Resolving the Mismatch of Estate Inclusion Value and Deduction Value

The changing value problem for FLP interests should not be overlooked, given its real potential to produce substantial estate tax liability upon the first spouse's death—even in the case of a well-structured and well-administered FLP that is not subject to Section 2036.

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Family limited partnerships ("FLPs") and limited liability companies ("LLCs") have received considerable attention from the IRS in the past several years, and the IRS has been successful in many cases attacking these entities—generally where the taxpayer has acted in an egregious manner. Despite the IRS's many successful attacks on these entities, most planners agree that these entities work to reduce value if properly structured, implemented and monitored. The ones that fail are those with "bad" facts[1] or where something was done wrong—for example, where the parties did not respect the existence and separateness of the entity.

Even if the entity was properly formed and maintained, however, many existing partnerships and LLCs have a latent defect regarding the conversion of these interests, pursuant to state law and the entity's governing instrument, into "assignee interests" that may not have been given adequate consideration in the context of marital deduction or charitable deduction planning. In the absence of corrective planning, many existing FLPs and LLCs could potentially expose to substantial estate taxes clients who do not expect to pay tax at their death because of the unlimited marital or charitable deductions.

In addition, planning for marital or charitable bequests of partnership or LLC interests has not been given adequate attention by advisors to protect against a mismatch of estate inclusion value and deduction value when dealing with closely held entities, including corporations as well as FLPs and LLCs. Illustrative of the latter problem is the situation where a decedent owns a controlling interest in an entity and the marital funding splits the interest so that the surviving spouse does not receive a controlling interest.[2]

Moreover, unless the FLP or LLC governing instrument is amended, in most instances the life insurance planning for married owners of these entities—particularly where one spouse is in control—may be improper because survivorship insurance has been sold with the expectation that the estate tax will be deferred.

Illustration. The problem involving a conversion to an assignee interest can be illustrated by assuming that a married male client has a two-thirds interest in a member-managed (to simplify the example) LLC worth $30 million. The client's

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estate plan has a will (or revocable trust), with a "reduce to zero" marital deduction formula provision. Most often, the life insurance component of the plan will be second-to-die insurance in an irrevocable life insurance trust ("ILIT").

The visceral reaction is that if the estate owner gives his entire interest in the LLC to his spouse, there is no estate tax. That conclusion, however, may be incorrect. In addition, because there is an estate tax exposure at the first death, the life insurance planning must be revisited. This article will examine (1) the technical reasons that there is estate tax exposure for transfers of FLP/LLC interests even though the decedent gives everything to his spouse in a qualified marital disposition; (2) how to cure the defect; (3) planning opportunities using FLPs/LLCs available after the defect is cured; and (4) why single life insurance can sometimes make more sense than survivorship life insurance from a wealth shifting standpoint.

The 'changing value' problem

The problem is that the valuation process and the asset being valued for estate tax *inclusion* purposes are different from what they are for *marital deduction* purposes. There is a mismatch between the inclusion value and the marital deduction value, and the differential will create an estate tax at the client's death. This result is quite counterintuitive and thus, deserves some technical discussion.

To place the change in value into proper perspective, we will first define "assignee" and then briefly set forth the technical analysis of the value differential for estate tax purposes. Sometimes, the disparity in value results in a benefit for the taxpayer, such as was obtained in *Chenoweth*.[3] In that case, the per share value was increased for marital deduction purposes to reflect a control premium when Mr. Chenoweth transferred a 51% interest in his corporation to his wife at death. The control premium increased the marital deduction. In most instances, though, a contrary result would occur, particularly in the FLP or LLC setting if the advisor has not taken into account the changing character of the FLP or LLC interest.

