Law Offices of Robert A. Briskin, a Professional Corporation
1901 Avenue of the Stars, Suite 1700, Los Angeles, California 90067

Certified Specialist - Taxation Law
The State Bar of California
Board of Legal Specialization

Telephone (310) 201-0507
Facsimile (310) 201-0588
Website: www.rablegal.com

FAMILY LIMITED PARTNERSHIPS - OPERATIONAL ISSUES

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FAMILY LIMITED PARTNERSHIPS - OPERATIONAL ISSUES

by

Robert A. Briskin

Family limited partnerships ("FLPs") (and family limited liability companies) can reduce the value of clients' estates for gift, estate and generation-skipping tax purposes, along with providing clients non-tax business benefits.

Because of the recent increase in the federal estate tax exclusion amount, there has been a decline in the number of filed estate tax returns, although the number of filed gift tax returns has increased. With the number of taxable estates decreasing, the IRS in July 2006 announced that it was going to layoff approximately one-half of Estate and Gift Tax Division attorneys (approximately 157 out of 345 attorneys), and in May 2007 the IRS indicated that it was merging all of its estate and gift tax personnel into IRS Branch 4. If in the year 2011 the 2001 estate and gift tax rules are returned, will the IRS increase the number of estate and gift tax attorneys and other personnel? Will Congress allow the elimination of estate taxes in 2010, followed by

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the return to the $1,000,000 estate tax exemption and higher estate and gift tax rates in 2011? With the changing political landscape, it is unclear what estate and gift tax legislation Congress may enact, if any, prior to 2010.

A common client question is: Will a Form 709 gift tax or Form 706 estate tax return be audited if FLP valuation discounts are reported on these returns? Currently, all estate and gift tax returns are reviewed in Cincinnati, Ohio. The IRS's local estate and gift tax attorneys take turns in visiting the Cincinnati office to "pull" returns for audit potential, looking at issues including the amount of tax dollars at stake, along with asset valuation issues. The IRS's personnel will tell you that valuation discounts of more than 50 percent reported on a return will cause "eyebrows to be raised" and that return is likely to be questioned.[1]

1. **WHAT TYPES OF VALUATION DISCOUNTS ARE AVAILABLE FOR A FLP INTEREST?**

Valuation discounts for minority interests and lack of marketability are well established by case law and are recognized by the Internal Revenue Service.[2] See Rev. Rul. 93-12 where the

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[1] The IRS currently has a national compliance program for FLPs. Before an IRS appeals officer may finalize a taxpayer settlement involving FLP transfer tax valuation issues, that appeals officer is required to obtain the approval of the appeals coordinator in the FLP valuation discount area, whose name is Mary Lou Edelstein.

[2] The IRS acknowledged in a redacted version of ***IRS Appeals Settlement Guidelines on Family Limited Partnerships and Family Limited Liability Corporations***, effective October 20, 2006, that there "is now a set of recognized criteria that estate planners can use in establishing family limited partnerships...." However, this Appeals Settlement Guidelines states that the IRS will scrutinize valuation of FLP interests, and in "certain circumstances" the IRS asserts that there should be minimal or no discounts for FLP interests. The IRS stated in these guidelines that the IRS may assert accuracy-related penalties under ' 6662 to deficiencies resulting

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IRS held that a valuation discount for a minority interest is allowed even where gifts are made to family members.[3]

In the last several years there have been proposed federal tax legislative changes to have attribution of ownership among family members apply for valuation purposes, and there have been other legislative proposals to repeal valuation discounts among family members. If such proposed legislation is ever enacted into law, then it effectively would remove the estate and gift transfer tax motivation as a reason to establish FLPs.

1.1 ***Lack of Marketability Valuation Discount***. The lack of marketability valuation discount is afforded FLP limited partner interests (or non-controlling membership interest in an LLC) based upon the fact that there is a limited ability to sell such interests. In other words, a partner of non-publicly traded FLP will have more difficulty than an owner of publicly traded stock in finding a willing buyer. The price of publicly traded stock already reflects a lack of control discount, but does not reflect a lack of marketability discount because such publicly held stock is already being traded on a nationally recognized stock exchange.[4] Some appraisers have based lack of marketability valuation

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from estate and gift tax audits of FLPs. Section 6662 imposes an accuracy-related penalty of 20 percent of the underpayment of tax attributable to any substantial valuation understatement, and a penalty of 40 percent if the underpayment is attributable to a gross valuation understatement.

[3] In Rev. Rul. 93-12, 1993-1 CB 202, the IRS said that a minority valuation discount will not be disallowed solely because the gifted interests to family members, when aggregated, would amount to a controlling interest.

[4] See, for example, ***Lappo***, T. C. Memo 2003-258, where the court allowed a 21 percent lack of marketability discount based upon the IRS's expert.

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discounts upon studies of restricted stock and initial public offerings.

1.2 ***Minority and Lack of Control Valuation Discount***. The minority and lack of control valuation discount is based upon the fact that the limited partner (or LLC member) is not able to control the management, distribution and investment decisions of the FLP. Some appraisers have based minority discounts upon closed-end mutual funds or real estate investment trusts.[5]

1.3 ***Discount for Tax Liabilities***. The valuation discount for tax liabilities which applies C corporations is not recognized by the IRS for pass-through entities such as partnerships or S corporations.[6]

1.4 ***Layering of Discounts***. In doing a valuation appraisal of a FLP interest, first the assets owned by the FLP must be appraised, and second the business appraiser must appraise the actual FLP partnership interest. Therefore, it is possible to have two valuation discounts affect FLP partnership interests. For example, if a fractional interest in rental real estate (such as a tenancy-in-common interest) is contributed to the FLP, that

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[5] See, for example, ***Kelley***, T. C. Memo 2005-235, where the Tax Court found a 12 percent minority discount and a 23 percent lack of marketability discount for a FLP owning passive securities and cash equivalent assets. Also, in ***Dailey***, T. C. Memo 2001-263, the Tax Court allowed a combined minority and lack of marketability discount of 40 percent for a FLP owning securities.

[6] For the IRS position that there is no reduction for income tax liabilities in valuing partnership interests, see ***Temple***, 423 F. Supp. 2d 605 (D.C. Tex. 2006). For the rule that there is no valuation reduction for taxes in valuing S corporation stock, see ***Robert Dallas***, T. C. Memo 2006-212; and ***Gross*** T. C. Memo 1999-254, *aff'd* 272 F.3d 333 (6th Cir. 2001).

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fractional real estate interest is entitled to a valuation discount, and there is a second minority and lack of marketability valuation discount applied to the FLP limited partner interests. Similarly, the FLP could own minority interests in other subsidiary limited partnerships, which subsidiary partnership interests may also be entitled to minority and lack of marketability valuation discounts.

1.5 ***Importance of Obtaining a Qualified Appraisal to Justify Valuation Discounts***. An experienced business appraiser should be retained to prepare a "qualified appraisal" of the FLP partnership interests. The determination of minority or lack of marketability valuation discounts is based upon the specific facts of the FLP interest being valued and cannot be based upon the amount of valuation discounts in a particular published tax case decision.

The use of an appraiser is especially important when a Federal Gift Tax Return Form 709 or a Federal Estate Tax Return Form 706 is filed. The gift tax statute of limitations will only run on a Form 709 Federal gift tax return where there is a qualified appraisal.

Based upon recent Tax Court cases, it is advisable that the appraisal report contain all relevant data and reasoning, and that the appraisal report relate to and analyze the specific facts and circumstances of the gifted, sold, or bequeathed FLP interest (and not just be a general "treatise" on appraisal techniques).

1.6 ***Differences of Using a Partnership Versus a Limited Liability Company***. Assuming that an LLC is managed by a manager versus a limited partnership managed by a general partner, many

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appraisers feel there is no real difference in valuation discounts. However, under the Chapter 14 rules the state "default" provision under California law is that a majority vote of limited liability company membership interests can vote to dissolve the LLC.[7] On the other hand, a California limited partnership requires a majority vote of the limited partners and the consent of the general partners to dissolve.[8] In certain fact situations this can arguably result in lower valuation discounts (and thus higher values) for LLC membership interests than for limited partner interests.

If the LLC is doing business in California, then California imposes a gross receipts fee on the LLC.[9] California limited partnerships are not subject to this gross receipts fee.

A limited liability company has an advantage over a limited partnership in that a limited liability company produces limited

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[7] California Corporations Code ' 17350.

[8] California Corporations Code ' 15681(a). This rule is basically the same under the new California Uniform Limited Partnership Act of 2008 at ' 15908.01(b).

California's limited partnership laws are being revised on January 1, 2008 by the new Uniform Limited Partnership Act of 2008. However, there will be transitional provisions for existing limited partnerships. See California Corporations Code ' 15900 ***et. seq.***

[9] LLCs must pay an annual fee based on the total LLC's income from all sources reportable to California. The annual LLC fee is: $900 if total income is $250,000 or more but less than $500,000; $2,500 if total income is $500,000 or more but less than $1,000,000; $6,000 if total income is $1,000,000 or more but less than $5,000,000; $11,790 if total income is $5,000,000 or more. See California Rev. and Tax. Code ' 17942(a). There is current litigation in the California courts as to the Constitutionality of this LLC fee.

Both limited liability companies and limited partnerships are required to also pay an $800 annual California franchise tax.

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liability for all of its members, while a limited partnership produces limited liability only for its limited partners. Thus, in order to protect the owners of the FLP general partner from FLP liabilities, the owner of a FLP general partner interest may choose to utilize either a corporation or limited liability company to own its FLP general partner interest.

1.7 ***Should the FLP Be Formed in California or in Another State?*** Some tax professionals feel that forming the FLP in certain states can take advantage of that state's more restrictive limited partnership or limited liability company laws. For example, Delaware and Nevada have, in some cases, more restrictive laws than does California.

This issue arises in the application of Section 2704, a provision under Chapter 14. Section 2704 provides that any "applicable restriction" in the partnership agreement is to be disregarded in valuing the FLP. An applicable restriction is defined to be a restriction that limits the ability of the partnership to liquidate, and such restriction either lapses after a transfer or the transferor and members of the transferor's family, alone or collectively, have the right to remove that restriction.[10] Importantly, a restriction is not an "applicable restriction" if it is not more restrictive than the limitations under the applicable state law. Depending on who the general partners and limited partners are, certain state laws may be more favorable to prevent liquidation or withdrawal of a partner from the FLP.

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[10] See Reg. ' 25.2704-2(b).

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2. **AVOIDING IRS ATTACK UNDER SECTION 2036 BY HAVING A BONAFIDE SALE WHERE THE FLP IS FORMED FOR A NON-TAX REASON**

Most recent IRS successes in attacking FLPs have been under Section 2036.[11] For the IRS to include property in the decedent's gross estate under Section 2036[12], the following three items must all be shown:

(i) the decedent must have made a transfer of the property during the decedent's lifetime;

(ii) that transfer must not have involved a bonafide sale for an adequate and full consideration in money or money's worth; and

(iii) the decedent has either: (a) retained possession or enjoyment of the property transferred or the income from the

[11] In addition to ' 2036, the IRS has also recently attacked FLPs under ' 2038. Section 2038 provides that the value of a decedent's gross estate will include the value of all property "[t]o the extent of any interest therein, which the decedent has at any time made a transfer (except in case of a bonafide sale for an adequate and full consideration in money or money's worth).... where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power, by the decedent alone or in conjunction with any other person...to alter, amend, revoke or terminate...." Most recent FLP tax cases have focused on the IRS's ' 2036 arguments, rather than ' 2038.

[12] Arguably, if the IRS is successful in making a ' 2036 argument to include the assets in a decedent's estate because of a retained interest, then there should not be a "double inclusion" of assets in part because of ' 2043. In other words, the decedent's taxable estate should not include FLP assets both under ' 2033 (as reflected in the value of the decedent's directly owned FLP partnership interest) and then include these same FLP assets a second time because of the decedent's "retained interest" in the FLP under ' 2036, which could result in an over 100 percent inclusion. It is this author's experience that the IRS will sometimes threaten to have an over 100 percent inclusion on audit for leverage purposes to settle estate tax cases at the audit level.

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property (known as a "Section 2036(a)(1)" retention); or (b) the decedent either alone or in conjunction with any person has retained the right to designate the persons who will possess or enjoy the property or the income from such property (known as a "Section 2036(a)(2)" retention).

The decedent's retained right under Section 2036 can be either by an express agreement, or by an "implied" agreement or understanding at the time of the decedent's transfer of the property pursuant to Regulation Section 20.2036-1(a). The Tax Court has found an implied understanding between a decedent and a FLP of the right to enjoy the transferred assets based upon facts and circumstances, where the decedent transferred substantially all of their assets to the FLP and made no other arrangements for their estate to pay their federal estate taxes.[13]

Thus, the IRS's attacks on FLPs under Section 2036 are based upon the allegation that the deceased client "retained" a prohibited interest in the FLP's assets.[14]

2.1 ***The "Adequate and Full Consideration" Exception to Section 2036***. One often used taxpayer defense to prevent the

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[13] See ***Erickson***, T. C. Memo 2007-107. In ***Erickson*** there was a delay in the transfer of the assets to the FLP, the decedent died shortly after the asset transfers were completed, and the FLP provided the decedent's estate with the funds to pay the estate's taxes and liabilities.

[14] The inclusion of FLP assets under ' 2036 can also produce problems in the decedent receiving a full marital deduction for estate taxes. FLP assets brought back into the decedent's gross estate under ' 2036 will not necessarily be entitled to a federal estate tax marital deduction. Thus, there could be estate taxes imposed upon the death of the first spouse if the IRS is successful in asserting that the marital deduction formula (in calculating how much is left to the surviving spouse) take into account the FLP's valuation discounts. See ***Estate of Disanto***, T. C. Memo 1999-421, and TAM 9403005.

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application of Section 2036 is to prove that the decedent transferred FLP interests to the family members (or that assets were contributed by the decedent to the FLP) in a bonafide sale "for an adequate and full consideration" in money or money's worth. In order to apply this "adequate and full consideration" exception to Section 2036, recent court decisions have required a non-tax reason for the establishment of the FLP.

In other words, for the IRS to apply either Section 2036(a)(1) or Section 2036(a)(2) to a client's contribution of property to a FLP (or to a transfer of the deceased client's FLP partnership interest), the decedent must have first made a transfer of assets to the FLP (or a transfer of a FLP partnership interest) without receiving adequate and full consideration, and second, the decedent must have retained a prohibited interest in, or control of, the FLP for the remainder of the decedent's life. If it can be evidenced that the deceased client, upon transferring assets to the FLP, received in exchange adequate and full consideration for such transfer (such as receiving FLP partnership interests in exchange for the client's transfer of property to the FLP), there is arguably no gratuitous transfer upon the formation of the FLP, and thus, Section 2036 should not apply.[15]

The Tax Court in ***Bongard***[16] observed that a "bonafide sale for adequate and full consideration" typically does not occur when a taxpayer stands on both sides of the transaction such as in an

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[15] The taxpayer was successful using this argument in ***Church***, 85 AFTR2d 2000-804 (W.D. Tex. 2000), *aff'd*, 268 F.3d 1063 (5th Cir. 2001).

[16] 124 T.C. 95 (2005).

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inter-family transaction. To qualify for the "bonafide sale" exception to Section 2036, the ***Bongard*** court pointed out that the transaction must "be made in good faith," which requires an examination as to whether there was some "legitimate and significant nontax reason" for the FLP's formation.

The Eighth Circuit Court of Appeals in ***Korby***[17] pointed out that if tax savings is the only reason for the "transfer" of assets to a FLP, then such transfer is not "bonafide" within the meaning of Section 2036. A sale is "bonafide" if it serves a "substantial business" or other non-tax purpose.[18] In ***Korby*** the husband and wife were on both sides of the transactions (as the contributor of assets to the FLP), without any input from the children limited partners.

In the ***Thompson***[19] case, the Third Circuit held that the "adequate and full consideration" exception to 2036(a) does not apply where the FLP's assets were not invested in a business enterprise motivated by legitimate business concerns.

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[17] T. C. Memo 2005-102, *aff'd* 471 F.3d 848 (8th Cir. 2006).

[18] See ***Korby***, ***ibid***, and ***Kimbell***, 371 F.3d 257 (5th Cir. 2004). In ***Kimbell*** the Fifth Circuit stated that family members may enter into FLPs, and that the contribution of assets to a FLP in exchange for partnership interests is for adequate and full consideration if: (i) the FLP interests credited to each partner are proportionate to the fair market value of the assets that each partner contributed to the FLP; (ii) the assets contributed by each partner to the FLP are properly credited to the respective capital accounts of the partners; and (iii) upon termination or dissolution of the FLP the partners are entitled to distributions from the FLP in an amounts equal to their respective capital accounts.

[19] ***Betsy Turner, Executrix of the Estate of Thompson***, 382 F.3d 367 (3rd Cir. 2004), *affm'g* T. C. Memo 2002-246. Importantly, the Third Circuit Court of Appeals in ***Thompson*** found that even receiving a discounted FLP interest could still, in certain circumstances, be "adequate consideration" for the "adequate and full consideration" exception to ' 2036.

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Bongard was a split Tax Court published decision. In the subsequent Tax Court Memorandum decisions of ***Rosen***[20] and ***Erickson***[21] the Tax Court stated that in order for a reason for the FLP's formation to qualify as a "legitimate and significant nontax reason", that "reason" must be an important one that actually motivated the formation of the FLP from a business standpoint.

