USES OF FAMILY LIMITED LIABILITY ENTITIES IN
ESTATE, FINANCIAL, TAX
AND ASSET PROTECTION PLANNING,
INCLUDING RECENT DEVELOPMENTS
AND OTHER ASSET PROTECTION VEHICLES

I. What is A Family Limited Partnership?

A Family Limited Partnership (hereafter generically referred to by abbreviation as an AFLP®) may actually be and more likely will be -

a Limited Liability Company (LLC)

a Limited Liability Limited Partnership (LLLP)

Limited liability entities are used in modern practice because no party, not the General Partner of an LLLP nor the Managing Member of an LLC, has general unlimited liability for the obligations of the entity, as the General Partner in a traditional Limited Partnership has.

In any event, it is created by a filing under state law of a simple one or two page form with a filing fee of probably $100 - $200, and the issuance by the state of a Certificate of Limited Partnership or Certificate of LLC. Generally the form needs only to disclose

the name of the entity, followed by identification of the type of entity, e.g., AFLLP®, and the name may be generic, e.g., APisces, LLC® for confidentiality.

the address of its principal place of business (may be general partner=s/managing member=s home address)
the name and address of the registered agent for service of process

(frequently the lawyer establishing the LLC)

This filing is a matter of public record, i.e., anyone may obtain a copy.

The relationship among the partners, called members in an LLC, and the duties and responsibilities and restrictions agreed, and the governance arrangements, are set out in a partnership agreement (or operating agreement for an LLC), which may be agreed anytime after the entity is organized under state law. This agreement is not filed with the state, is not a matter of public record, and may be amended from time to time.

The partnership agreement or operating agreement will name a Managing Partner (Managing Member in an LLC), and provide a mechanism for his selection, removal, resignation and succession, and will provide a protocol for amendment of the agreement and voting requirements. Other typical features of the agreement are restrictions on assignment of interests (voluntary or involuntary), buy-sell and/or rights of first refusal at death or incapacity, anti-dilution restrictions, and cash call obligations.

II. Why Is A Family Limited Partnership the Holy Grail of Estate, Tax and Financial Planning?

1. Using an FLP, clients can give away assets for income and estate tax purposes but keep control over the assets. The parent or other donor may be general partner or may create an entity to be General Partner over which the donor has direct or indirect control.

   This contrasts with the normal tax rule, whereby the price of getting income off of your income tax return and an asset out of your taxable estate requires abandonment
of control. Our clients almost always want to keep control over their assets, and loss of
control frequently discourages them from giving assets away where that would
otherwise make good estate planning, tax planning, financial planning sense. In this
sense -- that they may give away assets for tax purposes but keep control -- our clients
may have their cake and eat it too using an FLP.

2. Using an FLP, clients can leverage lifetime gifts using the annual gift tax
exclusion ($12,000) on gift tax applicable credit amount ($1 million) by taking discounts
on partnership interests given, where they could not take discounts giving the assets
held by the partnership. Discounts of up to 30% may be available on gifts of minority
interests, up to 20% on majority interests.

3. Using an FLP, clients can leverage testamentary gifts at death using the
estate tax applicable credit amount ($2 million in 2008, and scheduled to go to $3.5
million in 2009) by taking discounts on the partnership interests remaining in their
names at death. Even majority partnership interests held by the managing partner may
be discounted, e.g., maybe by 20%. If the donor, through lifetime gifts gets to a minority
position, greater discounts may be taken, again maybe up to 30%. If, during his life, the
donor gives up control, greater discounts may be taken.

So a donor gets discounts on both partnership interests gifted during life and on
partnership interests retained and passing at death. The IRS invented the minority
discounts in this area when it issued Revenue Ruling 93-12, which held that minority
discounts could be appropriate even for interests in a family controlled entity.

4. Assets held in an FLP are generally protected from creditors. Under the
Uniform Partnership Act and the Uniform Limited Partnership Act and under the LLC
and LLLP statutes of states with those entities, creditors with a judgment against a partner in a partnership or member of an LLC have NO RIGHT to:

- become substituted partner
- compel the general partner to make distributions
- compel the general partner to liquidate and distribute the partnership assets.

