

Family Partnership Rules of Code Sec. 704(e) and New Code Sec. 199A

By *Martin M. Shenkman, Esq., Jonathan G. Blattmachr, Esq., Alan S. Gassman, Esq., Joy Matak, Esq.*

Introduction to Code Sec. 704(e)

Family limited partnerships and limited liability companies taxed as partnerships (collectively referred to as “FLPs”) have been ubiquitous in estate and asset protection planning for decades. The focus has historically been creating discounts in valuation for estate and gift tax purposes. Less value generally means less estate or gift tax. With the doubled transfer tax exemptions under the Tax Cut and Jobs Act of 2017 (P.L. 115-97) to over \$11 million per person, and over \$22 million for each married couple, most clients will have little use for the discount that had propelled FLPs toward the top of the estate planning agenda. But, rather than dismissing FLPs under the new tax re-

gime, practitioners should continue to use them in many situations as a keystone of asset protection planning. Also, FLPs will be important to evaluate considering the new 20-percent deduction afforded pass-through entities under Code¹ Sec. 199A. This latter application of FLPs will require, in some instances, that practitioners consider the provisions of the family partnership rules. Code Sec. 704(e) and the regulations thereunder are essential components of estate and income tax planning for family entities. The temporary doubling of the exemptions by the Act has not affected their importance for controlling, protecting and passing through investment and business assets in succession planning to heirs.

Overview of Code Secs. 704(e) and 199A

While the new 20-percent deduction for pass-through entities under new Code Sec. 199A has received much attention, how might that provision interact with the family partnership rules of Code Sec. 704(e) and the regulations thereunder, which prevent allocating income from a gifted or bargain sale partnership interest to a family member if certain requirements are not met? Code Sec. 704(e)(2) states:

For purposes of this subsection, an interest purchased by one member of a family from another shall be considered to be created by gift from the seller, and the fair market value of the purchased interest shall be considered to be donated capital. The “family” of any in-

Mr. Shenkman is an estate planning attorney practicing in Fort Lee, NJ. See his blog posts on <https://www.shenkman-law.com>. Mr. Shenkman is also a member of the Wolters Kluwer FINANCIAL AND ESTATE PLANNING Advisory Board.

Mr. Blattmachr is a senior advisor at Pioneer Wealth Partners.

Mr. Gassman is an attorney, author, and speaker in the areas of estate planning and tax law and is the founder of Gassman, Crotty, & Denicolo, PA, an estate planning law firm based in Tampa Bay, Florida that specializes in personal and corporate planning for physicians. Mr. Gassman is the author and co-author of a number of books on estate planning, taxation, and creditor protection, including *The Annihilation of Wealth 2013* (co-author with Erica Good Pless).

Ms. Matak, is the Co-Leader of the CohnReznick Trusts and Estates National Practice and has significant expertise providing her clients with diverse wealth transfer strategy planning. Joy also performs tax compliance and consulting services related to asset protection, business succession, life insurance structuring and post-mortem planning.

Wolters Kluwer DRAFT

While you may be tempted to jump in response to the new law, it's a good idea to avoid making a rash move, especially if it involves your end-of-life planning.

"People should not make simplistic decisions without a broad analysis of their circumstances, the new law, the economics and everything else," Shenkman said.

Picking a life insurance policy

Life insurance policies last a long time, while tax laws come and go, so if you're in the market for life insurance, it's important to broadly consider your options.

Permanent life insurance policies, which double as investment vehicles, are meant to last your whole life (so long as you're paying premiums). Term life insurance policies, which cost less, last for a fixed period of time, usually 5 to 30 years. They're meant to provide a financial cushion to your family, in the event of your death, while they're dependent on your income. Our Policy geniuses can help you figure out what life insurance policies are best for you, but, if you're not ready to pull quotes, here's a crib sheet to deciding between term or whole life insurance.

Image: macniak

Related Topics: Taxes, News

dividual shall include only his spouse, ancestors, and lineal descendants, and any trusts for the primary benefit of such persons.

However, in the context of a bargain sale, perhaps the term “donated capital” would be equivalent to the amount of capital actually contributed by the purchaser.

