

Entities Must Be Formed, Funded, and Governed Properly

Highlights

Entities such as partnerships, trusts, or LLCs are often used to:

1. Protect assets
2. Transfer wealth
3. Structure how, when, and what taxes are paid

What most people fail to realize, is that in order for entities to be effective, they must be properly:

- Formed
- Funded
- Maintained (Governed)

In addition, many times multiple entities are used together to create a complete business or estate plan. All must follow established guidelines or one wayward entity can ruin the plan.

The following is a case study where the Tax Court did not have to pierce the veil of the entity; all they did was show that the original asset owner never transferred an asset into the entity. If the assets were not owned by the entity, how could the partners of the entity take advantage of the benefits of owning the asset in the entity?

They couldn't, and it cost the Senda family \$487,567 in gift tax penalties.

In addition to improper funding, there was poor documentation and significant corporate governance issues.

This case shows how easy it is to lose to the IRS when you don't form, fund, and govern entities as required.

Senda v. Commissioner

Background

Mark and Michele Senda of Missouri had three children- Mark Jr., Janell, and Ross. The Sendas also owned \$5-6 million of dollars of MCI-WorldCom stock which Mr. Senda received after MCI-WorldCom acquired two companies where Mr. Senda was employed.

Mr. Senda attended a seminar on tax planning and the benefits of forming a Family Limited Partnership (FLP.) He decided to use an FLP to transfer \$2.75M of his stock in MCI-WorldCom to his children. He planned that by doing this the gift tax paid between 1998 and 2000 would be reduced between 49-46% versus the tax on an outright gift of the stock to his children.

(The reduction in gift tax is possible because generally the IRS allows "lack of control", "lack of marketability", and "minority interest" discounts on assets held within a private business entity with multiple owners.)

The Senda Entities

Mark and Michelle set up two FLP's in 1996 and 1999. They formed these entities with their three children and indicated that the children's partnership interests in the FLP were held in trusts.

Mark maintained control of the trusts as the general partner in each. He also held a majority interest in each FLP as a limited partner. His wife and children (in trust) were all limited partners in both trusts.

Once the stock was transferred, the Senda's made gifts of the FLP interests to the children.

The Ongoing Business

The partnership agreements both spelled out operating conditions such as annual meetings, annual financial reports, and that accurate records and books be kept.

The Senda's personally paid all legal fees and filing costs for the formation of the partnerships.

The Tax Issue

The Sendas took significant discounts on the gifts of the FLP to their children based on the issues mentioned above. The Sendas argued that they made gifts not of MCI-WorldCom stock, but of valid FLP interests, and the FLP discounts should not be disregarded.

The tax court considered two key questions when the IRS contested the discounts:

1. Did the Sendas properly contribute the MCI-WorldCom stock to the FLP's before transferring the FLP interests to their children?
2. Did the Sendas properly maintain partnership formalities on how they utilized their FLP's?

The Legal Decision

For both questions the Tax Court looked for documented evidence of how the Sendas had conducted FLP business. The lawsuit identified bad facts in several areas that hurt the Sendas.

Entity Formation:

- No Documented Trusts. The children's FLP interests were purportedly held in trust, but there was no written trust agreement naming them as beneficiaries at the time of the transfer.
- Unsigned Trust. Citicorp was listed on some of the trusts as a trustee, but no representative of Citicorp ever signed the trust documents.

Entity Funding:

- No Funding of the FLPs. The Sendas presented no reliable evidence that they contributed stock to the partnerships before they transferred the partnership interests to the children.
- No Consideration for Business Interests: The children supposedly contributed accounts receivables orally to the FLP in exchange for their partnership interests (in other words, they promised to pay the FLP for the value of their partnership interests.) However, those oral agreements were never put into writing, had no terms for repayment, and had not been paid as of the time of the trial.

Entity Governance

- No Required Documentation. The partnership agreement required preparation of annual financial statements and an annual meeting of the partners, neither of which took place.
- Commingling of Funds- The Sendas personally paid all legal fees and filing costs for the formation of the partnerships. These costs were never reimbursed by the partnership.

The Court noted, "It is apparent from petitioner's evasive testimony and from the total record that petitioners were more concerned with ensuring that the beneficial ownership of the stock was transferred to the children in tax-advantaged transactions than they were with the formalities of FLPs."

What This Means to You

Sometimes people look at partnerships, corporations, LLCs or trusts that are used for estate planning and asset protection differently than those used to conduct an active business.

They say, "If I don't have customers, employees, and vendors, then I don't have to worry about formalities because my potential liability is not significant."

This is not true! The very fact that there were no outside parties forcing arm's length transactions contributed to the Sendas's problem.

The Sendas showed on multiple levels that failure to properly form, fund, and govern entities creates large holes in corporate or family veils. Individuals must take responsibility for these three areas of their financial lives, whether personal or business finances.

While the Sendas used an FLP, the facts would likely have had similar results for other types of entities, such as LLCs, LPs, and so on.

Summary & Conclusion

- The Sendas created FLPs to help reduce gift taxes.
- The FLPs were poorly governed and lacking critical documentation.
- The court agreed with the IRS that the Sendas did not comply with the formalities of establishing and maintaining an FLP and therefore had no access to the tax advantages of a FLP.
- The court ruled the Sendas deficient in a total amount of \$487,567 for gift taxes for the tax years 1998-2000.

Case law consistently demonstrates that individuals who use business entities for family estate planning often cut corners or ignore protocols when doing so.

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