FAMILY INVESTMENT PARTNERSHIPS:
STRUCTURE, DESIGN, ISSUES & PROBLEMS
(BEYOND THE VALUATION DISCOUNT)

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I. FAMILY INVESTMENT PARTNERHIPS GENERALLY

A. Introduction

1. I think it is safe to state that the family limited partnership (FLP) has become the most ubiquitous estate planning vehicle in the United States. The primary tax reason for utilizing a FLP (for publicly traded investments or other assets) is the valuation discount. The valuation discount, the surrounding cases, and the various theories that the Internal Revenue Service (IRS) has used to (successfully and unsuccessfully) invalidate or reduce it are covered extensively by other authors, so that is not of primary importance for this outline.

2. Furthermore, the Obama administration has proposed over the last few years that certain "disregarded restrictions" should be ignored in valuing interests in family-controlled entities that are transferred to family members and if such restrictions will lapse or can be removed by the transferor or the family.[1] A number of bills have been circulating that would eliminate or severely limit valuation discounts on interests in family-owned entities, in particular, with respect to passive assets held by such entities.[2]

3. For the foregoing reasons, this outline will focus less on the valuation discount benefits of investment FLPs and will concentrate on the following:

a. Reasons families use entities to hold publicly-traded investments of family members.

b. Different design structures utilized by families (for example, single share class partnership vs. preferred partnerships vs. profits partnerships).

c. The Chapter 14 implications of different family investment partnership structures and transfers.

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[1] Department of the Treasury, General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals, February 2012, available on the internet at http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf.

[2] For example, H.R. 436 (January 9, 2009) which provides that the "value of any nonbusiness assets held by the entity shall be determined as if the transferor had transferred such assets directly to the transferee (and no valuation discount shall be allowed with respect to such nonbusiness assets)." The bill specifically provides that "passive assets" (including, cash, stock, profits interest, capital interest, option, debt, derivative, etc.) will generally be considered nonbusiness assets unless those assets are required for working capital needs of a trade or business.

d. The tax and partnership accounting issues that arise when families create and administer family investment partnerships.

e. The investment implications of different family investment partnership structures.

f. The securities law issues that might arise with family investment partnerships and the pending legislation.

g. The fiduciary issues involved when a trustee or executor allows trust or estate assets to be commingled in a family investment partnership.

B. Reasons

1. Control

2. Centralized (and hopefully competent) management of family investments

3. Reduction of expenses

4. Expanded investment opportunities

5. Creditor protection

6. Platform for resolution of family disputes

7. Facilitate or enhance other estate planning techniques (including taking advantage of applicable valuation discounts and separating assets for community property purposes)

C. Choice of Entity

1. Taxation, Flexibility and Limited Liability

a. From a choice of entity standpoint, with respect to family investment partnerships, it comes down to three primary desired characteristics: pass-thru taxation, flexibility (with respect to structuring the beneficial ownership of the family members, determining the taxation of the family members and to handling the family investments) and limited liability for the investors.

b. As such, business entities or arrangements like joint ventures, general partnerships and C corporations are not often the entity of choice for centralizing family investments.

c. Furthermore, with the limitations that may be set out in a trust agreement and the higher fiduciary duties required of trustees, trusts (whether simple or complex) have less flexibility than those entities that do provide all or most of the desired characteristics, including: partnerships and limited liability companies, S corporations and regulated investment companies.

2. Partnerships and Limited Liability Companies

a. Generally

(1) With the Treasury Department's adoption of the "check-the-box" Treasury Regulations in 1996, limited partnerships and limited liabilities companies have become the entity of choice for "family investment partnerships." Both limited partnerships and limited liability companies, when taxed as a partnership for tax purposes, have pass-thru taxation, limited liability, and flexibility in determining how the partners/members share in the underlying investment portfolio.

(2) Since limited liability company statutes have now been enacted in all 50 states in the U.S., often the choice between choosing a limited partnership or a limited liability company depends on the state law differences in which the entity is being formed.

b. Except as otherwise noted, the term "family investment partnership" or FLP in this outline includes both limited partnerships and limited liability companies ("LLCs"), and the terms "partner" and "general partner" include a member and manager of an LLC and the terms "partnership agreement" includes the "limited liability company agreement," as the case may be.

c. "Series" LLCs

(1) A "new" form of business entity has recently been enacted in a few states, most notably the State of Delaware.[3] The "series" limited liability company is a essentially single, master limited liability company that has separate series or cells which are internally created within the entity and which are considered separate from each other (for liability and other purposes). It can issue shares that control or own a specific portion of each separate series or cell to the exclusion of the other classes.

(a) By way of example, Delaware provides, "a limited liability company agreement may establish or provide for the establishment of 1 or more designated series of members, managers or limited liability company interests having separate rights, powers or duties with respect to specified property or obligations of the limited liability company or profits and losses associated with specified property or obligations, and any such series may have a separate business purpose or investment objective."[4]

(b) In the family investment partnership context, an operating agreement could issue different classes of shares to its family members, with different classes being attributable to different investment strategies or portfolios. For example, Class A: U.S. equities, Class B: non-U.S. equities, Class C: taxable bonds, Class D: municipal bonds, Class E: hedge funds, etc. Thus, this would allow family members to personalize their own asset allocation by having one family member hold shares in Classes A, B, D and E, while another family member might hold Class A and C shares.

(c) This type of capital structure is often used in the regulated investment company context and is often referred to a series company or fund. If an investment company wishes to offer a range of investment strategies or asset classes, instead of establishing a separate company for each investment strategy, it will create a single company with multiple classes of ownership, each of which relate to the assets of the separate portfolios within the company. In the regulated investment

[3] *See* 6 Del. Code Ann. § 18-215.

[4] 6 Del. Code Ann. § 18-215(a).

company context, the Code treats each "fund" of a series fund as a separate corporation.[5] For these purpose, a "fund" means a segregated portfolio of assets, the beneficial interests of which are owned by the holders of a class or series of stock of the regulated investment company that is preferred over all other classes or series in respect of such portfolio of assets.[6] It is important to note that each fund then must obtain a separate tax identification number and there can be no offsetting capital gains and losses among the portfolios at least for Federal tax purposes. State tax laws may continue to treat a series fund as a single entity.

(d) Following a series of notices and rulings,[7] the IRS issued proposed Treasury Regulations[8] under Section 7701 regarding the classification of series LLCs and each related series for Federal tax purposes. Generally, in the context of this discussion, the proposed Treasury Regulations would treat each series as either a partnership (if there 2 or more members) or a disregarded entity (if there is only 1 member).

i. The proposed Treasury Regulations will generally apply on the date final regulations are published in the Federal Register, but provides an exception for series established prior to publication of the proposed regulations that treat all series and the series organization as one entity.[9]

ii. Generally, whether a series that is treated as a local law entity under the proposed regulations is recognized as a separate entity for Federal tax purposes is determined under Treasury Regulation Section 301.7701-1(b).[10] This Treasury Regulation provides that the tax classification of an organization recognized as a separate entity for tax purposes is determined by Treasury Regulations Sections 301-7701-2 through -3. These regulations provide that a business entity is any entity recognized for Federal tax purposes that is not properly classified as a trust or otherwise subject to special treatment under the Code. A business entity with 2 or more members is classified as a corporation or a partnership for Federal tax purposes. A business entity with one owner is classified as a corporation or is disregarded.

iii. The proposed Treasury Regulations do not address the entity status for tax purposes of the series organization, in particular, even if the series organization has no assets

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[5] § 851(g). Note, this Code section has been redesignated several times from § 851(q) and § 851(h).

[6] § 851(g)(2).

[7] *See* Ltr. Rul. 200803004 (the IRS concluded that each series of a series LLC should be treated as a separate business entity for federal income tax purposes. The LLC membership agreement provided that each series would consist of a separate pool of assets, liabilities, and stream of earnings complete with its own investment objectives, policies, and restrictions. Additionally, the members of each series could only share in the income of a series in which they were a member. Upon a distribution or withdrawal of capital, or in the event of termination of the LLC, the amount the member would receive was limited to the assets of that series. Finally the vote of the members would be conducted by each series separately with respect to matters that affected only that particular series, except to the extent that the applicable securities laws requires shares to be voted as a single class of shares); Notice 2008-19, 2008-1 C.B. 366 (2/4/2008) (proposing guidance that would include a rule that would treat each cell of a "protected cell company" as a separate entity for Federal tax purposes if the protected cell company and the cells meet certain conditions [specifically requiring that the assets and liabilities of the cell must be segregated from the assets and liabilities of any other cell]); National Securities Services—Industrial Stock Series, et al. v. Commissioner, 13 T.C. 884 (1949), *acq.* 1950-1 C.B. 4; and Rev. Rul. 55-416, 1955-1 C.B. 416.

[8] REG-119921-09 (September 14, 2010).

[9] Prop. Reg. §§ 301.7701-1(f)(1)- 301.7701-1 (f)(3).

[10] Prop. Reg. § 301.7701-1(a)(5)(iii) and (iv).

and engages in no activities independent of its series. Furthermore, the proposed Treasury Regulations do not address how a series should be treated for Federal employment tax purposes.

iv. The proposed Treasury Regulations define a "series organization" as a "juridical entity that establishes and maintains, or under which is established and maintained, a series…. A series organization includes a series limited liability company, series partnership, series trust, protected cell company, segregated cell company, segregated portfolio company, or segregated account company."[11]

v. The proposed Treasury Regulations define a "series" as a "segregated group of assets and liabilities that is established pursuant to a series statute … by agreement of a series organization …. A series includes a series, cell, segregated account, or segregated portfolio, including a cell, segregated account, or segregated portfolio that is formed under the insurance code of a jurisdiction or is engaged in an insurance business. However, the term series does not include a segregated asset account of a life insurance company."[12]

vi. A "series statute" is defined as "a statute of a State or foreign jurisdiction that explicitly provides for the organization or establishment of a series of a juridical person and explicitly permits: (1) Members or participants of a series organization to have rights, powers, or duties with respect to the series; (2) A series to have separate rights, powers, or duties with respect to specified property or obligations; and (3) The segregation of assets and liabilities such that none of the debts and liabilities of the series organization (other than liabilities to the State or foreign jurisdiction related to the organization or operation of the series organization, such as franchise fees or administrative costs) or of any other series of the series organization are enforceable against the assets of a particular series of the series organization."[13]

(e) Only a few other states including Iowa, Illinois, Nevada, Oklahoma, Tennessee, Texas, Utah and Puerto Rico have enacted similar statutes, and a number of unresolved questions exist including whether the separation of series will be respected in other states.[14]

d. "Tracking" LLCs and LPs

(1) A structure called a "tracking" partnership (or LLC) has emerged that purports to allow investors to have access to different asset classes within the partnership (like a series LLC) but without the burdensome tax treatment of having to treat each series as a separate entity for Federal income tax purposes. Essentially, each investor's interest in the partnership would be structured to "track" the economic performance of each class or tranche of investments held by the partnership. Each investor/partner would have the right to adjust his or her interest in each of the different asset classes, thereby allowing the investor to determine his or her personal asset allocation.

(2) The tracking partnership would intentionally be structured to not be considered a series LLC. For example, the partnership or operating agreement would provide that there

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[11] Prop. Reg. § 301.7701-1(a)(5)(viii)(A).

[12] Prop. Reg. § 301.7701-1(a)(5)(viii)(C).

[13] Prop. Reg. § 301.7701-1(a)(5)(viii)(B).

[14] The California Franchise Tax Board has ruled that each series in a Delaware Series LLC is considered a separate LLC and each must pay its own annual tax and fee. D. Newcomb, "What is FTB's Position on Delaware Series LLCs," Cal. Franchise Tax Board's Tax News (Mar./Apr. 2006).

would be no segregation of liabilities across the different asset classes or investments. Thus, as discussed above, each investment class would not be required to be treated as a separate entity for income tax purposes.

(3) In family-owned investment partnerships, consideration should be given to the possible Section 2701 implications of a tracking partnership. As discussed in more detail below, in order to avoid complications under Section 2701 of the Code, each investor's interest in the partnership, regardless of what proportion of each investment is being "tracked" for purposes of making up the partnership interest, would need qualify for the same class exception under Section 2701(a)(2)(B) of the Code. The argument in favor of qualifying for the exception in the tracking partnership context is that each partner, in fact, holds one class of interest, notwithstanding that each partner's interest "tracks" the various investments disproportionately. Each class of interest carries with it the partner's ability to allocate among different investment tranches or classes. Thus, the argument goes, each partner's interest are legally the same, carrying the same legal options and obligations as any other partner's interest.

(4) No rulings on the tax treatment of tracking partnerships in the family-owned context have apparently been issued.

3. S Corporations

a. Less often, family investments are consolidated and managed in and through an S corporation. This is frequently the result of a legacy family business (often in C Corporation form at one point) or investment holdings that have been liquidated and otherwise converted into stocks, bonds, or other publicly-traded investments.

b. While S Corporations provide for pass-thru taxation under subchapter S of the Code, they have a number of significant restrictions, especially in the investment context:

(1) S Corporation shareholders must be limited to 100 and to U.S. citizens, resident aliens, estates, or certain trusts or tax-exempt organizations.[15]

(2) The capital structure of an S Corporation investment is limited to 1 class of stock (so, alternative structures that might include preferred interests are not possible).[16]

(3) S Corporations with accumulated earnings and profits from prior C Corporation status are subject to a corporate level tax on "excess net passive income" (25% of gross receipts), and if the 25% gross receipts limitation is exceeded for 3 consecutive years, S Corporation status may be terminated.[17]

(4) S Corporations do not have an analogous election to correct inside and outside basis disparities as partnership do under Section 754 (discussed below).

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[15] §§ 1361(b)(1)(A), 1361(c)(1), 1361(b)(1)(B), 1361(c)(2) and 1351(c)(6).

[16] § 1361(b)(1)(D).

[17] §§ 1362(d)(3) and 1375. Please note, former §1372(e)(5) provided a subchapter S corporation with or without subchapter C earnings and profit would terminate its S Corporation status if more than 20% of its gross receipts came from passive income sources.

4. Regulated Investment Companies (Mutual Funds)

a. A small number of large and very wealth families have migrated away from using private FLPs to hold family investments. In order to avoid securities issues and family disputes centered around indirect transfers of wealth to different family members due to valuation discounts, some families consolidate their investments in a regulated investment company.

b. For purposes of this outline, a "regulated investment company"[18] is a domestic corporation[19] that is registered (at all times during the year) under the Investment Company Act of 1940[20] (the "Investment Company Act") either as a unit investment company[21] or a management company.[22]

c. Regulated investment companies generally issue one class of shares, but the IRS has ruled that an investment company may issue both preferred and common shares and still qualify as a regulated investment company.[23]

d. From a tax character standpoint, the IRS has ruled that regulated investment companies with multiple class shares must distribute tax items in a proportionate manner, so that items of ordinary income can not be allocated to one class of shares and capital gain to another class of shares.[24]

e. The relevant characteristics of ownership through a mutual fund are:

(1) Partial pass-through taxation of income to its shareholders, although the taxation does not always follow the economic understanding of those shareholders; and

(2) Free transferability of interest in the mutual fund.

II. STRUCTURE AND DESIGN

A. Chapter 14

1. Introduction

a. A discussion regarding the design and structure of family investment partnerships cannot start without considering Chapter 14 of the Internal Revenue Code, particularly

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[18] § 851(a).

[19] A domestic corporation includes an "association," so a trust (in particular, a business trust, which is common in this area), partnership, limited liability company and other entities can qualify for regulated investment company status as long as it is treated as an association for tax purposes. § 7701(a)(3). *See* Treas. Reg. § 1.851-1(a).

[20] 15 U.S.C. §§ 80a-1, et al.

[21] These are entities that are generally organized under a trust indenture, custodial agreement or similar instrument that issue only redeemable securities, which represent an undivided interest in a unit of specified securities. § 4(2) of the 1940 Act.

[22] Defined generally as "any investment company other than a face-amount certificate or a unit investment company." § 4(3) of the 1940 Act.

[23] Rev. Rul. 74-177, 1974-1 C.B. 165.

[24] Rev. Rul. 89-81, 1989-1 C.B. 226.

Section 2701. A complete and comprehensive discussion of Chapter 14 is beyond the scope of this outline.

b. However, an understanding of the salient points is necessary if a structure, other than a single class share FLP is being considered.

2. General Rule

a. Section 2701 provides that in determining whether a gift has been made and the value of such gift, when a person transfers interest in a corporation or partnership (or LLC) to a "member of the transferor's family"[25] the value of any of the following rights shall be treated as zero[26] (an "applicable retained interest"):

(1) A distribution right, if immediately before the transfer, the transferor and "applicable family members"[27] have "control"[28] of the entity.[29]

(2) A liquidation, put, call, or conversion right.[30]

3. Transfer Defined

a. It is important to note that a "transfer" is broadly defined and is deemed to include "a contribution to capital or a redemption, recapitalization, or other change in the capital structure of a corporation or partnership."[31]

b. However, these would not be considered a transfer if "the interests in the entity held by the transferor, applicable family members, and members of the transferor's family before and after the transaction are substantially identical."[32]

4. Exceptions

a. Market Quotation Exception

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[25] § 2701(a). A "member of the transferor's family" means: (a) the transferor's spouse, (b) a lineal descendant of the transfer or the transferor's spouse, or (c) the spouse of any such lineal descendant. § 2701(e)(1).

[26] § 2701(a)(3)(A).

[27] For purposes of determining control, this includes the transferor's spouse, an ancestor of the transferor or the transferor's spouse, or the spouse of any such ancestor and any lineal descendant of any parent of the transferor or the transferor's spouse. §§ 2701(e)(2) and 2701(b)(2)(C). In other words, it expands the definition to capture siblings of the transferor and the transferor's spouse and their descendants.

[28] If the entity is partnership (which would be the most likely choice of entity for a family investment entity), control means: (a) holding at least 50% of the capital or profits interests in the partnership, or (b) in the case of a limited partnership, the holding of any interest as a general partner. § 2701(b)(2)(B).

[29] § 2701(b)(1)(A).

[30] § 2701(b)(1)(B).

[31] § 2701(e)(5).

[32] § 2701(e)(5).

(1) Section 2701 does not apply to the "transfer of any interest for which market quotations are readily available (as of the date of transfer) on an established market."[33]

(2) Section 2701 does not apply to any right with respect to an applicable retained interest if market quotations are readily available (as of the date of transfer) on an established market.[34]

b. Same Class and Proportional Class Exceptions

(1) In addition to the foregoing, Section 2701 does not apply to any right with respect to an applicable retained interest if such interest is:

(a) The same class as the transferred interest (the "Same Class Exception"),[35] or

(b) The same as the transferred interest, without regard to nonlapsing differences in voting power (or, for a partnership, nonlapsing differences with respect to management and limitations on liability).[36]

(2) With respect to these exceptions, the Treasury Regulations provides, "[a] class is the same class as is (or is proportional to the class of) the transferred interest if the rights are identical (or proportional) to the rights of the transferred interest, except for non-lapsing differences in voting rights (or, for a partnership, non-lapsing differences with respect to management and limitations on liability)."[37]

(3) The Treasury Regulations provide that non-lapsing provisions that are necessary to comply with the partnership allocation requirements of the Code will be treated as non-lapsing differences with respect to limitations on liability.[38]

(4) A right that lapses by reason of Federal or State law will be treated as a non-lapsing differences unless the Treasury determines that it is necessary to treat such right as a lapsing right in order to accomplish the purposes of Section 2701.[39]

c. Vertical Slice Exception

(1) Section 2701 does not apply to a transfer "to the extent the transfer by the individual results in a proportionate reduction of each class of equity interest held by the individual and all applicable family members in the aggregate immediately before the transfer."[40]

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[33] § 2701(a)(1).

[34] § 2701(a)(2)(A).

[35] § 2701(a)(2)(B).

[36] § 2701(a)(2)(C).

[37] Treas. Reg. § 25.2701-1(c)(3).

[38] Treas. Reg. § 25.2701-1(c)(3).

[39] § 2701(a)(2) and Treas. Reg. § 25.2701-1(c)(3).

[40] Treas. Reg. § 25.2701-1(c)(4).

(2) The Regulations provide the following example: "Section 2701 does not apply if P owns 50 percent of each class of equity interest in a corporation and transfers a portion of each class to P's child in a manner that reduces each interest held by P and any applicable family members, in the aggregate by 10 percent even if the transfer does not proportionately reduce P's interest in each class."[41]

d. Guaranteed Payment Exception

(1) Excluded from the definition of "distribution right" is "any right to receive any guaranteed payment described in section 707(c) of a fixed amount."[42]

(2) The Treasury Regulations provide that a fixed amount under this exception is the right to receive a payment "the amount of which is determined at a fixed rate (including a rate that bears a fixed relationship to a specified market interest rate)."[43] Specifically, it does not include a payment that is contingent as to time or amount.

e. Mandatory Payment Right Exception

(1) A "mandatory payment right" is a right to a required payment at a specified time. For purposes of Section 2701 it is considered neither an extraordinary payment right nor a distribution right.[44]

(2) It includes a right in preferred stock requiring that the stock be redeemed at its par value on a date certain and it also includes a right to receive specific amount on the death of the holder.[45]

(3) The Service has also ruled that a mandatory payment right includes the right to redeem preferred stock at a stated value plus any accrued and unpaid dividends on the earlier to occur of a certain date or change in control of the company.[46]

f. Junior Equity Interest Exception

(1) A distribution right does not include a right to distributions with respect to any interest which is junior to the rights of the transferred interest.[47]

(2) The Treasury Regulations also exempt an interest that is of the same class, or a class that is subordinate to, the transferred interest.[48]

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[41] *Id.*

[42] § 2701(c)(1)(B)(iii).

[43] Treas. Reg. § 25.2701-2(b)(4)(iii). *See* § 707(c).

[44] Treas. Reg. § 25.2701-2(b)(4)(i).

[45] *Id.*

[46] Ltr. Rul. 9848006.

[47] § 2701(c)(1)(B)(i).

[48] Treas. Reg. § 25.2701-2(b)(3)(i).

(3) This is one of the most significant exceptions to section 2701 from an estate planning standpoint. Essentially, it is an exception for the transfer of the preferred or senior equity interest (with the retention of the junior equity or common interest by the transferor). As an exception, normal gift tax rules apply to such transfer of the preferred interest, along with any applicable valuation discounts for lack of marketability and minority interest discount. This is particularly beneficial because a transfer of a preferred interest with a "guaranteed" return of, for example, 7% annually (if that is the preferred rate) can be contributed at a discount to a grantor retained annuity trust[49] or charitable lead annuity trust[50] when the section 7520 (the assumed internal rate of return) is significantly lower than that, for example 1.6% (the rate currently in effect at the time of this article). In that instance, an automatic arbitrage between the 7% return on the preferred (not even taking into account the effective rate of return due to any applicable valuation discount) against the 1.6% is created, thus guaranteeing wealth transfer of 5.4% annually.

g. Other Exceptions of Some Note

(1) A non-lapsing right to convert an interest into an interest of the same class as the transferred interest that is subject to proportionate adjustment changes in the equity ownership of the partnership is not considered a liquidation, put, call, or conversion right.[51] As such, these conversion rights are not considered applicable retained interest subject to the zero valuation rule.

(2) A liquidation participation right (right to participate in a liquidating distribution) is considered neither an extraordinary payment right nor a distribution right. If the transferor and the transferor's family have the right to compel liquidation, this right will be valued as if the ability to compel liquidation did not exist, or if the lower-of rule applies, in a manner consistent with that rule.[52]

5. Qualified Payment

a. Assuming none of the exceptions above apply, for a distribution right (applicable retained interest) to avoid zero valuation under Section 2701, it must be considered a "qualified payment."

b. A qualified payment "means any dividend payable on a periodic basis under any cumulative preferred stock (or a comparable payment under any partnership interest) to the extent that such dividend (or comparable payment) is determined at a fixed rate."[53] A payment will be treated as a "fixed rate" if the payment is "determined at a rate which bears a fixed relationship to a specified market interest rate."[54]

c. The Treasury Regulations provides that a qualified payment is:

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[49] § 2702.

[50] *See* §§170(f)(2), 642(c), 2055(e)(2)(B) and 2522(c)(2)(B).

[51] § 2701(c)(2)(C) and Treas. Reg. § 25.2701-2(b)(4)(iv).

[52] Treas. Reg. § 25.2701-2(b)(4)(ii).

[53] § 2701(c)(3)(A).

[54] § 2701(c)(3)(B). *See* Treas. Reg. § 25.2701-2(b)(6)(ii).

(1) "A dividend payable on a periodic basis (at least annually) under any cumulative preferred stock, to the extent such dividend is determined at a fixed rate."[55]

(2) Any other cumulative distribution payable on a periodic basis (at least annually) with respect to an equity interest, to the extent determined at a fixed rate or as a fixed amount."[56]

d. A qualified payment made up to 4 years following its due date will be treated as having been made on the due date.[57] If a qualified payment is made after the 4 year grace period, the unpaid qualified payments essentially accrue interest at the "appropriate discount rate"[58] (the discount rate applied in determining the value of the qualified payment right at the time of the original transfer under Section 2701).

e. If there are unpaid qualified payments, upon a "taxable event"[59] (generally, the transfer of the qualified payment interest during lifetime or at death or the termination of the interest holder's right to the qualified payments), additional transfers taxes may become payable. The additional transfer taxes that become payable are implemented by increasing the taxable gifts of the transferor or the transferor's taxable estate, as the case may be, and is calculated through a series of computations that, significantly, assume all payments were made on the date payment was due and such payments were "reinvested by the transferor as of the date of payment at a yield equal to the discount rate."[60]

f. A qualified payment right that has no additional bells and whistles (in particular, liquidation, put, call, or conversion rights) will be valued without regard to Section 2701, using traditional gift tax rules.[61]

g. If a qualified payment right has certain bells and whistles ("1 or more liquidation, put, call, or conversion rights with respect to such interest"[62]), the value of the qualified payment right will be determined as if these bells and whistles are exercised in a manner resulting in the lowest value being determined for such rights.[63] The Treasury Regulation labels these types of bell and whistle as an "extraordinary payment right" and defines them "any put, call, or conversion right, any right to compel liquidation, or any similar right, the exercise or nonexercise of which affects the value of the transferred interest. A call right includes any warrant, option or other right to acquire one or more equity interests."[64]

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[55] Treas. Reg. § 25.2701-2(b)(6)(i)(A).

[56] Treas. Reg. § 25.2701-2(b)(6)(i)(B).

[57] § 2701(d)(2)(C).

[58] *See* § 2701(d)(2)(A) and Treas. Reg. § 25.2701-4(c)(3).

[59] § 2701(d)(3) and Treas. Reg. § 25.2701-4(b).

[60] § 2701(d(2)(A)(i)(II).

[61] § 2701(a)(3)(C).

[62] § 2701(a)(3)(B)(ii).

[63] § 2701(a)(3)(B) and Treas. Reg. § 25.2701-2(a)(3). *See also* § 25.2701-2(a)(5).

[64] Treas. Reg. § 25.2701-2(b)(2).

6. Deemed Qualified Payment

a. The Code provides that a transferor or applicable family member may make an election to treat a distribution right that is not a qualified payment under the definition above to treat it as a qualified payment.[65]

b. The election applies to specified amounts to be paid at specified times and "only to the extent that the amounts and times so specified are not inconsistent with the underlying legal instrument giving rise to such right."[66]

7. Subtraction Method

a. Methodology

(1) If Section 2701 applies to a transfer, the value of the transferred interest will be determined using the "subtraction method" described in the Treasury Regulations.[67] The value of the transferred interest is determined in the 4 steps (simplified for purposes of this outline):

(a) Step 1: Determine the fair market value[68] of all family-held[69] interests in the entity immediately before the transfer.

(b) Step 2: Subtract the value of all family-held senior equity[70] interests.

i. If the interest is an Applicable Retained Interest held by the transferor and applicable family members, the value as determined under Section 2701. This value could, obviously be zero by application of Section 2701.

ii. If held by persons other than the transferor and applicable family members, the value is the fair market value.[71]

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[65] § 2701(c)(3)(C)(ii).

[66] § 2701(c)(3)(C)(ii).

[67] Treas. Reg. § 25.2701-3.

[68] Fair market value is determined assuming that all of the interests are held by one individual (presumably to eliminate minority interest discount issues). Treas. Reg. § 25.2701-3(b)(1)(i). There has been some commentary that having all of the interest held by one individual essentially means that the value in this step is liquidation value. *See* Tech. Adv. Mem. 9447004. However, in that TAM, both the taxpayer and the Service stipulated that the value of the company was book value and the question of whether lack of marketability should be assigned to such interests was not at issue.

[69] For these purposes, "family" means the transferor, applicable family members, and any lineal descendants of the parents of the transferor or the transferor's spouse (held directly or through attribution). *See* Treas. Regs. §§ 25.2701-3(a)(2)(i) and 25.2701-2(b)(5)(i).

[70] Senior equity interest is "an equity interest in the entity that carries a right to distribution of income or capital that is preferred as to the rights of the transferred interest." Treas. Reg. § 25.2701-3(a)(2)(ii).

[71] The Treasury Regulations provide, "the fair market value of an interest is its pro rata share of the fair market value of all family-held senior equity interests of the same class (determined, immediately after the transfer, as is [if] all family-held senior equity interests were held by one individual)." Treas. Reg. § 25.2701-3(b)(2)(i)(A).

(c) Step 3: Allocate[72] the balance among the transferred interests and other family-held subordinate equity interests.

(d) Step 4: Apply certain discounts and other appropriate deductions, but only to the extent permitted by the Treasury Regulations.

i. The Treasury Regulations provide if the value of the transferred interest would have been determined (but for Section 2701) with a "minority or similar discount," the amount of the gift is reduced by the excess of a "pro rata portion of the fair market value[73] of the family-held interests of the same class" over "the value of the transferred interest (without regard to section 2701)."[74]

ii. The Service has ruled that "minority or similar discount" includes a "discount for lack of marketability" with respect to the transferred interest.[75]

iii. The Treasury Regulations provide, the value of the family-held interests of the same class is "determined as if all voting rights conferred by family-held equity interests were held by one person who had no interest in the entity other than the family-held interests of the same class, but otherwise without regard to section 2701."[76]

iv. It stands to reason also that non-preferred limited partnership interests should also be entitled to an additional discount for being subordinate to the rights of the preferred interests with respect to cash flow distributions and liquidation proceeds. As a result, non-preferred limited partnership interests will often be entitled to a significantly larger valuation discount than Single Class Share FLP interests. As a result, even when the subtraction method is applied to a transfer, the value of the gift is often much smaller than most practitioners anticipate.

b. 10% Minimum Value Rule

(1) If Section 2701 applies to a transfer of a "junior equity interest," then such transferred interest must be assigned at least that pro rata value which it would have if the total value of all of the common stock of the corporation, or junior equity interests of a partnership (or LLC), were equal to 10 percent of the sum of (a) the total value of all of the equity interests in the entity, plus (b) the total amount of indebtedness of the entity to the transferor and applicable family members.[77]

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[72] Allocation is done as follows: (1) if more than one class of family-held subordinate equity interest exists, the remaining value is allocated in a manner that would most fairly approximate their value if all zero-valued rights under Section 2701 did not exist; and (2) if there is no "clearly appropriate method" of allocation, the remaining value is allocated in proportion to their fair market values without regard to Section 2701. Treas. Reg. § 25.2701-3(b)(3).

