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Trusts & Estates newsletter

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LETTER FROM THE EDITOR

As the new editor of the Trusts and Estates Newsletter, I welcome you to our second issue. In this issue, Bill Christian discusses the recent successful challenge by the IRS of limited partnerships and limited liability companies in making wealth transfers. Elizabeth Blakely then discusses several ways to avoid property tax reassessment when transferring real property. We hope you enjoy both.

Jean Beasley

Jean Beasley

THE IRS ASSAULT ON FLP'S AND LLC'S TO TRANSFER WEALTH AT DISCOUNTED VALUES

by William R. Christian

Estate planners have been using family limited partnerships ("FLP's") and family limited liability companies ("LLC's") as an effective estate planning tool for a number of years. Their popularity has increased in recent years because of the publicity surrounding many taxpayers' successes. The recent case of *Albert Strangi v. Commissioner* represents a significant victory for the IRS, however, that may undermine much of the FLP or LLC planning techniques of the more aggressive practitioners.

FLP'S AND LLC'S HAVE BEEN USEFUL TO TRANSFER WEALTH AT A DISCOUNT

The concept behind the family limited partnership is quite simple: Assume you own 100% of a rental property worth $100 and transfer a 10% interest to a child as a gift. You would normally expect that the value of the interest gifted to your child would be $10. For transfer tax purposes,

however, the transfer of an undivided interest in the property qualifies for some discount because of its lack of control and lack of marketability. The result is that the 10% interest can be discounted by as much as 15%. The gift of the 10% interest will then only be a gift worth $8.50.

This simple scenario seems advantageous, but a client can be even more aggressive by using the form of a FLP. Because FLP's (and many forms of LLC's) can be structured to allow restrictions on the interest (such as prohibitions on voting, sale or other participation), even more substantial discounts are warranted. An entire industry has grown up around trying to determine the proper discount applicable to the transfer of a minority interest in a FLP or LLC. Discounts of 20% to 30% are common, and more aggressive participants may even claim discounts of up to 70%.

More conservative planners have used these vehicles to transfer single industrial or commercial properties or similar types of interests. The most aggressive planners have actually put entire estates into a family limited partnership and attempted to transfer deeply discounted interests to the next generation. Until recently these types of transfer devices, and the discount techniques used in that connection, have consistently survived IRS challenge.

The reasoning has been that a potential purchaser would be unwilling to pay full value for a 10% interest in a FLP controlled by a family member, with no right to receive distributions, tax liability on 10% of the taxable income and no ability to sell the purchased interest. The actual purchase price should therefore represent a deep discount from the proportionate share of the true value of the property in the FLP. The IRS' success has generally been limited in the past to challenging the actual percentage of discount claimed by aggressive taxpayers.

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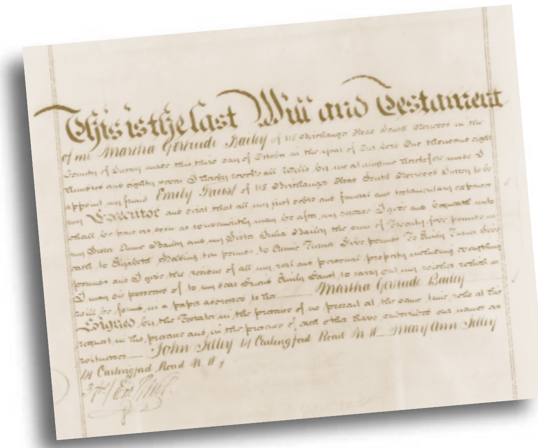

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Preserving the Benefits of Proposition 13 by Delaying Reassessment

by Elizabeth Blakely

In 1978 California voters approved Proposition 13 in response to years of steep, and what many perceived to be unfair, annual increases in real property taxes. The effect of Proposition 13 was to cap the assessed value of all real property, residential and commercial. This article will consider several ways that property owners, particularly those who have owned their properties since 1978, can avoid reassessment and in the process often transfer to others the low property tax basis they enjoy.

