

THE FLOP FLP!

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Table of Contents

I.	INTRODUCTION	1
II.	THE PROBLEM	1
III.	SUMMARY OF THE PROBLEM	1
IV.	IS THERE A SOLUTION?	1
V.	SUMMARY OF THE RULES AND TREASURY REGULATIONS	1
	A. Code §1014	1
	B. Code §743	2
	C. Code §754	3
	D. Revenue Ruling 79-124	4
	E. Code §2704	5
	F. Reg. §25.2704-1.	5
VI.	THE SOLUTION	6
VII.	SAMPLE LANGUAGE	8
VIII.	SUMMATION	9
IX.	CAVEAT	9

THE FLOP FLP!

I. INTRODUCTION

Family limited partnerships (“FLPs”) have become the centerpiece of many estate plans. The literature is replete with all of the benefits that an FLP can provide to our wealthy clients. There are numerous business, tax, asset protection, and family reasons for creating an FLP. After nearly a decade of use, however, some troubling problems concerning FLPs are now evident. The purpose of this outline is not to identify and address all the various troublesome areas but rather to address one particular problem and provide a possible solution.

II. THE PROBLEM

How do you overcome the loss of the step-up in basis for the assets in an FLP at the death of the first spouse to die that would otherwise be available to the assets if they were not in an FLP?

III. SUMMARY OF THE PROBLEM

Section 1014 of the Internal Revenue Code (“Code”) provides that when a person dies, the assets of that deceased person receive a step-up in basis to the respective assets’ fair market value as of the decedent’s date of death. In addition, because Texas is a community property state, when one spouse dies, not only the separate property of that decedent receives a step-up in basis but also that decedent’s community property assets and his or her surviving spouse’s community property assets receive the step-up in basis. Because of this treatment, estate planners for years have often told their clients to hold on to highly-appreciated assets until the first spouse’s death and then to dispose of that appreciated asset, which would result in little or no capital gains tax liability. This is especially true because estate planners knew that there would be no federal estate tax or state inheritance taxes at the first spouse’s death because of optimum marital deduction planning.

Our clients still faced significant death tax liability at the second spouse’s death, so we have been advocating and utilizing the use of FLPs in our clients’ estate plans to minimize the death taxes that would arise at the second spouse’s death. Our clients have been forming FLPs and contributing their significant and often highly-appreciated assets to their FLPs in order to begin active gifting programs and to position their respective estates to take advantage of minority and lack of marketability discounts.

This technique has allowed many of our clients to achieve significant death-tax savings. To accomplish this result, however, our clients have given up or reduced their ability to receive a step-up in basis for their assets inside the FLP. This loss of step-up in basis and the accompanying savings in capital gains taxes has arisen at the first spouse’s death when there is little or no likelihood of federal taxes or state inheritance taxes being imposed upon those assets. Because of this problem, some planners have been reluctant to form FLPs before the death of the first spouse to die, which has resulted in a number of complications. Or they have gone ahead and formed FLPs for their clients and then have the difficult and unpleasant task of advising the surviving spouse’s children and family financial advisors that the family is going to have to bear the effects of capital gains taxes that would not have been imposed if the FLP had not been used to achieve future federal estate tax and state inheritance tax savings. Most of these clients have been indoctrinated with the concept that “a tax delayed is a tax not paid” philosophy, which is prevalent in the income-tax arena. What our clients want is to have their cake and eat it, too. They want to have their assets receive a full step-up in basis at the time of the first spouse’s death; they do not want to pay any death taxes at the death of the first spouse to die; and they want to minimize the federal estate taxes and state inheritance taxes at the death of the second spouse to die.

IV. IS THERE A SOLUTION?

Can an FLP be designed to be able to give our clients a full step-up in basis for the assets in the FLP at the death of the first spouse to die and then be able to provide minority interest discounts and lack of marketability discounts to the partners at the death of the second spouse to die? Before you can answer this question, you need to look at the various Code sections and accompanying Treasury Regulations ("Regs.") that may be applicable.

V. SUMMARY OF THE RULES AND TREASURY REGULATIONS

A. Code §1014

Code §1014(a) provides that except as otherwise provided in Code §1014, the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent will, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be the fair market value of the property at the date of the decedent's death.