[73] The Treasury Regulations provide, the value is "determined as if all voting rights conferred by family-held equity interests were held by one person who had no interest in the entity other than the family-held interests of the same class, but otherwise without regard to section 2701." Treas. Reg. § 25.2701-3(b)(4)(ii)(A).

[74] Treas. Reg. § 25.2701-3(b)(4)(ii).

[75] Tech. Adv. Mem. 9447004.

[76] Treas. Reg. § 25.2701-3(b)(4)(ii)(A).

[77] § 2701(a)(4).

(2) For purposes of the 10% Minimum Value Rule, the following types of indebtedness are included in this calculation:

(a) Short-term indebtedness with respect to the current conduct of the partnership's trade or business;

(b) Third-party debt solely because it is guaranteed by the transferor or an applicable family member; and

(c) Amounts set aside in a qualified deferred compensation arrangement, to the extent unavailable for use by the partnership.[78]

B. Single Class Share FLPs

1. Single Class Share FLPs are the most popular type of FLP, especially since the enactment of Chapter 14 in 1992. The partnership agreement generally provides that all distributions of cash flow and items of profit and loss are shared pro rata according relative capital accounts. As such, at least with respect to beneficial rights to partnership property, earnings, cash flow and tax items, everything is shared on the same terms, with the only distinction being each partner's relative economic interest in the partnership at such time.

2. While transfers or assignments of the Single Class Share FLP will often be restricted by the terms of the partnership agreement, the transfers will be free of any complications under Chapter 14 due to the Same Class and Proportional Class Exceptions noted above. As such, normal gift tax rules apply and the value will be determined to be according to the ubiquitous standard of the "price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."[79]

3. The primary advantage to the Single Class Share FLP is its simplicity and ease of administration. The primary disadvantage is that each partner, regardless of their particular tax circumstances (marginal income tax bracket, state of residence, carry-over of tax losses, etc.), risk tolerance, return requirements and spending are treated exactly the same way.

C. Preferred Partnerships

1. Generally

a. Unlike the Single Class Share FLP, Preferred FLPs are structured to allow for at least 2 classes of interest, one which provides for a preferred return to the holder. The remaining class or classes of interest (the common shares) will receive any economic benefit from the partnership property above the preferred return.

b. Typically, the partnership agreement will provide that the preferred shares have the following rights:

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[78] Treas. Reg. § 25.2701-3(c)(3)(i).

[79] Treas. Reg. §§ 20.2031-1(b) and 25.2512-1.

(1) Preferred right to cash flow of the partnership. Typically, this is stated as a fixed dollar amount, fixed percentage of a liquidation preference amount or a variable percentage of a liquidation preference amount.

(2) One critical issue is whether the preferred payment is paid regardless of whether profits are made by the partnership or whether the amount payable is contingent upon the partnership being profitable. As discussed below, Qualified Payment Preferred FLPs and Guaranteed Payment Preferred FLPs are payable regardless of partnership profits. The Preferred Profits FLPs, as mentioned below, are contingent upon the partnership being profitable.

(3) Upon dissolution of the partnership, the preferred holders will receive liquidating distributions of a certain amount (liquidation preference amount) or certain percentage of the partnership assets.

c. By consequence, the common interest holders will have a residual interest in any cash flow, liquidation proceeds and earnings of the partnership after the preferred interest holders have been paid.

d. From an economic standpoint, the preferred holder's return is capped at the preferred rate or payment, and the common holder's return is any excess return above the preferred interest. As such,

2. Qualified Payment Preferred FLPs

a. Generally

(1) A "Qualified Payment Preferred FLP" specifically creates a preferred interest that meets the qualifications of being a "qualified payment" under Section 2701(c)(3), as discussed above. Namely, this requires that the payments be cumulative, payable annually, and at a fixed rate or amount.

(2) The payment is accrued and payable regardless of partnership profits. As such, while it is normally paid from net cash flow of the partnership, the lack of net cash flow in any given year will not affect the total amount that is due.

b. Typical Terms

(1) Qualified Payment Preferred FLPs will provide a cumulative preferential right to partnership cash flow. Typically, this preferential right will be a percentage of a stated liquidation preference amount (for example, 7% of $1,000,000).

(2) The preferred payment will accrue annually and will be cumulative to the extent payments are not made in any given year.

(3) The preferred payment will go into arrears for up to 4 years after the due date without interest being due on the unpaid preference. After the 4 year period, the unpaid payments will accrue interest at the specified preferred rate (for example, 7%).

(4) The partnership agreement will often provide that payments may be paid from available cash, first, and, at the discretion of the general partner, with in-kind distributions of partnership property.

(5) Upon dissolution, the preferred interest will receive liquidating distributions equal to the liquidation preference amount ($1,000,000) before any distributions are made to non-preferred interest holders.

(6) Often, the partnership agreement will provide the partnership the right to call the preferred interest at the liquidation preference amount upon the death of the preferred holder. This effectively freezes the value for transfer tax purposes at the liquidation preference amount. Keep in mind, the special valuation rules under Section 2701 only apply for gift tax purposes, not estate tax purposes.

c. Chapter 14 Implications

(1) Valuation of the preferred interest in the Subtraction Method under Section 2701, because it is a "Qualified Payment," will be according to regular gift tax rules. It is unclear, however, what standard should be used in valuing the preferred interest. Or, said another way, how does one determine the appropriate preferred annual payment to minimize the gift tax consequences, if any, under Section 2701?

(2) As discussed above, to be a "Qualified Payment" the preferred interest must generally provide for a cumulative and annual payment that is determined at a fixed rate. While certain "bells and whistles" must be ignored, no other requirements are set out in the Code or the Treasury Regulations.

d. Revenue Ruling 83-120

(1) Many commentators[80] and the Service in rulings[81] have asserted that the appropriate standard for valuing the preferred interest is under Revenue Ruling 83-120,[82] pertaining to preferred corporate stock. The Revenue Ruling provides a methodology for valuing preferred interests, based upon 3 primary factors:[83] yield, preferred payment coverage and protection of the liquidation preference.

(a) Yield of the preferred interest is compared against with the dividend yield of "high-grade, publicly traded preferred stock." The required credit rating is not explicitly stated in the ruling. The ruling does point out, however, that "[i]f the rate of interest charged by independent creditors to the [entity] on loans is higher than the rate such independent creditors charge their most credit worthy borrowers, then the yield on the preferred [interest] should be correspondingly higher than the yield on the high quality preferred stock."[84]

(b) The ruling provides that "[c]overage of the dividend is measured by the ratio of the sum of the pre-tax and pre-interest earnings to the sum of the total interest to

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[80] *See, e.g.,* Hatcher and Manigault, "Warming Up to the Freeze Partnership," Estate & Personal Financial Planning (June 2000).

[81] *See, e.g.,* Ltr. Rul. 9324018.

[82] Rev. Rul. 83-120, 1983-2 C.B. 170.

[83] The ruling also indicates that voting rights and lack of marketability are secondary factors, but these may cancel each other out in many instances. Rev. Rul. 83-120, 1983-2 C.B. 170 at Sections 4.01, 4.05 and 4.06.

[84] Rev. Rul. 83-120, 1983-2 C.B. 170 at Section 4.02.

be paid and the pre-tax earnings needed to pay the after-tax dividends."[85] Obviously, in the partnership context, due to pass-thru taxation under Subchapter K, concerns about pre-tax earnings and after-tax dividends are not relevant. Coverage is further supported if the partnership agreement provides that the preferred payment can be satisfied from both cash flow of the partnership and distributions in-kind of partnership assets.

(c) Protection of the liquidation preference is determined by comparing the value of the partnerships assets (net of liabilities) to the liquidation preference amount. In other words, what is the ratio of preferred interests in comparison to non-preferred interests?

(2) From a planning perspective, dividend (preferred payment) coverage and liquidation protection are within the control of the planner (whereas the yield on publicly-traded preferred stocks is determined by the vagaries of the market at the time of the purported transfer). In other words, if a FLP is being recapitalized into a Qualified Payment Preferred FLP, then how much dividend coverage or liquidation protection is a function of the sizing between the preferred and common interests. For example, dividend coverage and liquidation protection would be quite different if AB partnership, which holds $10,000,000 of assets is structured, as follows: (i) A holding a 7% preferred on a $5,000,000 liquidation preference amount and B holding the common shares, and (ii) A holding a 7% preferred on a $9,000,000 liquidation preference amount and B holding the common shares. In the first instance, the effective yield that must be paid from the portfolio is 3.5% per year and there is 2:1 ratio of liquidation protection ($10,000,000 of assets to satisfy a $5,000,000 liquidation preference), and in the second instance, the effective yield is 6.3% and there is a 10:9 ratio of liquidation protection ($10,000,000 of assets to satisfy a $5,000,000 liquidation preference). In the latter instance, the value of the preferred interest would most likely be much less than the liquidation preference of $9,000,000 because the required yield from the partnership is considerably higher (less dividend coverage) and there is very little cushion of liquidation protection.

e. Private Annuity

(1) An interesting Qualified Payment structure might include structuring the preferred payment as a private annuity for the life of partner. The argument here is that Revenue Ruling 83-120 is not the appropriate way to value a preferred interest like this, or at the very least, it is not the only way to value a preferred interest.

(2) From an estate planning standpoint, the benefits are clear. The private annuity preferred interest would not be includible in the gross estate of the preferred partner at death.

(3) Section 7520 provides a clear methodology for valuing an annuity interest based upon the appropriate mortality tables and valuation factors in the Treasury Regulations[86] and IRS Publication 1457[87] based upon the Section 7520 Rate at the time of its creation and/or transfer under Section 2701.

(a) That being said the Service has stated, without any support, that "in determining the value of a preferred stock based on the present value of the dividend stream to perpetuity,

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[85] Rev. Rul. 83-120, 1983-2 C.B. 170 at Section 4.03.

[86] Treas. Reg. § 20.2031-7(d).

[87] IRS Publication 1457, *Actuarial Values*.

the use of a discount factor based on the rate described by Section 7520 (120 percent of the federal midterm rate) is rarely valid when the corporation is closely-held."[88]

(b) Of course, that doesn't specifically address a private annuity that by definition will not pay in perpetuity and does not address whether that prohibition applies to partnership interests where the underlying property is primarily publicly-traded securities (not closely-held).

(c) The Treasury Regulations[89] provide that the use of Section 7520 will not apply to any Code section to the extent provided by the Service in revenue rulings or revenue procedures. To date, no revenue rulings or revenue procedures have been published with regard to Section 2701.

(4) For the private annuity preferred interest to be considered a partnership interest, the normal rules for taxing a private annuity to the recipient would not be applicable. Rather, the taxability of the payments would be determined by the partner's distributive share, as provided under the partnership agreement.

(5) It should also be noted that in structuring a private annuity preferred interest, one should take note that the Treasury Regulations provide that Section 7520 can not be used in valuing restricted beneficial interests. Restricted beneficial interests annuity interests payable from a restricted source which will exhaust itself before the end of the term or possible annuity period of 110 years.[90]

f. Deemed Qualified Payments Versus Mandatory Payment Rights

(1) As mentioned above, there is an election to treat a distribution right that is not a qualified payment to be treated as such for purposes of Section 2701 (Deemed Qualified Payment) provided the amount and times are specified (presumably fixed) in the election. Because this is a Deemed Qualified Payment and not an exception from being an distribution right, for example, this means that this right will be valued under the Subtraction Method, including the 10% Minimum Value Rule, which might provide for a phantom gift under certain circumstances.

(2) On the other hand, as discussed above, a Mandatory Payment Right is neither a "distribution right" nor an "extraordinary payment" right. As such, the Subtraction Method is not applicable, and Mandatory Payment Rights are valued under normal gift tax valuation rules.

(3) It is unclear how a Deemed Qualified Payment would differ from a Mandatory Payment Right, although the results for gift tax purposes would be quite different. Although the Treasury Regulations only refer to Mandatory Payment Rights as consisting of a single payment, nothing in the Treasury Regulations would preclude a Mandatory Payment Right from having several fixed payments at specified times.

(4) In either case, whether a Deemed Qualified Payment or a Mandatory Payment Right, from a valuation standpoint (in conjunction with the Subtraction Method or as an exception) the key to the ultimate results will be the appropriate discount rate applied to such payment or payments.

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[88] Ltr. Rul. 9324018

[89] Treas. Reg. § 1.7520-3(a)(9).

[90] Treas. Reg. §§ 1.7520-3(b)(2), 20.7520-3(b)(2) and 25.7520-3(b)(2).

3. Guaranteed Payment Preferred FLPs

a. The Code defines guaranteed payments as “payments to a partner . . . for the use of capital” but only “to the extent determined without regard to the income of the partnership to a partner for . . . the use of capital.”[91] The Treasury Regulations go on to explain that a guaranteed payment is meant to provide the partner with a return on the partner’s investment of capital (as opposed to payments designed to liquidate the partner’s interest in the partnership).[92]

b. As such guaranteed payment interests are similar to preferred interest in that they are not dependent or contingent upon partnership profits. For our purposes, the primary differences between a guaranteed payment interest and a preferred interest are:

(1) How the payments are treated for income tax purposes by the holder of the interest (recipient of the preferred payment) and the partnership;

(2) How the payments are treated for capital account purposes; and

(3) How guaranteed payment interests are treated for Section 2701 purposes.

c. A partnership that makes a guaranteed payment to partner is entitled to either deduct the payment as an ordinary and necessary business expense[93] of the partnership or capitalize[94] the expense as a capital expenditure, depending on the nature of the payment.[95] The partner receiving the guaranteed payment must include the payment as ordinary income[96] in the year in which the partnership paid or accrued the payment under its method of accounting.[97]

d. Guaranteed payments carry income with them, and as such, they do not affect the capital accounts of the recipient partner. Capital accounts are “adjusted only to the extent of such partner’s distributive share of any partnership deduction, loss, or other downward capital account adjustment resulting from such payment.”[98]

e. Other than for determining the taxability and deductibility of the payment and other limited purposes, guaranteed payments are considered interests in the partnership. The Treasury Regulations provide that “guaranteed payments are considered as made to one who is not a member of the partnership, only for the purposes of section 61(a) (relating to gross income) and section 162(a) (relating to trade or business expenses…Guaranteed payments do not constitute an interest in partnership profits for purposes of sections 706(b)(3), 707(b), and 708(b)). For the purposes of other provisions of the internal revenue laws, guaranteed payments are regarded as a partner’s distributive share of ordinary income.”[99]

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[91] § 707(c).

[92] Treas. Reg. § 1.707-4(a)(1)(i).

[93] § 162(a).

[94] § 263.

[95] § 707(c).

[96] *See* 61(a).

[97] § 706(a) and Treas. Reg. §§ 1.706-1(a)(1) and 1.707-1(c).

[98] Treas. Reg. § 1.704-1(b)(2)(iv)(*o*).

[99] Treas. Reg. § 1.707-1(c).

(1) Section 706(b)(3) defines a "principal partner" as one who has an interest of at least 5% of the partnership profits or capital;

(2) Section 707(b) disallows losses and treats gain as ordinary income on certain transactions between related parties; and

(3) Section 708(b) provides for the termination of a partnership if there is a sale or exchange of 50% or more of the interests in partnership capital and profits.

f. Reasonable Guaranteed Payment

(1) Guaranteed payments are made pursuant to a written provision of a partnership agreement and payable only to the extent that the payment is made for use of capital after the date on which the provision is added to the partnership agreement.

(2) For disguised sale purposes (discussed below), guaranteed payments are deemed to be reasonable if the sum of any guaranteed payment for the year does not exceed the amount determined by multiplying:

(a) The partner's unreturned capital at the beginning of the year, or at the option of the partner, the partner's weighed average capital balance for the year, by

(b) The safe harbor interest rate for that year. Safe harbor interest rate equals 150% of the highest applicable Federal rate, at the appropriate compounding periods, in effect at any time from the time that the right to the guaranteed payment for capital is first established.[100]

g. As discussed above, for purposes of Section 2701 are excluded from the definition of "distribution right" and as such, can not be considered an "applicable retained interest." Effectively what this means is that if a partner retains a Guaranteed Payment Preferred interest in a FLP and transfers a non-guaranteed interest in the FLP to a family member, the subtraction rule does not apply and the transfer will be valued under normal gift tax rules.

4. Profits FLPs

a. How preferred interests dependent upon profits (and other similar interests like carried interests) are treated in the family context has recently been addressed by other authors and commentators. There is some debate between them as to the application of Section 2701 in these circumstances. I have not endeavored to enter the debate. In other words, I am punting.

b. If you are interested in the subject, please read the following excellent articles and papers:

(1) Lee A. Wendel and Milford B. Hatcher, Jr., "How to Profit Without Getting Carried Away: Carried Interests, Profits Interests, or Black Holes?."[101]

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[100] Treas. Reg. §1.707-4(a)(3)(ii).

[101] Unpublished paper presented at Annual Meeting of American College of Trust and Estate Counsel (March 5 & 6, 2009).

(2) Richard L. Dees, “Profits Interests Gifts Under Section 2701: ‘I Am Not a Monster.”[102]

(3) Jonathan J. Rikoon, “Fun with Funds: FUNDamentals of Estate Planning with Carried Interests in Private Equity and Hedge Funds.”[103]

D. Mutual Funds

1. Like Single Class Share FLP interests, the transfers of interests in regulated investment companies (mutual funds) are free from the complications of Chapter 14 due to either the Market Quotation Exceptions or the Same Class and Proportional Class Exceptions, all noted above.

2. Unlike Single Class Share FLPs, mutual fund shares will not be entitled to the typical discounts for lack of marketability and minority interest.

3. Furthermore, the pass-thru income taxation of mutual funds, as discussed below, is based upon pro rata interests at the time of the taxable event, and as such, remedial allocations to correct “phantom” taxation like Reverse 704(c) Allocations and Stuffing Allocations are not available. Furthermore, because mutual funds are corporations for tax purposes, Section 754 elections are not available either.

III. PARTNERSHIP ACCOUNTING AND TAX ISSUES

A. Formation and Contribution of Assets In-Kind to Investment Partnerships

1. Generally, family investment partnership agreements provide it is within the discretion of the general partners regarding whether the investment partnership will accept contributions of stocks and securities from a family member.

2. Upon formation, each partner’s capital account is credited with the amount of cash and the fair market value of property contributed to the investment partnership. A contribution of a portfolio of stocks and securities to an investment partnership generally results in the contributor recognizing gain, but not loss, if the effect of the contribution is a "diversification" of the contributor's assets.[104] If gain is recognized upon contribution, the investment partnership’s basis in the securities is equal to the fair market value on the date of contribution.[105]

3. However, a contribution of such a portfolio to a partnership would not result in taxable gain if (i) the portfolio constitutes a "diversified portfolio” at the time of the transfer and (ii) such contribution is not part of a plan whereby another person contributes an "undiversified" portfolio of stock

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[102] Tax Notes, Vol. 123. No. 6, 2009. Available at SSRN: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1401595.

[103] 43 U. Miami Philip E. Heckerling Inst. on Est. Plan. (2009).

[104] § 721(b) provides that provides that gain is realized on the contribution of property to a partnership if the partnership would be treated as an “investment company” under § 351(e). Section 351(e) of the Code and the Treasury Regulations provide that any contributions will be deemed to be a transfer to an investment company if the transfer results, directly or indirectly, in diversification of the transferor’s interests, and the transferee is, in pertinent part, a corporation more than 80 percent of the value of whose assets are held for investment and are stocks or securities, or interests in regulated investment companies, or real estate investment trusts.

[105] *See* § 723.

and securities to the same investment partnership. A contributed portfolio will be considered diversified if, taken in the aggregate, (a) the stock or securities of any one issuer do not constitute more than 25% of the value of the contributed assets and (b) the stock and securities of 5 or fewer issuers do not constitute more than 50% of the value of the transferred assets.[106]

4. In making this determination, all cash and cash items (including receivables) are excluded as well as any assets acquired for purposes of meeting the requirements of diversification. U.S. Government securities are included in "total assets" for purposes of the denominator of the 25% and 50% tests, but are not treated as securities of an issuer for purposes of the numerator of the 25% and 50% tests. For these purposes, stocks and securities include money, stock in a corporation, notes, bonds, debenture or other debts, and derivative financial instruments.

5. There is an exception for contributions of assets which, in the aggregate, are an insignificant part of the total value of assets transferred. There have been a number of rulings on the issue of whether the contribution is insignificant. The rulings have generally held that if the contribution makes less than 5% of the total value, then it will be considered insignificant and thus will not trigger a taxable event.[107] Because family investment partnerships tend to have fewer partners/investors than publicly-traded mutual funds or hedge-funds run by third parties, this exception may not always be available.

6. If the contribution is tax-free to the investment partnership and the contributor, the partnership's basis and holding period in the securities is the same as the contributor.[108]

7. Furthermore, Section 704(c) requires that any built-in gain in the appreciated securities upon contribution must be tracked so that the built-in gain is allocated specially to the contributing partner at the time of realization by the partnership. As discussed later, this built-in gain may be limited by the "ceiling rule."[109] Any subsequent gain or loss by the investment partnership will be allocated among all of the partners, as provided in the partnership agreement.

8. The Treasury Regulations provide that Section 704(c) allocations are generally made on a property-by-property basis and, unlike Reverse 704(c) allocations (discussed below), generally cannot be aggregated.[110] The preamble to Section 1.704-3(e)(3) of the Treasury Regulations do not authorize aggregation of built-in gains and losses from contributed property with built-in gains and losses from revaluations because the aggregation can lead to substantial distortions in the character and timing of income and losses recognized by contributing partners.[111] That being said, the Treasury Regulations authorize the IRS to issue guidance as to when aggregation will be allowable. To that end, the IRS granted automatic permission for certain securities partnerships to aggregate contributed property for purposes of making Section 704(c) allocations under Revenue Procedure 2001-36.[112] Because the

[106] *See* § 368(a)(2)(F)(ii).

[107] *See* Rev. Rul. 87-9, 1987-1 C.B. 133 (contribution of cash representing 11% the total contribution was held to be significant, resulting in diversification), Ltr. Rul. 9451035 (cash in excess of 5% of the aggregate assets are considered significant, resulting in diversification) and Ltr. Rul. 9504025 (cash equal to 1% of the value of assets contributed is insignificant) and Ltr. Rul. 200006008 (contributions of stock portfolios to an LLC are insignificant because the assets constitute less than 5% of the company's total value after the transfer).

[108] § 723 and Treas. Reg. § 1.723-1.

[109] Treas. Reg. § 1.704-3(b)(1).

[110] Treas. Reg. § 1.704-3(a)(2).

[111] T.D. 8585, 1995-1 C.B. 120, 123.

[112] Rev. Proc. 2001-36, 2001-23 I.R.B. 1326.

automatic permission only applies to securities partnerships that are "Qualified Master-Feeder Structures,"[113] aggregation with respect to family investment partnership is generally only allowable through a ruling request. The Revenue Procedure describes the information that must be included with ruling requests for permission to aggregate contributed property for purposes of making Section 704(c) allocations submitted by partnership that do not qualify for automatic permission.[114]

B. Capital Account Maintenance

1. Generally, allocations of tax items under the partnership agreement must have "substantial economic effect" which will be deemed present if:

a. The allocation is found to have economic effect; and

b. Such economic effect must be substantial.[115]

2. An allocation will have economic effect if the partnership agreement provides:

a. Determination and maintenance of the partner's capital accounts in accordance with the rules set out in the Treasury Regulations;

b. Upon liquidation the partnership or partner's interest in the partnership, liquidating distributions will be made according to positive capital account balances of the partners; and

c. A partner with a deficit capital account balance is obligated to restore the deficit balance.[116]

3. For limited partnerships and limited liability companies, the foregoing test can not be satisfied because limited partners and members are not obligated to make-up deficit balances because of their limited liability. To that end, the Treasury Regulations provide that partnership agreement must contain a "qualified income offset" which generally requires that a partner who has a deficit capital account balance will be allocated partnership income and gain to eliminate such deficit capital account as quickly as possible.[117] The capital account must be adjusted (reduced) to take into account the following:

a. Certain reasonably expected depletion adjustments;

b. Reasonably expected allocations of loss and deduction resulting from certain provisions in the Code which override the allocation provisions of Section 704(b);[118] and

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[113] *See* Rev. Proc. 2001-36, 2001-23 I.R.B. 1326, Section 4.02.

[114] *See* Rev. Proc. 2001-36, 2001-23 I.R.B. 1326, Section 5 and Ltr. Ruls. 200438029 and 200633019 for examples of family investment partnership that were granted permission to aggregate contributed property.

[115] Treas. Reg. § 1.704-1(b)(2)(i).

[116] Treas. Reg. § 1.704-1(b)(2)(ii)(b).

[117] Treas. Reg. § 1.704-1(b)(2)(ii)(d).

[118] Treas. Reg. §1.704-1(b)(2)(ii)(d)(5). Such may be under §704(e)(2) (transfer of an interest in a family partnership), §706(d) (transfers of interests during the taxable year), and Treas. Reg. §1.751-1(b)(2)(ii) (allocations in respect of appreciated inventory held by the partnership).

c. Reasonably expected distributions from the partnership in excess of increases in the partner's capital account that are reasonably expected to occur by the end of the taxable year in which the distribution is expected.[119]

4. This latter provision might have some relevance in the context of distributions to preferred holders in an investment partnership, but is only applicable to the extent of creating a capital account deficit.

5. If an allocation fails both of the foregoing economic effect tests, the allocation is deemed to have economic effect if it has economic effect "equivalence."[120] Pursuant to this concept, an allocation will have economic effect if, as of the end of the partnership taxable year, a liquidation of the partnership at the end of the year or at the end of any future year would produce the same economic results to the partners as would occur if the general test for economic effect were satisfied, regardless of the economic performance of the partnership. This is sometimes referred to as "targeted capital accounts."

6. In order for the substantiality requirement to be satisfied, the Treasury Regulations provide, "there is a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences."[121]

7. What is clear is that allocations must be consistent with the economic arrangement of the partners, and proper capital account maintenance is the foundation of that economic arrangement. The capital accounts are meant to reflect what each partner would be entitled to receive upon liquidation of the partnership at any given time. In order to ensure that capital accounts properly reflect this economic arrangement, the Treasury Regulations[122] require that capital accounts be:

a. Increased by the amount of money contributed to the partnership by the partner; the fair market value of property contributed to the partnership by the partner; and allocations to the partner of items of partnership income and gain, including tax-exempt income.

b. Decreased by the amount of money distributed by the partnership to the partner; the fair market value of property distributed by the partnership to the partner; and allocations to the partner of items of partnership loss and deduction and partnership expenditures that are neither deductible by the partnership in computing its taxable income nor properly chargeable to capital account.

8. Specifically important to family investment partnerships, the Treasury Regulations[123] provide that capital accounts may be adjusted to reflect revaluations of partnership if the adjustment is made principally for a non-tax business purpose. Specifically, the revaluation events are:

a. Contribution of money or property to the partnership by a new or existing partner in exchange for a partnership interest;

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[119] Treas. Reg. §1.704-1(b)(2)(ii)(d)(6). For purposes of determining offsetting capital account increases, the fair market value of each partnership property is presumed to equal the adjusted tax basis of that property. Thus, it is not reasonable to expect that distributions will be offset by increases in the partners' capital accounts attributable to increases in the value of partnership assets.

[120] Treas. Reg. § 1.704-1(b)(2)(ii)(*i*).

[121] Treas. Reg. § 1.704-1(b)(2)(iii)(*a*).

[122] Treas. Reg. § 1.704-1(b)(2)(iv)(b).

[123] Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5).

b. Liquidation of the partnership or the distribution of money or property to a partner in exchange for a partnership interest, whether the partner is withdrawing or continuing;

c. Grant of a partnership interest as consideration for services performed for the partnership by an existing partner acting in a partner capacity or a new partner acting either in a partner capacity or in anticipation of becoming a partner; or

d. Periodic revaluations in accordance with generally accepted industry accounting practices, if substantially all of the partnership's assets consists of stocks, securities, commodities, options, warrants, futures, or similar instruments that are readily tradable on an established securities market.

9. If such revaluations are made, the adjustments to the capital accounts must be based on the fair market value of the partnership's properties and must reflect the manner in which gain or loss (not previously reflected in the capital accounts) would be allocated to the partners if each partnership property were disposed of at its fair market value in a taxable transaction.[124]

10. In the family investment partnership context, in particular if it is a Preferred FLP, proper capital account maintenance can have unexpected results. Consider the following example:

a. Assume AB partnership, where A contributes $5,000,000 to the partnership and taxes back a 7% Qualified Payment preferred interest on a liquidation preference amount of $5,000,000 (in other words, a Qualified Payment equal to a fixed amount of $350,000). B also contributes $5,000,000.

b. In year 1, AB partnership has no profits, no cash flow, no net tax items and the partnership property does not change in value. The partnership agreement provides for an annual revaluation of the capital accounts. At the end of year 1, because A's Qualified Payment right is not dependent upon profits of the partnership, A's capital account goes from $5,000,000 to $5,350,000 and B's capital account is reduced to from $5,000,000 to $4,650,000. That is the economic agreement of the partners, and that would be how the partnership property would be distributed if it liquidated at that time.

c. If AB partnership has no net cash flow and the partnership agreement provides that the preferred return is payable out of net cash flow, the capital account balances will remain as restated and the preferred return of $350,000 will remain in arrears until such time as it is paid out under the terms of the agreement.

C. Allocations of Profit and Loss

1. General Allocation of Profit and Loss

a. Generally, the partnership agreement for an investment partnership will provide that the partnership's net capital appreciation (increase in value of the partnership's net assets including unrealized gains) or net capital depreciation (decrease in value including unrealized losses) for each accounting period will be allocated among the partners and to their capital accounts without regard to the amount of income or loss actually recognized by the partnership for Federal income tax purposes.

[124] Treas. Reg. § 1.704-1(b)(2)(iv)(f)(1) and (2).

b. Items of income, deduction, gain, loss or credit actually recognized by the partnership for each taxable year generally are allocated for income tax purposes among the partners pursuant to the principles of Treasury Regulations issued under Sections 704(b) and 704(c) of the Code, based upon amounts of the partnership's net capital appreciation or net capital depreciation allocated to each partner's capital account for the current and prior taxable years and if none, upon relative capital account balances.

c. This type of allocation is straightforward in the Single Class Share FLP. Furthermore, the legislative history of Section 2701 point out that if all items of income, deduction, loss and gain are allocated among the partners in proportion to the capital contributions and liquidating distributions are made pursuant to their respective capital accounts then the Same Class Exception would apply.[125]

d. With a Preferred FLP, the allocation becomes a bit more convoluted.

(1) Typically, allocation provisions with preferred partnerships will use a "layer cake" methodology to provide multiple tiers of allocations. For example, they might provide:

(a) First, to the partners, to offset all prior loss allocations;

(b) Second, to the preferred partners until their capital accounts equal their unreturned capital contributions;

(c) Third, to the preferred partners in an amount equal to their preferred return; and

(d) Fourth, to the common partners (in some proportion, like relative capital accounts).