(1) ***List the Business Reasons in the Recital Paragraphs of the FLP's Partnership Agreement***. To evidence a "legitimate and significant non-tax reason" for the FLP's formation, it is helpful if the FLP's "business reasons" are listed in the beginning recitals of the FLP's partnership agreement. Additionally, the FLP partnership agreement should provide that: (i) the assets contributed to the FLP will be properly credited to each partner's capital account; (ii) each partner's FLP partnership interest will be proportionate to the value of the assets that each partner contributes; and (iii) the FLP's distributions will be debited to the appropriate partner's capital account.

(2) ***Be Careful On the Reasons For the FLP's Formation Which Are Stated in Correspondence and E-mails to the Client***. Do not state in e-mails and correspondence to the client that the FLP is being formed only to save taxes. Instead, evidence the nontax reasons for the FLP's formation.

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[20] See ***Rosen***, T. C. Memo 2006-115.

[21] See ***Erickson***, ***supra***, note 13.

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(3) ***Example***.

EXAMPLE: Assume that client forms a FLP and receives back a 98% limited partner interest, with a 1% FLP limited partner interest and a 1% FLP general partner interest issued to the client's children (who contribute 2% of the assets to the FLP). To evidence the client's receipt of the 98% limited partner interest upon the FLP's formation for "adequate and full consideration" in the form of the FLP partnership interests, the client should have a substantial business reason for establishing the FLP and should properly maintains the FLP's capital accounts. Thus, when the client dies, the client's estate can argue that the "transfer for adequate and full consideration" exception of Section 2036(a) applies to protect the client's estate from an IRS Section 2036 claim that the client's assets transferred to the FLP are included in the client's gross estate.

Under the above example, in addition to the client arguing the "transfer for adequate and full consideration" exception to Section 2036, the client should also avoid having a prohibited "retained interest" under Section 2036(a)(1), such as the client should not utilize the partnership's assets for the client's personal expenses, nor should the FLP make distributions to the partners which are disproportionate to the FLP's partnership interests.

Some nontax reasons for forming a FLP are discussed below:

2.2 ***Have an Active Business in the FLP and Not Just Passive Assets.*** Have the FLP engage in an active business such as real estate development (and not just owning triple-net rental real estate with no management duties or liquid stocks and bonds). In ***Kimbell***[22] the court found a business purpose existed where the FLP's

[22] See ***Kimbell, supra***, note 18. The Fifth Circuit Court of Appeals in ***Kimbell***, in reversing the Texas District

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assets were invested in oil and gas properties. The Court in ***Kimbell***, in finding that the Section 2036 "for adequate and full consideration" exception applied, also found that this exception applied in an inter-family transfer (even though an inter-family transfer may receive heightened scrutiny).

On the other hand, the court in ***Thompson***[23] found that owning passive marketable securities alone did not provide the requisite business purpose to apply the sale "for adequate and full consideration" exception to Section 2036. However, it is well established by other cases that FLPs can be validly formed with solely stocks, bonds and other passive investment assets.[24]

2.3 ***The FLP is Necessary For Management of the Family's Assets.*** Establish a FLP as a mechanism to properly manage, invest and control assets for the long-term benefit of the client's family. Having the family's assets owned in a FLP is a way to diversify the family's investments and lower the operating costs of managing those investments. For example, most outside investment advisors base their management fee upon the size of the portfolio they are managing. A larger securities portfolio in the FLP would thus generate a lower percentage management fee by the outside

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Court, held that ' 2036 did not apply, because there was not a "transfer" of assets and instead there was a "bonafide" sale for adequate and full consideration by the decedent's contributions of assets to the FLP in exchange for FLP partnership interests. The Court in ***Kimbell***, in finding that a "bonafide sale" took place to avoid the application of ' 2036, noted that there was no commingling of the decedent's personal assets with that of the FLP; the decedent had retained enough assets outside of the FLP to support the decedent; and partnership formalities were observed.

[23] ***Supra***, note 19.

[24] See, for example, the Tax Court cases of ***Peracchio***, T. C. Memo 2003-280; and ***Kelley, supra,*** note 5.

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investment advisor. Also, having a larger portfolio of securities in one FLP asset pool allows for greater diversity of investments (such as allocations to fixed income investments, equities, securities, small cap stocks, international investments, hedge funds, etc.).

2.4 ***The FLP Can Be Used to Pool Voting Rights.*** If different family members own publicly traded stock, then the FLP enables these different family members to pool their stock holdings in one entity for voting and control purposes.

2.5 ***A FLP Allows Transferring of "Hard to Split Up Assets" to Children and Other Family Members.*** For real estate or other assets that cannot easily be split up among family members, the FLP avoids having to gift fractional interests in such assets. Where family members directly own fractional interests in real estate (such as by tenancy-in-common ownership) problems occur in the event of death, divorce, bankruptcy, creditor claims, or where minor children own real estate. The FLP instead allows multiple ownership of assets (in the form of limited partner interests) by family members.

2.6 ***The FLP Assists in Providing Asset Protection.*** The FLP can assist to provide asset protection. For example, in California, the partner's creditor can obtain a charging order against the partner's FLP limited partnership interests.[25] However,

[25] A discouragement for a creditor to obtain a charging order against a FLP limited partner interest is that the creditor then becomes taxable on the limited partner's share of the FLP income even if the FLP makes no distributions to that creditor. See Rev. Rul. 77-137, 1977-1 CB 178 where an assignee partner is taxed on its share of partnership income.

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the partner's creditor cannot obtain a direct attachment of the underlying FLP's assets, nor force the general partner to make distributions from the FLP to the partner. Furthermore, having multiple owners of the FLP discourages one particular partner's creditor from proceeding against that partner's FLP interest.[26]

2.7 ***FLP Provides Centralized Management Control in the FLP General Partner.*** The FLP provides for on-going centralized "control" by the FLP's general partner to manage the FLP's assets. This protects younger family members[27] from being spendthrifts and provides a unified method for the family to control and invest their assets.[28]

2.8 ***The FLP Provides a Mechanism to Resolve Potential Family Disputes.*** Where there are potential family member disputes the FLP agreement can provide arbitration clauses to resolve family conflicts.[29] Binding arbitration can be especially important for

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[26] One creditor protection device is to include in the FLP partnership agreement a provision stating that if there is an involuntary transfer of a partner's FLP interest to a creditor, that the FLP (or the other partners) would then have the option of purchasing such creditor's FLP interest at a defined purchase price with valuation discounts, which will normally require the creditor/partner to sell its FLP interest for less than that partner's proportionate share of the underlying FLP asset value.

[27] Not only does the FLP prevent younger family members from selling their FLP interests, but the FLP general partner can elect to reinvest the FLP's cash flow (and not distribute this cash flow to younger family members).

[28] Even though this FLP business purpose is very similar to that of using a trust to control a child's assets, a FLP offers more flexibility than does a trust. For example, to amend an irrevocable trust in California in most cases court approval is required. See California Probate Code ' 15403. On the other hand, a FLP can be amended without court participation. Having to petition the Probate Court to amend a trust can be complicated, can expose the trust beneficiaries and the trust assets to public scrutiny, and for minor trust beneficiaries may require a guardian ad litem, all of which will cause expense to the client.

[29] Since the FLP partnership agreement is an agreement among all of the partners, the partners can agree on behalf of themselves and their assignees to have any dispute resolved by binding arbitration. Also, a FLP partnership agreement can discourage frivolous lawsuits by family members by requiring that the loser of any

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wealthy families or celebrity clients, such as those in the entertainment industry, who wish to avoid publicity and public lawsuits among family members.

2.9 ***The FLP Provides Protection in the Event of a Child's Divorce*.** The FLP provides protection should a family member's marriage dissolve. Through gifts and purchases, the FLP limited partner interests can be characterized as the sole and separate property of married children. It is difficult for a child to comingle the child's separate property FLP limited partnership interests with the child's community property. On the other hand, if real estate or securities (such as tradable stocks and bonds) are owned directly by the child (rather than in a FLP), there is a greater likelihood of the child commingling those assets with the child's community property, and a greater likelihood that the child's spouse will make a claim against those assets in the event of a divorce.[30]

2.10 ***Can Include Rights of Buyback and First Refusal in a FLP*.** Rights of first refusal, and even rights of purchase, can be included in the FLP's partnership agreement to prevent non-family members or non-lineal descendants from owning FLP interests. For example, in the event of a child's death, the other family members can be given the first right to purchase that deceased child's FLP interest.

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lawsuit pay the prevailing family members' legal fees.

[30] Similar to the creditor protection devices discussed at paragraph 2.6, a provision can be included in the FLP agreement providing that a divorced partner's FLP interest can be purchased at a discounted purchase price should the child's spouse make a claim against such FLP interest (with the fair market value of the FLP interest defined in the FLP partnership agreement as considering all valuation discounts, thereby producing a lower purchase price).

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2.11 ***The FLP Provides the Opportunity to Train Other Family Members to Manage the Family's Business Affairs.*** The FLP offers the opportunity to train other family members to manage the FLP's assets by training children and grandchildren, and slowly bringing these other family members into working for the FLP's managing general partner.

3. GUIDELINES TO ASSIST CLIENTS IN FORMING AND OPERATING FLPS IN ORDER TO AVOID SECTION 2036

Recent Tax Court and Court of Appeals cases indicate the importance of following proper formalities in both forming and operating a FLP. If the FLP is not properly operated, the client risks inclusion of the FLP's assets in the client's federal taxable estate under Section 2036, as well as other IRS attacks.

Usually the accountant is the client's tax professional who has the most contacts with the FLP's day-to-day operation.

Guideposts for the client to properly form and operate FLPs are discussed below:

3.1 ***Clients Forming FLPs Should Not Retain the Economic Benefits of the Assets Contributed to the FLP, or the Sold or Gifted FLP Interests.*** If the client retains the economic benefits of the assets transferred to the FLP, then the IRS will attempt to

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include those assets in the client's gross estate under Section 2036(a)(1).[31]

Section 2036(a)(1) states that the value of the decedent's gross estate includes the value of all property which the decedent transferred (except in case of a bonafide sale for an adequate consideration in money or money's worth), of which the possession or enjoyment of, or the right in the income from, the property is retained by the decedent.

For example, in the second ***Strangi*** decision, known as "***Strangi II***"[32] the Tax Court held that the FLP's assets, which were transferred by the decedent to the FLP, were includable in the decedent's estate under Section 2036(a)(1). The Tax Court found that the decedent possessed the right to enjoy the income from the property which the decedent transferred to the FLP under an "implied agreement." The court based its ruling upon the fact that

[31] See, for example, the recent Tax Court decision in ***Rosen***, T. C. Memo 2006-115, where the assets which the client contributed to the FLP were included in the decedent's estate under ' 2036(a)(1) because the decedent retained the right to the enjoyment of those contributed assets for the decedent's life. In ***Rosen*** the decedent transferred substantially all of the decedent's assets to the FLP, did not retain enough assets for her day-to-day living expenses, and there were non-pro rata distributions made by the FLP.

[32] T. C. Memo 2003-145, *rem'd* by 293 F.3d 279 (5th Cir. 2002). The Fifth Circuit Court of Appeals reversed the Tax Court's first ***Strangi*** opinion (known as "***Strangi I***") previously decided at 115 T.C. 478 (2000). This ***Strangi I*** Tax Court decision rejected the IRS's Chapter 14 arguments, IRS assertions on gift on formation, and lack of economic substance. The Fifth Circuit Court of Appeals reversed the Tax Court's ***Strangi I*** decision because the Fifth Circuit stated that the Tax Court had not considered the application of ' 2036.

Thus, in the second Tax Court ***Strangi*** decision (known as "***Strangi II***"), T. C. Memo 2003-145, the Tax Court applied ' 2036 to the FLP and held in favor of the IRS. The Fifth Circuit Court of Appeals then affirmed ***Strangi II*** at 417 F.3d 468 (5th Cir. 2005). In this second Fifth Circuit Court of Appeals ***Strangi II*** decision, the Court of Appeals did not comment on the Tax Court's analysis under ' 2036(a)(2) in ***Strangi II***, but did affirm the Tax Court's ***Strangi II*** analysis under ' 2036(a)(1).

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the decedent transferred 98 percent of the decedent's assets to the FLP, the decedent continued to occupy the decedent's personal residence without paying rent after transferring the residence to the FLP, the decedent's personal assets and the FLP's assets were commingled, the FLP made disproportionate distributions to the decedent, the decedent had access to the FLP's funds to pay the decedent's personal expenses, and the FLP was formed shortly before the decedent's death.

Additionally, the Tax Court in its ***Strangi II*** decision held that the decedent had the power to designate who would enjoy the income of the FLP and, thus, also applied Section 2036(a)(2) to include the FLP's assets in the decedent's gross estate. The Tax Court based its Section 2036(a)(2) holding upon the fact that the FLP partnership agreement gave the general partner the sole discretion to determine the FLP distributions, the decedent with the other partners could vote to dissolve the FLP, and that the decedent with the other FLP corporate general partner shareholders could make distributions. This ***Strangi II*** Tax Court's application of Section 2036(a)(2) has been criticized by commentators.

The IRS also has successfully made the Section 2036(a)(1) argument against FLPs, where the FLP paid the decedent's personal expenses, in ***Reichardt***[33] and ***Harper***[34]. In ***Korby***,[35] the Tax Court

[33] 114 T.C. 144 (2000). In ***Reichart***, the Tax Court found that the decedent and his children had an implied agreement that the decedent could continue to enjoy the FLP's assets during the decedent's lifetime. After the transfer of property to the FLP, the decedent continued to enjoy the FLP's property and retained the right to income from the FLP's assets. Importantly, in ***Reichart***, there was a commingling of the FLP's assets with the decedent's personal funds, and the decedent's personal residence was also contributed to the FLP in which the decedent continued to live without paying rent. Also, see ***Schauerhamer***, T. C. Memo 1997-242, for another similar ' 2036(a)(1) case.

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found an implied agreement for the decedent to have retained enjoyment of the transferred FLP assets under Section 2036, where the FLP made substantial distributions to pay the decedent's living expenses, including the decedent's wife's nursing home expenses, and the husband and wife FLP partners received distributions for their support without the other FLP partners receiving proportionate comparable distributions.

3.2 ***The FLP Should Make Timely Annual Distributions to its Partners in Proportion to Those Partners' Percentage Interests***. The ***Strangi II***, ***Reichardt***, ***Korby***, and ***Harper*** cases highlight the importance of observing the FLP's distribution formalities in order for the FLP to be recognized for tax purposes. To avoid the adverse tax results of these cases, the FLP should make distributions to its partners in proportion to their percentage interests, and the FLP should not make preferential distributions to the client, nor make advance distributions to a client that are to be repaid to the FLP in later years. Preferably, the FLP distributions should be made at least annually. Some FLPs violate these distribution formalities by making disproportionate distributions to the parents where the parents need FLP assets for their personal living expenses, medical needs, or for an outside

[34] T. C. Memo 2002-121. This was the second ***Harper*** Tax Court case. The taxpayer won the first ***Harper*** Tax Court case which involved a Chapter 14 issue. In the second ***Harper*** case, the IRS was successful in applying ' 2036. In ***Harper***, the decedent established a FLP shortly before the decedent's death, then transferred substantially all of the decedent's assets to this FLP, followed by a transfer of FLP limited partner interests to the decedent's children. The Tax Court, in finding the application of ' 2036, found among other items that there was a delay in the decedent transferring assets to the FLP; there was a commingling of the decedent's assets with those of the FLP; and there were FLP distributions not in proportion to those specified in the FLP partnership agreement.

[35] ***Supra***, note 17.

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investment that the parents may wish to make. However, to avoid an IRS Section 2036(a)(1) attack, no FLP assets should be used to pay the client's personal expenses or support or that of any other FLP partner.[36] It is important that clients be disciplined to not to make disproportionate distributions from the FLP, nor to receive loans or advances from the FLP.

3.3 ***It is Helpful If Other Family Members Are FLP Partners.*** It is helpful to show that the client's family members become initial FLP partners by way of gifts, sales of FLP interests, or preferably by having these family members contribute their own capital to the FLP. Having the client's children contribute the children's own capital to the FLP evidences that the FLP is a mutual business enterprise among the family members.[37]

3.4 ***It is Helpful if Different Family Members Are Represented By Different Attorneys.*** In the FLP's formation (and in the FLP's ongoing operations) it is helpful to evidence the FLP's business purpose if there are arm's-length negotiations among the parents and children, by the parents and children each having their own separate attorneys and separate financial advisors.[38]

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[36] In ***Estate of Abraham***, T. C. Memo 2004-39, *aff'd* 408 F.3d 26 (1st Cir. 2005), the First Circuit Court of Appeals found that the FLP funds were to be used to support the decedent, and as a result, there was a prohibited, retained interest for purposes of ' 2036.

[37] See ***Estate of Schutt***, T. C. Memo 2005-126.

[38] See ***Estate of Stone***, T. C. Memo 2003-309.

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3.5 ***Do Not Comingle FLP Assets With the Personal Assets of Any of the FLP Partners.*** None of the FLP partners should commingle their personal assets with the FLP's assets.

