

USE OF THE FAMILY LIMITED PARTNERSHIP TO PROTECT ILLINOIS FAMILY FARMS DURING A PERIOD OF UNCERTAINTY: PROCEED WITH CAUTION

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I. INTRODUCTION

The inability to plan ahead has created a broken system, leading to the ultimate demise of some family farms. Thus, now, more than ever, is a difficult time for attorneys to provide guidance and establish adequate asset protection for family farms. As a result of recent precedent and uncertainty surrounding the estate tax, business planning and estate planning must be approached with caution.

Family farms are now facing unprecedented difficulties. As the amount of farm land dwindles and land continues to reach historically high prices,¹ attorneys face the challenging task of minimizing clients' risks against future taxes. Attorneys traditionally face the tasks of protecting farms against loss from divorce, inefficient planning, risks associated with long-term care, and problems associated with the efficient transfer of ownership. However, these problems are now amplified. The federal estate tax is in a period of uncertainty,² and the state estate tax lacks uniformity with the federal system.³ Furthermore, because land prices are valued higher than ever before, estate planning decisions are subject to unparalleled effects and increased risk.

To minimize risk and shift future appreciation to younger generations, attorneys have traditionally been able to utilize the family limited partnership. A family partnership is a "business partnership in which the

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1. Farm values have reached \$13,000 an acre in certain parts of the United States, including Illinois. Press Release, Am. Soc'y of Prof'l Farm Managers and Rural Appraisers, Illinois Farmland Values/Rents Continue Upward Spiral (March 22, 2012), *available at* <http://www.asfmra.org/wp-content/uploads/2012/03/2012-Land-Values-News-Release-2.pdf>.
2. There is currently a maximum tax rate of 35% and an exemption of \$5,120,000 for 2012 federal estate taxes, but both are set to expire on January 1, 2013. *See* Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, §§ 101, 302, 124 Stat. 3296, 3298, 3301-02.
3. The 2012 Illinois estate tax exemption is set at \$3,500,000. *See* 35 ILL. COMP. STAT. 405/2(b) (2011).

partners are related.”⁴ The family limited partnership involves the establishment of a limited partnership as the underlying entity, resulting in both general partners who manage and run the entity and limited partners who benefit from the earnings and growth of the partnership.⁵ To reduce liability, an S-Corporation is commonly named as general partner. However, as an alternative to the limited partnership, the use of an LLC as an underlying entity is growing in popularity. Both entities may consist of family members. Therefore, although the term “family limited partnership” traditionally refers to the limited partnership, the use of the term “family limited partnership” within this Comment refers to both the use of the traditional limited partnership entity and the use of the family owned LLC, despite the two entities being completely separate and distinct.⁶

Both entities are subject to pass-through taxation, management flexibility, and limited liability,⁷ and both may provide substantial tax benefits.⁸ Furthermore, as a result of substantial increases in land and farm value, the use of the family limited partnership to transfer partial ownership and shift future appreciation is now as important as ever. However, after IRS attacks and recent case law called into question the feasibility of qualifying for estate and gift tax benefits, use of the family limited partnership must be approached with caution. Despite impending uncertainty and unprecedented dangers threatening family farms, recent case law can be used to guide and assist the future utilization of the family limited partnership to efficiently ensure the protection of Illinois family farms.

Section II of the Comment reviews the complications associated with the transfer of family farms, including the federal estate tax uncertainty and the state estate tax’s lack of uniformity. Section III reviews the complications associated with current asset protection of family farms, including the failure to plan ahead, protection against future long-term care risk, and protection against divorce. Section IV analyzes the use of the family limited partnership, including its historical benefits, the evolution and current uncertainty of the doctrine, and future guidance for its use.

4. BLACK’S LAW DICTIONARY 1230 (9th ed. 2009).

5. *Id.*

6. The term “family limited partnership” used throughout this Comment, shall be interpreted as a reference to both the traditional limited partnership entity and the LLC.

7. So long as an S-Corporation is named as general partner of the underlying limited partnership.

8. Courtney Lieb, *The IRS Wages War on the Family Limited Partnership: How to Establish a Family Limited Partnership That Will Withstand Attack*, 71 UMKC L. REV. 887, 887 (2003).

II. PROBLEMS ASSOCIATED WITH THE TRANSFER OF FAMILY FARMS

This section explores the complications associated with the transfer of family farms. This discussion is not intended to provide an exclusive list. Within this section, uncertainty surrounding the federal estate tax will first be addressed. Subsequently, the state estate tax's lack of uniformity will be discussed.

A. The Federal Estate Tax

To understand the current state of uncertainty, the historical evolution of the federal estate tax should be examined.⁹ By examining the historical evolution, the resulting implications derived from uncertainty surrounding the estate tax become transparent.

1. *Historical Overview of the Federal Estate Tax*

In 1916, to prevent unwanted concentrations in wealth and raise revenue as the United States prepared to enter World War I, the current¹⁰ federal estate tax was established.¹¹ However, much like now, the tax was the subject of substantial controversy.¹² The tax imposed in 1916 was limited to property under the control or enjoyment of the decedent at death.¹³ Therefore, through the use of lifetime gifts, the estate tax could be reasonably minimized.

In an attempt to eliminate this “loophole,” Congress enacted a gift tax in 1924.¹⁴ The gift tax was repealed the following year, but reimposed in 1932, and it remains in place today.¹⁵ From 1932 to 1976, the estate and gift taxes were essentially separate. However, in 1976, the two taxes were “unified” with one scheduled tax rate to cumulatively apply to all transfers

9. This section is meant to be a brief overview of the estate tax. For a more inclusive history of the United States estate tax, *See* Jeffrey A. Cooper, *Ghosts of 1932: The Lost History of Estate and Gift Taxation*, 9 FLA. TAX REV. 875, 881 (2010).

10. Before the current system, a stamp tax, inheritance tax, and mixed estate and inheritance tax were instituted and repealed to assist in the funding of various United States wars. *See* JOHN K. McNULTY & GRAYSON M.P. MCCOUCH, FEDERAL ESTATE AND GIFT TAXATION 3 (7th Ed. 2011).

11. Harry L. Gutman, *Reforming Federal Wealth Transfer Taxes After ERTA*, 69 VA. L. REV. 1183, 1187 n.4 (1983).

12. The constitutionality of an estate tax was upheld in 1921. *See* *New York Trust Co. v. Eisner*, 256 U.S. 345 (1921).

13. *See* Annotation, *Deduction of Federal Estate Tax Before Computing State Tax*, 7 A.L.R. 714 (1920).

14. *See* Cooper, *supra* note 9, at 883.

