Successful Discount Entities in Estate Tax Planning

by Lynn A. Buskey

A. Introduction

B. General Overview of Discount Entities

1. Family Limited Partnerships and Limited Liability Companies
2. Valuation and the Hypothetical Willing Buyer and Seller
3. Discounting in Valuation

C. IRS Challenges to Discount Entities

1. Challenges to the Discounts Applied in Valuing the Entity Interest
2. Challenges to Entity Itself
3. Application of §2036 to Discount Entities
4. Closer Look at §2036(a)(1)
5. Closer Look at §2036(a)(2)
6. Notable Defenses to a §2036 Challenge Raised by Taxpayers
7. Losing to the IRS under §2036

D. Avoid a §2036 Challenge by Respecting the Entity

1. A Good Offense – The Best (and Only?) Defense to §2036
2. A Well-Informed Client
3. Monitor Compliance
4. Commingling Personal and Entity Assets
5. Provide the Client a Checklist for Respecting the Entity

E. Conclusion

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A. Introduction

The use of the family limited partnership (FLP) and the limited liability company (LLC) has become almost standard in estate planning today. They are no longer considered entities for the very wealthy, but instead are used by owners of relatively modest business and investment interests as part of their basic estate plan. The popularity of these entities is not surprising. They are fairly simple to form and operate, do not require complex tax filings, and do not result in any additional taxes, while at the same time offering a variety of benefits at a relatively insignificant cost to form and maintain. For example, the use of an FLP or LLC can organize and consolidate business interests to facilitate management. They are used to segregate personal and business assets and, when properly structured, can protect the personal assets of the entity's owners (i.e. limited partners of the FLP and members of the LLC) from the entity's creditors. The reverse is also true, that creditors of the *owners* cannot levy against the entity's assets under most circumstances, but are instead limited to a charging order against a debtor's interest in the entity.[1]

[1] A creditor generally cannot directly attach a debtor's interest in an FLP or an LLC, but instead is limited to the remedy of a charging order. See M.G.L. c. 109, §41 (FLP) and M.G.L. c. 156C, §22 (LLC). A charging order entitles the creditor to receive only the distributions from the entity otherwise payable to the debtor, making the creditor the equivalent of an assignee of the FLP or LLC interest. Because the interest is not directly attached, the creditor has no other rights in the entity (e.g., no vote on matters otherwise voted by partners or members, no right to force distributions, etc.). The purpose of a charging order is to prevent a creditor from disrupting the going business to the detriment of the other partners or members where the FLP or LLC is not the debtor. It also prevents the situation in which the other partners or members are forced to do business with the creditor without their consent, which would be the case if the creditor were permitted to directly attach the interest and participate as a partner or member (as opposed to being merely an assignee).

For estate planning purposes, these entities have proven to be an invaluable tool for business succession and wealth transfer planning. They can be used by business owners to reward valued employees, oftentimes the owner's children, for their hard work and dedication with an ownership interest in the business (something that is not easily accomplished with a sole proprietorship). Even for the parent who is not ready to share control of the business with the children, or the parent who has children that are not working in the business, these entities can be used to transfer wealth to the children and accomplish significant estate tax savings without disrupting the business itself.

Although there are numerous advantages to operating a business in the form of an FLP or an LLC, this article will focus on their use in estate planning and the recent significant challenges waged by the Internal Revenue Service (IRS) to curtail the tremendous transfer tax advantages enjoyed by taxpayers over the past decades. The IRS has continued to attack these entities, particularly where it is abundantly clear that the only reason the taxpayer is operating an FLP or an LLC is to reduce estate taxes. For example, the IRS takes particular exception to an entity formed by a taxpayer on her deathbed and funded with only marketable securities and cash.

Despite how clear the estate tax purpose (as opposed to a business purpose) of these entities can be in many of these cases, the IRS has had its difficulties in quashing them. It has also had its victories. Specifically, the IRS has won a string of cases by demonstrating that that taxpayer did not respect the separateness of the discount entity, but instead continued doing business as if the entity did not exist. This article will briefly review these entities and the benefits they offer, particularly the benefit of discount valuation for transfer tax purposes. Although there are many different challenges by the IRS, the focus will be on the most difficult challenge to withstand – the §2036 argument[2]. Finally, this article will explore how to prevent a §2036 argument from being raised by the IRS through diligent, but relatively simple, efforts in managing the discount entity.

[2] Referring to Internal Revenue Code (IRC) Section 2036.

B. General Overview of Discount Entities

1. Family Limited Partnerships and Limited Liability Companies

Just a brief note about the entities chosen for this discussion. Although there are other vehicles for achieving the estate tax and business succession planning goals mentioned above, as noted, their relative simplicity has made FLPs and LLCs the popular choice. Although FLPs and LLCs are very similar creatures with regards to their ease of operation and their benefits, LLCs are fast becoming the forerunner because they eliminate the need for a "general partner". In an LLC all members (the equivalent of partners) enjoy limited liability, whereas with an FLP, there must be at least one general partner who has *personal liability* for the debts of the FLP in the event the FLP does not have sufficient assets to pay its debts.[3]

For example, consider an FLP and an LLC both holding and operating shopping plazas. Due to the negligence of the owner, each plaza burns down injuring many people. Assuming both entities are properly structured and maintained, the plaintiffs of each have different rights. The plaintiffs suing the FLP can execute a judgment against all assets held by the FLP and if the judgment is not thereby satisfied, can also attach the personal assets of the general partner. On the other hand, the plaintiffs suing the LLC are limited to the assets of the LLC to satisfy their judgments, no member is at personal risk.

To address the personal liability of the general partner, another entity will often be formed to act as the general partner, such as a corporation, which will then add a layer of protection between it and the shareholder of the corporation (who otherwise would have been the general partner). Although it adds complexity and costs to the arrangement, this has proven to be a generally acceptable plan over the years, particularly where liability is a primary concern. With the onset of the LLC, however, this extra step and its related

costs and complexity, became unnecessary. On this aspect alone, FLPs would presumably be extinct in very little time; however, there are still situations where an FLP is preferable. Although an LLC saves costs by eliminating the need to form an additional entity to serve as a general partner, it does have an ongoing cost that may discourage its use, particularly by clients who do not have a lot of liquidity or clients who are not concerned with liability issues. Currently in Massachusetts, the fee to form an FLP is $200, but there is no ongoing reporting or fee requirements. On the other hand, the fee to form an LLC is $500, and the entity is required to file annual reports and pay an annual fee of $500. The annual fee may be a disincentive to a client, particularly when there is little concern about liability (such as an FLP that will only hold marketable securities or other non-risk assets). On the other hand, if it is important to secure limited liability for all parties, the $500 annual fee can be looked at as an insurance premium, like an additional umbrella policy for the members' personal assets.

Although these distinctions could factor into an estate tax challenge, which tend to be very fact specific, for purposes of the remainder of this article there will be no distinction between the two entities, since they are viewed by the IRS as the same evil. Regardless it is important to understand the distinctions, so as to determine which is best for your client, not only based on the goals, but also based on the client's ability to meet the requirements for maintaining the entity going forward.

2. Valuation and the Hypothetical Willing Buyer and Seller

So why is the IRS against the use of FLPs and LLCs in estate planning? Because they were not designed for this purpose – they were designed for a *business* purpose. However, once the transfer tax side-effects of these entities became known, tax practitioners went to work to take advantage of what is perceived to be a flaw in the transfer tax system, or more specifically in the definition of "value" for determination of

[3] M.G.L. c. 156C, §22 (LLC) and M.G.L. c. 109, §§1 (requiring a general partner) and 19 (limiting liability

gift and estate taxes.[4] Although "value" is defined separately for gift and for estate tax purposes, the definitions are almost identical, and the application of either definition sanctions the use of valuation discounts for transfer tax purposes under the right circumstances. Despite the efforts of the IRS, the availability of discounts are no longer debatable absent legislative action.[5] The definition of value for gift tax purposes is defined under Treasury Regulation §25.2512-1 as follows:

> "The value of the property is the price at which such 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."

Similarly, the definition of value for estate tax purposes is defined under Treasury Regulation §20.2031-1(b) as follows:

> "The fair market value is the 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."