A Change of Ownership Triggers Reassessment

Reassessment of a property for property tax purposes will occur upon a "change of ownership." In the case of a purchase of the property, the county assessor will assign a new assessed value usually determined by the purchase price on that date, increased annually in subsequent years by two percent.

If a change of ownership occurs upon a transfer by inheritance or gift, the assessor is entitled to reassess the property unilaterally. The property owner then has the right to challenge that reassessment.

Finally, although not technically a change of ownership, if a property owner makes improvements to the property, such as by adding a swimming pool, an extra room or a second story, the county assessor is entitled to add the value of the new construction. Here again the reassessment is subject to challenge as to the correct reassessment.

Exempt Transactions Preserve the Property Tax Basis

Transfer to A Revocable Living Trust

Transfer of real property at death occurs through intestate succession (no Will), through a Will or through a funded living trust. Revocable living trusts are often the transfer vehicle of preference among Californians in order to avoid the expense and publicity of probate.

In funding their trust for that purpose, clients execute deeds transferring title to their real estate into their trust. Such transfers, although technically a change in ownership, are specifically exempt from reassessment for property tax purposes, whether or not the individual serves as Trustee of the trust, so long as the trust is revocable.

Exempt Transfers to a Spouse, Parents or Children

Whether by Will or trust, at death all of a decedent's real property may pass to his or her spouse, or into a trust for that spouse, without triggering a reassessment. Transfers between spouses are not changes in ownership.

Finally, transfers from grandparents to grandchildren can in certain circumstances also avoid reassessment. In order to claim the parent-child or grandparent-grandchild exclusions, however, the recipient of the property must complete and file a claim form with the county assessor.

In addition, transfers between parents and children enjoy a more limited exclusion: An individual may transfer his or her primary residence, regardless of its value, and up to $1,000,000 (total) of other property to a parent or child without triggering reassessment. The $1,000,000 exclusion applies to the *assessed* value of the property. For example, if a parent owns a commercial property with a property tax basis of $500,000 and a fair market value of $2,000,000, she may transfer the *entire* property to her child without reassessment, and $500,000 in exclusion value will still be available to future gifts of other property. The rule also applies if the gift is from the child to the same parent.

Finally, transfers from grandparents to grandchildren can in certain circumstances also avoid reassessment. In order to claim the parent-child or grandparent-grandchild exclusions, however, the recipient of the property must complete and file a claim form with the county assessor.

Avoid or Delay Reassessment in Selective Gift Programs

Annual Exclusion Gifts

Clients with substantial assets will typically make annual exclusion gifts (currently $11,000 per donor to *each* donee) to their children and grandchildren, in order to reduce their taxable estates at no gift tax cost. For example, in 2003, a married couple with two children and six grandchildren can make annual exclusion gifts totalling $176,000 without having to file a gift tax return or pay any gift tax.

If the gifts are interests in real property, the same rules of reassessment apply even though the real estate transferred is only a fractional interest. The transfer can qualify for the parent-child or, in the right circumstances, the grandparent-grandchild exclusion, thereby avoiding reassessment, and gifts between spouses are never reassessed. Gifts to other individuals, such as a favorite niece or nephew or a friend, will always be subject to reassessment; however, only the interest transferred is subject to reassessment; any interest retained by the donor will not be reassessed.

Qualified Personal Residence Trusts ("QPRT")

A qualified personal residence trust, or "QPRT", offers estate, gift *and* property tax advantages to homeowners. A person (or a couple) can establish a trust to hold a personal or vacation residence. The Settlors continue to enjoy all of the ownership privileges and be subject to the obligations of the property for a term of years. At the end of that term, the resi-

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The IRS Assault on FLP's and LLC's to Transfer Wealth at Discounted Values

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The IRS Successfully Unwinds an FLP and Threatens Its Use in Wealth Transfer Estate Planning

Recently a series of cases have held that aggressive immediate pre-death planning involving the use of FLP's were without substantive effect and could be disregarded in valuing a decedent's estate. The new *Strangi* case ventures much further, however, raising serious concern among estate planners, and giving the IRS a potentially significant new weapon in its challenge of the FLP and the LLC as wealth transfer vehicles.

