

PARTNERSHIPS, LLCs &
LLPs IN DELAWARE:
ORGANIZATION AND
OPERATION

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Citations

Unless otherwise specified, all references to “Code Section” or “Code §” are to the *Internal Revenue Code of 1986*, as amended (the “Code”), and all references to the “regulations,” “Treasury Regulation Section” or “Treas. Reg. §” are to the regulations promulgated under the Code.

All references to “DLLCA” are to the *Delaware Limited Liability Company Act, Delaware Code Annotated* title 6, Sections 8-101 through 18-1106 (2002).

All references to “DRUPA” are to the *Delaware Revised Uniform Partnership Act, Delaware Code Annotated* title 6, Section 15-101, *et seq.* (2002).

All references to “DRULPA” are to the *Delaware Revised Uniform Limited Partnership Act, Delaware Code Annotated* title 6, Section 17-101, *et seq.* (2002).

IV. AS USED IN ESTATE PLANNING

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IV. As Used in Estate Planning

A. Federal Estate, Gift and Generation-Skipping Transfer Taxes¹

The single largest threat to the ability to pass on wealth to the objects of our client's bounty is the federal wealth transfer tax system. The estate, gift and generation-skipping transfer taxes comprise the individual elements of this system. These three taxes impose a transfer tax on the transfer of property "at least once at the level of each generation regardless of whether any person assigned to a particular generation has any present interest or power."² The following explanation of these taxes is greatly simplified and is presented only to provide the reader with an understanding of the basic concepts applicable to a general introduction to estate and gift tax planning.

The federal gift and estate taxes are imposed on the transfer of property during the donor's lifetime and at the decedent's death, respectively. The two taxes are "unified" or

¹ Prepared by Bryan E. Keenan, Esquire. Copyright 2003 Bryan E. Keenan. This material is adapted from J. S. HAYES, JR., B. E. KEENAN AND J. REIVER, BASIC DRAFTING OF WILLS AND TRUSTS IN DELAWARE Ch. VI (NBI, 1993).

² J. Horn, PLANNING AND DRAFTING FOR THE GENERATION-SKIPPING TRANSFER TAX § 2.01 (1990) (emphasis in original).

“integrated” in many respects, sharing a common rate structure that takes prior transfers into account in determining tax and common deductions.

Temporary relief from the estate tax and generation-skipping transfer tax arrived in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).

EGTRRA repeals the estate and generation-skipping transfer taxes in 2010. EGTRRA does not repeal the gift tax. Estate and generation-skipping transfer tax repeal sunsets at the end of 2010, and the wealth transfer tax system in place prior to repeal resumes.³

1. *Basic Calculation of the Tax*

The tax on taxable transfers for any period is calculated by subtracting the tax on all taxable transfers for prior periods from a tentative tax on all taxable transfers for all periods, including for the current period⁴. In the case of the gift tax, the tentative tax is calculated on the total of gifts for the taxable year and all prior years⁵. The tentative estate tax is calculated on the gross value of the estate and all taxable gifts during the decedent’s lifetime⁶.

³ P.L. 107-6, § 901.

⁴ Code §§ 2001(b); 2501(a).

⁵ Code § 2501(a).

⁶ Code § 2001(b).

The unified estate and gift tax rates are graduated, ranging from 18% to 50%⁷. The highest marginal rate is reduced to 45%, before total repeal⁸

Example: Decedent has a gross estate of \$1,000,000. During decedent's lifetime, decedent made \$250,000 of taxable gifts. (1) the tentative tax on \$1,250,000 is \$448,300; (2) the tax on prior transfers is \$70,800; and (3) the estate tax is the difference, or \$377,500.

Note that one effect of the unified rate schedule is to push successive taxable transfers, whether during the donor's lifetime and at the donor's death, into progressively higher marginal tax brackets.

2. *The Gift Tax*

The federal gift tax applies to all gratuitous transfers⁹. Taxable transfers can occur whether in trust or otherwise, whether direct or indirect, and whether the property transferred is real or personal, tangible or intangible¹⁰. Donative intent on the part of the

⁷ Code §§ 2001(c)(1); 2502(a). The actual minimum marginal rate is 41% because the unified credit will offset the tax in lower tax brackets, rising to 45% before repeal in 2009. The rate schedule is reproduced on at the end of this section, page 60.

⁸ Code § 2001(c)(2).

⁹ See Treas. Reg. § 25.2511-1.

¹⁰ Treas. Reg. § 25.2511-1(a).

transferor is not an essential element in applying the gift tax to a transfer¹¹. The gift tax is applied based on the objective facts of the transfer and the circumstances under which it is made, rather than on the subjective motives of the donor¹². A gift to a corporation is a gift to the shareholders of the corporation and a gift by a corporation is a gift by its shareholders¹³.

To constitute a gift for gift tax purposes, the transfer must be complete.¹⁴ That is, the donor must part with dominion and control over the property, so as to leave the donor with no power to change its disposition.¹⁵

Each donor is entitled to an annual exclusion of \$11,000 per donee for gifts of present interests¹⁶. A special \$112,000 annual exclusion applies to gifts made by a United States citizen or resident to his or her non-United States citizen spouse¹⁷. The nondonor

¹¹ Treas. Reg. § 25.2511-1(g)(1).

¹² *Id.*

¹³ Treas. Reg. § 25.2511-1(h)(1).

¹⁴ *See* Treas. Reg. § 25.2511-2(b).

¹⁵ Treas. Reg. § 25.2511-2(b).

¹⁶ Code § 2503(b)(1); Rev. Proc. 2002-70, § 3.24(1), 2002-46 I.R.B. 845, 849. The annual gift tax exclusion is to be adjusted for inflation. Code § 2503(b)(2).

¹⁷ Code § 2523(i)(2); Rev. Proc. 2002-70, § 3.24(2), 2002-46 I.R.B. 845, 849. *See* notes 39-40 and accompanying text, below.

spouse can agree to “split” a donor spouse’s gifts, thereby permitting the donor spouse to give \$22,000 per donee¹⁸. A present interest gift is one in which the donee has an unrestricted right to immediately use, possess or enjoy the property or the income from property¹⁹.

3. *The Estate Tax*

Like the gift tax, the estate tax is an excise tax on the transfer of property²⁰. The estate tax is imposed on the taxable estate of every decedent who was a United States citizen or resident at the date of death²¹. The taxable estate is the decedent’s gross estate, less the allowable deductions²². Deductions are allowed for funeral and administration expenses and indebtedness and claims against the estate,²³ casualty and theft losses,²⁴

¹⁸ Code § 2513.

¹⁹ See Treas. Reg. § 25.2503-3(b).

²⁰ See Treas. Reg. § 25.2511-2(a).

²¹ Code § 2001(a).

²² Code § 2051.

²³ Code § 2053.

²⁴ Code § 2054.

charitable gifts,²⁵ and marital transfers²⁶. Finally, credits against the estate tax include the unified credit,²⁷ and the credit for state death taxes²⁸.

A decedent's gross estate includes the value of all property to the extent of the decedent's interest in the property at the time of the decedent's death²⁹. The gross estate includes the value of any annuity or other payment receivable by any beneficiary by reason of surviving the decedent under any agreement by which the annuity was payable for the decedent's life or for any period which does not, in fact, end before the decedent's death³⁰. The gross estate includes the value of all property held in joint tenancy with right of survivorship, with two exceptions³¹. The value of jointly-held property will be excluded to the extent it can be shown that the survivor contributed to the acquisition or improvement of the property,³² and one-half of most joint interests between husband and

²⁵ Code § 2055.

²⁶ Code § 2056.

²⁷ Code § 2010.

²⁸ Code § 2011. The credit is reduced to zero in steps until repealed in 2005 and replaced with a deduction for state death taxes paid. Code § 2011(c)(2).

²⁹ Code § 2033.

³⁰ Code § 2039.

³¹ Code § 2040.

³² Code § 2040(a).

wife are also excluded³³. The value of the gross estate includes the value of all property with respect to which the decedent had at the time of death a general power of appointment³⁴. Life insurance proceeds under policies on the decedent's life are included in the value of the gross estate if receivable by the executor³⁵. Life insurance proceeds receivable by any other beneficiary under a policy on the life of the decedent with respect to which the decedent possessed at death any incident of ownership are also includable in the value of the gross estate³⁶.

4. *Deductions and Credits*

a. Applicable Exclusion Amount (the Unified Credit)

Each taxpayer is entitled to a credit against the gift and estate taxes equal to the “applicable exclusion amount.” For the estate tax, this amount is \$1,000,000 in calendar

³³ Code § 2040(b). Joint tenancies created before 1977 are still subject to the contribution test of Code Section 2040(a). *Gallenstein v. United States*, F. Supp. , 68 A.F.T.R.2d (RIA) 91-5721 (D.C.E.D.Ky. 1991).

³⁴ Code § 2041.

³⁵ Code § 2042.

³⁶ *Id.*

year 2003, rising to \$3,500,000 for calendar year 2009.³⁷ For the gift tax, this amount is \$1,000,000.³⁸

b. Unlimited Marital Deduction

There is an unlimited deduction for transfers of certain interests to the donor's spouse³⁹. By treating a husband and wife as a single economic unit, the unlimited marital deduction defers estate taxation until the death of the second of them to die.