15. *Id.* at 883-84

made during life and at death.¹⁶ In 1981, the marital deduction was expanded by eliminating the limitation on the amount of property transferred between spouses during life or at death.¹⁷

In 2001, Congress enacted legislation to gradually increase the unified credit against the estate and gift taxes from \$675,000 in 2001 to \$3.5 million in 2009.¹⁸ Furthermore, the maximum estate and gift tax rate was gradually reduced from 55%, beginning in 2001, to 45% in 2009.¹⁹ The 2001 Act called for the repeal of the estate tax, but not the gift tax, and introduced a system of modified carryover basis²⁰ to replace the estate tax. Under the carryover basis regime, property passing from a decedent took the basis equal to the lesser of the decedent's basis or the value of the property at death.²¹ Under this system, the statute restricted a tax-free increase in basis to a maximum of \$1.3 million, regardless of relationship between the decedent and recipient.²² However, a \$3 million increase in basis was allowed for property passing to a decedent's qualifying surviving spouse.²³

Although this system was set to take effect on January 1, 2010, amendments retroactively reinstated the estate tax.²⁴ After the imposition of the 2010 amendments, a maximum tax rate of 35% and an exemption equivalent to \$5.12 million were established for 2012.²⁵ However, the system was enacted with a special "sunset" provision insuring all such changes will expire at the end of 2012.²⁶ Therefore, unless Congress changes the status quo, an estate exemption of \$1 million²⁷ and a maximum rate of 55% will be imposed in 2013.²⁸

2. *Implications of Current Federal Estate Tax Uncertainty*

As a result of the upcoming expiration of the favorable estate tax, the ability to advise clients regarding the best way to efficiently transfer their

16. See Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520.

17. See Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172.

18. See Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38.

19. See *id.*

20. I.R.C. § 1022 (repealed 2001).

21. See 115 Stat. 38.

22. See *id.*

23. See *id.*

24. See Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, §§ 101, 302, 124 Stat. 3296, 3298, 3301-02.

25. See *id.*

26. See *id.*

27. If the estate exemption were to fall to \$1 million, it would be equivalent, in some areas, to protection of about seventy-seven acres from federal taxation. See Press Release, Am. Soc'y of Prof'l Farm Managers and Rural Appraisers, *supra* note 1.

28. See Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act §§ 101, 302.

farm is a difficult matter to approach. Until Congress establishes a long-term approach to the estate tax system, estate planning should be approached with caution.

In 2013, the estate tax could do a number of things: (1) expire; (2) be renewed once again; or (3) be replaced by a completely new system, such as the “limited step-up in basis system” suggested in 2010. However, even after 2013, if Congress fails to establish a long-term plan, the period of uncertainty could extend into the unforeseeable future. Because family farms are now valued higher than ever, gambling on the estate tax may generate too much of a risk against the protection of family farms. Therefore, dependent upon the facts and circumstances, transfers before death may be the best choice. Accordingly, use of the family limited partnership could act as a very important tool to ensure the efficient transfer and protection of family farms. Section IV will address this matter in more detail.

B. The State Estate Tax

In addition to the federal estate tax, the state of Illinois levies a separate and distinct estate tax on resident decedents and non-resident decedents owning property within the state.²⁹ Before the Tax Act of 2001, the Illinois estate tax was a “sponge,” or “pick-up,” tax equivalent to the maximum allowable federal credit.³⁰ However, the 2001 Federal Act phased out the “sponge” credit and replaced it with a deduction for state death taxes.³¹ In response, Illinois acted to “separate” the federal and state estate tax as of January 1, 2003.³² Under current law,³³ the Illinois estate tax exemption is set at \$3.5 million for 2012 and \$4 million for those who die on or after January 1, 2013.³⁴ The maximum taxable rate for an estate of a decedent who dies in 2012 is 16%.³⁵ In contrast, the federal estate tax exemption rate is set at \$5.12 million and 35% in 2012 and changes to \$1 million and 55% on January 1, 2013.³⁶

As a result of the state exemption lacking uniformity with the federal exemption, additional problems have evolved. Anytime an estate plan is set

29. However, unlike the federal government, Illinois does not impose a gift tax.

30. See 35 ILL. COMP. STAT. 405/2(a) (2011).

31. See Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38.

32. See 405/2(a).

33. Current as of 2012.

34. See 35 ILL. COMP. STAT. 405/2 (2011).

35. See Lisa Madigan, *State Death Tax Credit Table*, ILL. ATT'Y GEN., <http://illinoisattorneygeneral.gov/publications/calculator/taxtable.htm> (last visited Feb. 4, 2012).

36. See Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, §§ 101, 302, 124 Stat. 3296, 3298, 3301-02.

forth, this lack of uniformity must be contemplated, and as a result, estate planning for family farms has become an ever-more complex issue. For example, beginning in 2010, the federal government established a portability provision enabling individuals to gift their unused estate tax exemption to their spouse.³⁷ However, the State of Illinois has no complementary provision. Therefore, use of the portability provision to shield future estates from taxation does not protect against estate tax liability on the state level.³⁸ Accordingly, the uncertainty resulting from the federal estate tax has amplified estate planning problems.

For example, even if the current federal exemption rate continues at \$5.12 million, or \$10.24 million for a married and qualifying couple, this may still leave Illinois farm owners with substantial state estate taxes. The state exemption is \$1.62 million less than the federal exemption in 2012 and would be \$1.12 million less than the federal exemption thereafter. Thus, farm owners would be forced to pay estate taxes on this additional amount to keep their land in the family. Although at first glance these appear to be large exemption amounts, calculating the effect historically high land prices have on the matter can help put the problem into perspective. As previously stated, land has reached prices as high as \$13,000 per acre in some places in Illinois.³⁹ Therefore, even if the 2012 exemption of \$5.12 million is upheld, a personal exemption would be limited to the protection of approximately 394 acres⁴⁰ from federal estate tax. To the contrary, about 308 acres,⁴¹ or about 28% less,⁴² would be protected after 2012 from state estate taxation.

In sum, the lack of uniformity in estate taxes can cause numerous problems. The average Illinois farm in 2012 is 368 acres.⁴³ This is sixty acres greater than the Illinois exemption level of about 308 acres⁴⁴ and 291 acres greater than the federal exemption level of about seventy-seven

37. Election requires irrevocable filing of estate tax return upon the death of first spouse. *See* 26 U.S.C § 2010 (2012).

38. The federal portability provisions create further uncertainty by establishing a sunset provision limiting its use under the current system to estates in which both spouses died between January 1, 2011, and December 31 2012. However, the portability provision may be renewed. *See* Marc S. Bekerman, *Credit Shelter Trusts and Portability Does One Exclude the Other?*, PROB. & PROP., May/June 2011, at 10, 15.

39. *See* Press Release, Am. Soc'y of Prof'l Farm Managers and Rural Appraisers, *supra* note 1.

40. The \$5.12 million federal estate tax exemption level of 2012 divided by the current high of \$13,000 per acre equals 393.85 acres.

41. The \$4 million state estate tax exemption level of 2013 divided by the current high of \$13,000 per acre equals 307.69 acres.

42. 394 acres is 27.92% greater than 308 acres.

43. Robert F. Flider, *Facts About Illinois Agriculture*, ILL. DEP'T OF AGRIC. (May 5, 2012), <http://www.agr.state.il.us/about/agfacts.html>.

