Estate Planning Strategies Using LLC's, Part Two

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LLC-P and LP Asset Valuation Discounting Strategies

(a) Key Concepts for Valuation Discounts - Valuation for estate and gift tax purposes is based upon three fundamental concepts.

- Hypothetical Willing Buyer, Willing Buyer. All property is valued knowledge of all relevant facts. Treas.Regs §§20.2031-1(b), 20.2031-3, for transfer tax purposes using the hypothetical "arm's length" transaction between a "willing buyer" and a "willing seller", neither of whom is acting under any compulsion to buy or sell, and each of whom has reasonable 25.2512-1, United States v. Cartwright, 411 U.S. 546 (1973).
- Gift Taxes and Value Received. Gift taxes are imposed on the donor based on the value of what is received by the transferee. Estate of Chenowith v. Commissioner, 88 T.C. 1577 (1982).
- Estate Taxes and Value Held. Estate taxes are imposed on what was held by the decedent at the time of his death and passed to his estate, not on what was transferred to his beneficiaries. Ahmanson Foundation v. United States, 674 F.2d 761 (9th Cir. 1981).

(b) What is Fair Market Value? The value of lifetime gifts and bequests at death are measured by the same standard. IRC §§2033(a), 2512(a). Thus, the value of the transfer is the "value of the property which is actually transferred as contrasted with the interest held by the decedent before death or the interest held by the legatee after death." See Estate of Bright v. United States, 658 F.2dc 999 (5th Cir. 1981). The objective of the estate planner in achieving valuation adjustments is to create an entity, such as a LLC-P or LP, that permits the membership interests to be valued for their "distributable cash flow" value (sometimes expressed as the "going concern value") rather than the "liquidation value" of the underlying assets. The manner in which this is accomplished involves creating a structure to which a business appraiser can properly apply either "percentage discounts" or from which he or she can determine a "capitalization rate" in

order to approximate what an investor's return on invested capital might bring in that particular enterprises. In either case, the "adjusted" value reflects "true economic value" as opposed to pro-rational (liquidation value) value relative to the underlying assets.

(c) How is Fair Market Value Determined? In determining value, the Treasury Regulations for transfer taxes require that the fair market value of a business interest be determined on the basis of all relevant factors, including a fair appraisal of all the business assets and the demonstrated earning capacity of the business. Treas. Reg. 20.2031-3 (1992), 25.2512-(3)(a) (1958). The best evidence of value would be previous arm's-length sales of the entire partnership interest or partial interests. However, since that rarely occurs, the appropriate starting point is the determination of the value of the entire partnership on a pre-discounted basis. The pre-discounted value is typically determined based on the "going concern value" or the "net asset value" or perhaps a combination of both. Courts have favored a valuation that uses a combination of both analyses. Ward v. Comm's, 87 T.C. 78 (1986). The IRS usually takes the position that the appropriate valuation approach is the one that produces the highest value. What a surprise!

(d) Going Concern Value. The going concern value of a LLC-P or LP is determined by capitalizing its past and projected net earnings. This approach properly recognizes that the members do not have the ability to unilaterally liquidate the LLC-P or LP. The only value to them in currently owning a partnership interest is their right to receive the distribution of earnings, which is often substantially less than the net asset value of the partnership. See *Estate of Gallo v. Comm's*, 50 T.C.M. (CCH) 470 (1985) and *Watts v. Comm's*, 823 F.2nd 483 (11th Cir. 1987). The nature of the underlying partnership assets and/or the business conducted by the entity will determine which valuation method will be most persuasive to the courts.

(e) Difference Between Going Concern Value and Liquidation Value. The Watts case illustrates the difference between the going concern value and the liquidation value. The parties in that case agreed that the liquidation value of the decedent's fifteen percent interest was $20,000,000 and the going concern value of that same interest was $3,933,181 before the application of any valuation discounts to the decedent's minority interest, the Eleventh Circuit, finding for the taxpayer, held that because the death of the

partner did not cause the partnership to dissolve, but instead, the partnership continued under the partnership agreement and state law, the partnership was properly valued on the basis of its going concern value, and not its liquidation value. The court concluded that because, under all the facts of the case, there was no reasonable prospect of the partnership being liquidated, the liquidation value of the partnership was irrelevant. (See also Harwood v. Comm's 82 T.C. 235 (1984) where the court rejected the going concern approach because the business of the partnership consisted solely of acquiring timber for the use of its affiliated companies. Consequently, the partnership's real value was tied directly to the current value and expected future value of its timber holdings.)