The only remedy of such a creditor is to get a charging order instructing the General Partner, if the General Partner makes a distribution to the interest subject to the order, to pay it instead to the judgment creditor. This principle of Virginia law was reaffirmed in a 1994 Fairfax County case, *First Union Bank v. Allen Lorey Family Ltd.*, VLW 094-8-328, which held that a creditor with a charging order does not have standing to ask a court to dissolve the partnership. (But see *Crocker National Bank v. Jon R. Perreton*, 208 Cal. App. 3d. 1, 255 Cal. Rpts. 794 (1989), which held that a creditor was not limited to a charging order and was able to attack and sell the debtor's limited partnership interest.) If the debtor has the ability to see to it that no distributions will be made from the partnership, and the creditor knows it, the partnership interest will be an unappealing target for the creditor. Interestingly, the California cases flowing from *Crocker* were expressly cited in the recent Fairfax County *First Union Bank* case, and the court declined to follow those California precedents. Virginia law is unlikely to support this change in law in the foreseeable future.

But in a family context, why would a general partner choose to make a discretionary distribution to a family member subject to a charging order? He would not.

In fact, it is even worse for the creditor: the IRS has ruled that a creditor with a
charging order gets the K-1, and must report and pay income tax on the income not distributed to him. (Rev. Rul. 77-137) So, to a creditor, a partnership is an ugly asset.

5. A partnership is a great vehicle for joint investments among friends, siblings, older parents and adult children, grandparents or parents and trusts for younger children. It is a great way for parents to teach children in their 20s and 30s how to invest, and to encourage active participation in the research, analysis and investment process.

III. Creation and Transfer of Interests in Family Partnership, Particularly for Purposes of Gifting Assets Expected to Explode in Value.

Low value publicly traded or pre-IPO tech stock and pre-development real estate may present excellent opportunities for favorable tax valuations on gifts to children or trusts for children. If minority limited partnership or LLC member interests are given in a family partnership of which the donor/parent is the general partner, discounts below the already low fair market values should be available for minority and lack of marketability and possibly other causes, so that considerable property may be transferred with minimum gift tax consequences. Harwood v. Commissioner, 82 T.C. 23 (1984).

However, consideration must be given to the intricacies of the Family Partnership rules of I.R.C. ' 704(e) and the 1990 Estate Freeze rules of I.R.C. ' ' 2601-2604. Use of a family partnership could permit the creator to retain control over the property by serving as General Partner, but retention of control could cause more exposure of the donor=s interest to the donor's creditors.


1. Generally a family limited partnership may be formed, assets contributed to an FLP in exchange for partnership interests, without negative tax
consequences. Code Section 721.

2. An LLC may elect to be treated for tax purposes as a partnership by checking the box on the tax return.

3. A Partnership is a better mechanism than a trust for managing a family investment enterprise. If the parent as general partners wants to manage the partnership by reinvesting significant amounts of the partnership earnings in new investments, there will be low cashflow distributions to the partners. This retained indirect power to affect the distributable cash income of the partners is not a power that will make any transferred partnership interest subject to the parent=s estate taxes. See United States v. Byrum, 408 U.S. 125 (1972); TAM 9131006. This result is more difficult to achieve by transferring assets to a trust in which the trustee is the client. If the client has the power as trustee to determine the distributable income the trust beneficiary will receive, the transferred trust assets could be subject to the client=s estate taxes.

V. New Tax Issues for FLPs. Recently the IRS has stepped up and broadened its attacks on discounted transfers to and through FLPs and some court rulings favorable to the IRS have caused new concern.

(a) Hackl v. Commissioner, 2003-2USTC 60, 465, casts a cloud over the availability of this gift tax annual exclusion for gifts of limited partnership interests, on the theory that the donee does not receive a present interest. The Seventh Circuit upheld the Tax Court=s view. If the availability of the annual exclusion to an FLP strategy is
strategy is essential, the case should be reviewed carefully, and the partnership agreement should be drafted to give the limited partners sufficient rights that they will be seen to have present interests. But the expansion of the applicable credit amount to $2 million in 2008, and $3.5 million in 2009, may permit FLP transactions to be structured without reliance on the annual exclusion.

