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**ADVANTAGES OF FAMILY LIMITED PARTNERSHIPS  
AND FAMILY LIMITED LIABILITY COMPANIES  
WITHOUT REGARD TO VALUATION DISCOUNTS**

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## **ADVANTAGES OF FAMILY LIMITED PARTNERSHIPS AND FAMILY LIMITED LIABILITY COMPANIES WITHOUT REGARD TO VALUATION DISCOUNTS**

Let us imagine that Congress and all the state legislatures suddenly adopted “look-through” and family attribution rules that in effect prohibited any transfer tax valuation discounts for gifts or bequests of interests in family limited partnerships and family limited liability companies (hereinafter, collectively, “FLEs”). Even in that unlikely scenario, there would still be compelling reasons for many well-to-do families to pool a large portion of their business and investment assets in that form.

·First, in the absence of complete “death tax” repeal, there would still be potential transfer tax advantages to donors in gifting assets during their lives, at least up to the amount of their lifetime gift tax and GSTT exemptions plus the annual and educational/medical expense exclusions. This would continue to be true so long as there was any progressivity built into the remaining federal and state “death tax” rates. With increased marginal rates at higher levels of wealth, transfers deferred until the donors’ deaths might well exceed by a large margin the applicable exclusion amount at that time and be subjected to higher and higher rates of tax the greater that margin. And, while this analysis of the potential transfer tax benefits of lifetime gifting holds true regardless of the form of the gifts, properly structured FLEs provide donors with the unique opportunity to move most of their business and investment assets out of their taxable estates before their deaths – while retaining substantial shared control over those assets.

The point, to be more precise, is that although trusts are the traditional means of controlling the use of property after a gift, it is certain that the degree of discretionary donor control long recognized as allowable in the context of an FLLE would not be allowable in the case of a trust (without drawing the gifts back into the donor's estate under I.R.C. §§2036(a) and (b) and §2038). This key difference in allowable retained control is a principal point of David Lewis's and Chris Jones's excellent article in the January/February 2004 issue of Probate and Property, entitled "Limited Liability Companies as Trust Substitutes, Part 2."

·Second, even if all transfer taxes (not merely valuation discounts) were repealed, there would still be income tax benefits to the well-to-do family donor in making family gifts of interests in an FLLE as opposed to, say, interests in a trust. This is because of the basic Family Partnership recognition rule of I.R.C. § 704(e), that the gift of an FLLE interest "shall be recognized" for income tax purposes so long as it involves a "capital interest in a partnership in which capital is a material income-producing factor." In contrast, the Grantor Trust rules of I.R.C. §§671-679 are designed to cause the recognition of trust income by the grantor in almost all instances of grantor control over a trust. (Moreover, the undistributed income of complex trusts is generally taxed at much higher rates than the undistributed income of FLLEs.)

·Third, not only do FLLEs permit greater control by the donors than do trusts, without adverse transfer or income tax consequences, but they also permit almost unlimited flexibility in the form of possible future amendments that irrevocable trusts, by definition, cannot (with all due respect to independent trust "protectors").

·Fourth, FLLEs provide greater asset protection than do trusts against the claims of creditors of the donors. The general rule in the United States is that all the present or

future creditors of the settlor of a trust may attach all the trust assets to the extent that the trustee has any discretion to distribute income or principal to the settlor or the latter holds a power of appointment over the trust assets. This is true even though the trust is irrevocable, and its funding does not involve a fraudulent conveyance. By contrast, at least in the absence of a fraudulent conveyance, the creditor of the donor/controlling person of an FLLE may not attach any assets belonging to the FLLE and may only have the dubious benefit of a “charging order” upon distributions with respect to the donor’s retained ownership interest (and not the ownership interest of any other member or partner). As this Committee will recall, last spring, we considered the partial exception made by various domestic asset protection trust statutes for asset transfers where the transferor retained only a completely discretionary income interest – in the discretion of an independent trustee. However, in the case of FLLEs, the exception swallows the rule because the donor may be the sole controlling person (at least if estate tax avoidance is not then a major concern) and may have almost unfettered discretion to make distributions to himself or herself – or not to make any distributions – and yet none of the donor’s interest will be subject to the claims of creditors until those distributions occur and the assets thus come out of the FLLE solution.

Fifth, FLLEs, like other limited liability ventures among unrelated investors, enable multiple partners or members to pool their resources and efforts in pursuit of the most profitable business or investment opportunities, with centralized management and economies of scale (and diversification) but without personal liability. Gift trusts, as opposed to business trusts, rarely if ever involve such a pooling, and for the same reason may not bring forth the same level of overall family involvement and cooperation as an FLLE.

Again, because of their inherent flexibility, FLLEs are more readily adaptable than trusts to management changes within the family, as for example, the takeover by younger

family members of a particular family business or investment portfolio. Indeed, in the wake of Strangi III, the devolution of primary control of the FLLE itself upon other members of the donor's family, a transition that can easily be accomplished either quickly or gradually due to the flexible nature of FLLEs, may be necessary to realize all the potential transfer tax benefits of an FLLE.

·Sixth, because of their consensual nature, FLLEs can and usually do require the binding arbitration of any internal disputes between or among their members – a requirement that trusts may not impose on trust beneficiaries. Quick, effective and confidential property dispute resolution among members of a family is almost always preferable to litigation.

·Finally, FLLE members may be subjected to much the same sort of restrictions upon the transfer or hypothecation of their interests as the “spendthrift,” anti-alienation provisions commonly imposed upon the beneficiaries of trusts. Thus, they may be prohibited from withdrawing from the FLLE (after having joined it) and from transferring their interests in it outside of the family group. FLLEs are, in short, an excellent means of keeping family wealth within the family as well as protecting and increasing it while it remains there.

Some of the recent state legislative changes authorizing the most extreme restrictions upon withdrawals and transferability may have been prompted in part by the technical requirements of securing legitimate valuation discounts for gift transfers to family members. By making continual membership in an FLLE the “default rule” in the absence of contrary provisions, for example, they have avoided the characterization of a withdrawal prohibition as an “applicable restriction” within the meaning of I.R.C. § 2703. However, the larger effect of these and other related changes has been to make these entities in general more “family-friendly” and protective of family wealth.

In conclusion, just as trusts served essential legal functions a thousand years before the federal transfer tax system, and will continue to serve those same functions long afterward, FLEEs, too, are in many cases an essential element of a proper estate plan, regardless of transfer tax considerations.