3.6 ***Do Not Have the Client's Personal Residence Owned in the FLP.*** Importantly, the client's personal residence should not be owned by the FLP. Since the client will be living in this personal residence, having the FLP own that residence allows the IRS to argue that the client improperly retained the "enjoyment" of that residence and the FLP's assets under Section 2036(a)(1).[39]

3.7 ***Preferably, Do Not Allow the FLP to Directly Pay the Client's Estate's Expenses or Estate Taxes on Death.*** If the FLP pays a deceased client's estate's expenses or estate taxes, then the IRS, as it did in ***Strangi II***, may assert that these payments represent the decedent's retention of the FLP's economic benefits, thereby including the FLP's assets in the deceased client's taxable estate under Section 2036(a)(1).[40] Preferably, the client's estate plan should contemplate that the client's estate's expenses and estate taxes will be paid from a source other than the FLP's assets.

In ***Erickson***[41] the Tax Court found that the decedent had retained enjoyment of the assets transferred to the FLP where those

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[39] See ***Disbrow Estate***, T. C. Memo 2006-34.

[40] This author believes that the IRS is incorrect in its position since, by way of analogy, ' 303 contemplates a decedent's closely held corporation paying the decedent's estate taxes without that corporation's assets being included in the decedent's estate under ' 2036.

[41] T. C. Memo 2007-107.

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assets were available to pay the decedent's debts, expenses and estate taxes after the decedent's death. In ***Erickson*** substantially all of the decedent's assets were transferred to the FLP shortly before the decedent's death. The Tax Court in ***Erickson*** found that the FLP's disbursement of funds to the estate indicated an "implied" understanding that those funds would be available for the decedent, and that the monies that were disbursed to the decedent's estate (to pay the decedent's estate taxes and estate's expenses) were made at a time when no other FLP partners received monies from the FLP.

(1) ***Have an Entity Other Than the FLP Make Loans to the Client's Estate to Pay the Client's Estate Taxes***. The FLP should avoid loaning monies to the client's estate to pay the client's estate taxes, or the IRS, as it did in ***Erickson***, may assert that the decedent retained the enjoyment of the FLP's assets under Section 2036. Instead, the estate could borrow monies to pay estate taxes and estate expenses from a third-party lender. The deceased client's estate may deduct under Section 2053 against estate taxes future interest payments. Under Section 2053, even though interest expenses on the estate's borrowings may be paid over many years in the future, the client's taxable estate can still deduct under Section 2053 these gross future interest amounts (even the interest which will be paid in the future) as a current Section 2053 administration expense on the client's Form 706 Federal Estate Tax Return.[42] Because the future interest payments

[42] See ***Graegin***, T. C. Memo 1988-477. The IRS issued PLR 200020011, which stated under the PLR's facts that future interest on a commercial loan to an estate was deductible.

However, Prop. Reg. ' 20.2053-4 issued April 20, 2007 adapts a rule that ' 2053(a)(3) claims against

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do not have to be presently valued, the technique of an estate borrowing from a third-party lender can produce a substantial Section 2053 estate tax interest deduction.[43]

3.8 ***Have the Client's Estate Planning Documents and Other Contracts Be Consistent With the FLP Documents***. The client's Will and revocable living trust should be consistent with the FLP. For example, the client's living trust should preferably provide for the payment of the client's estate taxes from assets other than those contained in the FLP, the client's trust should not attempt to gift real estate and other properties which are in fact titled in the name of the FLP, and the client's Will and trust should not attempt to have the client's executor and trustee manage the FLP after the client's death. Additionally, the client should not enter into contracts or side letter agreements which indicate that the FLP's income will be given to the client "if the client needs same" nor stating that the client will have indirect management powers over the FLP.

3.9 ***The Client Should Have Liquid Assets Outside of the FLP to Pay the Client's Living Expenses***. The IRS may assert that the

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the estate are only for amounts actually paid in settlement of claims against the estate. Prop. Reg. ' 2053-4(c) allows deduction of post-death accrued interest. Also, these Proposed Regulations have a rebuttable presumption that claims by related entities against the decedent's estate are not legitimate. These Proposed Regulations are only effective for decedent's dying after the date that these regulations become final.

[43] The estate tax savings of a *Graegin* type of promissory note may in certain circumstances become a circular calculation since the more interest that is generated on the promissory note the greater the ' 2053 deduction, which in turn lowers the estate taxes. These lower estate taxes then result in a lesser principal amount that needs to be borrowed by the estate, which in turn results in less ' 2053 deductible interest to be paid by the estate.

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client has retained an economic benefit from the FLP under Section 2036(a)(1) if the client relies upon the FLP's assets for the client's living expenses. Instead, the client should retain enough liquid assets outside of the FLP in order to pay the client's living expenses for the remainder of the client's life. In other words, clients should not transfer to the FLP substantially all of their liquid assets.[44] The client's retention of enough assets outside of the FLP for the client's support was an important element in the taxpayers' victories against the IRS's Section 2036 arguments in the ***Stone***[45] and ***Kimbell***[46] cases.

3.10 ***Clients Should Follow Partnership Formalities in Operating the FLP.*** The FLP should be operated in compliance with the terms and distribution provisions of the FLP's partnership agreement. In no event should the FLP assets be commingled with the client's personal funds, as occurred in ***Schauerhamer***[47] and ***Reichardt***[48], cases which the taxpayer lost.

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[44] In ***Thompson***, T. C. Memo 2002-46, *aff'd sub nom* ***Turner***, 382 F.3d 367 (3rd Cir. 2004), the decedent had transferred 95 percent of the decedent's assets to the FLP. The decedent had retained only enough liquid assets to pay for 3.5 years of his personal expenses even though the decedent's actuarial life expectancy was 4.1 years. In ***Korby***, ***supra***, note 17, the husband and wife transferors did not retain sufficient assets outside the FLP for their support. Also, in ***Erickson, supra***, note 13, substantially all of the client's assets were transferred to the FLP.

[45] ***Supra***, note 38.

[46] ***Supra***, note 18.

[47] ***Supra***, note 33.

[48] ***Supra***, note 33.

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(1) ***Avoid Loans By the FLP to the FLP Partners***. Loans to partners by the FLP should be avoided. If loans are made by the FLP to the FLP's partners, then: (i) the repayment of principal and the payment of interest should be regularly paid back to the FLP; and (ii) the loan should be evidenced by a signed written promissory note bearing adequate interest. One reason for the IRS's victory in the ***Thompson***[49] case was that the facts showed that the interest was paid late to the FLP on the FLP's loans to family members.

(2) ***Legally Title the Assets in the Name of the FLP and Properly Maintain and Show These Assets on the FLP's Financial Statements***. All FLP assets should be legally titled in the name of the FLP. In ***Hillgren***[50] the taxpayer lost under Section 2036(a)(1) where the real estate and its leases were not titled in the name of the FLP. Inform FLP real estate tenants in writing of the transfer of the real estate to the FLP and that future rent checks should be made payable to the FLP's name. All property and liability insurance for FLP assets should show the FLP as the assets' owner.

(3) ***The FLP Assets Should Be Contributed to the FLP Before the Limited Partner Interests are Gifted or Sold***. In the Tax Court case of ***Senda***[51] the taxpayer made contributions to the FLP on the same day that the FLP partnership interests were gifted.

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[49] ***Supra***, note 19.

[50] T. C. Memo 2004-46.

[51] T. C. Memo 2004-160 *aff'd* 433 F.3d 1044 (8th Cir. 2006). The decision was based upon an "indirect gift" of the underlying FLP assets by the taxpayer pursuant to ' 2501 and Reg. ' 25.2511-2(a).

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Since the taxpayer could not prove that the contributions of property to the FLP were made before the taxpayer gifted FLP partnership interests to the taxpayer's family, the gifts were treated as gifts of the underlying FLP assets (and not gifts of FLP partnership interests). Thus, the taxpayer/donor was denied minority and lack of marketability valuation discounts.

Similarly, in the ***Shepherd***[52] case the Tax Court held that taxpayers contributions of property to an existing FLP was an indirect gift of such property to the FLP children partners. Based on these cases, contributions of property to the FLP should be done prior to the gifting of FLP interests to family members, and FLP property contributions should be properly documented and recorded.[53]

In order to evidence that the partners have respected the formalities of the FLP, the partners should not delay the transfer of their assets to the FLP. If the FLP's agreement recites that the assets were transferred to the FLP on a specific date, then in fact those assets should be transferred to the FLP on that specified date.[54]

(4) ***The FLP Should Maintain Separate Books and Accountings***. The FLP should maintain separate books, separate

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[52] 115 T.C. 376 (2000), *aff'd* 89 283 F.3d 1258 (11th Cir. 2002).

[53] The issue of when assets are transferred to the FLP will be examined in the IRS's review of a FLP. See ***IRS Appeals Settlement Guidelines on Family Limited Partnerships and Family Limited Liability Corporations***, effective October 20, 2006.

[54] See ***Erickson***, T. C. Memo 2007-107, where the Tax Court found that the formalities of the FLP were not observed where the partners waited several months after the FLP's formation to transfer assets to the FLP.

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brokerage accounts and separate checking accounts, prepare financial statements at least annually, and timely file state and federal income tax returns. Contributions to the FLP by the partners should be credited to the contributing partner's capital account. Similarly, FLP distributions should be debited to the distributee partner's capital account. Importantly, FLP distributions to its partners should be made in accordance with each partner's FLP percentage interest.

(5) ***Do Not Commingle FLP Assets With the Client's Personal Assets***. The income, dividends and interest from the FLP assets should be deposited into the FLP's separate bank and brokerage accounts, and not into the client's personal account. In other words do not comingle the FLP's monies with those of the client. If income is transferred directly from FLP assets to the client's bank account (such as having FLP real property rents paid directly to the client), then the IRS may assert that the client retained the "enjoyment" of the FLP's assets under Section 2036(a)(1), thereby including the FLP's assets the client's taxable estate under Section 2036.

(6) ***Do Not Pay Personal Expenses of Client or Other Partners From the FLP***. Under no circumstances should the FLP pay the personal expenses of the client or any other FLP partner. See paragraph 3.1, above.

(7) ***The FLP Should Charge Fair Value to Outside Persons for Any Outside Person's Use of FLP Assets***. If FLP assets are used by another person (including a FLP partner), then that person must pay its fair market value for the use of such FLP assets (such as

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fair rental value for the use of FLP real estate). Thus, whether the client, the FLP general partner or a FLP limited partner uses FLP property, the user must pay the FLP fair market value for the use of such property.

(8) ***Have an Active Business in the FLP***. Preferably, the FLP should engage in an active business, and not just be a passive investor in stocks, bonds, and other securities. See paragraph 2.2, above.

Do not have e-mails or correspondence from attorneys or accountants to the client indicating that the sole purpose of the FLP is to save taxes.[55]

Cases have allowed only passive securities to be owned in FLPs. However, it is preferable that a business purpose for such ownership of passive securities be established. Any FLP owning solely passive securities will be subject to greater IRS scrutiny. In ***Peracchio***[56] the Tax Court valued transferred FLP interests where the FLP owned cash (44 percent of its assets), and marketable securities (56 percent of its assets) consisting of government and municipal bonds. The IRS in ***Peracchio*** initially raised, but subsequently did not pursue, issues such as lack of economic substance and Section 2704(b) applicable restrictions. In ***Peracchio*** the Tax Court allowed a six percent minority interest discount and a 25 percent marketability discount.

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[55] See ***Rosen***, ***supra***, note 20.

[56] T. C. Memo 2003-280.

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3.11 ***Regular Meetings and Minutes***. Although under California state law regular meetings of limited partners and minutes of such meetings are not required, having meetings with written minutes helps evidence the FLP's business purpose. However, where a limited partnership (rather than a member-managed limited liability company) is utilized, clients must be cognizant of the rule that the limited partners should not participate in the management of the FLP in order to avoid having these limited partners taking on the FLP's general partner's liabilities.[57]

3.12 ***Clients Should Consider Giving Up FLP Management Control***. This is probably the most controversial area in dealing with clients. Many clients will want to retain some "control" over how the FLP's assets are being managed. Remember that asking a client to give up control over the FLP may be inconsistent with that client's goals and desires to direct the FLP's business and investments.

The IRS successfully asserted in ***Strangi II*** that a client's management control over a FLP's general partner interest is a prohibited retained Section 2036(a)(2) power.[58] The Tax Court's ***Strangi II*** decision stated that the FLP assets were included in the decedent's taxable estate at death based in part upon the theory that the decedent indirectly retained the general partner's management powers, which was a prohibited retained Section

[57] See California Corporations Code ' 15632.

[58] Section 2036(a)(2) states that the decedent will have retained a ' 2036 power where the decedent has 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.

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2036(a)(2) power. In ***Strangi II***, the decedent's retained management rights were based upon the decedent's family's control of the FLP general partner interest.[59]

However, the IRS lost on this Section 2036(a)(2) issue in ***Kimbell***[60] where the decedent had the right to remove the general partner and replace the general partner.[61]

(1) ***Alternative of Having the Client Not Be the FLP's General Partner.*** One approach to avoid the adverse Section 2036(a)(2) tax result of ***Strangi II*** is to have the client not be the FLP's general partner and also not have the power to remove or replace that FLP general partner.

Clients who are currently serving as general partners of their FLPs could sell their FLP general partner interests to their children and other family members. As an example, a grantor trust discussed under paragraph 5.2 below, could be utilized to purchase a client's FLP general partner interest. The reason to sell the client's FLP general partner interest for consideration is to avoid the Section 2035 three-year inclusion rule. For a client's

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[59] Interestingly, the ***Strangi II*** Tax Court decision rejected the IRS's holdings in several prior Private Letter Rulings which stated that the ***Byrum***, 408 U.S. 139 (1972), case applied to a limited partnership's general partner's powers so that the general partner, because of that general partner's fiduciary duties towards the limited partners and the limited partnership, would not have a retained ' 2036 power over the transferred limited partnership interests. See, for example, PLRs 9332006 and 9310039.

[60] ***Supra***, note 18.

[61] The Fifth Circuit in ***Kimbell*** vacated and remanded the District Court's decision, holding that the District Court erred in finding that family members could not enter into bonafide transactions and that a transfer of assets for a pro rata partnership interest lacked full and adequate consideration. In ***Kimbell*** the decedent, who was 96 years old, established a FLP two months before her death.

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transfer of a FLP general partner interest (or a limited partner interest) during the client's lifetime, Section 2035(a) may apply to bring back within the client's gross estate FLP interests which are transferred within three years of the client's date of death.[62]

If the client is solely a FLP limited partner (and not a FLP general partner), then the client should not be able to exercise management rights over the FLP's affairs since this would be inconsistent with state limited partnership laws.

(2) ***Alternative to Have Other Family Members Serve as the FLP General Partner***. Where the client's family members (such as the client's children) are left as the sole FLP general partners, then the FLP partnership agreement should clearly state that the general partner has fiduciary duties towards the limited partners, and that the limited partners have no management rights over the FLP's affairs.

(3) ***Alternative to Use a Trust as the FLP General Partner***. The FLP general partner could be a trust with the client's children as trust beneficiaries and someone other than the client serving as trustee. It has been suggested that the client

[62] Section 2035(a) states that if a decedent dies within three years of transferring property, or relinquishing a right relating to such transferred property which would have triggered estate tax under certain specified Internal Revenue Code sections (including Section 2036), had the transferor died possessing such right, then the underlying assets are brought back into the decedent's gross estate.

One way to avoid Section 2035(a) is to make a "bonafide sale for an adequate and full consideration in money or money's worth" of the FLP interests under Section 2035(d). For example, the FLP general partner interest could be sold to the client's children (or trust for their benefit) in exchange for cash or a promissory note.

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could retain removal and replacement property over the trustee of a trust that is the FLP general partner as long as the newly appointed trustee is not subservient to the client's wishes.

(4) ***Preserve the Fiduciary Duties of the FLP General Partner***. If the client/donor retains control over the FLP's distributions either directly as the FLP general partner or indirectly by being able to direct family members who are the FLP general partners, then the IRS may argue that the client has retained control over the FLP distributions in a "non-fiduciary" capacity under Section 2036(a)(2). One way to counter this IRS argument is for the FLP's partnership agreement to state that the FLP's general partner must exercise all of their powers in compliance with state fiduciary law standards, that all FLP partners receive distributions only in proportion to their FLP percentage interests, and preferably that distributions shall be made at a specific time intervals (such as annually) to each FLP partner. See paragraph 3.13 below for a detailed discussion of the importance of the FLP's partnership agreement preserving state law fiduciary standards.

(5) ***Avoid the Donor Client From Reacquiring the General Partner's Management Powers By the Client's Actions, Agreements, or Powers of Attorney***. The client should avoid reacquiring FLP general partner management powers by oral agreements, the client's actions or by powers of attorney, all of which could cause Section 2036(a)(2) to apply. In ***Strangi II*** certain family members (who controlled the FLP general partner) were agents under powers of attorney from the decedent, which agents' powers (controlling the FLP general partner) were then attributed back to the decedent.

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Another way that prohibited Section 2036(a)(2) managerial powers can unwittingly be attributed back to the donor/client is if the donor/client, through its FLP limited partner voting rights (where FLP limited partner interests are retained by the client) can vote to dissolve the FLP, or to remove and replace the FLP general partner. Thus, should the donor/client FLP voting rights as a limited partner be entirely removed in the FLP's partnership agreement?

3.13 ***The FLP's Partnership Agreement Should Preserve the General Partner's Fiduciary Duties Towards the Limited Partners***. The FLP's Partnership agreement should not waive state law imposed fiduciary duties of the FLP's general partner towards the limited partners. The District Court decision of ***Kimbell***[63] (which District Court decision the taxpayer lost and which decision was later vacated by the Fifth Circuit), in applying Section 2036 to the FLP, found it significant that the FLP partnership agreement waived the general partner's fiduciary duties towards the limited partners and concluded that there was no fiduciary standard to prevent the decedent from retaining the economic benefits of the partnership.