The Facts of *Strangi*

As is so often the case, the IRS selected a case with extremely difficult factual circumstances. Mr. Strangi put 98% of his wealth, slightly less than $10,000,000, into a FLP in exchange for a 99% interest as a limited partner. Mr. Strangi and his four children also formed a corporation to serve as general partner, in which he retained 47% ownership. Coincidentally, Mr. Strangi's son-in-law, an attorney, had established this structure the day after attending a seminar on the tax benefits offered by the use of FLP's. He even patterned the entities after the documents sold by the program promoter. The son-in-law also held the taxpayer's power of attorney.

The *Strangi* Court Disregards the FLP Entity for Estate Tax Purposes

After Mr. Strangi's death, the IRS argued that the decedent, along with the son-in-law holding the power of attorney, had retained, after the transfer, a 99.47% beneficial interest in the FLP. The IRS then challenged the entire transaction citing Internal Revenue Code Sections 2036(a)(1) and (a)(2).

Under Section 2036(a)(1), a decedent's gross estate will include the value of property transferred if the decedent retained for his life the right to the income from that property. In this fact situation, the decedent transferred virtually all of his assets to the FLP, from which many of his personal bills were being paid. The facts established that the decedent, along with his son-in-law as his agent, retained significant "strings." The Court therefore concluded that this transaction was one where the decedent really had retained beneficial enjoyment of the property transferred during his lifetime, that the FLP should be disregarded and the entire property included in his estate at full value.

The *Strangi* Court Adds a Further Basis for Ignoring the FLP

The extreme facts of this case support the Court's conclusion in reliance on Section 2036(a)(1); however, the Court also chose to consider whether the FLP should be deemed a part of the decedent's estate by application of Section 2036(a)(2). Under Section 2036(a)(2), transferred property is includible in a decedent's estate if the decedent retains the right up until the time of death, either alone or in conjunction with any other party, to designate the persons who will possess or enjoy the property or its income.

> ***The Court therefore concluded that this transaction was one where the decedent really had retained beneficial enjoyment of the property transferred during his lifetime, that the FLP should be disregarded and the entire property included in his estate at full value.***

In this instance, through the vehicles of the retained general partnership interest, and the power of attorney held by the son-in-law, the Court held that the decedent had retained sufficient rights in the FLP to cause the property to be included in his estate as though the FLP had never been established. The court rejected the notion that fiduciary duties created under the partnership or the corporate general partner structure limited the actual rights retained by Mr. Strangi.

Assessing the Damage and Creating Damage Control

This one-two punch by the *Strangi* Court, relying on a code section not previously advanced by the IRS, has alarmed estate planning practitioners. Although it is difficult to assess the full impact of this decision, it is certain to limit the flexibility previously enjoyed by taxpayers in the use of FLP's and LLC's. The reasoning of the decision, if followed in other jurisdictions, could severely impair or even eliminate the use of a typical FLP, where the general partner has retained control of the entire property, as a viable wealth transfer device.

In this period of uncertainty, some general suggestions on how to avoid, or at least to minimize, the impact of the *Strangi* case are in order:

- Do not transfer substantially all of your estate into a FLP. Limit the funding to a single industrial or commercial property or an ongoing business venture.
- Do *not* serve as the general partner in the FLP or the manager of the LLC. Until the scope of *Strangi* in applying Section 2036(a) is further clarified, avoid retaining this kind of control unless such control is extremely important to you.
- Follow a plan that confirms an independent business, rather than clear estate planning and federal estate tax minimization goals. By all means, avoid the kind of last minute planning in which Mr. Strangi and his son-in-law engaged.
- Respect the entity's existence separate from the taxpayer. Take pains to avoid commingling assets and obligations.