Both of these definitions reflect the time-tested legal definition of "fair market value" as being the price that would be paid by the hypothetical willing buyer and accepted by the hypothetical willing seller without consideration of *internal* factors that affect what people are willing to pay or accept (e.g., a seller who must sell fast for personal reasons). In the past, the IRS has made unsuccessful attempts to attach an identity to these "hypothetical" buyers and sellers[6], but finally surrendered and acquiesced to the unidentifiable parties.[7]

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of limited partners with no counterpart limitation for general partners) (FLP).

[4] See Brant J. Hellwig, *Estate Tax Exposure of Family Limited Partnerships Under Section 2036*, 38 Real Property, Probate and Trust Journal, American Bar Association, Spring 2003.

[5] See Tres. Reg. §20-2031-3; Rev. Rul. 77-287, 1977-2 C.B. 319; Rev. Rul. 69-609, 1968-2 C.B. 327. See also Hellwig, Id.

[6] For example, see *Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. 1982).

[7] Revenue Ruling 93-12, 1993-1 C.B. 202, 1993-7 I.R.B. 13.

3. Discounting in Valuation

So, where does the discount actually come from? The transfer tax is levied on the value of the interest transferred. As noted above, the value is the price the hypothetical willing buyer would pay and the price at which the hypothetical willing seller would sell the interest being transferred.[8] It is the conversion of *the interest being transferred* from the actual asset to an interest in the entity (which happens to own that particular asset) that results in a different value.

For example, Mr. Smith (seller) owns a parcel of commercial real estate valued at $1,000,000, and Mr. Jones (buyer) wants to purchase the real estate for its value of $1,000,000. There is little question that the value of the property is $1,000,000. Now assume that only one-half of the real estate is for sale because Mr. Smith wants to retain one-half for himself. Mr. Jones will then have to purchase the one-half interest for sale and share the real estate with Mr. Smith, which entails cooperation and agreement as to all managerial decisions (e.g. How much rent will be charged? Who will be accepted as a tenant? Will the roof be replaced this year or next? Should the property be sold and the net proceeds reinvested elsewhere?). He is still buying real estate, but now, because the interest has changed, Mr. Jones is taking a risk that there will be disagreements and that resolving these disagreements will be costly, perhaps even requiring legal resolution through an action to partition the property (a very costly outcome). Therefore, Mr. Jones will not pay one-half of the value of the whole property ($500,000) for a one-half interest, but instead will discount the price to account for these unattractive qualities. Perhaps Mr. Jones will pay $450,000 for the one-half interest, which represents a so-called "fractional interest discount" of 10%.

Take the same concept and apply it to property transferred to a "discount entity." The real estate is worth $1,000,000 in Mr. Smith's hands. He then transfers the real

estate to The Smith LLC in exchange for a 100% ownership interest therein.[9] Mr. Jones, wanting to own one-half of the property, will now purchase a 50% membership interest in The Smith LLC instead of a direct interest in the real estate. Will Mr. Jones pay $450,000 for that 50% interest? Probably not. Those same issues and risks of "sharing" are still there, but there is an added layer of potential problems and, depending on the entity's operating agreement, this layer can become quite thick. As the potential problems of the investment grow, so does the discount.

Typical operating agreement provisions (and typical default provisions under state law, which apply where an operating agreement does not exist or is silent on an issue) provide for substantial restrictions on a member's (or partner's) rights.[10] For example, in most cases, members cannot force distributions from the entity, such as if Mr. Jones needed income but the Manager determined that it was in the best interest of The Smith LLC not to distribute the income[11]; members cannot make day-to-day decisions, so Mr.

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[8] Hereinafter all references to the buyer and seller shall mean the hypothetical willing buyer and the hypothetical willing seller unless otherwise noted.

[9] Note that the law of the state where the entity is formed governs the formation requirements. Some states permit the formation of a one-member LLC, while others require at least two members. Massachusetts has recently amended its definition of "limited liability company" under M.G.L. c. 156C, §2(5) to include one-member LLCs; however, the one-member LLC may have a flaw to be aware of that has yet to be tested in Massachusetts. A Colorado court has ruled that the assets of a single-member LLC are not protected from the sole member's creditors (meaning the debtor-member's creditor would not be limited to a charging order (see charging order discussion in *supra* note 1) against the interest, but instead could in fact reach the LLC's assets. *In re Albright*, 291 B.R. 538 (Bkrtcy.D.Colo, 2003). (A discussion of the Bankruptcy Court's reasoning is beyond the scope of these materials, but in this author's opinion, the reasoning was sound and likely to be applied by a Massachusetts Court under similar conditions.) The converse is not the case, however, since statutorily, the sole member's personal assets are not reachable to satisfy debts of the LLC. See M.G.L. c. 156C, §22.

[10] Although these materials are not intended to discuss the drafting of operating agreements, it is important to note that restrictions in an operating agreement for an entity wholly owned by family members (as defined under Tres. Reg. §25.2702-2(a)(1)) can be disregarded for valuation purposes (meaning no discount can be applied) under IRC §2704(b). The Treasury Regulations, however, identify an "applicable restriction" (meaning a restriction that will not yield a discount) as one that is "*more restrictive* than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction." Tres. Reg. §25.2704-2(b)(emphasis added). This means that discounts for restrictions in an operating agreement can be applied so long as the restrictions are not more restrictive than state law.

[11] Note that the manager of an LLC and the general partner of an FLP each owe a fiduciary duty to the non-controlling members and partners and must act in the best interests of the entity in making decisions; however, it is not difficult to justify retaining income in a business, so there is still a tremendous amount of

Jones may have no say in whether the excess income goes to a new roof or is distributed; members cannot unilaterally force liquidation of the entity; and members cannot easily cash out due to restrictions on selling or otherwise transferring the interest and due to provisions that make the interest even more unattractive to the next buyer.[12] After these considerations, Mr. Jones may only be willing to purchase a 50% interest in The Smith LLC for $325,000 (representing a "combined discount" of 32% to account for such factors as the fractional interest, the lack of control, and the lack of marketability).[13]

Further consider the effect on value if Mr. Jones purchases only a 25% interest in The Smith LLC. Now he not only has to cope with the other owner(s) and the restrictions in the operating agreement (to which he must agree in order to make the purchase), but there is also the fact that he cannot control or at least veto even those issues requiring a vote of the members because he holds a minority interest (obviously this assumes a majority vote to carry decisions; however, the operating agreement sets what number of votes is necessary to carry any particular decision). Also consider the type of business represented by the interest being transferred and the identity of the other owners. Unlike the buyer and seller, these factors are not hypothetical.[14] For example, if all of the other members are named Smith, the "hypothetical willing buyer" will be likely to lower the price he or she is willing to pay knowing that the Smiths will stick together on voting issues. All these factors affect the value in the eyes of the buyer, and thus affect it for transfer tax purposes as well.

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flexibility to be aware of here. See M.G.L. c. 156C, §63 (LLC) and M.G.L. c. 109, §41 (referring back to general partnership rules under M.G.L. c. 108A, §18) (FLP).

[12] It is standard practice for an operating agreement to provide that anyone who purchases a membership or partnership interest takes the interest as an assignee and not as a member or partner unless and until the remaining members consent to accept the buyer as a member. Such a provision protects the other members from being forced to accept an unwanted business associate who could disrupt the business. An assignee has less rights than a member, and therefore, an interest as an assignee is less valuable than a member's interest. M.G.L. c. 156C, §39 (LLC) and M.G.L. c. 109, §§40, 42 (FLP).

[13] Note that valuation discounts are applied seriatim. For example, assume the underlying property is valued at $1,000,000 and the following discounts will be applied: a 20% discount for lack of marketability and a 15% discount to reflect the minority and fractional interest. The value will be discounted as follows: $1,000,000 x 20% = $800,000, and then $800,000 x 15% = $680,000. This results in a *combined discount* of 32% (as opposed to a discount of 35% derived by adding the various discounts together).

[14] See Tres. Reg. §20-2031-3, Rev. Rul. 77-287, Id., Rev. Rul. 69-609, Id.