The general partner's fiduciary duties should also be preserved in order to apply the "adequate and full consideration" transfer exception of Section 2036, and to assist the client who remains a FLP general partner to avoid IRS attacks under Section 2036(a)(2).

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[63] ***Supra***, note 18.

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Preserving fiduciary duties was the basis for the landmark taxpayer victory in the U.S. Supreme Court case of ***Byrum***[64], a case in the Section 2036 corporate stock area. After the 1972 ***Byrum*** decision, Congress amended Section 2036 in the corporate context by adding Section 2036(b) which causes inclusion of corporate stock in a transferor's gross estate if voting stock of a controlled corporation is transferred for less than full and adequate consideration, where the transferor retains the right to vote that stock. However, Congress has never amended Section 2036 in the partnership or limited liability company context. Thus, the Supreme Court's ***Byrum*** rule that fiduciary standards trump Section 2036(a)(2) remains applicable to FLP general partners.

The client/general partner who controls the FLP should argue that under the Supreme Court's ***Byrum*** decision, Section 2036(a)(2) cannot apply where the client's only FLP distribution power is subject to a fiduciary standard which can be enforced by a court. In other words, ***Byrum*** prevents Section 2036(a)(2) from applying to FLPs if the FLP partnership agreement preserves the general partner's fiduciary duty towards other FLP partners and states that the general partner must make appropriate distributions to all of the FLP limited partners (including the client's children).

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[64] 408 U.S. 125 (1972). The Supreme Court in ***Byrum*** held that the decedent shareholder did not retain a prohibited ' 2036(a)(2) power because of the fiduciary duties owed by the decedent as the controlling shareholder to the corporation. In ***Byrum*** the decedent transferred stock to a trust for the decedent's children's benefit, but the decedent retained the right to vote such stock which represented 71 percent of the voting power. The Supreme Court stated that the decedent as controlling majority shareholder had a fiduciary duty not to misuse his power by promoting his personal interests at the expense of corporate interests.

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Among the fiduciary duties of the FLP general partner, the FLP's partnership agreement should prohibit the general partner from promoting the general partner's personal interests at the expense of the FLP's limited partners.

3.14 ***Structure the Transfer of FLP Limited Partner or General Partner Interests for "Adequate and Full Consideration" in Order to Avoid Section 2036(a)***. Section 2036(a) by its terms does not apply to a transfer where the transfer is a bonafide sale "for an adequate and full consideration in money or money's worth." Arguably, this Section 2036 transfer exception applies where each family member contributes assets to the FLP and receives back in return FLP interests which are proportionate to the fair market value of their contributed assets. See paragraph 2, above, for a detailed discussion of the "adequate and full consideration" exception, and the business purpose requirement to apply this Section 2036 "transfer" exception.

In ***Stone***[65] the Tax Court found that there was adequate and full consideration in a family's contribution of assets to FLPs, even where the FLP interests received back were subject to valuation discounts. However, importantly, in ***Stone*** each family member was represented in the transaction (parents and each of their children) by separate legal counsel. Furthermore, the Court in ***Stone*** found the FLPs had economic substance and were operated for a profit.

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[65] *Supra*, note 38.

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The "bonafide" adequate and full consideration transfer exception also applied in ***Kimbell***[66] where family members transferred assets to a FLP. In applying the "bonafide" transfer exception to Section 2036, the courts do not require an arms length transaction as long as the transfer by family members to the FLP is made in "good faith." The ***Thompson***[67] court cited a lack of business purpose for finding a lack of "good faith," and thus held there was not a "bonafide sale."

3.15 ***The FLP Should Be Formed and Funded Well Before the Client's Date of Death.*** The IRS will challenge FLPs formed shortly before a client's date of death under a "death bed partnership formation" theory and allege that the FLP is simply a substitute for a testamentary transfer. This IRS challenge is especially likely to occur where the transferring client is very elderly, in poor health, or terminally ill. In ***Kimbell*** and ***Strangi***[68] the FLPs were formed two months before date of death, in ***Schauerhamer***[69] the FLP was formed 11 months before date of death, and in ***Harper***[70] the FLP was formed eight months before date of death. In ***Erickson***[71] the assets were transferred to the FLP shortly before the decedent's death. Accordingly, FLPs should be formed and funded as far in

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[66] ***Supra***, note 18.

[67] ***Supra***, note 19.

[68] ***Supra***, note 32.

[69] ***Supra***, note 33.

[70] ***Supra***, note 34.

[71] ***Supra***, note 13.

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advance as possible prior to the client's date of death and should establish a history of operation.

3.16 ***The FLP Interests Should Be Structured as a "Present Interest" if the Goal is to Qualify for the Federal Gift Tax Annual Exclusion***. For a gifted FLP limited partner interest to qualify for the annual gift tax exclusion under Section 2503(b) (currently $12,000 per donee per year, or $24,000 in the aggregate per donee per year for husband and wife donors), the limited partner interests must be a present interest (and may not be a future interest).

In ***Hackl***[72] the Tax Court held that a gifted limited liability company membership interest did not qualify as a "present interest" because the donee could not require distributions from the limited liability company, the gifted membership interest could not be transferred without the manager's consent, and the donee could not cause the limited liability company's liquidation. Although ***Hackl*** was a family limited liability company case, this case's tax principles also apply to FLPs.

In order to avoid the adverse gift tax result of ***Hackl***, to qualify for the gift tax annual exclusion FLP partnership agreements should require annual distributions, provide limited partners with the ability to sell their interests without the consent of the general partner, and allow the FLP's liquidation only pursuant to state law.

[72] 118 T.C. 279 (2002), *aff'd* 335 F.2d 664 (7th Cir. 2003).

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In California, the partners of a FLP, by the consent of the general partner plus 51 percent of the limited partners, can cause the FLP to liquidate.[73] Furthermore, the default provisions of California law state that partners can only withdraw from a FLP upon the occurrence of an event specified in the partnership agreement.[74]

3.17 ***Clients Should Obtain a Qualified Appraisal of the Gifted FLP Interests***. See paragraph 1.5, above, for the importance of obtaining a qualified appraisal. To have the federal gift tax statute of limitations commence running, a qualified appraisal of the FLP interests should be attached to the gift tax return filed with the IRS. Regulations Section 301.6501(c)-1(f)(2) set forth the required items to include in a qualified appraisal, such as a description of the appraisal process employed and the specific reasoning of the valuation.

3.18 ***Should the FLP General Partner Receive a Management Fee***? In operating the FLP, it is a good practice for the general partner to receive reasonable compensation for that general partner's management services rendered to the FLP. Having a management fee paid to the general partner who provides services to the FLP evidences an arm's-length relationship in the FLP's operation. In any event, the FLP's partnership agreement should not waive the general partner's management fee.

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[73] See California Corporations Code ' 15661.

[74] See California Corporations Code ' 15681(b).

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A management fee will be deductible by the FLP for income tax purposes and will be taxed to the recipient general partner at ordinary income rates. Additionally, the management fee is self-employment income to the recipient FLP general partner subject to FICA taxes of 12.4 percent on compensation and self-employment income up to the social security wage base for the applicable year ($97,500 for 2007), plus the 2.9 percent (employee and employer amounts) Medicare hospital insurance tax.[75]

Under the family partnership income tax rules of Section 704(e)(2), if a FLP interest has been transferred by gift or where a family member has purchased a FLP interest from another family member, then the donor (which includes a person from whom another family member has purchased an interest) should receive reasonable compensation for their services to the FLP. The balance of the FLP's income should then be allocated proportionately according to each partner's capital account balance in order to avoid reallocation of the income under the family partnership rules of Section 704(e).

3.19 ***Should the FLP Continue to Be Operated After the Death of the Decedent***? It is helpful if the FLP continues to be operated after the client's death for the benefit of the client's children and other family members who are the continuing partners. The FLP's continuation evidences that the FLP did, in fact, have a

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[75] See ' 1401. Under ' 1402(a)(13) the general partner's distributive share is subject to self-employment income. The distributive share of a FLP limited partner is not self-employment income.

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business purpose in continuing the family's business affairs and to preserve the family's assets.[76]

4. **CHAPTER 14 AND FLP ISSUES**

Congress in 1990 enacted Chapter 14 of the Internal Revenue Code (Sections 2701-2704) to address abusive estate freeze transactions. Estate freeze transactions were either partnership or corporate structures under which a person retained income and management rights of transferred assets, while attempting to transfer appreciation in those assets to other family members. For example, in the FLP area, the parent would receive a preferred interest in the FLP, while the children would receive interests in all future appreciation of the FLP assets and did not participate in FLP management. The main issue with estate freezes (in the FLP area and otherwise) was whether the parents and children received adequate consideration in exchange for what they contributed to the FLP. Because of taxpayer abuses in valuing the parents' preferential rights where the parents would contribute all of the assets to the entity (such as a FLP), Congress enacted Chapter 14. The IRS in past court cases generally has not been successful in attacking FLPs under the Chapter 14 provisions.

4.1 ***IRS Attack Under Section 2703(a)***. The IRS failed in its attack of FLPs under Section 2703(a), when it argued that the FLP should be ignored for valuation purposes in the Tax Court case of ***Strangi I***[77]. In ***Strangi I*** the IRS unsuccessfully argued that the

[76] See ***Rosen***, ***supra***, note 20.

[77] ***Strangi I, supra***, at note 32.

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FLP partnership agreement should be ignored as a prohibited Section 2703(a)(2) restriction on the underlying partnership property.

4.2 ***IRS Attack Under Section 2704(b)***. The IRS has also generally been unsuccessful in arguing that Section 2704(b) can be used to disregard the FLP's restrictions on liquidating the FLP's property for valuation purposes.

Section 2704(b) provides that if there is a transfer of an interest in a partnership to or for the benefit of the transferor's family, and immediately before the transfer the transferor and members of the transferor's family control that entity, any restrictions which limit the ability to liquidate the partnership (referred to as an "applicable restriction") will be disregarded if the restriction lapses in whole or in part after the transfer or the transferor or members of the transferor's family, alone or collectively, have the right to alter that restriction. Importantly, the Section 2704(b) provisions do not apply to commercially reasonable restrictions required by third party financing or as to any applicable restriction imposed by state or federal law.

Accordingly, Section 2704(b) does not apply if the FLP cannot be unilaterally liquidated by the client (and their family) under that FLP's governing state law.[78] The IRS's Section 2704(b)

[78] California law provides that limited partners in a partnership with a fixed term may not withdraw from the partnership prior to the expiration of that fixed term; and that the consent of a majority of the limited partners and the general partner is required for the dissolution of a limited partnership. See California Corporations Code ' 15681(a).

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argument was rejected by the Tax Court in ***Kerr***[79] where the IRS argued that FLP restrictions on liquidating FLP assets were more restrictive than the state law default provisions. The ***Kerr*** court found that Section 2704(b) does not apply to the transfer of FLP limited partner interests from parents to their children because the FLP restrictions were no more restrictive than the default state law restrictions. Similarly, in the first ***Harper***[80] Tax Court case (a California case the IRS later won on other issues) the Tax Court found that the FLPs agreement's terms were no more restrictive than state law and that Section 2704(b) did not apply.

The lesson to be learned from these cases is that the FLP's agreement should be structured so that the liquidation restrictions are no more restrictive than those of the applicable state law. Under California law the FLP (as a limited partnership) can be liquidated by the consent of all of the general partners and a majority of the limited partners.[81] Thus, in a California-formed FLP the client should be a minority limited partner, or if the client does own a majority of the limited partner interests, then the client should not be the general partner. If California's laws are not restrictive enough for the FLP being formed, then the FLP can be organized in another jurisdiction, such as Delaware, in an effort to avoid Section 2704(b).

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[79] 113 T.C. 449 (1999), *aff'd* 292 F.3d 190 (5th Cir. 2002).

[80] T. C. Memo 2000-202. This was the first ***Harper*** case. In the second ***Harper*** case at T. C. Memo 2002-121 the taxpayer lost on the ' 2036(a) issue.

[81] See California Corporations Code ' 15681(a). Under California Corporations Code '15663, a limited partner may not withdraw from a limited partnership until the end of the partnership's stated term.

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5. **TAX PLANNING BY COMBINING FLPS WITH OTHER ESTATE PLANNING TECHNIQUES**

5.1 ***Use of GRATs to Own FLP Interests***. A Grantor Retained Annuity Trust ("GRAT") allows a client/grantor to make gifts at no gift or estate tax cost to younger family members. In a GRAT the client/grantor retains an annuity for a term of years with the remainder interest passing to children or other family members (which remainder interest can go outright to these family members or remain in a trust for the family members' benefit). The annuity must be a "qualified interest" under Section 2702(b), otherwise the GRAT remainder interest would be the entire gift with the client's retained annuity being valued at zero dollars. There are numerous technical requirements for the GRAT to qualify under Section 2702 which are beyond the scope of this outline.

All of the GRAT's income is taxed to the grantor. The income taxes on the GRAT's income may be paid by the client/grantor, and the grantor's payment of the GRAT's income taxes is not a gift to the remaindermen.[82]

A FLP enhances the ability for parents to transfer large amounts of assets to their children gift tax free. The ***Walton***[83] case allows the GRAT to be structured so that the remainder interest has zero gift tax cost. Under ***Walton*** the grantor can retain the annuity for a term of years, which annuity is paid to

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[82] The payment of income taxes by the grantor is not taxable as a grantor gift to the trust under Rev. Rul. 2004-64, 2004-27 IRB 7.

[83] 115 T.C. 589 (2000), IRS *acq.* in Notice 2003-72, 2003-44 IRB 964.

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the grantor/client's estate even if the grantor/client does not survive the full term of the annuity. Thus, under ***Walton*** the annuity period can be presumed actuarially longer, thereby reducing the value of the GRAT's remainder interest.

The grantor/client must survive the GRAT annuity term in order for the GRAT to produce its gift and estate tax savings. If the grantor dies before the end of the GRAT's annuity term, then all of the GRAT's assets are included in the grantor/client's gross estate for federal estate tax purposes.

GRATs work ideally with high yielding assets which appreciate in value. The lower the federal Section 7520 interest rates, the more favorable result that the GRAT produces for reducing the client's gift and estate taxes.

When a client uses a FLP limited partner interest as the property transferred to the GRAT, the value of this gifted FLP limited partner interest can be discounted, thereby increasing the yield to the GRAT remainder interest, which in turn allows for the transfer of a greater amount (in the form of the GRAT remainder interest) to the client's children. Thus, because of the discounted FLP interests the value of the GRAT's remainder interest is lowered.

> **EXAMPLE: Assume that a 60-year old client sets up a FLP to which that client contributes $1,000,000 of assets in exchange for a 75% FLP limited partner interest. Such contributed assets outside of the FLP produced a 6.5% return (or $65,000 per year). Assume also that other family members contribute assets to the FLP in proportion to a 25% FLP interest which they receive back in the form**

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of general and limited partner interests, which contributed assets also yield this same 6.5% return. Assume that the client's FLP limited partner interest (which the client received for the client's $1,000,000 contribution to the FLP) is valued with a 43% valuation discount for a minority interest and lack of marketability. Therefore, the value of the client's 75% FLP limited partner interest is $570,000 ($1,000,000 less a 43% valuation discount). Since this 75% ($570,000 valued) FLP limited partner interest still produces $65,000 of income each year, the client's 75% FLP limited partner interest now has an 11.4% yield after valuation discounts ($65,000 . $570,000 = 11.4%).

Under the GRAT actuarial tables (assuming a Section 7520 AFR interest rate of 5.56%), the 60-year old client's 75% limited partner interest in the FLP (which is valued at $570,000 and produces an 11.4% yield) results in a GRAT remainder value of zero dollars where the GRAT annuity term is 13 years and pays the grantor a $65,000 annuity each year. Thus, this GRAT's remainder interest is transferred tax free to the children.

5.2 ***Use of a Grantor Trust to Purchase FLP Interests***. An installment sale of FLP limited partner's interest to a grantor trust (sometimes referred to as an "intentionally defective income trust") can enable clients to transfer large amounts of wealth to younger generations at no gift or estate tax cost.

A grantor trust is an irrevocable trust in which the trust's income and deductions are allocated to the grantor for federal income tax purposes. Under a grantor trust, the client/grantor sells their FLP limited partnership interests to the grantor trust and receives back an installment promissory note. Since the client/grantor and the grantor trust are treated as the same taxpayer for income tax purposes, there is no sale for income tax

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purposes and the sale to the grantor trust is instead treated as a non-income tax event.[84] The client/grantor is treated as the "owner" of all grantor trust items for federal income tax purposes and, as such, all of the grantor trust's income, deductions and credits are attributable back to the grantor/client. However, the grantor trust is irrevocable for gift and estate tax purposes.

By the fact that the client/grantor pays the grantor trust's income tax burden, further shifts asset value away from the grantor to the grantor trust.

The grantor trust taxes its income to the grantor by "intentionally" violating one of the income tax grantor trust rules under Section 671 to 675 of Subchapter J of the Internal Revenue Code. For example, the grantor could be given the power to substitute assets to the trust of equal value in a non-fiduciary capacity under Section 675.

The client's FLP limited partner interests are then sold to this grantor trust in exchange for an installment promissory note which has an interest rate at least equal to the applicable federal rate ("AFR"). Since recent AFRs have been low, sales of FLP interest to grantor trusts have been attractive from a tax standpoint.