It is certain that the IRS will rely on the *Strangi* case to assail the use of FLP's and LLC's in wealth transfer estate planning. Clients must weigh the risk that the IRS will unravel the entity when evaluating the technique as an effective estate planning tool. Nevertheless, because the *Strangi* was strongly fact driven, the client may be able, by creating more favorable facts as suggested above, to realize the same tax benefits enjoyed prior to *Strangi*.

Preserving the Benefits of Proposition 13 by Delaying Reassessment

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dence passes to the named beneficiaries, typically the Settlors' children.

The QPRT offers several significant tax benefits: Because the gift to the beneficiaries is delayed for the term of the trust, the "present value" of the gift to them is deeply discounted. In other words, the gift tax value for reporting purposes is greatly reduced from the then current fair market value. In addition, if the Settlors survive the term of the trust, the property will not be included in their estate.

The change of ownership occurs only upon the termination of the trust and the transfer to the remainder beneficiaries. If the trust terminates early because the Settlors die, the property transferred will not be reassessed if the beneficiaries of the trust are the Settlors' children. Of course, if the beneficiaries are not exempt recipients, the reassessment will occur after the term of the trust ends.

Joint Tenancy Transfers

Adding a person to joint tenancy title is another form of testamentary disposition because at the death of one joint tenant ownership of the property passes automatically to the surviving joint tenant or joint tenants. The initial transfer of title into joint tenancy will not trigger reassessment if, after the creation of the joint tenancy, the original transferor or transferors will continue to be among the joint tenants. If a joint tenant other than the original transferor dies, no reassessment will occur.

Only at the death of the original transferor will the property be subject to reassessment. For example, a husband and wife could transfer real property owned by them into joint tenancy with a nephew to whom they want the property to pass on their death. When the first spouse dies, no reassessment will occur because one of the original transferors is still alive and on title. At the death of the second spouse, however, a change of ownership will occur to which the parent-child exclusion does not apply, and the property will be reassessed. If, however, that third joint tenant is a child rather than a nephew, the parent-child exclusion can exempt even that transfer from reassessment.

> ***For property tax assessment purposes, the transfer of real property by the original owner into the FLP or LLC is wholly excluded from reassessment so long as the ownership interests in the entity are identical to the ownership interests in the real property before the transfer.***

Transfers to joint tenancy can give rise to a host of gift, estate tax and liability issues, which are beyond the scope of this article. Clients contemplating the use of joint tenancy survivorship to transfer real property should consult their advisers for guidance.

Family Limited Partnerships ("FLP's") and Limited Liability Companies ("LLP's")

FLP's and LLC's are two popular entities often used to effect the transfer of real property. Aside from their usefulness as entities to hold real estate and business enterprises for liability protection and control purposes, individuals often find them useful to transfer, at minimum tax costs, partial interests in appreciated or appreciating property to younger generations. Provisions of the partnership or operating agreement limiting the rights to management, distributions and ability to assign or liquidate ownership interests may allow the original owner to transfer ownership interests at a discount for gift tax purposes from the fair market value of the assets owned by the company, in the past a major transfer tax benefit.

For property tax assessment purposes, the transfer of real property by the original owner into the FLP or LLC is wholly excluded from reassessment so long as the ownership interest in the entity are identical to the ownership interests in the real property before the transfer. Thereafter, so long as the owners do not cumulatively transfer to others more than 50% of the ownership interest in the entity, no change of ownership will occur for property tax purposes. A change in the ownership of more than 50% of the FLP or LLC interest will require the entity to report the change of ownership, and the entire value of the property will be reassessed.

The parent-child exclusion is not available for transfers of interests in entities. The exclusions for transfers between spouses and to revocable living trusts, however, are still available for changes of interests in entities. (Bill Christian's article in this *Newsletter* presents in greater detail the benefits and drawbacks of using FLP's and LLC's to transfer interests in property in the wake of recent Court rulings.)

The planning techniques described above are, of course, not appropriate for everyone and should be discussed with your tax and estate planning advisors before implementing.