Where the single economic unit theory will not apply, the unlimited marital deduction is disallowed. Thus, property passing to a non-United States citizen or nonresident alien does not qualify⁴⁰.

The marital deduction is not allowed for terminable interests, that is, interests that will end or fail on the passage of time or on the occurrence, or failure of occurrence of an

³⁷ Code § 2010. A table of applicable exclusion amounts appears at the end of this section, page 60.

³⁸ Code § 2505.

³⁹ Code §§ 2056, 2523. The unlimited marital tax deduction is disallowed if the donor's or decedent's spouse is not a United States citizen. Code §§ 2056(d), 2523(i). The basis for disallowing the unlimited marital deduction is that the property may not ultimately be included in the taxable estate of a citizen or resident alien. *E.g.*, H.R. REP. 100-795; CONF. REP. 100-1104 TAMRA '88. In the case of the gift tax, a \$100,000 annual exclusion applies to marital transfers. The estate tax marital deduction may be preserved by having property pass to the surviving spouse in a Qualified Domestic Trust. Code § 2056(d)(2).

⁴⁰ See note 39, above.

event or contingency⁴¹. Life estates and annuities are common examples of terminable interests.

The terminable interest rule may be avoided in several ways. One method is to combine a life estate in trust with a power of appointment⁴². To qualify, (1) the surviving spouse must have a life interest to all the income from the property, (2) the income must be payable annually or more frequently, (3) the surviving spouse must have a general power to appoint the entire interest, (4) the surviving spouse must be the sole person entitled to exercise the power of appointment and in all events, and (5) the interest must not be subject to a power in any other person.⁴³

Another vehicle to retain control over property and still qualify for the marital deduction is to make a Qualified Terminable Interest Property (“QTIP”) election⁴⁴. Qualified Terminable Interest Property is any property passing from the donor or decedent spouse to the other spouse in which the donee spouse receives a life income interest and for which a QTIP election is made⁴⁵. To qualify, (1) the surviving spouse

⁴¹ Code §§ 2056(b), 2523(b).

⁴² Code § 2056(b)(5).

⁴³ *Id.*

⁴⁴ Code §§ 2056(b)(7), 2523(f).

⁴⁵ *Id.*

must have a life interest to all the income from the property, (2) the income must be payable annually or more frequently, (3) no one may possess the power to appoint the interest to anyone other than the donee spouse, (4) the donor spouse or his or her executor must elect QTIP status⁴⁶. Additionally, the surviving spouse must have right to demand that the trustee convert non-income producing property to income producing property. The consequence of making the QTIP election is that the property will incur estate or gift tax, as the case may be, on the transfer of the property by the donee spouse during his or her life or on his or her death.

c. Charitable Deduction

The value of the gross estate is reduced by deducting the amount of any bequest, legacy, devise or other transfer to or for the use of a charitable organization, the United States or any State or local government⁴⁷. Charitable organizations include “any corporation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, . . . and the prevention of cruelty to children or animals, . . .”⁴⁸ Gifts to trusts and fraternal societies, orders or other associations operating under

⁴⁶ *Id.*

⁴⁷ Code § 2055(a).

⁴⁸ Code § 2055(a)(2). Note that the language of Code Section 2055(a)(2) differs from that of Code Section 170(c)(2).

the lodge system also qualify if the contribution is to be used exclusively for one or more of the statutory purposes.⁴⁹

5. *Generation-Skipping Transfer Tax*

Once upon a time, it was possible to transfer wealth to successive generations and avoid paying the estate or gift tax after the initial transfer. As each generation's interest came into possession and enjoyment, the estate tax would be skipped. This strategy took advantage of the fact that no estate tax is imposed on the expiration of a life estate created by someone other than the deceased life tenant, because there is nothing transferred by the decedent which may be included in the gross estate. Were it not for the rule against perpetuities, liability for the federal estate or gift tax would never arise after the initial transfer.⁵⁰

Congress attacked this abuse in the Tax Reform Act of 1976 with the introduction of the generation-skipping transfer tax ("GSTT")⁵¹. The statutory scheme was to approximate the estate tax that would have been imposed if the property had been

⁴⁹ Code § 2055(a)(3). Again, Code Section 2055(a)(3) is not identical with Code Section 170(c)(2) and (4).

⁵⁰ In Delaware, the rule against perpetuities did not present a problem.

⁵¹ P.L. 94-455, § 2006.

included in the estate of the person skipped. In an effort to simplify the statutory scheme, the generation-skipping transfer tax was substantially revised by the Tax Reform Act of 1986⁵². Most significantly, it imposes the tax at the highest marginal estate tax rate⁵³.

The generation-skipping transfer tax is imposed on generation-skipping transfers to persons (“skip persons”) who are more than one generation below that of the transferor⁵⁴. A “generation-skipping transfer” is either (1) a taxable termination, (2) a direct skip, or (3) a taxable distribution⁵⁵. A taxable termination occurs on the termination, whether by death, lapse of time, release of power, or otherwise, of an interest in property held in trust⁵⁶.

Example: Grandparent establishes a trust for the benefit of Child and Grandchild, with income to Child for life and remainder to Grandchild. At the death of Child, the termination of Child’s interest and the transfer to Grandchild is a “taxable termination.”

⁵² P.L. 99-514.

⁵³ Code § 2641(a).

⁵⁴ Code §§ 2601; 2613.

⁵⁵ Code § 2611(a).

⁵⁶ Code § 2612(a)(1).

The trustee is liable for the generation-skipping transfer tax on a taxable termination⁵⁷.

A direct skip is a transfer of an interest in property, whether outright or in trust, to a skip person that is subject to estate or gift tax⁵⁸.

Example: Grandparent transfers property outright to Grandchild. The transfer is both a gift and a generation-skipping transfer.

The transferor is liable for the generation-skipping transfer tax on a direct skip, except that a trustee is liable for the generation-skipping transfer tax on direct skips from a trust⁵⁹.

For purposes of direct skips, if the parent of a grandchild of the transferor is deceased, the grandchild becomes the parent and the great grandchild becomes the grandchild⁶⁰.

A taxable distribution is any distribution of income or corpus from a trust to a skip person that is not a taxable termination or a direct skip⁶¹.

Example: Grandparent establishes a trust for the benefit of Child and

⁵⁷ Code § 2603(a)(2).

⁵⁸ Code § 2612(c)(1).

⁵⁹ Code § 2603(a)(3).

⁶⁰ Code § 2651(e)(1).

⁶¹ Code § 2612(b).

Grandchild, with income to Child for life and remainder to Grandchild; the trustee may make distributions to Grandchild during Child's life. The trustee's discretionary distribution to Grandchild is a "taxable distribution."

The transferee is liable for the generation-skipping transfer tax on a taxable distribution⁶².

If the trustee pays the tax, the payment is treated as an additional taxable distribution.

A trust is broadly defined to include arrangements having substantially the same effect as a trust⁶³. These arrangements include life estates and remainders, estates for a term of years, and insurance and annuity contracts⁶⁴.

A "skip person" is (1) an individual assigned to a generation two or more below the transferor's generation; (2) a trust in which all interests are held by skip persons; or (3) a trust in which no interest is held by any person and distribution may not be made to a nonskip person at any time after the transfer⁶⁵. A "nonskip person" is any individual who is not a skip person⁶⁶.

⁶² Code § 2603(a)(1).

⁶³ Code § 2652(b)(1).

⁶⁴ Code § 2652(b)(3).

⁶⁵ Code § 2613(a).

⁶⁶ Code § 2613(b).

An individual's generation may be assigned by lineage, as follows:⁶⁷

Second Generation Higher	Grandparent				
First Generation Higher	Aunt	Parent		Uncle	
Same Generation Nonskip Persons	First Cousin	Brother	Transferor	Sister	First Cousin
First Generation Lower (Nonskip Persons)	First Cousin Once Removed	Nephew	Child	Niece	First Cousin Once Removed
Second Generation Lower (First Skip Persons)	First Cousin Twice Removed	Grandnephew	Grandchild	Grandniece	First Cousin Twice Removed
Third and Following Generations Lower (Skip Persons)	Lineal Descendants of the Above				

To determine lineal descendants of the transferor's spouse and former spouse, substitute Transferor's Spouse and Transferor's Former Spouse, respectively, for Transferor in the chart⁶⁸. Individuals related to any of the foregoing lineal descendants by adoption or marriage probably will be assigned by lineage⁶⁹. In the case of a direct skip only, the grandchild of the transferor (or transferor's spouse of transferor's former spouse) will be "stepped-up" a generation if the grandchild's parent who is a child of the

⁶⁷ Code § 2651; J. Horn, PLANNING AND DRAFTING FOR THE GENERATION-SKIPPING TRANSFER TAX § 3.02(c)(4) (1990).

⁶⁸ Code § 2651(b)(2).

⁶⁹ See Prop. Treas. Reg. § 26.2611-3(c) (withdrawn).

transferor (or transferor's spouse or transferor's former spouse) predeceases the transfer⁷⁰.