To evidence that the installment promissory note is a bonafide debt instrument for tax purposes, the promissory note should be

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[84] See Rev. Rule 85-13, 1985-1 CB 184, where the IRS held that a transfer of assets to a grantor trust in exchange for the grantor's installment promissory note is not recognized as a sale for federal income tax purposes.

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secured and there should be a fixed schedule for the promissory note's repayment. The grantor trust should have additional assets (other than solely the purchased FLP limited partner interest) in the form of additional assets or personal guaranties of the trust beneficiaries in order to evidence that the promissory note was a commercially reasonable loan, and that a third-party lender would have made a loan on similar terms given the trust's assets and the guaranties of the loan. Also, by having sufficient assets in the trust and guaranties of the promissory note/loan avoids the IRS claim that the transaction should be characterized as a gift with the grantor retaining an income interest under Section 2036 with the resulting inclusion of the trust's assets in the grantor's estate. It is a good practice that the grantor trust (or the beneficiaries who guaranty the installment promissory note) have assets (in addition to the sold FLP limited partner interests) equal to at least 10 percent of the principal amount of the installment promissory note.

The main tax advantage of a grantor trust sale over a GRAT is that in a grantor trust sale the client does not have to survive an annuity term (or the term of the grantor trust's installment promissory note) to obtain the estate tax advantages. If the grantor/client dies before all of the payments are made on the installment note then the value of the unpaid installment note is includable in the client's gross estate for estate tax purposes.

Since the client/grantor and the grantor trust (which is the purchaser of the FLP limited partnership interest) are treated as the same taxpayer for income tax purposes no gain or loss is recognized on the FLP's limited partnership's sale to the grantor

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trust (in exchange for the trust's installment note) nor is any of the interest paid on the installment note taxed to the grantor or deductible by the grantor trust.[85]

One of the areas of tax uncertainty for sales to grantor trusts is that if the grantor dies before the installment note is paid in full to the client/grantor, what happens to the promissory note's deferred gain?[86] Is the installment note's gain triggered on the date of the client's death? Is there a step-up in the Grantor trust's FLP's partnership interest's tax basis on the client's date of death without triggering any gain?

From a tax planning standpoint it is best if the installment promissory note is paid in full to the client before the client's death for, among other reasons, that the IRS cannot argue that the promissory note represents the client's retention of a prohibited income interest under Section 2036.

> **EXAMPLE: Assume, that the client in April 2007 has a $1,000,000 face value FLP limited partner interest which produces $65,000 per year. Assuming a 43% valuation discount, the 75% FLP interest with a discounted value of $570,000 produces a yield of 11.4% per year (or $65,000) per year.**
>
> **Assume that this $570,000 FLP limited partner interest is then sold by the client to a grantor trust in exchange**

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85 Furthermore, the client/grantor may pay the income taxes generated by the FLP interest owned by the Grantor trust without such income tax payments becoming a gift to the client's children, under Rev. Rul. 2004-64, ***supra***, note 82.

86 For a good discussion of these issues, see Laura H. Peebles, ***Death of an IDIT Noteholder***, Trusts and Estates, August 2005, at p. 28.

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for an installment promissory note with a face amount of $570,000 at 4.85% interest per year (this 4.85% is based upon the Federal AFR long-term rate for May 2007), which is amortized and paid monthly over 12 years. The resulting trust's annual installment promissory note payments (of principal and interest fully amortized over 12 years) to the client equals $62,749 per year ($5,229 per month x 12 months). Since the trust receives $65,000 of income each year from the FLP limited partner interest, the trust would have enough money to pay the annual $62,749 interest and principal on the installment promissory note.

In this example there are no income tax consequences on the sale of the FLP interest to the grantor trust. Effectively, the client's 75% limited partner interest's value is being "frozen" in the grantor trust. Assuming that the client lives the entire 12 years, the entire promissory note would then be paid to the client (with total payments of $752,988 of interest and principal to the client over the 12 years). At the end of 12 years, the trust owns a 75% FLP limited partner interest which represents $1,000,000 of underlying FLP assets <u>plus any appreciation</u> in these underlying FLP assets over that 12-year period.

The grantor trust's promissory note could be structured with a demand feature in the client/grantor so that the client can demand immediate full payment of this promissory note from the trust. If the client were to make such a demand, then the grantor trust would have to sell the trust assets (which effectively means the FLP would sell the underlying FLP property), which could generate capital gain to the client.

Importantly, a current sale of a FLP interest to a grantor trust can take advantage of the current tax laws' allowance of FLP valuation discounts, if in the future Congress were to pass tax

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legislation disallowing FLP valuation discounts and sales among family members.

5.3 ***<u>Sale of the Client's GRAT Annuity Rights to a Grantor Trust</u>.*** A GRAT annuity amount must be paid at least annually to the grantor, and the issuance by the GRAT of a promissory note does <u>not</u> constitute payment of this annuity amount.[87] Thus, the GRAT cannot pay the annual annuity by issuing to the client/grantor a promissory note. However, there is nothing in Section 2702 that prevents the GRAT annuity recipient (who is the client/grantor) from selling their annual GRAT annuity. Accordingly, the GRAT annuity recipient (who is the grantor) could arguably assign their annuity rights to a grantor trust in exchange for consideration from that grantor trust (such as a promissory note paid by the grantor trust to the grantor annuity recipient). It is important that this annuity sale by the grantor to the grantor trust <u>not</u> be deemed effectively the issuance of a promissory note by the GRAT through the step-transaction doctrine.[88]

> **<u>EXAMPLE</u>: Under the example of a GRAT at paragraph 5.1, above, where the GRAT is funded with FLP interests, assume that the client who receives the GRAT annuity <u>later each year sells that client's GRAT annuity right</u> (owed by the GRAT to the client for that year) to a grantor trust which has its own separate income-producing assets. Each year, in exchange for the client selling the client's GRAT annuity payment rights to the grantor trust, the grantor/client receives back from the grantor**

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[87] See Reg. ' 25.2702-3(b)(1)(i).

[88] Reg. ' 25.2702-3(b)(1)(i) uses the words "directly or indirectly" when referring to the prohibition of the GRAT from issuing a promissory note to pay the GRAT annuity.

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trust an installment promissory note (with interest at the AFR) equal to the value of the sold GRAT annuity receivable. The grantor trust, can repay the interest on these promissory notes back to the GRAT from the distributions from the purchased GRAT annuity receivable and from other assets that the grantor trust owns.[89]

Is the grantor trust's purchase of an annuity in this example a violation of Section 2702 in that a promissory note is being issued back to the GRAT annuitant? Arguably the above tax plan would satisfy Regulation Section 25.2702-3(b) since the GRAT is not the entity issuing a promissory note. Instead, it is a separate grantor trust that issues the promissory note to purchase the GRAT annuitant's annuity receivable.

5.4 ***Use of FLPs With QTIP and Bypass Trusts***. For clients owning partnership interests in existing FLPs as community property, upon the death of the first spouse, a portion of an existing FLP could be allocated to the trusts owning the deceased spouse's assets (such as a QTIP Trust or a Bypass Trust) and a portion of the existing FLP could be allocated to the surviving spouse's share (or to the surviving spouse's revocable trust which is sometimes known as the "Survivor's Trust"). This split of the clients' FLP interest among various trusts at the death of the first-to-die spouse can produce later valuation discounts since the trusts' FLP interests are not aggregated, but instead the FLP interests are valued separately in each trust. Thus, there is arguably a minority valuation discount where only one trust owns

[89] This structure of a sale to a grantor trust is distinguishable from the adverse taxpayer TAM 9604005, which found the GRAT made its annuity payments with prohibited loans. Under that TAM's facts, there were never any actual GRAT distributions for the annual annuity required to be made by the GRAT, and the grantor effectively loaned monies to the GRAT to pay the annuity. Importantly, in TAM 9604005 the promissory notes were interest free, while in the above example the promissory note issued by the grantor trust to the client bears interest at the AFR.

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the FLP general partner interest (such as the Bypass Trust) and the other trusts own the FLP limited partner interests.[90]

Another post-mortem planning technique is to have assets owned by the trusts owning the first-to-die spouse's assets (the QTIP Trust and Bypass Trust) and the assets of the surviving spouse (owned in the Survivor's Trust) contributed after the death of the first spouse to a new FLP which is formed after the death of the first-to-die spouse. The IRS in a 1999 Field Service Advice Memorandum noted that a QTIP Trust could be funded with FLP interests even though a FLP investment might not distribute income in any given year.[91]

In the cases of ***Mellinger***[92] and ***Lopes***[93] the Tax Court allowed stock held in the QTIP trust to not be aggregated with the stock owned by the surviving spouse for valuation purposes. Thus, under the tax principles of these two cases, no single person or trust would have a majority of the FLP limited partner interests or the controlling FLP general partner interest (except for the trust that actually owned the FLP general partner interest).[94]

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[90] For possible mismatching of the estate tax marital deduction against a FLP's potential ' 2036 inclusion upon the death of the first-to-die spouse, see note 14.

[91] See FSA 199920016 where after the death of the first spouse the QTIP Trust contributed assets to a FLP and the surviving spouse's issue also contributed assets to the FLP. The requirement for annual income under ' 2056(b)(7)(B) for a QTIP Trust was satisfied with such FLP interests. Additionally, this FSA indicated that there was no gift of the QTIP Trust's assets under ' 2519.

[92] 112 T.C. 26, *acq.* 1999-35 IRB 314.

[93] T. C. Memo 1999-225.

[94] However, assets owned by a spousal "general power of appointment marital trust" were aggregated with the

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5.5 ***Transferring Only an "Assignee" Limited Partnership Interest***. In an effort to obtain lower valuations, clients can transfer only an "assignee" FLP limited partner interest, instead of the entire FLP limited partner interest, known as a "substituted" limited partner interest. Transferring only an assignee limited partner interest, arguably, produces a greater FLP valuation discount since the assignee FLP interest does not have the limited partner's voting rights, which results in a greater valuation discount.[95]

5.6 ***Use of Formula Clauses in Making Gifts of FLP Interests***. FLP interests utilizing valuation discounts are subject to IRS scrutiny because of the subjectivity of determining the amount of these discounts (such as minority and lack of marketability valuation discounts). Accordingly, in some cases, taxpayers have utilized "valuation formulas" to transfer FLP interests to family members. Taxpayers over the years have drafted formula clauses in a variety of ways. However, only certain types of formula clauses will be respected for gift tax purposes.

For example, the percentage of FLP interest being transferred by the client to their children can be defined by a formula with any excess FLP interests resulting from a final IRS determination to then pass to a qualified charity. This has sometimes been

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surviving spouse's assets for valuation purposes in ***Fontana***, 118 TC 318 (2002).

[95] An assignee of a limited partnership interest can only become a substitute limited partner under a California limited partnership as specified in the limited partnership agreement or if all of the other partners consent. California Corporations Code ' 15674.

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called a "charitable lid gift" or a "defined value gift," and at least in the Fifth Circuit will be respected for gift tax purposes.[96]

A formula clause must be drafted so as not to be a "price reimbursement" formula clause that was rejected by the IRS in Revenue Ruling 86-41[97] and by the court in the ***Procter***[98] case.

On the other hand, a formula clause that simply defines the amount of the transfer or the identity of who the transferee is (such as to a charity in a charitable lid formula clause), should arguably be effective for tax purpose under the principles of the ***McCord*** case.

The reason that price reimbursement formula clauses were found by the IRS and the ***Proctor*** case to be ineffective tax formula clauses is that such clauses prevent the federal gift tax rules from being enforced, since there would never be a gift tax deficiency in such price reimbursement formula clauses. Thus, the Internal Revenue Service would never have an incentive for auditing such formula gifts. On the other hand, in the ***McCord*** case[99] the Fifth Circuit, in reversing the Tax Court, found that a formula

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[96] See ***McCord***, 461 F.3d 614 (5th Cir. 2006).

[97] 1986-1 CB 300. The IRS held in Revenue Ruling 86-41 that a formula increase in the consideration paid for transferred property (in order to avoid a taxable gift), or a formula that causes a portion of the transferred property to revert to the transferor is a "condition subsequent," and as such is not effective for tax purposes to avoid a taxable gift from being made on the transfer of that property.

[98] 142 F.2d 824 (4th Cir. 1944), *cert. den.* 323 US 756 (1944).

[99] ***Supra***, note 96.

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clause which subsequently transferred increases in value (which would increase gifts) to a charity (which charity qualified for the gift tax charitable deduction) was a permissible tax formula clause.

6. **ADJUSTMENT TO A DECEASED FLP PARTNER'S TAX BASIS, AND THE FLP'S ASSETS' TAX BASES, UPON THE PARTNER'S DEATH**

When a FLP partner dies, that deceased partner's outside FLP interest's income tax basis is adjusted under Section 1014 to its date of death value.[100]

6.1 ***Section 754 Election***. If the deceased FLP partner's outside partnership basis is higher than the deceased partner's share of the FLP's assets' tax basis, then a Section 754 election should be considered in order to adjust the deceased partner's share of its "inside bases" of the FLP's assets under Section 743(b).[101] A Section 754 election (which then causes Section 743 to

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[100] See ' 1014(a)(1). Any income in respect to a decedent (known as "IRD") which is attributable to the deceased partner's partnership interest reduces this fair market value amount under ' 1014(c). If the FLP interest is not discounted for valuation purposes, then the IRD items generally create no problems in the calculation of the FLP outside basis. However, where valuation discounts are applied to FLP interests, the reduction in the deceased partner's outside basis by the undiscounted amount of the IRD items could magnify a reduction in the adjustment downward in the FLP's inside assets' bases. On the other hand, if the IRD items in the FLP's outside tax basis were discounted, then this would avoid magnifying a reduction in the FLP's assets' tax bases.

[101] When a ' 754 election is made, the bases of the FLP's assets will be adjusted in the manner provided in ' 743, in the case of a transfer of FLP interests; and in the manner provided in ' 734, in the case of a distribution of FLP assets. Both ' ' 734 and 743 adjust the distortion between a FLP's inside assets' tax bases and the FLP partner's outside partnership interest's tax basis.

The ' 754 election applies with respect to all transfers of FLP interests during the taxable year in which

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operate) provides for an adjustment in the deceased FLP partner's share of their inside bases of the FLP's assets, which is the difference between the deceased partner's outside FLP interest's tax basis and the deceased partner's share of the inside tax bases of the FLP's assets.

The result of the Section 754 election (with its Section 743 adjustment) is that pre-contribution gain or loss under Section 704(c) with respect to the deceased partner is eliminated.[102]

For example, if the FLP was holding appreciated depreciable real estate, a Section 754 election will probably be beneficial to the deceased partner's estate since it would step up the deceased partner's share of such FLP's real estate's tax basis, thereby increasing future depreciation and amortization deductions to the deceased FLP partner's estate, as well as reducing potential gain to the deceased partner's estate on any FLP sale of that real estate.

6.2 ***FLP Interests Which are Community Property***. If the FLP partnership interest is community property, both the deceased spouse's share of that FLP interest and the surviving spouse's share of that FLP interest receive a basis adjustment under Section 1014(b)(6). The Section 754 basis adjustment to the inside bases of the FLP's assets will apply to both the deceased spouse's and the surviving spouse's share of the FLP's community property

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the election is made and all subsequent taxable years, unless the election is revoked as provided in Reg. ' 1.754-1(c).

[102] See Reg. ' 1.743-1(j).

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partnership interest.[103] In other words, upon the death of either spouse the surviving spouse benefits by the Section 754 election for the entire community property FLP interest.

6.3 ***Taxpayers in Some Cases May Not Be Consistent in Reporting Values For Income Tax and Estate Tax Purposes***. Some taxpayers have tried to have it "both ways" by obtaining FLP valuation discounts for purposes of gift and estate taxes, while valuing for income tax purposes their outside FLP tax basis proportionate to the fair market value of the FLP's underlying assets. For example, upon the death of the client/parent, some children who liquidate the FLP will attempt to value for income tax purposes their inherited outside partnership interest tax basis based on the proportionate value of the underlying FLP assets.[104]

The Ninth Circuit Court of Appeals in ***Janis***[105] affirmed the Tax Court in holding that the beneficiaries of an estate have a "duty of consistency" to use the Estate Tax Return reported value of artwork (which was reported with valuation discounts) when calculating their future income taxes on the sale of that artwork.[106] On the other hand, in ***Shook***[107], the owner of an

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[103] See Rev. Rul. 79-124, 1979-1 CB 224.

[104] The ***IRS Appeals Settlement Guidelines on Family Limited Partnerships and Family Limited Liability Corporations***, effective October 20, 2006, indicates that the IRS is cognizant of some taxpayers using non-discounted values of FLP interests to compute gain upon the liquidation of the FLP and, accordingly, the IRS alleges that these taxpayers improperly understate the reportable income tax on the FLP's liquidation.

[105] 461 F.3d 1080 (9th Cir. 2006).

[106] In ***Janis*** the beneficiaries were also the co-executors of the estate and thus were found to be related to the party that reported the estate tax values.

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inherited property was not the executor of the estate, so the Court held that the owner was not bound for income tax purposes to the estate tax valuation of the stock of a closely held corporation. In ***Shook*** the beneficiary/owner did not make any representation to the IRS on the estate tax value of such stock (since the beneficiary did not file the estate tax return). Accordingly, in ***Shook*** the beneficiary/owner could take a different position on the income tax basis of the stock from that of the estate tax valuation.