44. *See supra* text accompanying note 41.

acres⁴⁵ currently in place for 2012. Thus, if the estate tax is kept at current levels, substantial estate tax liability awaits many farm owners. Therefore, dependent upon the facts and circumstances, it is once again suggested that transfers before death may be the best choice. Accordingly, use of the family limited partnership could act as an important tool to ensure the efficient transfer and protection of family farms.

III. PROBLEMS ASSOCIATED WITH THE PROTECTION OF FAMILY FARMS

Before farm owners may begin preparing to efficiently transfer ownership, they must first address awaiting perils. This section sets forth traditional problems associated with the protection of current family farms. This section is not meant to give an in depth analysis into any particular area. It is meant to call attention to, and give a brief overview of, problems associated with asset protection of family farms. Accordingly, this section begins with a discussion of the failure to plan ahead. Subsequently, it addresses risks associated with long-term care. Finally, this section concludes with a discussion of protection against divorce.

A. Failure to Plan Ahead

To combat the current period of uncertainty surrounding estate planning, farm owners must take affirmative steps to acquire a comprehensive estate plan. Failure to take this initiative may lead to unwelcome consequences. Instead of acquiring a plan customized to insure their desired intent is carried out upon death, a lack of initiative may lead to the unintended loss of the family farm, or at least a substantial portion of it. Whether farm owners are unaware of the importance associated with estate planning, attempting to avoid costs associated with a comprehensive estate plan, unwilling to provide the time and effort to accomplish their goals, or unwilling to admit their mortality, all roads lead to same impending risk: the loss of the family farm. Therefore, unless farm owners proactively seek estate and business planning, an amplified risk associated with the protection of family farms will continue to exist.

B. Long-Term Care Risk

Farmers are also faced with the risks associated with the cost of future long-term care. Farmers who own farmland may not qualify for

45. The \$1 million federal estate tax exemption level of 2013 divided by the current high of \$13,000 per acre equals 76.92 acres.

Medicaid.⁴⁶ Therefore, to cover potential long-term care costs, farmers are forced to either (1) purchase expensive long-term care insurance⁴⁷ or (2) self-insure. The average annual cost for a private room in a nursing home is estimated at \$79,935.⁴⁸ Thus, self-insurance can cause substantial future problems because liability for such payments may endanger the preservation of family farms. As a result, if farm owners do not cautiously plan ahead, they may be faced with a difficult and unwanted future: liquidating part of the farm to pay nursing home costs.

Although this looks to be the unfortunate future of many farm owners, preemptively tackling the issue may lead to minimization of future problems. As an alternative to long-term care insurance, annual transfers of partial farm ownership, through the utilization of the family limited partnership, may enable individuals to reduce the total value of assets owned to the Medicaid exemption level. However, reaching the maximum asset value of \$2000⁴⁹ for an individual entering a nursing home and the \$109,560 limit for a community spouse may take many years.⁵⁰ Therefore, this alternative may be impracticable. Depending on the circumstances, a lump sum gift or transfer made in good faith could be made prior to the five-year “look-back” period to establish Medicaid eligibility.⁵¹ However, all plans are dependent upon the specific facts and circumstances of each farm owner, and before any plan may be carried out, farm owners must first plan ahead. If preemptively transferring assets is appropriate,⁵² the family limited partnership could be a useful tool to attain this goal.

46. According to current proposed regulations, income-producing farmland and farm equipment are no longer entirely exempt from consideration as assets, but are subject to the same \$6000 exemption limit as other income producing assets. Also notable, the maximum standard community spouse resource allowance (CSRA) for Medicaid qualification is reducing from \$113,640 to \$109,560 in resources and from \$2841 to \$2739 per month income. *Illinois Regulation*, THE FLINN REPORT, July 13, 2012, at 1, 2, available at http://www.ilga.gov/commission/jcar/flinn/20120713_July%2013,%202012%2020Issue%2028.pdf.

47. Individuals are typically recommended to purchase long-term care insurance at the attainment of age 50, however, the earlier it is purchased, the cheaper it becomes. See Rome Neal, *Long-Term Care Insurance: Worth It?*, CBSNEWS (Feb. 11, 2009, 9:00 PM), http://www.cbsnews.com/2100-3480_162-522781.html.

48. *Ways to Pay for Long Term Care*, CONSUMER REPORTS, <http://www.consumerreports.org/cro/money/retirement-planning/ways-to-pay-for-long-term-care/overview/index.htm> (last visited February 5, 2012).

49. See 305 ILL. COMP. STAT. 5/5-2(17) (2012).

50. See *supra* text accompanying note 46.

51. See 42 U.S.C. § 1396p (2012).

52. Before determining whether a transfer of such property is appropriate, an analysis of the inability to pay unexpected expenses, such as an increase in living expenses or illness, is suggested.

C. Risk Against Divorce

In addition to facing risks against the failure to plan ahead and possible high costs of long-term care, farm owners are also subject to a substantial risk from divorce. The United States has one of the world's highest divorce rates (3.4 divorces and 6.8 marriages per 1,000 population in 2009), and the state of Illinois is not far behind (2.5 divorces and 5.6 marriages per 1,000 population in 2009).⁵³ Upon the event of a divorce, farm assets may be considered in the "equitable" division of assets.⁵⁴ Thus, it is important to consider and plan against the risk of future divorce. Although prenuptial or postnuptial agreements present possibilities to address this issue, the subject has been, and will inevitably be, a sensitive one. Therefore, as a way to sidestep the dreaded divorce issue, while still addressing it, the family limited partnership may be an attractive alternative. As previously stated, Section IV will further explain the use and benefits of this entity.

IV. USES OF THE FAMILY LIMITED PARTNERSHIP

This section analyzes the many uses of the family limited partnership. Therefore, this section will first address the historical benefits of the family limited partnership. Second, this section will address case law, which has caused the current state of uncertainty surrounding the use of the entity. Finally, this section will provide future guidance for the utilization of the family limited partnership to ensure the protection of family farms.

A. Benefits of Family Limited Partnership

The family limited partnership has traditionally offered many advantages. First, it offers the opportunity to transfer wealth without relinquishing control of the underlying asset. Second, it is subject to significant discounts. Third, it offers a multitude of miscellaneous benefits.

1. *Transferring Wealth Without Relinquishing Control*

The family limited partnership can assist in the efficient transfer of wealth without relinquishing underlying control of the family farm. Individuals are often reluctant to relinquish control of their family farm via gift or sale. By definition, a gift of detached and disinterested generosity is

53. U.S. Census Bureau, *Marriages and Divorces—Number and Rate by State: 1990 to 2009*, U.S. CENSUS BUREAU, (February 5, 2012), <http://www.census.gov/compendia/statab/2012/tables/12s0133.pdf>.

54. See 750 ILL. COMP. STAT. 5/503 (2012).

complete when a donor has “parted with dominion and control” and is left with “no power to change its disposition.”⁵⁵ Therefore, there must be a complete relinquishment of the right to the property before a gift is realized.