Code §1014(b)(6) provides that property that represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any state will be considered to have been acquired from or to have passed from the decedent if at least one-half of the whole of the community interest in the property was includible in determining the value of the decedent's gross estate under chapter 11 of subtitle B (Code §2001 and following, relating to estate tax) or §811 of the Internal Revenue Code of 1939.

The above Code provisions provide that all the assets in the estate of the first spouse to die and the one-half community property of a surviving spouse will receive a step-up in basis to the fair market value of the assets at the date of death of the first spouse to die.

B. Code §743

Code §743(a) provides that the basis of partnership property will not be adjusted as the Reg. 1.743-1(a) provides that the basis of partnership property will not be adjusted as the

result of a transfer of an interest in a partnership by sale or exchange or on the death of a partner unless the election provided by Code §754 (relating to optional adjustment to basis of partnership property) is in effect with respect to the partnership.

Code §743(b) provides that in the case of a transfer of an interest in a partnership by sale or exchange or upon the death of a partner, a partnership with respect to which the election provided in Code §754 is in effect will:

(1) increase the adjusted basis of the partnership property by the excess of the basis to the transferee partner of his or her interest in the partnership over his or her 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 his or her interest in the partnership.

It further provides that under the Regs., such increase or decrease shall constitute an adjustment to the basis of partnership property with respect to the transferee partner only. A partner's proportionate share of the adjusted basis of partnership property will be determined in accordance with his or her interest in partnership capital and, in the case of property contributed to the partnership by a partner, Code §704(c) (relating to contributed property) will apply in determining the share. In the case of an adjustment under this subsection to the basis of partnership property subject to depletion, any depletion allowable will be determined separately for the transferee partner with respect to his or her interest in the property.

Code §743(c) provides that the allocation of basis among partnership properties where subsection (b) is applicable will be made in accordance with the rules provided in Code §755. result of a transfer of an interest in a partnership, either by sale or exchange or as a result of the death

of a partner, unless the election provided by Code §754 (relating to optional adjustment to basis of partnership property) is in effect with respect to the partnership. Whether or not the election provided in Code §754 is in effect, however, the basis of partnership property will not be adjusted as the result of a contribution of property, including money, to the partnership.

Reg. 1.743-1 (b) provides that in the case of a transfer of an interest in a partnership, either by sale or exchange or as a result of a partner's death, a partnership as to which the election under Code §754 is in effect will:

(i) increase the adjusted basis of partnership property by the excess of the transferee's basis for his or her partnership interest over his or her share of the adjusted basis to the partnership of all partnership property; or

(ii) decrease the adjusted basis of partnership property by the excess of the transferee partner's share of the adjusted basis of all partnership property over his or her basis for his or her partnership interest.

The amount of the increase or decrease constitutes an adjustment affecting the basis of partnership property with respect to the transferee partner only. Thus, for purposes of depreciation, depletion, gain or loss, and distributions, the transferee partner will have a special basis for those partnership properties that are adjusted under Code §743(b) and this paragraph. This special basis is his or her share of the common partnership basis (i.e., the adjusted basis of such properties to the partnership without regard to any special basis adjustments of any transferee) plus or minus his or her special basis adjustments. A partner's share of the adjusted basis of partnership property is equal to the sum of his or her interest as a partner in partnership capital and surplus, plus his or her share of partnership liabilities. Where an agreement with respect to contributed property is in effect under Code §704(c)(2), that agreement will be taken into account in determining a partner's share of the adjusted basis of partnership property. Generally, if

a partner's interest in partnership capital and profits is one-third, his or her share of the adjusted basis of partnership property will be one-third of the basis. The following example is provided:

D is a member of partnership DEF in which the partners have equal interests in profits, but not in capital. The partnership has made the election under Code §754. D dies and his interest passes to W, his widow. The balance sheet of the partnership at the date of D's death shows the following:

