Family Limited Partnership and Family Limited Liability Company Valuation Discount Planning

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During the last few years, the IRS has aggressively challenged the structure and operation of Family Limited Partnerships (FLP) and Family Limited Liability companies (FLC) and valuation discounts. In particular, the IRS has sometimes questioned whether or not a gift was actually made; whether there was a purpose other than an avoidance of taxation for the FLP/FLC; whether the formalities of the entity were followed; and whether the parties treated the FLP or FLC as a true agreement among partners.

As a result of this policy we are suggesting to our clients that they review their FLPs and FLCs to confirm that these entities are managed consistent with best practices.

Business Purpose

The partnership/operating agreement should list non-tax purposes for the FLP/FLC. These may include centralized management of investments, creditor protection planning, teaching family members' long term financial planning and/or pooling of assets.

Distributions

Distributions should always be made pro rata among partners/ members. An FLP/FLC is not like a trust where the needs of an individual can be considered. The governing documents must be followed in terms of distributions.

Meetings

Both the IRS and courts seem to be emphasizing the necessity of regular meetings and on the maintenance of minutes of the meetings. The FLC/FLP must be run for the benefit of all family members.

General Partner/Managing Member

Fiduciary Duties to Entity. Because state laws vary on whether or not a managing member or general partner has fiduciary duties to the other members and to the entity, we recommend the insertion of fiduciary responsibility language in most FLP/FLC operating documents.

Control Issues. FLP/FLC operating documents should be screened to reduce elements of managing member/general partner control, including strengthening the rights of members/limited partners to remove a managing member/general partner and reducing super-majority voting percentages.

Because of successful IRS attacks on FLP/FLC assets in the decedent's estate under a Section 2036(a)(2) argument, we now caution parties to cede as much control as possible to the manager. Alternatives include having a comanaging manager/general partner. Some commentators are recommending a loosening of control maintained by a parent in a FLP/LLC; others are specifically suggesting that a parent not serve as general partner/managing member.

Right of Withdrawal/Restrictions on Transfers

No partner should have the right to liquidate his or her partnership or membership interest unilaterally and/or withdraw from the FLP/FLC. Restrictions on transfer should be reviewed to allow transfers of economic interests (if not membership interests) in the FLP or FLC. Transfers can be subject to right of first refusal by the entity or remaining owners but the blanket approach of prohibiting transfers without the consent of the managing partner or managing member, while still recommended by many commentators, is coming under greater scrutiny.

Funding and Operational Issues

Do not transfer your personal residence or other personal use assets to FLP or FLC. If the personal residence has been transferred, the parent should pay a fair rental to the limited partnership/limited liability company and have a formal lease agreement. Payments must actually be made, not accrued.

When Making Funding Decisions Retain Sufficient Liquid Assets

The IRS has mounted successful challenges where the parent/decedent transferred 95%+ of their assets to the FLP/FLC, and in those cases where the court found an implied agreement to retain the right to income and/or possession of the entity's assets. Parties should keep enough money out of the FLP/FLC to pay routine living expenses. Be sure to establish a separate bank account for each FLP/FLC. Never commingle entity and personal funds.

Additional Contributions to FLP/FLCs

Additional contributions to FLP/FLCs should be documented as made in return for additional FLP/FLC interests. The K-1 should always reflect capital accounts; avoid temptation to make large, independent distributions from the FLP/FLC to help pay estate taxes after a general partner/managing member's death. Consider other options including (i) a bank loan to the estate secured by the estate's partnership/membership interest supported by personal guaranties of the estate's beneficiaries, if necessary for bank approval; (ii) loan from another family entity secured by estate's partnership/membership interest; (iii) partnership/limited liability company loan to estate secured by estate's partnership/membership interest; and (iv) repurchase/redemption of some of the estate's interest in the FLP/FLC (but at same discount used with the IRS).

The rationale for valuation discounts for FLP/FLC interests still apply. The FLP/FLC interest is worth significantly less than a pro rata share of the liquidation value of the assets because a member/limited partner has no voice in management and limited partners and members have no rights to the underlying assets. Limited partners/members are also, in most cases, not permitted to withdraw from the entity prior to its final distribution. Probably the most important factor is that the limited partner/member has no ability to control cash distributions from the partnership/limited liability company.

Restrictions on Transfers

Restrictions on transfers of a membership/partnership interest can affect the valuation of the interest. It is important to note that valuation discounts are still regularly recognized in a FLP/FLC context. Some limited partnerships/limited liability companies may be subject to higher discounts because of the illiquid nature of their assets. In light of the above, we recommend that parties review their FLP/FLC documentation and management practices to respond to these developments.