'Assignee' concept. Most advisors are familiar with the concept of an "assignee" interest in the context of creditor protection planning. Under state law, unless otherwise provided to the contrary, the transfer of a partnership or membership interest converts such interest to an assignee interest. The rights of an "assignee" are limited to receiving distributions, if and when made. There are no other rights. An assignee is not entitled to attend meetings, receive accountings, inspect the books, vote, or do anything except receive distributions. That's why the "assignee" interest has a significant role in creditor protection planning. The assignee concept also operates to reduce such interest's value

[1] See, e.g., Rosen, TCM 2006-115; Strangi, TCM 2003-145, *aff'd* 417 F.3d 468, 96 AFTR2d 2005-5230 (CA-5, 2005).

[2] This disparity may also result from the inclusion of "phantom assets" in the decedent's gross estate as a result of the application of Section 2036. A discussion of Section 2036 is beyond the scope of this article, which is intended to address FLPs that are Section 2036 compliant. For an extensive analysis of Section 2036 and the phantom asset marital deduction concerns, and possible solutions, where Section 2036 applies, see Matz, "Special Concerns in FLP Planning Where Both Spouses Are Living," 34 ETPL 16 (Jan. 2007).

[3] 88 TC 1577 (1987).

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because it carries less rights than does a partnership interest or membership interest.

The fact that the recipient of an assignee interest receives something of severely diminished value should also mean that the spouse receives an asset of compressed value and the amount of the marital deduction should be reduced accordingly. If we assume that the decedent's interest were worth $20 million at death, a 40% reduction would create estate tax exposure in our illustration on $8 million of "phantom value." Furthermore, because the typical life insurance product is a second-to-die policy, there is a mismatch as to the time the tax is incurred and the time the policy pays off.

It gets uglier. If the estate uses other assets to pay the tax, those assets are not available to fund the marital deduction. Moreover, this problem is not limited to estate tax planning entities. Business interests, real estate entities, and other assets put into a partnership or LLC wrapper for non-estate planning purposes are also at risk. Consider the typical real estate investment placed in an LLC wrapper by a real estate lawyer who is unaware of the transfer tax considerations. Another area that lends itself to this troublesome result is asset protection planning. For example, a popular asset protection structure is to integrate an LLC or FLP with either a domestic or foreign asset protection trust, where the estate owner retains the control for managerial purposes. This structure is subject to the changing value transfer tax exposure.

We have often encountered LLCs where one spouse owns 51% and the other spouse owns 49% of the entity, or FLPs where one spouse is the general partner ("GP") for family control purposes, or perhaps a bank or other lending institution required control in the working spouse. These structures are also at risk. In fact, even aside from the risk posed by IRC Section 2036, in the absence of protective planning, if the majority owner dies first leaving all to the survivor, there could be taxes due on the valuation disparity at the first death and a tax on 100% of the value of the entity when the survivor dies, unless the marital disposition is to a QTIP trust.[4]

Solution

FLP and LLC forms can be changed (and existing FLPs and LLCs should be amended) to provide that a distribution at death to a spouse, or to charity, of an interest in the entity retains its character and does not become an assignee interest. Alternatively, the entity's governing instrument can provide that the spouse (for testamentary transfers)[5] and charities would be "permitted transferees," and thereby prevent any "downgrade" to assignee status upon the transferee's execution of a joinder agreement. Therefore, the asset that passes to the spouse, or charity, would be identical to what the decedent owned and the valuation differential would be eliminated. Elimination of the valuation disparity will, however, have a ripple effect, since the asset owned by the recipient spouse (or marital trust) will be includable in her estate as a control interest in the absence of additional planning.

Planning—Turning a lemon into lemonade

Instead of the adverse tax consequences, we can take advantage of valuation changes and achieve some fantastic beneficial tax results.

For example, upon receipt of the marital gift, the surviving spouse can take advantage of the valuation disparity between the gift and estate taxes. Thus, a transaction that achieves significant tax benefits is for the survivor to sell the interests in an LLC to income tax defective trusts in a manner that obtains a valuation discount for the assignee interests transferred.