	ASSETS	

Market		Adjusted basis per
value		books
	-----	-----

	-----		\$		-----
			Total	7	81,000
				57,000	
				,	
			LIABILITIES AND CAPITAL		
				0	-----
				0	
Accounts					
receivable	10,000	10,000			
Inventory	20,000	24,000			
Depreciable					

s
s
e
t
s

			2		basis per
Value			0		books
			,		-----
			0		
			0		
			0		

4
0

\$
1
0
,
0
0
0

\$
1
0
,
0
0
0

Capital:			
D	18,000	26,000	
E	15,000	23,000	
F	14,000	22,000	

The amount of the adjustment under Code §743(b) is the difference between the basis of the transferee's interest in the partnership and her share of the adjusted basis of partnership property. Under Code §742, the basis of W's interest is \$29,333 (the fair market value of D's interest at his death, \$26,000, plus \$3,333, his share of partnership liabilities). W's share of the adjusted basis of partnership property is \$21,333 (i.e., \$18,000 plus \$3,333, her share of partnership liabilities). The amount to be added to the basis of partnership property is, therefore, \$8,000, the difference between \$29,333 and \$21,333. This amount will be allocated to partnership properties in accordance with the rules set forth in Code §755 and Regulation 1.755-1.

Note that in the above example, the amount of the adjustment does not depend upon the adjusted basis to the transferor for his interest in partnership capital.

C. Code §754

Code §754 provides that if a partnership files an election, in accordance with the

Regulations, the basis of partnership property will be adjusted, in the case of a distribution of property, in the manner provided in Code §734 and, in the case of a transfer of a partnership interest, in the manner provided in Code §743. Such an election will apply with respect to all distributions of property by the partnership and to all transfers of interests in the partnership during the taxable year with respect to which the election was filed and all subsequent taxable years. That election may be revoked by the partnership, subject to such limitations as may be provided by the Regs.

Reg. 1.754-1(a) provides that a partnership may adjust the basis of partnership property under Code §734(b) and Code §743(b) if it files an election in accordance with the rules set forth in Regulation 1.754-1(b). An election may not be filed to make the adjustments provided in either Code §734(b) or Code §743(b) alone, but such an election must apply to both sections. An election made under the provisions of this section will apply to all property distributions and transfers of partnership interests taking place in the partnership taxable year for which the election is made and in all subsequent partnership taxable years unless the election is revoked pursuant to Reg. 1.754-1(c).

Reg. 1.754-1(b) provides that:

(1) an election under Code §754 and this section to adjust the basis of partnership property under Code §734(b) and Code §743(b), with respect to a distribution of property to a partner or a transfer of an interest in a partnership, must be made in a written statement filed with the partnership return for the taxable year during which the distribution or transfer occurs. For the election to be valid, the return must be filed not later than the time prescribed by paragraph (e) of Reg. 1.6031-1 (including extensions thereof) for filing the return for such taxable year. Notwithstanding the preceding

Reg. 1.754-1(c) provides that a partnership having an election in effect under Code §754 may revoke the election with the approval of the district director for the internal revenue district in which the partnership return is required to be filed. A partnership that wishes to revoke such an

two sentences, if a valid election has been made under Code §754 and this section for a preceding taxable year and not revoked in accordance with Reg. 1.754-1(c), a new election is not required to be made. The statement must (i) set forth the name and address of the partnership making the election, (ii) be signed by any one of the partners, and (iii) contain a declaration that the partnership elects under Code §754 to apply the provisions of Code §734(b) and §743(b).

(2) This principle may be illustrated by the following example:

A, a U.S. citizen, is a member of partnership ABC, which has not previously made an election under Code §754 to adjust the basis of partnership property. The partnership and the partners use the calendar year as the taxable year. A sells his interest in the partnership to D on January 1, 1971. The partnership may elect under Code §754 and this section to adjust the basis of partnership property under Code §734(b) and Code §743(b). Unless an extension of time to make the election is obtained under the provisions of Reg. 1.9100-1, the election must be made in a written statement filed with the partnership return for 1971 and must contain the required information. The return must be filed by April 17, 1972 (unless an extension of time for filing the return is obtained). The election will apply to all distributions of property to a partner and transfers of an interest in the partnership occurring in 1971 and subsequent years, unless revoked pursuant to Reg. 1.754-1(c).

election must file an application setting forth the grounds on which the revocation is desired. The application must be filed not later than 30 days after the close of the partnership taxable year with respect to which revocation is intended to take effect and must be signed by any one of the

partners. Examples of situations that may be considered sufficient reason for approving an application for revocation include a change in the nature of the partnership business, a substantial increase in the assets of the partnership, a change in the character of partnership assets, or an increased frequency of retirements or shifts of partnership interests, so that an increased administrative burden would result to the partnership from the election. No application for revocation of an election will, however, be approved when the purpose of the revocation is primarily to avoid stepping down the basis of partnership assets upon a transfer or distribution.