6.4 ***Effect of Valuation Discounts on FLP Assets' Bases Adjustment***. Even where discounts for lack of marketability and minority interests are utilized, if the deceased partner's outside partnership basis (valued with valuation discounts) is higher than that deceased partner's share of the underlying FLP's assets, a Section 754 election will in most cases be advantageous to the deceased partner's estate.[108]

Because of lack of marketability and minority valuation discounts of FLP interests, the outside income tax basis of a deceased FLP partner may in certain cases be lower than that deceased partner's proportionate share of the FLP's underlying partnership assets. Under these circumstances, a Section 754

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[107] 713 F.2d 662 (11th Cir. 1983).

[108] The calculation of the FLP's assets' tax bases from the adjustment to the deceased partner's valuation discounted outside basis is not totally clear under the Section 755 Regulations. Under Reg. Section 1.755-1(b)(3)(iii), example 2, there was an adjustment to the partner's outside partnership interest tax basis, which was less than that partner's pro rata share of the partnership's underlying assets' fair market value. This example evidences that the ordinary income class of the partnership's assets receive their entire amount of the adjustment. However, the partnership's capital gain class of property received the remainder of the adjustment allocated among it based on the capital class assets' relative relationship of the fair market value of their assets.

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election can lead to a "step-down" in the deceased partner's share of FLP assets' tax basis. Accordingly, if valuation discounts produce an outside deceased partner's partnership basis which is less than that deceased partner's share of the FLP's inside assets' basis, then no Section 754 election should be made. Note, however, in certain cases the mandatory basis adjustments discussed at paragraph 6.5, below, may apply.

6.5 ***Mandatory Basis Adjustments***. For transfers of FLP interests, including those transfers upon the death of a partner (see Section 743(a)), the FLP in some cases is required to adjust the basis of FLP assets even if no Section 754 election is in effect.

(1) ***Substantial Built-in Loss of Section 743***. The Section 743 basis adjustment rules are mandatory if there is a transfer of the FLP interests (by sale or at the death of a partner) for which there is a "substantial built-in loss" of the FLP's assets.[109] There is substantial built-in loss if the FLP's tax bases in the FLP's total assets exceed by more than $250,000 the fair market value of those FLP's total assets pursuant to Section 743(d)(1). In other words, the $250,000 threshold test is computed as to the entire FLP assets' tax bases over such total FLP assets' value. Thus, the new Section 743(d) rules mandate that the deceased

[109] See ' 743(b). There is an alternative rule for "electing investment partnerships." An electing investment partnership is not treated as having a substantial built-in loss with respect to any transfer. However, a transferee partner of an electing investment partnership is not allowed to recognize allocated losses except to the extent that it is established that the losses exceed the loss, if any, recognized by the transferor on the transfer of the partnership interest. To be an "electing investment partnership," the partnership must make certain elections and qualify under the Investment Company Act of 1940, plus must meet other requirements. Most FLPs will probably not meet this "electing investment partnership" criteria.

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partner's share of the FLP's assets' bases will be reduced as if the FLP had made a Section 754 election. This new Section 743(d) rule mandates negative basis adjustments (but not positive basis adjustments).

The determination of whether there is a "substantial built-in loss" calculation is based on all of the FLP's assets, and if there is a "substantial built-in loss" then the deceased FLP partner's share of the FLP's assets' tax bases is decreased (but only that deceased partner's share of FLP assets) by the excess of: (i) that deceased partner's share of the adjusted bases of the FLP's assets; over (ii) that deceased FLP partner's income tax basis in its partnership interest.

> **EXAMPLE: Assume that the FLP has assets with a total fair market value of $4,000,000 and tax bases of $5,000,000. Assume that a FLP partner owning a 1% limited partner interest dies. Because the total FLP assets' bases exceeds the total fair market value by more than $250,000 (in this example by $1,000,000), the $250,000 loss threshold is met. Thus, the deceased FLP partner's estate will be required to make a mandatory Section 743 downward basis adjustment in its proportionate share of the FLP's assets. The result is a $10,000 downward adjustment (1% of $1,000,000). However, if the deceased partner's outside basis is discounted by valuation discounts, then instead of being worth $40,000 (1% of $4,000,000), the 1% interest might, for example, be worth $24,000 after valuation discounts ($40,000 value less a 40% valuation discount), in which case the Section 743 adjustment would then be a $26,000 downward adjustment ($50,000 share of the assets' inside tax bases less the $24,000 discounted outside basis value), rather than a $10,000 downward adjustment.**

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As the above example illustrates, valuation discounts under the new mandatory valuation adjustment rules of Section 743(b) may magnify and substantially increase the downward bases adjustments of a deceased FLP partner's share of FLP assets.

(2) ***Substantial Basis Reduction of Section 734***. Also, the inside bases adjustment of a FLP's assets is mandatory, rather than elective, under Section 734 if there is a distribution of partnership property for which there is a "substantial basis reduction."[110] A substantial basis reduction means where a downward adjustment of more than $250,000 would be made to the tax bases of the FLP's assets if a Section 754 election were in effect.[111] Accordingly, a Section 734(b) adjustment to the FLP's inside assets' tax bases is required in the liquidation of a partner's interest if the reduction in the tax bases of the FLP's assets (assuming a Section 754 election were in effect) would exceed $250,000. This Section 734(b) provision will be triggered, for example, by a FLP liquidating distribution of appreciated property to a FLP partner with a high outside partnership interest tax basis.

EXAMPLE: FLP partner A has an outside tax basis of its FLP interest equal to $4,000,000, with a value of $5,000,000 (based upon that partner's pro rata portion of the underlying FLP assets). Assume that partner A then receives in complete liquidation of its FLP interest a distribution of $5,000,000 in value of real estate, which real estate has a tax basis of $3,000,000. Partner A takes a $4,000,000 basis in this distributed FLP real estate under Section 732(b) (which is the same basis as

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110 See ' 734(a).

111 See ' 734(d)(1).

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partner A's outside partnership interest tax basis of $4,000,000). The FLP is then required under the Section 734(b) mandatory basis adjustment rule to reduce the FLP's remaining properties' tax bases by $1,000,000 (the amount of the increase in the distributed real property's tax basis on the FLP's distribution to partner A, from $3,000,000 to $4,000,000).

<u>EXAMPLE</u>: The parents establish an FLP to which they contribute assets with a fair market value of $5,000,000. Through the use of their gift tax exclusion, annual gifts and sales, the parents are able to transfer to their children FLP limited partner interests equal to 25% of the FLP's interests. The FLP then distributes property in kind to the children in full liquidation of the children's FLP limited partner interests (which property-in-kind distributed to the children have a fair market value of $1,000,000, with the FLP's tax bases in such distributed property of $250,000). At the time of the property's distribution, the children had an outside tax basis in their FLP interest of $2,500,000. Thus, the tax basis of the FLP's distributed assets to the children receive a positive adjustment to $2,500,000 (from $250,000) under Section 734(b)(2)(B). However, under the new mandatory Section 734 basis adjustment rules, the FLP would have to reduce the tax bases of the remaining FLP assets by $2,250,000 (the difference between the $2,500,000 and $250,000 amounts) under Section 734(d).

If a partner dies and the deceased partner's estate fails to make a Section 754 election, then these new mandatory basis adjustment rules can trigger a reduction in the remaining FLP assets' bases if property is distributed to the deceased partner's estate. This results from the fact that the deceased partner's FLP interests' outside tax basis gets stepped up at death, but without a Section 754 election the FLP assets distributed to that deceased partner's estate have a lower tax basis, which in turn results under Section 734(b) in a decrease to the remaining FLP assets' tax

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bases. The above assumes that there is a substantial basis reduction for the FLP property distributed to the deceased partner's estate. Therefore, in this fact scenario it is advantageous to the continuing partners (along with the deceased partner's estate) that the FLP make a Section 754 election on the partner's death in order to avoid this potential future FLP property tax bases reduction.

6.6 ***How the Section 743 Adjustments Are Made to the FLP's Inside Basis of the FLP's Assets When a Section 754 Election is Made***. Section 755 explains how a FLP partner's adjusted outside partnership interest's tax basis is allocated among multiple FLP assets under Section 743(b) when a Section 754 election is made.[112] The following steps are performed under the Sections 743 and 755 Treasury Regulations:

(1) First, the difference between the partner's outside basis of the partner's FLP interest,[113] and that partner's share of the adjusted bases of the FLP's properties is performed, which is known as the Section 743 adjustment.[114]

(2) Second, the FLP's properties are separated into two classes -- ordinary income property and capital gain property. The allocations are based on the amount of income, gain or loss that would be allocated with respect to the deceased partner's FLP

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112 See ' 743(c).

113 The partner's outside tax basis will be that partner's fair market value of its FLP interest, plus its share of FLP liabilities under ' 752, minus IRD items.

114 Reg. ' 1.743-1.

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interest with respect to each FLP property, if all of the FLP properties were sold for their fair market value in a fully taxable transaction (a "hypothetical sale").[115] The portion of the Section 743 adjustment allocated to ordinary income property is equal to the total income, gain and loss (including remedial allocations) that would be allocated to the transferee with respect to the hypothetical sale of all ordinary income property in the hypothetical sale transaction. The basis adjustment to capital gain property is equal to the total Section 743(b) basis adjustment, less the amount allocated to ordinary income property.[116] If the basis adjustment to the capital gain property is a decrease under the above calculation, then that basis adjustment may not exceed the partnership's basis in capital gain property.[117] Any excess amount is then applied to reduce the basis of the ordinary income property.

(3) Third, the adjustment of each FLP's class's adjustment in their properties (whether a step-up or a step-down for that class's assets) is generally allocated within each class of property on an asset-by-asset basis based upon the taxable gain or loss that would be allocated to the deceased partner's successors from the hypothetical sale of each item of property.[118]

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[115] See Reg. ' 1.755-1(b)(1)(ii).

[116] See Reg. ' 1.755-1(b)(2)(i).

[117] See Reg. ' 1.755-1(b)(2)(i)(B).

[118] Reg. ' 1.755-1(b)(3).

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6.7 ***Determining Whether to Make a Section 754 Election***. Some issues to consider in deciding whether to make a Section 754 election are summarized below:

(1) The election can increase the FLP's accounting and clerical requirements since the FLP will have to keep track of different depreciation and amortization schedules and assets' bases calculations.

(2) The Section 754 election is irrevocable once made, unless the IRS consents otherwise.[119] Accordingly, if there are future partner deaths or future transfers of FLP interests, adjustments to the FLP's assets will have to be made. Some of these adjustments could even produce a decrease in the FLP's assets' tax bases.

(3) If the deceased FLP partner's partnership interest's value is lower than the value of that partner's share of the FLP's assets, then there will be the adverse tax result of stepping down the basis of that partner's share of the FLP's assets' inside tax

[119] It may be difficult to obtain an IRS consent to revoke a ' 754 election. An application for a revocation of a ' 754 election must be filed within 30 days of the end of the partnership year with respect to which the revocation is intended to take effect. At Reg. ' 1.754-1(c), examples of grounds for IRS consent for revocation of a ' 754 election would be: a change in the nature of the partnership's business; a substantial increase in the assets of the partnership; a change in the character of the partnership's assets; and an increased frequency in partnership retirements or partnership interest shifts which have increased administrative burdens.

A common planning technique which is used to revoke a ' 754 election without the necessity of obtaining the IRS's consent is to intentionally terminate the partnership under ' 708(b) by having partners holding 50% or more of the capital and profits of the partnership transfer their interests within a 12-month period.

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bases. However, see the new Sections 734 and 743(d) mandatory basis adjustment rules discussed above.

(4) If the <u>entire</u> FLP liquidates immediately after a deceased partner's death, the deceased partner's share of the FLP's appreciated assets' tax bases receives the benefit of any step-up in the deceased partner's outside tax basis, so a Section 754 election may not then be necessary.

6.8 ***<u>Required Section 754 Notice to the FLP By a Deceased Partner's Estate</u>***. When a FLP partner dies, the transferee partner (for example the deceased partner's estate or revocable living trust) which receives an interest in a FLP having a Section 754 election in effect <u>must notify the FLP</u> of its acquisition of the deceased partner's FLP interest in writing, and such notice must be delivered to the FLP within one year of the death of the deceased partner.[120]

One issue with this notice to the FLP will be determining the fair market value of the deceased partners's FLP interest, since it may be several months after the decedent's date of death before the deceased FLP partner's estate's appraiser is able to prepare the FLP partnership interest appraisal (including any valuation

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[120] See Rev. Proc. 2002-71 and Reg. ' 1.743-1(k)(2)(ii). The estate (or the decedent's revocable living trust) should provide the FLP with the deceased partner's name, address and tax identification number, along with that deceased partner's date of death and the fair market value of the FLP interest in the estate on the deceased FLP partner's date of death.

See Notice 2005-32, 2005-16 IRB 895, which imposes a similar notice requirement where the estate (or revocable living trust) acquires a FLP interest that has built-in losses under the new mandatory basis adjustment rules discussed at paragraph 6.5, above.

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discounts). If there is an IRS estate tax audit, or even litigation between the decedent's estate and the IRS, then the final determination of the value of the deceased FLP partner's interest could take several years. Upon the final determination of the federal estate tax fair market value (including any discounts) of the deceased partner's FLP interest, the inside tax bases of the FLP's assets attributable to that deceased partner can then be determined if a ' 754 election has been made.[121]

When a Section 754 election is in effect and the FLP has knowledge of the deceased partner's transfer, then the FLP is required to attach a statement to the FLP's income tax returns.[122] This FLP statement contains the deceased partner's name, taxpayer identification number, and the computation of the deceased partner's adjustment under Section 743(b).

7. AVOIDING A CHANGE OF OWNERSHIP FOR FLP-OWNED REAL ESTATE UNDER THE CALIFORNIA PROPERTY TAX RULES

Many FLPs are funded with contributed real property which has been owned by the client for many years, and thus this real estate has a low property tax assessed value due to California's Proposition 13.[123] Clients generally do not want to lose the benefit of their real estate's low assessed property tax basis when their real properties are transferred to the FLP. In other words,

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[121] The FLP and the deceased partner's estate can amend their income tax returns at the time of such final valuation determination for tax years falling within the three-year income tax statute of limitations.

[122] See Reg. ' 1.743-1(k)(1).

[123] See California Constitution Article 13A, and California Revenue and Taxation Code ' ' 60-63.1.

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clients do not want to have a "change of ownership" of their contributed real property which would result in a reassessment of that real property for California property tax purposes.[124] The California statutes and property tax rules promulgated under Proposition 13 provide planning opportunities to structure the transfer of real properties to FLPs and FLP interests to family members, while avoiding a change of ownership.

7.1 ***Same Ownership Exception of Section 62***. The California statute and rules provide that if real property is transferred to a FLP in which the former co-owners of that real property own FLP interests exactly equal to their prior co-ownership interests in that transferred real property, then the transfer does not constitute a change in ownership.[125] This is sometimes referred to as the "original co-owner rule."

7.2 ***Change of Ownership Exception For Transfers Among Family Members***. A transfer of real property between husband and wife is not a change of ownership.[126]

An important exception to a change of ownership in planning FLPs is that a transfer of property between a parent and a child is not a change of ownership to the extent the aggregate full cash value (for property tax purposes) of all property transferred under this exemption is $1,000,000 or less; or that the transferred

[124] See California Rev. and Tax. Code ' 60.

[125] See California Rev. and Tax. Code ' 62(a)(2).

[126] See California Rev. and Tax. Code ' 63.

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property is the transferor's principal residence.[127] It should be noted that this parent-child exemption does not apply to the transfer of FLP interests between parents and their children, but only applies to the transfer of the real property between parents and their children. Therefore, when parents transfer real property to a FLP in which their children are to receive FLP interests, the parents should use a two-step process. First, the parents should transfer a portion of their real estate's fee interest to their children utilizing the parent-child property tax exemption. Second, the parents and their children should then transfer their respective interests in the real estate into the FLP utilizing the "original co-owner rule" of Section 62(a)(2).

7.3 ***Later Transfers of FLP Interests in an Operating FLP***. Later transfers of FLP interests (whether by a gift or a sale) can in certain circumstances trigger a change of ownership of the underlying FLP real property.

If, upon the FLP's formation, the FLP claimed the benefit of the "original co-owner rule" of Section 62(a)(2) as a change solely in the manner of holding title to the real property, these original co-owners who created the FLP are referred to as the "original co-owners." If these "original co-owners" then subsequently transfer in the aggregate FLP interests constituting more than 50 percent of the FLP capital and profits, a change in ownership of all of this

[127] See California Rev. and Tax. Code ' 63.1. The $1,000,000 exclusion applies for each eligible transferor/parent. A grandchild would qualify for this exception to receive a transfer of property from their grandparent if that grandchild's parent (which grandchild's parent is the child of the grandparent transferring the property) is then deceased.

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previously contributed FLP real property will result.[128] Thus, a change in ownership of all of this previously contributed FLP real property will occur once the transfers of FLP interests cross this 50 percent threshold limitation. Accordingly, if the parents form the FLP using the original co-owner rule, then the parents should not later transfer more than a 50 percent interest in their FLP interests in order to avoid a change of ownership and a reassessment of the FLP's underlying real property. However, the parents (who are original co-owners) deaths may result in a greater than 50 percent FLP interest transfer, thereby causing a change of ownership to the FLP's previously contributed property.