(b) Strangi v. Commissioner, T.C. Memo 2003-145 is the latest case in a series of IRS attacks on FLPs based on '2036, in which the IRS has argued and courts have agreed that minority discounts were not available because of substantial retained interests by the donors. Careful reading of these cases and careful drafting of partnership agreements, this author believes, will permit taxpayers to avoid this pitfall.

I do not think this case in any way kills family limited partnerships, but it does suggest certain ways of drafting family limited partnerships that will minimize the risks raised by this case.

One of the key issues is control. There is no question if the person=s whose assets are going into the family limited partnership (FLP) is willing to give up control of the family limited partnership and permit someone else to serve as managing partner (or in the case of a limited liability company (LLC), as managing member), the risks of inclusion of FLP or LLC assets in his or her estate are substantially diminished. In certain cases this will work fine and the transferring party will be willing to permit someone else to serve as manager, perhaps an entity, such as another LLC, in which he or she may or may not have a controlling interest. In cases where it is not realistic or acceptable to the person transferring assets to the partnership or LLC to give up control,
if the suggestions below are followed the author believes that the party can be the managing partner or managing member, and if circumstances change in the future in any way which suggest it is undesirable for that person to be the manager, whether because of further tax cases make it clear that such control causes a problem or because that party becomes subject to creditor claims, at that time the manager may resign and the operating agreement or partnership agreement should contain language permitting the succession to management by someone other than the transferring party, someone or an entity which is not related or subordinate to the transferring party.

For whatever it is worth, the Fellows of the American College of Trusts and Estate Counsel (an elite group of trusts and estates lawyers and tax lawyers from around the country), and particularly the Estate and Gift Tax Committee of that organization, at a recent meeting, took the view that while the taxpayer should have lost the Strangi case, the taxpayer should not have lost the case based on Section 2036. These lawyers believed the Judge was faulty in her application of Section 2036.

The Fifth Circuit affirmed and remanded to the Tax Court, which then held that the partnership assets were includible in the decedent’s gross estate because he had retained the beneficial enjoyment of the partnership assets under IRC Sec. 2036(a)(1). Once again the case was appealed and the Fifth Circuit again affirmed, but it did not reach the issues of whether in serving as general partner the taxpayer had thereby retained a power to control the beneficial enjoyment of the partnership assets.

Certainly the facts in Strangi were particularly obnoxious to the IRS and the Courts, and it is a truism that bad facts make bad law.

The Strangi case is relevant particularly to cases where the assets of the family
limited partnership or limited liability company are going to be entirely or mostly
marketable securities and other passive investments, and the issues raised by the case
would not be so likely to apply if the assets were instead closely-held business interests
or real estate, which in many cases are the assets typically used to fund such an entity.

More recent FLP/FLLC tax cases include Estate of Bigelow, 503 F. 3rd 955 (9th
Cir. September 2007), Estate of Rector, T.C. Memo 2007-367 (December 13, 2007) and

In Bigelow, Virginia, an 85 year old in poor health in a nursing home created an
FLP between her revocable trust and her children, putting in real estate but holding the
partnership harmless on debt secured on the real estate. Virginia did not retain
sufficient income to meet her expenses or enough assets to cover her debts. The Court
included the real estate in the partnership in her estate under IRC Sec. 2036(a)(ii)
because she retained a life estate. The Court found an implied agreement for her to
retain the beneficial enjoyment of all partnership assets.

In Rector the Court again included in the decedent=s estate under IRC Sec.
2036(a)(i) all assets conveyed to an FLP, again on an implied agreement that she
could have and use all partnership income and assets for life.

In Erickson the FLP transfer was made for an Alzheimers patient in assisted
living by her daughter as attorney-in-fact under a power of attorney. The Court found
retained beneficial enjoyment over partnership assets and stressed that there was no
independent non-tax reason for the arrangement.

Further suggestions to avoid the transfer tax implications of the Strangi Decision
would include the following:

1. Refraining from making non-pro rata distributions to the owners, particularly non-prorated distributions favoring the person who funded the entity. Distributions should be made pro rata to partners or members, and made directly to them, not to creditors or taxing authorities.

2. The entity’s funds and expenses should not be commingled or confused with personal funds or expenses of the person funding the entity.

3. Accurate books should be kept for the entity reflecting that the operating agreement or partnership agreement was followed carefully in the formation and operation of the entity.