C. IRS Challenges to Discount Entities

1. Challenges to the Discounts Applied in Valuing the Entity Interest

If valuation discounts to FLPs and LLCs are now indisputably valid, why all the continued litigation about the discounts? Even where the IRS cannot attack the *use* of a discount in valuing an entity interest, they can still look at the amount of the discount applied. If a discount appears to be too aggressive or poorly supported, then there is likely to be a challenge by the IRS to reduce the discount and increase the transfer tax. Determining the discounts that can be applicable to the underlying value is a science of its own, albeit not an exact science. It is crucial that qualified expert appraisers are hired to analyze the interest being reported on a gift or an estate tax return and to provide the applicable discounts in a well-supported appraisal. Valuations are hotly contested by the IRS, particularly where taxpayers are claiming aggressive discounts, and the courts are not shy about openly criticizing appraisers, regardless of whether they work for the taxpayer or the IRS.[15]

Absent a good appraisal and an expert appraiser to defend it, a court is likely to disregard the appraisal entirely and accept the IRS appraiser's report if it is credible and well-documented. If neither party's expert passes muster, the courts have been known to provide their own analysis of value.[16] A poorly supported valuation can result in a significant additional tax owed by the client and can even cause the IRS to take that second look and audit the return. On the other hand, a strong appraisal will go a long way to support the discounts taken on gift and estate tax returns and either prevent a

[15] See, for examples, *Estate of Bailey v. Commissioner*, T.C. Memo 2002-152 (June 17, 2002); and *McCord v. C.I.R.*, 120 T.C. 13 (May 14, 2003).
[16] See Id.

challenge or successfully defend against one. Taxpayers have successfully withstood challenges in the courts with discounts as high as 70% of the underlying value![17]

Every entity is different so there are no set numbers for any of these discounts. However, there are guidelines used by the IRS in settling cases with taxpayers. These guidelines come into play at the appellate level (although they are certainly on everyone's mind early on) and were set to address the problem of different discounts being accepted in different areas of the United States. For example, Texas is known for its aggressive estate planners, and their clients were successfully taking much larger discounts than seen in other areas of the country. Also, the IRS now has an Appeals National Family Limited Partnership Coordinator with whom every settlement offer is discussed to ensure they are applying their standards consistently across the country. These guidelines contain ranges of discounts to adapt to the specific facts of each case, while still achieving the goal of relative consistency. The ranges (again primarily for the purpose of settlement negotiations at the appellate level) are as follows[18]:

Partnerships formed on deathbed and to which §2036 is applicable	0% - 15%
Partnerships holding passive assets (e.g. marketable securities, bonds, REIT interests, etc.)	25% - 30%
Partnerships holding active assets (e.g., operating businesses and actual real property)	35% - 40%

[17] See, for examples, *Martin v. C.I.R.*, T.C. Memo 1985-424 (August 14, 19985) (combined discount of 70% for stock in a closely-held corporation); *Church v. United States*, 85 A.F.T.R.2d 2000-804 (W.D. Tex. 2000) (combined discount of over 57% for interest in FLP).

[18] These ranges were provided by Mary Lou Edelstein, Chief Appeals Officer for the Estate and Gift Tax Division of the IRS for Southern Florida, during her presentation "Transfer Tax Audit Issues: What's Hot, What's Not" at the 2003 Heckerling Institute on Estate Planning in Miami, Florida. Ms. Edelstein is also the Appeals National Family Limited Partnership Coordinator for the IRS.

2. Challenges to the Entity Itself

Although the IRS continues to challenge the size of discounts taken on gift and estate tax returns, because discounts themselves cannot be denied, they continue to search for that winning argument that will overcome the very use of discount entities solely to achieve transfer tax advantages. A review of all of the arguments brought by the IRS over the years, successful or otherwise, is beyond the scope of this article. Instead, the focus will be on the newest, and perhaps the most significant, weapon in the IRS arsenal – IRC §2036.

Not only does this argument result in the most severe tax consequences to an unsuccessful taxpayer (including a complete disregard for the entity itself, loss of valuation discounts, and loss of lifetime gifting advantages); but it can also be applied to *any* FLP or LLC situation. It does not only attack "deathbed" entities, over-aggressive discounts, entities with clearly no true business purpose, and all the other openly flawed arrangements, but instead it can be wielded against virtually any entity based on the behavior of the family members controlling and holding its interests. Section 2036, more than any other argument, frightens transfer tax practitioners, because we cannot control what our clients do when they leave the office. No matter how much we plan and structure and advise, the fate of the entity under §2036 is not within our control, it is in the hands of the client. The best we can do is educate the client as to what needs to be done and why, which is rarely an easy task.

3. Application of §2036 to Discount Entities

It is important to understand how §2036 works in order to understand how to avoid it with FLPs and LLCs. Section 2036 reads as follows:

Sec. 2036. Transfers with Retained Life Estate

(a) General Rule. – The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in the case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death –

(1) the possession or enjoyment of, or the right to the income from, the property, or

(2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

Successful IRS attacks have come under both §§2036(a)(1) and (a)(2), with §2036(a)(1) being the most prominent because it is easier for the IRS to prove as discussed in more detail below. Note, however, that §2036(a)(2) is coming into its own and may prove to be one of the strongest arguments yet under certain (common) circumstances (see discussion below regarding §2036(a)(2) and the issue of retaining control of the entity). The theory behind §2036 is that of a "string" attached to property transferred by a decedent during her lifetime whereby the decedent retained some type of control or rights to the property. The key to transferring value, and thereby removing it from the transferor's estate, is to relinquish control and benefits. A transfer on paper is not sufficient to move value from an estate, but instead the decedent had to have truly relinquished control over the asset and all benefits from it.

For example, Mr. Smith lives in a $1,000,000 home. He wants to avoid paying estate taxes on the $1 million value, so he deeds the home to his daughter. The deed is recorded and for all purposes, his daughter is the owner of the house. However, Mr. Smith never moves out and never pays his daughter rent. On his death, §2036(a)(1) includes the value of the house on his date of death (i.e., the appreciated value, which will

likely exceed the earlier $1,000,000 value) in Mr. Smith's estate, and it is fully taxed despite the transfer of title.[19]

For another example, assume Mr. Smith transfers $1,000,000 in income producing assets to an irrevocable trust for the benefit of his children. He is not a beneficiary of this trust, and therefore, seemingly does not continue to possess or enjoy the property. Sounds good so far, but also assume that Mr. Smith is the trustee and that the trustee has the absolute discretion to make or not make distributions of income or principal to or among the beneficiaries (a very common provision in trust drafting). This is deemed a power to designate who will possess or enjoy the property or its income, and §2036(a)(2) applies to include *all* of the trust assets in Mr. Smith's estate, valued as of his date of death, regardless of whether or not he actually exercises this discretion.

In the discount entity realm, the IRS is demonstrating that a "string" is attached to the property transferred by a senior family member to an FLP or LLC by showing there is an express or an implied agreement among the members of the entity that the senior family member shall have unfettered access to the property or control over it even after it is contributed to the entity, e.g., the right to use and enjoy the property under § 2036(a)(1) and/or the right to designate who shall use and enjoy it under § 2036(a)(2).

4. Closer Look at §2036(a)(1)

The § 2036(a)(1) argument has been successful in several cases so far, where the IRS demonstrated that the senior family member (the transferor) commingled entity and personal funds or accessed entity funds at will for personal expenses.[20] It is important to

[19] See *Rapelje's Estate v. Commissioner*, 73 T.C. 82 (1979).
[20] See *Estate of Strangi v. Commissioner*, T.C. Memo 2003-145 (May 20, 2003) (*Strangi II*); *Kimbell v. United States*, 244 F.Supp. 2d 700 (N.D. Tex. 2003); *Estate of Harper v. Commissioner*, T.C. Memo 2002-121 (May 15, 2002); *Estate of Thompson v. Commissioner*, T.C. Memo 2002-246 (September 26, 2002). In both *Strangi II* and *Kimbell*, the courts discussed the applicability of both §2036(a)(1) and §2036(a)(2),

note that most of the §2036 cases have had bad facts for the taxpayer. They demonstrate the more obvious failings. However, it is even more important to note that, although these cases appear to demonstrate extreme failings by the taxpayers, the same problems can surface on a much smaller scale as well.

For example, many cases involve facts whereby the decedent transferred virtually all of his or her assets into the entity, not leaving enough assets outside the entity to cover personal living expenses.[21] Under facts like these, it is not difficult to demonstrate an implied agreement among the parties that the decedent would have access to the property for living expenses. The question becomes, how much is too much? There is guideline, and many factors must be considered, such as the types of assets being transferred (personal, investment, business, income-producing, etc.), what assets are not being transferred, and can the retained assets support the transferor's standard of living, and so on.

