and guests shall use their best efforts to leave the family cabin in a clean an/d orderly condition, and (ii) partners shall separately pay or reimburse the partnership for (a) any costs of utilities or cleaning costs attributable to excessive or unusual use and (b) any costs of utilities, cleaning costs and opening and closing and other costs attributable to nonseasonal personal use. For this purpose, "nonseasonal" personal use is any personal use between September 15 and May 15 other than for purposes of seasonal opening and closing of the family cabin.

C. Restriction on transfer or sale of the family cabin.

1. *Example*. The partnership shall not sell, dispose of, assign, transfer or hypothecate all or any portion of the family cabin without unanimous approval by vote or written consent of all partners.

D. Rental to non-family members

1. *Example.* The family cabin shall be rented on a short term basis to vacationers during the rental season to the maximum extent possible at such times as personal use by the partners (and individual beneficiaries of any trusts that are partners) and their families and guests is not desired. The purpose of such rentals is to provide a source of income to the partnership to defray all or a portion of the costs of owning and maintaining the family cabin, but not otherwise to provide income to the partnership or the partners.

E. Property manager

1. *Example*. The partnership may from time to time engage and pay a property management company to manage the rental of the family cabin, and to provide services in connection with such rental management. The engagement or termination of a property management company, the determination or modification of the scope of services to be provided by that company, and the determination or modification of the schedule of rental rates for each rental season, each require a vote or written consent of partners holding at least a majority of the outstanding interest in the partnership, and all partners must be notified

Notes and Questions

pursuant to the partnership agreement and consulted prior to such vote or written consent. By such vote or written consent, the partners may, but shall not be required to, delegate to a single partner the authority to approve or reject particular rentals proposed by the property management company and to execute on behalf of the partnership any required rental agreements for particular rentals.

F. <u>Mediation/arbitration provisions</u>

1. *Examples*

a. <u>Arbitration-Dispute Resolution</u>. Any dispute or controversy arising under, out of, in connection with, or in relation to this partnership agreement or any amendments thereto or any breach thereof or in connection with the dissolution of the partnership shall be submitted to and settled by arbitration in Minneapolis, Minnesota, in accordance with the rules then obtaining of the American Arbitration Association, and judgment upon the award may be entered in any court of competent jurisdiction

b. <u>Mediation-Dispute Resolution</u>. Any dispute or controversy arising under, out of, in connection with, or in relation to this partnership agreement or any amendments thereto or any breach thereof or in connection with the dissolution of the partnership which cannot be resolved by the parties through direct communication without mediation, shall be promptly submitted to mediation.

(1) <u>Definition of mediation</u>. Mediation is a voluntary process entered into by the parties. In this process, the parties continue direct communication but with the assistance of a neutral person who is the mediator. The mediator has no authority to require any concession or agreements. A good faith effort shall be made to resolve any claim or controversy arising between the parties.

(2) <u>Selection of mediator</u>. The mediator shall be selected by mutual agreement of the parties or by obtaining a list of five qualified persons and alternately striking names.

(3) <u>Duties and responsibilities of mediator</u>. The mediator shall have the duty and responsibility to assist the parties in resolving all issues submitted for mediation.

(4) <u>Duties of parties</u>. Both parties agree to cooperate and act in good faith to resolve the matter(s) in dispute with the assistance of the mediator.

(5) <u>Payment of costs</u>. Both parties shall share the mediator’s fees and disbursements equally unless they mutually agree otherwise. The mediator shall provide the parties with his/her fee and disbursement schedule in

Notes and Questions

advance of mediation.

(6) Confidentiality and privilege. Within the limits of the law, the mediator will accord confidentiality and privilege to all communications with the parties.

(7) Restrictions. The mediator shall not participate as witness, collateral contact or attorney in a custody or visitation study or inquiry involving either party. Further, neither party may ever call the mediator as a witness to testify in any proceeding involving their children or the subject matter of the mediation.

(8) Exhaustion of remedies. The above procedure shall be followed before either party may apply to the Court for relief.

2. Division of personal property on liquidation or sale of the family cabin. Many times the most important asset located at a family cabin are items of personal property that have been in the family for generations. Partners should periodically review a written list of items of tangible personal property to determine who will get what when the lake cabin is sold, similar to a written list prepared for a will. The list should be reviewed and approved by all partners and made a part of the partnership records.

Notes and Questions