(2) This, however, does not specifically provide which class of partnership will be allocated losses first. Typically, the common partners would be allocated losses first to the extent of positive capital accounts, but that does not necessarily have to be the case. It might be equally valid to allocate losses pro rata to all of the partners, perhaps according to relative capital accounts. As long as the methodology reflects the economic understanding of the partners and is exercised consistently, the foregoing allocation method of loss should be valid.

(3) The McKee, Nelson and Whitmire treatise provides that the Service expects a preferred return to be matched by a corresponding allocation of available income or gain.[126]

(4) The Treasury Regulations, in the context of the disguised sale rules, provide that a preferred return means "a preferential distribution of partnership cash flow to a partner with respect to capital contributed to the partnership by the partner that will be matched, to the extent available, by an allocation of gain."[127]

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[125] *See* Senate report on Omnibus Budget Reconciliation Act of 1990, 136 Cong. Rec. S 15691 (Oct. 18, 1990).

[126] McKee, Nelson and Whitmire, *Federal Taxation of Partnerships and Partners*, ¶ 13.02[3][b][iii], at 3-19 (3d ed. 1997).

[127] Treas. Reg. § 1.707-4(a)(2).

(5) What happens if there is no income or gain to be allocated that year or insufficient income or gain in subsequent years to satisfy the total preferred payments?

(6) Must a special allocation of partnership income and gain in subsequent years to match distributions on the preferred or must it be limited to the available income at such time?

(7) Can the partnership provide that all tax items are allocated based upon relative capital accounts after taking into account all revaluation events (as discussed above) and reliance upon a targeted capital account methodology (as discussed above), based upon economic effect "equivalence" under the Treasury Regulations?

e. Despite the uncertainty that allocations of profit and loss can have in the Preferred FLP context, it seems clear that "bottom line" allocations[128] (where an allocation of the partnerships net taxable income or loss will be treated as an allocation of a share of all items of income, gain, loss and deduction) are allowable, administratively easier, and to a certain extent mandated by the family partnership rules under Section 704(e).[129]

2. Allocations of Gains (Reverse 704(c) Allocations)

a. When a partnership recognizes a gain, the partnership must allocate the gain among the partners. In other words, typical partnership accounting does not record unrealized gains on a mark to market methodology unless there is a taxable event. If the partnership allocates the taxable gain on the capital percentage at the time of the taxable event (like mutual funds do), this will create a book and tax disparity among the partners. "Reverse 704(c)" allocations is a methodology to remedy this problem by attempting to ensure that the ultimate gain is allocated appropriately to the partners according to the economic deal among the partners.

b. The Treasury Regulations provide that capital accounts of the partners can be increased or decreased upon the occurrence of certain revaluation events with respect to partnership property.[130] In a situation where gain needs to be allocated among the partners, it provides that taxable gain should be allocated using the principles of Section 704(c).[131] Just as a partner who contributes appreciated property to a partnership receives special allocations of built-in gain upon the sale of that property, so should a partner who receives a book-up of capital resulting from the appreciation of an asset upon a revaluation event.

(1) The Treasury Regulations provide with respect to these revaluation allocations, "these tax items must be shared among the partners in a manner that takes account of the variation between the adjusted tax basis and its book value in the same manner as variations between the adjusted tax basis and fair market value of property contributed to the partnership are taken into account in determining the partner's shares of tax items under Section 704(c)."[132]

(2) Generally, the examples provided in the Treasury Regulations provide that when a new partner is admitted, the old partners receive a special allocation of taxable income on the

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[128] Treas. Reg. § 1.704-1(b)(1)(vii).

[129] *See* Treas. Reg. § 1.704-1(e)(3) and Woodbury v. Commissioner, 49 T.C. 180 (1967).

[130] Treas. Reg. § 1.704-1(b)(2)(iv)(f).

[131] Treas. Reg. § 1.704-1(b)(2)(iv)(f)(4).

[132] Treas. Reg. § 1.704-1(b)(4).

sale of the appreciated asset to the extent of the unrealized gain at the time of the admission of the new partner.[133]

c. There are two methods of making Reverse 704(c) allocations: "detailed" and "aggregate."

(1) The detailed layering method tracks each individual security. Effectively, this requires the partnership to track each lot of security with respect to its adjusted tax basis and holding period. This requires extensive record-keeping, especially with actively-managed investment portfolios.

(2) In the aggregate layering method, taxable gains are allocated among the partners in the ratio of each partner's unrealized income on the securities position to the total amount of unrealized income of all partners on the securities positions. The Treasury Regulations allow "securities partnerships" to use aggregation in making Reverse 704(c) allocations.[134] Once a partnership adopts an aggregate approach, the partnership must apply the same aggregate approach to all of its qualified financial assets for all taxable years in which the partnership qualifies as a securities partnership.

(3) A "securities partnership" includes an investment partnership that makes all of its book allocations in proportion to the partners' relative capital accounts (except for reasonable special allocations to a partner who provides management services or investment advisory services to the partnership).[135] Under the Treasury Regulations, a partnership will be deemed an investment partnership if (1) on the date of each capital account restatement, the partnership holds "qualified financial assets" that constitute at least 90% of the fair market value of the partnership's non-cash assets, and (2) the partnership reasonable expects, as of the end of the first taxable year in which the partnership adopts an aggregate approach to make revaluation at least annually.[136]

(4) Qualified financial assets are defined as any personal property (including stock) that is actively traded, as defined in Treasury Regulation Section 1.1092-1 (generally, actively traded property for purposes of the straddle rules, as discussed later in the outline).

(5) The Treasury Regulations allow for any reasonable method, but discuss two specifically: "aggregation with full netting" and "aggregation with partial netting."[137] Furthermore, the Treasury Regulations provide that any allocation method will not be considered reasonable if the corresponding Reverse 704(c) allocations are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.[138]

(6) For example, assume AB Partnership that purchased Stock 1 for $100 and Stock 2 for $200 when there are 2 equal partners, A and B. Stock 1 appreciates to $400, and Stock 2 appreciates to $1,000 by the end of the year. New partner, C, joins as an equal partner at the beginning of year 2 during which Stock 1 appreciates from $400 to $700, at which time it is sold. There is $600 of resulting gain that must be allocated among the partners.

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[133] Treas. Reg. § 1.704-1(b)(5), Example (14).

[134] Treas. Reg. § 1.704-3(e)(3).

[135] Treas. Reg. § 1.704-3(e)(3)(iii)(A).

[136] Treas. Reg. § 1.704-3(e)(3)(iii)(B)(2).

[137] Treas. Reg. § 1.704-3(e)(3)(iv) and (v). *See also* Ltr. Ruls. 200438029 and 200633019.

[138] Treas. Reg. § 1.704-3(a)(10).

(a) If the $600 gain is allocated equally among the partners because all of the partners were equal partners at the time of the taxable event, then each partner would be allocated $200 each. This is how a mutual fund would allocate the gains.

(b) If a "detailed" Reverse 704(c) allocation methodology is used, the taxable gain would be allocated $250 to A, $250 to B and $100 to C.

(c) If an "aggregate" Reverse 704(c) allocation methodology is used, the taxable gain would be allocated $278 to A, $278 to B and $44 to C, based on the ratio of each partner's total unrealized appreciation on the date of the sale of Stock 1. Keep in mind, A and B's unrealized appreciation includes the appreciation in Stock 2.

(7) Revenue Procedure 2007-59[139] grants permission to certain "qualified partnerships" to aggregate gains and losses from "qualified financial assets" for purposes of making Reverse 704(c) allocations. Unfortunately, this is often not available to many family investment partnerships because a "qualified partnership" requires a reasonable expectation of having at least 10 unrelated[140] partners at all times during the year. However, the Revenue Procedure provides a decent methodology for layering for family investment partnerships to follow.

d. The Treasury Regulations provide a cap on Reverse 704(c) allocations, often referred to the "ceiling rule."[141] The ceiling rule provides that the amount of taxable gain or loss with respect to property that a fund may allocate among its partners may not exceed the taxable gain or loss actually realized on the property. The problem occurs when an asset (like a volatile stock) as frequent fluctuations in value.

(1) For example, assume a partnership purchases an asset for $50 and it appreciates to $100. The partnership admits a new partner at that time. Soon thereafter, the asset depreciates to $75 and is then sold for a taxable gain of $25.

(2) Under the general principles above (allocating gain and loss to the partners who experienced them), the old partners should be allocated $50 of gain and the new partner should be allocated a loss of $25. The ceiling rule precludes that result, because the partners can not be allocated more gain than is actually realized.

(3) This problem can be solved by using curative allocations under the Treasury Regulations,[142] which are just a reallocation of gain or loss from other partnership property to prevent distortion caused by applying the ceiling rule. As long as there are sufficient gains on the securities to allocate the total economic gains to the partners, the ceiling rule should not create this distortion.

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[139] Rev. Proc. 2007-59, 2007-40 I.R.B. 745.

[140] Within the meaning of § 267(b) or § 707(b).

[141] Treas. Reg. § 1.704-3(b)(1).

[142] Treas. Reg. § 1.704-3(c)(1).

3. Disguised Sale Rules (Section 707(a)(2)(B))

a. If a partner who has contributed appreciated property to the family investment partnership receives a distribution of any other property or cash within two years of the contribution,[143] based on the applicable facts and circumstances, the distribution may cause the partner to recognize gain as of the original date of contribution with respect to his or her contributed securities under the "disguised sale" provisions of Section 707(a)(2)(B) of the Code.

b. Distributions in a transaction determined to be a disguised sale are treated as payments by the family investment partnership to the disguised seller/partner, acting in an independent capacity, and not as a partner.[144]

c. The Treasury Regulations provide that a guaranteed payment or a preferred return on unreturned capital, at a rate not in excess of 150% of the highest applicable Federal rate, at the appropriate compounding period, in effect at any time the guaranteed payment or preferred return is established, is reasonable for disguised sale purposes.[145]

d. Often family investment partnerships will make distributions to its partners for their allocable share of the partnership's taxable income. Because the disguised sale rules are based on a facts and circumstances test, it is unclear whether the IRS will treat these distributions as a disguised sale. The Treasury Regulations do, however, provide that distributions from a partnership accompanied by a corresponding allocation of gain or loss and distributions of a partner's share of operating cash flow may escape disguised sale treatment.[146]

4. Distributions of Cash (Liquidating and Non-Liquidating)

a. Generally, a partner receiving a liquidating cash distribution from family investment partnership (in connection with a partner's complete withdrawal from the partnership),[147] will recognize capital gain or loss to the extent of the difference between the proceeds received by such partner and such partner's adjusted tax basis in its interest in the partnership.[148] Such capital gain or loss will be short-term, long-term or some combination of both, depending upon the timing of the partner's contributions to the fund. However, a withdrawing partner will recognize ordinary income to the extent such partner's allocable share of the fund's "unrealized receivables" exceeds the partner's basis in such unrealized receivables.[149] In an investment partnership context, accrued but untaxed market discount, if any, on securities held by the partnership will be treated as an unrealized receivable, with respect to which a withdrawing partner would recognize ordinary income.

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[143] Distributions within two years are presumed to be part of a disguised sale, and those more than two years are presumed not to be part of a disguised sale. Treas. Reg. § 1.707-3.

[144] § 707(a)(2) and Regs. § 1.707-3.

[145] Treas. Reg. § 1.707-4(a)(3).

[146] *See* Regs. § 1.707-4(a) and (b).

[147] § 761(d).

[148] § 731(a)(1) and (c) and Regs. § 1.731-1(a)(1).

[149] § 751(b).

b. A partner receiving a non-liquidating cash distribution (often referred to as current distributions) will recognize income in a similar manner only to the extent that the amount of the distribution exceeds such partner's adjusted tax basis in its partnership interest.[150]

5. Distributions of Securities

a. Generally, a partner's receipt of a distribution of property from a partnership is generally not taxable unless the distribution is in excess of the partner's adjusted basis in the partnership immediately before the distribution.[151]

b. For these purposes, a distribution consisting of marketable securities generally is treated as a distribution of cash (rather than property).[152] For these purposes, marketable securities includes financial instruments (stocks, equity interests, debt, options, forward or futures contracts, notional principal contracts and other derivatives) and foreign currencies which are actively traded.[153]

c. There are a number of applicable exceptions to the foregoing treatment of distributions of marketable securities, including: (1) distributions of contributed securities to the partner who contributed them;[154] (2) distributions of securities that were not marketable when acquired by the partnership;[155] and (3) distributions of securities from an "investment partnership" to an "eligible partner."[156]

d. An "investment partnership" is defined as a partnership that substantially all of whose assets consist of specified investment-type assets and has never been engaged in a trade or business.[157] Specified investment-type assets include (1) money, (2) stock in a corporation, (3) notes, bonds, debentures, or other evidences of indebtedness, (4) interest rate, currency, or equity notional principal contracts, (5) foreign currencies, and (6) derivative financial instruments (including options, forward or futures contracts and short positions).[158] A partnership will not be considered engaged in a trade or business by reason of any activity undertaken as an investor, trader or dealer in such specified investments.[159]

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[150] § 731.

[151] § 731(a)(1).

[152] § 731(c).

[153] § 731(c)(2)(A) and (C).

[154] § 731(c)(3)(A) and Regs. § 1.731-2(d)(1).

[155] § 731(c)(3)(A)(ii) and Regs. § 1.731-2(d)(1)(iii). To qualify for this exception, the security must not have been marketable on the date acquired and the entity to which the security relates must not have had any outstanding marketable securities on that date. Further, the hedge fund must have held the security for at least 6 months prior to the security becoming marketable, and the hedge fund must distribute the security within 5 years from the date the security became marketable.

[156] §§ 731(c)(3)(C)(i) and 731(c)(3)(A)(iii).

[157] § 731(c)(3)(C)(i).

[158] § 731(c)(3)(C)(i)(I) through (VIII).

[159] § 731(c)(3)(C)(ii)(I) and Regs. § 1.731-2(e)(3)(i).

e. An "eligible partner" is one who, before the date of distribution, did not contribute to the partnership any property other than specified investment-type assets permitted to be held by an investment partnership.[160]

6. Distributions of Securities to a Contributing Partner (Mixing Bowl)

a. If a partner contributes appreciated securities (or other property) to the partnership and, within 7 years of the date of contribution, that partner receives a distribution of any property other than these contributed securities, such partner generally will be required to recognize gain upon the receipt of such other property.[161] On the other hand, a distribution of securities previously contributed by the same partner does not trigger gain.[162]

b. The amount of the gain is equal to the lesser of (a) the excess of the fair market value of the distributed property over the adjusted tax basis of such partner's partnership interest immediately before the distribution, reduced by the amount of money received in the distribution; (b) the excess of the fair market value of such partner's contributed securities over their adjusted tax basis at the time they were contributed to the partnership or (c) the excess of the fair market value of such partner's contributed securities over their adjusted tax basis in the hands of the partnership, at the time of the distribution of such other property.[163]

c. The character of the gain is determined by the character of the contributed securities in the hands of the partnership.[164]

d. The partner's adjusted tax basis in the partnership interest and the partnership's tax basis in the contributed securities are automatically adjusted without the need for a Section 754 election.[165] Further, the basis of the distributed securities is adjusted to reflect the recognized gain.

7. Distributions of Securities to a "Non-Contributing" Partner (Mixing Bowl)

a. If contributed securities (or other property) are distributed within 7 years of the date of contribution to any partner other than the partner who contributed such securities, the contributing partner must generally recognize a taxable gain or loss in the year of distribution.[166]

b. The amount of such gain or loss would generally equal the lesser of (a) the difference between the fair market value of the contributed at the time such securities had been contributed to the partnership and the contributing partner's tax basis in such securities, or (b) the difference between the fair market value of the contributed securities and their adjusted tax basis in the hands of the partnership at the time of their distribution.[167]

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[160] § 731(c)(3)(C)(iii)(I).

[161] §§ 704(c)(1)(B) and 737.

[162] § 737(d)(1) and Regs. § 1.737-1(d).

[163] §§ 737(a)(1) and (2).

[164] § 737(a) and Regs. § 1.737-1(d).

[165] § 737(c) and Regs. § 1.737-3.

[166] § 704(c)(1)(B).

[167] § 704(c)(1)(B)(i) and Regs. § 1.704-4(a).

c. The character of any such gain or loss is determined by the character of the contributed securities in the hands of the partnership.[168]

d. The adjusted tax basis of the contributing partner in the partnership and the adjusted tax basis in the contributed property to the partnership and the "non-contributing" partner (distributee) are immediately adjusted for any gain or loss without the need for a Section 754 election.[169]

e. Since the gain or loss recognized under these provisions adjusts for differences in the adjusted tax basis and the book value of the contributed securities, it does not generally affect the contributing partner's capital account.

8. Distributions of Property or Securities on a Complete Redemption

a. If a partner receives only property in complete redemption of his or her capital account, the partner will not recognize taxable gain or loss. The adjusted tax basis of the property in the hands of the partner will be equal to the partner's adjusted tax basis in the partnership interest immediately prior to the redemption.[170]

b. The holding period of the of the property distributed will be the same as the partnership's holding period, without regard to the time the partner has owned the partnership interest.[171] As such, gain or loss on the property is deferred until the disposition of the property received.

9. Stuffing Allocations

a. A "stuffing" allocation is a special allocation often used by investment partnerships to minimize the tax burden to the partners. As mentioned above, when a partner redeems his or her interest for cash, the partner will recognize gain on the redemption to the extent the cash distribution exceeds his or her basis. If a partnership chooses to sell a marketable security, for example, to fund the redemption, the partner's tax basis will include an allocable share of the gain or loss from such sale. However, under Section 704(b), the fund must allocate the gain among all of the partners, even though it intends to distribute all of the proceeds to the withdrawing partner. When this occurs, the partnership may wish to allocate additional taxable gain to the withdrawing partner to equalize the tax and book basis. Allocating additional gain to the withdrawing partner reduces the amount of taxable gain that would otherwise be allocated to the remaining partners.

(1) For example, assume Partner A, a 25% partner in the ABCD Partnership, redeems his or her interest in the partnership. Partner A's partnership interest has a fair market value of $300 and an adjusted tax basis of $200. In order to fund the redemption the partnership sells a security (Stock 1) that has an adjusted tax basis of $200 and a fair market value of $300. As a 25% partner, the partnership would allocate $25 (25% of the $100 of gain) to the Partner A. Partner A's adjusted tax basis would be increased by $25 to $225, and Partner A would recognize an additional $75 under Section 731 upon receipt of the $200 of cash to redeem his or her interest. The remaining partners (B, C and D) will bear the tax burden of the remaining $75 on the sale of Stock 1.

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[168] Treas. Reg. § 1.704-4(b).

[169] § 704(c)(1)(B)(iii) and Treas. Reg. § 1.704-4(e).

[170] Treas. Reg. §1.732-1(b).

[171] § 735(b).

(2) If ABCD Partnership had a Section 754 election in place, it could increase the basis of the remaining assets by the $75 of gain to Partner A. This would reduce the gain (or increase the loss) allocable to the remaining partners. However, as discussed below, many partnerships do not make a Section 754 election because of the administrative burdens associated with it.

(3) Without this adjustment, the remaining partners would not recover the incremental tax associated with the earlier sale of assets until they also redeem their shares for a higher tax basis.

(4) One possible solution to this timing problem, is to make a "stuffing" allocation to the withdrawing partner. In this example, instead of allocating the $100 of gain among all of the partners, the partnership would allocate the entire amount to Partner A. As a result, Partner A's adjusted tax basis increases from $200 to $300 and no additional taxable gain would be allocable under Section 731 upon redemption and receipt of the $300 in cash.

(5) The tax deferral as a result of the reduced allocation of gain to the remaining partners only lasts until the assets which gave rise to unrealized gain for the withdrawing partner are disposed of in a taxable transaction. At the time of the sale, the remaining partners will have to include the withdrawing partner's portion of the unrealized gain in their taxable incomes. Thus, the reduced tax liability at the time of withdrawal is offset by increased tax liability in later years.

b. There is no specific authority for "stuffing." The general principal under Section 704 is that the allocation of income or loss by a partnership is governed by the partnership agreement and those allocations will be respected unless the allocations lack "substantial economic effect." In other words, taxes should follow the economics of the business deal.

c. It has been argued that "stuffing allocations" do not have substantial economic effect.

(1) Substantial economic effect provides that (i) in order for an allocation to have economic effect it must be consistent with the underlying economic arrangement of the partners;[172] and (ii) such economic effect must be substantial. An economic effect is substantial if there is a reasonable possibility that the allocation will affect substantially the dollar amounts to be received by the partners from the partnership, independent of the tax consequences.[173]

(2) The argument goes that a "stuffing" allocation does not affect the amount of cash or other property that is to be distributed to the withdrawing member. Thus, the allocation has no economic effect, substantial or otherwise.

(3) However, most partnerships do not revalue its assets periodically as investment partnerships do. The Treasury Regulations generally provide the basic rules for capital account maintenance. A partner's capital account is increased by money contributed, the fair market value of property contributed, and allocations of partnership income and gain. The capital account is decreased by money distributed, the fair market value of property distributed and the amount of partnership loss and deduction.[174] There is no mention of any increases or decreases as a result of a revaluation of the assets. As such, normally, partnerships capital accounts are kept on a cost-type basis. The Treasury Regulations provide, in pertinent part, "allocations made to a partner that do not otherwise have economic

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[172] Treas. Reg. § 1.704-1(b)(2)(ii).

[173] Treas. Reg. § 1.704-1(b)(2)(iii).

[174] Treas. Reg. § 1.704-1(b)(2)(iv)(b).

effect…shall nevertheless be deemed to have economic effect, provided that at the end of each partnership taxable year a liquidation of the partnership at the end of such year…would produce the same economic results to the partners."[175]

(4) In addition, there is some support that the Treasury Regulations that provides, "the adjusted tax basis of partnership property (or if partnership property reflected on the books of the partnership at book value that differs from its adjusted tax basis, the book value of such property) will be presumed to be the fair market value of such property," supports "stuffing" allocations.[176]

10. Section 754 Election

a. An alternative to "stuffing" elections, Section 754 provides that in the case of a taxable distribution to a partner, the partnership can elect to adjust the basis of the assets in the partnership by the gains recognized by the distributee partner.

b. Section 734(a) provides that the adjusted basis of partnership is not adjusted as a result of a distribution of distribution by the partnership to a partner. Discrepancies can arise following a distribution in which the distributee partner recognizes gain or in which the partner's adjusted basis in the distributed property is greater than or less than the partnership's adjusted basis in the partnership interest. For example, if a partner's interest is redeemed in full for cash, the partner will recognize gain equal to the excess of the cash over the partner's adjusted basis in the partnership interest. The gain recognized essentially is gain attributable to some appreciation in the partnership's assets. However, absent a basis adjustment to the partnership property, upon a sale of the assets, the remaining partners would recognize that portion of gain that should have been allocated to the former partner.

c. The election, once made, cannot be revoked without the IRS's consent.[177] Administratively, the adjustments required under the election are quite onerous because the adjustment must be made across all security positions.

d. Too often tax professionals will recommend that upon the death of a family member, a Section 754 election should be made. Because of the valuation discount for transfer tax purposes on the decedent's interest, a Section 754 election may actually result in a step-down in partnership tax basis. For example, assume a FLP with $20,000,000 in marketable securities and $16,000,000 of adjusted tax basis. The FLP is owned 50% by the grantor and 50% by other family members or trusts. The grantor dies, and the grantor's interest is valued at a 30% discount for estate tax purposes ($7,000,000). The FLP makes a Section 754 election. As a result of the election, under Section 743, the basis of the assets in the partnership are adjusted down by $1,000,000. The decedent's share of tax basis went from $8,000,000 (50% of the inside basis) prior to death to $7,000,000 as a result of the valuation discount at death.

e. Under some circumstances, a Section 754 step-up is mandatory. Under Section 734(b), any distribution that would trigger a "substantial basis reduction" is subject to a mandatory

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[175] Treas. Reg. § 1.704-1(b)(2)(ii).

[176] Lohnes and Gerson, "Value Equals Basis and Partners' Distributive Share: Stuffing, Fill-Ups and Waterfalls," J. of Taxation, Vol. 105 (Aug. 2006).

[177] Regs. § 1.754-1. An election may be revoked if there exists: (i) a change in the nature of the partnership business; (ii) a substantial increase in or a change in the character of the partnership's assets; and (iii) an increase in the frequency of partner retirements or shifts in partnership interests (resulting in increased administrative costs attributable to the § 754 election).

Section 754 adjustment. A "substantial basis reduction" is defined as a negative adjustment in excess of $250,000 to the inside basis of partnership assets (loss upon distribution to the partner and the excess basis of the distributed property to the partner over the adjusted basis of the distributed property immediately before the distribution).[178]

f. Generally, a Section 734(b) adjustment applies under the following 4 circumstances: (1) distributee partner recognizes gain under Section 731(a)(1); (2) the distributee partner recognizes loss under Section 731(a)(2); (3) the distributee partner's adjusted basis in the distributed property is less than the partnership's adjusted basis in the property immediately preceding the distribution; and (4) the distributee partner's adjusted basis in the distributed property is more than the partnership's adjusted basis in the property immediately preceding the distribution.

g. Section 743(f) provides that the adjusted basis of partnership property is not adjusted when a partnership interest is transferred or when a partner dies.[179] This can create a number of discrepancies between the adjusted basis of partnership property (inside basis) and the adjusted basis in the partnership interest (outside basis). Without some adjustment, double taxation might result. When an interest in partnership is transferred by sale or exchange or on the death of a partner, then Section 743(b) requires a partnership that has a "substantial built-in loss" or that has a Section 754 election in effect to:

(1) Increase the adjusted basis of the partnership property by the excess of the basis to the transferee partner in the partnership interest over the partner's proportionate share of the adjusted basis of the partnership property; or

(2) Decrease the adjusted basis of the partnership property by the excess of the transferee partner's proportionate share of the adjusted basis of the partnership property over the basis of the partner in the partnership interest.

h. A partnership will have "substantial built-in loss" if the partnership's adjusted basis in partnership property exceeds the property's fair market value by more than $250,000, determined immediately after the transfer or the death of the partner, as the case may be.[180]

i. The mandatory Section 743(b) adjustment for partnerships with substantial built-in loss does not apply to certain "electing investment partnerships."[181] This narrow exception would disallow the transferee partner's distribute certain losses under Section 743(e)(2). Given the conditions required to meet the definition, this would generally not be applicable to family investment partnerships.

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[178] § 734(d).

[179] *See* Treas. Reg. § 1.743-1.

[180] § 743(d).

[181] The conditions include: (i) the partnership would be an investment company Section 3(a)(1)(A) of the Investment Company Act of 1940 but for an exemption under Section 3(c)(1) or 3(c)(7) of such act (see the securities law considerations portion of this outline); (ii) the partnership has never engaged in a trade or business; (iii) substantially all of the partnership assets are held for investment; (iv) at least 95% of the assets contributed to the partnership are money; (v) no contributed assets had an adjusted basis in excess of fair market value at the time of contribution; (vi) all of the partnership's interest are issued pursuant to a private offering within 24 months of the first capital contribution; (vii) the partnership agreement substantially restricts each partner's ability to cause a redemption of the partner's interest; (viii) partnership agreement provides for a term of 15 years or less; and (ix) the partnership makes an election, which is irrevocable. § 743(e)(6).

D. Selected Tax Issues

1. Related Party Transactions

a. Section 267 of the Code

(1) Section 267(a)(1) of the Code disallows "any loss from the sale or exchange of property, directly or indirectly, between" related parties. Parties are considered related to the taxpayer if they are a spouse, siblings, ancestors (just parents and grandparents) and lineal descendants (just children and grandchildren).[182] In addition to these direct relationships, a related party relationship will exist through constructive ownership rules under Section 267(b) of the Code.

(2) Section 267(b) of the Code attributes constructive ownership through trusts, estates, C corporations and S corporations but does not specifically address partnerships. However, the Regulations provide:[183]

(a) Transactions between partners and partnerships do not come within the scope of Section 267, as they are governed by Section 707 (discussed below).

(b) Transactions described in Section 267(a) between a partnership and a person other than a partner will be considered as occurring between the other person and the members of the partnership separately. As such, if the "other person" and any member of the partnership are related under Section 267(b), a portion or all of the deduction with respect to such transaction would be disallowed.[184]

(3) Transactions with an "other person" and a family investment partnership are beyond the scope of this outline, and as such, Section 267(a) will generally not be an issue in the normal operation and design of a family investment partnership. Furthermore, for Section 267(a)(1) to apply, a direct or indirect, sale or exchange must have occurred. In the normal formation and operation of a family investment partnership, taxable sales or exchanges are relatively rare, especially with the popularity of grantor sales to an intentionally defective grantor trust.

(4) Furthermore, it should also be noted that while Section 267(e) provides a specific rule for pass-thru entities like partnerships, it applies to Section 267(a)(2) transactions. Section 267(a)(2) of the Code provides a matching rule that is designed to ensure that deductions are matched with income in the same taxable year. Thus, the deduction of the payment by the payer is deferred until the tax year in which the payment is included in the payee's gross income.[185] In the family investment partnership context, while this might theoretically be applicable to the deductibility of guaranteed payments, for example, the vast majority of the time the partners of the partnership will have the same accounting method (cash) and the same taxable year (calendar). As such, this matching rule will generally not defer the deductibility of any such payments.

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[182] § 267(c)(4) and Treas. Reg. § 1.267(c)-1(a)(4).

[183] Treas. Reg. § 1.267(b)-1(b)(1).

[184] With respect to the related partnership, the deduction is disallowed to the extent of the partner's distributive share of partnership deductions for losses or unpaid expenses or interest resulting form the transaction. Treas. Reg. § 1.267(b)-1(b)(1)(i).

[185] § 267(a)(2).

b. Section 707(b) of the Code

(1) Generally, a transaction between a partnership and a partner is considered a transaction (for example, a sale or exchange of property, loan, etc.) between the partnership and a non-partner if the partner engages in the transaction in a capacity other than as a partner.[186]

(2) Section 707(b) provides for the disallowance or deferral of loss realized on the "sale or exchanges of property (other than an interest in the partnership), directly or indirectly, between"[187] a partnership and a partner "owning, directly or indirectly, more than 50 percent of the capital interest, or the profits interest"[188] in such partnership.[189]

(3) For purposes of determining the ownership of a capital or profits interest, Section 707(b)(3) provides that the constructive ownership rules for stock in a corporation under Section 267(c) will apply (other than the provision dealing with controlled groups). As such, the capital or profits interest owned by a corporation, partnership, estate or trust is considered owned proportionately by the shareholders, partners or beneficiaries, as the case may be.

c. Section 704(e)

(1) Section 704(e) of the Code provides that a person, for income tax purposes (not for transfer tax purposes), will be recognized as a partner if he or she "owns a capital interest in a partnership in which capital is a material income-producing factor."[190] A capital interest, for this purpose, is an interest in partnership assets that would be distributable upon a liquidation or withdrawal from the partnership (not a mere participation in profits).[191] The Treasury Regulations provide that capital is not a material income-producing factor if the income of the business consists principally of fees, commissions, or other compensation for personal services performed by the members or employees of the partnership.[192] Most family investment partnerships are created to hold marketable securities and other investments passively, rather than to provide investment services. As such, the underlying capital in an investment partnership will most likely be a material income-producing factor Section 704(e) purposes.