D. Revenue Ruling 79-124

Revenue Ruling 79-124 addresses the effect of Code §743(b) under the circumstances described below:

Facts:

Husband, a domiciliary of a community property state, was a member of a partnership at the time of husband's death. Under state law the interest in the partnership was community property of husband and wife, but wife was not a member of the partnership under state law. The election provided by Code §754 was in effect with respect to the partnership for 1976, the year in which husband's death occurred.

One-half of the partnership interest that was owned by husband and wife as community property was transferred to husband's estate at husband's death and was included in husband's gross estate for federal estate tax purposes. Husband's estate was substituted by the partnership as a successor partner for purposes of administering the estate. Wife was not substituted as a successor partner but continued to own one-half of the partnership interest without being considered a member of the partnership under state law.

Revenue Ruling 79-124 summarized the law as follows:

Code §754 provides, in part, that if a partnership files an election in accordance with regulations prescribed by the Secretary of Treasury, the basis of partnership property will be adjusted in the case of a transfer of a partnership interest in the manner provided in Code §743. That election will apply with respect to all transfers of interest in the partnership during the taxable year with respect to which the election was filed and for all subsequent years.

Code §743(b) provides that if the election under Code §754 is in effect, in the case of a transfer of an interest in a partnership by sale or exchange or upon a partner's death, the partnership will (1) increase the adjusted basis of its property by the excess of the basis to the transferee partner of the partner's interest in the partnership over the partner's proportionate share of the adjusted basis of the partnership property, or (2) decrease the adjusted basis of its property by the excess of the transferee partner's proportionate share of the adjusted basis of partnership property over the basis of the partner's interest in the partnership. Such increase or decrease is an adjustment to the basis of partnership property with respect to the transferee partner only.

Code §1014(a) provides, in part, that the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent will, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be

the fair market value of the property at the date of the decedent's death.

Code §1014(b)(6) provides that property that represents the surviving spouse's one-half share of property held by the decedent and the surviving spouse under the community property laws of any state, or possession of the United States or of Revenue Ruling 79-124 goes on to say that because one-half of the partnership interest owned by husband and wife as community property was included in husband's gross estate for federal estate tax purposes, wife's share of the partnership interest is considered, under Code §1014(b)(6), to have been acquired from husband upon husband's death. Husband's half of the partnership interest was actually transferred to husband's estate at husband's death. Therefore, the basis of the entire partnership interest in the hands of husband's estate and wife is to be determined in accordance with Code §1014(a). In addition, for purposes of Code §743(b), both husband's community interest and wife's community interest in the partnership interest are considered to have been transferred, upon the death of husband, to husband's estate and to wife respectively.

Revenue Ruling 79-124 holds that adjustments to the basis of partnership properties under Code §743(b) are to be made in respect of the portion of such properties that is allocable to the entire interest in the partnership that was owned by husband and wife as community property immediately preceding the death of husband. Furthermore, the same result would apply if wife predeceased husband.

E. Code §2704

If there is a lapse of voting or liquidation rights in an entity that is controlled by a family before and after the lapse, the individual holding the right will be deemed to have transferred by gift or inclusion in that individual's gross estate the amount determined equal to the excess of the value of all interest in the entity held immediately before the lapse (determined as if the voting and liquidation rights were non-lapsing) over the value

any foreign country, shall be considered to have been acquired from or to have passed from the decedent if at least one-half of the whole of the community interest in the property was includible in determining the value of the decedent's gross estate for purposes of the federal estate tax.

of the interest immediately after the lapse. If there is a lapse of voting or liquidation rights in an entity that is controlled by a family before and after the lapse, the lapse will be disregarded and the interest transferred will be treated as if there had been no lapse. Code §2704(a) may be avoided entirely by not having lapsing liquidation or voting rights in the FLP. Or Code §2704(a) can be made applicable by drafting the FLP to contain lapsing liquidation or voting rights.