Through the use of the family limited partnership, however, annual exclusion gifts⁵⁶ of the family farm may be transferred without relinquishing control of the underlying farm. By holding the general partnership interest⁵⁷ and transferring portions of the limited partnership interest,⁵⁸ owners of the general partnership shares can retain control and management powers, while efficiently transferring part of the farm. If done correctly, this will result in a reduction in the taxable estate, a minimization or possible elimination of transfer tax, and the retention of control of the family farm until the appropriate time.⁵⁹

2. Significant Discounts are Offered

Probably the most significant benefit of the family limited partnership is its ability to assist in the efficient transferring of wealth. As a result of transferring partial ownership before death, liability for future appreciation is shifted to younger generations.⁶⁰ The increasing value of farmland continues to appreciate. Accordingly, estate tax liability may be substantially reduced by shifting ownership prior to future appreciation, especially through the use of leveraged⁶¹ gifting discounts. Leveraged gifting can result from discounts derived from ownership of a minority interest and lack of control, or from a lack of marketability.

As previously mentioned, the use of the family limited partnership can result in a significant tax advantage. One way to obtain a taxable advantage is through the use of a minority interest discount.⁶² A minority interest and lack of control discount represent the owner’s lack of complete control over

55. 26 C.F.R. § 25.2511-2(b) (2012).

56. The current annual gift tax exclusion is \$13,000 for 2012. See 26 U.S.C. § 2503(b) (2012).

57. A general partner interest, as opposed to limited partner interest, holds the control and management of the entity. BLACK’S LAW DICTIONARY, *supra* note 4, at 1229.

58. The equivalent to holding voting interest shares and transferring non-voting interest shares of a LLC.

59. While the use of the family limited partnership has many benefits, it is not the correct entity for all individuals. Farm owners with risks against supporting future economic needs and foreseeable cash flow problems should be advised of other options.

60. However, there is one major disadvantage to this concept: there is “no ‘step-up’ in basis for the assets in the partnership at the death of the (transferor).” See Lieb, *supra* note 8, at 891.

61. Tax leverage provides credit to improve speculative ability to transfer ownership. See BLACK’S LAW DICTIONARY, *supra* note 4, at 990.

62. A minority discount is a reduction in the value of a closely held business’s shares that are owned by someone who has only a minority interest in the business. The concept underlying a minority interest discount is recognition that controlling shares—those owned by someone who can control the business—are worth more in the market than noncontrolling shares. *Id.* at 1086-87.

the entity.⁶³ For example, to a willing buyer, ownership of a minority interest would not establish immediate control over the entire underlying asset. Accordingly, the market value of a minority interest is calculated at a value less than the net asset value.⁶⁴ As a general rule, minority interest and lack of control discounts vary greatly in range.⁶⁵

In addition to a favorable discount for a lack of control, there is also an available discount for the lack of marketability.⁶⁶ A discount for the lack of marketability reflects the difficulty owners subject themselves to when they must find a willing buyer in the market to purchase their interest.⁶⁷ A discount for lack of control and lack of marketability are frequently claimed together.⁶⁸ However, in some situations, a discount for lack of marketability may be easier to obtain. For example, a 100% owner may be able to claim a discount for lack of marketability.⁶⁹

As a result of the aforementioned discounts, the market value is less than the net asset value. Therefore, the ability to make lifetime gifts is enhanced through the possibility of “leveraged gifting.” This enables multiple advantages associated with lifetime gifting. For example, by using the annual gift tax exclusion to transfer shares of the limited partnership, the gifts are excluded from the grantor’s gross estate.⁷⁰

Furthermore, provided the grantor survives three years from the date of any gift of the family limited partnership, the gift tax paid on the taxable transfer would not be included in the gross estate of the grantor.⁷¹ Thus, the legacy received would not be depleted by the additional estate taxes, as would be the case at death. For example, if an individual owned a farm valued at \$5 million and made a gift of \$3,833,333 to beneficiaries, they could pay a tax of \$1,125,250 on the \$3.8 million gift.⁷² If the donor survives three years from the date of the gift, the gift would not increase the

63. See Howard M. Zaritsky, ¶ 10.02 *Valuation Discounts for Partnership Interests*, TAX PLANNING FOR FAMILY WEALTH TRANSFERS: ANALYSIS WITH FORMS, 1999 WL 1032126, at *1 (2011).

64. See *Williams v. Comm’r*, 75 T.C.M. (CCH) 1758, at *8 (1998) (tax court accepted taxpayer’s 44% combined discount for lack of marketability and lack of control).

65. See *Dailey v. Comm’r*, 82 T.C.M. (CCH) 710, at *3 (2001) (40% combined minority and marketability discount); *Wheeler ex rel. Melton v. U.S.*, 77 A.F.T.R.2d 96-1405 (10% discount).

66. In some other situations, there is an available capital gains discount and market absorption discount. See *Davis v. Comm’r*, 110 T.C. 530, 560 (1998) (capital gains discount held as proper); *Estate of Foote v. Comm’r*, 77 T.C.M. (CCH) 1356, at *11 (1999) (3.3% market absorption discount held appropriate).

67. For a list of factors used to determine the appropriate discount for a lack of marketability, see *Mandelbaum v. Comm’r*, 69 T.C.M. (CCH) 2852, at *11 (1995) (factors include restrictions on transfer and the presence of the right of first refusal), *aff’d*, 91 F.3d 124 (3d Cir. 1996).

68. See *Dailey*, 82 T.C.M. (CCH) 710 at *3.

69. See *Estate of Bennett v. Comm’r*, 65 T.C.M. (CCH) 1816, at *15 (1993) (15% discount entitled to 100% owner of real estate development company for lack of marketability).

70. See 26 U.S.C. § 2001 (2012).

71. 26 U.S.C. § 2035(b) (2012).

72. For purposes of this example, assume there is no annual exclusion or estate tax credit.

donor's gross estate for taxable purposes. The \$5 million would be nearly depleted. However, if the individual held the same \$5 million until death, a tax on the \$5 million could be \$2,151,333. This would leave the intended beneficiaries with the net amount of \$2,848,667, or \$984,666 less, because they are taxed on the transfer of a lesser value. Thus, planning ahead to reduce taxes can make a substantial difference, and, through the use of leveraged gifting and the annual gift tax exclusion, the amount of tax savings can be even greater than the example provided above.

As the previous example illustrates, the use of leveraged gifting through the family limited partnership can be a valuable technique, which is applicable to minimizing both the gift tax and the estate tax. The value of assets which are included in a decedent farm owner's gross estate is the fair market value of farm assets under the dominion and control of the decedent as of the date of death.⁷³ Therefore, any applicable discounts on the fair market value of farm assets which are under a decedent's dominion and control at death act to reduce the value of a decedent's gross estate for estate tax purposes.