(2) If a partnership interest is created by gift,[193] the "distributive share of the donee under the partnership agreement shall be includible in his gross income, except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the

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[186] § 707(a).

[187] § 707(b)(1).

[188] § 707(b)(1)(A).

[189] Also included is any transaction between two partnership in which the same person owns, directly or indirectly, more than 50 percent of the capital or profits interest of the partnerships. § 707(b)(1)(B).

[190] § 704(e)(1).

[191] Treas. Reg. § 1.704-1(e)(1)(v).

[192] Treas. Reg. § 1.704-1(e)(1)(iv).

[193] The Treasury Regulations provide a set of factors to determine whether a bona fide gift is accomplished, whether sufficient dominion and control over the partnership has been relinquished. The factors listed include retained control, management participation, distributions, conduct of business and motive for the transfer. Treas. Reg. § 1.704-1(e)(2). However, many of these factors irrelevant in the context of limited partnerships and limited liability companies because the retention of management rights is immaterial to the extent such control is consistent with the conduct of that form of entity in the normal course of business. Treas. Reg. § 1.704-1(e)(2)(ii)(d).

partnership by the donor, and to the extent that the portion of such share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor's capital."[194]

(a) If the partnership does not allocate the partnership income in accordingly, the distributive shares of the donor and the donee will be reallocated by making reasonable allowance for the services of the donor and by attributing the balance of such income to the partnership capital of the donor and donee.[195] Any reallocations hereunder to reflect value for services of the donor will likely be treated as a guaranteed payment,[196] and any balance reallocated to the partnership capital will likely have the same character as a ratable share of partnership income.[197]

(b) The Treasury Regulations provide that an interest in a partnership can be created, directly or indirectly, by gift. Where the partnership interest is created by an indirect gift, the nominal transferor of the gift would not be considered the "donor" in making the foregoing determination with respect to distributive share.[198] By way of example, if a father gives property to his son, and the son transfers the property to a partnership consisting of the father and the son, then the partnership interest created by the son would be considered to have been created by gift (the father being the "donor" for Section 704(e)(2) purposes).[199]

(3) For these purposes, an interest purchased by a family member shall be "considered to be created by gift from the seller, and the fair market value of the purchased interest shall be considered to be donated capital."[200]

(a) The "family" of an individual includes only his or her "spouse, ancestors, and lineal descendants, and any trusts for the primary benefit of such persons."[201]

(b) A family member who purchases an interest from the partnership may not be treated as a partner for income tax purposes unless it can be shown that it was a bona fide transaction. This can be shown if the purchase has the "usual characteristics of an arm's-length transaction"[202] or in the absence of that, the purchase was "genuinely intended to promote the success of the business by securing participation of the purchaser in the business by securing participation of the purchaser in the business or by adding his credit to that of the other participants."[203] Notwithstanding the existence of the foregoing facts, if the purchase price or the loan, as the case may be, is not paid, then these facts will be "taken into account only as an aid in determining whether a bona fide purchase or loan obligation existed."[204]

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[194] § 704(e)(2).

[195] Treas. Reg. § 1.704-1(e)(3)(i)(*b*).

[196] *See* Gorrill v. Commissioner, T.C. Memo 1963-168.

[197] *See* Woodbury v. Commissioner, 49 T.C. 180 (1967).

[198] Treas. Reg. § 1.704-1(e)(3)(ii)(*a*).

[199] Treas. Reg. § 1.704-1(e)(3)(ii)(*a*), Ex. (1).

[200] § 704(e)(3).

[201] *Id.*

[202] Treas. Reg. § 1.704-1(e)(4)(ii)(*a*).

[203] Treas. Reg. § 1.704-1(e)(4)(ii)(*b*).

[204] Treas. Reg. § 1.704-1(e)(4)(ii).

d. Section 482 of the Code

(1) Section 482 provides that the IRS may "distribute, apportion, or allocate gross income, deductions, credits, or allowances" among "organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interest" if it is determined that such "distribution, apportion, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income."[205]

(2) This provision is rarely asserted in partnership situations, and to my knowledge, it has never been asserted in situations involving only individuals. However, in *Dolese vs. Commissioner*,[206] the IRS successfully reallocated capital gains and charitable deductions among an individual and his wholly owned corporation in a partnership context:

(a) The wholly owned corporation contributed real property to a partnership in exchange for a 51% interest. The taxpayer owned the remaining 49%. The partners agreed to allow Oklahoma City to acquire the real property in a part sale/part gift transaction, which would have resulted in realized capital gain and charitable deductions. The tax advisers determined that the corporation would not be able to fully utilize 51% of the total charitable deduction if the partnership proceeded with the transaction. As a result, instead of having the partnership sell/gift the property, the partnership subdivided the property into 2 tracts of land (or approximately the same value). The tract that was to be contributed to the city was distributed 76% to the individual taxpayer and 24% to the corporation. The tract that was eventually sold to the city was distributed 24% to the individual taxpayer and 76% to the corporation.

(b) The IRS argued that the individual's tax liability should be adjusted to reflect a reduced charitable contribution equal to 49% of the value of the contributed tract (rather than the 76% claimed) and an increased capital gain equal to 49% of the sold tract (rather than the 24% claimed).

(c) The taxpayer argued that Section 482 did not apply because in this situation because it did not involve two or more "organizations, trades or businesses." In rejecting this argument, the Tax Court concluded that the individual's position as an executive of the wholly owned corporation satisfied this requirement.

(d) It is significant to note that the Tax Court rejected the IRS's substance over form argument (claiming the partnership had actually contributed and sold the two tracts of land, rather than the partners), but nonetheless held for the IRS because of the broad latitude given to the IRS under Section 482.[207] If the IRS makes a reallocation under Section 482, the burden is on the taxpayer to prove that the IRS's determination is "unreasonable, arbitrary, or capricious."[208]

(3) It is unclear to what extent the IRS can use Section 482 in the context of family investment partnerships, especially if all of the partners are individuals or trusts. Although the IRS

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[205] § 482.

[206] 82 T.C. 830 (1984), *aff'd*, 811 F.2d 543 (10th Cir. 1987).

[207] Dolese v. Commissioner, 82 T.C. 830, 836 (1984).

[208] Ballantine Motor Co. v. Commissioner, 321 F.2d 796, 800 (4th Cir. 1963).

has used Section 482 in different situations involving partnerships,[209] the transaction involved in *Dolese vs. Commissioner* predated the amendments to Section 704 and the subsequent promulgation of the comprehensive regulatory scheme governing partnership allocations.

2. Classification for Tax Purposes

a. Generally, most family investment partnerships will act as an investor, [210] not as a trader[211] or dealer, [212] with respect to its securities transactions. A trader and an investor buy and sell securities for their own account. A dealer, on the other hand, purchases securities for resale to customers rather than for investment or speculation. The distinction between a trader and an investor for tax purposes is not clear and only makes a difference from a tax standpoint regarding the treatment certain itemized expenses or deductions. Generally, a trader buys and sells securities for short-term profit swings. As an investor, the gains and losses realized by the family investment partnership on the sale of securities will generally be capital.

b. As mentioned in the choice of entity portion of this outline above, almost all family investment partnership will be classified as partnerships for tax purposes. As such, the taxation of the partnership and its partners is pursuant to subchapter K of the Code. Each partner is required to report separately on its income tax return its distributive share of the partnership's net long-term capital gain or loss, net short-term capital gain or loss and all other items of ordinary income or loss. Each partner is taxed on its distributive share of the partnership's taxable income and gain (regardless of whether it has received or will receive a distribution from the partnership).

c. While not common, a few family investment partnerships will be considered "publicly traded partnerships," which are generally treated as corporations for Federal tax purposes. A publicly traded partnership is any partnership the interests in which are traded on an established securities market or which are readily tradable on a secondary market (or the substantial equivalent thereof).[213] However, a partnership will be exempt from classification as a publicly traded partnership if 90% or more of its annual gross income consists of "qualifying income" within the meaning of Section 7704(d).[214]

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[209] *See* Keller v. Commissioner, 77 T.C. 1014, aff'd, 723 F.2d 58 (10th Cir. 1983) (involving a personal service corporation and its sole shareholder-employee), Rev. Rul. 88-38, 1988-1 C.B. 246 (involving a shareholder-employee providing services to the corporation), Tech. Adv. Mem. 8539003 (Section 482 can apply to payments for services rendered by corporate partners in a partnership) and FSA 200149019 (Section 482 can apply to the reallocation of income among a foreign and domestic partnership where the partnerships were under the common control of a domestic partner).

[210] *See* Marrin v. Commissioner, T.C. Memo 1997-24, *aff'd*, 98-2 USTC ¶50,490 (2d Cir. 1998), and Hart v. Commissioner, T.C. Memo 1997-11.

[211] *See* Liang v. Commissioner, 23 T.C. 1040 (1955), *acq.*, 1955-1 C.B. 3.

[212] *See* Treas. Reg. § 1.471-5.

[213] § 7704.

[214] "Qualifying income" includes dividends, real property rents, gain from the sale or other disposition of real property, including Section 1221(a)(1) property, gain from the sale or disposition of a capital asset or Section 1231 property, and in the case of a partnership, where a principal activity of the partnership is the buying and selling of such items, income and gain from commodities (not described in Section 1221(a)(1)) or futures, options or forward contracts with respect to such commodities (including foreign currency transactions of a commodity pool),

3. Straddle Rules

a. Generally, as defined in the Code, a "straddle" refers to a holding of two or more offsetting positions in actively traded personal property.[215] It applies generally to positions that are valued on an established market, which can be sold, exchanged or otherwise liquidated, and the value change in one position will result in an inverse change in value in the offsetting position. From a tax standpoint, prior to the enactment of the straddle rules,[216] partners used these offsetting positions, which gave them the discretion to recognize losses on one side of the transaction and defer the gain on the other side of the transaction.

b. A straddle is defined as "offsetting positions with respect to personal property."[217]

(1) In the family investment partnership context, a position can include direct ownership, and interests through the use of financial derivatives like futures contracts, forward contracts and options (either held directly by the investment partnership or held possibly through a hedge fund investment).[218]

(2) Personal property is defined as any personal property which is actively traded on an established financial market (where such positions can be easily sold, exchanged or otherwise liquidated).[219] Stock is considered personal property if: (1) such stock is of a type which is actively traded and at least 1 of the positions offsetting such stock is a position with respect to such stock or "substantially similar or related property," or (2) such stock is of a corporation formed or availed of to take positions in personal property which offset positions taken by any shareholder.[220]

(3) A taxpayer is deemed to have "offsetting positions" if "there is a substantial diminution of the taxpayer's risk of loss from holding any position with respect to personal property by reason of holding one or more positions with respect to personal property (whether or not of the same kind)."[221]

(4) Specifically exempted from the definition of straddle are "covered call," which are established when the owner of a stock sells a call option on the stock, as long as the option is not "deep in the money" (where the strike price is significantly below fair market value).[222]

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[215] *See* § 1092.

[216] Generally, "straddle rules" are encompassed by §§ 263(g), 1092, 1234A and 1256.

[217] § 1092(c)(1).

[218] § 1092(d)(2) and (3).

[219] Defined as a national securities exchange that is registered under § 6 of the Securities Exchange Act of 1934, 15 U.S.C. §78f, an interdealer quotation market registered under §15A of the Securities Exchange Act of 1934, domestic board of trade registered with the Commodities Futures Trading Association, foreign securities exchange or board of trade registered with a similar regulatory authority and rules, an interbank market, interdealer market and a debt market. Treas. Reg. § 1.1092(d)-1(b)(1).

[220] § 1092(d)(3)(A)(ii).

[221] § 1092(c)(2)(A).

[222] § 1092(c)(4).

(5) Certain "hedging transactions" are exempted from the definition of a straddle and thus the loss deferral provisions. However, because family investment partnerships are investors (rather traders) for tax purposes, the transactions entered into by the partnership would not fall into this exemption. This is because the term "hedging transaction" is generally defined as a transaction, which are entered into in the normal course of the taxpayer's business to reduce or to manage the risk of price change or currency fluctuations with respect to property held by the taxpayer, are used to hedge with respect to ordinary property, and are specifically identified by the taxpayer as a hedging transaction.[223] Specifically, the Treasury Regulations provide that transactions entered into for speculative purposes are not treated as hedging transactions.[224]

c. Property is considered substantially similar or related to stock when the following are, based on the facts and circumstances, present:[225]

(1) The fair market values of the stock and the property primarily reflect the performance of (1) a single firm or enterprise, (2) the same industry or industries, or (3) the same economic factors such as interest rates, commodity prices or foreign currency exchange rates; and

(2) Changes in the market value of the stock are reasonably expected to approximate, directly or indirectly, changes in the market value of the property in questions or a fraction or a multiple of the market value of the property.

d. A taxpayer is deemed to have a diminished risk of loss on stock if it holds a position with respect to a substantially similar or related property if changes in the fair market value of the stock and the positions are reasonably expected to vary inversely.[226]

e. Since 2004, if a taxpayer holds stock and enters into a short sale with respect to such stock or substantially identical stock, the taxpayer will establish a straddle. Where a taxpayer establishes a short position in respect of a stock index, in order to determine whether a straddle has been established, the Treasury Regulations apply a mechanical test. This test differentiates between indices representing 20 or more stocks and those of fewer stocks.[227]

f. When a straddle has been established, the straddle rules apply to defer some or all of the losses realized with respect to the straddle.

(1) Any loss realized from the disposition of one or more positions of a straddle is taken into account for any taxable year only to the extent that the amount of such loss exceeds the unrecognized gain with respect to the positions that were offsetting positions.[228]

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[223] § 1256(e)(2).

[224] Treas. Reg. § 1.1221-2(c)(4)(ii).

[225] Treas. Reg. § 1.246-5(b)(1). Section 246 deals with certain limitations with respect to the dividends received deduction for corporations under Section 243. However, the definition of substantially similar or related property under Section 246 is applied with respect to the interpretation of the same phrase in the straddle rules under Section 1092.

[226] Treas. Reg. § 1.246-5(b)(2).

[227] *See* Treas. Reg. § 1.246-5(c)(1). Furthermore, the Code has a general anti-abuse section under Treas. Reg. § 1.246-5(c)(1)(vi).

[228] § 1092(a)(1)(A).

(2) Unrecognized gain is the amount that would be taken into account if the positions were marked to market on the last day of the taxable year.[229]

(3) Any such loss disallowed is carried forward to successive taxable years until the taxpayer no longer holds offsetting positions with unrecognized gain.[230]

g. The IRS may treat certain positions in securities held (directly or indirectly) by a partner and its indirect interest in similar securities held by the family investment partnership as "straddles" for Federal income tax purposes. The application of the "straddle rules," as discussed herein, in such a case could affect a partner's holding period for the securities involved and may defer the recognition of losses with respect to such securities. Specifically, the Treasury Regulations provide that a taxpayer is treated as diminishing its risk of loss under the straddle rules if it holds an interest in, or is the beneficiary of, a pass-thru entity or other arrangement with a view to avoiding the application of the straddle rules.[231]

4. Constructive Sales (Section 1259)

a. Often, family investment partnerships will make investments in hedge funds, which in turn employ short sales as part of their investment process. In a short sale, the owner of the stock (the lender) transfers the stock to the borrower who agrees to: return identical stock (same number of shares, issuer, class but obviously not the same exact shares), and make substitute payments equal to the dividends that otherwise would be payable to the original owners of the stock but for the short sale transaction. The borrower then sells the stock for cash (the short sale). When the borrower repays the lender, it closes out the short sale. If the stock has dropped in price, the borrower is able to purchase the stock in the open market at a lower price than the cash proceeds, thus making a profit. If, consequently, the stock price rises, the borrower will have a loss, which theoretically is unlimited since stock prices can rise infinitely.

b. Under the constructive sale rules of Section 1259 of the Code, if the borrower already owns the stock that is the subject of a short sale and the original stock has appreciated, then the appreciated stock will be deemed to have been sold and the borrower will recognize the inherent gain in the position.[232] This is called a "short against the box" position. This constructive sale or deemed sale is taken into account if the original shares are used to close out the short sale position, so the subsequent holding period for any appreciated financial position that is subject to these constructive sale rules will be determined as if such position were acquired on the date of the constructive sale.[233] With respect to an investment in a hedge fund, this could arise in a number of contexts:

(1) If the hedge fund holds an appreciated financial position (whether contributed by an investor or not) with respect to stock, certain debt obligations or partnership interests and then enters into a short sale with respect to the same or substantially identical property, the hedge fund

[229] § 1092(a)(3)(A)(i).

[230] § 1092(a)(1)(B). There are some specific rules regarding "identified straddles" under § 1092(a)(2)(B) where this loss deferral rule is replaced with an adjustment of basis, but that is beyond the scope of this discussion.

[231] Treas. Reg. § 1.246-5(c)(6).

[232] § 1259.

[233] § 1259(a)(2)(B). The holding period of the position starts at the date of the deemed sale.

(and its investors) generally will recognize gain as if the appreciated financial position were sold at its fair market value on the date it enters into the short sale.

(2) If the hedge fund holds a short sale position with respect to stock, certain debt obligations or partnership interests that has appreciated in value and then acquires property that is the same as or substantially identical to the property sold short, the hedge fund (and its investors) generally will recognize gain on the date it acquires such property as if the short sale were closed on such date with such property.

c. The Code provides that a constructive sale under Section 1259 will be deemed to occur when taxpayers enter into short sales against the box or other hedges that transfer substantially all of an appreciated asset's risk and return.[234] For these purposes, activities of certain related persons are attributed to the taxpayer when a "transaction is entered into with a view toward avoiding the purposes of this section."[235] The legislative history describes a constructive sale occurring when there is a hedge that "substantially eliminates risk of loss and opportunity for gain." However, the Code enumerates four examples: (1) a short sale against the box; (2) an offsetting notional principal contract, (3) a forward contract; and (4) a long purchase by a taxpayer who has an appreciated short position.[236]

d. One unresolved issue is if a family member of a family investment partnership holds an appreciated financial position in his or her personal account outside of the partnership and the partnership or a hedge fund manager in which it invests shorts or otherwise hedges that same position within the fund, will a constructive sale be deemed to have occurred?[237]

5. Deductibility of Interest and Short Sale Expenses

a. For noncorporate partners, Section 163(d) of the Code limits the deduction for "investment interest."

(1) "Investment interest" includes interest "which is paid or accrued on indebtedness properly allocable to property held for investment"[238] which also includes short sale expenses.

(2) Investment interest is not deductible in the current year to the extent that it exceeds the taxpayer's "net investment income," consisting of net gain and ordinary income derived from investments in the current year less certain directly connected expenses (other than interest or short sale expenses).[239]

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[234] § 1259(c)(1).

[235] § 1259(c)(4).

[236] § 1259(c)(1).

[237] If the constructive sales rules were deemed to apply under these circumstances, it is more often than not that the investor will be deemed to have hedged a fewer number of shares than owned by the investor (because it would be likely be limited to the investor's distributive share in the hedge fund). Under these circumstances, the Code provides, "[i]f a taxpayer holds multiple positions in property, the determination of whether a specific transaction is a constructive sale and, if so, which appreciated financial position is deemed sold shall be made in the same manner as actual sales." § 1259(e)(3). As such, the taxpayer is allowed to identify which shares have been constructively sold under the Treasury Regulations. *See* Treas. Reg. § 1.1012-1(c) (allowing taxpayers to designate which stock as been sold if it can be adequately identified).

[238] § 163(d)(3)(A).

[239] § 163(d)(1).

(3) To the extent a deduction is disallowed in one year, partners may carry forward such amounts to succeeding taxable years.[240]

(4) If a partnership has individual partners, the partnership must separately state any investment interest expense it incurs so that each individual can aggregate his or her share of the investment interest expenses with other investment interest expenses and determine weather the limitation on the deduction for investment interest expenses Section 163(d) is exceeded.[241]

(5) "Net investment income" is the excess of investment income over investment expenses.[242] Investment income, in turn, is the sum of the gross income from property held for investment plus ordinary gain attributable to the disposition of such property, but only to the extent that such amounts are not derived from the conduct of a trade or business.[243] For purposes of this calculation, qualified dividends[244] and long-term capital gains are excluded from net investment income unless the taxpayer elects to pay tax on such amounts at ordinary income tax rates.[245] The election is made on IRS Form 4952.

(6) Generally, a family investment partnership's activities will be treated as giving rise to investment income for partners, and the investment interest limitation would apply to a noncorporate partner's share of the interest and short sale expenses attributable to the hedge fund's operations.[246] In such case, a noncorporate partner would be denied a deduction for all or part of that portion of its distributive share of the hedge fund's ordinary losses attributable to interest and short sale expenses unless it had sufficient investment income from all sources including from the hedge fund.

(7) The investment interest limitation would also apply to interest paid by a noncorporate partner on money borrowed to finance its investment in the hedge fund.[247]

b. The Code provides that there will be no deduction with respect to "interest and carrying charges properly allocable to personal property which is part of a straddle."[248] In such circumstances, the interest and carrying charges are capitalized and added to basis. This would include interest and other expenses with respect to short sales.

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[240] § 163(d)(2).

[241] Rev. Rul. 84-131, 1984-2 C.B. 37. *See* Treas. Reg. § 1.163-8T, Notice 88-20, 1988-1 C.B. 487, and Notice 89-35, 1989-1 C.B. 675.

[242] § 163(d)(4)(A).

[243] § 163(d)(4)(B).

[244] § 1(h)(11)(B).

[245] § 163(d)(4)(B)(iii) and the flush language of § 163(d)(4)(B).

[246] *See* Treas. Reg. § 1.58-2(b)(2)(i). *See also* FSA 200111001 (whether noncorporate partners are subject to §163(d) limitations on their share of partnership's interest expense attributable to partnership's activity as a securities trader depends on each partner's participation).

[247] *See* § 163(d)(5)(A).

[248] § 263(g).

6. Deductibility of Partnership Investment Expenses

a. As mentioned above, the investment activities of a family investment partnership are typically as an investor, not a dealer or trader.

b. Investment expenses (for example, investment advisory fees) of an individual, trust or estate are deductible only to the extent they exceed 2% of adjusted gross income.[249]

c. The IRS has the authority to issue regulations that prohibit an individual from indirectly deducting, through pass-through entities, amounts that are not allowable if paid or incurred directly by an individual.[250] Pursuant to this, the IRS issued temporary regulations that introduce the terms "affected investor" and "affected expenses."[251]

(1) Generally, an affected investor in a pass-through entity must separately take into account, as an item of income and as an item of expense, an amount equal to the affected investor's allocable share of the affected expenses. The expenses separately taken into account are treated as paid or incurred by the affected investor in the same manner as they were paid or incurred by the entity.[252]

(2) An affected investor is essentially anyone who owns an interest in a pass-through entity and who is subject to the 2% of adjusted gross income floor.[253]

(3) Affected expenses are expenses that, if paid or incurred by an individual, would treated as Section 67(b) of the Code miscellaneous itemized deductions

(4) This prohibition against using pass-thru entities to avoid the 2% floor limitation does not apply to publicly-offered regulated investment companies (mutual funds).[254]

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[249] §67(a) and Treas. Reg. § 1.67-1T(a)(1). However, § 67(e) of the Code provides that, in the case of a trust or an estate, such limitation does not apply to deductions or costs which are paid or incurred in connection with the administration of the estate or trust and would not have been incurred if the property were not held in such trust or estate. The Supreme Court recently resolved a disagreement among the courts about the treatment of investment advisory fees incurred by a trust (whether they were exempt from the 2% adjusted gross income floor on deductibility). The Supreme Court held that costs paid to an investment advisor by a nongrantor trust or estate are generally subject to the 2% floor. Michael J. Knight, Trustee of William L. Rudkin Testamentary Trust. v. Commissioner, 552 U.S. 181 (2008). With respect to "bundled fiduciary fees," some of which are subject to the 2% floor and some of which are fully deductible, the IRS recently published Notice 2010-32, 2010-16 I.R.B. (4/1/2010), extending the interim guidance that provides that taxpayers will not be required to determine the portion of a bundled fiduciary fee that is subject to the 2% floor for any taxable year beginning before January 1, 2010. Instead for such taxable year, taxpayers may deduct the full amount of the bundled fiduciary fee without regard to the 2% floor.

[250] § 67(c)(1).

[251] Treas. Reg. § 1.67-2T(a), (h), (i).

[252] Treas. Reg. § 1.67-2T(a).

[253] Treas. Reg. § 1.67-2T(h)(1).

[254] § 67(c)(2)(A). A mutual fund is publicly offered if its shares are: (1) continuously offered pursuant to a public offering, as defined in § 4 of the Securities Act of 1933, (2) regularly traded on an established securities market, or (3) held by or for no fewer than 500 persons at all times during the taxable year. § 67(c)(2)(B)(i) and Regs. § 1.67-2T(g)(3)(ii).

(5) Each partner in a partnership must separately take into account the partner's distributive share of any partnership deductions that are miscellaneous itemized deductions. The 2% floor does not apply to the partnership but does apply to the partners with respect to these deductions.[255]

d. The Code further restricts the ability of an individual with an adjusted gross income in excess of a specified amount (for 2009 the specified amount was $166,800 or $83,400 for a married person filing a separate return) to deduct investment expenses.[256] Under this limitation, investment expenses in excess of 2% of adjusted gross income may only be deducted to the extent such excess expenses (along with certain other itemized deductions) exceed the lesser of (i) 3% of the excess of the individual's adjusted gross income over the specified amount[257] or (ii) 80% of the amount of certain itemized deductions otherwise allowable for the taxable year.[258]

(1) The 2001 tax act[259] provided for the eventual repeal of this overall limitation on itemized deductions by 2010 (phased in over five years beginning in 2006). The otherwise applicable overall limitation on itemized deductions was reduced by one-third in tax years beginning in 2006 and 2007, and by two-thirds in tax years beginning in 2008 and 2009. Thus, for 2010 tax years, the 3% limitation was fully repealed.

(2) The 2001 tax act contained a "sunset" provision that resulted in the limitation on itemized deductions being restored in 2011. The "Tax Relief Act of 2010,"[260] enacted on December 17, 2010, extended some provisions of the 2001 tax act until December 31, 2012, but the repeal of these limitations was not extended.

e. The investment expenses of the family investment partnership will be considered miscellaneous itemized deductions which are not deductible by a noncorporate taxpayer in calculating its alternative minimum tax liability.[261]

7. Passive Activity Rules

a. The Code restricts the deductibility of losses from a "passive activity" against certain income which is not derived from a passive activity.[262] This restriction applies to individuals (including partners in partnerships), personal service corporations and certain closely held corporations.

b. Pursuant to Temporary Regulations, income or loss from the partnership's securities investment activity generally will not constitute income or loss from a passive activity.[263]

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[255] Treas. Reg. § 1.67-2T(b)(1).

[256] § 68(a).

[257] § 68(a)(1).

[258] § 68(a)(2).

[259] 2001 Tax Relief Act, P.L. 107-16.

[260] Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, P.L. 111-312.

[261] §§ 55 through 58.

[262] § 469.

[263] § 469(e)(1)(A). *See also* Treas. Reg. § 1.469-2T(c)(3)(i). Although there is an exception for income and gains derived in the ordinary course of a trade or business under § 469(e)(1)(A)(i)(I), it is limited to certain circumstances that generally are applicable in the hedge fund context. *See generally* Treas. Reg. § 1.469-2T(c)(3)(ii).

Therefore, passive losses from other sources generally could not be deducted against a partner's share of such income and gain from the partnership. Income or loss attributable to the family investment partnership's investments in other partnerships, however, that are engaged in certain trades or businesses may constitute passive activity income or loss.

8. The "At Risk" Limitations

a. Under the "at risk" rules, the amount of any loss of that a partner is entitled to include in its income tax return is generally limited to its adjusted tax basis in the partnership interest as of the end of the partnership's taxable year in which such loss occurred.[264] However, for purposes of the at risk computations, there may be certain differences:

(1) The adjusted basis in the partnership interest will generally include nonrecourse debt (partnership liabilities), whereas the "at risk" amount may not include such debt.[265]

(2) A partner's at risk amount may not include any amount to the extent that there is an arrangement protecting the partner against loss.[266]

b. Generally, a partner's adjusted tax basis for its interest in a family investment partnership (and at risk amount) is equal to the amount paid for such interest, increased by the sum of (i) its share of the partnership liabilities,[267] and (ii) its distributive share of the partnership's realized income and gains, and decreased (but not below zero)[268] by the sum of (i) distributions (including decreases in its share of partnership liabilities) made by the partnership to such partner and (ii) such partner's distributive share of the partnership realized losses and expenses.

c. However, with partnerships, with the exception of qualified nonrecourse financing (dealing with real property primarily), no partner is considered at-risk with respect to a partnership loan if the loan is secured by partnership property and neither the partnership nor any of the partners are personally liable for the debt.[269]

d. A partner that is subject to the "at risk" limitations (generally, non-corporate taxpayers and closely held corporations)[270] may not deduct losses of the partnership to the extent that they exceed the amount such partner has "at risk" with respect to its interest in the partnership at the end of the year.[271]

e. Losses denied under the basis or "at risk" limitations are suspended and may be carried forward in subsequent taxable years, subject to these and other applicable limitations.[272]

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[264] § 465(b).

[265] Except as provided in § 465(b)(2)(B) and qualified nonrecourse financing in § 465(b)(6). *See also* Treas. Reg. § 1.752-2(c)(1).

[266] § 465(b)(4).

[267] *See* Treas. Reg. § 1.752-2(b)(1).

[268] § 704(d).

[269] Prop. Reg. § 1.465-25(b)(1)(i).

[270] § 465(a)(1)(A) and (B).

[271] § 465(a)(1).

[272] § 465(a)(2).

f. The Regulations provide that amounts "at risk in any activity" are "amounts determinable at the partnership level."[273]

E. Selected Valuation Issues

1. One of the reasons family investment partnerships are formed is to allow family members the ability to invest in a broader set of investment strategies. Often that broader set includes hedge funds, which as discussed later in this outline, can only be offered to certain "accredited investors" who have to meet certain net worth requirements. If a family investment partnership has a hedge fund investment, too often they take the "value" reported by the hedge fund as the value for transfer tax purposes.

2. Hedge fund investments, unlike shares in mutual fund where the fair market value for wealth transfer tax (estate, gift and generation-skipping transfer) purposes is the "public redemption price,"[274] the value of an interest in a partnership is, in all likelihood, the "price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."[275]

3. In particular, the Treasury Regulations provide that the fair market value of a partnership interest is the net value that the hypothetical willing buyer would pay, with net value being based upon all relevant factors including "a fair appraisal as of the applicable valuation date of all the assets of the business . . . and other factors set forth in paragraph (f) . . . of § 20.2031-2 (25.2512-2)."[276] The "other factors" reference is to the valuation of stocks for wealth transfer tax purposes, when there are no actual sales prices or bona fide bid and asked prices on the valuation date in question.[277]

4. From a methodology standpoint, the starting point in valuing an interest in a partnership is the value of the partnership's assets on the applicable valuation date. Next, a determination should be made about the applicability of any valuation discounts (marketability and minority interest) based upon the terms of the partnership agreement.