An individual not related to the transferor, the transferor's spouse or the transferor's former spouse is assigned to a generation by comparing the individual's birth date to the transferor's birth date⁷¹. For this purpose, a generation comprises a twenty-five year period, twelve and one-half years on each side. Thus, the first generation lower than transferor will include persons born more than twelve and one-half years and not more than thirty-seven and one-half years after the transferor.

a. Intentional Skips

There are situations where it may be better to skip generations to minimize the generation-skipping transfer tax. One example is the use of a wholly exempt trust (that is, a generation-skipping trust for which the inclusion ratio is zero)⁷². As distributions from and the termination of this trust will be exempt from the generation-skipping transfer tax, the trust should skip as many generations as possible.

Certain types of transfers are exempt from the generation-skipping transfer tax. Qualified payments of educational and medical expenses exempt under Code Section

⁷⁰ Code § 2612(c)(2).

⁷¹ Code § 2651(d).

⁷² See text accompanying notes 82-89.

2503(e) are exempt from the generation-skipping transfer tax⁷³. Further, all gifts within the \$11,000 annual gift tax exclusion are exempt⁷⁴. To extent possible, such transfer should be made to skip persons.

The annual gift tax exclusion exemption for generation-skipping transfer tax purposes may be combined with a *Crummey* trust⁷⁵. If the donee is the only distributee of the trust during the donee's life and the donee possesses a general power of appointment over the trust corpus, contributions within the \$11,000 annual exclusion will be a nontaxable direct skip.⁷⁶

There is an incentive to skip more than one generation when making a taxable transfer because there is only one generation-skipping transfer tax after passing the generation one below the transferor⁷⁷. If a distribution is made to the great-grandchild of

⁷³ Code §§ 2611(b)(1); 2642(c)(3)(B). To the extent that another person's support obligation is discharged, there may be an unintended taxable transfers. See text accompanying notes 80-81, below.

⁷⁴ Code § 2642(c)(3)(A).

⁷⁵ A *Crummey* trust includes a "five and five" power or right to withdraw to make what would otherwise be gifts of future interests gifts of present interests. See *Crummey v. Comm'r*, 397 F.2d 82 (9th Cir. 1968).

⁷⁶ J. Horn, PLANNING AND DRAFTING FOR THE GENERATION-SKIPPING TRANSFER TAX § 7.03(b)(3) (1990).

⁷⁷ See J. Horn, PLANNING AND DRAFTING FOR THE GENERATION-SKIPPING TRANSFER TAX § 8.04(a) (1990).

the transferor, the interests of the transferor's child and grandchild are terminated.

However, this will be one taxable distribution, not a taxable distribution and a taxable termination or two taxable terminations⁷⁸.

Note that these planning techniques are biased towards families of substantial wealth. They are possible only where the intervening generations already have sufficient funds (or, where the transferor is willing to by-pass the intervening generations).

b. Unintentional Skips

Common estate planning schemes involve taxable generation-skipping transfers and the drafter must carefully calculate when these transfers will occur. Consider a simple trust for the benefit of the decedent's children for life, remainder outright to the decedent's grandchildren. If the corpus remains in a single trust until the youngest child has reached some age, for example, twenty-one, there will be a taxable termination when the last child dies. If, instead, the principal is divided into separate trust shares on initial funding, there will be a taxable termination as to each share when the child-beneficiary of that share dies. Alternatively, the single trust could "spin off" a separate share when a child dies. In this case, there is a taxable termination at each "spin off." If any of the single trust variants lets the trustee make discretionary distributions of income to the

⁷⁸ See J. Horn, PLANNING AND DRAFTING FOR THE GENERATION-SKIPPING TRANSFER TAX § 6.07(d)(1) (1990).

children of a deceased child, each distribution will be taxable⁷⁹.

Another inadvertent skip involves the use of the educational or medical expense exemption from the generation-skipping transfer tax⁸⁰. A payment of educational or medical expenses exempt as to the beneficiary might be a taxable transfer if the payment discharges another person's support obligation.⁸¹

c. Exemption

Each transferor is entitled to a \$1,120,000 GSTT exemption⁸². The donor or his or her executor may allocate the GSTT exemption to property subject to the tax⁸³. To the extent property is allocated the GSTT exemption, it will escape generation-skipping transfer tax no matter how much it later appreciates.

As a husband and wife may split gifts for generation-skipping transfer tax

⁷⁹ See J. Horn, PLANNING AND DRAFTING FOR THE GENERATION-SKIPPING TRANSFER TAX § 6.06 (1990).

⁸⁰ See text accompanying note 73, above.

⁸¹ J. Horn, PLANNING AND DRAFTING FOR THE GENERATION-SKIPPING TRANSFER TAX §§ 7.04(a), 6.08 (1990).

⁸² Code § 2631(a); Rev. Proc. 2002-70, § 3.25, 2002-46 I.R.B. 845, 850. In the past, the GSTT exemption was adjusted for inflation. Beginning in 2004 it becomes equal to the estate tax applicable exclusion amount. Code § 2631(c)

⁸³ *Id.*

purposes,⁸⁴ a couple effectively has a \$2,240,000 GSTT exemption. The difference between the GSTT exemption (\$1,120,000) and the unified credit shelter amount (currently \$1,000,000) affects the commonly employed marital deduction share-unified credit shelter share estate plan. To fully allocate the GSTT exemption at the death of the first spouse to die will require the payment of estate tax, because the unified credit shelter share must be overfunded by \$120,000, or a “reverse” QTIP⁸⁵ election for the marital deduction share. Further, to avoid making a reverse QTIP election as to the entire marital deduction share, the instrument must require or permit the trustee to divide the marital deduction share into two trusts⁸⁶. The difference in the applicable exclusion amount and the generation-skipping transfer tax exemption disappears beginning in 2004.

The GSTT exemption is statutorily allocated to direct skips made during the transferor’s lifetime, unless the transferor makes a positive election against the deemed allocation⁸⁷. To the extent the GSTT exemption remains unallocated at the transferor’s death, the balance is allocated first to direct skips at death and then to trusts of which the

⁸⁴ Code § 2652(a)(2).

⁸⁵ Called a “reverse” QTIP election because it is made for the estate of the first spouse to die, rather than for the estate of the second spouse to die.

⁸⁶ J. Horn, *PLANNING AND DRAFTING FOR THE GENERATION-SKIPPING TRANSFER TAX* § 7.02(b)(1) (1990).

⁸⁷ Code § 2632(b).

decedent is the transferor and from which a generation-skipping transfer might occur at the decedent's death or thereafter⁸⁸.

When a generation-skipping transfer occurs, the inclusion ratio is used to determine how much of the property is sheltered by the GSTT exemption. The inclusion ratio is

$$1 - \frac{\text{GSTT Exemption Allocated}}{\text{FMV Property Transferred} - (\text{Death Taxes} + \text{Charitable Deduction})}$$

where "Death Taxes" is the amount of federal estate tax and State death taxes recovered from the trust attributable to the property transferred and "Charitable Deduction" is the amount of any charitable deduction allowed under Code Sections 2055 or 2522 with respect to the property transferred⁸⁹. If none of the GSTT exemption is allocated to the property, the inclusion ratio is one. If all of the GSTT exemption is allocated to property equal to the exemption, the inclusion is zero. The exclusion ratio for a direct skip, which is a nontaxable, outright gift, is zero⁹⁰.

⁸⁸ Code § 2632(c).

⁸⁹ Code § 2642(a)(2).

⁹⁰ Code § 2642(c)(1). Nontaxable gifts include gifts of present interests within the annual gift tax exclusion, Code Section 2503(b), and gifts for educational and medical expenses, Code Section 2503(e).

The generation-skipping transfer tax is applied to the fair market value of the property received⁹¹. The amount of a taxable distribution or taxable termination is reduced by the amount of any expense incurred by the transferee in connection with the determination, collection or refund of the generation-skipping transfer tax⁹².

The generation-skipping transfer tax is flat rate equal to the maximum federal estate tax rate in effect at the time of the taxable transfer times the “inclusion ratio.”⁹³

Example: In 1992, Grandparent establishes a trust for the benefit of Child and Grandchild, with income to Child for life and remainder to Grandchild. The trust is funded with \$1,000,000 and none of the GSTT exemption is allocated to the property in trust. At the taxable termination on the death of Child in 1999, the fair market value of the property is \$2,000,000. The inclusion ratio is 1 (1-[0/1,000,000]), the maximum federal estate tax rate is 50 percent, and the generation-skipping transfer tax is \$1,000,000 (50% x 1 x \$2,000,000).

Example: Assume the same facts as in the prior example, except that \$500,000 of the GSTT exemption is allocated to the amount transferred in trust. At the taxable termination on the death of Child, the inclusion ratio is .5

⁹¹ Code §§ 2621 (taxable distribution), 2622 (taxable termination), 2623 (direct skip).

⁹² Code §§ 2621 (taxable distribution), 2622 (taxable termination).

⁹³ Code § 2641(a).

$(1 - [500,000/1,000,000])$, the maximum federal estate tax rate is 50 percent, and the generation-skipping transfer tax is \$500,000 ($50\% \times 5 \times \$2,000,000$).

Example: Assume the same facts as in the prior example, except that \$1,000,000 of the GSTT exemption is allocated to the amount transferred in trust. At the taxable termination on the death of Child, the inclusion ratio is 0 ($1 - [1,000,000/1,000,000]$), the maximum federal estate tax rate is 50 percent, and the generation-skipping transfer tax is \$0 ($50\% \times 0 \times \$2,000,000$).