(f) Types of Discounts that Might be Applied to LLC-P or LP Interests.

- Restricted Securities Discount – There are cases involving holders of restricted securities of publicly traded companies. *Estate of Piper v. Commissioner* 72 T.C. 1062 (1979) held that in such instances, the discount should not exceed the cost of registering and selling the stock. In the *Estate of Gilford v. Commissioner* 88 T.C. 38 (1987), the court allowed a 33% discount for a block of stock that could not be sold without registration.
- Portfolio Discount - If the LLC-P owns a large amount of a single asset, courts recognize a discount for having a non-diversified portfolio. See *Estate of Barudin v. Comm's* T.C. Memo 1996-335. See also *Piper*, supra, in which the court, analogizing to closed end mutual funds, recognized a 17% discount for "relatively unattractive portfolios."
- Blockage and Absorption Discounts - The Treas. Regulations expressly recognize a discount for the time frame that the market would require to absorb a large block of stock. See Treas. Reg. 20.2031-2(e) (1992). The same reasoning can apply to real estate. See *Carr v. Commissioner* 49 T.C.M. (CCH) 507 (1985) in which the court found that a thirty percent discount was appropriate when valuing a large block of lots in the same geographic area.
- Fractional Interest Discount - A number of cases have recognized that significant discounts should be applied to partial interests in real estate.

See *Propstra v. United States* 680 F.2d 1248 (9th Cir. 1982) 15% discount; *Estate of Anderson v. Comm'r* 56 T.C.M. (CCH) 78 (1988) 20% discount; and *Estate of Della van Loben Sels v. Comm'r* 52 T.C.M. (CCH) 731 (1986) 60% discount.

- Promissory Notes - The face value of a promissory note is rarely indicative of its real value. Fractional ownership of the note, the quality of the collateral that secures the note, the interest rate and other factors affect its marketability. Accordingly, significant discounts may be applied in valuing these interests. See *Smith v. U.S.* 923 F.Supp 896 (S.D. Miss. 1996); *Hoffman v. Commissioner*, T.C. Memo, 2001-109 citing Treas. Reg. Sec 20-2031-4 which provides that the burden of proof is on the taxpayer to prove that a promissory note is not worth its face amount plus accrued interest, but nonetheless found that the burden of proof had been met and applied substantial discounts to the promissory notes.
- Built-in Capital Gains - A number of cases have held that the repeal of the *General Utilities* doctrine, the built-in capital gains inside C corporations, is a relevant factor to consider when valuing the stock of the corporation. See *Estate of Davis v. Commissioner*, 110 T.C. No. 35; *Estate of Simplot v. Comm'r*, 112 T.C. 13 (1999) rev'd on other grounds, 87 AFTR 2d Par. 2001-923 (oth Cir. 2001); *Estate of Borgatello v. Comm'r*, T.C. Memo 2000-264 (2000); *Estate of Jameson v. Comm'r*, 2001 AFTR 2d Par 2001-3253 (5th Cir. 2001); *Estate of Welch v. Comm'r* 85 AFTR 2d Par. 2000-534 (6th Cir. 2000). However, the Tax Court recently denied discounts for built-in gains when valuing limited partnership interests reasoning that a Code §754 election would correct any built-in gains disparity. *Estate of Jones II v. Commissioner*, 116 T.C. No. 11 (2001). More recently, however, the Tax Court has shown some willingness to allow the built-in gains inside a partnership to be considered. *Estate of Dailey v. Commissioner* T.C. Memo 2001-263 (2001).

(g) Determining the Discount

- A discount is based upon the value of the asset transferred. Once the underlying assets in the LLC have been properly valued, the next step in the valuation process is to determine the nature of the interest that is being transferred. As mentioned previously, a transfer for estate tax purposes focuses on the property that passed to the decedent's estate and not on what was received by the decedent's beneficiaries. *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981). So, while the decedent's interests in the LLC-P may be aggregated for estate tax purposes, if the same interests in the LLC-P were transferred to the same beneficiaries through lifetime gifts, the focus would not be on what the donor held, but instead on the value of the interests transferred to each donee. *Chenoweth v. Comm'r* 88 T.C. 1577 (1987).
- Discount for Lack of Marketability - If an asset is less attractive and more difficult to sell than publicly traded stock, a discount for its relative lack of marketability may be available to adjust it's value for transfer tax purposes. If a member wanted to get out of the LLC-P, who would buy their interest? An interest in a closely held enterprises is less attractive and more difficult to sell than a publicly traded interest. This discount acknowledges the economic reality of the inherent inflexibility of getting into and out of investments where there is no ready market. Discounts are not automatic and must be established by empirical data and appraisal. The lack of marketability discount is available for both majority and minority interests. See *Estate of Mazcy v. Commissioner*, 28 T.C.M. (CCH) 783 (1969), rev'd on other grounds, 441 F.2d 192 (5th Cir. 1971), *Estate of Folks v. Commissioner*, 43 T.C.M. (CCH) 427 (1982) (40% discount allowed in closely held real estate investment company where decedent owned 62% of stock).
- Discount for Costs of Liquidation. For stock in a corporation, the costs of liquidation alone of the corporate form must also be taken into account. The court in *Estate of Curry v. United States*, 706 F.2d 1424 (7th Cir.) (1983), rejected the argument that the majority shareholder may liquidate.