The planner should make sure that there is more than one sale so that noncontrolling interests would be transferred. That would finesse the result in Section 2704(a), which deals with lapsing rights, imposing a gift tax if a control interest were transferred even though the recipient would receive only an assignee interest.[6] Hence, the advisor would want to be sure that the interests transferred are minority interests. For example, if the clients have two children, two separate ILITs would be created, each acquiring 30% noncontrolling assignee interests.

A transfer of the 60% interest in a single sale would expose the transaction to a gift of the difference between the control value and the noncontrol value at the time of the transfer.[7] Section 2704(a)(1), which provides that the lapse of liquidation or voting rights will be treated as a transfer by the transferor whether the transfer is at death or during life, and Reg. 25.2704-1(a)(4), which includes lapses by reason of state law, will create a tax if an interest which previously was a control interest is transferred.[8] The legislative history[9]

4 See Estate of Bonner, 84 F.3d 196, 77 AFTR2d 96-2369 (CA-5, 1996); Estate of Mellinger, 112 TC 26 (1999), *acq.*

5 This is to prevent the passing of an interest if made on account of divorce or separation.

6 See Field Ser. Adv. 2000-49-003 (9/1/00, released 12/8/00), in which the IRS announces its theory that the conversion of an LLC member's interest into an assignee interest is a lapse of a voting right resulting in a transfer under Section 2704.

7 Section 2704(a).

8 If the IRS were to prevail on its position that a lapse of voting rights causes a transfer under Section 2704, the gift tax exposure—if a noncontrolling interest is transferred—should be limited to the valuation differential between a noncontrolling interest in an LLC and an assignee interest, which members of the appraisal community have advised us is negligible. Moreover, pursuant to Rev. Rul. 93-12, 1993-1 CB 202, the gifts should not be aggregated for purposes of Section 2704.

9 Conf. Report at 1137.

provides that the lapsing rights rules do not apply to minority or other discounts available under prior law, which should provide a safety net to the transferor.

The combined selling price would be $12 million in our example, reflecting the fact that assignee interests are being sold. As a result, $8 million would be removed from the transfer tax system, hopefully into a trust which is generation-skipping transfer ("GST") tax-exempt. The $8 million value which evaporated as a result of the differential between transfer tax systems also escapes the GST tax system, and—inside a properly drafted dynastic trust—provides perpetual transfer tax, divorce and creditor protection for the descendants.[10]

Typically, estate planners use life insurance trusts which own single life policies on the original estate owner to acquire the entity interest from the decedent's estate, or from the surviving spouse. The life insurance proceeds are used to fund the purchase of such entity interest, often at a discount to reflect the lack of control and lack of marketability of the entity interest.

All too often, however, clients and advisors think survivorship insurance is the answer without looking at the economics of single life policies. The use of a single life policy in this instance can be far better because of the leverage it offers.[11] In such instances, the trust is buying the assets at a discount as well as moving post-purchase appreciation out of the estate. Because the assets of the LLC are often "hot assets" (such as a growing business) which are expected to have substantial appreciation, a wealth shift from the transfer tax system soon after the death of the first spouse will achieve significantly more wealth preservation benefits than transferring the LLC interests after the second spouse dies. This type of planning is particularly important where the client seeks to preserve the family business or other significant assets such as real estate holdings, and shift them from the transfer tax system.

The wealth shift advantage of the sale is magnified because of the differences between the estate and gift tax systems. In addition to the valuation benefit of converting from a control block to a noncontrolling interest, generally, the ILIT's should be dynastic trusts exempt from GST tax, and increasing the leverage of the GST tax exemption.

Another meaningful benefit of the transaction outlined above is based on the fact that the estate tax is tax-inclusive and the gift tax is tax-exclusive. If the spouse dies with a controlling interest worth $20 million, the estate would need to be $40 million (assuming a 50% estate tax) in order to pass the LLC interest intact. Conversely, the removal of $8 million from the transfer tax system would require only $24 million to be subject to the transfer tax system. Furthermore, in many instances the spouse would have invested the cash in liquid assets which could be sold to pay the tax.