5. "Hedge funds" is a catch-all term that includes a wide variety of investment strategies, often includes atypical investments and the use of arcane financial instruments, many of which do not trade actively on an established exchange. As such, a valuation of the underlying assets of a hedge fund may not be a simple endeavor. The subprime mortgage crisis in 2007 and 2008 is a prime example of the difficulty in determining the true value of hedge fund investments. Many hedge funds had borrowed to invest in Collateralized Debt Obligations (CDOs) and other Mortgage Backed Securities. The margin requirements of the prime brokers that extended credit to these hedge funds is based upon the fair value of these securities. However, the fair value of CDOs and other similar instruments is subject to wide interpretation. The valuation of these instruments should derive from the collectability and quality of the subprime mortgage payments supporting these securities, often as determined by the credit agencies like

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[273] Treas. Reg. § 301.6231(a)(3)-1(a)(1)(vi)(C).

[274] Treas. Reg. §§ 20.2031-8(b) and 25.2512-6(b).

[275] Treas. Reg. §§ 20.2031-1(b) and 25.2512-1.

[276] Treas. Reg. §§ 20.2031-3 and 25.2512-3. With hedge fund interests, generally, good will and earnings capacity, which are specifically noted in the Treasury Regulations, are not applicable.

[277] Treas. Reg. §§ 20.2031-2(f) and 25.2512-2(f). The Treasury Regulations provide a laundry list of company, industry and economic factors to be considered in making this determination.

Moody's and Standard and Poors (because CDOs do not trade on an exchange and for the most part, were not expected to be traded, at all, in an over the counter transaction). Within a very short period of time, the credit agencies (that had given AAA ratings to the senior tranches of these securities) drastically downgraded the quality and thus the value of these CDOs. In some circumstances, the lower rated tranches (mezzanine and equity tranches) lost all or virtually all of their value. This required hedge funds to deleverage their investments either by selling the CDOs to a limited number of buyers who would only purchase the CDOs at a deep discount or by selling the more liquid investments (stocks and bonds) to satisfy the margin calls. In addition, institutions that are restricted to holding only AAA rated investments had to sell the CDOs, further dropping the value of these instruments. All of which begs the question regarding what the true value of these CDOs actually is. The underlying mortgage securities collateralizing the CDOs did not change, but the "value" quickly dropped, in some cases, to zero.[278]

6. Interests in hedge funds are generally not registered under the Securities Act of 1933 and, thus, can not be sold unless subsequently registered. Furthermore, the partnership agreement of most hedge funds provides that a partner may not assign its interest in the fund without the prior consent of the general partner. For these reasons, valuation discounts for lack of marketability and minority interest should be available.

7. Although hedge fund investors are restricted from assigning or otherwise transferring their interest in the fund, the partnership agreement often provides that an investor has the right to withdraw all or some portion of his or her capital account upon prior written notice (for example, 30 or 60 days). It is important to note that a number of hedge funds provide a penalty if an investor withdraws in the first few years of the investment. Generally, this right of withdrawal is allowed at specific times of the year. For example, once a year on December 31 or twice a year on December 31 and June 30 or quarterly on the last day of each quarter-annual calendar period. The amount to be paid is often based upon the value of the assets on the withdrawal date (assuming there is no penalty), and the withdrawn capital account value will be paid to the withdrawing investor, in cash or with assets in kind, on such date or within a reasonable amount of time. This right of liquidation should be taken into account in determining the value for wealth transfer tax purposes and, if such right of withdrawal passes to the transferee or assignee, will likely reduce the lack of marketability and minority interest discounts that would otherwise apply.[279]

8. Assuming the right of withdrawal passes to an assignee and redemptions do in fact occur (or could have occurred at a determined value on such withdrawal dates) prior to and after the wealth transfer date, one alternative method of valuation is to use the same methodology used for listed and over-the-counter stocks and bonds. It is unlikely that the wealth transfer/valuation date will actually be on a withdrawal date under the partnership agreement. In fact, even if the transfer did occur on that date, the assignee or transferee would likely not have the right to withdraw because of the prior written notice requirement. The Treasury Regulations provide with respect to stocks and bonds that the fair market value is the mean between the highest and lowest quoted selling prices on the valuation date.[280] If there are no sales on the valuation date, the value is based on sales "within a reasonable period both before and after the valuation date."[281] The Treasury Regulations provide that the value is based upon a weighted

[278] In a survey of institutional investors, nearly two-thirds of the respondents said that accurately valuing their hedge fund holdings was problematic. State Street Corporation, *2007 Hedge Fund Research Study* (March 2007).

[279] *See e.g*. Kerr v. Commissioner, 113 T.C. 449 (1999), *aff'd*, 292 F.3d 490 (5th Cir. 2002) and McCord v. Commissioner, 120 T.C. 358 (2003), *rev'd and rem'd*, 461 F.3d 614 (5th Cir. 2006).

[280] Treas. Regs. §§ 20.2031-2(b) and 25.2512-2(b).

[281] *Id.*

average of the values determined before and after the valuation date, with the average to be weighted inversely by the respective number of "trading days" between the "selling dates" and the valuation date.[282] These provisions are not directly applicable to valuing partnership interests because a right of withdrawal is not a "sale" of the interest and the valuation date may not be considered "within a reasonable period" of such withdrawal dates. However, the courts have held that both actual sales both before and after a valuation date are relevant in determining value for wealth transfer tax purposes.[283]

9. From an accounting standpoint, hedge funds marketed to U.S. investors must generally follow U.S. generally accepted accounting principals (GAAP). Under Financial Accounting Standards Board ("FASB") Financial Account Standards ("FAS") No. 159, a hedge fund has the option to report selected financial assets and liabilities at "fair value."[284] It generally permits the hedge fund to irrevocably elect the fair value option on an instrument-by-instrument basis. Under FASB Statement No. 157, "fair value" is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."[285] FAS No. 157 establishes a "fair value hierarchy" that prioritizes the inputs to valuation techniques into three levels. This hierarchy gives the highest priority (Level 1 inputs) to observable inputs based on market data obtained from independent sources (quoted prices in active markets for identical assets or liabilities on the measurement date). Level 2 inputs are inputs (other than quoted prices included in Level 1) that are directly or indirectly observable for the asset or liability (for example, quoted prices for similar assets) and observable inputs such as interest rates, yield curves, volatilities, credit risks and default rates. Level 3 inputs are unobservable inputs which can be used to the extent observable inputs are not available and may reflect the fund's own assumptions developed on the basis of the best information available. FAS No. 157 points out that a hedge fund may need to make adjustments in determining fair value because other factors may affect the fair value of an investment, such as the investor's counterparty risk, fund redemption and lock-up provisions, and other attributes of the investment.

a. In January 2009, AICPA published a draft issues paper title "FASB Statement No. 157 Valuation Considerations for Interests in Alternative Investments." The AICPA suggests that it would be inconsistent with FAS No. 157 to presume Net Asset Value (NAV) automatically equals fair value. The paper suggests that an investment manager needs to consider applying a discount to NAV for a variety of reasons including liquidity provisions or NAV not reflecting actual redemption value.

b. In May 2009, FASB issued proposed additional guidance related to determining the fair value of certain alternative investments, such as interests in hedge funds (and private equity and venture capital). This guidance is limited to investments in entities that apply the AICPA "Audit and Accounting Guide, Investment Companies," with a blanket exception for exchange traded funds. FASB decided that an investment entity could estimate the fair value of its interests in alterative investments using the NAV as the investor entity's financial statement date, as long as the NAV has been calculated in accordance with guidance set forth in the Investment Companies Guide. Applying a discount was not discussed as a consideration for fair value. The FASB guidance goes on to require disclosure for (i) the terms and conditions upon which the investor may redeem its investment, and (ii) the terms and conditions

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[282] *Id.*

[283] *See e.g.* Est. of Helen M. Noble v. Commissioner, T.C. Memo 2005-2, Est. of Jung v. Commissioner, 101 T.C. 412 (1993), First Nat'l Bank of Kenosha v. U.S., 763 F.2d 891 (7th Cir. 1985), Est. of Fitts v. Commissioner, 237 F.2d 729 (8th Cir. 1956), and Douglas Hotel Co. v. Commissioner, 190 F.2d 766 (8th Cir. 1951), *aff'g*. 14 T.C. 1136 (1950).

[284] FASB Statement No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (Feb. 2007).

[285] FASB Statement No. 157, Fair Value Measurements (Sept. 2006) (effective for financial statements issued for fiscal years beginning after November 15, 2007).

of any restrictions that would (or could) temporarily preclude redemption by the investor, including the partner's best estimate of when the restriction will lapse.

F. Mutual Fund Taxation

1. Subchapter M of the Code provides the special provisions that keep a regulated investment company from being taxed like a typical corporation. Generally, a regulated investment company that satisfies certain distribution requirements under Section 852(a) of the Code (90% distribution requirement) is entitled to a dividends paid deduction in computing its taxable income and gains.[286] If the distribution requirement is met, the regulated investment company may distribute its income and gains to its shareholders free of tax at the entity level.

2. It is important to note that regulated investment companies that are personal holding companies (generally, companies where at least 60% of its adjusted ordinary gross income for the year consists of dividends, interest, rents, royalties, etc. and where more than 50% of the corporation is owned directly or indirectly by 5 individuals). are taxed on their investment company taxable income at the maximum rate applicable to corporations. As such, any undistributed income and short-term capital gains would be taxed at 35% (at current rates).[287] Furthermore, if a regulated investment company is a personal holding company, it would also be subject to personal holding company tax on its undistributed personal holding company taxable income.[288] As such, given that most regulated investment companies generally distribute all of their net income and gains, then this latter tax is only imposed on those items that would be considered personal holding company income but not investment company taxable income.

3. No gain is recognized when a regulated investment company distributes property to its shareholders in redemption of stock.[289] Loss is not recognized either.[290] In order to prevent a distribution of highly appreciated assets from the regulated investment company, the IRS has required that the tax basis of the distributed property is proportional to the tax basis of the fund's total assets, within certain permitted deviations.[291]

4. If a regulated investment company distributes cash or property (other than in redemption or liquidation) of its shares, the taxability is predicated upon whether it is considered a dividend (from the company's current accumulated earnings and profits)[292] or a return of capital[293] (which reduces the adjusted basis of the shareholder's stock). To the extent the nondividend portion of a distribution exceeds adjusted basis of the shareholder's stock, then the excess is treated as gain from the sale of the stock.[294]

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[286] *See* § 852(b)(2)(D).

[287] § 852(b)(1).

[288] § 541.

[289] § 852(b)(6). *See also* Rev. Rul. 57-421, 1957-2 C.B. 367. Section 852(b)(6) provides that Section 311(b), which provides for recognition of gain on distribution of appreciated property to shareholders does not apply with regulated investment companies.

[290] *See* § 311(a).

[291] *See, e.g.,* Ltr. Rul. 200536002.

[292] § 316(a).

[293] § 301(c)(2).

[294] § 301(c)(3).

5. In determining if the dividends are taxable to the shareholders, the Code provides that earnings and profits of the regulated investment company are allocated on a pro rata basis among all distributions made during the taxable year.[295] To the extent the distribution from a regulated investment company is taxable, it is included in the shareholder's gross income for the taxable year in which the shareholder receives the distribution.[296]

6. If a distribution is treated as a dividend, then the regulated investment company may designate the character of the dividend most notably, as:

a. Capital gain (which are taxed as long-term capital gains to the shareholders) to the extent of the fund's net capital gain.[297]

b. Exempt interest (for a fund that has at least 50% of its assets invested in tax-exempt obligations).

c. Qualified dividends.

7. As a consequence, except where distributions are designated as interest-related dividends or short-term capital gain dividends for certain foreign shareholders, shareholders may not treat dividends as interest income or short-term capital gains.[298]

8. With respect to redemptions, Section 302 determines whether the redemption distribution is treated as payment in exchange for stock (resulting in capital gain or loss) or as a distribution under Section 301 (dividend) or Section 316 (return of capital), depending on the fund's accumulated earnings and profits.

a. Generally, a redemption by a shareholder of all of its shares in the regulated investment company will be treated as payment in exchange for stock.[299] Notably, however, in the family context, Section 302 uses the attribution rules under Section 318.[300]

b. A partial redemption (perhaps through the application of the attribution rules) will be treated as a sale of stock if the redemption is "substantially disproportionate"[301] (generally, where the shareholder's ownership is reduced by more than 20%) or if the redemption is "not essentially equivalent to a dividend"[302] (where a shareholder has an insignificant ownership interest in the fund).[303] In the family investment fund context, this latter argument may not be available.

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[295] Treas. Reg. § 1.316-2(b).

[296] Treas. Reg. § 1.852-4(a)(1). However, if a fund declares a dividend in October through December that is payable to shareholders of record in those months but is actually paid in January, the dividend will be treated as having been received on December 31. § 852(b)(7).

[297] § 852(b)(3).

[298] *See* § 871(k).

[299] § 302(b)(3).

[300] § 302(c).

[301] § 302(b)(2).

[302] § 302(b)(1).

[303] *See* Rev. Rul. 78-6, 1978-2 C.B. 81 and Rev. Rul. 76-385, 1976-2 C.B. 92.

9. With respect to liquidating distributions, non-corporate shareholders will get exchange of stock treatment, generally, at a capital gain or loss depending on the shareholder's adjusted tax basis in the stock.[304]

10. Many regulated investment companies allow shareholders to participant in dividend reinvestment programs pursuant to which dividends that are declared are automatically reinvested in additional shares. Dividends received in an automatic reinvestment program are deemed to have been constructive received by the shareholder for income tax purposes and are included in the shareholder's income in the year that it is credited.[305]

11. The basis of the shares held by the shareholder follow the regular basis adjustment rules for stock ownership, purchase and receipt, with the following notable quirks specific to regulated investment companies:

a. Additional shares purchased pursuant to automatic dividend reinvestment programs have a basis equal to the amount of the distribution.

b. If a shareholder is required to include an undistributed capital gain into income, the shareholder may increase the adjusted tax basis in the shares by the difference between the amount includible gains and the tax deemed paid by the shareholder (net amount retained by the fund after payment of the tax by the fund on such gain).[306]

c. A shareholder who receives a tax free return of capital under Section 301(c)(2) must reduce basis in the shares by such distribution, as discussed above.

12. For shares purchased, acquired or received on different dates or different prices, the Code generally provides the following methods in identifying shares sold or redeemed:

a. If the lot of stock can be "adequately identified," then the cost basis and the holding period is determined according to the particulars of that lot.

b. However, if the lot can not be "adequately identified," the stock sold or transferred is charged against the earliest of such lots purchased or acquired in order to determine the cost or other basis of such stock and in order to determine the holding period of such stock.[307] In other words, the Code assumes a first-in, first-out (FIFO) accounting methodology.

c. If the taxpayer so elects, the Treasury Regulations allow the taxpayer to use an "average basis" methodology (using either the "double category"[308] method or the "single category"[309] method).

(1) The "double category" method segregate short-term and long-term held shares with the adjusted basis of each share in the category having the average cost of all remaining shares

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[304] § 331.

[305] *See* Rev. Rul. 78-375, 1978-2 C.B. 130.

[306] § 852(b)(3)(D)(iii).

[307] § 1.1012-1(c)(1) and Hall v. Commissioner., 92 T.C. 1027 (1989).

[308] Treas. Reg. § 1.1012-1(e)(3).

[309] Treas. Reg. § 1.1012-1(e)(4).

in that category. The shareholder can elect to have shares sold from either the long-term holding category or the short-term holding category, with the presumption that if there is no designation made by the shareholder, it will be deemed to come from the long-term holding category.[310]

(2) The "single category" method aggregates all shares, regardless of holding period and the total adjusted tax basis is averaged over all of the shares. Sales are deemed to be made on a FIFO basis. The "single category" method may not be used where it appears from the facts and circumstances that the method is being used to convert long-term gains or losses to short-term gains or losses or vice versa.[311]

IV. INVESTMENT IMPLICATIONS

A. Generally

1. As mentioned in the introduction, there are many potential advantages of consolidating family investments in a family investment partnership including centralized (and competent) management of the investments, reduction of total expenses through larger economies of scale and access to an expanded set of investment opportunities (for example, hedge funds, venture capital, private equity and other alternative investment strategies).

2. It is important that family investment partnerships have clear investment objectives for the management of its assets. As the recent decision in *Holman vs. Commissioner*[312] points out, using a partnership to merely custody assets without any stated investment goal puts the validity of the partnership as a bona fide business enterprise at jeopardy, subjecting the valuation of partnership interests to attack under Sections 2703(a)[313] and 2036(a)[314] of the Code. In the *Holman* case, the partnership passively held Dell stock. The taxpayer, according to the Tax Court, "failed to identify any current or planned activity by the partnership other than holding passive investments without a clearly articulated investment strategy. In addition, he made clear that asset preservation meant preservation from dissipation by the children, not the pursuit of any particular investment strategy."[315] The court analogized the facts of the case to a "partnership structure to hold a passbook savings account, an interest-bearing checking account, government bonds, or cash."[316] As such, where a partnership "holds only an insignificant fraction of stock in a highly liquid and easily valued company with no stated intention to retain that stock or invest according to any particular strategy,"[317] ignoring the restrictions under Section 2703 is warranted.

3. Because each partner's beneficial interest in the underlying investments is based upon their rights under the terms of the partnership agreement, it is natural that different structures will have

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[310] Treas. Reg. § 1.1012-1(e)(3)(ii).

[311] Treas. Reg. § 1.1012-1(e)(4)(i)-(iii).

[312] Holman v. Commissioner, No. 08-3774 (8th Cir. 2010) *aff'g* 130 T.C. 170 (2008).

[313] In particular, Section 2703(b) provides an exception to Section 2703(a), which values property without regard to certain restrictions, provided the restrictions are a bona fide business arrangement, not a device to transfer the property for less than full and adequate consideration, and are comparable to similar arm's length transactions.

[314] In particular, the "bona fide sale" exception to Section 2036(a), which some the Tax Court has interpreted to require a good faith and "legitimate business purpose." *See* Est. of Schutt v. Commissioner, T.C. Memo 2005-126.

[315] Holman v. Commissioner, No. 08-3774 (8th Cir. 2010) *aff'g* 130 T.C. 170 (2008).

[316] *Id.*

[317] *Id.*

different implications on the partner's economic interest from the investments. Also, different partnership structures will have different investment implications.

B. Single Class Share FLPs

1. In Single Class Share FLPs, each partner shares in the income, profits, losses and tax items, pro rata according to their relative interests in the partnerships. Other than voting and management rights, each shareholder effectively has the same underlying investment portfolio. In most instances, this effectively means that each partner has the same asset allocation as the partnership, regardless of that partner's personal circumstances. Each partner, regardless of their marginal income tax bracket, state of residence, risk tolerance, return requirements and spending has exactly the same mix of stocks, bonds, and other asset classes. This obviously is not ideal from an investment standpoint.

2. Basic financial planning provides that each investor should have a personalized asset allocation based upon his or her time horizon (life expectancy, time until retirement, etc.), tax situation, risk tolerance and return requirements (spending). As such, with a Single Class Share FLP, the partners can end up with mismatches in asset allocation and sub-optimal after-tax returns. For example, one could easily have a situation where a Single Class Share FLP has a portfolio of 60% equities and 40% multi-state municipal bonds, despite the fact that Partner A who is retired, in the highest marginal income tax bracket and living in California would have had an asset allocation of 20% equities and 80% California municipal bonds, and Partner B who is much younger, in a lower income tax bracket and living in Texas would have an asset allocation of 90% equities and 10% taxable bonds.

3. The advantages of utilizing a Single Class Share FLP are two-fold: simplicity and the ability to rebalance across the asset classes. Rebalancing back to a strategic asset allocation has two primary benefits. First, it ensures that the portfolio stays at the agreed upon risk and return profile. Second, rebalancing can provide additional return because it simply forces the asset classes that have outperformed to sell high and redeploy those proceeds into asset classes that have underperformed. Diversification through a combination of low correlated asset classes means the portfolio will have an assortment of investments that tend not to perform at the same time. It provides a less volatile portfolio and gives, through rebalancing, the opportunity to sell high and buy low across the asset classes.

C. Preferred FLPs

1. In Preferred FLPs (whether a Qualified Payment, Guaranteed Payment or any other type of preferred partnership), the economic interests of the partners are generally segregated into two broad types: fixed return (like a bond) and excess return (like a stock). Therefore, the primary benefit over a Single Class Share FLP is that partners who prefer to have a more conservative investment can hold preferred interests, and partners who prefer to have an equity-like investment can hold the common interests.

2. From an investment standpoint, a Preferred FLP has the same advantages as utilizing a Single Class Share FLP, simplicity and rebalancing, as discussed above. In addition, it frees the partnership to invest the portfolio in a more aggressive fashion (for example, more equities and alternative investments) and still allow the preferred holders to hold a bond-like investment. Over time, the more aggressive investment portfolio should theoretically result in more total wealth to the family, as a whole.

3. The one disadvantage to a Preferred FLP is that it does not allow for the partners to choose asset classes based upon their personal tax situation. For example, a family member residing in Florida that has no state income tax would prefer multi-state municipal bond portfolios, while another

family member residing in New York would generally prefer New York municipal bond portfolio. Their taxation will be determined on a collective basis based upon their distributive share, as discussed above.

D. Series FLPs and Tracking FLPs

1. As discussed above, a Series FLP (and Tracking FLP) would allow a family investment partnership to hold separate and segregated investment portfolios (for example, U.S. equities, non-U.S. equities, bonds, alternative investments, etc.) and issue different classes of shares to its family members, with different classes being attributable to different investment strategies or portfolios. For example, Class A: U.S. equities, Class B: non-U.S. equities, Class C: taxable bonds, Class D: municipal bonds, Class E: hedge funds, etc. Thus, this would allow family members to personalize their own asset allocation by having one family member hold shares in Class A, B, D and E, while another family member might hold Class A and C shares.

2. This is a clear advantage over a Single Class Share FLP and even a Preferred FLP. This would allow each family member to have a set of shares that would comprise a personal asset allocation matched to their risk tolerance and return objectives, and to a certain extent, matched to their tax situation (for example, municipal bond or taxable bond class shares depending on their marginal income tax bracket).

3. The one disadvantage, from an investment standpoint, of a Series FLP is that each investment portfolio, strategy or asset class is segregated into separate silos, very much like an open architecture investment platform. As such, rebalancing across the portfolio can only be achieved by either:

a. Offering a series of shares that relate to a diversified portfolio set to a particular asset allocation where rebalancing occurs internally within the portfolio (for example, Class F would be a 80% globally diversified equity and 20% multi-state municipal bond portfolio, and Class G would be a 20% globally diversified equity and 80% multi-state municipal bond portfolio, so a person who wished to have a 50%/50% portfolio would simply have an equal amount of Class F and Class G); or

b. Requiring each family member to "rebalance" their total investments in the Multi-Series FLP by periodically redeeming or exchanging their shares back to their strategic asset allocation, which may be a taxable event for income tax purposes (depending upon their basis in the partnership interest and depending upon whether it is a redemption or exchange)

V. SECURITIES LAW CONSIDERATIONS

A. There are a number of securities laws that need to be considered:

1. Securities Act of 1933[318] (the "1933 Securities Act")

2. Investment Company Act of 1940[319] (the "Investment Company Act")

3. Investment Advisors Act of 1940[320] (the "Investment Advisers Act")

[318] 15 U.S.C. § 77a et seq., as amended (the "1933 Securities Act").

[319] 15 U.S.C. § 80-1 et seq., as amended (the "Investment Company Act").

[320] 15 U.S.C. § 80b-1 et seq., as amended (the "Investment Advisers Act").

B. 1933 Securities Act

1. The formation of and the issuance of shares in a partnership involves the acquisition of "securities." As such, both Federal and state regulatory provisions are applicable to the offer and sale of such securities. The 1933 Securities Act provides, generally, that absent some exemption, any issuance of such securities requires registration with the Securities and Exchange Commission ("SEC"), which is often a long and expensive process.

2. Section 4(2) of the 1933 Securities Act generally exempts "transactions by an issuer not involving any public offering"[321] from the registration requirements. This is often referred to as the private placement exemption. However, in the 1993 Act very little guidance is given regarding the when an offering will be considered a public or non-public offering.

3. The SEC adopted Rule 506 to Regulation D of the 1933 Securities Act. Rule 506 provides that there can be no public offering of the shares to be issued. Since family investment partnerships are, by their nature, only offered to family members, this is not generally an issue. However, Rule 506 limits the number of purchasers to:

a. 35 "non-accredited investors," and

b. Unlimited number of "accredited investors."

4. An "accredited investor" is defined as:

a. Any natural person whose individual net worth, or joint net worth, with that person's spouse, at the time of purchase exceeds $1 million.

b. Any natural person who had income from all sources in excess of $200,000 in each of the 2 most recent years or joint income from all sources with that person's spouse in excess of $300,000 in each of the most 2 recent years and how reasonably expects at least the same level in the year of purchase.

c. Any organization described in Section 501(c)(3) of the Code (tax-exempt organizations), any corporation, business trusts, or a partnership not formed for the specific purpose of acquiring the securities offered, with total assets in excess of $5 million.

d. Any trust with total assets in excess of $5 million not formed for the specific purpose of acquiring the securities offered whose purchase is directed by a "sophisticated person" as described in Rule 506(b)(2)(ii) under the 1933 Securities Act, or any revocable trust which may be amended or revoked at any time by the grantors, all of whom are accredited investors.

e. Any director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer.

f. Private business development company as defined in Section 202(a)(22) of the Investment Advisors Act.

[321] § 4(2) of the 1933 Securities Act.

g. The following "institutional" investors:

(1) Any bank as defined in Section 3(a)(2) of the 1933 Securities Act, or any savings and loan institution or other institution as defined in Section 3(a)(5)(A) of the 1933 Securities Act, whether acting in its own or in a fiduciary capacity;

(2) Any broker or dealer registered under Section 15 of the 1933 Securities Act;

(3) Any insurance company as defined in Section 2(3) of the 1933 Securities Act;

(4) Any investment company registered under the Investment Company Act, or any business development company as defined in Section 2(a)(48) of the Investment Company Act;

(5) Any Small Business Investment Company licensed by the U.S. Small Business Administration under Section 301(c) or (d) of the Small Business Investment Act of 1958;

(6) Any plan established and maintained by a state, its political subdivisions, or any instrumentality of a state or its political subdivisions, for the benefit of its employees, if the plan has total assets in excess of $5 million; and

(7) Any employee benefit plan within the meaning of Title I of the Employment Retirement Income Security Act of 1974 whose investment decision is made by a fiduciary, as defined in Section 3(12) of the Securities Act, which is either a bank, savings and loan, insurance company, or registered investment advisor, or whose total assets exceed $5 million, or, if a self-directed plan, a plan whose investment decisions are made solely by person who are accredited investors.

h. Any entity in which all of the equity owners are accredited investors.

5. The following purchasers are excluded from the 35 non-accredited investor limitation:

a. Accredited investors;

b. Non-U.S. citizens and residents;

c. Any relative (by blood, marriage or adoption but not more remote than a first cousin), spouse, or relative of the spouse of a purchaser who has the same principal residence as the purchaser;

d. Any trust or estate in which an accredited investor and any persons related to him or her collectively have more than 50% of the beneficial interests (excluding contingent interests); and

e. Any corporation and entity of which a purchaser and any of the persons related to him or her above are beneficial owners of more than 50% of the equity interests.

6. For purposes of the 35 non-accredited investor limitation, each corporation, partnership or other entity is generally counted as one purchaser, unless the entity was created with the express purpose of acquiring the securities in question. In that latter case, each beneficial owner is counted as a separate purchaser.

7. The 35 non-accredited investor limitation also applies to a "single offering." Rule 502(a) of Regulation D provides that all offers and sales that take place at least 6 months before the start of, or six months after, the termination of the offering in question will not be considered part of the same offering. Where this 6 month grace period is not satisfied, Rule 502(a) provides that the following factors will be considered in determining whether the sale of the securities are part of an integrated sale:

a. Whether the sales are part of a single plan of financing;

b. Whether the sales involve issuance of the same class of securities;

c. Whether the sales have been made at or about the same time; and

d. Whether the same type of consideration is received and whether the sales are made for the same general purpose.

8. If securities are sold only to accredited investors, no disclosure like a private placement memorandum is required, but the issuer is, of course, obligated to comply with the anti-fraud provisions of the 1933 Securities Act. If any securities are sold to an accredited investors, certain disclosures must be made including:

a. Full, fair and complete disclosure of all material facts about the offering and the issuer, its management business operations, and finances; and

b. The risks associated with the purchase of these securities.

9. Securities purchased under Rule 506 are acquired for investment purposes and generally may not be sold for an indefinite period of time after purchase. The typical transfer restrictions that family investment partnerships will normally have will provide significant protection regarding this requirement under Rule 506. That being said, often the partnership agreement will provide that the partner is purchasing the securities for his or her own account and the partnership interests have not been registered under the 1933 Securities Act and cannot be resold unless they have been so registered.

10. With respect to subsequent transfers, sales, gifts or assignments of family partnership interests:

a. Rule 144 of the 1933 Securities Act allows resale of restricted securities if certain conditions are met. Restricted securities generally are securities acquired through private placement offerings, Regulation D offerings, employee stock benefit plans, as compensation for professional services, or in exchange for providing "seed money" or start-up capital to the company.[322] Securities held by an "affiliate" are considered control securities and are subject to Rule 144. Generally, an affiliate is a person, such as a director or large shareholder, in a relationship of control with the issuer. Control means the power to direct the management and policies of the company in question, whether through the ownership of voting securities, by contract, or otherwise. Rule 144 provides a safe harbor for selling securities including a certain holding period (6 months to 1 year), information requirement about the issuer, volume limitations (1% of the outstanding shares) and notice requirements (if the sale involves a dollar amount greater than $50,000 in 3 month period).

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[322] *See* Rule 144(a)(3) of the 1933 Securities Act.

b. Gifts, as opposed to sales, of restricted securities are allowable but the securities remain restricted in the hands of the donee, and the donee will be deemed to have acquired them on the date the donor acquired them from the issuer.[323]

c. For purposes of gifts, sales, transfer or assignments of the shares (assuming it is not part of a plan to circumvent the 35 non-accredited investor limitation) it is irrelevant whether the donee, purchaser, transferee or assignee would be considered an accredited investor for purposes of the 1933 Securities Act.

C. Investment Company Act

1. The Investment Company Act defines "typical" investment companies as those companies that are in the business of investing, reinvesting, or trading securities.[324] As such, family investment partnerships, as discussed here, are likely to be considered "investment companies" that might fall within the purview of the Company Act.

2. The Investment Company Act provides 2 relevant exemptions for family investment partnerships from being considered a regulated "investment company."

a. Section 3(c)(1) of the Investment Company Act provides an exemption for any investment entity with no more than 100 beneficial owners.

b. Section 3(c)(7) of the Investment Company Act provides an exemption for an investment entity which limits its beneficial owners solely to "qualified investors."

3. Section 3(c)(1) of the Investment Company Act Exemption

a. For purposes of the 100 beneficial owner limitation, a natural person is treated as a single owner, and spouses holding a security jointly will be deemed a single owner.

b. Generally, an entity holding a security will be considered a single owner.