In summation, the use of the family limited partnership can provide multiple discounts which can be used to reduce the fair market value of limited partnership shares of the underlying farm. Farmland continues to substantially increase in value, and there is a lack of indication that the rate of future appreciation will regress in the foreseeable future.⁷⁴ Therefore, utilization of the family limited partnership to shift future appreciation and tax liability to future generations through transferring ownership via the annual gift tax exclusion can substantially reduce future estate tax liability while ensuring the preservation of control of the family farm. Accordingly, discounts available through the use of the family limited partnership should not be overlooked.

3. *Miscellaneous Benefits*

The family limited partnership presents other advantages as well. For example, the entity offers benefits in estate administration,⁷⁵ and significant operations and control flexibility.

In addition to deriving income, estate, and transfer tax benefits, the use of the family limited partnership may also generate income tax benefits.

73. See 26 U.S.C. § 2031 (2012).

74. Illinois land prices have increased by an average of 6.7% between 1970 and 2011 and yearly increases have averaged 12% from 2005 to 2011. Press Release, Am. Soc'y of Prof'l Farm Managers and Rural Appraisers, *supra* note 1.

75. Ownership of a shareholder interest in a family limited partnership is considered intangible personal property. Thus, it is subject to probate in the owner's state of residence, and there is no risk of expensive ancillary probate for the farm assets owned in multiple states. See 755 ILL. COMP. STAT. 5/5-2 (2011).

The family limited partnership, via the use of the limited partnership or LLC as an underlying entity, is subject to “pass-through” taxation.⁷⁶ Thus, partners of the business must file a Schedule K-1⁷⁷ and are subject to individual income tax rates on profits, as opposed to corporate income tax rates.⁷⁸ Partners or members are also exempt from double taxation, as opposed to owners of a C-Corporation. Therefore, because corporate tax rates are generally higher, individuals are able to increase net earnings.

The family limited partnership⁷⁹ partners or LLC members generally are protected against liability associated with the business property. When an S-Corporation is named as general partner of an underlying limited partnership or an LLC is used as the underlying entity of the “family limited partnership,” the business assets are generally not subject to creditor claims against partners or members of the family limited partnership.⁸⁰ The family limited partnership is considered a separate legal entity. Accordingly, liability for the entity is limited to the assets under control of the entity.⁸¹ However, to ensure maximum protection against personal liability of members or partners, respect of corporate formalities is essential to ensure protection against the possibility of “piercing the corporate veil.”⁸²

In addition to shielding owners against personal liability, a family limited partnership also protects owners against the claims of creditors and ex-spouses.⁸³ Generally, a limited partner is entitled to distributions made and is not entitled to seek partition of the entity for his or her interest.⁸⁴

76. “A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.” 26 U.S.C. § 701 (2012).

77. The partnership uses a Schedule K-1 to report the owners’ share of the partnership’s income, deductions, credits, etc. The partnership files a copy of Schedule K-1 (Form 1065) with the IRS. *Purpose of Schedule K-1*, INTERNAL REVENUE CODE, <http://www.irs.gov/instructions/i1065sk1/ch01.html> (last visited April 5, 2012).

78. If an S-Corporation is formed to act as general partner of an underlying limited partnership, members are also subject to pass through taxation. *See IRS Offers Tips for Accurate Schedule K-1 Filing*, INTERNAL REVENUE CODE (last visited November 11, 2012), <http://www.irs.gov/uac/IRS-Offers-Tips-for-Accurate-Schedule-K-1-Filing>.

79. Remember that when the term “family limited partnership” is used throughout this Comment, the term is to be interpreted to mean both the traditional limited partnership entity and the LLC.

80. *See* 805 ILL. COMP. STAT. 5/6.40 (2011); *see also* 805 ILL. COMP. STAT. 180/10-10 (2011).

81. Although most family limited partnerships have shifted to the use of the LLC, where the use of the limited partnership is used or is already in effect, the use or formation of an S-Corporation or additional LLC is typically suggested to be formed to act as “general partner” of the limited partnership to additionally limit liability. *See Delaney v. Fid. Lease Ltd.*, 517 S.W.2d 420, 423 (Tex. Civ. App. 1974) (“It is permissible . . . to form a limited partnership where a corporation is the only general partner, provided that the purpose to be carried out by the limited partnership is lawful.”), *aff’d in part, rev’d in part*, 526 S.W.2d 543 (Tex. 1975).

82. *See Sturm v. Harb Dev., LLC*, 2 A.3d 859, 866 (Conn. 2010).

83. *See Holman v. Comm’r*, 130 T.C. 170 (2008) *aff’d*, 601 F.3d 763 (8th Cir. 2010).

84. Partnership agreements may vary.

However, to ensure protection, family limited partnership assets and income must be kept separate and distinct from marital property to prevent commingling and possible transmutation of assets.⁸⁵ Moreover, the drafting of the partnership agreement should provide contingency options for divorce and establish a reasonable and agreed upon forced buyout plan to minimize future variables associated with the risk against future divorce. Addressing these issues before setting up the entity can ensure the family limited partnership offers substantial protection for family farm owners against the claims of others.

In sum, the family limited partnership offers a wide array of benefits. It has the ability to establish asset protection, reduce taxes, thereby increasing net income, increase flexibility and management, and reduce liability. Therefore, when considering the ability to efficiently transfer ownership through leveraged gifting combined with the ability to shift future appreciation and hold underlying control of the farm, the entity is entitled to thorough consideration by farm owners as they attempt to protect their family's land.

B. The Current State of Uncertainty

While the family limited partnership has many advantages, it has consistently been subject to challenges by the IRS. The IRS has predominately focused its efforts on valuation-based discounts and the validity of the family limited partnership as a separate and distinct entity.⁸⁶ Valuation-based challenges have been fairly unsuccessful.⁸⁷ However, challenges on the entity itself have been somewhat successful.⁸⁸ Nevertheless, cautious and efficient planning has enabled business and estate planners to avoid and overcome such unnecessary attacks. However, in the midst of all other uncertainty surrounding the protection of family farms, two recent cases have further complicated the matter and called into question the future use of the family limited partnership.

85. See 750 ILL. COMP. STAT. 5/503(c) (2011).

86. See Lieb, *supra* note 8, at 894-906.

87. See *Church v. United States*, No. SA-97-CA-0774-OG, 2000 WL 206374 (W.D. Tex. Jan. 18, 2000) *aff'd*, 268 F.3d 1063 (5th Cir. 2001); *Estate of Jones v. Comm'r*, 116 T.C. 121 (2001); *Strangi v. Comm'r*, 417 F.3d 468 (5th Cir. 2005).

88. See *Estate of Thompson v. Comm'r*, 84 T.C.M. (CCH) 374 (2002) *aff'd*, 382 F.3d 367 (3d Cir. 2004); *Harper v. Comm'r*, 83 T.C.M. (CCH) 1641 (2002); *Strangi*, 417 F.3d 468; *Kimbell v. U.S.*, 371 F.3d 257 (5th Cir. 2004).