Also, in several notable cases, the taxpayers transferred their personal assets and continued to use them as such without any formal arrangement to do so with the "new owner" (i.e., the entity).[22] Although personal assets can be transferred to an entity under the right circumstances, it is highly advisable to avoid doing so. For example, it is not uncommon for taxpayers to transfer a personal residence to an entity, particularly where the personal residence has significant value, intending to use the entity discounts on the value of the home as well as the investment and business assets. This can be an acceptable arrangement where the transferor recognizes that she is no longer the owner of

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holding that either section would bring the assets transferred by the decedents to the respective entities back into the estate. Also note that in *Kimbell* the IRS won this §2036 challenge on summary judgment!

[21] See, for example, *Strangi, II* (approximately 98% of the decedent's overall wealth transferred to the FLP at issue, apparently leaving only two bank accounts for the decedent's personal use, which held a combined $762 on his death just two months later). Id.

[22] See, for example, see *Strangi, II* where the decedent transferred his personal residence to an FLP, but continued to live there. The FLP attempted to demonstrate that the residence was leased back to the decedent, but, despite records of rent obligations, actual payments were not made and the court refused to recognize any lease agreement to overcome the application of §2036 to the residence. See *Strangi I* in *supra* note 18.

the house, and if she wants to continue living there, she must rent it from the entity. This cannot be a be a transaction on the books, but must be a formal, valid and *actual* arrangement, whereby payments are changing hands and all related obligations of landlord and tenant are being fulfilled.[23]

This trap does not only appear with a personal residence, it also catches taxpayers using assets (personal or otherwise) transferred to an entity for their personal expenses. Even if a taxpayer is careful to retain personal assets and adequate resources to cover personal expenses, use of entity funds to pay personal expenses directly, including estate taxes after the senior member's death, is common and problematic. For example, if the income earned on rental property owned by an FLP is properly distributed to the FLP account, but then a check from the FLP account is subsequently written to a creditor of the senior family member who contributed the real estate that contributed the income, there is the §2036(a)(1) string – retained use and enjoyment of the income from the property.[24] Assets of an entity simply (or not so simply) cannot be used to pay the personal expenses of a member (or partner), especially the member who contributed the asset in the first place.

Consider one more example wherein Mr. Smith sets up The Smith LLC with himself and his four children as members and contributes all of his income producing parcels of real estate (disregard the transfer tax consequences of the formation for this example). Assume all state law requirements are met and a valid entity exists. Subsequent to the contributions, Mr. Smith continues to collect the rents from the properties and deposits them *into his own checking account*, commingling The Smith

[23] Again, in *Strangi, II* the FLP demonstrated that rent payments were *charged*, that the FLP reported the income on its income tax return, that the decedent's Estate reported the obligation on the estate tax return, and that the payments were actually made. However, the payments were not actually made until about two years after the obligation accrued, and the Court found that a valid lease agreement did not exist, but instead, that the decedent retained the use and enjoyment of the residence. See *Strangi I* in *supra* note 18.
[24] *Strangi, II* also demonstrates this point, where the assets of the FLP were used to make direct payments to creditors of the decedent (such as medical and care payments, funeral expenses, administration expenses and estate taxes). See *Strangi I* in *supra* note 18.

LLC's income with his personal assets. This demonstrates, at the very least, an implied agreement among the members that Mr. Smith will continue to have access to the properties as if they were his own. The §2036(a)(1) string attaches because Mr. Smith has, in practice, retained income and enjoyment of the transferred property.

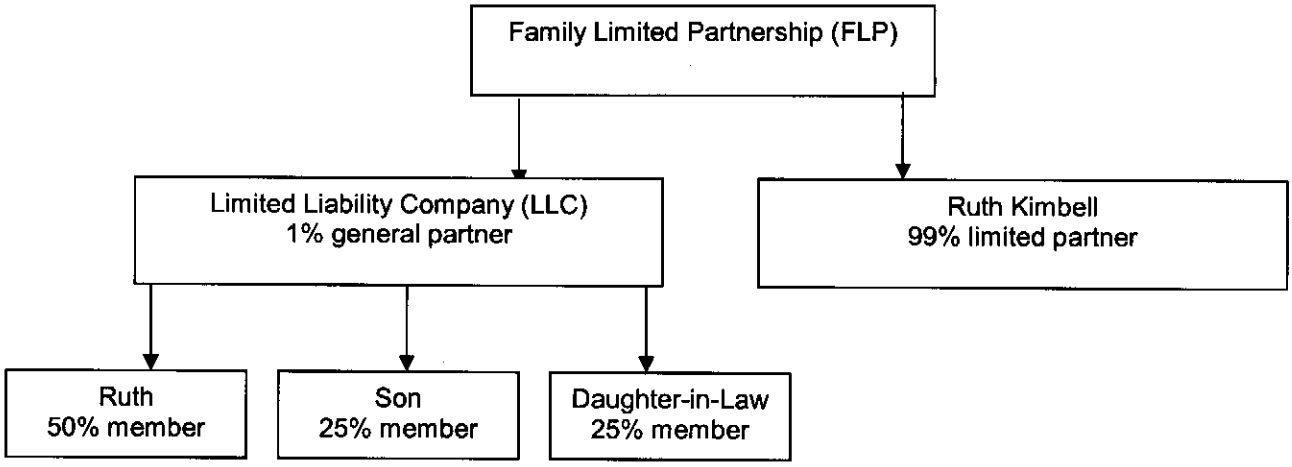
5. Closer Look at §2036(a)(2)

As noted in footnote 20, the application of §2036(a)(2) to bring entity assets back into the transferor's estate is discussed at length in both the *Strangi II* and *Kimbell* cases, even though in both cases the court agreed with the IRS that §2036(a)(1) applied to fully include the transferred assets and therefore, that §2036(a)(2) was not necessary for the IRS to include the assets in the decedent's estate. In both cases, the IRS successfully demonstrated through a detailed analysis of the various hats worn by the relevant parties that the decedent retained "the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom."[25]

For example, in *Kimbell*[26], the court found that the decedent, Ruth Kimbell, retained §2036(a)(2) rights in the transferred property because she had the ability to accumulate income, which falls within the purview of the right to designate who shall enjoy the income under §2036(a)(2). This ability to accumulate income was demonstrated by looking through the entities to identify the decedent as being in control of the ultimate distributions of income to the members. The analysis in *Kimbell* is a straightforward and an excellent example of how §2036(a)(2) can be applied. At issue was the decedent's 99% limited partnership interest in the FLP reported on the estate tax return, which was valued for estate tax purposes taking into consideration various discounts to the underlying value of the FLP assets. With a §2036(a)(2) victory for the IRS (as well as a win on §2036(a)(1)), the ultimate result was the full inclusion of all properties transferred by the decedent to the FLP (and also to an LLC which in turn

[25] IRC §2036(a)(2).
[26] See *Kimbell* in *supra* note 18.

contributed to the FLP) in the decedent's estate. The structure of the entities was as follows:



Brief summary of analysis by the court to apply §2036(a)(2):

1. The court deemed Ruth to be a 99.5% owner of the FLP because she held 99% directly (her limited partnership interest) and 0.5% indirectly through her 50% interest in the 1% general partner LLC.

2. The general partner of the FLP has the discretion to make distributions or accumulate income under the operating agreement. The general partner was the LLC; however, in accordance with the provisions of the operating agreement, Ruth had the ability to remove and replace the LLC as general partner, even placing herself in that role (the operating agreement stated that 70% of the limited partners could replace the general partner, and Ruth held a 99% interest).

3. Because Ruth had the ability to remove the general partner and appoint herself as general partner instead, she had the unfettered ability to control the distribution or accumulation of income, and thus retained a §2036(a)(2) string over the property transferred.

4. This power was also found to be a §2036(a)(1) string because she had the power to personally benefit from the income of the partnership, not just to control the benefit to others.