Another property tax rule which can cause a change of ownership to occur is the so-called "control rule." Under the control rule, if any person acquires a greater than 50 percent interest in the FLP's capital and profits, then a change of ownership results and a reassessment of the FLP's property occurs.[129]

7.4 ***Transfers of Real Property From a FLP***. A FLP may want to transfer some or all of the FLP's real properties to the FLP's partners. For example, children after the death of their parents may wish to liquidate real properties from the FLP. Alternatively, during the life span of a FLP, the FLP may distribute real properties to only certain partners. These real property distributions from a FLP can cause a change of ownership to the distributed real property. To avoid such a change of ownership,

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[128] See California Rev. and Tax. Code ' 64(d) and California Code Regs. 462.180.

[129] See California Rev. and Tax. Code ' 64(c).

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all of the FLP partners must receive distribution of FLP real property in the exact same ownership percentages as such partners' FLP interests.[130] This is the "original co-owner rule" discussed at paragraph 7.1, above.

> **EXAMPLE: Assume that the FLP is owned by the parents' four children in equal percentages (25% each). The FLP consists of four real properties, each property having an equal value. The parents died over 10 years ago, and the children now wish to liquidate the FLP, with each child to receive one real property on the liquidation. If each child receives a 100% interest in one of the four real properties in liquidation of the FLP, there will be a change of ownership as to each real property distributed to the children, since each child owns a 100% interest in their own respective real property after the distribution (not a 25% interest in each of the four real properties). Thus, the proportionate ownership of each of the four properties changed under Section 62(a)(2) on the properties' distribution, resulting in a change of ownership for all four properties.**
>
> **An alternative tax plan to avoid this change of ownership is instead for the four children to each receive a 25% tenancy-in-common interest in each real property upon liquidation of the FLP, and then have the children later do a Section 1031 tax-free exchange of their real property interests among themselves. Note, however, that there may be a "holding" issue for Section 1031 income tax purposes, as well as a step-transaction issue for California property tax purposes.**

[130] See California Rev. and Tax. Code ' 62(a)(2).

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8. **INCOME TAX ISSUES WHEN A FLP MAKES DISTRIBUTIONS TO THE FLP'S PARTNERS**

8.1 ***Rules on FLP Distributions***. Partners generally recognize no gain on distributions from the FLP nor is the FLP required to recognize gain or loss on a distribution of money or property to the partners under Section 731.[131] There are, however, exceptions to this general tax rule, as discussed below.

When gain is recognized by a FLP partner on receipt of a FLP distribution, the gain generally is capital gain under Section 741.

(1) ***Money or Securities***. First, a partner recognizes capital gain to the extent of the value of money or marketable securities that partner receives from the FLP in excess of that partner's outside basis in that partner's FLP interest under Sections 731(a)(1) and (c)(1). Also, that partner is deemed to receive a constructive cash distribution from the FLP to the extent that the FLP partner is relieved of all or any portion of the FLP's liabilities under Section 752.

(2) ***Special Statutory Exceptions***. Second, there are exceptions where the Section 737 anti-mixing bowl rules apply and for Section 751 assets.

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[131] A loss is not recognized in a FLP distribution to a partner which is not in liquidation of that partner's entire partnership interest, and if the distribution is in liquidation of that partner's FLP interest, only if the property received on distribution consists of money, unrealized receivables and/or inventory. If the FLP partner receives any other property on liquidation, then no loss is recognized and the FLP partner's basis for such other received property is the remaining tax basis of that partner's outside interest in the FLP.

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8.2 ***Recipient Partner's Tax Basis in the Property Which That Partner Receives in Distribution From the FLP***. If the FLP distributes property other than money to a partner in a non-liquidating distribution, then the recipient partner's adjusted tax basis in the received property will be the lesser of: (i) the FLP's basis in that property immediately before distribution; or (ii) that receiving partner's tax basis in his partnership interest (i.e., that partner's outside tax basis), less any money distributed or deemed distributed (such as by forgiveness of liabilities) to that partner in that distribution.[132]

When a FLP partner's interest is liquidated, then a different set of tax rules apply to calculate the recipient partner's basis in the property received from the FLP. If property (other than money) is distributed to a FLP partner in liquidation of that partner's FLP interest, then under Section 732(b) the recipient partner's tax basis in the received property will equal that partner's tax basis in their FLP interest (i.e. their outside tax basis) less any money distributed in connection with that liquidation.

8.3 ***Adjustment to the Tax Basis of the Remaining FLP Assets When a FLP Makes a Distribution to a FLP Partner***. When FLP property is distributed to a partner, generally no gain or loss is recognized by the FLP under Section 731(b). If a Section 754 election has been made, then the FLP adjusts the tax basis of the remaining FLP assets under Section 734(b) where the recipient partner's basis in that distributed property varies from the FLP's

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[132] ' ' 732(a)(1) and 733.

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basis in that distributed property. Under Section 734(b)(1), if the distributee partner recognizes gain on the distribution or if the distributee partner's tax basis in the distributed property is less than the FLP's tax basis in that distributed property, then the FLP is required to increase the FLP's basis of the remaining FLP property to the extent of the recognized gain or the excess of the FLP's basis in the distributed property over the distributee partner's basis of the distributed property. See paragraph 6, above, for a detailed discussion of Section 754 and mandatory FLP property basis adjustments.

8.4 ***Distributions By a FLP of Marketable Securities to a FLP Partner***. It is common for FLPs to own marketable securities and to distribute these marketable securities to FLP partners.

For purposes of Sections 731(a) and 737, marketable securities are treated as money received by the partner to the extent of the fair market value of such marketable securities on the date of their distribution to the partner.

Any gain which is recognized on the FLP distribution of marketable securities to the partner then increases the tax basis of the distributed securities in the hands of the distributee partner.[133]

Importantly, the amount of the gain recognized by a FLP partner receiving marketable securities as a distribution is reduced by that partner's share of the FLP's net appreciation in

[133] See Reg. ' 1.731-2(f)(1)(i).

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the securities which that partner receives.[134] If the fair market value of the marketable securities distributed to the FLP partner exceeds that partner's basis in that partner's FLP interest (i.e. that partner's outside basis), then that portion of those marketable securities treated like money may be reduced by that distributee partner's share of the unrealized gain in those marketable securities.[135]

The following Regulations' examples explain this marketable securities calculation at Regulation Section 1.731-2(j):

> **EXAMPLE: A and B form a partnership as equal partners. A contributes property with a fair market value of $1,000 and an adjusted tax basis of $250. B contributes $1,000 cash. The partnership then purchases security X for $500 and immediately distributes security X to A in a current distribution. The tax basis in A's partnership interest at the time of the distribution is $250. The distribution to A of security X is treated as a distribution of money to A in an amount equal to the fair market value of security X on the date of distribution (which is $500).**
>
> **Note that the amount of the distribution that is treated as money to A is not reduced under Section 731(c)(3)(B) because if that security had been sold immediately before the distribution, there would have been no gain recognized by the partnership and A's distributive share of the gain would therefore have been zero (security X's**

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[134] This treatment of marketable securities under ' 731(c) does not require that the FLP recognize gain on the distribution of the marketable securities. Additionally, Reg. ' 1.731-2(f)(1)(ii) indicates that there is no basis adjustment to the recipient partner's partnership interest under ' 733 for the gain recognized by the distributee partner, nor is there any adjustment to the basis of the FLP's property under ' 734 for the gain recognized by the distributee partner under ' 731(c). Reg. ' 1.731-2(f)(2).

[135] See ' 731(c)(3)(B).

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value and tax basis are both $500). As a result, partner A recognizes $250 of gain under Section 731(a)(1) on the partnership's distribution of security X to A (the $500 distribution of money/security X less the $250 adjusted tax basis in A's outside partnership interest).

EXAMPLE: A and B form a partnership as equal partners. The partnership subsequently distributes security X to A in a current distribution. Immediate before this distribution to A, the partnership held securities with the following fair market values, adjusted tax basis, and unrecognized gain or loss:

Security	Fair Market Value	Tax Basis	Gain (loss)
Security X	$100	$70	$30
Security Y	$100	$80	$20
Security Z	$100	$110	($10)

If the partnership sold the securities for fair market value immediately before the distribution of the securities to A, the partnership would have recognized $40 of net gain ($30 gain on security X plus $20 gain on security Y, minus $10 loss on security Z). Each of partners' A and B distributive share of this gain would have been $20 (one-half of $40 net gain to each of A and B). If the partnership had sold the remaining securities immediately after the distribution of security X to A, the partnership then would have $10 of net gain ($20 of gain on security Y minus $10 loss on security Z). Partner A's distributive share of this gain would have been $5 (one-half of $10 net gain). As a result, the distribution of security X to A resulted in a decrease of $15 in Partner A's distributive share of the net gain in the partnership's securities ($20 net gain before distribution minus the $5 net gain after distribution).

Therefore, under Section 731 the amount of distribution of security X that is treated as a distribution of money to partner A is reduced by $15. The distribution of

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security X is therefore treated as a distribution of $85 of money to A under Section 731(c) ($100 fair market value of security X distributed to A minus the $15 reduction).

(1) ***Definition of Marketable Securities***. "Marketable securities" are defined as being financial instruments and foreign currencies which are, as of the date of distribution, actively traded.[136]

(2) ***Exceptions to Marketable Securities Rule***. In the FLP area there are the following three exceptions to be aware of to the above marketable securities rules:

First, marketable securities are not treated as money when distributed to that partner who contributed that security. However, under this rule there is no provision to treat the transferee of a FLP interest as the contributor of the same security that the transferor contributed. Thus, if parents contribute marketable securities to a FLP and then receive distribution of those same securities, the parents do not treat any part of those distributed securities as money. However, if the parents sell or gift their FLP interests to their children and their children later receive from the FLP a distribution of those securities (previously contributed to the FLP by the parents), the children are not treated as contributing those securities to the FLP and thus must treat the receipt of those securities as a receipt of money.[137]

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[136] ' 731(c)(2)(A).

[137] Reg. ' 1.731-2(d)(1) does not allow the children to "step-in-the-shoes" of their parents for the ' 731(c)

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Second, is if the marketable securities were not marketable securities when acquired by the FLP, then they will not be treated like money.

Third, is if the marketable securities are distributed by an entity (i.e. the FLP) classified as an "investment partnership" to an "eligible partner."[138] A FLP will qualify as an "investment partnership" for purposes of Section 731(c) if: (i) that FLP has never been engaged in a trade or business; and (ii) substantially all of the assets of the FLP always were in the form of money, stock, notes, bonds, debentures or other assets as identified in the Regulations. An "eligible partner" is a partner who has never contributed non-investment type assets to the partnership. "Substantially all" means consisting of 90 percent or more marketable securities or monies. This investment partnership exception may apply in the FLP area where, for example, the FLP at all times consists of marketable securities.

8.5 ***Application of Anti-mixing Bowl Rules to FLPs***. Congress enacted the anti-mixing bowl rules to prevent partners from contributing appreciated property to a partnership, followed by those partners withdrawing from the partnership different properties than those properties which the partners initially contributed. The anti-mixing bowl rules are contained in Internal Revenue Code Section 704(c)(1)(B), Section 737 and Section 731(c).

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marketable securities rules.

[138] See Reg. ' 1.731-2(d).

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A full discussion of these rules is beyond the scope of this outline.

(1) ***Anti-mixing Bowl Rule For Later Distributions of Contributed Property, Section 704(c)(1)(B)***. If a partner contributes property to a FLP in which that contributed property's book or fair market value is greater than that property's tax basis, then this contributed property is referred to as Section 704(c) property. If the FLP later distributes such previously contributed "Section 704(c) property" to another FLP partner (other than the partner who contributed that property to the FLP) within seven years of the partner's contribution of that property to the FLP, then the contributing partner must recognize gain or loss.[139] The amount of gain is the amount of that distributed property's remaining Section 703(c) gain on the date of the property's distribution.

In FLPs it is common for appreciated real estate, appreciated securities and other appreciated property to be contributed to the FLP by parents (and even other family members) upon the FLP's formation. Accordingly, many FLPs contain "Section 704(c) property." If this Section 704(c) property is then later distributed by the FLP to partners other than the contributing partner, that contributing partner will have potential recognized gain on that property's distribution.

An additional consequence of partners contributing Section 704(c) property to the FLP is that the contributing partner's

[139] See ' 704(c)(1)(B).

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amortization and depreciation deductions relating to such contributed property are calculated under an elected Section 704(c) method, known as the traditional method, the remedial method or the curative method. The recovery of the amortization/depreciation deductions over time gradually reduces the amount of the 704(c) gain to the contributing partner.

When a parent transfers a FLP interest to their children by gift, sale or otherwise, the parent's built-in Section 704(c) gain attributed to that FLP interest is also transferred to those donee/children.[140] Built-in losses are also transferred to the child, but only for contributions of built-in loss property contributed on or before October 22, 2004.[141]

(2) ***Application of Anti-mixing Bowl Rules of Section 737 to FLPs***. Under Section 737(a) a partner who makes a contribution of Section 704(c) property to a FLP will be taxed if that partner later receives a distribution of any other FLP property within seven years of that partner's contribution of the appreciated "Section 704(c) property" to the FLP. Section 737 taxes the contributing partner who later receives other property distributions from the FLP. The gain that is taxed to the contributing partner under Section 737 is limited to the excess of the received property's fair market value over the recipient partner's outside tax basis. Under Section 737 the distributee FLP partner recognizes gain (but not loss) equal to the lesser of (i)

140 See Reg. ' 1.704-3(a)(7).

141 See ' 704(c), and the fact the children step in the parent's shoes under ' 704(c)(1)(B) for the same contributed property.

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the excess (if any) of the fair market value of the property (other than money) received from the FLP over the adjusted basis of that partner's FLP interest immediately before the distribution; or (ii) that partner's "net pre-contribution gain." The net pre-contribution gain is that gain that would be allocated to the distributee partner under Section 704(c)(1)(B) if all the property that had been contributed by that partner to the FLP immediately before the distribution where distributed to another partner.

Under Section 737, distributions to a partner of that partner's own previously contributed property are not taken into account for purposes of Section 737.[142] It is not clear, as was the case under Section 704(c)(1)(B), if a transferee FLP partner (such as a child) "steps into the shoes" of the transferor partner under the Section 737 rules. Thus, it is not clear if the parents' gift of a FLP interest to their children will cause those children to step into the parents' shoes (for the parents' portion of the transferred Section 704(c) gain or loss property) for the donee/child to be treated as the contributing partner for determining whether that child received the distribution of that child's previously contributed property back to the child under Section 737(d)(1). The Treasury Regulations are unclear as to whether the Section 737(d)(1) contributed property exception applies to a transferee child, since these Regulations only refer to the original contributing partner, and not to a transferee partner.[143]

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[142] See ' 737(d)(1).

[143] See Reg. ' 1.737-2(d)(1). Commentators disagree as to whether the transferee (i.e. the child) partner would step into the shoes of the parent as to the receipt of previously contributed property being distributed back to the child. See Carol A. Cantrell, ***Avoiding "Oops" With Partnerships in Your Estate or Trust***

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(3) ***Priority of Mixing Bowl Rules Application to Marketable Securities***. Where several of the mixing bowl provisions apply to distributions of marketable securities, the Treasury Regulations at Section 1.731-2(g)(2)(i) indicates the priority of application. Section 704(c)(1)(B) applies first, followed by Section 731(c) and then Section 737.

In summary, first, distributions by FLPs of marketable securities or money to the FLP partner may cause the recipient FLP partner to recognize gain under Section 731(a), and second, gain may be recognized under the Section 737 anti-mixing bowl rules where a FLP partner receives distributions of marketable securities which have pre-contribution gain[144] within seven years of that partner's contribution of 704(c) property to the FLP. In terms of the ordering rules, the calculation of gain under Section 731(c) is first applied before the Section 737 gain is calculated, and any portion of the marketable securities that is treated like money under Section 731(c) is then ignored for purposes of applying Section 737.[145]

8.6 ***Liquidation of a FLP Partner's Interest***. If a FLP partner's partnership interest is entirely redeemed or liquidated,

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Administration, Chapter 10, 2006 *Heckerling Institute on Estate Planning*. Also, see Ferguson, Freeland and Ascher, ***Federal Income Taxation of Estates, Trusts & Beneficiaries***, 3rd Ed., at & 4.04[A].

144 Pre-contribution gain is the gain which the contributed securities (or other property) would have, and is the difference between the property's fair market value (or book value) and its tax basis on the date of the property's contribution to the FLP.

145 See Reg. ' 1.731-2(g).

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then the tax consequences are analyzed under Section 736. Section 736 provides that generally upon a liquidation of a FLP interest the provisions of Section 731 apply. Furthermore, if the entire FLP is liquidated, then the FLP distributions to all of the partners are taxed under Section 731 without applying Section 736.

Payments made in liquidation of a retiring FLP partner's interest are treated as payments in exchange for a partnership interest, usually resulting in capital gain or loss treatment under Section 731. Payments by the FLP for the liquidation of a partner's interest are split into payments in exchange for "property" under Section 736(b) (which are taxed under the general distribution rules), and other payments that are treated as either guaranteed payments or distributive shares of partnership income under Section 736(a) (so they are not subject to the general distribution rules).

If a FLP distribution alters the recipient partner's interest in the FLP's Section 751 assets,[146] such as increasing the recipient partner's interest in Section 751 property, and decreasing that partner's interest in other FLP assets, a portion of the Section 751 property which is "distributed" to that partner is then treated as acquired in a taxable transaction in exchange for that recipient partner's interest in the other non-Section 751 property. The result is that the taxable gain could be triggered under Section 751(b).

[146] Section 751 assets include unrealized receivables, inventory items which have substantially appreciated in value, and ordinary income depreciation recapture amounts under ' ' 1245 and 1250.