The Conference report provides that, with respect to high earner taxpayers with flow through entity income, “the wage limit applicable to taxpayers with taxable income above the threshold amount is the greater of (a) 50 percent of the W-2 wages paid with respect to the qualified trade or business, or (b) the sum of 25 percent of the W-2 wages with respect to the qualified trade or business plus 2.5 percent of the unadjusted basis, immediately after acquisition, of all qualified property.” It might be advantageous for a client to transfer qualified business (QB) interests to a family member, such as a child, who has taxable income below the threshold in order to maximize the 199A deduction. Doing so, if the entity is a partnership or LLC taxed as a partnership would also have to pass muster under the Code Sec. 704(e) rules for that donee to be recognized as the owner of the partnership interest. With the new doubled estate tax exemption, there will be considerable incentive to make such gifts for income tax planning purposes. The concepts of “capital” under each provision, 704(e) and 199A also are quite different.

Code Sec. 704(e) and Actual Ownership; Capital as a Material Income Producing Factor

For gifts of FLP interests to be respected for purposes of shifting FLP income to the donee, the LLC will be tested under the provisions of Code Sec. 704(e), the family partnership rules. A failure to meet these tests could result in a portion or all of the LLC income being taxed to the transferor member rather than to the donees of the FLP interests (e.g., the transferor's children). This might result, post-Act, in the loss or reduction of the Code Sec. 199A deduction. The Code Sec. 704(e) rules are designed to ensure that the allocation of partnership income follows economic reality, with capital assets being required to be held under the partnership entity

if ownership and interests are to be shifted. Capital must be a material income-producing factor in the partnership (Code Sec. 704(e); Reg. §1.704-(e)(1)(ii)). This requirement is, perhaps, most easily met for transactions involving the transfer where real estate properties and other valuable assets are owned by the FLP, since capital is usually the material income producing factor in a real estate investment. Other transactions may be less certain. The donee members (e.g., the transferor's children or other heirs) must be the real owners of the capital interests given to them (Code Sec. 704(e)(1)). The donee members must have genuine interests in the FLP. They must be entitled to receive a portion of the assets on withdrawal from the LLC, and they must be able to transfer their interests in the LLC without financial detriment. These requirements are based upon the premise that the donees are the real economic owners of their capital interests in the FLP. The donees must have dominion and control over their FLP interests (Reg. §1.704-(1)(e)(2)(i)). This should be evidenced in the transfer documents, governing documents and actual operations of the FLP.

These provisions may conflict with the transferor's desire to control the FLP interests and the income actually received by the donee of the FLP interest. Where trustees or minors are partners, a special ownership test is applied. The transferor member of the FLP should not have unrestricted authority to establish reserves, pay himself or herself fees, or otherwise unreasonably influence the proper flow of income to the donees. The greater the control that the general partner (manager or controlling member) can exercise over distributions, and the more restrictive the donee non-controlling partner's (member's) rights are to realize the value of his or her interest, the greater the likelihood that the donee may not be recognized as a partner (member) for income tax purposes (Reg. §1.704-1(e)(2)(ii)). If the donee is not recognized as the partner then he or she may not be able to qualify for the Code Sec. 199A 20-percent deduction.

Care should also be taken to assure that the general partner or manager's powers are not so broad so as to prevent the technical completion of the gift, or to otherwise cause estate tax inclusion of the FLP interest transferred in the parent's/donor's estate. Cf. *N. Powell Est.*, 148 T.C. —, No. 18, Dec. No. 60,901 (2017). This issue is closely related

to the question as to whether or not the gift of an FLP interest qualifies as a gift of a present interest, under Code Sec. 2503(b). See, e.g., *A. Hackl, Sr.*, 118 T. 279, Dec. 64,686 (2002), *aff'd*, CA-7, 2003-2 USTC ¶60,464, 335 F.3d 664.

Code Sec. 704(e) Background

Code Sec. 704(e) was enacted to prevent taxpayers from using FLPs as a vehicle to shift income from higher bracket to lower bracket income taxpayers in abusive situations. To the extent that a donor has given ownership of the FLP that qualifies as a qualified business ("QB") under Code Sec. 199A, income (after a fair salary for services) should appropriately be allocable for tax purposes to the donee. However, to the extent that the donor did not part with control and ownership of the interests, any such allocation may not be respected and if the income is reallocated back to the donor then the donor's taxable income brackets, as opposed to the donees, may be applied for Code Sec. 199A purposes. In all events, however, the FLP income attributable to the uncompensated services rendered by the donor should not be allocable to the donee (and, therefore, should not be taxable at the donee's lower tax bracket, nor subject to the donees taxable income for 199A calculation purposes). Code Sec. 704(e) establishes rules to make these distinctions.