4. Whoever is the managing partner or managing member of the entity should actively manage the assets.

5. The entity should comply with all the formalities imposed by state law scrupulously.

6. Meticulously retitling the assets purported to be transferred to the entity into the name of the new entity.

7. If an older or very sick person is transferring assets to the entity, it should not be such a great proportion of such person’s assets that they cannot provide for their own reasonable support without distributions from the entity.

8. The partnership agreement or operating agreement should confirm that the manager is subject to normal fiduciary obligations and agrees to abide
by the normal fiduciary obligations imposed upon him or her. It has been
suggested that the manager should only be liable for decisions that are
outside of the Business Judgment Rule. It has been suggested that the
partners or members be entitled to seek arbitration of disputed
management decisions, but that the losing party in the arbitration would
have to bear all costs of all parties associated with the arbitration action.

9. Do not transfer all or most of the individual’s assets into the partnership.

10. In general, do not transfer personal use assets into the partnership, such
as homes and furniture and automobiles.

11. Limited partners should pay for their own partnership interests with their
own assets, but if that is not possible, make gifts in advance and let them
age. Do not have limited partners hold minuscule percentage interests:
instead, have them hold more substantial interests.

12. Do not create the partnership or LLC on behalf of the transferor using a
power of attorney. The principal himself should create the entity and effect
the transfer.

13. Ideally all partners should have separate legal representation.

14. Someone transferring assets to a family limited partnership or LLC should
retain a substantial portion of his or her assets outside the entity.

15. ADeathbed® transfers will be more likely to be scrutinized.

16. Howard Zaritsky has drafted an Audit proof® partnership agreement form.
17. If the motivation for the FLP is not aggressive tax discounts, but asset protection, or a clean pooling of investments -- and not infrequently FLPs are created for these purposes, not tax planning -- Strangi is irrelevant.

VI. **Non-Tax Aspects of Family Limited Partnerships.**

1. The use of a family limited partnership has the following advantages:
   - The consolidation of family investments into one "pocketbook" to use one investment manager, to meet minimum account size requirements.
   - Simplifies annual giving, particularly of assets which are not easily susceptible of division into $12,000/$24,000 units. Partnership units may be given.
   - To keep assets within the family by use of buy-sell provisions, restrictions on alienation, including assignments to creditors.
   - Unlike an irrevocable trust, a family partnership may be amended, so it is a more flexible vehicle.
   - Business judgment rule, rather than the stricter prudent man rule which governs trustees, applies to managing general partners.
   - Arbitration can be required to resolve internal disputes, whereas beneficiaries may not be required to arbitrate disputes with trustees.

2. To most effectively preserve the partnership's assets from the creator's creditors, because the law is not completely settled in the area, a trusted family member who is not the creator or the creator's spouse should serve
as general partner. The creator may be a limited partner.

3. Limited partnership interests may be sold to children or trusts for children, using the same discounted valuations.

4. Where the limited partnership contains only liquid investment assets -- marketable securities -- it is important to be able to demonstrate credible non-creditor avoidance business purpose to feel secure behind the "charging-order-only" shield, a credible non-tax business purpose to be able to claim a valuation discount. (Probably a more modest valuation discount will be available for partnerships holding only marketable securities than for a partnership holding inherently illiquid assets, such as real estate or closely-held business interests.)

VII. The Threat Posed by Bajaj Valuations.

Professor Mukesh Bajaj has recently received tremendous attention because he alleges that the data base of restricted stock studies many in the discount appraisal industry have been using does not support the level of minority and marketability discounts appraisers have been opining to in FLPs.

He has been criticized for

S suggesting discounts of 5-15% might be appropriate for FLP interests, rather than 25%-45%, which many appraisers have been using.


S using a data base covering unusual or skewed economic circumstances.

Critics have attacked the macroeconomic periods covered by his study as not representative of any recent periods.
Shannon Pratt, founder of Willamette, recently authored an article detailing criticisms of Bajaj in *Business Valuation Updates* in February. Bajaj responded in the March issue.

In the McCord case, 120 T.C. No. 13 (May 14, 2003), the Tax Court rejected the Bajaj Method, but the Court endorsed his restricted stock study. Bajaj suggested 16% discount, Court granted 32%.