The last three examples have ignored the estate or gift tax that would be incurred in making the initial transfer. An integrated example illustrates the confiscatory nature of the generation-skipping transfer tax:

Example: In 1992, Grandparent establishes a trust for the benefit of Child and Grandchild, with income to Child for life and remainder to Grandchild. The trust is funded with \$3,000,000 and none of the GSTT exemption is allocated to the property in trust. Assuming that all of Grandparent's unified credit has been applied to other gifts, at Grandparent's marginal rate the gift tax is \$1,650,000. At the taxable termination on the death of Child in 1999, the fair market value of the property is still \$3,000,000. The inclusion ratio is 1 ($1 - [0/3,000,000]$), the maximum federal estate tax rate is 50 percent, and the generation-skipping transfer tax is \$1,500,000 ($50\% \times 1 \times \$3,000,000$). Grandparent's original

\$4,650,000 has been reduced to \$1,500,000. The effective federal wealth transfer tax rate is 67 percent; the total tax is more than twice the amount received by Grandchild.

B. Family-Owned Entities as Wealth Transfer Vehicles

In passing on family wealth to following generations, the senior generation has several concerns, not the least of which is the transfer tax cost. The gift tax annual exclusion and the gift tax lifetime exclusion provide a transfer tax-free method of passing on wealth. Family-owned entities allow donors to efficiently make gifts, maximize the value of the gift and achieve other goals.

It is possible for the senior generation to annually give a direct interest in particular assets. For example, parents could deed to their children interests as tenants in common in family real estate. Direct ownership has two substantial disadvantages. First, the donees have an interest in property, with the attendant rights. Therefore, a donee tenant in common could exercise the donee's right to sell his or her interest to an unrelated third party. Additionally, the donee could exercise his or her right to partition the property. Securities and other forms of intangible property can present their own problems.

Moreover, direct gifts of interest in property, particularly real property, are

clumsy. Each year a deed must be prepared and recorded. Each deed creates the opportunity for errors in description of the interest, must be notarized, must be recorded, etc.

A family owned entity can eliminate these problems. Each year, the senior generation can give interests in the family owned entity. By statute or agreement, the parties can restrict the ability of a donee to transfer his or her interest to an unrelated third party. Interests may be transferred by a deed of gift that does not the formalities of a real estate deed. In addition to marshaling property rights and providing administrative convenience, a family entity also serves the following objectives:

- **Asset Management.** By transferring assets over time to the next generation, the senior generation is able to continue managing the assets, until the next generation is capable. Additionally, by retaining assets in a common vehicle, it is possible to reduce management expenses while increasing diversification.
- **Succession Planning.** The family owned entity provides for succession planning.
- **Asset Protection.** The family owned entity protects assets of the donee from the donee's own imprudent actions. Additionally, the family owned entity provides asset protection against creditors and ex-spouses.

- Family Harmony. The family owned entity facilitates family harmony by providing a common objective and a dispute resolution process.

Finally, as explored later in this section, a family owned entity allows the senior generation to maximize the use of the gift tax annual exclusion and lifetime exclusion through the use of valuation discounts.

C. Investment Partnership Rules

1. Introduction

The estate planner cannot ignore income tax rules when using partnerships as wealth transfer vehicles. One set of important income tax provisions are the investment company rules, reviewed in this part of the materials. The next part addresses another set of income tax provisions, the family partnership rules.

Typically, parents will contribute appreciated non-cash assets, securities and/or real estate to the capital of the partnership. Code Section 721 provides that a partnership and its partners do not recognize gain or loss when a partner contributes property to the partnership in exchange for an interest in the partnership.⁹⁴ This rule does not apply to gain realized on a transfer of property to a partnership that would be treated as an

⁹⁴ Code § 721(a).

investment company within the meaning of Code Section 351 if the partnership were incorporated.⁹⁵

The Treasury Regulations under Code Section 351 provide that a shareholder recognizes gain if the transferee is an investment company and the transfer results in diversification of the shareholder's interest.⁹⁶ That is, not only must the corporation meet the definition of an investment company, but the capital contribution must result in the diversification of the contributing shareholder's investment portfolio. It bears repeating that there are two requirements, (a) an investment company and (b) diversification.

2. *Investment Company Definition*

A corporation will be an investment company if the corporation is (a) a regulated investment company, (b) a real estate investment trust, or (c) a corporation, after the exchange, more than 80 percent of the value of whose assets are held for investment and are stocks or securities (or interests in regulated investment companies or real estate investment trusts).⁹⁷ This definition applies to a partnership investment company.⁹⁸

⁹⁵ Code § 721(b).

⁹⁶ Treas. Reg. § 1.351(c)(1).

⁹⁷ Treas Reg. § 1.351-1(c).

⁹⁸ S. Rep. No. 938, 94th Cong., 2d Sess., pt. 2, at 43 (1976).

Therefore, a partnership will be an investment company if, after the exchange, more than 80 percent of the value of its assets are held for investment and are stock or securities.

The statute broadly defines “stocks and securities” to include the following:⁹⁹

- Money¹⁰⁰
- Stocks and other equity interests in corporations, evidences of indebtedness, options, forward or futures contracts, notional principal contracts and derivatives.
- Foreign currency.
- Interests in real estate investment trusts, common trust funds, regulated investment companies, publicly-traded partnerships or any other equity interest (other than in a corporation) that pursuant to its terms or any other arrangement is readily convertible into, or exchangeable for, any other asset defined as stock and securities by Code Section 351.
- Interests in precious metals (unless used or held in the active conduct of a trade or business or excepted by regulation).

⁹⁹ Code § 351(e)(1)(B).

¹⁰⁰ The legislative history provides an exclusion for contributed cash that, pursuant to a plan, is used to purchase non-listed assets or pay expenses (for example, salary). Jt. Comm. on Tax'n, General Explanation of Tax Legislation Enacted in 1997, at 184 (Dec. 17, 1997).

- Interests in any entity if substantially all of the assets owned by such entity consist, directly or indirectly, of any of the foregoing assets.¹⁰¹

In addition, the Secretary of the Treasury is granted broad power to list or delist assets constituting stock and securities.¹⁰²

Example: Husband and wife propose to form a partnership. Husband will contribute \$80,000.00 of duPont stock, while wife will contribute \$20,000.00 cash. Because the cash is included in the term “stock and securities,” the partnership will be an investment company because 100 percent of its assets after the exchange will be stock and securities.

Real estate is not a list asset deemed to be stock and securities and can be used to defeat the 80 percent test.

Example: Husband and wife propose to form a partnership. Husband will contribute \$80,000.00 of duPont stock, while wife will contribute real estate have a value of \$20,000.00. The partnership will not be an investment company because only 80 percent of its assets after the exchange will be stock and securities.

¹⁰¹ There are no regulations defining “substantially all” for this purpose and the legislative history is silent. The almost identical rules under Code Section 731(c) might be applied. See Treas. Reg. § 1.731-2(c)(3).

¹⁰² Code § 351(e)(1)(B).

3. *Diversification*

Generally, diversification requires transfers of non-identical assets by two persons.¹⁰³ A transfer by one person usually results in an identical portfolio before and after the transfer.¹⁰⁴ Further, small or *de minimus* differences in contributed assets will not result in diversification.¹⁰⁵

This rule does not apply if the property being contributed consists of a diversified portfolio of securities.¹⁰⁶ A portfolio is diversified if no more than twenty-five percent (25%) of the assets consist of stock or securities of any one issuer and no more than fifty percent (50%) of the assets consist of stock or securities of five or fewer

It is obvious that cash is not “identical to stock and securities and, in theory, the contribution of more than an insignificant amount of cash should result in diversification. However, where one transferor contributes a diversified portfolio and the other transferor contributes more than an insignificant amount of cash, the cash will be viewed as a

¹⁰³ Treas. Reg. §1.351(c)(5).

¹⁰⁴ *Id.*

¹⁰⁵ *Id.* See Priv. Ltr. Rul. 200006008 (transfers of three portfolios to partnership (LLC) amounting in the aggregate to less than 5 percent of the value of the partnership’s portfolio after the transfer are insignificant and disregarded in determining whether diversification exists).

¹⁰⁶ Treas. Reg. §1.351(c)(6)(i).

diversified portfolio.¹⁰⁷ The apparent basis for reaching this conclusion is that the person transferring cash could have purchased a diversified portfolio and contributed the portfolio to the partnership.¹⁰⁸

Example: Husband and wife propose to form a partnership. Husband will contribute \$80,000.00 of duPont stock, while wife will contribute \$20,000.00 cash. Because the cash is included in the term “stock and securities,” the partnership will be an investment company because 100 percent of its assets after the exchange will be stock and securities. In addition, there will be diversification because husband is contributing a single security, while wife is contributing a deemed diversified portfolio.

Example: Husband and wife propose to form a partnership. Husband will contribute a diversified portfolio valued at \$80,000.00, while wife will contribute \$20,000.00 cash. Because the cash is included in the term “stock and securities,” the partnership will be an investment company because 100 percent of its assets after the exchange will be stock and securities. The transfers will not result in diversification because husband and wife are each contributing a diversified

¹⁰⁷ Priv. Ltr. Rul. 200125053, 200118039, 200113010, 200121016, 200008025, 9925017, 9909045, 9644007, 9643006.