The Court found that the fiduciary duties of the controlling shareholder restrained the majority interests without regard to the minority interests. Discounts have also been held to apply to assignee interests in general partnerships. *Adams v. United States*, 218 Ff.3d 383 (5th Cir.) (1971). Taken together, this line of cases demonstrates that there is a quantifiable discount for lack of marketability.

- Many cases indicate that the courts recognize the validity of marketability discounts. See *Peracchio v. Commissioner*, T.C. Memo 2003-280 (September 25th, 2003) (25% marketability discount and 6% minority discount); *Lappo v. Commissioner* T.C. Memo 2003-259 (September 3rd, 2003), (24% marketability discount and 15% minority discount); *Estate of Godley v. Commissioner* T.C. 2000-242 (2000) (20% marketability discount); *Estate of Strangi v. Commissioner* 115 T.C. No. 35 (2000) (31% discount), rev'd on other grounds (5th Cir. 7/15/2005); *Estate of Hoffman v. Commissioner*, T.C. Memo 2001-109 (2001) (35% lack of marketability discount and an additional 18% minority interest discount); *Knight v. Commissioner* 115 T.C. No. 36 (2000) (15% discount); see also *Estate of Jones II v. Commissioner*, supra, where the court valued two separate partnership interests, one which had the power to cause the dissolution of the partnership interests, and one which did not. The court applied a 7% marketability discount to both partnership interests and an additional "secondary market discount" for the interests that lacked the ability to dissolve the partnership.
- Minority Interest or Lack of Control Discount - The lack of control or minority interest discount is distinct from a marketability discount. The minority interest discount is applied when the owner of the interest does not have managerial control over the partnership entity. Also consider that individual equity cannot be sold if transfer rights are restricted. Liquidation value has little meaning to an individual investor if the owner cannot compel or vote to force liquidation. A proper analysis of value would consider comparable sales. However, there usually are not

comparable sales. Typically, minority discounts range from 25% to 55% of the pre-discount value of the partnership interest. See *Gallun v. Commissioner* 33 T.C.M. (CCH) 1316 (1974) which allowed a 55% discount on a partnership interest whose assets consisted of an investment portfolio.

- Application of the Discounts - When both minority and marketability discounts are available and taken, they are not simply added together. The minority interest discount is placed on top of the lack of marketability discount.

Use of LLC-P's in Estate Planning

(g) General Reasons for Use of LLC-P’s in Estate Planning

- Asset Transfer Discounting - The formation of a family limited partnership or PFLLC or corporation is another estate-valuation-discount planning vehicle sometimes used by persons with over $2,000,000 in assets who wish to transfer property to younger generation family members at reduced transfer tax costs. It involves setting up one or more LLC-P's or LP's in which asset and control features are differentially distributed to younger generation family members over time. In the beginning the parents own and control. Later, they may own less as a result of transferring shares to children while retaining control, at least initially. Limited Partnerships and Limited Liability Corporations taxed as partnerships are the preferred forms of business organization because entities taxed as corporations do not receive a step-up in basis for appreciation of the underlying assets when the shares are transferred at death. The result is that lifetime gifts, including annual exclusion gifts, and the balance of the parents' interests at death, may be discounted for tax purposes because of the lack of liquidity and control inherent in shares of closely held business organizations. Such interests are typically appraised at 35% to 45% of the value of the underlying assets. Interest

transferability and income distribution discretion provisions in the LP and LLC-P documents need to be drafted carefully obtain annual gift exclusions.