5. The fiduciary duty to the other partners or to the FLP itself was virtually non-existent and did not operate as a constraint on the power to distribute or accumulate income for several reasons, including: (1) the application §2036(b) expressly overrules the *Byrum*[27] decision (discussed below); (2) as a 99.5% partner, the fiduciary duty ran only to herself and "miniscule" partnership interests; and (3) the FLP operating agreement specifically stated that the general partner did not have a fiduciary duty.[28]

Although at first glance the §2036(a)(1) argument appears to be the easiest for the IRS to apply, particularly where the taxpayer has blatantly disregarded the formalities of the business entity, §2036(a)(2) may be the more problematic to estate planners. First, note that the court is analyzing the applicability of §2036(a)(2) even where the IRS has been successful without reaching that argument.[29] This indicates the court's support for the application of this argument in a fight that has long fought and lost by the IRS to stop the use of discount entities for what the IRS perceives to be purely estate planning purposes. In addition, as demonstrated by the purpose of this article, it is not impossible to beat the §2036(a)(1) argument. All it takes is an understanding of the entity and the steps necessary to respect its separate existence.

On the other hand, §2036(a)(2) cuts straight through to an often imperative aspect of using discount entities for estate planning purposes – control. Clients are often willing to make transfers to their children to move wealth and reduce estate taxes. They are often also willing to begin the succession of the business to the children as well. What many are not willing to do is transfer or share the ultimate control of the business. Assuming §2036(a)(2) continues to flourish as an argument for the IRS, many clients will be faced with a very difficult decision – to take a chance on their children and share control, or to incur the estate taxes that may otherwise have been

[27] *United States v. Byrum*, 408 U.S. 125 (1972).
[28] Query as to why the operating agreement expressly removed the fiduciary duty, especially where the fiduciary duty has been an important element in supporting discounts in the past, as discussed further herein. Generally, it is a good idea to reinforce the statutory fiduciary duty in the operating agreement, if mentioned at all.
[29] See *Strangi II* and *Kimbell* in *supra* note 18.

limited or avoided. To play the devil's advocate for a minute, this argument makes sense. As noted above, it is the relinquishment of control that governs whether an asset has been sufficiently transferred to be excluded from the decedent's estate for estate tax purposes. If there is a string of control, there is estate tax inclusion under §2036(a)(2).

6. Notable Defenses to a §2036 Challenge Raised by Taxpayers

As discussed above, one seemingly strong defense to the application of §2036(a) where property is transferred to an entity subsequently controlled by the transferor, as seen in *Kimbell* and *Strangi II*, is the fiduciary duty to act in the best interests of the entity and the other members or partners.[30] The argument is that the fiduciary duty prevents the application of §2036(a) because it is a constraint on the right to income or to designate who can enjoy the income. Previously, the court has found that §2036(a) did not apply where there were not only economic constraints to be considered in the decision to distribute or accumulate income, but also the legal constraints of a fiduciary duty, particularly where the other members or partners had a legally enforceable right to ensure that duty is honored.[31]

Unfortunately, this otherwise strong precedent is no longer being accepted by the courts as a blanket rule where the relationship described on paper does not reflect reality. The court also notes that §2036(b), which was enacted subsequent to the *Byrum* decision, and effective for transfers made after June 22, 1976, expressly overrules *Byrum*. Section 2036(b) states that for purposes of §2036(a)(1), "...the retention of the right to vote (directly or indirectly) shares of stock of a controlled corporation shall be considered to be a retention of the enjoyment of transferred property." Although §2036(b) is clearly

[30] See M.G.L. c. 156C, §63 (LLC) and M.G.L. c. 109, §41 (referring to M.G.L. c. 108A, §18 by reference) (FLP). Also see *Byrum*, which found that the fiduciary duty of a controlling shareholder, as well as the economic constraints of maintaining the business, sufficiently restricted the shareholder's control to avoid the application of §2036. See *Byrum* in *supra* note 27.
[31] See *Byrum* in *supra* note 27.

problematic to the fiduciary duty argument, there is likely to be further discussion of its applicability, particularly to a §2036(a)(*2*) argument (note that §2036(b) refers specifically to §2036(a)(1)).

Another attempt to avoid the application of §2036(a) all together, which has been unsuccessful in the major cases noted in this article, is to focus on the parenthetical language in the statute which carves out an exception to its application: "except in the case of a bona fide sale for an adequate and full consideration in money or money's worth".[32] The argument is that because the decedent transferred the property to the entity in exchange for a membership or partnership interest in the entity, the transfer was a bona fide sale for adequate consideration, the consideration being the entity interest. The courts have rejected this argument finding that a "bona fide sale" does not exist where the decedent was on both sides of the transaction, meaning there was no negotiating or bargaining to raise the transaction to the level of a "bona fide sale".[33] Instead, the courts have described these transactions as a mere "recycling" of the assets, noting that the decedent did not invest in a business enterprise, but instead recycled his or her assets by changing only the form of ownership.[34]

7. Losing to the IRS under §2036

The end result of a successful §2036 argument can be devastating to the decedent's heirs (or to the client should the challenge arise in a gift tax situation). If the IRS can demonstrate that the decedent retained a §2036 string on the property transferred to the entity, then the entire property transferred is fully included in the decedent's estate at its full, undiscounted, date of death value. This means that there is no applicable valuation discount because it is the underlying property being valued as opposed to the entity interests that warrant such discounting.

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[32] See cases cited in *supra* note 18.
[33] Id.
[34] Id.

It also means that any entity interests gifted to the children during the decedent's life are disregarded since the property is *fully* included in the estate. For example, assume Mr. Smith faithfully made his annual exclusion gifts of LLC membership interests to his children for many years, and by the time he died was only a 10% member of the LLC. The estate tax return reports only the 10% interest in the LLC, which of course will be the discounted value of 10% of the underlying property (likely to be much less than 10% of the underlying value). A successful §2036 challenge would result in the inclusion of the *full* value of the underlying property transferred by Mr. Smith. This not only eliminates the discount, but also disregards all the gifts made over the years. In addition to the large estate tax deficiency, consider the opportunity cost of all those annual exclusion gifts, and also consider the ancillary costs of the legal fees to prepare the gifting documents and gift tax returns over the years, not to mention the cost of the audit itself.

To demonstrate the financial consequences of a successful §2036 argument by the IRS, consider the following case results:

Kimbell:

Limited partnership interest as valued by the estate:	$ 1,257,000
Limited partnership interest as valued by the IRS:	$ 2,463,000
Estate tax deficiency assessed:	**$ 837,089**

Strangi II:

Limited partnership interest as valued by the estate:	$ 6,823,582
Limited partnership interest as valued by the IRS:	$10,947,343
Estate tax deficiency assessed:	**$ 2,545,826***

*Note that the court would have gone higher had the IRS properly asserted a higher deficiency for the §2036 argument.

Not only is this a devastating result for the family who is now paying the additional unanticipated estate tax with interest, but it will also be devastating to you when the family asks about all the legal fees spent setting up the entities and making all those annual exclusion gifts to the children, and again, in attempting to defend against the §2036 challenge. And there were the additional tax preparer fees, the annual reports, the annual fee, and so on. The documents in the file are not sufficient evidence that the job is done. In fact, the documentation of the entity and subsequent gifts are probably *far less* persuasive than the everyday activities of the business and the interest holders.

D. Avoid a §2036 Challenge by Respecting the Entity

1. A Good Offense – The Best (and Only?) Defense to §2036

As you may notice, the courts in these cases are looking at the reality of the transaction. Does the relationship between the decedent and the transferred property differ subsequent to the transfer? To successfully defend against a §2036 argument, it is imperative to demonstrate that the decedent's rights and powers relative to that property changed after the transfer – not only on paper, but in practice. In other words, the entity must be respected as a separate and operating business. Think about it this way – in what true partnership would the partners allow one partner to hold all of the income in his personal account? Or when would partners allow the partnership to pay one partner's personal living expenses? It is important that the relationships created realistically reflect the attributes of a business relationship. Are the rights and duties of the parties legally enforceable, and if so, is there a realistic chance that they will be enforced? There may very well be fiduciary duties under state law and under the operating agreement, but if the duty runs only to oneself and a "miniscule" partner, then in reality the duty is not subject to enforcement.[35]

[35] See *Kimbell supra* note 18.