¹⁰⁸ Monte A. Jackel & James B. Sowell, *Transfer to Investment Companies: Complexity in a Conundrum*, 94 TAX NOTES 1659 (Mar. 25, 2002).

portfolio.

Of particular significance in many cases, a portfolio is deemed to own a percentage of each security held by a real estate investment trust, a regulated investment company or an investment company under the investment company rules.¹⁰⁹ Consider a partnership formed by deceased husband's marital trust and surviving wife's revocable trust. Each trusts holds a portfolio consisting of a few stock and several mutual funds. Table III (page 62) tests each portfolio for diversification. Table III lists the securities held by each trust. The first column of numbers lists the value of all investments held by each trust. The second column of numbers lists the value of those investments that are tested (that is, the second column excludes those investments not tested under the regulations). Using the value of the securities to be tested, the middle column of numbers gives the percentage of each security's value in its portfolio.

The "25% Test" column identifies the largest single holding in each trust's portfolio. Question marks identify the fact it is not known whether the mutual fund holdings would be sufficient to push trust ownership in any one issuer to more than 25 percent. While it seems unlikely that the holdings of any of the funds owned by the trusts

¹⁰⁹ Treas. Reg. § 1.351-1(c)(6)(i), incorporating Code Section 368(a)(2)(F) by reference.

could cause the portfolio to fail the 25% Test, it is necessary to review the prospectus for each fund to see if the fund's holdings could potentially cause problems.

The "50% Test" column identifies each trust's holdings that meet the 50% Test's requirements. In the case of the marital trust, the comments above on the 25% Test apply.

In the case of the surviving wife's revocable trust, three holdings together are more than 50 percent of the value of the portfolio. Therefore, the revocable trust fails this test and is not a diversified portfolio.

The lack of diversification may be solved by contributing less than all of the securities in the revocable trust's portfolio to the partnership. The last column, as an example, shows that the 50% Test will be met if the duPont stock is not contributed to the partnership.

Table IV (page 63) presents the diversification analysis for the portfolio actually contributed to the partnership. The client did not want to retain all of the duPont stock. Instead, the client held back shares of three securities to diversify the portfolio.

In the family investment partnership context, the *de minimus* exception is often used to avoid diversification. The owner of the portfolio contributes it to the partnership in exchange for a partnership interest. The other partners make nominal contributions in

exchange for their interests.¹¹⁰ Eleven percent cash is too much¹¹¹ and 1 percent is safe.¹¹² In at least one private letter ruling, the Service ruled that cash in excess of 5 percent was insignificant.¹¹³

Alternatively, the owner of the portfolio may make a gift of some part of each security in the portfolio to his or her spouse. Each of them contributes their separate but identical portfolio to the partnership in exchange for a partnership interest.¹¹⁴ There is no gift tax cost, because of the unlimited marital deduction. The partners may then make gifts of partnership interests to their children. When implementing a partnership for a surviving spouse, the surviving spouse will make a gift of an interest in the portfolio to one or more children, who then contribute their interests in the portfolio to the partnership in exchange for a partnership interest. Typically, this is accomplished by the surviving parent making gifts as tenants in common of interests in the brokerage account to the

¹¹⁰ See Priv. Ltr. Rul. 9544012 (no gain where 99 percent partner contributing cash and marketable securities and 1 percent partner contributes cash); Priv. Ltr. Rul. 9345047 (cash contributions representing less than 1 percent of total asset value ignored in determining diversification).

¹¹¹ Rev. Rul 87-9, 1987-1 C.B. 133.

¹¹² Treas. Reg. § 1.351-1(c)(7), Example (1).

¹¹³ Priv. Ltr. Rul. 9451035.

¹¹⁴ See Priv. Ltr. Rul 9012024 (husband and wife exchange interests in each other's portfolios, resulting in identical portfolios; contribution of portfolios to partnership does not result in gain recognition).

children. The account holders, the parent and the children, then contribute the brokerage account to the partnership. The gifts of interests in the portfolio may result in taxable gifts. Whether this is so is a function of the total value of the portfolio and the percentage interest gifted to the children.

D. Family Partnership Income Tax Rules

1. Introduction

Historically, taxpayers have attempted to reduce the federal income tax burden by shifting income to lower tax bracket taxpayers. Invariably, each new technique is viewed as “abusive” by the Internal Revenue Service and provisions are engrafted upon the Internal Revenue to address the perceived abuse.

One such perceived abuse is the family partnership where capital is a material income producing factor. By having a high tax bracket family member contribute income producing property to a partnership consisting of family members, income can be allocated to lower tax bracket family members. The same abuse exists in a service partnership, where income from services performed by one partner is allocated to non-service providing partners.

Code Section 704(e) was enacted to address this issue, to tax income “to the person who earns it through his own labor and skill and the utilization of his own

capital.”¹¹⁵ Unless certain requirements are met, family members will not be recognized as partners, resulting in the allocation of income to the partner who contributed the income producing property.

2. *Section 704(e)(1): Capital Ownership as the Hallmark of a Partner*

Under Code Section 704(e)(1), if capital is a material income-producing factor, a person will be recognized as a partner if that person owns a capital interest in the partnership. A capital interest is an interest in the assets of the partnership that is distributable on withdrawal or liquidation.¹¹⁶

Ownership of a capital interest requires a bona fide transaction and real ownership.¹¹⁷ A transfer of a partnership interest to a family member must vest dominion and control in the transferee.¹¹⁸ The Internal Revenue Service will examine whether the transferor has retained control over the interest, whether the transferee can participate in management, the actual distribution of income by the partnership, and the conduct of the

¹¹⁵ Treas. Reg. § 1.704-1(e)(1)(i).

¹¹⁶ Treas. Reg. § 1.704-1(e)(1)(v).

¹¹⁷ Treas. Reg. § 1.704-1(e)(1)(ii).

¹¹⁸ *Id.*

partnership's business.¹¹⁹

The ownership requirement generally will be established, first, by documenting the transfer of the interest. If the transfer is by gift, the transfer should be evidenced by an irrevocable deed of gift, not merely by entries on the books and records of the partnership. If the transfer is by purchase, there should be a purchase agreement and an assignment of the purchased.

3. *Control and Retained Interests; Transfer Restrictions*

Beyond documenting the transfer of the partnership interest, consideration must be given to the controls retained by the donor in determining whether a donee is the owner of an interest in the partnership.¹²⁰ If the donor retains sufficient control over the donee's interest, the donor will be treated as the "substantial owner of the interest."¹²¹ The Treasury Regulations set forth a nonexclusive list of retained controls:

- Retention of control over the distribution of amounts of income or restrictions on the distribution of income (excluding the reasonable needs of the business).

¹¹⁹ Treas. Reg. § 1.701(e)(2)(ii)-(vi).

¹²⁰ Treas. Reg. § 1.701(e)(2)(ii).

¹²¹ *Id.*

- Limitations on the right to liquidate or sell the interest at the donee's discretion and without financial detriment to the donee.
- Retention of control of essential business assets (for example, leasing key assets to the partnership).
- Retention of management powers not consistent with the normal relationships among partners.

Limited partners may not participate in the management of the partnership without losing their limited liability shield.¹²² Does this mean that a donee limited partner will not be recognized as a partner? The answer is, no. A donee limited partner will be recognized as a partner if the donee actually owns the interest.¹²³ Thus, use of a limited partnership is one way for a donor to retain management control, yet have transfers of partnership interests recognized for income tax purposes. A limited partnership must be organized and conducted under the governing limited partnership act.¹²⁴ The limited partnership interest cannot be subject to substantial restrictions and the general partner cannot retain controls that would not exist if the agreement were with unrelated partners.

A manager-managed limited liability company is operationally similar to a limited

¹²² 30 Del. C. § 17-303.

¹²³ Treas. Reg. 1.701-1(e)(2)(ix).

¹²⁴ *Id.*

partnership. The managers exercise all management authority, as do general partners. The limited partners are analogous to the members. However, the grant of management authority to general partners is of necessity, while management by managers is optional. Therefore, it can be argued that the donor of member interests has retained control where the limited liability company is manager-managed. It should be possible to eliminate this argument by having the donor member have a less than 50 percent manager interest.

4. *Meeting the Capital Ownership Test*

The following actions should be taken to establish that donee partners are true partners for federal income tax purposes:

- Gift limited partner interests to avoid the argument that the donor has retained management control.
- Comply with the governing law.
- Distribute income pro rata.
- Distribute cash not needed for the business needs of the partnership to the partners in proportion to their interests.
- Document the transfer and make sure that all partnership records reflect the status of the donee as a partner.
- File partnership income tax returns consistent with the donee's status as a

partner.

- Transfer restrictions and management authority in the partnership agreement should be consistent with those that would be in partnership agreement between unrelated partners.
- Partnership interests held by minors should be owned by a UTMA custodian or a trustee independent of the donor.

5. *Section 704(e)(2): Compensation for Services*

If the donor partner renders services to the partnership, he or she must be adequately compensated for those services.¹²⁵ In most family partnerships, the services rendered to the partnership by the donor partner(s) are not significant. However, as a protective measure, the partnership agreement should provide for the compensation of partners rendering services to the partnership.