1. *Fisher v. United States*

In *Fisher*, Mr. and Mrs. Fisher made a series of gifts consisting of a 4.762% membership interest in an LLC to each of their seven children.⁸⁹ The primary asset of the business was a parcel of undeveloped land bordering Lake Michigan.⁹⁰ The LLC operating agreement consisted of several restrictions: (1) the manager of the LLC had complete discretion of the timing and amount of distributions; (2) members were limited in transferring their interests to family members or their descendants; (3) the LLC held a right of first refusal to match any offer to purchase an interest in the LLC in all other instances; (4) the LLC had thirty days to exercise the right of first refusal; and (5) if the LLC exercised the right of first refusal, it would pay the transferring member with a non-negotiable promissory note consisting of equal annual installments over a period not exceeding fifteen years.⁹¹ The IRS challenged the gifts of the membership interest by claiming the Fishers' gifts to their children were not transfers of a present interest in property and therefore did not qualify for the gift tax exclusion under 26 U.S.C. § 2503(b)(1).⁹²

Although the Internal Revenue Code imposes a tax on gifts, an annual gift tax exclusion from such tax applies to the first \$13,000⁹³ in gifts of a present interest.⁹⁴ A present interest is “an unrestricted right to the immediate use, possession, or enjoyment of property or the income from property.”⁹⁵ By contrast, a future interest in property consists of “reversions, remainders, and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession, or enjoyment at some future date or time.”⁹⁶ “[T]he ‘sole statutory distinction between present and future interest lies in the question of whether there is postponement of enjoyment of specific rights, powers or privileges which would be forthwith existent if the interest were present.’”⁹⁷ Therefore, “unless the donee is entitled unconditionally to the present use, possession, or enjoyment of the

89. *Fisher v. United States*, No. 1:08-CV-0908-LJM-THB, 2010 WL 935491, at *1 (S.D. Ind. Mar. 11, 2010).

90. *Id.*

91. *Id.* at *1-2.

92. *Id.* at *1.

93. See 26 U.S.C. § 2503(b) (2012).

94. An additional exclusion is allowed for amounts paid directly to a qualified educational institution for tuition or to a health care provider for medical expenses on a donee's behalf. 26 U.S.C. § 2503(e)(2)(A)-(B) (2012).

95. 26 C.F.R. § 25.2503-3(b) (2012).

96. 26 C.F.R. § 25.2503-3(a) (2012).

97. *Hackl v. Comm'r.*, 335 F.3d 664, 667 (7th Cir. 2003) (quoting *Stinson Estate v. United States*, 214 F.3d 846, 848-49 (7th Cir. 2000)).

property transferred, the gift is one of a future interest,⁹⁸ and the annual gift tax exclusion does not apply.

The *Fisher* court established that the right to receive distributions was subject to numerous contingencies and therefore was not a present interest.⁹⁹ The manager had exclusive discretionary control over distributions, the non-pecuniary benefits associated with the right to use, possess, and enjoy the LLC assets were not a present interest, and the right of first refusal prevented donees from obtaining the present interest.¹⁰⁰ Accordingly, the U.S. District Court for the Southern District of Indiana held that the gifts of ownership interests in the LLC did not qualify for the annual exclusion.¹⁰¹

2. *Price v. Commissioner*

In *Price*, as in *Fisher*, the annual gift tax exclusion was at issue. In *Price*, Mr. and Mrs. Price formed a limited partnership, Price Investments, and transferred to it stock of a closely held corporation they owned, three parcels of commercial real estate leased to the closely held corporation, and an equipment company.¹⁰² Price Management Corp., a corporation owned by Mr. and Mrs. Price, was named the general partner of the limited partnership and held a 1% interest in Price Investments Limited Partnership.¹⁰³ Two revocable trusts established by Mr. and Mrs. Price were each the remaining 49.5% limited partners.¹⁰⁴ Months after funding Price Investments, the partnership sold the closely held corporate stock it held and invested the proceeds in marketable securities.¹⁰⁵

Over a five year period, Mr. and Mrs. Price gifted all of their limited partnership interest to their adult children through their revocable trusts.¹⁰⁶ The limited partnership agreement consisted of several restrictions: (1) partners were restricted from withdrawing contributions; (2) profits were distributed in the discretion of the general partner, unless the majority of the partners voted otherwise; (3) partners were restricted from selling or transferring their interest to those outside the partnership, unless unanimous consent was obtained; and (4) all other completed transfers contrary to such limitations were subject to an indefinite option to buyout at fair market

98. *Stinson*, 214 F.3d at 849.

99. *Fisher v. United States*, No. 1:08-CV-0908-LJM-THB, 2010 WL 935491, at *1 (S.D. Ind. Mar. 11, 2010).

100. *Id.* at *3.

101. *Id.* at *4.

102. *Price v. Comm'r*, T.C.M (RIA) 2010-002, 1 (2010).

103. *Id.*

104. *Id.*

105. *Id.*

106. *Id.*

value.¹⁰⁷ The IRS challenged the gifts on the grounds that they were not gifts of a present interest in property and therefore failed to qualify for the annual gift tax exclusion.¹⁰⁸

The Tax Court held that the partnership agreement's limitations could not support the finding of a present interest.¹⁰⁹ In support of this position, the IRS provided four supporting rationales.¹¹⁰ First, the taxpayers did not meet their burden of proving there was an ascertainable portion of income which would flow steadily to the donees, and, in contrast, there was merely a discretionary right to the distribution of income.¹¹¹ Distributions were in the discretion of the general partner or as otherwise directed by a majority of the partners.¹¹² Second, partners were restricted from withdrawing capital.¹¹³ Third, the partnership agreement established that a transferee of an interest in the partnership would not be admitted as a partner.¹¹⁴ Thus, according to the Tax Court, the Price children had no present right to enjoy the ownership rights¹¹⁵ associated with the partnership. Fourth, partners were restricted from freely transferring their interest to third parties and any failure to follow these established rules implemented an indefinite buyout option.¹¹⁶ In sum, the Tax Court held that the gifts of partnership interests were not entitled to the gift tax exclusion under section 2503(b) because the gifted interest was not a present interest.¹¹⁷

C. Future Guidance for the Use of the Family Limited Partnership

Fisher and *Price* provide a roadmap to the future use of the family limited partnership during the current period of uncertainty.¹¹⁸ If properly established, the future use of the family limited partnership can avoid future attacks and act as a much needed tool to ensure the adequate protection and efficient transfer of Illinois family farms. Accordingly, in this part of Section IV, several guidelines are provided to support the proposition that

107. *Id.* at 2.

108. *Id.* at 3.

109. *Id.* at 7.

110. *Id.* at 2-7.

111. For a more thorough analysis, *See Hackl v. Comm'r.*, 335 F.3d 664, 666 (7th Cir. 2003).

112. *Price*, T.C.M. (RIA) 2010-002, at 2.

113. *Id.*

114. *Id.*

115. Rights include fiduciary protection, access to records, and voting.

116. *Price*, T.C.M. (RIA) 2010-002, at 2.

117. *Id.* at 7.