Capital Interest Requirement

Code Sec. 704(e) achieves the above goal of protecting the integrity of the income taxation of partners with essentially a three-part test, the first of which is that a donee will be recognized as a partner for federal income tax purposes if he or she owns the capital interest in the FLP and capital is a material income producing factor in generating FLP income. The ownership via partnership interests of "substantial" inventories, or "substantial" investment in plant or equipment, should satisfy the requirement that capital is a material income producing factor. If the FLP does not own significant capital, and the donor renders management or other services, then capital may not be a material income producing factor and the income of the FLP may be "principally" generated by the rendering of personal services, in which event

capital would not be a material income producing factor and income otherwise taxable to the donee will instead be taxable to the donor who no longer owns the interest.

There is little law to define the critical term "substantial" or "principally." Thus, practitioners structuring transactions and drafting documents need to be cognizant of these rules in order to support the positions necessary to achieve the intended tax results. New Code Sec. 199A seems to embody a similar concept. The Conference report provides: "The conferees expect that the reduced threshold amount will serve to deter high-income taxpayers from attempting to convert wages or other compensation for personal services to income eligible for the 20-percent deduction under the provision." While the concepts of Code Secs. 704(e) and 199A might be similar, it is not clear how the Code Sec. 199A rules will be applied in this regard. Concepts similar to Code Sec. 704(e) may be used, or new tests may be developed, but in any event the Code Sec. 704(e) rules provide a useful framework for practitioners to consider, and for FLPs the 704(e) rules will have to be contended with when applicable.

The requirement for capital in an entity taxed as a partnership can raise difficult issues with respect to common asset protection planning steps of fractionalizing ownership interests in separate entities. It has long been common to segregate real estate into a separate FLP and lease it to the operating company in order to insulate the valuable but passive real estate asset from business claimants, as well as to achieve other estate planning goals (e.g., children not in the business can own the real estate FLP, while children in the business own the operating entity). This type of planning is often carried out by having expensive equipment owned in a separate leasing entity (e.g., an S corporation owning the truck fleet to insulate other assets from the considerable liability risk). Finally, intangible assets may be structured to be held in separate entities which license these rights back to the operating company (e.g., web site, domain name, telephone number, logo, etc.). This type of planning can be used to affirmatively address the Code Sec. 704(e) issues if the planning is to have the children/donees own interests in the real estate, equipment and intangible FLPs in which capital is likely to be a material income producing

Wolters Kluwer DRAFT

factor. However, this type of planning may inadvertently prevent allocations to children/donees of the operating company, which is now devoid of significant capital, from being respected. Similar planning may be used to bifurcate income in specified services businesses ("SSBs") which generally does not qualify for deduction under Code Sec. 199A and non-SSB income which may qualify.

Services

If the donor renders services to the FLP, reasonable compensation must be paid for those services or it probably will be imputed for purposes of Code Sec. 199A, thereby reducing the qualified business income which may be deductible in whole or in part. As noted above, Code Sec. 199A seems to embody similar concepts. In the above example, the FLP would have to allocate/pay the donor a fair or arm's-length compensation for management or other services. (Note, however, the salary paid to the owner of a business will constitute W-2 wages which is used, in some circumstances, to determine the deduction under Code Sec. 199A.)

Example: The enterprise is a real estate endeavor for which a local real estate management company would provide all these services for an all-inclusive fee of 8 percent of gross rents. That may be a reasonable benchmark for compensation to the donor. The reality of many FLPs in today's environment is the opposite of the circumstances leading to the enactment of Code Sec. 704(e). Reasonable compensation would appear to have to be allocated before the deduction under 199A can be calculated because the income otherwise constituting qualified business income may be reduced by the amount of such compensation?

The Conference report provides the following:

"Qualified business income does not include any amount paid by an S corporation that is treated as reasonable compensation of the taxpayer. Similarly, qualified business income does not include any guaranteed payment for services rendered with respect to the trade or business, and to the extent provided in regulations, does not include any amount paid or incurred by a partnership to a partner who is acting other than in his or her capacity as a partner for services."

Facts and Circumstances

The above tests are all to be applied with consideration of all the "relevant facts and circumstances" (Reg. §1.704-1(e)(2)).

Donor Must Not Retain Excessive Control

If the donor retains excessive control over the FLP without having strict fiduciary obligations, then the donee/child will not be recognized as a partner for federal income tax purposes. Reg. §1.704-1(e)(2)(ii) identifies certain "controls of particular significance ... as tending to show the lack of reality of the partnership interest of the donee." Further, when the interests in the partnership are transferred to a trust, unless the trustee is independent of the grantor, the controls retained by the trustee will be subject to additional scrutiny to ensure that the trustee "actively represents and protects the interests of the beneficiaries in accordance with the obligations of a fiduciary and does not subordinate such interests to the interests of the grantor." (Reg. §1.704-1(e)(2)(vii)).