E. Future Appreciation

The goal of a gift program is to transfer wealth from the senior generation to a junior generation at the lowest possible tax cost. A gift of property removes not only the value of that property as of the date, but also all future appreciation. Thus, the donor will

¹²⁵ Code § 704(e)(2); Treas. Reg. § 1.701(e)(1)(ii).

maximize the benefit of wealth transfer by selecting those assets that the donor expects to appreciate the most. Removal of appreciation further leverages the power of a regular gift program.

F. Valuation Discounts

1. Introduction

Code Section 2512 provides that when a gift “is made in property, the value thereof at the date of the gift shall be considered the amount of the gift.”¹²⁶ The Regulations provide that “[t]he value of property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts.”¹²⁷

While valuation methodologies and the appraisal process is beyond the scope of this material, valuation experts generally consider the net asset value of the partnership and the net income or cash flow generated by the assets of the partnership. The beginning point in net asset valuation is to determine the fair market value of each of the partnership’s assets. The individual values are totaled, and then the partnership liabilities are subtracted to determine net asset value. The value of each percentage interest or

¹²⁶ Code § 2512(a).

¹²⁷ Treas. Reg. § 25.2512-1.

partnership unit is determined merely by dividing the total net asset value by the number of units or 100 percent.

The net asset value method is usually employed where a partnership is, or is becoming, a holding or an investment company. The method is also appropriate where earnings are subnormal or non-existent. Conversely, the income approach is appropriate for valuing an operating company. The income approach to valuation considers the partnership's current and projected earnings and cash flow.

2. *Valuation Discounts*

It is a fundamental principal of valuation that a partial interest is worth less than the whole. The simplest example is property held equally by two tenants in common. The value of one co-tenant's interest is worth less than one-half the value of the whole because one co-tenant does not possess 100 percent of the rights with respect to the property. At a minimum, a potential purchaser would discount the value of one co-tenant's interest by the cost to partition the property.

In the case of partnership interests, there are two primary discounts, the "lack of control" or "minority interest" discount and the "lack of marketability" discount. In the case of limited partnerships, the lack of control or minority interest discount reflects the limited voting rights accorded to limited partners. The amount of the discount depends

upon the amount of partnership distributions, if any, the degree of risk associated with the assets of the limited partnership and the terms of the limited partnership agreement.

The lack of marketability discount reflects the fact that the lack of a market in which the interest trades and transfer restrictions under state law and by agreement make a partnership interest unattractive. Usually, the marketability discount is based on comparable sales of restricted stock of publicly traded companies.

3. *Valuation Rules of Chapter 14*

Code Sections 2701 through 2704 (“Chapter 14”) set forth statutory valuation rules for transfer of equity interests between family members. These rules must be taken into account when valuing gifts of interests in entities. While a detailed discussions of these provisions is beyond the scope of these materials, a general discussion follows.

a. Code Section 2701

Code Section 2701 was designed to attack “estate freezes,” transactions where the value held by the senior generation is frozen and any appreciation inures to the benefit of the junior generation. In the prototypical corporate estate freeze, the senior generation recapitalized a business with preferred and common stock. The preferred stock held sufficient extraordinary rights that it represented the entire value of the corporation, with the result that the common stock had little or no value. The senior generation retained the

high value senior interest and gave the low or no value junior interest to members of the junior generation.

Code Section 2701 applies to a corporation or partnership with more than one class of equity interests (for example, preferred stock and common stock), where one class possesses an “extraordinary payment right.” When Code Section 2701 applies to a transfer of a junior interest, the value of the junior interest is valued by subtracting the value of interests in the entity retained by the transferor. In valuing the interests retained by the transferor, the value of the senior interest is zero, resulting in the non-senior interests having a value equal to the 100 percent of the entity value.

For the purposes of Code Section 2701, the differences between general and limited partner interests are not two classes of interests.¹²⁸ Thus, Section 2701 can be avoided by using a garden variety limited partnership.

b. Code Section 2702

Code Section 2072 has no application to partnerships because it is limited by its terms to trusts.

c. Code Section 2703

Code Section 2703 provides that for transfer tax purposes, “any restriction on the

¹²⁸ Code § 2701(a)(2)(C).

right to sell or use such property” is ignored.¹²⁹ A right or restriction may be contained in a certificate of limited partnership, partnership agreement or any other agreement or be implicit in the partnership’s capital structure.¹³⁰ Code Section 2703 attempts to avoid valuation discounts based on transfer restrictions.

A transfer restriction will not be ignored if it meets a three-part test:

- The restriction is a bona fide business arrangement;
- The restriction is not a device to transfer property to family members for less than full and adequate consideration; and
- The restriction is comparable to similar arrangements entered into in arms’ length transactions.¹³¹

To avoid the application of Code Section 2703, drafters structure restrictions to take advantage of state law restrictions and to be comparable to third party arrangements.

d. Code Section 2704

Code Section 2704(b) provides that “applicable restrictions” are ignored in valuing interests if the transferor and members of the transferor’s family control the entity

¹²⁹ Code § 2703(a)(2).

¹³⁰ Treas. Reg. § 25.2703-1(a)(3).

¹³¹ Code § 2703(b).

immediately before the transfer.¹³² Applicable restrictions are restrictions that limit the right of the entity to liquidate and the restriction either lapses after the transfer or the transferor and the members of the transferor's family, alone or together, have the right to remove the restriction.¹³³

Restrictions imposed by state law are not applicable restrictions.¹³⁴ Thus, the best way to avoid Code Section 2704(b) is to form the entity in a state, such as Delaware, with favorable laws. Under the default rules of the Delaware Revised Uniform Limited Partnership Act, "a limited partner may not withdraw from a limited partnership prior to the dissolution and winding up of the limited partnership"¹³⁵ and a limited partnership may not be dissolved except with the consent of all general partners and two-thirds of the limited partners by interest.¹³⁶

The right of a member of a Delaware limited liability company to resign is similarly restricted by the Delaware Limited Liability Company Act.¹³⁷ A Delaware

¹³² Code § 2704(b)(1).

¹³³ Code § 2704(b)(2).

¹³⁴ Code § 2704(b)(3)(B).

¹³⁵ DRULPA § 17-603.

¹³⁶ DRULPA § 17-801(2).

¹³⁷ DLLCA § 18-603.

limited liability company may be dissolved with the consent of two-thirds of the members by interest.¹³⁸

4. *Surviving Internal Revenue Service Attacks*

The Internal Revenue Service views the generation of discounts through family-owned entities as abusive. As a consequence, the Service has applied a shotgun blast approach to its attacks on family owned entities. Much of the case law and other guidance can be summarized as follows:

- Comply with state law filing requirements for the entity (and do it before transferring assets or making gifts)
- Enter into an entity agreement (and do it before transferring assets or making gifts)
- Avoid deathbed/power of attorney transactions
- Follow the terms of the governing statute and agreement
 - Contribute capital as provided in the agreement
 - Manage the entity as provided in the agreement
 - Distribute cash as provided in the agreement

¹³⁸ DLLCA § 18-801(a)(3).

- Distribute cash pro rata according to the equity owners' interests in the entity
- Open a bank account or brokerage account for the entity
- Don't transfer all senior generation assets to the entity
- Don't co-mingle non-entity property with entity property
- Don't put the senior generation's personal residence in the entity
- Wait a reasonable period of time after capital contributions to begin gifts of interests
- Document gifts of interests in the entity
 - Gift document
 - Acknowledgment of gift and entity agreement

G. Gift Tax Reporting Requirements

The Taxpayer Relief Act of 1997, among other things, amended Code Sections 2504(c) and 6501(c)(9) to provide a meaningful gift tax statute of limitations.¹³⁹ For any gift required to be shown on a gift tax return that is not shown on such return, the gift tax may be assessed, or a proceeding in court for the collection of the gift tax may be begun

¹³⁹ For a discussion of the failure of the gift tax statute of limitations prior to amendment, see David W. Reinecke, *Gift Tax Return Statute of Limitation: A Statute With Too Many Limitations*, 21 ACTEC NOTES 227 (1995).

without assessment, at any time.¹⁴⁰ For gifts made in calendar 1997 and years thereafter, the statute of limitations will begin to run as to any item that is disclosed in a gift tax return, or in a statement attached to the gift tax return, in a manner adequate to notify the Secretary of the nature of the item.¹⁴¹

The Treasury Department issued final regulations on adequate disclosure for gifts tax returns on December 3, 1999.¹⁴² A transfer (not necessarily a gift) will be adequately disclosed on a gift tax return only if it is reported in a manner adequate to apprise the Service of (1) the nature of the gift and (2) the basis for the value so reported.¹⁴³

a. The Regulatory Safe Harbor

The regulation provides a safe harbor. Transfers reported on the return as gifts will be considered adequately disclosed if the return, or a statement attached to the return, provides the following information:¹⁴⁴

1. Transfer Description. A description of the transferred property and any consideration received by the transferor;

¹⁴⁰ Code § 6501(c)(9).

¹⁴¹ *Id.*

¹⁴² T.D. 8845, 64 Fed. Reg. 67767-67773 (Dec. 3, 1999), corrected by T.D. 8845c, 65 Fed. Reg. 1059 (Jan. 7, 2000).

¹⁴³ Treas. Reg. § 301.6501(c)-1(f)(2).