Where the IRS has been able to show that funds have been commingled and that the decedent was using the entity's assets as if they were his or her own, the cases have been slam dunks – not only to disallow the discount to the valuation, but also to show the dreaded §2036 "string" on the property pulling it all back into the estate.[36] Even in the first attack on the *Estate of Strangi I* where the partnership at issue withstood an onslaught of IRS challenges (losing only on a valuation issue due to the taxpayer's weak appraisal), several judges noted that the assets of the entity *could* have been brought back into the decedent's estate had the IRS timely raised the §2036 argument.[37] As we now know, the IRS was given an opportunity to raise and win the §2036 argument on remand.[38]

2. A Well-Informed Client

So how can these entities be made to serve their estate planning purposes, as well as their business and liability protection purposes? Start before the client makes the decision to take your advice and form the entity. Make sure in conversations – and written correspondence to protect yourself – that the client is clearly informed of the responsibilities and the consequences of failing to meet them before going forward. Despite the myriad of benefits offered by these discount entities, some clients just don't want the extra work, even if the financial rewards are greatly disproportionate to the necessary work. By discussing all that lies ahead with the recommended entity, you gain the opportunity to weed out those clients that simply cannot handle the plan, either because they cannot fully grasp it or because they simply will not comply with the requirements. You also keep the client informed about what the process entails so there are no unwelcome surprises after the entity is formed.

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[36] See *Estate of Thompson, supra* at note 18; *Estate of Harper, supra* note 18; *Estate of Reichardt v. Commissioner*, 114 T.C. 114 (2002); *Estate of Schauerhamer v. Commissioner*, T.C. Memo 1997-242 (May 28, 1997).
[37] *Estate of Strangi I, supra* note 32.
[38] *Estate of Strangi II, supra* note 18.

Provide examples up front – again before the client takes your advice and goes forward. Make sure there is no way the client can misunderstand that if he sells that parcel of real estate for $1,000,000 from the LLC, the money sale proceeds go to the LLC. If there is to be a distribution of the proceeds, then assuming Mr. Smith is a 50% owner and each of his five children are 10% owners, Mr. Smith gets $500,000 and the children each get $100,000. *Show the math – numbers work!* Use real examples and realistic numbers to avoid obscuring your point.

It is not always difficult to predict which clients will put in the necessary effort and which will not. It is important to know your client before moving forward with a plan, despite how commonplace a plan it is. Be aware of clients that just don't understand the importance of respecting the entity and identify clients that are not likely going to be able to implement the plan properly and thoroughly. This not only means clients who no not fully understand the separate existence of the entity, but also clients who cannot accept this separation. Remember, without relinquishing something to the children, nothing (except wasted time, effort, and money) can be accomplished. It is not uncommon to have a client who simply will not involve the children, either by way of participation in the business or by way of sharing in the income. This is not the plan for that client.

For those that do go forward, make sure it is clear that they not only understand what is required to maintain the integrity of the entity in the eyes of the state (e.g. filing annual reports, paying required fees, etc.), but also that they understand about the day-to-day practices expected of them. Keeping up with the state requirements is the easy part, but if overlooked the entity may not provide the anticipated limited liability or the anticipated transfer tax savings. Note that in many of the cases involving an estate tax challenge, the IRS includes a claim that the entity should be disregarded because it lacks a business purpose or economic substance, but the courts have rejected that argument

where the entity was validly organized and maintained under state law.[39] This should not be a losing argument for the taxpayer.

3. Monitor Compliance

When the client walks out of the office with the newly formed entity, there is no continuing *duty* to call every day and check up on the operations, and it is important to make sure the client understands this. However, going beyond the call of duty in following-up with clients will go a long way to maintain a strong client relationship and ensure the entity (and your reputation) is respected when it means the most. Consider the impact of your follow-up on the client. If it is important enough to warrant the letter or the phone call, they are more likely to pay closer attention. Also, remember who the client will blame if things go wrong, regardless of who is at fault, so it is important to be able to demonstrate that you made the effort (particularly when your client is deceased and you are facing the heirs instead).

By the time the entity is up and running, you have already spent hours drafting agreements, drafting ancillary documents, and preparing detailed letters of explanation, all usually in addition to the more basic estate planning documents. Also, by this point, the client has already paid more in legal fees than he or she anticipated when they came in for a simple Last Will. But even as you are winding down, you don't have to lose steam. If you have a system in place to educate the client and to follow-up periodically, this process can be quick, easy, and relatively painless in comparison to the potential consequences of not doing so. It will also give you a steady stream of business with the follow-up work.

[39] See *Gulig v. Commissioner*, 293 F.3d 279 (5th Cir., 2002) affirming in part and reversing in part *Estate of Strangi v. Commissioner*, 115 T.C. 478 (2000) (*Strangi I*); *Estate of Thompson*, in *supra* note 18.

4. Commingling Personal and Entity Assets

Commingling assets is one of the most damaging things a client can do to a discount entity, and thus deserves special attention. It is usually a very difficult concept for the clients to grasp that a portion of what was once their income is actually earned for the other partners or members of the entity. If the entity set up by the parents nets $100,000 and the five children are each 10% owners, then the parents really only "net" $50,000 (assuming all of the net income is distributed, which means actually giving each of the children their $10,000 share).[40] This is important for the clients to understand up front, not only to determine what their income needs will be, but also to determine if they can live with this change. And, of course, follow-up with them and their accountant to ensure that the income is being distributed *in accordance with the entity interests* and that it is being properly reported on their respective income tax returns.

Remember also, that §2036 is not avoided by simply making the proper income allocations on the books. Even if the client's personal use of the entity's assets does not exceed the client's share of the income based on ownership interests, the IRS still has a strong argument under §2036 that the client retained an interest by having the access to the transferred assets for her personal use. First, there has to be actual and proportionate distributions to the members or partners. If the client continually uses assets of the entity, while the other members or partners do not receive distributions, there is a real problem. Also, remember that the court has quashed the afterthought of a book entry to cope with the discrepancies.[41] Actual distributions must be made.

Be aware that the client's *other* assets can be used to demonstrate that there was an implied understanding that the client would retain control over the transferred assets.

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[40] There are creative ways to guide the income towards the parent. For example, the payment of a management fee, if reasonable and warranted under the circumstances, can move a significant amount of income to the parent, but watch the income tax consequences to ensure reporting accurately reflects the arrangement.

[41] See *Strangi II* in *supra* note 18.

If the client has transferred the bulk of his or her assets – not retaining enough to support the lifestyle to which the client is accustomed – the IRS can easily show that the client anticipated full access at will to the entity's assets for personal use on the face of the arrangement. Otherwise, why would she have given up the accustomed lifestyle? Add to that the inevitable use of the entity's assets for personal expenses since the client did not retain enough assets to cover them.

So, the easy (or at least easier part) of the commingling or §2036 equation is to ensure that your client has ample liquid assets that will remain outside of the entity and that the income outside the entity plus the allotted anticipated income from the entity is sufficient to meet the actual and perceived (or psychological) needs of the client. Assuming this is possible and successfully covered by the planning, the harder part – simply because it is out of your sight and your control – is ensuring the client does not treat the entity's assets as her own but instead, funds her lifestyle with those assets that were so carefully chosen and retained to meet her needs.

This is certainly not easy because, as we all know, clients want to maintain control and full access to everything. This is almost as important as the asset protection and estate tax saving goals they want to achieve, of course at no cost or inconvenience. It is important to remember that clients that warrant estate tax planning are rarely unsophisticated. They *can* do the right thing, it is just a matter of fully understanding what needs to be done and why. Establishing good habits will come with time, but until there is a certainty that the client really "gets it", the follow-up and supervision cannot be ignored.

5. Provide the Client a Checklist for Respecting the Entity

As seen from the more recent cases, the IRS is taking advantage of the small failures, and not the just the obvious ones. They are stacking the smallest of oversights to

create an overall picture of not respecting the entity. So, start with the checklist of *everything* that will help support the integrity of the entity, because the more you throw against the client, the more that will stick. Putting these requirements in list form will help the client grasp and remember what needs to be done. Most clients would do what is required if they could see the big picture, or at the very least have it broken down into a series of simple tasks. Provide this list to the client as part of your letter explaining your recommendation to create the entity so that they see the list before they decide to go forward. Provide the list again when the organization is complete.

Although the following list is intended to be comprehensive, it can be expanded to include anything that helps to support the existence of a separate business entity. For examples of what should be done, look at non-family owned entities and compare to how unrelated parties do business with each other.