- Asset Protection - Another effect may include increased protection from creditor claims. To the extent family assets consist of shares or interests in family partnerships creditors may only be able to attach future distributions of income. Such distributions are subject to considerable control and discretion of the family members possessing the control features of the organization.
- Additional Benefits - Additional advantages include the spreading out of income among family members (thus potentially lowering overall income tax rates), less exposure to divorced spousal claims (shares of family organization are not easily commingled with marital assets), and facilitation of annual exclusion giving (no need to divide up assets, shares of family organization gifted instead).

Using LLCs for Asset Freezes

(a) What is an asset Freeze? An estate freeze is a transaction or series of steps undertaken to allow future growth in the value of one or more assets to accrue to someone else, the beneficiary of the freeze.The beneficiary of the freeze is usually the person, or persons, who will ultimately become the beneficiary of the owner's estate. The simplest method of an asset freeze is to gift assets to heirs before death in a manner that takes the asset out of the owner's estate. A simple gift of an asset will remove the asset from the owner's estate, and from the owner's control.

(b) What is Frozen In An Asset Freeze? The owner of the asset (the "freezor") is the individual who initiates the freeze. The asset value and/or the income from the frozen asset is transferred to the beneficiaries, thus freezing this asset/income value outside of the freezor's estate. An estate freeze eliminates the value of the frozen asset and/or income from that asset from the freezor's estate.

(c) What is the Goal of An Asset Freeze? The term "freeze" refers to fixing the value of an asset at its current value. By freezing the values today, the freezor can accomplish a number of objectives. The freezor can quantify the tax liability, which will be triggered upon death or the disposition of a freezor's assets. The freezor can also take steps, in many circumstances, to actually work towards reducing those liabilities over a period of time. By limiting the value of the estate, the freezor also reduces the exposure to probate and other estate settlement costs.

(d) When Would You Use An Asset Freeze? If a client expects at their death to have more than the $2,000,000 estate tax exemption amount, less taxable gifts made during their life, and it is unlikely that they will be able to lower the amount using tax exemption vehicles, their estate will likely benefit greatly from use of estate valuation freezing and discounting tools to reduce heirs tax exposure. The primary reason to implement an estate freeze is to maximize the value of the estate that will accrue to the freezor's beneficiaries. One of the most important questions to address at the outset is whether a person is ready to embark upon an estate freeze. The freezor must accept that all or some of the future growth in his or her assets will be limited or will not accrue to him or her at all. The problems for an owner may be both financial and psychological. Financially, the freezor must be satisfied that they have left themselves with enough capital to sustain their lifestyle, even after taking inflation into account. Psychologically, they must be prepared for the fact that to a greater or lesser degree they are giving up a portion of their assets to the beneficiaries of the freeze and that beneficiaries, too, will have an interest in how the business or property is managed. Next to the financial matter, the issue that most often concerns the freezor is the extent of the control they may exercise over the assets after the freeze takes place. The desire to exercise control may stem from the fact that the beneficiaries cannot manage the frozen property because they are minors, or it may stem from an unwillingness on the part of the freezor to "let go".

(e) What Tools Are Available to Accomplish An Asset Freeze? Some of the commonly used tools used to accomplish an asset freeze are the grantor retained interest trust (“GRIT”), the grantor retained annuity trust (“GRAT”), the grantor retained unitrust (“GRUT”), the qualified personal residence trust (“QPRT”), the personal residence life estate trust (“PRLET”), asset installment sales, self cancelling installment notes

(“SCINS”), corporations, limited partnerships and LLC’s. In many fact situations, a PLLC will be the best entity for an asset freeze, often along with one or more of the asset freeze tools mentioned above, and would usually be structured for discounted valuation transfers to minimize gift and estate taxes.

(f) A Simple LLC Freeze. An example of a simple asset freeze using a PLLC would be the transfer of an appreciating asset of any type, it could be a business, real estate, personal property or any other appreciating asset, to a newly formed PLLC in exchange for a preferred membership interest in the LLC that equals or exceeds the value of the asset transferred to the PLLC. An example would be the transfer of real estate with a net value of $1,000,000 to a PLLC in exchange for preferred membership interests in the PLLC that provide the holder of the preferred membership interests with the first $1,000,000 in operating (profits) and/or capital distributions from the PLLC. The PLLC could then sell non-preferred membership interests to heirs at a minimal cost, or such membership interests could be gifted to heirs with little or no gift tax result, because the non-preferred membership interests would have little or no value at the time of the transfer. However, over time, the non-preferred membership interests would represent all of the appreciated value of the asset. The “freeze” PLLC would also be structured to maximize the discounts for any membership interest that might be gifted in the future, including the preferred membership interests should the owner wish to gift them, or sell them, to heirs prior to death to reduce estate tax on the owner’s estate.