¹⁴⁴ *Id.*

2. Identification of Parties. The identity of, and relationship between, the transferor and each transferee;
3. Trust Description. If the property is transferred in trust, the trust's tax identification number and a brief description of the terms of the trust or a copy of the trust instrument,¹⁴⁵
4. Valuation Information. Unless a qualified appraisal is provided, a detailed description of the method used to determine the fair market value of property transferred, including any financial data (for example, balance sheets, with explanations of any adjustments) that were utilized in determining the value of the interest, any restrictions on the transferred property that were considered in determining the fair market value of the property, and a description of any discounts, such as discounts for blockage, minority or fractional interests, and lack of marketability, claimed in valuing the property.
 - a. If the transferred interest is actively traded on an established national exchange, or a regional exchange in which quotations are published on a daily basis, recitation of the exchange where the interest is listed, the CUSIP number of the security, and the mean between the highest and lowest

¹⁴⁵ Where gifts will be made over more than one year to the same trust, many gift tax return preparers file the trust agreement with the initial return and reference the return first filed with the trust agreement on later returns. Query whether this meets the new regulatory requirements.

quoted selling prices on the applicable valuation date will satisfy the valuation requirement.

b. In the case of the transfer of an interest in an entity that is not actively traded, the disclosure must provide a description of any discount claimed in valuing the interests in the entity or any assets owned by the entity. If the entity, or of the interests in the entity, is properly valued based on the net value of the assets held by the entity, the disclosure must include the fair market value of 100 percent of the entity determined without regard to any discounts, the pro rata portion of the entity subject to the transfer, and the fair market value of the transferred interest as reported on the return. If the value of 100 percent of the entity is not disclosed, the taxpayer bears the burden of demonstrating that the fair market value of the entity is properly determined by a method other than a method based on the net value of the assets held by the entity.

c. If the entity that is the subject of the transfer owns an interest in another non-actively traded entity (either directly or through ownership of an entity), the required valuation information must be provided for each such entity if the information is relevant and material in determining the value of the interest.

5. Contrary Position Statement. A statement describing any position

taken that is contrary to any proposed, temporary or final Treasury regulations or revenue rulings published at the time of the transfer.

b. Qualified Appraisal

In lieu of the submitting the required valuation information, the taxpayer can supply an appraisal meeting the regulatory requirements.¹⁴⁶ The appraisal must contain the following information:¹⁴⁷

1. The date of the transfer, the date on which the transferred property was appraised, and the purpose of the appraisal.
2. A description of the property.
3. A description of the appraisal process employed.
4. A description of the assumptions, hypothetical conditions, and any limiting conditions and restrictions on the transferred property that affect the analyses, opinions, and conclusions.
5. The information considered in determining the appraised value, including in the case of an ownership interest in a business, all financial data that was used in determining the value of the interest that is sufficiently detailed so that another person can replicate the process and arrive at the appraised value.

¹⁴⁶ Treas. Reg. § 301.6501(c)-1(f)(3).

¹⁴⁷ Treas. Reg. §301.6501(c)-1(f)(3)(ii).

6. The appraisal procedures followed, and the reasoning that supports the analyses, opinions, and conclusions.

7. The valuation method utilized, the rationale for the valuation method, and the procedure used in determining the fair market value of the asset transferred.

8. The specific basis for the valuation, such as specific comparable sales or transactions, sales of similar interests, asset-based approaches, merger-acquisition transactions, etc.

The appraisal must be prepared by an appraiser satisfying the following requirements:¹⁴⁸

1. The appraiser must hold himself or herself out to the public as an appraiser or must perform appraisals on a regular basis.

2. The appraiser must be qualified to make appraisals of the type of property being valued, based on the appraiser's qualifications, as described in the appraisal, detailing the appraiser's background, experience, education, and membership, if any, in professional appraisal associations.

3. The appraiser cannot be the donor or the donee of the property, or a

¹⁴⁸ Treas. Reg. §301.6501(c)-1(f)(3)(i).

member of the family of the donor or donee,¹⁴⁹ or any person employed by the donor, the donee, or a member of the family of either the donor or the donee.

c. Adequate Disclosure of Non-Gift Transfers to Family Members

Completed transfers to members of the transferors family¹⁵⁰ that are made in the ordinary course of operating a business are adequately disclosed if the transfer is properly reported by all parties for income tax purposes.¹⁵¹ For example, salary paid to a family member employed in a family owned business will be treated as adequately disclosed for gift tax purposes if the item is properly reported by the business and the family member on their income tax returns.¹⁵²

Adequate disclosure of any other transfer not a gift requires that the following information be reported on or attached to a gift tax return:¹⁵³

1. The information required for adequate disclosure; and
2. An explanation of why the transfer is not a gift.

d. Split Gifts

¹⁴⁹ As defined in Code Section 2032A(e)(2).

¹⁵⁰ See n. 12.

¹⁵¹ Treas. Reg. §301.6501(c)-1(f)(4)

¹⁵² *Id.*

¹⁵³ *Id.*

Where a husband and wife split gifts, it is sufficient to make adequate disclosure on the return of the donor spouse.¹⁵⁴

e. Finality

If adequate disclosure is made of a transfer after August 6, 1997, the statute of limitations will run on all gift and estate tax issues, both as to valuation and as to the tax law.¹⁵⁵ For gift before August 7, 1997, the statute of limitations will run only for gifts reported for which gift tax was assessed or paid.¹⁵⁶

Example: In 1996, A transferred closely-held stock in trust for the benefit of B, A's child. A timely filed a Federal gift tax return reporting the 1996 transfer to B. No gift tax was assessed or paid as a result of the gift tax annual exclusion and the application of A's available unified credit. In 2001, A transferred additional closely-held stock to the trust. A's Federal gift tax return reporting the 2001 transfer was timely filed and the transfer was adequately disclosed under Treasury Regulation Section 301.6501(c)-1(f)(2). In computing the amount of taxable gifts, A claimed annual exclusions with respect to the transfers in 1996 and 2001. In 2003, A transfers additional property to B and timely files a Federal

¹⁵⁴ Treas. Reg. §301.6501(c)-1(f)(6)

¹⁵⁵ Treas. Reg. §§ 25.2504-2(b), 20.2001-1(b).

¹⁵⁶ Treas. Reg. §§ 25.2504-2(a), 20.2001-1(a).

gift tax return reporting the gift. Under Code Section 2504(c), in determining A's 2003 gift tax liability, the amount of A's 1996 gift can be adjusted for purposes of computing prior taxable gifts, since that gift was made prior to August 6, 1997. Adjustments can be made with respect to the valuation of the gift and legal issues presented (for example, the availability of the annual exclusion with respect to the gift). However, A's 2001 transfer was adequately disclosed on a timely filed gift tax return and, thus, the amount of the 2001 taxable gift by A may not be adjusted (either with respect to the valuation of the gift or any legal issue) for purposes of computing prior taxable gifts in determining A's 2003 gift tax liability.¹⁵⁷

Example: In 1996, A transferred closely-held stock to B, A's child. A timely filed a Federal gift tax return reporting the 1996 transfer to B and paid gift tax on the value of the gift reported on the return. On August 1, 1997, A transferred additional closely-held stock to B in exchange for a promissory note signed by B. Also, on September 10, 1997, A transferred closely-held stock to C, A's other child. On April 15, 1998, A timely filed a gift tax return for 1997 reporting the September 10, 1997, transfer to C and, under Treasury Regulation Section 301.6501(c)-1(f)(2), adequately disclosed that transfer and paid gift tax

¹⁵⁷ Treas. Reg. §25.2504-2(c), Example 1.

with respect to the transfer. However, A believed that the transfer to B on August 1, 1997, was for full and adequate consideration and A did not report the transfer to B on the 1997 Federal gift tax return. In 2002, A transfers additional property to B and timely files a Federal gift tax return reporting the gift. Under Code Section 2504(c), in determining A's 2002 gift tax liability, the value of A's 1996 gift cannot be adjusted for purposes of computing the value of prior taxable gifts, since that gift was made prior to August 6, 1997, and a timely filed Federal gift tax return was filed on which a gift tax was assessed and paid. However, A's prior taxable gifts can be adjusted to reflect the August 1, 1997, transfer because, although a gift tax return for 1997 was timely filed and gift tax was paid, under Treasury Regulation Section 301.6501(c)-1(f) the period for assessing gift tax with respect to the August 1, 1997, transfer did not commence to run since that transfer was not adequately disclosed on the 1997 gift tax return. Accordingly, a gift tax may be assessed with respect to the August 1, 1997, transfer and the amount of the gift would be reflected in prior taxable gifts for purposes of computing A's gift tax liability for 2002. A's September 10, 1997, transfer to C was adequately disclosed on a timely filed gift tax return and, thus, the amount of the September 10, 1997, taxable gift by A may not be adjusted for purposes of

computing prior taxable gifts in determining A's 2002 gift tax liability.¹⁵⁸

¹⁵⁸ Treas. Reg. §25.2504-2(c), Example 2.