A voting right is a right to vote with respect to any matter of the entity. In the case of a partnership, a general partner's right to participate in management is a voting right. The right to compel the entity to acquire all or a portion of the holder's equity interest in the entity by reason of aggregate voting power is treated as a liquidation right and not as a voting right. A liquidation right is a right or ability to compel the entity to acquire all or a portion of the holder's equity interest in the entity. A voting right or a liquidation right may be conferred and may lapse by reason of a state law, the corporate charter or bylaws, an agreement, or other means. A lapse of a liquidation right or a voting right occurs at the time a presently exercisable right is restricted or eliminated. A transfer of an interest that results in the lapse of a liquidation right is not subject to Code §2704(a) if the rights with respect to the transferred interest are not restricted or eliminated. For example, if a holder owned 70% interest in an entity and the entity could be liquidated by a 66 2/3% vote of the ownership interest, and the holder gifts 10% ownership interest to the holder's children and, thus, could no longer cause the entity to liquidate because of the holder's aggregated voting power, then the loss of the holder's liquidation right is not subject to the Code §2704(a) valuation provisions. The rights

associated with the 10% interest transferred to the children must not be otherwise restricted or eliminated.

There may be a technical problem with lapsing voting rights that may arise by operation of some state law or by contract. This problem arises when a general partner attempts to withdraw from the FLP and has that general partner's general partnership interest, which has voting rights, converted to a limited partnership interest, which lacks those corresponding voting rights. The loss of those voting rights will be a lapse of voting rights, which will be caught by the Code §2704(a) valuation provisions.

There may be a way to draft an FLP so that a limited partner has a liquidation right by aggregated voting power. Later have the limited partner transfer part of his limited partnership

VI. THE SOLUTION

After reviewing Code §743, Code §754, Code §2704(a), and their accompanying Regs., Revenue Ruling 79-124, and all published private letter rulings discussing Code §2704(a), there is a way to solve the problem of how you overcome the loss of the step-up in basis for the assets in an FLP at the death of the first spouse to die that would otherwise be available to the assets if they were not in an FLP and still preserve the ability to receive valuation discounts for limited partnership interests at the death of the second spouse to die. The FLP agreement is drafted with a limited liability company ("LLC") as the general partner, owning a 1% general partnership interest, and mom and dad as the limited partners, each owning 49.5% limited partnership interest. Mom and dad each own 50% membership interest in the LLC general partner. The FLP agreement is drafted so that any limited partner who owns at least 45% of the limited partnership interest has the right to cause a liquidation of the partnership. This follows Reg. 25.2704-1(f), EXAMPLE 7. In Example 7, dad owns 80% of the stock in a corporation and because of his aggregated voting power, he has the right to liquidate the corporation. If dad were to transfer 5% of the ownership in the corporation to each of his three children so that his ownership

interest so that there is a loss of a liquidation right because the limited partner no longer has aggregated voting power to liquidate the partnership. The lapse of the right to liquidate the FLP because of a loss of an aggregated voting power will not be a lapse of a liquidation right subjected to the provisions of Code 2704(a) and its accompanying Regulations.

F. Reg. §25.2704-1.

Reg. 25.2704-1 provides that if, after any restriction described in Code §2704(b) is disregarded, the remaining requirements for liquidation under the governing instruments are less restrictive than the State law that would apply in the absence of the governing instruments, the ability to liquidate is determined by reference to the governing instruments.

interest in the corporation was reduced to 65%, which is below the 70% ownership interest requirement necessary to liquidate the corporation, then dad has a loss of liquidation right because of the loss of aggregated voting power. Assuming that the 5% ownership interest in the corporation that was transferred to each of the three children were transferred with all their associated voting and liquidation rights, then dad's loss of a liquidation right because of his transfer of ownership interest in the corporation to his children is not subject to the provisions of Code §2704(a).

Following the Example 7 in the Regs., the FLP may be drafted so that the limited partner who owns 45% limited partnership interest or more has a liquidation right by his aggregated voting power. If a limited partner owns 49.5%, then the limited partner could transfer 4.5% of his limited partnership interest, through annual exclusion gifts, and still have the right to liquidate the partnership. If it is anticipated that the limited partner will make more than 4.5% transfer in limited partnership interest through annual exclusion gifts, then the threshold to allow a limited partner to liquidate the partnership could be reduced to 40%. This would allow the limited partner to gift away up to 9.5% of his limited partnership interest through annual exclusion gifts and still retain the right to liquidate the partnership.