118. In recent developments, *Estate of Wimmer* has provided additional guidance to qualify the transfer of an interest in a limited partnership as a valid annual exclusion. As stated in *Wimmer*, even if a donee does not receive unrestricted and noncontingent rights to immediate use, possession, or enjoyment in the limited partnership interest, the court will consider whether such donees received such rights in the income derived from that interest. *See Estate of Wimmer v. Comm'r.*, 103 T.C.M. (CCH) 1839 (2012).

gifts of a family limited partnership interest constitute a “present interest,” and thus qualify for the annual gift tax exclusion. Several general guidelines are also provided to maximize the probability of success against a possible IRS challenge.

1. Post-Fisher and -Price Guidelines for Qualifying for the Annual Gift Tax Exclusion

As expounded in *Fisher* and *Price*, the donee must be entitled to the unconditional present use, possession, or enjoyment of the property transferred for the gift of such property to qualify as an annual gift tax exclusion. Therefore, to avoid future IRS attacks, restrictions on the rights associated with gifted property must be established with caution. With greater restrictions comes the possibility of greater discounts on shares. However, with this advantage comes greater risk. Although there is no bright line as to the correct amount of restrictions, recent case law can be used as a good indicator of how to proceed.

First, the right of alienability must be addressed. According to *Fisher*, restrictions which limit the transfer of interest to family members or their descendants, combined with a right of first refusal in all other instances, is subject to scrutiny.¹¹⁹ *Price* further displayed that restricting partners from selling or transferring their interests to those outside the partnership without unanimous consent is also questionable.¹²⁰ Thus, operating agreements should be drafted to ensure they do not (1) completely prohibit the transfer of ownership interest or (2) unreasonably restrict alienability. Therefore, to obtain a marketability discount and qualify for the annual gift tax exclusion, a right of first refusal¹²¹ should be implemented without further restriction. The right of first refusal should be at the fair market value of the interest. As a result, donees will be left with the complete and unconditional present use, possession, or enjoyment of the property transferred. At the same time, the family farm will have the ability to match any offer made and preserve family control.

As an alternate way to implement additional restrictions on ownership, a transfer of ownership shares to a trust, as opposed to outright gifts to an individual, may be an option. By these means, the beneficiary of the trust should be given the power to compel the trustee to pay a fixed sum to him or her from the corpus upon demand. Such a power will establish the gift as a present interest, even if the beneficiary has no other immediate

119. *Fisher v. United States*, No. 1:08-CV-0908-LJM-THB, 2010 WL 935491, at *1-2 (S.D. Ind. Mar. 11, 2010).

120. *Price*, T.C.M (RIA) 2010-002, at 2.

121. “A potential buyer’s contractual right to meet the terms of a third party’s higher offer.” BLACK’S LAW DICTIONARY, *supra* note 4, at 1439.

right to receive income or corpus.¹²² By using this well-known “*Crummey* Right,” the power holder’s right is limited to demand the greater of 5% of the trust principal or \$5000.¹²³ The holder of such a right must be given proper, written notice and a reasonable opportunity to exercise his or her demand right.¹²⁴ Caution should be used to ensure a withdrawal formula equivalent to the annual exclusion amount is applied and additional unnecessary gift tax liability is not incurred. In addition, because the annual exclusion amount is not uniform with the *Crummey* demand right, additional steps may be necessary. For example, the use of the lifetime gift exclusion to reach the point in which \$13,000 is 5% of the trust corpus may be advisable.¹²⁵ As a result of taking steps along these lines, the annual transfer of ownership interests in the family farm can be efficiently transferred to future generations. The donees are given the right to transfer or sell the donated property for a limited or thirty day period, subject to the right of first refusal implemented in the shareholder or partnership agreement. After the expiration of such period, the trust will qualify as a present interest gift for the purposes of the annual gift tax exclusion, and the trust may further place additional reasonable restrictions on alienability thereafter.¹²⁶

Second, consideration for the right of first refusal must be addressed. The agreement for repurchase must be on reasonable terms and payment must be completed within a reasonably short period of time. *Fisher* established the use of a reasonable thirty day exercise period for the buyout option, but implemented the terms of the contract as a nonnegotiable fifteen-year note.¹²⁷ As a result, the court questioned the terms of the contract as unreasonable. Therefore, for the future use of buyout or right of first refusal restrictions, immediate payment or payment over a more reasonable period of time is suggested.

Third, the right to distributions must be addressed. In *Fisher*, the manager of the LLC had complete discretion as to the timing and amount of the distributions.¹²⁸ In *Price*, profits were distributed in the discretion of the general partner, unless the majority of partners voted otherwise.¹²⁹ In

122. See *Crummey v. Comm’r*, 397 F.2d 82 (9th Cir. 1968).

123. See 26 U.S.C. § 2514(e) (2012).

124. It has been established that a period of thirty days between notice of the right of withdrawal and the lapse of the right to demand the addition to the trust constitutes an adequate time period. See Marc A. Chorney, *Transfer Tax Issues Raised by Crummey Powers*, 33 REAL PROP. PROB. & TR. J. 755, 760 (1999).

125. Whether this is advisable is dependent upon the facts and circumstances of each individualized situation.

126. “Additional reasonable restrictions” include the delay in transferring ownership.

127. *Fisher v. United States*, No. 1:08-CV-0908-LJM-THB, 2010 WL 935491, at *1-2 (S.D. Ind. Mar. 11, 2010).

128. *Id.*

129. *Price v. Comm’r*, T.C.M (RIA) 2010-002, 2 (2010).

both cases, these operating or partnership agreements were subject to scrutiny. Therefore, the right to distributions should be more definitive. Accordingly, the regular distribution of funds should be made (1) to the extent not needed to conduct the business of the family farm and (2) to the extent necessary to pay any income tax liability the respective share has on family limited partnership income. A regular pattern of distributions should also be obtained. As a result, the future ability to qualify for the annual gift tax exclusion will be maximized.¹³⁰

Fourth, the status of donees must be addressed. In *Price*, any assignment made to one who was not already a partner was only effective as a transfer of the right to receive profits, and not as a transfer to become a partner.¹³¹ The court questioned whether the donees were mere assignees and whether they had a present right to enjoy the ownership rights associated with the partnership. To avoid this issue in the future, an operating or partnership agreement should grant donees an automatic right to become a substitute partner. As an alternative way to ensure control of the family farm is preserved after shares are gifted, the operating agreement could establish that gifted shares transmute into shares with limited voting abilities. Therefore, the same objective sought in *Price* may be obtained while preserving the ability to qualify for the annual gift tax exclusion.

Fifth, the use of any non-income-producing family limited partnership property must be addressed. In *Fisher*, the court noted the partners' inability to use the entity's property was one factor taken into account, which led to its denial of the annual gift tax exclusion.¹³² Non-income producing assets are typically considered a poor choice to fund a family limited partnership.¹³³ Therefore, a better approach is to ensure all non-income-producing personal use property is kept out of the family limited partnership.¹³⁴ If for any reason such property is placed into the partnership, in light of *Fisher*, any attempt to give members a present interest in the non-income-producing property of the family limited partnership should be approached with caution and limited to the use of the property for the non-personal benefit of the entity.

