LOEB & LOEB LLP

Trusts and Estates

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Reviewing Family Partnership and LLC Arrangements

Last summer we reported to you on the Tax Court case *Estate of Nancy H. Powell v. Commissioner*, 148 T.C. No. 18 (2017) (summarized in Loeb & Loeb High Net Worth Family Tax Report, July 2017). In the *Powell* case, the Tax Court held for the first time that assets of a limited partnership could be pulled back into the gross estate of a decedent who held only a limited partnership interest. It was also the first time that the court relied exclusively on IRC Section 2036(a)(2), which includes in the decedent's estate assets he or she had previously transferred if the decedent retained "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." In previous cases, courts had relied on Section 2036(a)(1), which includes transferred assets when the decedent has retained "the possession or enjoyment of, or the right to the income from, the property."

Does anything need to be done with respect to existing family partnerships?

Since the *Powell* case was decided a year ago, some commentators have suggested that changes be made with respect to existing family limited partnerships or LLCs (FP) if the founder of FP is still living and previously transferred FP interests to the other partners or members, but retained an interest in FP after the transfer. There does not appear to be a consensus over exactly what should be done. We believe that in many or even most cases nothing needs to be done, although in limited circumstances some clients may wish to consider some of the approaches we will describe below to reduce the risk of unexpected estate tax on assets previously transferred to family members or trusts based on the novel theory underlying the case.

Background of *Powell*

Nancy Powell's son Jeffrey, acting under a power of attorney for his mother, formed NHP Enterprises, LP (NHP) on August 6, 2008, and on August 8, he transferred cash and securities to NHP in the amount of $10 million. Jeffrey was the general partner, holding a 1% interest, and Nancy's revocable trust held a 99% interest as a limited partner. The partnership agreement allowed the general partner to determine the amount and timing of distributions. NHP could be dissolved with the consent of all partners.

On August 8, Jeffrey, purporting to act under his power of attorney, transferred the 99% interest held by Nancy's trust to a charitable lead annuity trust (CLAT) that would pay an annuity to the Nancy H. Powell Foundation each year, for the remainder of her life. Upon her death, any assets remaining in the CLAT were to be divided equally between Jeffrey and his brother. Nancy Powell died a week later, on August 15. A small gift was reported on a gift tax return filed after Nancy's death for the claimed value of the remainder interest in the trust passing to the sons at the end of the CLAT.

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The IRS proposed both a gift tax deficiency and an estate tax deficiency. Before the Tax Court, the IRS took the position that the assets transferred to NHP were includible in Nancy Powell's estate under IRC Sections 2036(a)(1), 2036(a)(2), or 2038. Section 2036(a)(1) includes property transferred during the decedent's lifetime if the decedent retained the possession, enjoyment or right to income from the property. Section 2036(a)(2) includes property transferred during life if the decedent retained 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. As we reported last summer, the court determined that the assets of NHP were includible in Nancy Powell's estate under IRC Section 2036(a)(2) because she, in conjunction with the general partner, could dissolve the partnership.

The *Powell* case is unfortunate for a few reasons. First, it was another in a long line of "death bed" transfer cases where someone, this time acting through an attorney-in-fact, attempted to remove assets from her taxable estate with last minute planning. These fact patterns often result in negative outcomes before courts. Even worse, the estate's counsel did not offer any defense or rebuttal to the IRS argument that IRC Section 2036 should be applied to pull the property transferred to NHP back into Nancy Powell's estate. The estate argued only that Nancy Powell's limited partnership interest had been given to the CLAT, so at her death she did not own any interest in NHP and therefore could not act to dissolve the partnership.

The court determined that the gift to the CLAT exceeded Jeffrey's authority under the power of attorney, so the transfer of the limited partnership interest by gift was not effective. The court then concluded that the transferred assets were includible in Nancy Powell's estate under IRC Section 2036(a)(2) because, in conjunction with the general partner (her son), she could dissolve the partnership. All seventeen judges of the Tax Court who participated in the case agreed with the result.

The most worrisome aspect of the case is the Section 2036(a)(2) holding, which was apparently not even necessary to trigger estate tax on the partnership assets due to the other bad facts. The fact is that in almost every limited partnership or LLC, each partner or member (including the founder who transferred interests to the other partners or members) can participate in a vote to dissolve under the default rules of governing law or the partnership or LLC agreement. Therefore, under the *Powell* theory, virtually everyone who has transferred assets to family members or trusts through a limited partnership or LLC, but who kept any interest at all as a partner or member, even as a limited partner or non-managing member, runs the risk that all the previously-transferred interests will be pulled back into her or his estate, as happened to Nancy Powell. This implication is what so concerns estate planners. Until now, only retained interests with some degree of control (such as a general partner or managing member interest) had been found to present that risk.

The bona fide sale exception should prevent a Powell type result in most cases.

IRC Section 2036 does not apply to any transfer by a decedent that was "a bona fide sale for adequate and full consideration in money or money's worth." Over time, courts have grafted onto this exception an additional requirement that the creation of the partnership and transfer of property to it must serve a significant nontax purpose. The IRS argued in *Powell* that there was no such nontax purpose for the transfer and the estate did nothing to try to rebut that argument, so the court accepted the IRS's position.

In several prior cases courts have accepted as a valid nontax purpose for the formation of an FP a reason such as: i) to provide a vehicle for the pooled investment of a family's wealth; ii) to apply a consistent investment strategy across all of a family's assets over extended periods; iii) to retain particular assets within the family over extended periods; and iv) to operate an active business or real estate in a form that provides liability protection. In many or most cases, partnerships or LLCs our clients have formed should easily fit within one or more of these purposes, in which case we believe that *Powell* is unlikely to apply.