In *F. Miller*, CA-6, 53-1 USTC ¶9261, the U.S. Court of Appeals for the Sixth Circuit reversed the Tax Court's conclusion (Dec. 16,784(M), 8 TCM 26) that donors who contributed partnership interests to trusts for their children did not intend to create a bona fide partnership because the donors were the trustees of the trusts. The court pointed to the substantial efforts that the Millers made to give effect to the transfers in trust for the benefit of their children, such as registering the trusts with the Commonwealth of Pennsylvania, changing the business name on all official documents, and obtaining the appropriate tax stamps as required in the name of the partnership. Because the Millers were also the trustees of the trusts for their children, the Court closely scrutinized the controls retained under the trust agreements and the partnership agreement. In concluding that the Millers had not retained any rights of control over the partnership interests except in their fiduciary capacity, the Court upheld the arrangement and determined that the trusts were valid owners of the partnership interests transferred.

In contrast, the IRS determined in a private letter ruling that a trust could not be considered a partner where a trust contained a provi-

sion that might reasonably permit distributions to the grantor and also provided that the trustee would only be paid book value for the partnership interest and not fair market value. The IRS also found the fact that the trustee had never actively participated in partnership affairs as fatal in concluding that the income should be taxed to the donor under Code Sec. 704(e)(2) (IRS Letter Ruling 8030015).

The “reality” of ownership is an important consideration. The donor should not retain excessive control over the distributions of profits. For example, if a parent/donor can only retain income in the FLP for the “reasonable needs of the business,” that may be respected. Actual distributions of income to the FLP’s owners may be evidence of the donee partner’s actual ownership (Reg. §1.704-1(e)(2)(v)). Such distributions are similarly important to qualifying gifts of FLP interests as “present interests” to qualify for the gift tax annual exclusion. However, after the Act, few clients may be concerned with annual gift exclusion qualifications considering the size of the new lifetime exemption.

The donee should have reasonable freedom to dispose of his or her FLP interest without financial detriment. This requirement conflicts with the restrictions on transfers often implemented to qualify FLP interests for discounts, as well as for meeting asset protection motives of restricting transferability. The regulations state that the retention of management rights by a general partner in an FLP is not relevant because limited partners cannot participate in management in any event (Reg. §1.704-1(e)(2)(ii)). In the context of an LLC, it is not clear how this would be applied since members are not prohibited by law from participating in the management of the LLC even in a manager managed LLC. Management control can be retained indirectly. For example, if the parent/donor retains control over entities leasing real estate, equipment or intangibles to the FLP in question, this might be sufficient indirect control for the IRS to challenge the FLP allocations under Code Sec. 704(e) (Reg. §1.704-1(e)(2)(iii)). It is not clear how these concepts may be addressed in the context of Code Sec. 199A.

Should FLPs be Converted to S Corporations

Many taxpayers will want to avoid the partnership tax rules by placing business operations into an S corporation instead of a partnership, or converting an FLP (or LLC) taxed as a partnership into an S corporation or a Code Sec. 1202 C corporation, depending upon circumstances. S corporations do not have the same issues that apply to partnerships under Code Sec. 704(e), in that an S corporation’s ownership can be donated to another party, who will be taxed on the income reported out to the owners without having to specify that capital is material. Although even an S corporation is subject to assignment of income and other tax doctrines that could prevent hoped for results.

Planners considering converting partnership entities into S corporations should take into account the many differences between S corporation and partnership tax treatment, which include that if there is entity level debt exceeding the basis of assets taxable gain will be triggered upon incorporation under Code Sec. 357, and upon liquidation of an S corporation there is a taxable gain equivalent to what would occur if the corporate assets were sold at fair market value. S corporations also must have pro-rata distribution and other rights under the second class of stock rules, which prohibit preferred stock, and shareholders cannot deduct losses that exceed their tax basis in the stock.

Conclusion

The Tax Cut and Jobs Act (by whatever name it is ultimately known) has transformed most aspects of tax, estate and asset protection planning. This article explores but one small facet of the implications of those changes. As practitioners continue to evaluate the implications of the new law, new aspects and perspectives will no doubt be identified.

ENDNOTE

¹ Code as used in this article means the Internal Revenue Code of 1986, as amended.