Estate inclusion value. For inclusion purposes, the estate is valuing a two-thirds controlling interest in the LLC as it existed in the hands of the decedent, ignoring the change in character to an assignee interest in the hands of the recipient.[12] Using the hypothetical "willing-buyer, willing-seller" test set forth in the Regulations,[13] that interest should receive a discount for lack of marketability, perhaps with some offset because it is a control interest.[14] If we assume (to simplify the math) that the control premium and the discount for lack of marketability are equal (and thereby will offset each other), the value for estate tax inclusion purposes of the controlling interest will be $20 million since the change in value occasioned by death will be ignored.

Marital deduction value. On the other hand, the marital deduction is measured by the value of what is passing to the spouse.[15] Unless the LLC agreement provides otherwise, the asset passing to the spouse under state law is an "assignee" interest—not an LLC "member" interest, and its value should be determined accordingly. If we assume that the value of the assignee interest should be reduced by 40% due to its restrictive nature, the value of the interest passing to the spouse is $12 million.

Charitable deduction planning. The changing value problem also occurs in the charitable deduction area, including for outright transfers as well as for charitable lead trusts. Those planners who use testamentary charitable lead annuity trusts ("CLATs") in conjunction with FLPs and LLCs either to zero out the tax, or to define the tax exposure, need to examine that planning in light of the potential changing value problem inherent in those entities. The estate tax expo-

[10] R. Oshins and Kasner, "The Dynastic Trust Under the Relief Act of 2001," Tax Notes (10/8/01).

[11] See D'Addona, "Survivorship Life Insurance—Is It Always the Right Solution?," Million Dollar Roundtable, Proceedings of the 2004 Annual Meeting (2004); Blattmachr, Ross, and Slade, "Rethinking the Use and Ownership of Survivorship Insurance," The Chase Review (Jan. 1992).

[12] Sections 2031, 2033, and 2704(a). Section 2704(a) states, in relevant part: "(I)f there is a lapse of any voting or liquidation right in a corporation or partnership...such lapse shall be treated as a *transfer* by such individual by *gift*, or a *transfer* which is includible in the *gross estate*....the amount (is) the value....before the lapse....over....the value immediately after the lapse" (emphasis supplied). The Regulations provide that the "transfer" pursuant to Section 2704(a) is applicable even though the transformation occurs by reason of state law. Reg. 25.2704-1(a)(4).

[13] Reg. 20.2031-1(b).

[14] Section 2704(a); Reg. 25.2704-1(a)(4).

[15] Section 2056(a).

sure as a result of the "changing value" imbroglio is similar to what occurred in *Ahmanson Foundation*,[16] where stock transferred by the decedent to his charitable foundation was discounted from its estate tax value because a noncontrolling interest was given. Other than the foregoing caveat, charitable deduction planning discussion is beyond the scope of this article.

Basis bump-up: A valuable commodity

An often overlooked aspect of the estate planning process is the integration of the effect that a certain plan of action has on the income tax basis of an asset and what protective solutions could be used to obtain (or possibly obtain) favorable results in both. The following items should be factored into this analysis: the rate differentials; the time the tax might be incurred; the fact that an inter vivos gift would be beneficial because of the various distinctions between the gift tax and the estate tax systems; the wealth shifting benefits of the income tax defective trust; whether there is depreciable property; and whether the property will be sold.

In planning with FLP and LLC interests, both the results and the complexity are expanded because the basis of the entity and the inside basis are affected. Where the property owned by the entity is low basis or negative basis assets, the importance of getting a basis step-up is magnified.

Basis for decedent's interest in the entity (outside basis). The basis of the interest in the entity would be adjusted to the estate tax value.[17] For interests where the estate tax value exceeds the decedent's basis, the bump-up in outside basis will be beneficial upon any subsequent taxable disposition of the interest in the entity.