- ❑ **Meet all state filing and fee requirements.** This includes not only the formation of the entity, but also the maintenance of the entity. Requirements for annual or special filings differ among states and among entities. A list of filing requirements should be provided to the client so they are aware of them. The most obvious filing requirements include:

    - o **File the organizational certificate or other required form and pay the initial fee.**

    - o **File annual reports and pay all annual fees if required.**

    - o **Report changes as necessary.** For example, report changes in the management or the mailing address of the entity when they occur. This is an often overlooked requirement with all business entities. These filings are simple, but crucial from a business perspective – not only to meet the

lowest level of scrutiny for estate tax purposes, but also to ensure any anticipated limited liability protection the entity should provide. Perhaps missing one filing is not dispositive of these matters, but it goes into the pile against your client (and usually its not just one anyway!)

- ❑ **Keep accurate and abundant business records.** This is one of the most important yet overlooked points, particularly with family limited partnerships and limited liability companies, but really with all family-owned entities. More often than not, clients come to us with a business that has been operating for decades – whether as a corporation, partnership or other entity – and they do not have a single corporate record. This is a serious problem and should be rectified upon discovery by creating a record book and documenting important business transactions over the years, especially the appointment and annual ratification of the management of the entity (an "Affidavit of Lost Records" can bring the business up to date quite quickly).

    - **Order a business record book.** Order a record book with the name of the entity printed on the side and the pre-printed ownership certificates. This shows the client that this <u>is</u> a business and there is something more to it than simply signing the formation documents and going home. It is also a great visual reminder to keep up with the records. It the record book is on the client's shelf, they are more likely to at least remember that something needs to be done, and if it is on your shelf, you will remember to follow-up with the client and bring in that additional business of maintaining the records on the client's behalf.

    - **Hold and document annual and special meetings.** At least annually there should be a meeting to discuss the business and ratify all transactions

of the prior year. Additional meetings should be held to discuss major transactions.

- **Prepare Minutes for the record book.** For all meetings, a set of minutes should be added to the record book detailing what was discussed and what was voted. In lieu of a meeting, an "Action on Consent" or similar record can be signed by all management persons and added to the record book. This document is very similar to the minutes, but states that in lieu of a formal meeting, the signing parties consent to the actions detailed. Any major transaction, such as mortgaging property, making loans, and buying or selling assets, should be the subject of at least an Action on Consent, if not an actual meeting. This demonstrates that the management is working for the business and not making decisions completely in isolation of the other owners. Even if a manager has the absolute authority to make decisions, it is not uncommon to seek consent in significant business transactions. In fact, with large sales and mortgages, third parties require additional assurances that everyone is on board with the manager even if the entity's operating agreement bestows the absolute authority on the manager to close the deal.

- **Keep a journal of business decisions.** For example, if the entity holds real estate and a new roof is going on, write in the record book the information about the decision, such as who provided estimates for the work, who was chosen to do work and why, how much was estimated and how much was spent, etc. This does not have to be formal, just notes which the client would otherwise take on scrap paper and throw away. These notes will not only help build the integrity of the entity in the event of a challenge, they will help to build the minutes when it comes time to prepare them and document what has been done during the year.

- **Maintain ownership certificates.** Prepare and maintain accurate ownership certificates. Doing so will greatly facilitate further estate planning (such as annual gifting or private annuity plans when the senior members are ready to sell out). It will also facilitate business transactions and the administration of an interest holder's estate, particularly with documenting the ownership interest for the third party (i.e. the bank that is loaning funds to the entity or the IRS on an estate tax return). Often a family will come in for estate planning and not know who the actual owners are of their going business, or worse, think they know and find out they are wrong. Consider the following scenario:

    - A family comes in to do estate planning. Dad, Mom, Daughter and Son all work closely in the successful family business, which operates as a corporation. Dad and Mom are the sole shareholders, or so they think. After an extended discussion of business succession planning through a recapitalization of the stock and gifts of non-voting interests to the children, it is discovered – deep down in the "corporate records" (a stained and rotted manila file folder containing "everything we've got") – that not only had gifts been made to the children several years prior, but also that Mom is not even a shareholder. Disregarding the unwelcome surprise to Mom, this has serious effects on the recommend plan. For example, (1) in whose name is the recapitalized stock issued? (2) who makes gifts to the children (what is the result if Mom made significant gifts of stock she did not own)? (3) what was the opportunity cost of disregarding gifts to the children many years prior when the business was worth much less? (4) what is the result if Mom dies first and there is an attempt to fund her credit shelter

trust with stock she does not own (or worse, Mom does not own sufficient assets to fund the credit shelter trust at all)? A well-maintained record of ownership addresses these problems and facilitates future planning with the entity.

- ❑ **Don't commingle business and personal assets!** As far as importance, this should have been first on the list. This is where the IRS is watching. Instruct clients and follow-up as often as necessary to ensure they understand. This is probably one of the most difficult concepts for a client to put into practice. On the other hand, it is one of the easiest concepts for the IRS to sell to a court under §2036. The client cannot use the money in the entity's accounts for the cable bill or island vacation – if the client needs money for personal expenses, formal distributions based on the ownership percentages must be made.

    - o **Establish separate bank and investment accounts for the entity**. Make sure that the client opens at least a checking account for the entity into which <u>all</u> income on entity assets is deposited and from which <u>all</u> entity expenses are paid. If not all of the net income will be distributed to the owners, then open an investment account – do not distribute it all to an investment account held by the client. Maintaining separate accounts is absolutely crucial, and with some clients, we will go so far as to request copies of the bank account statements to ensure it is done properly. Without at least one separate account, it is inevitable that commingling will occur.

    - o **Deposit entity income *only* into the entity's account <u>and</u> deposit *only* entity income or proceeds into the entity's account.** If the client has other income producing property that is not held in the entity, the income cannot be commingled with the entity's assets. If the client deposits

income from another source into the entity's account, at best it will be deemed an additional contribution to the entity with all the resulting tax effects. At worst, if coinciding with the use of the account for personal expenses, it will be used to build a §2036 argument.

- **Pay entity expenses *only* from the entity's account and pay *only* entity's expenses from the entity account.** The client's cable bill should not be paid from the entity account, but also, the client should pay entity expenses from his personal account. The client cannot move money from personal accounts into the entity account; if money is short in the entity, the client should seek advice on how to handle this situation properly to avoid making unintended additional contributions. This can be handled by making loans or properly structured contributions. *Remember, also, that advisors should bill the entity, and not the client's personal account, for services rendered to the entity including legal fees related to formation and ongoing maintenance, accounting fees for entity income tax returns, investment advisor fees for investment accounts transferred to the entity, etc.*

- **Use the separate tax identification number.** Part of the formation process is obtaining a tax identification number for the entity (assuming the entity has two or more members). This is the number supplied to the bank or other institution when opening an account. For individual accounts, the tax identification number is the client's social security number, so it is an easy mistake for clients to make to provide the wrong number, especially when the estate planning attorney has just finished advising them to use their social security number for bank accounts being transferred into the estate planning trust.

- **Keep annual bank statements in the record book.** This is yet another reminder that a separate entity exists and that the funds must be kept separated.

- **Get some letterhead for the entity.** Letterhead is simple, cheap (can be created on a personal computer), and can even be a fun way for clients to show a little style.

- **Use the letterhead for all business correspondence.** This includes letters to tenants, clients, business advisors, insurance companies, banks, etc. Using letterhead for all business communications provides numerous benefits:

    - **Reminds the sender that this is business and not personal.** Getting into the habit of using letterhead will be a constant reminder that there is an entity to respect.

    - **Identifies the sender as a representative of the business even if the signature line fails to do so.** Make sure that the letterhead properly identifies who the signatory is and in what capacity he or she is signing, i.e., John Smith, Managing Member, The Smith LLC. Print this on the letterhead so that when Mr. Smith just signs his name at the bottom, he is not creating any ambiguity as to who is signing. Its not Mr. Smith, it's the Managing Member on behalf of The Smith LLC.

    - **Informs the recipient that they are dealing with an entity and reminds the recipient who the payee should be.** Remember, they now pay the entity, which denotes a change for everyone

involved (checks used to be written out to Mr. Smith, now they must be written out to The Smith LLC). This will also strengthen the defense for your client should a plaintiff attempt to pierce the entity and sue for personal assets. For example, if a tenant slips and falls, the tenant will have a tough time claiming that Mr. Smith held himself out as the owner when she wrote the monthly rent checks to The Smith LLC!

