HOW TO PROTECT YOUR CLIENT'S FAMILY LIMITED PARTNERSHIP AND OTHER CLOSELY HELD BUSINESSES FROM I.R.C. § 2036 INCLUSION.

Presented by: Christy Lee[1]

IRC Section 2036
Transfers with Retained Life Estate

(a) General Rule - The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (***except in 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.

SECTION 2036(a)(1) QUESTION:

DID THE DECEDENT RETAIN A RIGHT TO THE POSSESSION OR ENJOYMENT OF, OR A RIGHT TO THE INCOME FROM, THE ASSETS HE CONTRIBUTED TO THE PARTNERSHIP?

Applicability of § 2036(a)(1) turns on whether, if at the time of transfer, there was an express or implied agreement that the transferor would retain lifetime possession or enjoyment of or right to income from, the transferred property.

The courts look to the following factors when considering if an implied agreement existed among the parties at the time of the transfer:

- (1) Decedent's age and health when the entity was formed;
  - The younger and healthier the better.
- (2) Partnership's asset mix changed during the decedent's life;
  - Sell and buy assets, especially marketable securities.
- (3) Decedent received disproportionately large distributions;
  - Any and all distributions should be made pro rata to the partners.
  - Note: When distributions are paid, limited partners could use the distributions to purchase more limited partnership units from the founders of the FLP should they desire to sell some of theirs.
- (4) Partnership meetings;

[1] Christy Lee is a solo practitioner at Law Offices of Christy Lee, P.C., in Anchorage, Alaska.

    - Partners should meet periodically and thoroughly document these meetings.
    - The partners should have a business plan that is followed.
    - Meet with advisors periodically to review the operation of the FLP.
- (5) Partnership books and records;
    - Maintain appropriate books and records.
    - All business conducted by the FLP should be conducted in the FLPs name to preserve its status as a legal person.
    - FLP should maintain its own bank accounts separate from its partners, and all partnership receipts should be deposited in its accounts and partnership expenses paid from its accounts.
        - Leave a "paper trail."
    - Written records must be kept and maintained at the principal or registered office of the partnership.
- (6) Decedent's personal home contributed to the entity; and
- (7) FLP paid the decedent's estate tax.

SECTION 2036(a)(2) QUESTION:

DID THE DECEDENT DETERMINE WHO COULD POSSESS OR ENJOY THE PROPERTY OR THE INCOME FROM THE PROPERTY?

The main question to ask is: Did the decedent have control over the FLP at the time of death?

- Decedent should not be the managing general partner at the point in time that an interest is subject to gift or estate tax.
- Decedent should have less than 50% of the outstanding partnership units at the point in time that an interest is subject to gift or estate tax.

SECTION 2036 EXCEPTION QUESTION:

WAS THE TRANSFER OF ASSETS TO THE PARTNERSHIP A BONA FIDE SALE FOR ADEQUATE AND FULL CONSIDERATION?

The courts look at the following factors when considering if there was a bona fide sale for adequate and full consideration. These factors include

- (1) The entity engaged in legitimate business operations;
    - There should be a greater opportunity for profit.
    - The General Partner should:
        - diversify the assets of the FLP among many types of investments;
        - diversify among various industries; and
        - seek professional guidance both for initial investment and for continuing review of investments.
    - The General Partner should *not*:
        - lend FLP assets without adequate security, or engage in other forms of self-dealing; or

        - delegate investment decisions to others.
- (2) Transferred assets were assigned an appropriate contribution value;
    - The value of contributions should be proportionate to the number of partnership units received in exchange.
    - All assets transferred to the FLP must be valued at the time of contributions by a qualified appraiser.
- (3) Property transferred to the entity;
    - Partner contributions should be transferred to the FLP and held in the FLP name.
        - FLP should be fully organized before contributions made.
    - FLP should have active business assets and not merely passive activity assets
    - Untitled tangible business property – such as business equipment, inventory, livestock, etc. is best accomplished with a bill of sale or an assignment.
    - Real property should be transferred by deed.
    - Your stockbroker will need to register marketable securities in the FLP's name.
    - Notes and security instruments should be transferred to an FLP.
    - Be aware: transferring assets into a FLP is not usually a taxable event. If more than 80% of the FLPs assets are stocks and securities, the FLP could be classified as an "investment company".
- (4) Decedent's personal assets and the entity's assets were commingled;
- (5) Decedent was financially dependent on distributions from the entity; and
- (6) Decedent stood on both sides of the transaction
    - Prior to the entering into the partnership, each partner should have his/her own attorney review and comment on the partnership agreement.

Special Note for Valuations:

- A qualified business appraiser must value the partnership units.
- The valuation appraisal is needed to justify any valuation discounts claimed in connection with gifting, in order to substantiate the positions taken on the Federal Gift Tax Returns.
- A federal gift tax return should be filed for all gifts of partnership interests.