Assuming that dad and mom retain sufficient limited partnership interest each (45% or more limited partnership interest) and dad dies first, then the limited partnership interest owned by dad would be included in dad's gross estate for estate-tax purposes virtually undiscounted. The limited partnership interest included in dad's gross estate would receive a step-up in basis to the fair market value of the limited partnership as of the date of dad's death in accordance with Code §1014. If dad's and mom's limited partnership interest is

Once the outside basis of the limited partnership interest of both mom and dad and the corresponding assets inside the FLP have been adjusted upward, then the executor will be in a position to fund a QTIP pecuniary marital deduction trust ("marital trust"). It is important to avoid the problem identified in *Estate of Chenoweth v. Commissioner*, 88 T.C. 1577 ("*Chenoweth*"). In *Chenoweth*, a controlling ownership interest of a business entity was included in the husband's gross estate, but the marital trust was funded with minority interests in that same business entity, which resulted in an underfunding of the marital trust. Thus, it is critical that the marital trust be funded with a sufficient percentage of dad's limited partnership interest that will allow the trustee to liquidate the FLP. To insure that this is the result, the FLP must be drafted so that the executor, and succeeding the trustee of the marital trust, continues to have the right to vote the limited partnership interest in a manner that will allow them to liquidate the FLP. In this plan, we are not concerned about funding the applicable equivalent exclusion amount (unified credit) to a bypass trust, because we have sufficient other assets to fund the bypass trust or the applicable equivalent exclusion amount has already been used through prior gifts. Please note that because of dad's liquidation right in the FLP, we will not be able to pack the bypass trust with discounted limited partnership interests of this FLP.

Another solution would be to have two or more FLPs, one that uses traditional discount planning to be used in funding the bypass trust and one that does not use traditional discount planning at the death of the first spouse to die to be used in funding the marital trust.

community property, then both dad's and mom's limited partnership interest will receive a step-up in basis in accordance with Code §1014. In addition, if the general partner elects a Code §754 election, which will trigger a Code §743(b) adjustment of the percentage of assets inside the FLP that correspond to dad's and mom's percentage of limited partnership interest in the FLP, then those assets will receive a step-up in basis to their respective fair market values as of dad's date of death.

In drafting the marital trust, it is critical that the surviving spouse be granted a \$5,000 or 5% withdrawal right that meets the requirements of Code §2041(b). If mom (the surviving spouse in our example) is not given this withdrawal right, then it becomes more difficult to place the marital trust in a position to have its limited partnership interest subjected to minority interests and lack of marketability discounts at the time of mom's death. If the trustee of the marital trust continues to have the right to liquidate the FLP, then the marital trust limited partnership interest will not be discounted at the surviving spouse's death and will not be able to avail itself of the benefits provided in the case of *Estate of Louis F. Bonner, Sr. v. United States of America* 84 F.3d 196 (5th Cir. 1986) ("*Bonner*"). If mom has a continuing right to withdraw \$5,000 or 5% of the trust corpus, whichever is greater, from the marital trust each year, then the trustee of the marital trust could distribute limited partnership interests to mom. And mom could then make gifts of or sell limited partnership interests to other family members or the bypass trust. It is critical that the limited partnership interests withdrawn by mom from the marital trust be transferred with all of their associated voting and liquidation rights. Because of a transfer of a small portion of limited partnership interests as a result of mom's exercise of her withdrawal right, sufficient limited partnership interests are transferred from the marital trust and subsequently from mom so that the trustee and mom no longer have the right to respectively liquidate the FLP. As long as the transferred limited partnership interests are transferred with all of their associated voting and liquidation rights, then the lapse of a liquidation right that occurs because of a

transfer of an ownership interest in the FLP will not be a lapse of a liquidation right caught by the provisions of Code §2704(a).

Another reason to draft the marital trust so that mom has a \$5,000 or 5% withdrawal right is to avoid any conflict with or reluctance on the part of the trustee of the marital trust. A trustee could be concerned and/or the Internal Revenue Service (“Service”) could argue that the trustee who transferred or sold the limited partnership interests that resulted in the loss of the trustee’s right to liquidate the FLP would be a breach of the trustee’s fiduciary duty by causing the corpus of the marital trust to significantly decrease. If mom has the absolute right to withdraw limited partnership interests of the marital trust, then the trustee is not responsible for and, thus, should not be liable for any decrease in the corpus of the marital trust.