(1) Section 3(c)(1) provides attribution through the entity to the owners of the entity if the entity owns 10% or more of the voting securities of the underlying fund (the family investment partnership in question) being tested for exemption under Section 3(c)(1).

(2) If 2 or more of these entities are used to circumvent the 10% voting test, the SEC will combine these entities if an investor in one entity would not view that interest as "materially different" from an interest in the other entity. For purposes of determining whether the entities are "materially different," the SEC will look to whether the entities have the same investment objectives, the same basic risk and return structures and the types of securities held by the entity.

4. Section 3(c)(7) of the Investment Company Act Exemption

a. A "qualified purchaser" is defined as:

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[323] *See* Rule 144 of the 1933 Securities Act.

[324] § 3(a)(1)(A) of the Company Act.

(1) A natural person (including a spouse holding an interest jointly) owning not less than $5 million in investments;

(2) A company (including for this purpose, estates and trusts owned directly or indirectly by direct lineal descendants) owning not less than $5 million in investments that is owned directly or indirectly by or for 2 or more related natural persons (including spouses);[325]

(3) A trust that is not formed for the purpose of investing in a Section 3(c)(7) fund, as to which the trustee or other person authorized to make decisions with respect to the trust and each settler or other person who has contributed assets to the trust, is a qualified purchaser; or

(4) A person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests not less than $25 million in investments on a discretionary basis.

b. Although there is no limitation on the number of "qualified purchasers" under Section 3(c)(7), the Securities Exchange Act of 1934[326] (the " 1934 Exchange Act") requires, in pertinent part, registration of any equity security of an issuer that has total assets in excess of $10 million and the class of equity security is "held of record" by 500 or more persons.[327]

D. Investment Advisers Act

1. The Investment Advisers Act defines an "investment adviser" as "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as toe the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities."[328] With respect to family investment partnerships, even if the partnership managers simply monitor or evaluate other investment managers, under the SEC's view, this is considered investment advice.

2. Prior to the enactment of the "Dodd-Frank Act" (discussed below), investment partnerships relied upon the "private adviser" exemption.[329] This exemption has been eliminated and replaced with new provisions for "private funds" (defined and discussed below).

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[325] A trust is deemed "owned directly or indirectly by lineal descendants" if the beneficiaries of the trust are lineal descendants of a settler and related as aunts and unless or nieces and nephews. ABA Interpretive Letter Meadowbrook Real Estate Fund (August 26, 1998).

[326] 25 U.S.C. § 78a et seq. (the "1934 Exchange Act")

[327] § 12(g) of the 1934 Exchange Act. Rule 12g5-1 of the 1934 Exchange Act provides that "held of record" refers to persons appearing in the corporate stock books (thus, counting a corporation, partnership, trust, or joint holder as one holder). However, if the issuer knows or has reason to know that the beneficial owners of an entity are using the entity to circumvent this provision, then the issuer is required to look through to the beneficial owners of the entity.

[328] § 202(a)(11) of the Investment Advisers Act.

[329] Section 203(b)(3) of the Investment Advisers Act exempted "any investment adviser who during the course of the precedent twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company registered" (§ 203(b)(3) of the Investment Advisers Act) under the act. For purposes of determining the 15 clients: (a) Natural persons and spouse or other relatives sharing a principal residence will be considered 1 client; (b) Importantly, in this context, a legal organization, such as a corporation, general partnership, limited partnership, limited liability company, or trust, that receives investment advice based on its investment objectives rather than the individual investment objectives of its

3. Absent an exemption, the Investment Advisers Act has onerous record keeping (including email retention) and compliance requirements (in addition to provisions regarding advertising and marketing, solicitation and annual disclosure). In addition, the U.S. Supreme Court has recognized that there is a private, federal right of action under the Investment Advisers Act.

E. Dodd-Frank Act

1. On July 21, 2010, the Dodd-Frank Wall Street Reform Consumer Protection Act (the "Dodd-Frank Act")[330] was enacted, with many of the provisions becoming effectively on July 21, 2011 (one year from enactment).

2. The Dodd-Frank Act generally provides the following:

a. Elimination of the previous "private adviser" exemption under the Investment Advisers Act;

b. A new definition of "private funds,"[331] which is any fund that would be an investment company but for the exemptions contained in section 3(c)(1) and 3(c)(7) of the Investment Company Act.

c. Requirement that registered investment advisers must maintain records of (and file as required by the SEC) private funds advised by the investment adviser "as necessary and appropriate in the public interest and for the protection of investors, or for the assessment of systematic risk by the Financial Stability Oversight Council." The information to be maintained (and the required filing or disclosure of such information) is left to the discretion of the SEC.

3. Most significantly for family investment partnerships, the Dodd-Frank Act provides for an exemption for "family offices" from the definition of "investment adviser," which would place such entities outside the scope of the Investment Advisers Act (specifically from the recordkeeping and reporting requirements). The Dodd-Frank Act requires that when the SEC defines the term "family office" it must do so in a manner that:

a. Is consistent with its existing exemptive orders on the subject;

b. Recognizes the range of organizational, management and employment structures employed by family offices; and

c. Does not exclude certain "grandfathered" advisers (person who were not registered or required to be registered under the Investment Advisers Act on January 1, 2010, solely because such persons provide investment advice to, and were engaged in providing (prior to January 1, 2010) investment advice to, certain natural persons and entities associated with a family office.

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shareholders, partners, limited partners or other owners, may be counted as a single client (Rule 203(b)(3)-1(a)(2) of the Investment Advisers Act); and (c) The SEC has ruled that consulting with and otherwise offering investment choice to the investors, such as allowing investors to elect from two different asset pools established to meet two different individual tax objectives, qualifies as providing separate advisory services on an investor-by-investor basis

[330] P.L. 111-203.

[331] § 202(a) of the Investment Advisers Act.

4. Family offices exempted from the definition of the term "investment adviser" by virtue of the grandfathering provision will nevertheless be deemed investment advisers for purposes of certain anti-fraud provision of the Investment Advisers Act, specifically Section 206(1), (2) and (4).

5. On June 22, 2011, the SEC issued Release IA-3220[332] finalizing Rule 202(a)(11)(G)-1,[333] its definition of "family office" (the text of the final rule is contained in the Appendix), the effective date of which was August 29, 2011.

a. Pursuant to the final rule, a "family office" is a company (including partnerships, limited liability companies, trusts, and similar organizations) that:

(1) Provides investment advisory services only to "family clients,"

(2) Is wholly owned and controlled (directly or indirectly) by family clients,[334] and

(3) Does not hold itself out to the public as an investment adviser.

b. This exclusion applies only to single family offices and will not be available to multi-family offices.

c. The term "family clients" includes any:

(1) Family member,

(2) Former family member;

(3) Key employee,

(4) Former key employee,

(5) Charitable foundation, charitable organization, or charitable trust established and funded exclusively by family members or former family members,

(6) Trust or estate that exists for the sole benefit of other family clients, and

(7) Any company wholly owned and controlled by family clients.

d. The term "family member" includes:

(1) All lineal descendants of a common ancestor,[335] and

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[332] 17 CFR Part 275 (Release No. IA-3220; File No. S7-25-10).

[333] Family Offices, Final Rule, 76 Fed. Reg. 37983-37996 (June 22, 2011) [to be codified at 17 C.F.R. 275.202(a)(11)(G)-1].

[334] The proposed rule had originally required that the family office be wholly owned and controlled by "family members." Proposed rule 202(a)(11)(2)(G)-1(b)(2).

[335] The final rule eliminates the concept of a "founder" that was contained in proposed rule 202(a)(11)(2)(G)-1(d)(5) and replaces it with "common ancestor," thereby allowing families to choose a common ancestor in order to define the family.

(2) All spouses or spousal equivalents of such lineal descendants;

(3) Provided that the common ancestor is no more than 10 generations removed from the youngest generation of family members.

(4) For purposes of the foregoing:

(a) Lineal descendants include children by adoption, stepchildren, foster children, and individuals that were a minor when another family member became a legal guardian of that individual; and

(b) Spousal equivalent means a cohabitation occupying a relationship equivalent to that of a spouse.

e. The term "former family member" includes any spouse, spousal equivalent or stepchild that was a "family member" but is no longer a family member due to a divorce or other similar event.[336]

6. Other provisions of note when the family office exemption is unavailable

a. As mentioned above, the Dodd-Frank Act eliminates the private adviser exemption mentioned and adds a new definition of "private funds." Unless an exemption applies, all private funds are required to register under and comply with the provisions of the Investment Advisers Act. For purposes of this, the Dodd-Frank Act provides for 2 other pertinent exemptions:

(1) Section 407 of the Dodd-Frank Act exempts venture capital fund advisers from registration under the Investment Advisers Act. Final Rule 203(l) issued on June 22, 2011,[337] defines a venture capital fund as a private fund that:

(a) Immediately after acquiring any assets (not including "qualifying investments" or "short-term holdings") holds no more than 20% of the fund's aggregate capital contributions and uncalled committed capital in assets (other than "short-term holdings") that are not "qualifying investments;"[338]

(b) Represents to investors that it pursues a venture capital strategy;

---

[336] The proposed rule had proposed to limit former family members from making any new investments. Proposed rule 202(a)(11)(G)-1(d)(2)(vi) and (d)(iv).

[337] SEC Release IA-3222, adopting rules 203(l) and 203(m).

[338] Essentially, the SEC is imposing a limit of 20% on secondary market transactions. "Qualifying investment" is defined as any equity security: (i) issued by a qualifying portfolio company (a "QPC") and received in exchange for directly acquired equities issued by the same QPC, (ii) issued by a QPC and acquired directly by the private fund from the QPC; and (iii) issued by accompany of which a QPC is a majority-owned subsidiary or a predecessor, and acquired by the private fund in exchange for an equity security. A QPC is further defined as any company that (i) is not reporting or "foreign traded," (ii) does not incur leverage in connection with the investment in it made by the private fund and distribute the proceeds of borrowing to the private fund in exchange for its investment, and (iii) is an operating company and not a fund. Rule 203(l) further provides that a fund's status as a venture capital fund is not affected if the securities of any of its QPCs become publicly traded following the date of the fund's investment.

(c) Does not borrow, issue debt obligations, provide guarantees or otherwise utilize leverage in excess of 15 percent of the fund's capital contributions and uncalled committed capital, and any such borrowing, indebtedness, guarantee or leverage is for a non-renewable term of no longer than 120 calendar days;

(d) Does not provide its investors with the right to redeem their interests in the fund except under extraordinary circumstances; and

(e) Is not registered under the Investment Company Act and has not elected to be treated as a business development company.

(2) Section 408 of the Dodd-Frank Act exempts certain fund advisers with less than $150 million of assts under management in the United States. Final Rule 203(m) issued on June 22, 2011, provides with respect to this exemption, the following:

(a) This private fund adviser exemption permits an investment adviser to advise an unlimited number of private funds as long as the aggregate value of the adviser's private fund assets under management in the U.S. is less than $150 million.

(b) The determination of whether a private fund adviser as "assets under management" at a U.S. place or business will turn on the question of whether the adviser provides "continuous and regular supervisory or management services" in respect of certain securities portfolios from such U.S place of business.

(c) Any location where an adviser simply conducts research, including research used to produce non-public information relevant to investment decisions and recommendations, will be deemed a "place of business."

(d) All advisers relying on this exemption must report annually on a Form ADV certain information about the private funds they manage. The Form ADV requires advisors to disclose information including form of organization, control persons, financial industry affiliations, other business activities of the adviser, and the asset values of the private funds, inclusive of uncalled capital commitments.

VI. CONCLUSION

Family investment partnerships offer significant planning opportunities and benefits, apart from the transfer tax valuation discounts that may be significantly curtailed in the future. For practitioners willing to wrestle with the complications of Section 2701 and break away from the Single Class Share FLP, the use of preferred interest structures (whether qualified payment or otherwise) give families a platform to consolidate their investment holdings, but more importantly bifurcate their interests into fixed and growth-oriented investments. As such, each family member, depending on their personal circumstances, can choose to retain all or any portion of the fixed or the growth interests. From a wealth transfer standpoint, the benefits are even more significant, especially if careful consideration is given to those circumstances when preferred interests should be transferred (an exception to Section 2701) or when they should be retained. Finally, while there are a surprising number of traps and issues that have not yet been answered in the income tax arena, that, in and of itself offers, the careful tax practitioner quite a bit of planning opportunities.

APPENDIX
FINAL SEC RULE DEFINING FAMILY OFFICES

§ 275.202(a)(11)(G)-1 Family offices.

(a) *Exclusion*. A family office, as defined in this section, shall not be considered to be an investment adviser for purpose of the Act.

(b) *Family office*. A family office is a company (including its directors, partners, members, managers, trustees, and employees acting within the scope of their position or employment) that:

(1) Has no clients other than family clients; provided that if a person that is not a family client becomes a client of the family office as a result of the death of a family member or key employee or other involuntary transfer from a family member or key employee, that person shall be deemed to be a family client for purposes of this section for one year following the completion of the transfer of legal title to the assets resulting from the involuntary event;

(2) Is wholly owned by family clients and is exclusively controlled (directly or indirectly) by one or more family members and/or family entities; and

(3) Does not hold itself out to the public as an investment adviser.

(c) *Grandfathering*. A family office as defined in paragraph (a) of this section shall not exclude any person, who was not registered or required to be registered under the Act on January 1, 2010, solely because such person provides investment advice to, and was engaged before January 1, 2010 in providing investment advice to:

(1) Natural persons who, at the time of their applicable investment, are officers, directors, or employees of the family office who have invested with the family office before January 1, 2010 and are accredited investors, as defined in Regulation D under the Securities Act of 1933;

(2) Any company owned exclusively and controlled by one or more family members; or

(3) Any investment adviser registered under the Act that provides investment advice to the family office and who identifies investment opportunities to the family office, and invests in such transactions on substantially the same terms as the family office invests, but does not invest in other funds advised by the family office, and whose assets as to which the family office directly or indirectly provides investment advice represents, in the aggregate, not more than 5 percent of the value of the total assets as to which the family office provides investment advice; provided that a family office that would not be a family office but for this paragraph (c) shall be deemed to be an investment adviser for purposes of paragraphs (1), (2) and (4) of section 206 of the Act.

(d) *Definitions*. For purposes of this section:

(1) *Affiliated family office* means a family office wholly owned by family clients of another family office and that is controlled (directly or indirectly) by one or more family members of such other family office and/or family entities affiliated with such other family office and has no clients other than family clients of such other family office.

(2) *Control* means the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of being an officer of such company.

(3) *Executive officer* means the president, any vice president in charge of a principal business unit, division or function (such as administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions, for the family office.

(4) *Family client* means:

(i) Any family member;

(ii) Any former family member;

(iii) Any key employee;

(iv) Any former key employee, provided that upon the end of such individual's employment by the family office, the former key employee shall not receive investment advice from the family office (or invest additional assets with a family office-advised trust, foundation or entity) other than with respect to assets advised (directly or indirectly) by the family office immediately prior to the end of such individual's employment, except that a former key employee shall be permitted to receive investment advice from the family office with respect to additional investments that the former key employee was contractually obligated to make, and that relate to a family-office advised investment existing, in each case prior to the time the person became a former key employee.

(v) Any non-profit organization, charitable foundation, charitable trust (including charitable lead trusts and charitable remainder trusts whose only current beneficiaries are other family clients and charitable or non-profit organizations), or other charitable organization, in each case for which all the funding such foundation, trust or organization holds came exclusively from one or more other family clients;

(vi) Any estate of a family member, former family member, key employee, or, subject to the condition contained in paragraph (d)(4)(iv) of this section, former key employee;

(vii) Any irrevocable trust in which one or more other family clients are the only current beneficiaries;

(viii) Any irrevocable trust funded exclusively by one or more other family clients in which other family clients and non-profit organizations, charitable foundations, charitable trusts, or other charitable organizations are the only current beneficiaries;

(ix) Any revocable trust of which one or more other family clients are the sole grantor;

(x) Any trust of which: Each trustee or other person authorized to make decisions with respect to the trust is a key employee; and each settlor or other person who has contributed assets to the trust is a key employee or the key employee's current and/or former spouse or spousal equivalent who, at the time of contribution, holds a joint, community property, or other similar shared ownership interest with the key employee; or

(xi) Any company wholly owned (directly or indirectly) exclusively by, and operated for the sole benefit of, one or more other family clients; provided that if any such entity is a pooled investment vehicle, it is excepted from the definition of ``investment company'' under the Investment Company Act of 1940.

(5) *Family entity* means any of the trusts, estates, companies or other entities set forth in paragraphs (d)(4)(v), (vi), (vii), (viii), (ix), or (xi) of this section, but excluding key employees and their trusts from the definition of family client solely for purposes of this definition.

(6) *Family member* means all lineal descendants (including by adoption, stepchildren, foster children, and individuals that were a minor when another family member became a legal guardian of that individual) of a common ancestor (who may be living or deceased), and such lineal descendants' spouses or spousal equivalents; provided that the common ancestor is no more than 10 generations removed from the youngest generation of family members.

(7) *Former family member* means a spouse, spousal equivalent, or stepchild that was a family member but is no longer a family member due to a divorce or other similar event.

(8) *Key employee* means any natural person (including any key employee's spouse or spouse equivalent who holds a joint, community property, or other similar shared ownership interest with that key employee) who is an executive officer, director, trustee, general partner, or person serving in a similar capacity of the family office or its affiliated family office or any employee of the family office or its affiliated family office (other than an employee performing solely clerical, secretarial, or administrative functions with regard to the family office) who, in connection with his or her regular functions or duties, participates in the investment activities of the family office or affiliated family office, provided that such employee has been performing such functions and duties for or on behalf of the family office or affiliated family office, or substantially similar functions or duties for or on behalf of another company, for at least 12 months.

(9) *Spousal equivalent* means a cohabitant occupying a relationship generally equivalent to that of a spouse.

(e) *Transition*.

(1) Any company existing on July 21, 2011 that would qualify as a family office under this section but for it having as a client one or more non-profit organizations, charitable foundations, charitable trusts, or other charitable organizations that have received funding from one or more individuals or companies that are not family clients shall be deemed to be a family office under this section until December 31, 2013, provided that such non-profit or charitable organization(s) do not accept any additional funding from any non-family client after August 31, 2011 (other than funding received prior to December 31, 2013 and provided in fulfillment of any pledge made prior to August 31, 2011).

(2) Any company engaged in the business of providing investment advice, directly or indirectly, primarily to members of a single family on July 21, 2011, and that is not registered under the Act in reliance on section 203(b)(3) of this title on July 20, 2011, is exempt from registration as an investment adviser under this title until March 30, 2012, provided that the company:

(i) During the course of the preceding twelve months, has had fewer than fifteen clients; and

(ii) Neither holds itself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a), or a company which has elected to be a business development company pursuant to section 54 of that Act (15 U.S.C. 80a-54) and has not withdrawn its election.

CURRENT ISSUES INVOLVING FLPS, LLCS, AND OTHER CLOSELY HELD ENTITIES

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I. INTRODUCTION

The steps that partners and their advisors take in forming and operating a family limited partnership[1] can impact a court's view on valuation to such a great extent that valuation evidence can become irrelevant. In transfer tax cases addressing legal issues such as indirect gifts and the applicability of § 2036,[2] courts may conclude that the facts in a given case are such that it is a proportionate share of the assets of the partnership, rather than the transferred partnership interest, that is to be valued for transfer tax purposes. In other words, if the existence of the partnership is judicially disregarded, the question of the value of the transferred partnership interest need not be reached – only the value of the underlying assets of the partnership matters. The result to the taxpayer in such a situation is that although he transferred a partnership interest subject to various duties and restrictions found in the governing partnership agreement, for transfer tax purposes, those duties and restrictions are ignored, and the resulting discounts for lack of marketability and lack of control are disregarded. Thus, when the existence of a partnership is judicially ignored, the value that is used for transfer tax purposes is the portion of the underlying assets of the partnership attributable to the transferred interest, without regard to the fact that a hypothetical buyer would take into account the terms of the partnership agreement when deciding on the price that he would be willing to pay for the interest.

As the Internal Revenue Service ("the IRS") increases its efforts to deprive taxpayers of the tax benefits that family limited partnerships offer, a pattern of issues raised by the IRS has emerged. For instance, in recent cases, the IRS has focused on whether Internal Revenue Code § 2703 applies to disregard rights of first refusal and buy-sell provisions when determining the value of a partnership interest that was transferred. *Fisher v. United States*, 2010 WL 3522952 (S.D. Ind. Sep. 1, 2010); *Holman v. Comm'r,* 130 T.C. 170 (2008), *aff'd*, 601 F.3d 763 (8th Cir. 2010). The IRS also generally argues that the fair market value of partnership interests reported on various transfer tax returns is too low – that the valuation discounts applied were too aggressive or simply were not applicable.

In the gift tax context, the IRS has focused on whether gifts of partnership interests can qualify for the annual gift tax exclusion and whether gifts of partnership interests made close in time to the partnership's formation are, instead, gifts of underlying assets of the partnership that were then contributed to the partnership by the gift recipient (the indirect gift theory). For instance, in a case where a father and his two sons created a partnership, and the father, at creation, transferred all of the assets to

[1] Although this article refers to limited partnerships, many of the suggestions contained herein also apply to other closely held entities, such as limited liability companies.

[2] The author has attempted to provide a thorough analysis, for educational purposes only, of the arguments that the IRS has made and the courts have sometimes adopted in addressing certain "pitfalls" in the structure and operation of family entities. However, no statement herein should be construed as a concession of the legal sufficiency of those analyses or that any such "pitfall" precludes recognition of the entity for any federal tax purposes.

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the partnership (and the sons made no individual capital contribution), the Tax Court held that the father had not made gifts of partnership interests, but rather made gifts of undivided interests in the real estate and securities transferred to the partnership to the extent that those properties were attributed to his sons' capital accounts. *Shepherd v. Comm'r*, 115 T.C. 376 (2000), *aff'd,* 283 F.3d 1258 (11th Cir. 2002). The Court reasoned that because a partnership of one cannot exist, the father made indirect gifts of the property transferred to the partnership, and not of the partnership interests that the sons received. *See also Estate of Liljestrand v. Comm'r*, 102 T.C.M. (CCH) 440 (2011); *Estate of Malkin v. Comm'r*, 98 T.C.M. (CCH) 225 (2009); *Senda v. Comm'r*, 88 T.C.M. (CCH) 8 (2004), *aff'd*, 433 F.3d 1044 (8th Cir. 2006); *Holman v. Comm'r,* 130 T.C. 170 (2008), *aff'd*, 601 F.3d 763 (8th Cir. 2010); *Gross v. Comm'r*, 96 T.C.M. (CCH) 187 (2008).

And in the estate tax context, the IRS has increasingly raised the spectre of IRC § 2036(a). Typically, the IRS has argued that all assets contributed by a decedent to a limited partnership during lifetime should be included in the decedent's gross estate under § 2036(a)(1), arguing that the decedent retained rights to assets contributed. Most recently, the IRS successfully argued that a decedent's retention of the right to dissolve a partnership, in conjunction with another person, caused § 2036(a)(2) inclusion – an argument on which the IRS had not been successful since *Estate of Strangi*, 85 T.C.M. (CCH) 1331 (2003), *aff'd* 417 F.3d 468 (5th Cir. 2005). The IRS's most recent attack on partnerships is becoming commonly referred to as "the marital deduction mismatch." *See, e.g., Estate of Turner v. Comm'r*, 138 T.C. No. 14 (2012) (limiting the decedent's marital deduction to the actual value of the property passing to the wife, where the will provided for a calculation based upon the actual, rather than discounted value, of the assets); *Estate of Shurtz v. Comm'r*, 99 T.C.M. (CCH) 1096 (2010) (declining to reach the marital deduction mismatch argument because the exception to § 2036 applied).

In determining fair market value for transfer tax purposes, the value of a transferred interest is determined according to the "hypothetical willing buyer/willing seller" test found in § 2031 (for estate tax purposes) and § 2512 (for gift tax purposes) and the related Treasury Regulations. *See Ludwick v. Comm'r*, 99 T.C.M. (CCH) 1424 (2010) (determining fair market value of undivided interest for gift tax purposes). Therefore, the fair market value of the transferred interest is not a proportionate share of the partnership's assets, because a hypothetical willing buyer would not be willing to pay for a pro rata share of the underlying assets of the partnership, in part because the buyer would not own the underlying assets and in part because the terms of the partnership agreement burden the assets. Consequently, the fair market value of a partnership interest is almost certain to be less than the proportionate value of the assets of the partnership. And it is the fair market value *of the transferred partnership interest* that is used to determine the amount of tax due as a result of the transfer.

With regard to estate tax cases, the IRS has been successful in its efforts largely in cases where taxpayers have failed to respect the integrity of the entities that they form. In these cases, the Tax Court has applied § 2036(a) to bring the value of the

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assets of the partnership back into decedents' estates as retained life interests. Section 2036(a) provides as follows:

> (a) GENERAL RULE—The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—
>
> (1) the possession or enjoyment of, or the right to the income from, the property, or
>
> (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.
>
> I.R.C. § 2036.

This material is intended to assist practitioners in advising their clients at each step of forming, operating, and defending a partnership to avoid pitfalls that the courts and the IRS are pointing to when opining that, in essence, the existence of a partnership should be disregarded for valuation purposes.

II. CONSIDER APPROPRIATENESS OF PARTNERSHIP

A. KEEP POTENTIAL FUTURE AUDIENCE IN MIND

Preparing for a potential estate tax examination really begins at the estate planning level. Keep in mind that anything that you write or your client writes (even if protected from discovery by one or more privileges) may later be viewed by the IRS, a judge, or even a jury. *See Estate of Jorgensen v. Comm'r,* 97 T.C.M. (CCH) 1328 (2009) ("Guess we have to be real straight on who borrowed what etc. so the partnership looks very legit."), *aff'd,* 431 Fed. Appx. 544 (9th Cir. 2011); *Linton v. United States,* 638 F. Supp. 2d 1277 (W.D. Wash. 2009) ("[Y]ou have to get the assets into the LLC first so it's the owner of the assets before you start making transfers."), *rev'd in part and remanded*, 630 F.3d 1211 (9th Cir. 2011). For instance, in cases where the IRS has asserted that § 2036 applies (and thus the person who formed a partnership has passed away), the only evidence of non-tax reasons for forming the partnership may be contained in privileged documents.

While advisors should not shy away from explaining the tax effects of forming a limited partnership, it is preferable to have such discussions take place in the context of a discussion of the non-tax reasons, as well. The best evidence of a taxpayer's rationale for forming a partnership often comes from the correspondence prepared in connection with the decision to create the entity.

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In attempting to establish the non-tax reasons for forming a partnership, it is helpful if the documentation is such that the taxpayer feels comfortable waiving the attorney-client privilege and producing requested communications that would otherwise be protected from discovery under the attorney-client privilege.

B. Consider Whether Clients Are Ready for Partnership

Family limited partnerships are like blowfish sushi – handled with precision and care, they can be wonderful; handled carelessly, they are downright dangerous. Limited partnerships can be confusing, and, at a minimum, they are complex. Therefore, it is important to evaluate whether the people who are considering forming a limited partnerships are up to the task. Can they get along? Are they willing to abide by the rules? Are they prepared to pay the legal and accounting fees that tend to come along with the entity? These questions and others are important to address in determining whether your clients are ready for a partnership.

C. Evaluate Potential Assets

1. Maintain Assets Outside of the Partnership

The courts and the IRS have opined that partners should retain enough assets outside of the partnership to support their lifestyles. The IRS has often asserted that a contributing partner's failure to retain sufficient assets outside of a partnership to maintain his or her standard of living is evidence of an implied agreement of that partner to retain rights to the income from the assets contributed to the partnership. *See Estate of Miller v. Comm'r,* 98 T.C.M. (CCH) 159 (2009); *Estate of Jorgensen v. Comm'r,* 97 T.C.M. (CCH) 1328 (2009), *aff'd,* 431 Fed. Appx. 544 (9th Cir. 2011); *Estate of Hurford v. Comm'r*, 96 T.C.M. (CCH) 422 (2008); *Estate of Rector v. Comm'r*, 94 T.C.M. (CCH) 567 (2007); *Estate of Bigelow v. Comm'r*, 89 T.C.M. (CCH) 954 (2005), *aff'd*, 503 F.3d 955 (9th Cir. 2007); *Estate of Stone v. Comm'r*, 86 T.C.M. (CCH) 551 (2003); *Estate of Thompson v. Comm'r*, 84 T.C.M. (CCH) 374 (2002), *aff'd,* 382 F.3d 367(3d Cir. 2004). *But see Estate of Mirowski v. Comm'r*, 95 T.C.M. (CCH) 1277 (2008) (declining to apply § 2036 where decedent anticipated funding lifestyle with partnership distributions). In combating, for instance, a § 2036 argument, it is helpful to have contemporaneous documentation of the fact that a contributing partner had sufficient cash flow outside of the partnership to support his or her lifestyle without depending on extraordinary distributions from the partnership.

2. Refrain from Contributing Personal Use Assets

In determining whether formation of a partnership is appropriate, partners should consider the nature of the assets to be contributed to the partnership. For instance, the IRS and the courts have, in their

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consideration of whether a partnership is to be respected, considered as a negative factor the contribution of "personal use" assets to partnerships (in great part because those assets, on contribution to the partnership, become partnership property but may not be treated as such). *See, e.g., Estate of Liljestrand v. Comm'r*, 102 T.C.M. (CCH) 440 (2011); *Estate of Bigelow v. Comm'r*, 503 F.3d 955 (9th Cir. 2007); *Estate of Korby v. Comm'r*, 471 F.3d 848 (8th Cir. 2006), *aff'g* 89 T.C.M. (CCH) 1150 (2005); *Estate of Strangi v. Comm'r*, 85 T.C.M. (CCH) 1331 (2003), *aff'd* 417 F.3d 468 (5th Cir. 2005); *Estate of Strangi v. Comm'r*, 115 T.C. 478 (2000), *aff'd in part and rev'd in part,* 293 F.3d 279 (5th Cir. 2002); *Estate of Harper v. Comm'r*, 83 T.C.M. (CCH) 1641 (2002); *Estate of Reichardt v. Comm'r*, 114 T.C. 144 (2000). Such assets include personal residences, vacation homes, and recreational equipment. If the partners feel strongly about contributing such assets to the partnership, care should be taken to minimize the possibility of IRS attack by ensuring that the partnership is compensated for individuals' (including and perhaps most importantly, partners') use of those assets, *i.e.*, rent should be paid to the partnership for use of the partnership's assets. Failure to do so may lead the IRS to assert, for instance, that § 2036 should apply at death, in light of the fact that a contributing partner retained the right to use partnership property without paying for it.