He has been praised for doing what the Tax Court wants an expert witness to do, tailor his analysis and conclusion to the precise facts and circumstances of the particular business or investment entity and the details of the transaction before the Court. The Tax Court does not like generic views of discounts from expert appraisers. It wants to know why the specific circumstances of the case in front of it justify the particular discount in this case.

For whatever it is worth, in conferences on FLPs for estate planners the Bajaj method is never mentioned. His method is of interest to appraisers not tax and estate lawyers.

See also Clarissa Lupo v. Commissioner, T.C. Memo 2003-258 (September 3, 2003), in which Dr. Bajaj’s study was cited by the IRS= appraiser but the Court approved a discount of 19.5% rather than the 29% sought by the taxpayer or the 7% discount sought by the IRS based on the Bajaj study.

VIII. Discount Vehicle for S Corporation Stock.

In a remarkable recent ruling the IRS showed how S Corporation stock, which
normally may not be held in a partnership without forfeiture of S Corporation status, in fact may be held in a limited partnership. This provided a very creative solution to the otherwise challenging question of how to protect S Corporation stock from claims of creditors.

IX. **Our Recent Experience.**

$ An audit of a Gift Tax Return on which a discount on a transfer of partnership interests in a partnership containing a 250 year old homestead in McLean of 55% was claimed. (Appraisal by Barry Goodman several years ago.)

The IRS settled for a discount of 43%, but increased the value of the gift to a level that a small taxable gift occurred and a small gift tax (about $10,000) was due.

The IRS appeared to have made up its mind on what it was going to do - cause a small taxable gift and a small tax, to make a point -- before the meeting started. The level of discount allowed, while surprisingly high, appeared not to matter to the IRS, which seemed to be prepared to permit whatever discount generated the tax result it wanted.

The respectable purpose of the partnership -- to preserve in a family a piece of property its ancestors had owned for 250 years, probably helped.

$ We recently claimed in a $400 million estate a 20% discount (opined to by MPI) on a majority partnership interest held by the testator who was Managing Partner. Until shortly before his death, the Partnership had 200 limited partners and had 25 pieces of commercial real estate. This discount was approved without objection on audit.

$ We claimed a 43% discount on limited partnership gifts on an FLP holding a
concentrated position in one publicly traded stock on the gift tax return. Deloitte and Touche opined to the valuation of the gift several years ago. The donor died a few years later. We settled the case about 2 years ago at a 31% discount. In the course of that audit the auditor told us that there is a vertical mandated agreement within the IRS, from Audit to Appellate to the Office of Chief Counsel, not to agree to discount minority interests above 29% - 31%. If a taxpayer insists on claiming more, he will have to litigate.

X. Other Recent Cases Favoring the Taxpayer.

In September of 2003 in T.C. Memo 2003-289 Peracchio v. Commissioner, the U.S. Tax Court agreed to a 31% discount for gifts of limited partnership interests to a family trust where the partnership held publicly traded securities. Howard Zaritsky noted how rare it was to find a decision on a partnership holding only marketable securities, and thought the decision extraordinarily generous. See also Estate of Daily v. Commissioner, T.C. Memo 2001-263, where the Court allowed a 40% discount to a similar partnership gift because the IRS appraiser did such a poor job, i.e., failed to read the partnership agreement.

In Estate of Stone v. Commissioner, T.C. Memo 2003-309 (November 7, 2003) the Tax Court found facts and circumstances which were not found in Strangi and therefore refused to include in decedent=s estate under Code Section 2036(a) assets transferred to a family partnership during life.

On May 20, 2004, the Fifth Circuit issued its long awaited opinion in the case of Kimbell v. USA, reversing the Tax Court=s holding for the IRS. In this victory for the
taxpayer the Court confirmed that (1) family members may enter into a bona fide transaction, and (2) a transfer of assets in return for a pro rata partnership interest can be a transfer for full and adequate consideration. The Court cited with approval that (a) the decedent retained sufficient assets outside of the partnership for her support; (b) there was no commingling of partnership and personal assets of the decedent; (c) partnership formalities were satisfied, and assets contributed to the partnership were actually assigned to it; (d) the assets contributed to the partnership required active management; (e) there were non-tax business reasons for the establishment of the partnership. A 49% discount was claimed. The Fifth Circuit did not deal with the discount: it remanded the case to the Tax Court for reconsideration.