- ❑ **Comply with all income tax filing requirements.** This seems obvious, but not doing so makes the entity an easy target. Remember, if the basic paperwork is not in order, the IRS does not have to look further to demonstrate their point. The attorney should make particular note if there is no accountant involved, as there is likely to be a problem without that extra advisor helping to keep things in order.

- ❑ **Communicate with the accountant.** If an accountant will be preparing the income tax returns for the entity (which is highly recommended), make sure the accountant knows about the entity well in advance of the filing deadline. Also, keep the accountant timely informed of changes in ownership interests due to gifting programs. It is strongly advised that the accountant be involved in the planning stages, not only to form the entity, but also throughout the gifting program. The accountant, particularly one that has worked closely with a family for many years, can help determine the client's ability to cope with the formalities, i.e. can this client actually transfer 20% to a child and still have enough income to meet personal needs? Or more importantly, will this client respect the child's 20% interest when the time comes to make distributions? These questions are not always best answered by the client. Furthermore, since they are reviewing many of the client's financial statements at least annually, an accountant can also note any problematic expenditures that may result in a §2036 problem if not addressed. *Tip: It is important to communicate with the accountant*

as to the timing of gifts, since changes in ownership interests can have a significant effect on their workload. For example, accountants generally prefer that changes in ownership interests occur on the first or last day of the tax year (or at least on the first or last day of a quarter) so that the allocations of entity income and deductions are more manageable.

- ☐ **Communicate with all owners.** Treat them as business associates, not "just the kids". Use the letterhead to give them periodic updates about the business, particularly when anything significant occurs. These can be quick and easy letters, nothing formal. Just enough so that everyone is generally on-board with their investment. And, of course, keep copies of the letters in the record book.

- ☐ **Make appropriate distributions.** Most operating agreements provide virtually unfettered discretion in the management to make distributions or to hold net income in reserves; however, it is important to make informed and documented decisions to make or not make distributions based on the business operations.

    - o **Do not make disproportionate distributions.** [42] Distributions should not be made to only one owner, they must be matched with proportionate distributions to all interest holders.

    - o **Make distributions.** Although not absolutely necessary, it can only help to actually make distributions to demonstrate *everyone's* participation and benefit in the entity.[43]

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[42] Under IRC §704 (and its corresponding Treasury Regulations), a special (disproportionate) allocation is permissible if the special allocation has "substantial economic effect" as defined in Tres. Regs. §§1.704-1(b)(2). Special allocations are strongly discouraged since they are subject to heightened scrutiny even outside of the estate tax arena.

[43] In *Hackl v. Commissioner*, 118 T.C. 279 (March 27, 2002), the taxpayers had made a significant number of tax-free annual exclusion gifts (41 in 1996 alone) pursuant to IRC §2053(b) of interests in an LLC holding primarily timberland that would not produce income for several years. The IRS successfully demonstrated that the gifts did not qualify under §2053(b) for the annual exclusion because there was no

- **Actually distribute.** Distributions should be made, and to all owners at the same time, and not just noted on the books. Courts are looking closely at the distributions and have even commented on *proportional* distributions (which are technically appropriate) that were not properly made. In the *Estate of Strangi II* the court rejected evidence that proportionate distributions were made where the distributions were "on the books" and made up at a later date (after the client's death).[44] The lesson is to do it right the first time and actually distribute funds because it cannot be fixed after the fact with future distributions or adjustments to the books.

- **Base distributions on the needs of the business.** Distributions should not be made based on the owners' personal needs, meaning if the senior member needs a distribution of $40,000 to purchase a new car, do not make a distribution of $40,000 and follow it with corresponding proportional distributions to the other owners. This could be used as evidence of an implied agreement that the senior member will have access to the assets for personal needs and that the other distributions were simply to disguise the client's use of the entity's funds. Instead, base the distributions on the business and make sure the senior member retains ample personal assets outside of the entity to meet these needs. Another potential pitfall is making distributions to other owners (i.e. the children)

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present interest transferred, and thus were not tax-free gifts. The basis of this argument was that there were no distributions made on the interests and that based on the financial prospectus of the timberland business operated by the LLC, there were no distributions planned or possible for several years. Restrictions on transferring the interests in the operating agreement also played a role in the outcome of this case. Although this decision was based on very specific facts that are unlikely to repeat often (there is usually at least the potential to make distributions, an argument which may have affected this decision), it is best to avoid this argument all together by demonstrating that there is a present interest given to the donees by making income distributions. There are also ways of structuring the operating agreement that will purportedly avoid this problem; however, this issue is beyond the scope of this article.

[44] See *Strangi II* in *supra* note 18.

just before they have to pay an income tax on their allocable share of the entity's income. The IRS can strengthen its argument by showing that distributions were made in March or early April each year and were just enough to pay the income tax obligation incurred by the child due to the ownership interest.

- **Document reasons for or against distributions.** If no (or relatively small) distributions will be made in any given year, send a letter on the letterhead to the owners providing an explanation of why the net income is being retained, or why only a small distribution is being made. For example, note large anticipated expenses or expansion considerations. A copy of the letter should be added to the record book demonstrating that this was a business decision.

E. Conclusion

Respect the entity is a phrase with which estate planning attorneys, and hopefully their clients, are very familiar. We throw this phrase out to clients, but how do we make sure they understand it? Clients who have never participated in a formal business entity, which can include even our wealthiest client with a successful business operating as a sole proprietorship, may be overwhelmed by the whole process. If the entity is going to succeed to achieve its transfer tax goals, it is imperative that the client not only understand how to respect it as a business and a separate entity, but also that the client puts this understanding into practice habitually.

If a client fails to keep up the formalities and the estate is audited, and worse is assessed a significant deficiency, it's the advisors who look bad and get blamed, not poor old – and dead – Mr. and Mrs. Smith. "I told them not to do it that way" does not go far to save your professional reputation in the eyes of the client's heirs, the other advisors,

the IRS, and your peers when the entity you recommended and helped form (for a nice fee nonetheless) fails to meet its purpose. With perhaps a touch of paranoia, also consider the ripple effect that if the IRS realizes your entities are easy to challenge, they may actually keep an eye on you in the future in hopes of making a fast buck off other estates you helped to plan.

The moral of this story is to go above and beyond the call of duty. Take it upon yourself to follow-up with your clients. Keep in touch. Ask to review how the bank accounts are structured and question where income is deposited and how expenses are paid. Check up on distributions – were they made, to who, and how much? When was the last time the record book was updated? Do spot checks to see if the annual reports are filed. This is easy enough now that most filings are available on-line.[45] Call your client and say, "hey, I noticed that your annual report has not been filed. Can I help you with that this year? And, while I'm at it, lets get those corporate records up to date." Remind them that your fee is money well spent, like a life insurance premium, it will pay off when the entity withstands challenges, not only from plaintiffs in lawsuits, but also from the ultimate creditor, the IRS. Don't forget, maintaining records for clients is a great way to earn some additional fees as well.

Some clients, understandably, are looking for the light at the end of the tunnel where the fees stop. But most will appreciate and take advantage of the follow-up to ensure all is in order. Those that do not appreciate the follow-up should get a statement, *in writing*, clearly informing them that you will not continue to follow-up with them. Enclose another checklist to remind them one last time what needs to be done. Make it clear that there is on-going work to be done and make it abundantly clear what the consequences of failure will be. Just remember that most clients understand what's at stake and truly appreciate that you are checking up on them.

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[45] The website address for the Secretary of the Commonwealth of Massachusetts, Corporations Division, is: www.state.ma.us/sec/cor.htm. Some records can also be accessed through legal search engines, such as LexisNexis and Westlaw.

Finally, there are those clients who you know, from day one, are just not up to the challenge. There are different ways to handle this. One is to follow-up and repeat the requirements more often with them. This will not only give the entity a fighting chance, but will also protect you from blame later if there is a problem. Another option, which is admittedly difficult to do, is to forego the entity planning. If a client cannot handle the plan despite all the benefits, consider the possibility that it may be better *not* to continue with that aspect of the overall estate plan. The fees you forego are minimal in comparison to the problems you forego, especially since you know that this client will not provide repeat business with annual gifting and upkeep of record books. Think ahead to the day you face the surviving family members and the IRS at the same time, to defend the failing entity. Not only will it fail to serve its purpose, but it will be very costly to attempt to defend it. This will be especially painful where the writing was on the wall from the first time the client set foot in the office! Despite the great benefits, these entities are not for everyone.