Inside basis. An election under Section 754 may be made to adjust the basis of the property owned by the entity that is attributable to the decedent's interest in the entity. An increase in basis is desirable upon disposition of the property, particularly where the property is depreciable. The ability to obtain a basis step-up for low basis or negative basis assets is quite a substantial advantage, and avoids the lock-in effect inherent in holding such an asset and/or enables the recipient to start the depreciation process again—a very valuable income tax benefit. The asset that would most benefit from the basis bump-up is highly depreciated, or low or negative basis, real estate.

Integrated planning. Interestingly, the desired result for income tax purposes is that the appraiser conclude that the decedent's interest had a control premium, and very little discount, so that both the outside, as well as the inside, basis adjustments are higher. If the recommended planning of increasing the value of the entity for marital deduction purposes is adopted, such increase would not have any adverse effect for transfer tax purposes, since the surviving spouse will still be receiving assets identical in value to what was included, thereby negating any adverse transfer tax implications. Accordingly, in our illustration, if the estate tax value for inclusion purposes is $22 million (considering a 10% control premium and no discount), the marital deduction would also be $22 million; the basis would reflect the higher valuation.

The surviving spouse's subsequent disposition of noncontrolling interests would, however, result in discounts for both lack of control and lack of marketability. Moreover, if the survivor sells to a trust which is income tax defective to the survivor, the higher basis would be maintained.

Structuring the ILIT

For simplicity purposes, the following discussion assumes that the trusts acquiring the assets from the spouse (or the trustee of the marital deduction trust) own life insurance which will be sufficient either to acquire the assets or to make a down payment on an installment purchase of the entity interests. Acquiring at least some life insurance on the estate owner is the more probable course of action for most clients, although the transaction can also be accomplished without life insurance, using cash, an inter-

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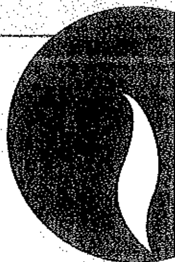

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[16] 674 F.2d 761, 48 AFTR2d 81-6317 (CA-9, 1981).

[17] Section 1014(b)(9).

est-only note, a self-canceling installment note ("SCIN"), a private annuity, or some variation or combination of these forms of payment. Certainly, the multiple leverage advantages of life insurance on the estate owner, if he were to predecease his spouse, would enhance the overall family wealth planning, including increasing the comfort of the spouse in most instances.

Structuring the trust to maximize the family tax benefits is somewhat counterintuitive. There are three basic options: (1) the insured is the grantor ("Traditional ILIT"); (2) the spouse is the grantor ("Spousal ILIT"); or (3) the ILIT is created and funded by a third party, such as a parent or grandparent ("Inheritor's ILIT"). In each instance, the ILIT should be exempt from GST tax, accentuating the planning benefits perpetually.

In analyzing the foregoing options, there are two potentially significant virtues that should be considered by the planner:

1. Will there be a "tax burn" effect on the spouse's estate—i.e., will income earned by the ILITs diminish the spouse's taxable estate as a result of her paying income tax incurred because of the trust's grantor trust status as to her; and
2. Are the assets of the ILITs available to the surviving spouse if she needs them?

In many instances, the virtues of the Spousal ILIT or Inheritor's ILIT can be superior to the Traditional ILIT and should be strongly considered if at all possible. As a general proposition, if the ILIT continues to be income tax-defective following the death of the insured, we can achieve greater results for the family. The ability to use those vehicles is, however, fact-driven because the spouse (for the Spousal LIT) or a third party (for the Inheritor's ILIT) must have the wherewithal and the willingness to set up the transaction. Despite the foregoing, the discussion must be considered in proper perspective. All three of the options will result in significant tax benefits, including having the value of the discount disappear from the transfer tax base and freezing the survivor's estate; however, some choices offer superior planning opportunities.

Practice Notes

In the absence of corrective planning, many existing FLPs and LLCs can potentially expose to substantial estate taxes clients who do not expect to pay tax at their death because of the unlimited marital or charitable deductions.

Traditional ILIT. Typically, life insurance trusts are set up by the insured. Let's assume it is the husband. At the death of the husband, the trust is no longer a grantor trust, reducing the postmortem benefits that might otherwise be obtained.