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If a decedent's estate (or their revocable living trust after death) receives cash in the liquidation of the estate's interest, then the estate has gain or loss to the extent that the received cash exceeds the estate's tax basis in the estate's FLP interest under Section 731(a). However, because there is an adjustment at the date of death under Section 1014 in the partnership interest to its fair market value, a redemption for cash will generally produce no gain (or loss) to the redeemed estate.[147] The adjustment to the outside basis of the partnership interest under Section 1014 will generally offset any gain or loss caused by a Section 704(c) built-in gain account. However, these anti-mixing bowl rules could trigger gain for property which appreciates after the date of the partner's death which is later distributed within the seven-year window, or if there are valuation discounts which do not fully offset the gain.

8.7 ***Anti-mixing Bowl Rules Upon Dissolution and Liquidation of the FLP***. If a FLP is dissolved and liquidated, then the anti-mixing bowl rules may apply in certain circumstances.

(1) ***Section 704(c) Gain***. If in the course of a FLP's liquidation the FLP's assets are sold, then the Section 704(c) gain will be allocated to the partners to the extent of pre-contribution gain.[148] If a Section 754 election is made as to the deceased partner's successors, the Section 704(c) gain of the deceased

[147] If there are appreciated marketable securities which are distributed to the estate, then under ' 731(c)(1) discussed above, there may be gain resulting to the estate. However, an exception would be if the estate's share of the appreciation in the securities can reduce the amount of gain, or if a ' 754 election were made.

[148] ' 704(c).

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partner can be eliminated, since there will be a adjustment in the deceased partner's share of that FLP assets' inside tax basis.

(2) ***Distributions of FLP Assets to Partners in Liquidation***. Upon liquidation, the FLP asset distributions to FLP partners are subject to the anti-mixing bowl rules previously discussed. For example, if property is distributed by the FLP to a partner, which property was previously contributed to the FLP by another partner within the past seven years, then the contributing partner will be required to recognize gain under Section 704(c)(1)(B). However, if the contributed property is distributed to the contributing partner or to the donee of the contributing partner (such as a child/donee who received their FLP interest from their parents), then gain is avoided.[149]

Similarly, the Section 737 anti-mixing bowl rules' gain may apply. Under Section 737 a child/donee later receiving assets from the FLP may have to recognize gain to the extent of pre-contribution gain on its parents' previously contributed property to the FLP, or if it is less, the excess of the value of the property distributed by the FLP to that child over that child's outside FLP interest's tax basis prior to the distribution (less any money distributed in the distribution to that child), if such distribution is made to the child within seven years of the property contribution to the FLP by the parent.[150]

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149 See Reg. ' 1.704-4(d)(2) and the step-in-the-shoes rules of Section 704(c)(1)(B).

150 See Reg. ' ' 1.737-1(c)(2)(iii); and 1.737-2(d)(1). However, as discussed at paragraph 8.5, ' 737 arguably does not contain the same step-in-the-shoes rules of ' 704(c)(1)(B) where a parent has contributed appreciated property to a FLP.

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To the extent that a FLP distributes marketable securities to a partner in liquidation of the partner's FLP interest, regardless of whether made within seven years after the FLP formation, a portion or all of the marketable securities may be treated as "money" in computing gain on the distribution under Section 731. See paragraph 8.4, above, for a discussion of the distribution of marketable securities.

9. FLP INCOME WHICH IS "INCOME IN RESPECT OF A DECEDENT"

When a FLP partner dies, their FLP interest generally receive an adjusted outside tax basis under Section 1014.[151] However, that deceased partner does not receive an adjusted Section 1014 basis for that portion of the deceased partner's FLP interest attributable to "income in respect of a decedent" (known as "IRD") pursuant to Section 691.[152] The tax basis of the deceased partner's FLP interest is reduced to the extent that such deceased partner's partnership interest's value is attributable to items constituting income in respect of a decedent.[153]

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[151] Valuation discounts which are assigned to IRD have no effect on the amount of IRD reported because the entire amount of IRD is taxable.

[152] See ' 1014(c) which denies a beneficiary a ' 1014 increase in basis for IRD items; and Reg. ' 1.742-1. The Eighth Circuit and the Ninth Circuit Courts of Appeal have refused to permit the tax basis of partnership interests to be increased to reflect the value of the partnership's assets that would be IRD if such partnership IRD items were inherited directly. See ***George Edward Quick Trust***, 444 F.2d 90 (8th Cir. 1971), and ***Chrissie H. Woodhall***, 454 F.2d 226 (9th Cir. 1972). The ***Woodhall*** case suggests that FLP IRD items would include any FLP items that would be IRD if the items were held by the deceased partner in that deceased partner's individual capacity.

[153] See Reg. ' 1.742-1.

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Thus, the deceased FLP partner's interest does not receive an adjusted tax basis for IRD items, whether or not a Section 754 election has been made. Examples of IRD would be: (i) Section 736(a) payments being paid by the FLP to a deceased partner in liquidation of that deceased partner's interest; (ii) the decedent's share of partnership income for the partnership year during which the decedent's death occurs[154]; and (iii) income rights held by the FLP that would be IRD if held directly by that deceased partner (an example is zero-basis accounts receivable of a service type partnership, such as a law or accounting partnership).[155]

9.1 ***Deduction of Estate Taxes Paid For IRD Items***. A basic tax rule is that estate taxes attributable to IRD is deductible for income taxes under Section 691(c).[156] Thus, a decedent's estate (or their living trust) which is a partner of a FLP that has IRD will be entitled to an IRD income tax deduction based on the estate's proportionate share of IRD items during the estate's ownership.[157]

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154 See Reg. ' 1.706-1(c)(3)(i). A deceased FLP partner's share of FLP income must now be included on such partner's final income tax return, and thus this IRD rule probably has no further application.

155 The various Courts of Appeal and commentators are not in agreement as to whether zero-basis accounts receivable should be an item of IRD. See McKee, Nelson and Whitmire, ***Federal Taxation of Partnerships and Partners***, 3rd Ed., at & 23.03[2][c] and & 24.08[1]. For an excellent discussion of IRD items and cash basis accounts receivable owned by partnerships, see Ferguson, Freeland and Ascher, ***Federal Income Taxation of Estates, Trusts & Beneficiaries***, 3rd Ed., at & 4.02.

156 IRD items are subject to both an estate tax under ' 2033 and an income tax under ' 691. Section 691(c) mitigates the effect of this double taxation. See Reg. '' 1.691(c)-1 and -2.

157 A partner (such as the estate partner of the FLP) that reports IRD is allocated its portion of the IRD for the time period before the estate disposes of the IRD item under the allocation rule of ' 706(c)(2).

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9.2 ***Transferring FLP Interests With IRD to Satisfy Pecuniary Bequests at Death***. If the decedent's estate (or living trust) transfers a FLP interest to satisfy a pecuniary bequest (such as distributing a FLP interest to satisfy a specific dollar amount which is required to be distributed to a subtrust), then the estate could recognize gain on this FLP interest transfer if the FLP interest being transferred has a higher value on its date of transfer than its value on the deceased partner's date of death (which date of death basis arguably is reduced by IRD items).[158] Such estate distributions are treated as deemed sales of the FLP interests by the estate. In reaching this result of a potential gain for pecuniary bequests, the IRS might look through the FLP to the underlying FLP IRD items. Thus, a FLP that owns installment notes or cash basis accounts receivable may arguably generate recognized IRD income for pecuniary bequests. However, taxpayers can refute this IRS argument by pointing out that the FLP should be viewed as an entity and that the IRS should not be able to "pierce" through the FLP for underlying FLP IRD items.

On the other hand, if FLP interests (including those with IRD items) are transferred as a residuary bequest or a specific bequest (for example, as part of a fractional share or a specific bequest of the FLP interest to a specified person), then there is no recognition event, and the recipient only recognizes the IRD when the IRD is received.[159]

10. **ISSUES WHEN A TRUST OWNS A FLP INTEREST**

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[158] See Reg. ' ' 1.661(a)-2(f); and 1.651(a)-2(d).

[159] See ' ' 102(a) and 643(e)(4); and Reg. ' 1.691(a)-4(b)(2).

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It is common for FLP interests to be owned in a trust. For example, upon the death of the first spouse, a FLP interest may be owned by the Bypass Trust, QTIP Trust or Survivor's Trust (see paragraph 5.4, above). Clients many times fund GRATs or grantor trusts[160] (sometimes referred to as a defective income trust) with FLP interests to achieve certain tax advantages (see paragraphs 5.1 and 5.2, above). Additionally, the general partner of the FLP might be a trust as described in paragraph 3.12, above, or the parents may simply want their minor children's FLP interests to be owned in an irrevocable trust (rather than outright by their minor children).

For trusts owning a FLP interest, there are unique tax and trust fiduciary accounting issues which the tax professionals must be aware of. First, there is the income tax issue of the trust being able to deduct for federal income tax purposes the income which the trust distributes to trust beneficiaries in the form of FLP interests, FLP cash or FLP property distributed to a trust, or other trust assets. Second, there are issues of trust fiduciary accounting and allocations of FLP items between trust income and trust principal under the fiduciary accounting rules of the trust instrument or applicable state law (such as the California Uniform Principal and Income Act[161]).

10.1 ***Trust Income Tax Rules***. A trust or estate has an income tax imposed on it. However, the trust is entitled to deduct from

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[160] A grantor trust will have all of its income taxed to the grantor.

[161] See California Probate Code ' 16320 **et. seq.**

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trust income the cash or in-kind amounts which the trust distributes to trust beneficiaries. A trust may deduct for income tax purposes: (i) the income of the trust for the tax year <u>required to be distributed currently</u> (though not actually distributed during the year); and (ii) any other amounts promptly paid or credited, or required to be distributed by the trust.[162] There is a ceiling on the amount of the trust's income tax deduction, which is that the deduction is limited to the trust's "distributable net income" (known as "DNI") for that tax year.[163]

If the trust distributes property in kind (such as a FLP partnership interest) to a trust beneficiary, then such trust distribution is taken into account at such property's fair market value on the date of the distribution. This trust distribution includes trust discretionary distributions. The trust's deduction (or that of a deceased FLP partner's estate) for the distribution carries out to the distributee trust beneficiary a DNI deduction, which DNI amount is then included in the beneficiaries' gross income.[164] The beneficiaries' reportable income is limited by the trust's DNI. Accordingly, where there are multiple recipients of trusts (and estate) distributions, the DNI is allocated among these recipient beneficiaries based upon the actual distributions received by each beneficiary and each beneficiary's distribution is

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[162] See '' 651(a) and 661(a).

[163] See '' 651(b) and 661(a).

[164] See '' 652(a) and 662(a).

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then deemed to consist of a pro rata portion of each class of income included in the DNI.[165]

In summary, when the FLP interest is distributed by the estate or trust to a beneficiary, it will carry out a portion of the trust's (or estate's) DNI except if that distribution of the FLP interest is a: (i) specific bequest to a trust beneficiary of that FLP interest[166]; (ii) distributions to a qualifying charity beneficiary under Section 642(c); or (iii) amounts distributed if Sections 651 or 661 applied to such amount for a preceding taxable year of an estate or trust because credited or required to be distributed in such preceding taxable year.

The ability of the trust (or estate) to carry out DNI on distributions of FLP interests to trust beneficiaries (or to shares of the trust or estate) will be based upon the extent to which the trust beneficiaries (or trust shares) are entitled to receive the trust net fiduciary accounting income.[167] Trust distributions in satisfaction of pecuniary bequests that are not entitled to share in the trust's fiduciary accounting income do not carry DNI out of the trust.

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165 See Reg. ' ' 1.652(b)-2(a) and 1.662(b)-1 for manner of prorating.

166 See ' 663(a).

167 See Regs. ' ' 1.663(c)-5 and 1.663(c)-2(b)(2). The Regulations provide that a separate trust share exists if the economic interests of the beneficiary or class of beneficiaries neither effect nor are affected by the economic interests accruing to another beneficiary or class of beneficiaries. If a ' 645 election is made, there will be a separate share of the estate.

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EXAMPLE: Assume that the trust (or estate) provides for a specific pecuniary bequest to the child of $1,000,000. The trust does not allow any additional amounts (above this pecuniary $1,000,000 amount) to be distributed to that child, nor for that child to participate in any appreciation or income of the trust's assets. When the trust distributes a $1,000,000 FLP interest to fund the child's pecuniary bequest, none of the trust's DNI is carried out to that child's share under Regulation Section 1.663(c)-5.

10.2 ***Allocating Among the Trust's Beneficiaries Income Which a Trust Partner Receives From the FLP***. Income which a trust partner receives from the FLP is allocated among that trust partner's separate shares in the same proportion that trust's fiduciary accounting income from that FLP is apportioned to the trust's shares under the trust document and state law.[168]

For example, if the FLP issues to its trust partner a Schedule K-1 which shows interest income, then none of that FLP's interest income would be allocated to a person receiving a specific trust pecuniary distribution.[169] Instead, the trust would pay the income tax on the FLP's Schedule K-1 allocation of interest income to the trust, and the trust would not receive a DNI deduction (since none of the trust's interest income was paid to a beneficiary or to a separate trust share).

10.3 ***Determining What is Trust Fiduciary Accounting Income Under the California Uniform Principal and Income Act***. In order to

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[168] See Reg. ' 1.663(c)-2(b)(4).

[169] See Reg. ' 1.663(c)-5.

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determine trust fiduciary accounting income, the trust document must be examined.

Most recent California trust documents rely upon the provisions of the California Uniform Principal and Income Act.[170] Generally, the California Uniform Principal and Income Act provides that distributions of money from a FLP to a trust partner will be treated as income, and distributions of property from a FLP to the trust will be treated as principal.[171] There are exceptions to this rule, such as that money distributed by the FLP to the trust in complete or partial liquidation of the FLP will be treated as principal.[172]

10.4 ***Allocation to a Trust Partner of Taxable Income Shown on the FLP's K-1 Which is Issued to That Trust Partner***. Many times FLPs will issue Schedule K-1s to a trust partner, which trust partner must then report taxable income greater than the amount of money or property that the FLP distributes to that trust partner (or in some cases the FLP may make no distributions to that trust partner even though the FLP allocates taxable income to that trust partner).

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[170] See California Probate Code ' 16320 **et. seq.**

[171] See California Probate Code ' ' 16350(b) and (c).

[172] See California Probate Code ' ' 16350(d). California Probate Code Section 16350(d)(1)(B) states that money is received in a partial liquidation (thereby allocated to trust principal) if the total amount of money and property received by all FLP owners, collectively, in a distribution or series of related distributions is greater than 20 percent of the entity's (i.e. the FLP's) gross assets, as shown on the FLP's year-end financial statement immediately preceding the initial receipt.

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If the FLP allocates taxable income to that trust partner, but makes no distributions to that trust partner, then that trust's tax liability (because of the FLP's allocated taxable income to that trust) remains entirely in the trust and effectively is then allocated entirely to that trust's principal because that trust received no FLP distributions from which the trust can pay the taxes on the allocated income. Thus, the trust partner pays all of the trust-level income taxes on this FLP allocated income out of trust principal.[173] There is no trust deduction for DNI (because there is no trust taxable income distributions which the trust can distribute to any beneficiary). If in later years the FLP then distributes monies to that trust partner, but the FLP allocates no taxable income to that trust partner in these later years, unless that FLP distribution is a liquidating distribution, the FLP's distribution of monies to that trust partner will be considered trust fiduciary accounting income and those distributed FLP monies will then be solely allocated to that trust's income beneficiaries. The result will be that the trust's income beneficiaries could receive a tax-free distribution (of the FLP accounting income in the form of these later distributed monies) at the expense of the trust principal beneficiaries (who had previously paid the tax on the prior allocated FLP taxable income). To correct this potential problem, the trustees can adjust the trust's fiduciary income in later years to repay the trust principal for the taxes that the trust principal paid in previous years on this prior allocated FLP taxable income.[174]

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173 See California Probate Code ' 16374(c)(2)(B).

174 See California Probate Code ' 16375(a)(3).

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If the FLP makes a distribution to a trust partner, then the California fiduciary trust accounting rules state that the trustee is required to allocate the tax on those received distributions between trust income and trust principal, based upon the following principles: the tax on FLP receipts which are allocated to trust income are paid from trust income, and the tax on FLP receipts allocates to trust principal are paid from trust principal.[175]

In determining whether FLP receipts are to be allocated to trust income or to trust principal for trust fiduciary accounting purposes, the trust document governs, or if there is no specific trust document provision, then the California Uniform Principal and Income Act states that the trust's assets distributed to the trust beneficiaries are considered paid in the following order from the following sources: (i) from that taxable income other than capital gains; (ii) from net realized short-term capital gains; (iii) from net realized long-term capital gains; (iv) from tax-exempt and other income; (v) from trust principal.[176]

10.5 ***Notice to IRS of Fiduciary Capacity***. The executor of the deceased FLP partner's estate (or the trustee of the deceased partner's revocable living trust which owns the FLP interest), acting in a fiduciary capacity, must give the IRS written notice of such relationship and, upon its termination of the fiduciary relationship, must file a notice of termination with the IRS.[177] This notice of fiduciary relationship is done on IRS Form 56, and

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[175] See California Probate Code ' 16374.

[176] See California Probate Code ' 16374.5.

[177] See Reg. ' 301.6903-1(a).

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is signed by the fiduciary and is filed with the IRS office where the income tax return for the deceased partner is filed.

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SPEECH11\FLP.2007

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