Table I

UNIFIED RATE SCHEDULE FOR ESTATES AND GIFTS			
AMOUNT EXCEEDING	BUT NOT EXCEEDING	TAX ON FIRST COLUMN*	RATE ON EXCESS*
	10,000		18%
10,000	20,000	1,800	20%
20,000	40,000	3,800	22%
40,000	60,000	8,200	24%
60,000	80,000	13,000	26%
80,000	100,000	18,200	28%
100,000	150,000	23,800	30%
150,000	250,000	38,800	32%
250,000	500,000	70,800	34%
500,000	750,000	155,800	37%
750,000	1,000,000	248,300	39%
1,000,000	1,250,000	345,800	41%
1,250,000	1,500,000	448,300	43%
1,500,000	2,000,000	555,800	45%
2,000,000	2,500,000	780,800	49%
2,500,000		1,025,800	50%

*Before phase-in of reduction of highest marginal rate

Table II

ESTATE AND GST TAX EXEMPTIONS AND HIGHEST RATES FOR TRANSFERS AT DEATH		
YEAR	EXEMPTION AMOUNT	HIGHEST RATE
2003	\$1 million	49%
2004	\$1.5 million	48%
2005	\$1.5 million	47%
2006	\$2 million	46%
2007	\$2 million	45%
2008	\$2 million	45%
2009	\$3.5 million	45%
2010	n/a	n/a
2011+	\$1 million	55%

Gift tax exemption amount remains fixed at \$1 million and the maximum gift tax rate in 2010 equals the maximum individual income tax rate of 35%

Table III

Table IV

VII. ETHICAL CONSIDERATIONS

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PARTNERSHIPS, LLCs & LLPs IN DELAWARE:
ORGANIZATION AND OPERATION

February 18, 2003

VII. Ethical Considerations¹

A. General Ethical Considerations

1. *Competence*

A lawyer is ethically required to refuse to accept cases in areas of the law where he or she is not competent. “A lawyer shall provide a competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation necessary for the representation.”² Although most lawyers are competent to prepare simple partnership agreements and limited liability company agreements, simple agreements are appropriate in very few cases today. A large portion of drafting cases require extensive knowledge of tax laws, as well as the Delaware Revised Uniform Partnership Act, the Delaware Revised Uniform Limited Partnership Act, the Delaware Limited Liability Company Act,

¹ Prepared by Bryan E. Keenan, Esquire. Copyright 2003 Bryan E. Keenan. This material is adapted from J. S. HAYES, JR., B. E. KEENAN, AND J. REIVER, BASIC DRAFTING OF WILLS AND TRUSTS IN DELAWARE Ch. V (NBI 1993).

² DEL. LAW. R. PROF. COND. Rule 1.1 (2003).

fiduciary duties and general principles of agency law. Accordingly, a lawyer must be careful not to undertake drafting assignments without an appropriate level of knowledge.

The ease with which drafting errors may be made compels an honest evaluation of your professional competence. Competence may be acquired by training and experience, preparation and study, and association or consultation with competent counsel.³

2. *Communications*

a. The Initial Contact

If an attorney has not “regularly represented the client, the basis or rate of the fee shall be communicated to the client, preferably in writing, before or within a reasonable time after commencing the representation.”⁴ Foreshadowing the related problems of conflicts and confidentiality, the engagement letter should:⁵

³ Comment to DEL. LAW. R. PROF. COND. Rule 1.1 (2003).

⁴ DEL. LAW. R. PROF. COND. Rule 1.5(b) (2003).

⁵ See Walsh, *Ethical Issues in Estate Planning (with Forms)*, 15 ALI-ABA COURSE MATERIALS JOURNAL 7-8 (1991).

- Identify the client;
- Define the scope of the representation;
- Outline the scope of the services to be rendered;
- Explain how the fee for those services will be determined;
- Explain what costs will be passed through to the client;
- Specify when payments for fees and costs are due;
- Explain how the parties' interests may conflict and obtain a waiver of those conflicts;
- Explain the attorney's duty of confidentiality and obtain consent to disclose confidences of one party to the other; and
- Reserve the right to withdraw and provide a procedure for withdrawal.

a. The Continuing Duty to Communicate

An attorney is required to “keep a client reasonably informed about the status of a matter and promptly comply with reasonable requests for information.”⁶

Further, an attorney must “explain a matter to the extent necessary to permit the

⁶ DEL. LAW. R. PROF. COND. Rule 1.4(a) (2003).

client to make informed decisions regarding the representation.”⁷ As lack of communication underlies a majority of malpractice claims, full and frequent communication with the client is in the attorney’s self-interest.

2. *Confidentiality*

“A lawyer shall not reveal information relating to representation of a client unless the client consents after consultation, except for disclosures that are impliedly authorized in order to carry out the representation,”⁸ The duty does not end when the relationship is terminated⁹ or, if an individual, when the client dies.¹⁰

Example: Prospective Member A separately informs the lawyer that she will hold her interest as a nominee of an undisclosed principal.

The lawyer may not disclose this fact to prospective Member B. The knowledge creates a conflict between the members, the lawyer must inform each

⁷ DEL. LAW. R. PROF. COND. Rule 1.4(b) (2003).

⁸ DEL. LAW. R. PROF. COND. Rule 1.6(a) (2003).

⁹ ABA Comm. on Ethics and Professional Responsibility, Informal Op. 1301 (1975).

¹⁰ ABA Comm. on Ethics and Professional Responsibility, Informal Op. 1293 (1974).

that a conflict exists, the lawyer must inform each that the conflict prevents the lawyer from representing either one or both of them, and the lawyer must inform each of them to retain new and separate counsel.¹¹ Further, the lawyer has become an intermediary between them and cannot represent either without first completely revealing the cause of the conflict and the need to change the attorney-client relationship and then obtaining the express consent of both.¹²

¹¹ DEL. LAW. R. PROF. COND. Rule 1.7 (2003). Avery, *The Rules of Professional Conduct for Lawyers are Confusing*, 131 TRUSTS & ESTATES 10 (1991).

¹² DEL. LAW. R. PROF. COND. Rule 2.2 (2003). Avery, *The Rules of Professional Conduct for Lawyers are Confusing*, 131 TRUSTS & ESTATES 10 (1991).

DELAWARE LAWYERS' RULES OF PROFESSIONAL CONDUCT Rule 2.2 provides:

(a) A lawyer may act as intermediary between clients if:

(1) the lawyer consults with each client concerning the implications of the common representation, including the advantages and risks involved, and the effect on the attorney-client privileges, and obtains each client's consent to the common representation;

(2) the lawyer reasonably believes that the matter can be resolved on terms compatible with the clients' best interests, that each client will be able to make adequately informed decisions in the matter and that there is little risk of material prejudice to the interests of any of the clients if the contemplated resolution is unsuccessful; and

(3) the lawyer reasonably believes that the common representation can be undertaken impartially and

(continued...)

Example: Attorney represents Grandparents, individuals of substantial wealth. To coordinate estate planning with the goal of minimizing death taxes over several generations, Grandparents send Child and Child's spouse to attorney. Grandparents will pay for the services and want the statement for fees sent to them.

Rule 1.8(f) prohibits an attorney from accepting payment for services from anyone other than the client.¹³ Third party payment will not violate the Rule if

(...continued)

without improper effect on other responsibilities the lawyer has to any of the clients.

(b) While acting as intermediary, the lawyer shall consult with each client concerning the decisions to be made and the considerations relevant in making them, so that each client can make adequately informed decisions.

(c) A lawyer shall withdraw as intermediary if any of the clients so requests, or if any of the conditions stated in paragraph (a) is no longer satisfied. Upon withdrawal, the lawyer shall not continue to represent any of the clients in the matter that was the subject of the intermediation.

DEL. LAW. R. PROF. COND. Rule 2.2 (2003).

¹³ DELAWARE LAWYERS' RULE OF PROFESSIONAL CONDUCT Rule 1.8(f) provides:

A lawyer shall not accept compensation for representing a client from one other than the client unless:

(1) the client consents after consultation;

(continued...)

safeguards to protect the professional relationship are taken: The client must after consultation, the lawyer's independence and the client-lawyer relationship must be maintained, and client confidences preserved.¹⁴

3. *Other*

Other issues arise in all matters the lawyer seeks to undertake: The lawyer is responsible for acts of his or her paralegals and secretaries. The lawyer adopts the form book language he or she uses as the lawyer's own. The lawyer is obliged to keep his or her boilerplate current. The DRUPA, DRULPA and DLLCA are usually revised each legislative session, necessitating form revisions.

B. Conflicts

(...continued)

(2) there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship; and

(3) information relating to representation of the client is protected... .

DEL. LAW. R. PROF. COND. Rule 1.8(f) (2003).

¹⁴ *Id.*

By definition, a partnership has at least two members. A limited liability company may have more than one member. Thus a conflict is inherent in almost every representation. The planner may turn to Delaware Lawyer's Rule of Professional Conduct 1.7 for guidance. That Rule provides that

(a) A lawyer shall not represent a client if the representation of that client will be directly adverse to another client, unless:

(1) the lawyer reasonably believes the representation will not adversely affect the relationship with the other client; and

(2) each client consents after consultation.

(b) A lawyer shall not represent a client if the representation of that client may be materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interests, unless:

(1) the lawyer reasonably believes the representation will not be adversely affected; and

(2) each client consents after consultation. When representation of multiple clients in a single matter is undertaken, the consultation shall include explanation of the implications of the common representation and the advantages and risks involved.¹⁵

The partnership or limited liability company agreement should also contain a provision stating who the drafter of the agreement represents and that all other

¹⁵ DEL. LAW. R. PROF. COND. Rule 1.7 (2003).

members were advised to consult independent counsel.