Tax burn. Because the income from the Traditional ILIT will not be taxed to the spouse, there is no depletion in the spouse's estate. With larger estates, where the spouse is otherwise financially secure, a valuable potential planning opportunity is wasted if a Spousal ILIT is not used. In contrast, as later described herein, the use of an Inheritor's ILIT would reduce the estate by the income tax payments and, in addition, the spouse would not have eco-

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nomic risk because she could be a beneficiary of the Inheritor's ILIT as well as a trustee.

Spousal security. The Traditional ILIT, if the spouse is a beneficiary, will, however, offer the spouse financial security.

Spousal ILIT. The simpler method of creating and funding a trust that is defective to the wife is for the wife to set up the trust and retain powers which would create grantor trust status to her. Because it is essential that the trust does not contain powers which will expose the trust to estate tax inclusion in her estate, the wife's powers in the trust must be restricted and she cannot be a beneficiary or trustee of the trust or retain the right to make any changes to the trust. In the appropriate situation, the tax burn will be desirable because it is the functional equivalent of a tax-free transfer to the trust. Conversely, because the spouse cannot be a beneficiary of a trust she creates, many clients will not select this option. Moreover, the "tax burn" effect will increase the risk to the spouse's security, unless a tax reimbursement clause is used.[18]

Inheritor's ILIT. The Inheritor's ILIT can provide the ideal solution because it satisfies the dual objectives of spousal participation and tax burn. A third party (e.g., parent, grandparent, etc.) can set up the trust giving the wife a power of withdrawal which will cause the wife to be treated as the income tax grantor as to the entire trust under IRC Section 678.[19] Because the trust is created and funded by a third party, the wife can be a beneficiary and a trustee of the trust without inclusion in her estate. The ability to use this alternative can be problematic, however, unless the clients are able to identify someone who is willing and able to set up a trust for them. The ideal candidates for this structure are clients with business or investment opportunities that require negligible seed money.

The result of this planning can be "to turn lemons into lemonade" by shifting substantial wealth to GST tax-exempt and estate tax-protected grantor trusts that can grow unimpeded by capital gains tax attributable to the sale of FLP interests to them, and by any income taxes whatsoever during the life of the surviving spouse. Moreover, through proper structuring of the ILIT trust instruments—such as by giving the primary beneficiary of each trust removal and replacement powers over the trustee[20]—this can be even better than outright ownership because the beneficiaries of these GST tax-exempt and estate tax-protected grantor trusts would be afforded outstanding creditor and divorce protection that would be unavailable to them had they owned the FLP's property outright.[21]

Conclusion

The changing value problem for FLP interests should not be overlooked, given its real potential to produce substantial estate tax liability upon the first spouse's death—even in the case of a well-structured and well-administered FLP that is not subject to Section 2036. This estate tax risk can be avoided by employing the techniques described in this article—and this should be done in tandem with managing the Section 2036 risk. In conjunction with addressing these risks, the planner should also consider funding one or more ILITs with single life policies to take maximum advantage of the outstanding leveraged transfer opportunities that can be presented following the first death through GST tax-exempt grantor trusts that are both estate tax- and creditor-protected.

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[18] In planning for the reimbursement clause, care must be exercised taking into account applicable state law to confirm that the tax reimbursement clause is fully compliant with Rev. Rul. 2004-64, 2004-2 CB 7.

[19] One of the exceptions to general power of appointment treatment under IRC Section 2041 could be used for this purpose. A discussion of such approaches is beyond the scope of this article.

[20] These trustee removal and replacement powers should be subject to the safe harbor set forth in Rev. Rul. 95-58, 1995-2 CB 191, to prevent a removed independent trustee from being replaced with a beneficiary or certain related or subordinate parties within the meaning of Section 672(c).

[21] See R. Oshins and Ice, "The Inheritor's Trust: The Art of Properly Inheriting Property," 30 ETPL 419 (Sept. 2003).