The FLP must be drafted so that the executor for the estate of a family member or the

Mom could also make gifts or sales of limited partnership interests owned by her to other family members or the bypass trust. When sufficient limited partnership interests have been withdrawn from the marital trust and mom has transferred sufficient limited partnership interests owned by her so that the respective ownership interests of the marital trust and of mom is below the 45% liquidation threshold, then both the marital trust limited partnership interest and mom’s limited partnership interest would be subject to minority interest and lack of marketability discounts at the time of mom’s death.

The *Bonner* case: Louis F. Bonner died in January, 1989. At the time of his death, he owned undivided interests in real and personal property. The other undivided interests were owned by a QTIP trust established by the will of Bonner’s wife, who died in 1986. A marital deduction was allowed on the property that passed to the QTIP trust. The value of the property in the QTIP trust was included in Bonner’s estate in accordance with Code §2044, and the value of the properties owned by Bonner were included in his estate in accordance with Code §2033. The fair market value for the property held jointly by Bonner and the QTIP trust was \$2,000,500. Bonner’s

trustee of a trust for the benefit of a family member are all permitted transferees. Then if a partnership interest is transferred to any of these permitted transferees, they will not be assignees of limited partnership interests but full, admitted limited partners. If any of these permitted transferees were only assignees of limited partnership interests, then there could be a problem under Code §2704(a) if the Service could prove that the transferee of the limited partnership interest was only an assignee. The Service might argue that there was a lapse of a voting or liquidation right when there was a transfer of an assignee’s interest in a limited partnership interest. Or, in the alternative, they might argue that if the transferor (trustee or mom) continued to have all of the voting rights over the assignee’s interest transferred, the transferor would continue to have a liquidation right in the FLP.

estate took a 45% discount for the fractional interests held by the estate. On cross motions for summary judgment, the district court, adopting the reasoning of the government, held that the estate is not entitled to a refund of estate tax, granted the government’s motion for summary judgment, and denied the estate’s motion for summary judgment. Federal estate tax is an excise tax on transfer of property at death, and, thus, valuation of property is to be made at moment of death. The value must be measured by interest that passes, in contrast with interest held by decedent before death or the interest held by legatee after death.

Courts have consistently recognized that the sum of all fractional interests in a property is less than the whole and have upheld the use of fractional interest discounts in valuing undivided interests. In *Bonner*, the government took the position that the interest held by the QTIP trust and the interest held by Bonner merged at the time of Bonner’s death, pursuant to the plain language of Code §2044, extinguishing the fractional undivided interests and resulting in 100% fee ownership of the assets by the estate. The government contended, and the district court found, that the “plain language of Code §2044 resulted in 100% fee ownership by the estate at the moment of Bonner’s death, and

precluded any potential problems with fractional ownership. According to Reg. 20.2031-1(b), the fair market value is 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. The “willing seller” is not the estate itself, but is a hypothetical seller. Therefore, family attribution, which depends on the identity of seller as the legatee and the executor, cannot control the value of the asset.

Although Code §2044 contemplates that the QTIP property will be treated as having passed from Bonner for estate-tax purposes, the statute does not require, nor logically contemplate that in so passing, the QTIP assets would merge with other assets. The assets in the QTIP trust could have been left to any recipient of Mrs. Bonner’s choosing, and neither Bonner nor the estate had any control over their ultimate disposition.

The assets, although taxed as if they passed through Bonner’s estate, in fact were

Finally, after the first spouse's death and after the marital trust has been funded, then all of the partners of the partnership could, by unanimous agreement, amend the partnership agreement to change the definition of a *permitted transferee*. The new definition for a *permitted transferee* will require that a permitted transferee have the status of an *assignee* and will no longer automatically be considered a substitute limited partner. This would mean that at the death of the second spouse to die, the assignee's interest (of the limited partnership interest) of that spouse and the marital trust would be valued with the largest valuation adjustment possible. It is generally understood by most business appraisers that an assignee's interest in a limited partnership interest is valued less than the limited partnership interest itself.