In sum, by using the five pointers above as guidance, recent case law can be used to ensure the greater probability that future transfers of interests in a family limited partnership qualify for the annual gift tax exclusion.¹³⁵

130. For additional information regarding the rights to distributions, see *Hackl v. Comm'r*, 118 T.C. 279 (2002) *aff'd*, 335 F.3d 664 (7th Cir. 2003).

131. *Price*, T.C.M. (RIA) 2010-002, at 5.

132. *Fisher*, 2010 WL 935491, at *3.

133. See *Hackl*, 118 T.C. at 279.

134. Non-income-producing property should rarely, if ever, be placed into the family limited partnership.

135. For additional information and guidance regarding qualifying annual gifts as a "present interest" through income generated by property, see *Estate of Wimmer v. Comm'r*, 103 T.C.M. (CCH)

The right to transfer ownership, adequate consideration for the right of first refusal, the guaranteed right to distributions, the guaranteed status as a partner, and the possible individual use of the farm property should all be cautiously planned to ensure the issues which arose in *Fisher* and *Price* are carefully avoided.

2. *General Guidelines to Avoid IRS Challenges*

In addition to the above mentioned roadmap to qualify transfers under the annual gift tax exclusion, additional steps should be taken to protect family farms and avoid traditional IRS attacks on the family limited partnership. This part of section IV is not meant to act as an all-inclusive list, but provides an overview of ways to avoid some of the most common IRS attacks.

First, the formation of the partnership and subsequent transfers of interest must have a sufficient business purpose,¹³⁶ and the transaction must not be created principally as a testamentary vehicle.¹³⁷ To avoid such attacks, the formation of a family limited partnership to protect an underlying family farm is at somewhat of an advantage, because it is comprised of income producing property and has a legitimate business purpose. For example, benefits include the creation of flexible and possibly long-term management, limited liability, protection of family farms,¹³⁸ and protection against creditors. To increase the ability to avoid such attacks, the family limited partnership should be established and funded before death is imminent. If transfer is delayed until the death of the party seeking to transfer ownership appears imminent, the transfer is at much higher risk against IRS attacks. In addition, documentation of a lengthy discussion should be preserved to establish sufficient evidence that the partnership transaction is genuine.¹³⁹

Second, the partnership agreement should establish that general partners are subject to a fiduciary duty to limited partners in the operation of the business.¹⁴⁰ As a result, this will reaffirm the duty to distribute income and qualify for the annual gift tax exclusion.

1839 (2012) (holding that to qualify as a gift of a “present interest” to which the annual gift tax exclusion applies, a gift must confer on the donee a substantial present economic benefit by reason of use, possession, or enjoyment: (1) of property or (2) of income from the property).

136. See *Church v. United States*, SA-97-CA-0774-OG, 2000 WL 206374 (W.D. Tex. Jan. 18, 2000) *aff’d*, 268 F.3d 1063 (5th Cir. 2001).

137. See *Harper v. Comm’r*, 83 T.C.M. (CCH) 1641 (2002); *Estate of Murphy v. Comm’r*, 60 T.C.M. (CCH) 645 (1990).

138. See *Estate of Black v. Comm’r*, 133 T.C. 340 (2009).

139. See *Keller v. United States*, V-02-62, 2009 WL 2601611, at *19 (S.D. Tex. Aug. 20, 2009).

140. See *Hackl v. Comm’r*, 335 F.3d 664 (7th Cir. 2003).

Third, substantial steps should be taken to ensure there is no appearance of an implied agreement existing among partners of the family limited partnership allowing previous partners to retain the use and enjoyment of the farm assets or partake in the income from the underlying farm assets transferred.¹⁴¹ Transfers of ownership should be completed when an individual is certain they are willing and financially able to relinquish control of the family farm, thereby preventing personal use of farm assets by former partners.¹⁴²

Fourth, the family limited partnership should not get overly aggressive with valuation discounts. Discounts over 35-40% may be viewed as unreasonable and are subject to additional scrutiny as not a genuine “arm’s-length” transfer between partners.¹⁴³

Fifth, all partners should respect the formalities of the entity. The IRS commonly attempts to ignore the partnership for federal estate tax purposes and include all underlying partnership assets into the estate of the decedent, but respect for formalities of the entity can substantially reduce the probability of a successful IRS attack.¹⁴⁴ To ensure formalities are followed, all of the following observations should be given thorough concern. First, the title of all assets should be properly transferred to the family limited partnership. Second, partnership interests should be transferred only after farm assets are properly transferred to the family limited partnership. Third, the partnership should have its own bank accounts, and commingling of personal funds with the partnership should be completely avoided.¹⁴⁵ In addition, financial statements, calculations of capital accounts, and proof of adjustments to ownership should be distributed to all partners annually. Furthermore, the family limited partnership funds should not be used for any of the partners’ personal expenses.¹⁴⁶ Moreover, all compensation paid to partners should be reasonable. Finally, the filing of all federal and state tax returns should be timely and thoroughly completed.¹⁴⁷

141. See *Strangi v. Comm’r*, 85 T.C.M. (CCH) 1331 (2003) *aff’d*, 417 F.3d 468 (5th Cir. 2005).

142. When former partners use the assets of the farm for personal use, documentation of the payment of the reasonable rental value should be completed.

143. See *Estate of Thompson v. Comm’r*, 84 T.C.M. (CCH) 374, at *17 (2002) *aff’d*, 382 F.3d 367 (3d Cir. 2004).

144. See *Estate of Reichardt v. Comm’r*, 114 T.C. 144 (2000).

145. See *id.* at 155.

146. Loans should also be avoided at all costs. However, any loans procured should provide for sufficient interest, at a minimum of the federal rate, and should be documented in writing.

147. Gifts of interests in the family limited partnership should be accompanied by a copy of a qualified appraisal. Records of subsequent annual gifts should be documented by the original appraisal and sufficient evidence to support the change in the assets underlying value (i.e. attachment of inflation or deflation in land values). See Press Release, Am. Soc’y of Prof’l Farm Managers and Rural Appraisers, *supra* note 1.

By taking the aforementioned steps to avoid traditional IRS attacks and using the roadmap provided by *Fisher* and *Price*, the family limited partnership can be utilized during the current state of uncertainty. As a result, the family limited partnership can serve as a much needed tool to ensure adequate protection and efficient transfer of Illinois family farms.

V. CONCLUSION

The current state of uncertainty has established a difficult challenge to ensuring the protection of family farms. However, impending and unprecedented uncertainty surrounding the estate tax, business planning, and estate planning can be cautiously approached to ensure the efficient transfer and protection of family farms through the use of the family limited partnership, using recent precedent as guidance. As a result, family farms can minimize the uncertainty surrounding long-term risks associated with estate planning, protect against tax liability, and ensure the efficient transfer and preservation of Illinois farms.