3. Secure Appraisals for Hard-to-Value Assets

In recent cases, the courts have examined the propriety of partners' capital accounts on formation as a factor in whether § 2036 should be applied to various partnership interest transfers. In that regard, advisors should keep the full and adequate consideration element of the exception to § 2036 in mind and ensure that capital accounts of all partners are properly created, credited, and maintained. Consequently, if partners intend to contribute assets to the partnership that are hard to value (*e.g.*, real estate, oil and gas interests, interests in closely held entities), it is advisable to obtain appraisals of the fair market value of those assets so that the calculation of initial ownership interests in the partnership is as accurate as possible. *See generally Hendrix v. Comm'r*, 101 T.C.M. (CCH) 1642 (2011) (exhibiting value of using two appraisals for hard-to-value assets). It is equally important to follow the appraiser's fair market value calculations. *See Estate of Liljestrand v. Comm'r*, 102 T.C.M. (CCH) 440 (2011). For instance, obtaining and relying on the reasonable opinion of a professional appraiser can help the client avoid penalties. *See Giustina v. Comm'r*, 101 T.C.M. (CCH) 1676 (2011).

Likewise, if assets subject to debt or non-liquid assets (such as real estate) are to be contributed to the partnership, the partners should make sure to fund the partnership with sufficient cash to support those assets,

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such that the partnership can service its debt[3] and pay real estate taxes and other expenses related to its property. *See Estate of Bigelow v. Comm'r*, 89 T.C.M. (CCH) 954 (2005), *aff'd*, 503 F.3d 955 (9th Cir. 2007) (concluding that decedent retained economic benefit of contributed real estate where property continued to secure decedent's debts and rental income was used to pay decedent's expenses). Doing so may help to minimize fuel for an IRS argument that a contributing partner's debt service or payment of maintenance costs related to assets contributed to the partnership evidences an implied agreement under § 2036 of that partner's right to use those partnership assets.

4. Review Transfer Restrictions

Finally, when determining which assets are to be contributed to the partnership, be sure to review any transfer restrictions that might be applicable to those assets. If the documents governing a particular asset do not permit transfer of that asset without, for instance, written authorization of a certain person or entity, try to begin that authorization process sooner rather than later (or to avoid contributing that asset to the partnership, if it is determined that the transfer restrictions are too onerous).

D. Evaluate Potential Partners

First, potential partners should consider with whom they wish to be partners. Family limited partnerships often have long terms of existence. It is a good idea to consider whether partners think that they will be able to work together throughout the term of the partnership. Evidence of discussion of such considerations is helpful in establishing that the terms of the partnership agreement were negotiated, a factor that is considered, for instance, in determining whether the bona fide sale element of the exception to § 2036 is applicable.

On a similar note, participants should consider the health of their proposed partners. The IRS likes to point to "deathbed partnerships" as evidence of its assertion that the only reason for forming the partnership was tax avoidance. If one or more of the potential partners is seriously ill, the partners might reconsider whether to include her. *See, e.g., Estate of Black v. Comm'r*, 133 T.C. 340 (2009), *supp. by* 103 T.C.M. (CCH) 1302 (2012) (91 years old but in good health); *Estate of Malkin v. Comm'r*, 98 T.C.M. (CCH) 225 (2009) (bad health); *Estate of Miller v. Comm'r,* 98 T.C.M. (CCH) 159 (2009) (stable health for first contribution; steep decline for second contribution); *Estate of Mirowski v. Comm'r*, 95 T.C.M. (CCH) 1277 (2008) (stable health); *Estate of Erickson v. Comm'r*, 93 T.C.M (CCH) 1175 (2007) (bad health); *Estate of Rector v. Comm'r*,

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[3] Keep in mind, however, that relief of the contributing partner's debt in this regard may require consideration of income tax issues for that partner.

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94 T.C.M. (CCH) 567 (2007) (bad health); *Estate of Rosen v. Comm'r*, 91 T.C.M. (CCH) 1220 (2006) (bad health); *Estate of Strangi v. Comm'r*, 85 T.C.M. (CCH) 1331 (2003), *aff'd*, 417 F.3d 468 (5th Cir. 2005) (bad health); *Estate of Stone v. Comm'r*, 86 T.C.M. (CCH) 551 (2003) (good health). And beware forming a partnership with a person who is not competent to execute the partnership agreement himself; when determining whether partnerships were formed for bona fide, non-tax reasons, the IRS and the courts have taken into account the fact that an agent, rather than the partner, executed the formation documents. *See, e.g., Estate of Erickson v. Comm'r*, 93 T.C.M. (CCH) 1175 (2007); *Estate of Rosen v. Comm'r*, 91 T.C.M. (CCH) 1220 (2006); *Estate of Strangi v. Comm'r*, 115 T.C. 478 (2000), *aff'd in part and rev'd in part,* 293 F.3d 279 (5th Cir. 2002).

Second, participants should consider whether the partners will be individual family members, trustees of trusts for family members, entities formed by family members (such as a limited liability company), or some combination of any or all of the above.

In choosing partners, the participants should consider who will be able to make meaningful capital contributions to the partnership. *See Estate of Bongard v. Comm'r*, 124 T.C. 95 (2005). To the extent possible, it is preferable to have each partner make a meaningful contribution to the partnership so as to establish that a real pooling of assets and services occurred and to avoid the IRS's argument that, for instance, a child's proportionately small contribution had no real impact – that creation of the partnership was a "mere recycling of value," as that term is used in *Estate of Harper v. Comm'r*, 83 T.C.M. (CCH) 1641 (2002). (Beware, though, the implications of the investment company rules when determining the nature and amount of the assets to be contributed to a partnership. *See, e.g.*, I.R.C. §§ 721, 351, 368; Priv. Ltr. Rul. 200931042.)

Finally, in determining who the partners will be, forming partners should consider what roles each of the partners will play, if any, in partnership management. Do the partners intend to have the parent manage the partnership? Is the partnership to be used as a tool to progressively teach the next generation? Or is management to be passed immediately to the children? A parent's considerations in this regard and a written record of those considerations can play a pivotal role in later establishing the non-tax reasons for which a partnership was formed.

E. AVOID GIFT PLANNING UNTIL PARTNERSHIP IS UP AND RUNNING

In an ideal world, the entity would be formed, funded, and functioning before discussion of gift planning even began. However, most clients want to understand all of the pros and cons related to formation of an entity, and most estate planners want to explain all of the possibilities at the outset. The likelihood that the concept of gift planning with partnership interests will not even be mentioned until after the entity is up and running is minimal at best.

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However, the risk that advisors and clients take when discussing (and perhaps beginning to implement) gift planning at the outset is that the IRS will assert the indirect gift theory – or even the step transaction doctrine.

That said, it is clear that even the courts anticipate that the tax benefits of an entity will be discussed and explored. *See Estate of Turner v. Comm'r*, 102 T.C.M. (CCH) 214 (2011), *supp. by* 138 T.C. 14 (2012) ("We are particularly struck by the implausibility of petitioner's assertion that tax savings resulting from the family limited partnership were never discussed. . . . We do not find testimony to that effect to be credible and that lack of credibility infects all of the testimony petitioner offered."). As long as the tax savings discussions are had within the context of the non-tax considerations, later gifts (occurring *after* formation and funding) should withstand scrutiny, barring other negative factors.

Compare Pierre v. Comm'r, 133 T.C. 24 (2009), *supp. by* 99 T.C.M. (CCH) 1436 (2010), *Holman v. Comm'r*, 130 T.C. 170 (2008), *aff'd,* 601 F.3d 763 (8th Cir. 2010), *Gross v. Comm'r,* 96 T.C.M. (CCH) 187 (2008), *Estate of Strangi v. Comm'r*, 85 T.C.M. (CCH) 1331 (2003), *aff'd*, 417 F.3d 468 (5th Cir. 2005), *Estate of Jones v. Comm'r*, 116 U.S. 212 (2001), *and Estate of Strangi v. Comm'r*, 115 T.C. 478 (2000), *aff'd in part and rev'd in part*, 293 F.3d 279 (5th Cir. 2002), *with Linton v. United States*, 638 F. Supp. 2d 1277 (W.D. Wash. 2009), *rev'd in part and remanded*, 630 F.3d 1211 (9th Cir. 2011), *Heckerman v. United States*, No. C08-0211-JCC, 2009 WL 2240326 (W.D. Wash. Jul. 27, 2009), *Senda v. Comm'r*, 88 T.C.M. (CCH) 8 (2004), *aff'd*, 433 F.3d 1044 (8th Cir. 2006), *and Shepherd v. Comm'r*, 115 T.C. 376 (2000), *aff'd*, 283 F.3d 1258 (11th Cir. 2002).

III. PARTNERSHIP FORMATION

In the IRS's view, and more importantly, that of the courts, it is critical that partners in a partnership respect the entity as an entity (*i.e.*, comply with the terms of the governing partnership agreement, treat assets of the partnership as partnership assets, etc.). If the partners fail to do so, it is highly unlikely that the IRS or a court will. In that regard, it is important to dot all of the Is and cross all of the Ts. Some suggestions follow:

A. CONSIDER SEPARATE COUNSEL FOR PARTICIPANTS

Although having each partner represented by separate counsel may be expensive, it also goes a long way toward ensuring that the interests of each partner are considered when forming the partnership and that the terms of the partnership agreement will be reviewed by and discussed among the partners at that time. It also serves to evidence the arm's-length nature of the creation of the partnership. *See, e.g., Estate of Jorgensen v. Comm'r,* 97 T.C.M. (CCH) 1328 (2009), *aff'd,* 431 Fed. Appx. 544 (9th Cir. 2011); *Estate of Erickson v. Comm'r,* 93 T.C.M. (CCH) 1175 (2007); *Estate of Rector v. Comm'r,* 94 T.C. M. (CCH)

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567 (2007); *Estate of Rosen v. Comm'r,* 91 T.C.M. (CCH) 1220 (2006); *Estate of Stone v. Comm'r,* 86 T.C.M. (CCH) 551 (2003).

B. ENGAGE/CONSULT WITH EXPERIENCED ADVISORS

It is important to hire an attorney and an accountant who are experienced in partnership issues to assist in the decision-making processes, and hiring such advisors should happen sooner rather than later. The earlier that experienced advisors are involved, the less likely the partners are to make a misstep in a potential minefield. Beware of simplified "kit" partnerships that do not take into account the partners' individual reasons for and goals in forming the partnership. *See, e.g.*, *Estate of Strangi v. Comm'r*, 85 T.C.M. (CCH) 1331 (2003), *aff'd*, 417 F.3d 468 (5th Cir. 2005); *Estate of Thompson v. Comm'r*, 84 T.C.M. (CCH) 374 (2002), *aff'd,* 382 F.3d 367 (3rd Cir. 2004); *Estate of Strangi v. Comm'r*, 115 T.C. 478 (2000), *aff'd in part and rev'd in part*, 293 F.3d 279 (5th Cir. 2002).

C. DISCUSS PARTNERSHIP TERMS

In establishing that the creation of the partnership is a bona fide sale as that term is used in § 2036, it is important to document any facts evidencing the arm's-length nature of the transaction. Negotiation of the terms of the partnership agreement by the intended partners is precisely the type of evidence that can be used to establish that the bona fide sale element of the § 2036 exception is met, as was the case in *Estate of Stone v. Comm'r*, 86 T.C.M (CCH) 551 (2003). Furthermore, all partners should be included and participate in these negotiations. *See Estate of Liljestrand v. Comm'r*, 102 T.C.M. (CCH) 440 (2011). Governing agreements generally should not allow senior family members to maintain 100% management control, nor should the sole power to change partnership terms rest in those senior family members, as these provisions could cause the IRS to argue that the right to possess and enjoy the property was retained by the transferor, thus triggering § 2036 inclusion. *See Estate of Turner v. Comm'r*, 102 T.C.M. (CCH) 214 (2011), *supp. by* 138 T.C. 14 (2012).

Using a "kit" partnership may play into the hands of the IRS, as such pre-formulated documents rarely leave room for the tailoring that an attorney with experience in family partnerships can provide. *See, e.g., Estate of Rector v. Comm'r*, 94 T.C.M. (CCH) 567 (2007); *Estate of Strangi v. Comm'r*, 417 F.3d 468 (5th Cir. 2005); *Estate of Thompson v. Comm'r*, 84 T.C.M. (CCH) 374 (2002), *aff'd*, 382 F.3d 367 (3rd Cir. 2004); *Estate of Harper v. Comm'r*, 83 T.C.M. (CCH) 1641 (2002).

Some of the partnership agreement terms that family members might consider important to negotiate and discuss in this regard are:

- Purpose – what are the family-specific reasons that this taxpayer and her family have for forming the partnership?

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- Management structure – who will serve as general partner(s)? Will there be a managing partner(s)? Will unanimity be required for management decision-making if more than one person or entity is managing the partnership?

- Management powers – what actions may partnership management take without the approval or input of the other partners?

- Compensation to managers – will the general partners/managing partners be compensated? If so, at what level?

- Investment policy – what will the partnership's investment policy be? *See Estate of Jorgensen v. Comm'r*, 97 T.C.M. (CCH) 1328 (2009), *aff'd,* 431 Fed. Appx. 544 (9th Cir. 2011). *But see Estate of Schutt v. Comm'r*, 89 T.C.M. (CCH) 1353 (2005).

- Books and records – what books and records will the partners be required to keep? Do partners wish to prepare annual financial statements?

- Distribution policy – will the partnership make regular distributions? Will it make distributions sufficient to cover each partner's income tax liability attributable to his partnership interest?

- Transfer restrictions – what transfer restrictions should be included in the partnership agreement? How will those transfer restrictions impact each partner?

- Partnership term – how long should the partnership stay in existence?

- Use of partnership assets – under what terms may a partner or third party rent a partnership asset?

D. ENCOURAGE PARTNERS TO DISCUSS PURPOSES OF PARTNERSHIP

Some of the partnership purposes that family members might consider important are:

- Joint enterprise for profit; s*ee Estate of Stone v. Comm'r*, 86 T.C.M. (CCH) 551 (2003).

- Centralized management; *see, e.g., Estate of Kelly v. Comm'r,* 103 T.C.M. (CCH) 1393 (2012); *Estate of Black v. Comm'r*, 133 T.C. 340 (2009), *supp. by* 103 T.C.M. (CCH) 1302 (2012).

- Furtherance of family investment strategies; *see, e.g., Estate of Black v. Comm'r*, 133 T.C. 340 (2009), *supp. by* 103 T.C.M. (CCH) 1302 (2012); *Estate of Miller v. Comm'r*, 98 T.C.M. (CCH) 159 (2009);

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Estate of Schutt v. Comm'r, 89 T.C.M. (CCH) 1353 (2005); *Estate of Miller v. Comm'r*, 98 T.C.M. (CCH) 159 (2009). *But see Estate of Turner v. Comm'r*, 102 T.C.M. 2011, *supp. by* 138 T.C. No. 14 (2012) (management of passive investments not a legitimate non-tax purpose).

- Preservation of the family business*; see Estate of Shurtz v. Comm'r*, 99 T.C.M. (CCH) 1096 (2010).

- Division of control, financial benefits among children; *see, e.g., Estate of Kelly v. Comm'r,* 103 T.C.M. (CCH) 1393 (2012)*; Estate of Murphy v. United States,* 2009 WL 3366099 (W.D. Ark. Oct. 2, 2009).

- Marriage protection; *see Keller v. United States*, 2009 WL 2601611 (S.D. Tex. August 20, 2009), *aff'd*, 697 F.3d 238 (5th Cir. 2012).

- Bankruptcy protection.

- Creditor protection.

While the sole purpose of the partnership should not be to save on estate taxes or facilitate gift giving, the existence of these motives, in conjunction with valid, non-tax reasons for forming the partnership, should not preclude the application of the bona fide sale exception to § 2036. *See, e.g.*, *Estate of Stone*, 103 T.C.M. (CCH) 1237 (2012); *Estate of Black v. Comm'r*, 133 T.C. 340 (2009), *supp. by* 103 T.C.M. (CCH) 1302 (2012); *Estate of Miller v. Comm'r*, 98 T.C.M. (CCH) 159 (2009).

E. ENSURE AGREEMENT'S SCHEDULES ARE COMPLETE

Most partnership agreements refer to an attachment, schedule, or exhibit that is intended to list all of the assets that the partners agree to contribute to the partnership at formation and the resulting partnership interests to be received by the partners in return. In some states, such attachments are required by statute; and in some of those states, the attachments must also detail the fair market value of the assets to be contributed. In combating IRS arguments that the formalities of a partnership were not respected, it is important that any such attachments to a partnership agreement be complete at the time that the partnership agreement is signed. And in order to best anticipate questions in audit, such attachments should accurately set forth the assets contributed to the partnership, the fair market value of those assets, and the resulting ownership interests of each partner of the partnership.

Sometimes, it is impossible to know the fair market value of contributed assets – and thus the amount of the resulting percentage interests – at the time that the partnership agreement is formed. This situation can occur if, for instance, there are hard to value assets such as real estate for which an appraisal as of the formation date is being obtained. This can also occur with

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regard to securities, for which the value cannot be known until the close of business on the day of formation. If necessary, an amendment to the partnership agreement can be executed once accurate fair market values are known.

F. Reflect Contributions in Capital Accounts in Proportion to Fair Market Value of Assets Contributed

Creating capital accounts timely is critical in establishing that the transfer of assets in exchange for partnership interests was a transfer for full and adequate consideration, as that term is used in the exception to the application of § 2036, or was not an indirect gift of the assets contributed to the partnership. To avoid IRS attack, each partner's capital account should reflect the value of the assets that he contributed to the partnership and the percentage interest received by the partner in return. Consider creating capital accounts prior to preparation of the entity's first tax return. *See Linton v. United States,* 638 F. Supp. 2d 1277 (W.D. Wash. 2009) ("The tax return itself . . . does not constitute contemporaneously prepared evidence as to the sequence of transactions resulting in the capital account balances."), *rev'd in part and remanded*, 630 F.3d 1211 (9th Cir. 2011). In order to refute the application of, among other theories, § 2036, the percentage interests received by the partners should be proportionate to the fair market value of the assets that each contributed. *See, e.g., Estate of Kelly v. Comm'r,* 103 T.C.M. (CCH) 1393 (2012); *Estate of Shurtz v. Comm'r*, 99 T.C.M. (CCH) 1096 (2010); *Estate of Black v. Comm'r*, 133 T.C. 340 (2009), *supp. by* 103 T.C.M. (CCH) 1302 (2012).

G. Prepare Transfer Documents in Advance and File with Relevant State Authorities

As referenced above, in disputing the IRS's assertions that a partnership should not be respected, it is important to establish that the formalities surrounding formation (and operation) of a partnership are respected. One of those formalities is the transferring of assets to the partnership that the partners agreed to contribute when creating the partnership. In that regard, it is most efficient to have the transfer documents ready at the time that the partnership agreement is signed, so that partners can sign all of the relevant documents necessary to form the partnership agreement and transfer title to the assets into the partnership's name all at once. Doing so also ensures that this very important step does not get overlooked. *See Estate of Hurford v. Comm'r*, 96 T.C.M. (CCH) 422 (2008) (finding that partnership formalities were disregarded by significant delays in contributing assets to the partnerships); *Estate of Hillgren v. Comm'r*, 87 T.C.M. (CCH) 1008 (2004) (finding that the taxpayer delayed in transferring property to the partnership); *Estate of Rosen v. Comm'r*, 91 T.C.M. (CCH) 1220 (2006) (finding that decedent made no contribution to partnership until more than two months after formation).

Typically, a limited partnership is not formed until a certificate of limited partnership or similar document is filed with the relevant state authority (often,

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the Secretary of State). Be sure to file such required documentation with the state (and obtain any state licenses or registrations) timely. Delays between the date that a partnership agreement is executed and the date that the partnership is actually formed under state law can be problematic when the IRS gets involved. *See, e.g., Estate of Hillgren v. Comm'r,* 87 T.C.M. (CCH) 1008 (2004*); Senda v. Comm'r*, 88 T.C.M. (CCH) 8 (2004), *aff'd*, 433 F.3d 1044 (8th Cir. 2006); *Shepherd v. Comm'r*, 115 T.C. 376 (2000), *aff'd*, 283 F.3d 1258 (11th Cir. 2002); *Estate of Erickson v. Comm'r*, 93 T.C.M. (CCH) 1175 (2007); *Estate of Rector v. Comm'r*, 94 T.C.M. (CCH) 567 (2007); *Estate of Harper v. Comm'r*, 83 T.C.M. (CCH) 1641 (2002).

H. FILE FOR EMPLOYER IDENTIFICATION NUMBER

Likewise, in order to avoid IRS attack, once a partnership is formed, it is important to apply to the IRS for a federal employer identification number ("EIN") as quickly as possible, *e.g.*, as soon as the certificate of limited partnership is filed and returned by the relevant state authority. *See Estate of Thompson v. Comm'r*, 84 T.C.M. (CCH) 374 (2002), *aff'd*, 382 F.3d 367 (3rd Cir. 2004). *But see Estate of Miller v. Comm'r,* 98 T.C.M. (CCH) 159 (2009). As with the failure to timely file certificates of limited partnership, the IRS has pointed to delays in obtaining EINs as evidence that partnership formalities were not respected.

I. ESTABLISH BANK/BROKERAGE ACCOUNTS TIMELY

It is important to set up partnership bank and brokerage accounts and transfer contributed assets to those accounts as soon as possible after formation for two reasons: first, to establish that the partnership entity is being respected by its partners and the partners understand that the partnership's assets are just that – partnership assets; second, to ensure that any income earned on partnership assets is credited to the partnership – not to the contributing partner. Otherwise, the door is left open for the IRS to assert the applicability of § 2036, on the grounds that the contributing partner had an implied agreement to retain the income from the assets contributed to the partnership. *See, e.g., Estate of Liljestrand v. Comm'r*, 102 T.C.M. (CCH) 440 (2011); *Estate of Rector v. Comm'r*, 94 T.C.M. (CCH) 567 (2007); *Estate of Thompson v. Comm'r*, 84 T.C.M. (CCH) 374 (2002), *aff'd*, 382 F.2d 367 (3rd. Cir. 2004).

J. ENGAGE PARTNERSHIP ACCOUNTANT

Accounting issues can make or break a court's view of whether to respect the existence of a partnership. In that regard, it is important to hire an experienced partnership accountant who has knowledge of, among others, such partnership issues as capital accounts, the impact of distributions on partners' respective basis in their partnership interests, the impact of additional capital contributions, redemptions, and sales on ownership interests, § 754 elections, protective claims, audit procedures, etc. *See, e.g., Estate of Shurtz v. Comm'r*, 99 T.C.M. (CCH) 1096 (2010); *Estate of Jorgensen v. Comm'r,* 97 T.C.M. (CCH)

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1328 (2009), *aff'd,* 431 Fed. Appx. 544 (9th Cir. 2011); *Linton v. United States*, 638 F. Supp. 2d 1277 (W.D. Wash. 2009), *rev'd in part and remanded*, 630 F.3d 1211 (9th Cir. 2011).

K. Consider Deducting Partnership Set-Up Fees

The IRS consistently examines the identity of the payor of partnership set-up fees. If a partner has paid the legal and accounting fees related to creation of the entity and has not been repaid by the partnership, the IRS typically asserts that the partnership has not been respected; that, if it were truly a business entity (and not merely an entity created for tax avoidance purposes), the paying partner would have sought reimbursement by the partnership. *See Estate of Jorgensen v. Comm'r,* 97 T.C.M. (CCH) 1328 (2009), *aff'd,* 431 Fed. Appx. 544 (9th Cir. 2011). Keep in mind that a partnership that pays for (or reimburses) set-up fees may, in most cases, deduct those fees for income tax purposes, although, depending on the amount, it may have to do so by way of amortizing them.

L. If Necessary, Amend Partnership Percentages as Quickly as Possible After Formation

In order to minimize IRS attack, if assets were contributed to the partnership but the precise fair market value of some or all of those assets was not known on the date of formation (as is likely to be the case with hard-to-value assets such as real estate or mineral interests), the partnership agreement (or its attachments) should be amended as soon as information on all contributed assets becomes available. If such amendments are not made, the IRS is likely to assert that the capital accounts of the contributing partners are not proportionate to the fair market value of the assets contributed and, as a result, the exception to § 2036 cannot apply.

M. Consider Whether to Establish Partnership Office

Increasingly, in its attacks on partnerships, the Service has pointed to entities' lack of physical office space, telephone numbers, and phone book listings as evidence of no "business purpose" for the creation of the partnership. While the purported requirement of business purpose is disputed, obtaining a phone number and perhaps even office space could facilitate a partnership's operations.

IV. PARTNERSHIP MAINTENANCE

A. File Accurate Returns and Registration Statements For Each Year In Existence

It seems common sense – a legal entity has been established; thus, at the appropriate time, a tax return for the partnership must be filed, right? But what if the entity is formed on December 27? Should a tax return for those four days be

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filed? And what if the entity has no income for the first two or three years that it exists (perhaps it holds only cash and non-income producing real estate, or non-dividend paying stock)? What then?

In both examples, it may be tempting to forgo filing a partnership return. However, to minimize avenues of IRS attack, it is advantageous to file, despite the apparent lack of necessity to do so. First, partnerships often rely on the information contained in the partnership return to document partners' capital accounts. If no partnership return is filed in the partnership's first year of existence, it may be difficult to evidence that the capital accounts were properly created, reflecting the proportionate exchange of assets for partnership interests. Second, even if the partnership has no income, the IRS has been known to assert that the failure to file a return reflects the partners' intent in forming the partnership only as a transfer tax device. Consequently, despite the fact that doing so may seem unnecessary, it is advisable to file returns for partnerships consistently from inception.

In addition, it is important to maintain the partnership in good standing with the relevant state authorities. It is not uncommon for IRS litigators, as their first step in reviewing a transfer tax case, to check with the state authorities for all documents on file for the relevant partnership. It is often at this stage that it is first discovered that an entity's good standing has been revoked for the simple failure to send in annual updates or confirmations of the partnership's address. The IRS typically argues that such revocations are indications that the entity is an entity without any purpose other than transfer tax avoidance.

B. COMPLY WITH TERMS OF PARTNERSHIP AGREEMENT

This suggestion seems only common sense. However, the IRS consistently reviews partnership agreements with a fine-toothed comb. If the partners have not themselves done so, they may have neglected to comply with some of the more straightforward requirements of the partnership agreement. Consider reading the partnership agreement with a fresh eye and making a list of all periodic administrative requirements. For instance, are regular meetings required? If so, in light of the IRS's frequent assertions that partnerships are nothing other than transfer tax avoidance devices, partners might choose to take minutes, even if not required (although continuing to keep in mind the eventual potential audience), to establish the business approach taken by the partnership. *See, e.g., Estate of Kelly v. Comm'r,* 103 T.C.M. (CCH) 1393 (2012); *Estate of Jorgensen v. Comm'r,* 97 T.C.M. (CCH) 1328 (2009), *aff'd,* 431 Fed. Appx. 544 (9th Cir. 2011). Are annual statements (other than returns) required? Are annual distributions required? Are payments on preferred interests required? Is documentation of the partners of the partnership required to be kept in a certain manner? In order to avoid IRS attack, it is important to ensure that partners treat the entity as a business entity and comply with the terms governing that entity. *See Estate of Bigelow v. Comm'r*, 89 T.C.M. (CCH) 954 (2005), *aff'd*, 503 F.3d 955 (9th Cir. 2007) ("The parties' failure to respect the provisions of the

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agreement governing their transaction tends to show that the transaction was not entered into in good faith.”).

C. COMPLY WITH LOAN TERMS, IF LOANS ARE MADE

Beware of lending from the partnership to family members. The IRS and the courts have not looked kindly on partnerships where such loans were made, particularly where the terms of the loans were either undocumented or, where documented, were not complied with. *See Estate of Malkin v. Comm'r*, 98 T.C.M. (CCH) 225 (2009). According to the IRS, such loans indicate that partners continue to have access to the assets contributed to the partnership. To minimize IRS attacks, any loans made by the partnership should be properly documented and should comply with the terms of the governing partnership agreement. *See Estate of Thompson v. Comm'r*, 84 T.C.M. (CCH) 374 (2002), *aff'd*, 382 F.3d 367 (3rd Cir. 2004). Loan terms should be reasonable, and payments should be made timely. In addition, both the partnership and the debtor should comply with the terms of the loans, including foreclosure, if necessary. As noted in various discussions in this chapter, it is important to treat the partnership for what it is – a separate, legal entity.

D. DISTRIBUTIONS, IF MADE, SHOULD BE PRO RATA

In order to minimize avenues of IRS attack, and assuming that the partnership agreement requires pro rata distributions (as most do), make sure that any distributions made by the partnership are proportionate to the percentage interests held by the partners in the partnership. In cases under IRS scrutiny where non-pro rata distributions have been made (typically to the parent partner), the IRS typically has argued that the partner receiving distributions retained rights to the assets contributed to the partnership such that § 2036 applies. *See Estate of Jorgensen v. Comm'r,* 97 T.C.M. (CCH) 1328 (2009), *aff'd*, 431 Fed. Appx. 544 (9th Cir. 2011). If a prohibited non-pro rata distribution has been made, consider making “make-up” distributions to the remaining partners, perhaps with interest at a reasonable rate. *See Estate of Thompson v. Comm'r*, 84 T.C.M. (CCH) 374 (2002), *aff'd,* 382 F.3d 367 (3rd Cir. 2004).

E. REFRAIN FROM USE OF PARTNERSHIP ASSETS FOR PARTNERS' PERSONAL OBLIGATIONS

Once contributed to the partnership, partnership assets belong to the partnership – not to the contributing partner and not to any of the other partners. As such, partnership assets should not be used for partners' personal expenses, nor should partners personally pay partnership obligations. *See Estate of Jorgensen v. Comm'r,* 97 T.C.M. (CCH) 1328 (2009), *aff'd*, 431 Fed. Appx. 544 (9th Cir. 2011). Consequently, in order to avoid IRS scrutiny, it is important that partnership assets be treated as such. Where partners may have used partnership funds to pay for their individual expenses or used partnership real estate without contemporaneously paying fair rental value, the IRS has often

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asserted the application of § 2036, on the grounds that there was, at a minimum, an implied agreement that the contributing partner retained the right to use the assets contributed. *See Estate of Disbrow v. Comm'r*, 91 T.C.M. (CCH) 794 (2006). *But see Estate of Stewart v. Comm'r*, 92 T.C.M. (CCH) 357 (2006), *vacated and remanded*, 617 F.3d 148 (2d Cir. 2010), (holding § 2036 was not applicable despite decedent remaining in residence when co-occupied by family member who received 49% interest as gift). To this end, it is important for the partners to maintain sufficient assets outside of the partnership to fulfill their personal needs. *See Estate of Kelly v. Comm'r,* 103 T.C.M. (CCH) 1393 (2012). As discussed above, where § 2036 is held to apply, the existence of the partnership is essentially disregarded, and evidence as to the value of a transferred partnership interest becomes irrelevant, as it is the value of the underlying assets, rather than the partnership interest itself, on which the transfer tax is imposed. *See, e.g., Estate of Jorgensen v. Comm'r,* 97 T.C.M. (CCH) 1328 (2009), *aff'd,* 431 Fed. Appx. 544 (9th Cir. 2011); *Estate of Miller v. Comm'r,* 98 T.C.M. (CCH) 159 (2009) (payoff of margin debt of founding partner is not personal expense)*; Estate of Hurford v. Comm'r*, 96 T.C.M. (CCH) 422 (2008); *Estate of Rector v. Comm'r*, 94 T.C.M. (CCH) 567 (2007); *Estate of Gore v. Comm'r*, 93 T.C.M. 1436 (2007); *Estate of Bigelow v. Comm'r*, 89 T.C.M. (CCH) 954 (2005), *aff'd*, 503 F.3d 955 (9th Cir. 2007); *Estate of Abraham v. Comm'r*, 87 T.C.M. (CCH) 975 (2004), *aff'd*, 408 F.3d 26 (1st Cir. 2005); *Estate of Strangi v. Comm'r*, 85 T.C.M. (CCH) 1331 (2003), *aff'd,* 417 F.3d 468 (5th Cir. 2005). *But see Estate of Mirowski v. Comm'r*, 95. T.C.M. (CCH) 1277 (2008) (declining to apply § 2036 where decedent anticipated funding lifestyle with partnership distributions).