VII. SAMPLE LANGUAGE

To effectuate the outcome of this outline, Section XV.A. of my partnership agreement would reflect the following language:

controlled at every step by Mrs. Bonner, which a tax valuation with a fractional interest discount would reflect. At the time of Bonner’s death, his estate did not have control over Mrs. Bonner’s interests in the assets such that it could act as a hypothetical seller negotiating with willing buyers free of handicaps associated with fractional undivided interests. The valuation of the assets should reflect that reality.

The U.S. Court of Appeals, 5th Circuit, reversed the District Court and stated that fractional interest discounts applied when valuing decedent’s undivided interests in property for federal estate tax purposes, even though remaining interests were owned by a QTIP trust created by decedent’s spouse and were also included in decedent’s estate for federal estate tax purposes. Interests held by the QTIP trust and by decedent did not merge at decedent’s death and using fractional interest discounts would reflect separate disposition of assets made by decedent and decedent’s spouse.

XV. DISSOLUTION

Events of Dissolution. Any one of the following events works an immediate dissolution of the Partnership:

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- 6.

Section XVI.A.1. of my partnership agreement would reflect the following language:

XVI. LIQUIDATION

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The definition in the partnership agreement for a "Permitted Transferee" would read as follows:

Permitted Transferee means (1) any person; (2) a trust created for the benefit of person; and (3) any organization described in each of the following sections of the Code: §170(b)(1)(A), §170(c), §2055(a) and §2522(a); and (7) a charitable remainder trust created under Code §664. A Permitted Transferee, upon receiving a transfer of a Limited Partnership Interest, will be a substitute Limited Partner automatically without consent of any other Partner and will have all the rights of a Partner."

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The partnership agreement allows certain transferees to become substitute limited partners without the consent of the other partners if (1) the transfer occurs by reason of or incident to the death, incompetence, or gift of the transferor partner and (2) the transferee is a permitted transferee as defined above.

Section 7.02 of the Texas Revised Limited Partnership Act states that unless the partnership agreement states to the contrary, a partnership interest is assignable in whole or in part. The partnership agreement states that neither record title nor beneficial interest to a partnership interest may be transferred without required consent except as may be allowed to a permitted transferee in the agreement.

Section 7.04 of the Texas Revised Limited Partnership Act states that an assignee of a partnership interest may become a substitute limited partner if all partners consent or the partnership agreement provides. If a permitted transferee is defined as having the status of an assignee, the permitted transferee who receives a transfer of a partnership interest will receive only a beneficial interest as an assignee. An assignee permitted transferee may become a substitute limited partner only by receiving required consent. If a permitted transferee is defined as having the status of a substitute limited partner, the permitted transferee who receives a transfer of a partnership interest will receive both record title and beneficial interest to the partnership interest and have the status of a substitute limited partner without receiving required consent.

If you are attempting to utilize the FLOP FLP technique, it is critical that a permitted transferee be defined as becoming an automatic substitute partner. This is necessary so that when a partner transfers a limited partnership interest, the limited partnership interest transferred will be transferred with all of its associated voting and liquidation rights to meet the requirements of Code §2704(a).

Section XII.B.3.b. of the partnership agreement entitled "Transferee Has the Status of an Assignee" would be revised to read as follows:

"Status of a Transferee. If there has been no pre-arranged transfer as provided above, the executor, administrator, guardian, conservator, or legal representative of a deceased or incapacitated Limited Partner will have the status of a substitute Partner. In accordance with Section 7.05 of the Act, that person may exercise all the deceased or incapacitated Limited Partner's rights and powers to settle the Limited Partner's estate or administer the Limited Partner's property, including the right to become a Limited Partner without obtaining Required Consent."

VIII. SUMMATION

If you want to utilize the FLOP FLP technique, below is a checklist of items to consider:

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4. i Attempt to have all partners unanimously agree to amend the partnership agreement to provide that a permitted transferee will no longer automatically be considered a substitute limited partner but only an assignee (the default

status under the Texas Revised Limited Partnership Act).

IX. CAVEAT

This is a new concept, untried and untested, but should be available.

SPECIAL ACKNOWLEDGMENT

This was a concept first brought to my attention by Noel Ice of the firm of Cantey & Hanger, L.L.P, Fort Worth, Texas, and I wish to express my appreciation for his originality, ingenuity, and help in structuring this technique.