Moreover, many of our clients have created FP for trusts benefiting family members, but the client has retained no interest in or control over FP. The client's retained interest in the underlying assets (often real property or a business), partly owned by FP, is held entirely outside FP, with the client as a co-owner of those assets. In such a case, the novel theory of *Powell* does not appear to present an estate tax risk; but the structure of any entity holding the underlying assets and co-owned by FP and the client should still be analyzed under the longstanding rules of Section 2036 to ensure that there are no tax traps.

Some clients may still wish to take protective measures.

Despite the bona fide sale exception, some clients who retained interests in FP in which family members or trusts hold interests transferred from the client may still wish to implement additional protective measures to avoid any circumstances in which their position may have to be defended against an IRS attack after their death. The clearest way to avoid a *Powell* type attack is to not own or control any interest in FP at death. There are a few approaches to this end that can be considered.

Unwind the founder's retained interest in the family partnership or LLC. It may be possible for the founder to withdraw his or her interest in the assets owned by FP by redeeming his or her entire partner or LLC interest in kind. This would entail an appraisal in the case of assets other than publicly-traded securities or cash. In some cases the underlying assets (for example, an interest in real estate or a business) will then be jointly owned by the founder and FP, which will require thoughtful governance arrangements because these same estate tax rules operate at the level of any underlying business entity as well. In other cases it will be possible to redeem the founder's interest with discrete assets. Often there will be no income tax consequences to a redemption like this (for example, if all the partners or members are grantor trusts of the founder or if the founder receives cash and marketable securities in an amount less than his or her basis in the partnership or LLC), but under some circumstances there could be some capital gain. This approach permits the client to retain the same level of income from or control over the underlying assets or business as before the unwinding.

Transfer the founder's interest in the family partnership or LLC to family members or trusts. If the founder is willing to part with his or her remaining interest in FP and the value is such that it can be transferred without substantial gift tax liability, it may make sense simply to give the remaining interest to the trusts or family members who currently hold the balance of the interests, or to other trusts or family members. In some cases, the additional lifetime exemption provided by the Tax Cuts and Jobs Act might be used to minimize gift tax exposure. An alternative to a gift is a sale of the interest to a grantor trust that is not included in the transferor's estate but the transferor remains the income tax owner of the asset; the sale is disregarded for income tax purposes. This type of sale will use much less, if any, gift tax exemption. And in some cases a Grantor Retained Annuity Trust (GRAT) will allow a gift-tax free transfer after a few years. For clients who need or want the income from the retained interest for an indefinite period (e.g., beyond the term of GRAT annuity payments or installment note payments), this alternative may not be appropriate.

Contribute the retained interest to a new partnership or LLC with restricted powers for the founder. Another approach is to contribute the retained interest in FP to a newly formed entity (Newco). Newco would be organized with a management structure such that the founder could continue to control the interest in FP on matters relating to the operation of the business or investment of the assets of FP, but another manager would hold any powers over distributions from FP and the power to dissolve FP. This should prevent a Section 2036(a)(2) inclusion of the assets of FP because the founder has no right to cause a liquidation of FP (or otherwise affect "beneficial enjoyment") alone or in conjunction with anyone else. The party who serves as the manager holding the prohibited powers should be a trusted friend or advisor, and the founder can have the ability to remove and replace this manager with another independent person.

Transfer the retained interest to a non-gift trust. The retained interest in FP could alternatively be transferred to an irrevocable trust in a manner such that the founder (or the founder's spouse) can retain the economic benefits associated with the retained interest in FP, but an independent trustee would be the only fiduciary able to exercise any powers that could cause estate tax inclusion of the assets of FP, such as voting to dissolve FP or determining whether FP should make any distributions. The founder could serve as an additional trustee with powers over the management of the business or assets of FP. Delaware is an ideal state for the creation of such a trust as its law allows a particular trustee to be excluded from the exercise of certain trustee powers without being exposed to liability for the actions of the other trustee who is allowed to act. Due to the retained economic benefit, this transfer is not a taxable gift and the retained interest would be taxed on death in essentially the same manner as if not transferred. But the risk that the other interests in FP, or the assets of FP, will be subject to estate tax at the founder's death will have been ameliorated.

Dissolve the family partnership or LLC. If the family partnership or LLC has been in existence for some time and its assets have appreciated significantly since its formation, it may have accomplished its purposes. In such case, another course of action may be simply to dissolve FP and distribute the assets to the partners or members in accordance with their interests. If FP is dissolved prior to the death of the founder, there is no string remaining to which IRC Section 2036 could apply. In most cases a partnership or LLC can be dissolved without negative tax consequences. This alternative probably has no application to ongoing active businesses, and may not be appropriate for a real estate entity because the protection against liability may be lost.

Three-year lookback. In general, relinquishment of a problematic power under IRC Section 2036 may result in estate tax inclusion if the transferor who had the power dies within three years of the relinquishment. Some of the approaches in this Alert might result in the relinquishment of a prohibited power, but if the approach is for full and adequate consideration, the three year period does not apply. Accordingly, when considering which approach to use, the client's age and health should be taken into account.

We continue to believe that for active businesses and real estate entities that have been in existence for some time and had significant non-tax reasons for creation, the *Powell* case should have no applicability. In other cases, some of the approaches set forth in this Alert should be considered.

Please contact us if you wish to discuss your family partnership or LLC or to consider any protective actions.

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