As indicated above, it is important to keep the partnership's assets separate from the partners' assets. This suggestion applies as well at the death of any of the partners. Often, death causes financial hardship, in that a decedent's assets may be frozen for the time between date of death and the date that a personal representative for the estate is appointed and has collected sufficient assets to begin paying the decedent's debts. If expenses of the decedent must be paid in the interim (beware of personal liability of the personal representative), and no one has access to the decedent's assets, the partnership's checking account should not be used to pay those expenses. (In such cases, despite objections that post-death facts are irrelevant to valuation of the decedent's partnership interests, the IRS has argued that the fact that partnership funds were used to pay a decedent taxpayer's debts is evidence of an implied agreement by the decedent to retain the right to use assets contributed to the partnership, such that § 2036 should apply.) If absolutely necessary, the partnership may wish to make a loan to the estate of the decedent so that the estate's representative can take care of business.

Alternatively, perhaps beneficiaries of the estate or a third-party lending institution could loan funds to the estate. *Cf. Estate of Duncan v. Comm'r*, 102 T.C.M. (CCH) 421 (2011) (upholding deduction of interest on loan taken from family trust to pay Federal estate tax as necessary administrative expense under

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§ 2053); *Estate of Graegin v. Comm'r*, 56 T.C.M. (CCH) 387 (1988) (upholding loan – and allowing deduction of interest – made to estate by related entity for purpose of paying estate taxes); *Estate of Stick v. Comm'r*, 100 T.C.M. (CCH) 194 (2010) (denying interest deduction on loan from decedent's own foundation where estate failed to show loan was necessary).

F. MAINTAIN CURRENT AND ACCURATE BOOKS AND RECORDS

It is important for partners to maintain a partnership's records, as failure to do so may allow the IRS to argue that the partnership was formed solely for tax purposes. *See Estate of Liljestrand v. Comm'r*, 102 T.C.M. (CCH) 440 (2011). In addition, keeping good books and records should allow partners to demonstrate that the partnership was operated as the business that it is, formed with valid non-tax reasons in mind.

G. AVOID MULTIPLE AND IRREGULAR TRANSACTIONS BETWEEN PARTNERS AND PARTNERSHIP

When asserting that § 2036 should apply, the IRS looks for any facts that it can find to indicate an implied agreement that a taxpayer retained rights related to assets transferred to a partnership. For example, where a partnership has redeemed numerous partnership interests held by a partner, or made multiple loans, non-regular distributions, or non-pro rata distributions to that partner, the IRS may argue that the facts indicate an implied agreement that the taxpayer retained rights to the assets that he transferred to the partnership, such that § 2036 should apply to, in effect, disregard the existence of the partnership for valuation purposes. In order to avoid such arguments by the IRS, numerous transactions of this type between the partnership and its partners should be avoided.

H. KEEP IN MIND NON-TAX REASONS STATED FOR FORMING PARTNERSHIP

As the partnership grows and the partners develop a working relationship, keep in mind the non-tax reasons that were given for forming the partnership at the outset. *See Estate of Jorgensen v. Comm'r,* 97 T.C.M. (CCH) 1328 (2009), *aff'd,* 431 Fed. Appx. 544 (9th Cir. 2011). To the extent possible, try to implement them. Doing so can help undercut an IRS attack that the partnership was formed only for tax savings. Rote listing of standard non-tax purposes in the partnership agreement will not necessarily be considered definitive; the partnership agreement should include partnership-specific purposes, and the partnership (and its partners) should implement and fulfill those purposes. *See Estate of Turner v. Comm'r,* 102 T.C.M. (CCH) 214 (2011), *supp. by* 138 T.C. 14 (2012).

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V. TRANSFERS OF PARTNERSHIP INTERESTS

A. GENERALLY

When partnership interests are transferred, it is a good time to review the books and records of the partnership to ensure that they are in order. Due diligence at this stage (and at all others) bolsters the defensibility of the partnership – it is a respected, stand-alone entity.

It is also important to consider whether a transfer of a partnership interest triggers any rights of first refusal; if so, it is important in warding off IRS attacks to comply with any such transfer restrictions.

It is helpful at the audit stage in particular if partnership management (and its accountants) have kept careful track of changes in partnership interests (perhaps through keeping a historical spreadsheet outlining each transfer of partnership interests) and to update the partnership books and records to reflect any such changes. Doing so concurrently with transfers assists at the audit level, as such a record provides contemporaneous evidence of the transfers and can, again, bolster the position that the partnership is an entity separate from its partners. If necessary, consider restating the applicable schedule or exhibit to the governing partnership agreement to reflect the change.

Regardless of the nature of the transfer, it is important to document the transfer of partnership interests. In order to minimize IRS attacks, such transfer documents should be executed by transferor and transferee, and the document should be dated on the date that they are signed (though the effective date may be different). *See, e.g., Estate of Lockett v. Comm'r*, 103 T.C.M. (CCH) 1671 (2012); *Linton v. United States,* 638 F. Supp. 2d 1277 (W.D. Wash. 2009*), rev'd in part and remanded*, 630 F.3d 1211 (9th Cir. 2011); *Holman v. Comm'r,* 130 T.C. 170 (2008), *aff'd,* 601 F.3d 763 (8th Cir. 2010).

Ensure that the Certificate of Limited Partnership for the partnership is amended, if necessary, and filed with the relevant state authority. Failure to do so may give the IRS room to argue that the entity was not respected by its partners.

Finally, consider whether to make a § 754 election. Many factors should be taken into account when determining whether a § 754 election should be made when an interest in a partnership is transferred (whether by sale or by transfer at death). One such consideration, however, is whether any transfer tax return related to the transfer may be audited by the IRS. If the return is audited, to the extent that it is finally determined that the value of any partnership interest is greater than the value reported on the estate tax return, an election by the partnership under § 754 may be advantageous, as it could apply to cause a step-up in the partnership's inside basis in the decedent's proportionate share of the partnership's assets. Be sure to use the stepped-up basis resulting from a timely

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made § 754 election. *See Estate of Jorgensen v. Comm'r,* 97 T.C.M. (CCH) 1328 (2009), *aff'd,* 431 Fed. Appx. 544 (9th Cir. 2011). Thus, any finally determined increase in value of the decedent partner's partnership interest, where such an election has been made, may allow the partnership to seek an income tax refund related to sales of partnership assets since date of death, as any capital gains related to such sales will have been reduced. (Keep in mind that protective claims may need to be filed if the statute of limitations is close to running on the income tax returns but the examination of the transfer tax return has not been completed.)

B. BY GIFT OR SALE

In addition to the considerations discussed in paragraph A above, when the transfer is to occur by gift, it is important to refrain from gift planning until the partnership is formed and operating in order to avoid (as much as possible) the indirect gift theory discussed above. *Compare Pierre v. Comm'r*, 133 T.C. 24 (2009), *supp. by* 99 T.C.M. (CCH) 1436 (2010), *Holman v. Comm'r*, 130 T.C. 170 (2008)*, aff'd,* 601 F.3d 763 (8th Cir. 2010), *Gross v. Comm'r*, 96 T.C.M. (CCH) 187 (2008), *Estate of Strangi v. Comm'r*, 85 T.C.M. (CCH) 1331 (2003), *aff'd*, 417 F.3d 468 (5th Cir. 2005), *Estate of Jones v. Comm'r*, 116 U.S. 212 (2001), and *Estate of Strangi v. Comm'r*, 115 T.C. 478 (2000), *aff'd in part and rev'd in part*, 293 F.3d 279 (5th Cir. 2002) *with Linton v. United States*, 638 F. Supp. 2d 1277 (W.D. Wash. 2009), *rev'd in part and remanded*, 630 F.3d 1211 (9th Cir. 2011), *Heckerman v. United States*, 2009 WL 2240326 (W.D. Wash. Jul. 27, 2009), *Senda v. Comm'r*, 88 T.C.M. (CCH) 8 (2004), *aff'd*, 433 F.3d 1044 (8th Cir. 2006); *and Shepherd v. Comm'r*, 115 T.C. 376 (2000), *aff'd*, 283 F.3d 1258 (11th Cir. 2002). *But see Estate of Mirowski v. Comm'r*, 95 T.C.M. (CCH) 1277, 1289-91 (2008) (declining to apply § 2036 even where gift planning occurred simultaneously with entity planning due to fact that (1) taxpayer had sufficient funds outside partnership to pay gift taxes related to gift of partnership interests; (2) taxpayer's capital account was properly credited with assets contributed; and (3) taxpayer would have been entitled to distribution in accordance with capital account upon dissolution of partnership).

Additionally, gifts of entity interests may not qualify for the gift tax annual exclusion if the present interest test is not satisfied. To satisfy the present interest test, a donee must have a right to either the immediate enjoyment of the property (including the ability to immediately transfer it) OR the immediate enjoyment of the income from the property. *See, e.g., Estate of Wimmer v. Comm'r,* 103 T.C.M. (CCH) 1839 (2012); *Fisher v. United States*, 2010 WL 935491 (S.D. Ind. Mar. 11, 2010); *Price v. Comm'r*, 99 T.C.M. (CCH) 1995 (2010).

When a transfer occurs by sale, be sure to consider the income tax implications of such a transfer.

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C. At Death

When the transfer of partnership interests occurs as a result of a partner's death, it is especially important to review the transfer to determine whether a lapse occurs under Chapter 14 of the Internal Revenue Code and to report the interest transferred accordingly. While many partnership agreements are written with an eye toward avoiding the application of Chapter 14, not all have incorporated this concept.

Further, in order to simplify estate administration and potential audit, consider maintaining the partnership interest in the hands of the Executor, subject to estate administration, until a closing letter is received from the IRS. Once an IRS closing letter is received and the partnership interest is to be transferred into the hands of the appropriate beneficiary, document the transfer from the estate to the beneficiary, and that transfer document should be executed by both the executor and the recipient beneficiary.

D. By Redemption

When a partnership interest is transferred by way of redemption from a partner by the partnership, be sure to review the partnership agreement to ensure that the partnership is not prohibited from redeeming the interest from the interest holder. Next, be sure to document the redemption, to be executed by partnership management and the transferring partner. Consider having other partners consent, given that a redemption may affect them economically. Finally, be sure that the books and records of the partnership reflect a decrease in the transferring partner's interest and a corresponding proportionate increase to all remaining partners' interests. Taking these steps will help avoid IRS attack.

VI. TRANSFER TAX REPORTING

In order to ensure that any gift, estate, or generation-skipping transfer tax return is prepared in a manner that is most defensible in audit, the taxpayer should engage an experienced attorney or accountant to prepare such return.

A. Obtain Appraisal from Independent, Qualified Appraiser

To minimize IRS attack, the taxpayer should select an appraiser who will provide an independent and qualified appraisal of the fair market value of the transferred interest. In that regard, consider whether the selected appraiser is independent from the taxpayer, is credible, is experienced in the area of partnership valuation, and has the appropriate certifications. In addition, attaching an appraisal to a tax return can be a way to satisfy adequate disclosure requirements and to start the running of statutes of limitations. Perhaps most importantly, the appraiser should not act as an advocate for the taxpayer. *Knight v. Comm'r*, 115 T.C. 506, 519 (2000).

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B. ENCOURAGE COMMUNICATION AMONG APPRAISER, CLIENT, AND ADVISORS

Strong communication between the client, the client's advisors, and the appraiser should greatly improve the quality (and defensibility) of an appraisal. A high-quality appraisal, which is more often the product of thorough communication, improves the odds that a case involving good legal facts will achieve the best result possible.

C. CONFIRM WITH THE APPRAISER THE INTEREST TO BE VALUED

Depending on the terms of the partnership agreement and the identity of the transferee, the interest transferred by the taxpayer may be a general partnership interest, a limited partnership interest, or an assignee interest in a partnership interest (and, depending on the terms of the partnership agreement, there may be classes within one or more of these types). It is important to identify the nature of the interest transferred, as each type carries with it specific rights and responsibilities that are likely to impact value.

D. CONSIDER WHETHER TO AGGREGATE INTERESTS

If the transferred partnership interests include more than one class (*i.e.*, general partnership interests *and* limited partnership interests), be sure to clarify with the appraiser as to whether those interests should be aggregated for valuation purposes. For instance, if a general partnership interest and a limited partnership interest are transferred by the decedent, certain real authority suggests that the interests should be aggregated. If, however, the general partnership interest was held by the decedent, and the limited partnership interest is held in a marital trust created by the decedent's pre-deceasing spouse, the taxpayer may be able to take the position that the interests should *not* be aggregated. *See, e.g., Estate of Bonner v. United States,* 84 F.3d 196 (5th Cir. 1996); *Estate of Bright v. United States,* 658 F.2d 999 (5th Cir. 1981); *Estate of Mellinger v. Comm'r*, 112 T.C. 26 (1999).

E. CONSIDER WHETHER TIERED DISCOUNTS MIGHT BE APPROPRIATE

Depending on the nature of the asset transferred, two layers of discounts might be merited. *See, e.g.*, *Astleford v. Comm'r*, 95 T.C.M. (CCH) 1497, 1502 n.5 (2008). If the transferred asset is a minority interest in an entity that holds a minority interest in another entity, two sets of discounts could apply to each of the two separate entities. *Id.* (*citing Estate of Piper v. Comm'r*, 72 T.C. 1062, 1085 (1979); *Janda v. Comm'r*, 81 T.C.M. (CCH) 1100 (2001); *Gow v. Comm'r*, 79 T.C.M. (CCH) 1680, 1690-91 (2000), *aff'd*, 19 Fed. Appx. 90 (4th Cir. 2001); *Gallun v. Comm'r*, 33 T.C.M. (CCH) 1316, 1320-21 (1974)). However, where the transferred asset constitutes a significant portion of the parent entity's assets or where the transferred asset is the parent entity's "principal operating subsidiary," the Service may argue that only one level of discounts should be applied. *Id.*

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(*citing Estate of O'Connell v. Comm'r*, 37 T.C.M. (CCH) 822, 825, 833 (1978), *aff'd on this point and rev'd on other grounds*, 640 F.2d 249 (9th Cir. 1981)).

F. PROMOTE DEFENSIBILITY OF VALUATION REPORTS

A readily defensible partnership valuation report does not arise by happenstance, but rather by the conscientious efforts of the appraiser, advisors, and the client. The more thorough the valuation report, the more defensible it likely will be should a dispute arise. The appraiser should conduct due diligence, discussing with the general partner issues such as the partnership's investment philosophy, asset allocation, and return targets. The appraiser should review and consider the appraisals of the partnership's underlying assets. The valuation report should be supported by empirical data that is clearly understood by the appraiser, such as restricted stock studies and discussion of comparables, and the comparative factors employed should be relevant and useful. The report should fully describe the partnership's assets and financial history. Throughout the valuation report, care must be taken to avoid typos and errors, as they may call into question the competence of the author of the report. Finally, a non-appraiser should be able to understand the analysis and conclusions of a valuation report.

G. REVIEW APPRAISAL CLOSELY FOR FACTS

In opining as to fair market value, the appraiser will likely take into account numerous partnership-specific facts, such as the terms of the governing partnership agreement, the fair market value of the partnership's underlying assets, cash flow to the partnership, and the distribution policy of partnership management. As a result, when reviewing the appraiser's conclusions, it is important to confirm that the appraiser has properly reflected these facts in his report so that his valuation conclusions are not based on incorrect factual assumptions. It is also helpful to make sure that a copy of the partnership agreement is included with the final appraisal, perhaps as an exhibit. *See Kohler v. Comm'r*, 92 T.C.M. (CCH) 48, 56 (2006) (declining to rely on IRS appraisal where expert "did not understand Kohler's business").

H. TRY TO LIVE BY FACTUAL INFORMATION PROVIDED TO APPRAISER

Once the appraiser has completed his appraisal, it is helpful in defending his conclusions if, after the valuation date, the partnership is operated in the manner reported to the appraiser, for example, in such areas as the distribution policy, anticipated cash flow, etc. Arguably, post-valuation date facts are irrelevant to valuation conclusions. However, the IRS may assert that deviation from the factual assumptions by the appraiser indicate that the appraiser's conclusions were faulty, especially if the partners anticipate at the time of the transfer that such an occurrence might take place. Living with the factual information provided to the appraiser may help avoid such assertions.

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I. Beware of Rounding on Appraisals and Tax Returns

If there is a reason to round value up or down, be sure that the appraiser explains his reasons in the appraisal. If the appraiser cannot explain why the value should be rounded up or down, he likely will not be able to do so on the stand either. And the courts are increasingly examining and parsing practically each and every valuation conclusion of appraisers of limited partnership interests. Unexplained rounding may cause a court to question other conclusions that the appraiser has made in the appraisal.

J. Understand IRS Settlement Guidelines

In early 2007, the IRS issued new settlement guidelines for matters involving limited partnerships. In those guidelines, the IRS explained that its goal is to promote consistency of approaches across different jurisdictions and that its primary modes of attack on partnerships would be the indirect gift theory and § 2036, in addition to valuation. *See* Settlement Guidelines, 07 No. 020 BNA Taxcore 25. *See, e.g., Lappo v. Comm'r,* 86 T.C.M. (CCH) 333 (2003); *McCord v. Comm'r,* 120 T.C. 358 (2003), *rev'd,* 461 F.3d 614 (5th Cir. 2006); *Peracchio v. Comm'r,* 86 T.C.M. (CCH) 412 (2003).

VII. PREPARING TO RESPOND TO IRS AUDITS

A. Consider Bringing in Litigation Counsel

Once the audit begins, it is particularly helpful to involve litigation counsel sooner rather than later, even if litigation counsel does not meet with the IRS and only serves as a consultant to the taxpayer. Doing so allows the litigator to be involved from step one, assisting in determinations related to the assertion or waiver of various privileges, responsiveness of documents and information, and consideration of the eventual burden of proof under § 7491.

B. Determine Whether a Document Destruction Policy Exists; If So, Suspend

Some corporate trustees and executors have document destruction policies. It has become advisable for attorneys whose clients are involved in litigation to ensure that their clients suspend document destruction policies. The consequence of failure to do so may include sanctions against the attorney and the client for spoliation of evidence. *See, e.g.*, *Phoenix Four, Inc., v. Strategic Resources Corp.*, 2006 WL 1409413 (S.D.N.Y.); *Qualcomm Inc. v. Broadcom Corp.*, No. 05CV1958-B, 2008 WL 66932 (S.D. Cal. Jan. 7, 2008).

C. Implement Your Own "Audit"

At this stage (or even before an IRS audit begins), it may be beneficial to your client to review the taxpayer's books and records to determine which issues the IRS may identify as problematic. Test the strengths and weaknesses of the

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planning, reviewing both the legal authorities (new and old) and any post-planning administration that may impact the analysis of the validity of the plan or entities within the plan.

Assess the strength of the IRS's position. Has the IRS obtained an appraisal? Or is the IRS relying only on an engineer's report? Is the examining agent in a position to review the merits of the case? Does the agent have authority to negotiate settlement? Or will you need to consider requesting a meeting with the agent's supervisor?

D. CONSIDER THE BURDEN OF PROOF

Until the late 1990s, the burden of proof in a tax case fell on taxpayers. In other words, if a court could not decide who should win in light of the evidence, the taxpayer lost. For examinations beginning after July 22, 1998, however, it became possible for taxpayers in certain circumstances to shift the burden of proof to the IRS, so that if a court cannot decide who should win in light of the evidence, the taxpayer will win. Under § 7491, if a taxpayer (who is not a partnership, corporation, or trust) maintains all required records under the Code and complies with the IRS's reasonable requests for documents, information, and interviews, the burden of proof shifts to the IRS, and, if a court is undecided, the taxpayer wins. Although cases in which a court weighs the evidence and still comes down on the fence are very rare, the IRS has, in recent years, been very reluctant to agree that taxpayers meet the factual requirements of § 7491.

E. CONSIDER THE IMPACT OF PRIVILEGES

Various privileges apply in the context of estate planning, the most familiar of which is the attorney-client privilege (often referred to simply as "the privilege"). As a general rule, the privilege covers client communications made to the attorney with the purpose of seeking legal advice. *See Scott v. Beth Israel Medical Center, Inc.*, 847 N.Y.S.2d 436 (N.Y. Sup. 2007) (holding that employer's e-mail monitoring policy caused e-mails sent to attorney from work to lose attorney-client privilege because they were not confidential, and work product privilege does not apply where careless conduct suggests no concern for protecting privilege). *But see Sims v. Lakeside School*, 2007 WL 2745367 (W.D. Wash.) (holding that web-based e-mails and other materials prepared for communicating with counsel on employer-provided laptop were protected by attorney-client privilege). Keep in mind that the privilege is the client's (rather than the attorney's) to waive.

The work-product doctrine, on the other hand, protects an attorney's thoughts and work *in preparation for litigation*. The work product of an attorney or his or her staff prepared in anticipation of litigation is protected from disclosure. In fact, the attorney work product doctrine is not a privilege, although some courts (and many practitioners) refer to it as one. The purpose of the work product doctrine is to encourage lawyers to thoroughly prepare for litigation (even

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if not yet pending) through investigation of the good and the bad, without fear of being forced to disclose their thoughts and analysis. *See* Fed. R. Civ. P. 26(b)(3). Contrary to common misconception, the work-product doctrine only begins to apply to an attorney's work that is done "in anticipation of litigation." The required level of anticipation varies by court, but it is clear that in many jurisdictions, a court action need not be imminent. *See United States v. Adlman*, 68 F.3d 1495 (2d Cir. 1995). According to the Seventh Circuit, audit can be the antechamber to litigation, and thus, the work-product doctrine may apply to an attorney's work even during the audit process. *See United States v. Frederick*, 182 F.3d 496, 502 (7th Cir. 1999). Courts have extended work product doctrine protection even to proposed transactions. Recently, one district court found that the work product doctrine applied to tax accrual work papers of a company because the company's counsel believed that certain transactions entered into by the company would eventually be challenged by the IRS. *United States v. Textron*, 507 F. Supp. 2d 138 (D.R.I. 2007), *aff'd in part, vacated in part, and remanded,* 553 F.3d 87 (1st Cir. 2009).

More recently, the U.S. Congress enacted a new federal privilege under § 7525 – the tax practitioner privilege. This privilege applies only in non-criminal tax cases, and it protects from discovery communications that, if communicated to an attorney, would have been protected from discovery under the attorney-client privilege.[4] Note, however, that in some jurisdictions, the tax practitioner privilege has been interpreted not to cover advice related to tax return preparation. *See United States v. Frederick*, 182 F.3d 496 (7th Cir. 1999).

While privileges can be waived, and often waiver is highly recommended (particularly in cases where the IRS is asserting the application of § 2036 and/or penalties), beware of subject matter waiver. Once the privilege has been waived on a particular subject matter, that waiver covers all communications on that subject matter. *See* FED. R. EVID. 502 (addressing effect of inadvertent waiver as well). Unfortunately, you cannot just pick and choose to waive the privilege with regard to favorable documents.

F. CONSIDER WHETHER PRODUCTION OF PRIVILEGED INFORMATION MAY HELP YOUR CASE

Various privileges may apply in any given situation – the attorney-client privilege; the work product doctrine; and the tax practitioner's privilege under § 7525. As discussed above, however, there are often times when, if appropriate, it is helpful if the taxpayer waives such privileges, such that documents and information that would otherwise be protected from discovery are produced. This is particularly true in estate tax cases, where the best person

[4] "With respect to tax advice, the same common law protections of confidentiality which apply to a communication between a taxpayer and an attorney shall also apply to a communication between a taxpayer and any federally authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney." I.R.C. § 7525.

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with personal knowledge – the decedent taxpayer – is not available to testify. Beware, though, of subject matter waiver. In essence, you cannot pick and choose what to produce. If the taxpayer waives the privilege as to one document with regard to, for instance, formation purposes, you cannot refrain from producing another document on the same subject that may contain potentially harmful discussion as well.

G. PROVIDE RESPONSES TO THE IRS THAT ARE TRUE AND CORRECT, TO THE BEST OF THE TAXPAYER'S KNOWLEDGE

The taxpayer's duty is to provide responses to IRS requests that are true and correct to the best of the taxpayer's knowledge. Be precise when responding to the IRS. For instance, if the partnership owns primarily real estate, but has a small equity portfolio, be sure to disclose the existence of both (and in detail) when asked by the IRS for the assets of the partnership. It is also important to keep in mind that the examiner involved may not have the authority to negotiate a settlement. When determining how much information to reveal voluntarily, the strength of the IRS's position must also be considered.

H. KEEP IN MIND THAT ANYTHING STATED OR WRITTEN CAN BE TREATED AS AN ADMISSION

It is important to keep in mind that a judge or a jury might eventually read what is written related to the taxpayer's planning. Anything stated or written to the IRS at this stage can be treated as an admission. Further, anything written to the appraiser or any expert may be discoverable by the IRS.

I. PRODUCE RESPONSIVE DOCUMENTS IN THE TAXPAYER'S POSSESSION, CUSTODY, OR CONTROL

It is the taxpayer's duty to produce responsive documents in his possession, custody, or control. While documents held by the taxpayer's attorney, accountant, or bank are likely to be construed as within his possession, custody, or control, documents held by others may not. Be sure to consider the relationship between the taxpayer and the advisor in analyzing this issue.

However, the taxpayer need produce *only* those responsive documents in his possession, custody, or control; generally, there is no need to *create* documents to respond to IRS requests. If necessary, indicate in responding to the IRS that the taxpayer has no such documents in his possession, custody, or control that are responsive to the request.

J. KEEP CAREFUL TRACK OF DOCUMENTS AND ELECTRONIC FILES PRODUCED TO THE IRS

Particularly if litigation counsel becomes involved at some point, it is helpful to have a precise record of the documents and electronic files that have been provided to the IRS, from inception of the audit through the close of

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discovery. In that regard, consider Bates-labeling every page produced to the IRS, such that there is a number associated with every page. Doing so also helps in the stipulations process, as each exhibit can be identified by Bates-label number, ensuring that everyone (including the judge) is literally on the same page.

K. UNDERSTAND THE IRS'S BROAD SUMMONS POWER

The IRS has a very broad power to summons any information, books, and records that it deems necessary to carry out is mission. The IRS may examine or summons a laundry list of items and people for the purpose of "ascertaining the correctness of any return, making a return where none has been made, or determining the liability of any person for any internal revenue tax." I.R.C. § 7602(a); *see also United States v. Richey*, 632 F.3d 559 (9th Cir. 2011). As might be expected, however, this broad power is subject to traditional privileges.

L. FILE PROTECTIVE CLAIMS IF NECESSARY

Keep in mind that sometimes resolutions of estate tax issues may impact income tax issues related to the partnership or the estate. Be sure to analyze whether the resolution of the estate tax issue might come too late to file a claim for refund (Form 843) on the income tax side. If so, you may find it necessary to file protective claims for refund or administrative adjustment requests (AARs) if the partnership is a TEFRA partnership to protect rights to income tax refunds that may eventually be due. *See* I.R.C. §§ 6031(A), 6222-6231. Keep in mind the Variance Doctrine as you formulate your protective claims.

M. CONSIDER WHETHER IT IS FEASIBLE TO KEEP PARTNERSHIP IN PLACE

At least until the examination of the transfer tax return has been closed and the taxpayer's tax liability finally determined, it is better if the partnership remains in place. Although facts that occur after the valuation date are arguably irrelevant, the IRS does not hesitate to use those facts when doing so might increase the value of the transferred interest (and resulting transfer tax); and terminating the partnership could play into the IRS's hands in this regard. *See Estate of Bigelow v. Comm'r*, 89 T.C.M. (CCH) 954 (2005), *aff'd*, 503 F.3d 955 (9th Cir. 2007).

N. IN THE ESTATE CONTEXT, BEWARE OF DISTRIBUTING ENTITY INTERESTS

Beware of advising your client executor to make distributions of partnership interests from the estate (or other estate assets for that matter) prior to receiving an IRS closing letter. Among other reasons, under I.R.C. § 6324, a special federal estate tax lien immediately attaches to the entire gross estate of a taxpayer at her death. Under 31 U.S.C. § 3713, an executor has personal liability to pay estate taxes to the extent that he has paid any debts of the decedent or made any distributions to beneficiaries of the estate prior to payment

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in full to the IRS of the estate tax owed. An executor may request a release of personal liability from the IRS under I.R.C. § 2204 upon the payment in full of estate taxes owed.

O. Treat Informal Interviews as Depositions

Although interviews by the IRS can be quite informal, neither the taxpayer nor the advisor should be caught off guard. These interviews are, in essence, depositions. In order to ensure that any additional requests for documents and information are provided in writing, such interviews likely ought to be held at an advisor's office (that of the attorney or accountant), rather than at the taxpayer's office or home. Consider also having a court reporter present to ensure that the taxpayer's responses are not misconstrued.

P. Understanding the IRS's Settlement Guidelines

In early 2007, the IRS issued settlement guidelines for matters involving limited partnerships. In those guidelines, the IRS explained that its goal is to promote consistency of approaches across different jurisdictions and that its primary modes of attack on partnerships would be the indirect gift theory and § 2036, in addition to valuation. *See* Settlement Guidelines, 07 No. 020 BNA Taxcore 25; *see also, e.g., Lappo v. Comm'r*, T.C. Memo 2003-258; *McCord v. Comm'r*, 120 T.C. 358 (2003), *rev'd*, 461 F.3d 614 (5th Cir. 2006); *Peracchio v. Comm'r*, 86 T.C.M. (CCH) 412 (2003).

VIII. CONCLUSION

In conclusion, many of the suggestions considered here should assist estate planners to fine-tune interactions with clients to ensure that creation of an entity fits with and implements clients' goals – both tax and non-tax in nature. A practical approach that the courts seem to rely on, whether explicit or implicit, is the smell test. Does the transaction "smell bad" or "look bad"? If so, you might re-structure, explore further with the client, or even recommend against a partnership structure to accomplish the client's goals. Use your olfactory senses to assist the client in addressing his needs in the most tax-efficient manner, all the while keeping in mind that anything you say or write may be discoverable (despite the attorney-client privilege). Work with your appraiser to ensure that she has all relevant information, thereby ensuring the most defensible appraisal. When done right, implementation of an entity can accomplish numerous client goals, while at the same time saving taxes. When done wrong, the same structure can save no taxes and cost the client time, money, and emotional drain. To avoid this result, help your clients treat entities as the business structures that they are. And ensure that your appraisers understand the nature of the clients' business and goals.

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