XI. Variety of Attacks by IRS Against Discounted Partnership Gifts.


Remedy: Consider

$ Permitting donees to freely sell membership interests.

$ Give donees Crummey withdrawal powers with respect to gifts of their interest.

$ Best: give each donee the temporary right to put® interests to the partnership for FMV, taking into account applicable discount.
2. Gift of limited partnership or LLC interest does not remove assets from donor=s estate where he retains the beneficial enjoyment of the assets give away. Estate of Strangi v. Commissioner (above). See also Estate of Abraham v. Commissioner, T.C. Memo 2004-39 (February 18, 2004) and Estate of Hillgren v. Commissioner, T.C. Memo 2004-46 (March 3, 2004 by the same Judge Cohen who authored Strangi). Estate of Thompson v. Commissioner, T.C. Memo 2002-246 (September 2002), where the Tax Court ignored gifts of partnership interests and included the partnership=s property in the decedent=s estate because of implied agreements among the parties leaving the donor with control over the partnership assets. Code Section 2036(a)(1) and 2036(a)(2). In all 2036 cases -- Strangi, Abraham and Hillgren -- the donors were very old and infirm. But see Estate of Stone v. Commissioner, cited above, where Section 2036(a)(1) held not to apply.

See above for suggestions to avoid Strangi.

XII. What Does the Future Hold?

$ All estate and gift tax returns showing discounts on partnerships or other closely-held business and investment interests with potential for tax due will be audited.

$ Lower discounts will be allowable in the future than in the past. The greater the discount claimed and the greater the taxpayer=s determination to sustain it, the more fight may be expected from the IRS.

$ The June-July 2008 edition APrivate Wealth, described the 15 years of struggle
between the IRS and taxpayers over FLP discounts as a kind of Texas Steel Cage Death Match.

XIII. Other Asset Protection Techniques to Consider

1. Tenancy By the Entirety
2. Outright Gift
3. Gifts to Irrevocable Trusts (Revolvable Trust Do NOT Work)
   - General Accumulation Trusts fbo Family Members
   - Domestic or Foreign Asset Protection Trusts fbo Settlor and Family Members (see below)
   - Gifts to Irrevocable Life Insurance Trusts
4. Gifts to Charity, including Charitable Remainder Trusts, Private Foundations, and Advised Funds at Community Foundations
5. Sale of Asset to Family Member
   - Installment Sales
   - Private Annuities
   - Self-Canceling Installment Sales
6. GRITs, GRATs, GRUTs, QPRTs
7. Qualified Retirement Plans
8. IRAs
9. Non-Qualified Retirement Plans
10. Business Interests
11. What Interests You Can Retain?
12. Protecting Inheritance

13. A Uglifying@ Assets

14. Marital Agreements as a Shield Against Other Creditors

15. Planning for Spousal Claims

16. Planning for Claims of Creditors of Beneficiaries

17. Umbrella Liability Insurance

18. IRS as Creditor

XIV. Domestic Asset Protection Trusts


2. Vulnerabilities

X Latest Bankruptcy Act: BAPCPA 2006: 10-year Clawback

X Public Policy -- fading in strength

X sham/alter ego

X Fraudulent Conveyance

X Constitutional Challenges

1. Full Faith and Creel

2. Supremacy Clause

3. Contract Clause

XV. Offshore Asset Protection Trusts

About 20 jurisdictions, mostly English-speaking islands, including Bahamas, Bermuda, Cayman Islands, Gibraltar, Channel Islands (Jersey and Guernsey), Isle of
Man, Liechtenstein (note recent problems with disclosure) Cook Islands, Nevis, etc.

S Permit Self-Settled Spendthrift Trust fbo inter alia Settlor
S Less Stringent Fraudulent Conveyance Statutes
S Less Inclined to Enforce Foreign Judgments

XVI. **What is Fraudulent Conveyance?**

Transfer with intent to
S hinder
S delay
S or defraud an existing or contemplated future creditor

OR

Transfer which renders debtor insolvent.

XVII. **Who Needs/Wants Asset Protection Planning?**

XVIII. **Who Can You NOT Help?**