January
2009
Volume 9
Issue 1

BEAN KINNEY & KORMAN PC
ATTORNEYS

Business Law Newsletter

Family Limited Partnership and Family Limited Liability Company Valuation Discount Planning

By: Jonathan C. Kinney

During the last few years the IRS has aggressively challenged the structure and operation of Family Limited Partnerships/ Family Limited Liability companies 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 as control as possible to the manager. Alternatives include having a co-managing 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.

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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.

Tax Law Change

By Jonathan C. Kinney

A recent tax law change designed to help address the financial burden facing those who have seen their IRAs or 401(k)s shrink in recent months may affect your tax planning for 2009. Depending on your particular situation, you might want to consider taking prompt action.

The new law suspends the Required Minimum Distribution (RMD) requirement for 2009. This waiver, which is available to everyone regardless of your total retirement account balances, applies to all so-called "defined-contribution plans," which includes 401 (k) plans, 403(b) plans, 457(b) plans, and IRA accounts. Suspending the RMD requirement allows you to keep the money in your retirement account if you choose, possibly recovering some of the current stock market loss.

Many individuals have annual RMD withdrawals set up to occur automatically in January. If that is the case for you, and if you want to take advantage of this new law, you should contact your IRA custodian or plan administrator immediately and alter your withdrawal schedule before the RMD is automatically distributed.

Virginia Legislative Update

By Christopher A. Glaser

The 2009 Session of the Virginia General Assembly convenes January 14, 2009. The House and the Senate will consider several proposed bills that if passed could significantly impact you or your business. Among them are the following:

Corporation as Grantee of a Deed or Deed of Trust

Delegate Robert Marshall (R-13th District (Parts of Loudoun and Prince William Counties)) has proposed a bill that would change the procedures when a corporation is a grantee of a deed or a deed of trust. HB 1640 would require that when a corporation is the grantee of a deed or a deed of trust, the deed or deed of trust must contain the names of the registered agents and the directors, officers, partners, etc., of these various business entities. This bill would change the current Virginia provisions which do not require the disclosure of such underlying interests.

Worker's Compensation Presumption

Senator Richard Stuart (R-28th District, Portions of Fauquier and Prince William Counties; all of Stafford, King George County, Lancaster, Northumberland, Richmond County, and Westmoreland Counties and the City of Fredericksburg) has proposed a bill that would create a presumption in certain worker's compensation cases. SB 821 would create a legal presumption that a workplace injury resulted from an accident arising out of employment under the Workers' Compensation Act in two circumstances: first, if the employee is found dead; or, second, if the employee has suffered a brain injury such that the employee cannot remember the circumstances of the accident. This bill would modify a current presumption which exists only when the employee is found dead and no evidence is offered to show that he was not engaged in employment business.

If passed, SB 821 would create a presumption that a company would have to overcome to avoid a worker's compensation claim.

If a worker is found dead or suffers a brain injury such that the employee cannot recall the accident, this law would make it such that the employer would have to present evidence that the accident did not take place in the course of employment. Otherwise, the law would presume that the accident was work-related. This could increase the success rate of worker's compensation claims by raising the evidentiary burden for employers.

Check Cashing

Delegate Riley Ingram (R – 62nd District, Portions of Chesterfield, Henrico, and Prince George Counties and the City of Hopewell) has proposed a bill that would change the identification requirements for check cashing. As defined under HB 1585, a "check casher" is a person engaged in the business of cashing checks, drafts, or money orders for compensation. If the bill passes, check cashers will be required to obtain a copy of an identification card, a photograph, a thumbprint, and a copy of the item cashed for every transaction. Any business governed by the bill would be required to keep records from each transaction it conducts for one year. The records must be made available to law-enforcement officials upon request. Failure to comply with the new requirements would become a Class 1 misdemeanor.

This bill, if passed, could significantly increase the costs of operating a check cashing business. Satisfying the requirements of the new law for each transaction would require additional time and expense. Furthermore, the business would have to devise a filing system to maintain the records from each transaction. The penalty for failure to comply is severe, as criminal sanctions can be imposed.

Each of these three bills may be considered in the upcoming session. Businesses that may be affected should monitor whether the General Assembly passes the bills. Bean, Kinney & Korman can provide assistance to your business by advising you whether or not you should make allowances to adjust for these potential changes.

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Meet our Attorneys

Mr. Thomas is a shareholder in the firm representing clients in business and contractual matters, commercial real estate and leasing transactions, and general corporate, employment and financial matters. He also has extensive experience in counseling business owners and entrepreneurs in the formation, structure and governance of organizations and business entities, and in the resolution of ownership and employee disputes. Mr. Thomas has also handled a multitude of transactions involving the acquisition or sale of businesses, commercial real estate and professional organizations.

Mr. Thomas graduated from Brown University and the Georgetown University Law Center. He is admitted to the District of Columbia Bar, Virginia State Bar and the Florida State Bar.

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