

In this issue:

- Guidelines for operating family gifting entities
- Trademark protection
- Mallgren & Ferrell, P.C. has a second location

SUMMER, 2008

Family Gifting Entities

Paul Chmielewski, Esq., LL.M.

Many people form family limited partnerships or family limited liability companies in order to gift interests to their children for estate tax purposes. Throughout this article, I will refer to these entities as family gifting entities (“FGEs”). When used properly, FGEs provide valuable asset protection and estate tax reduction benefits. Unfortunately, some people have engaged in abusive transactions that have caused the IRS to closely analyze the estate tax benefits claimed from use of FGEs. The purpose of this article is to provide a brief description of the benefits of FGEs and some guidelines to follow when creating and operating a non-abusive FGE.

What is an FGE? An FGE works in the same manner as any other limited liability company or limited liability partnership except that it is designed to gift assets to children or other beneficiaries in order to reduce estate taxes on a grantor’s estate. Discounted values are often applied to gifts of FGE interests due to lack of control and lack of marketability by a minority member.

Estate and Gift Tax Benefits. Currently, every person is allowed to gift up to \$1,000,000 during their lives without paying any gift tax. Persons utilizing this strategy will reduce the amount of assets that can pass free from estate taxes at death (currently \$2,000,000) dollar for dollar. For example, if a person gifts \$1,012,000 to a child, the first \$12,000 will generally pass gift tax free via the annual gift tax exemption and the remaining \$1,000,000 will pass free from any payment of gift tax (although a gift tax return will have to be filed) but will reduce the amount the person can shelter from estate taxes at their death to \$1,000,000 (\$2,000,000 - \$1,000,000). Lifetime gifting is often preferable to waiting until death to gift an asset because once an asset is gifted all future appreciation escapes estate tax. Therefore, if an asset is gifted when it is worth \$1,000,000 but appreciates to \$3,000,000 at the time of the donor’s death, the donor has reduced his or her estate tax burden by approximately \$900,000 (based upon current rates and exemption equivalents).

In addition to the benefits discussed above, a gift of an interest in an FGE often allows for the use of discounted valuations. The IRS generally allows discounts for transfers of minority interests due to lack of marketability and lack of control. For example, the gift of a minority interest in an LLC with a fair market value of \$1,300,000 may only be valued at \$1,000,000 for purposes of gift taxes due to applicable discounts.

Guidelines for the Operation of an FGE. As is discussed above, abusive FGEs are under increased scrutiny by the IRS. The following guidelines should be adhered to in creating and operating an FGE in order to avoid classification as an abusive FGE:

1. Clear Business Purpose. An FGE must have a clear business purpose. There is no absolute rule stating what constitutes a business purpose. However, it is

(Continued on page 2)

Family Gifting Entities, Cont.

(Continued from page 1)

likely that the consolidation of assets in order to facilitate professional management and the use of the FGE to achieve creditor protection are valid business purposes. Many people gift interests in FGEs that contain liquid investments (such as stocks and bonds) and rental real estate.

One thing is clear, a grantor's personal residence should never be placed into an FGE. This is because the grantor would retain full use of the gifted property even though a portion of the property would be considered owned by the other members of the FGE. In other words, the grantor would have not relinquished control over the gifted asset. Similarly, it is not advisable to gift other types of personal use assets, such as vacation homes, to an FGE unless these assets are leased to third parties for a portion of the year.

“Strict corporate formalities should be followed when operating an FGE.”

2. Operate the FGE as a Business. Strict corporate formalities should be followed when operating an FGE. Personal assets should not be commingled with FGE assets. FGE assets should not be used solely to satisfy any individual claims, obligations or liabilities of the grantors. Any distributions a person receives from an FGE can be used to satisfy their personal obligations but all distributions should be made to all members/partners based upon their proportionate interest in the FGE. All members/partners should have the right to participate in management and operation of the FGE. This does not mean that the FGE cannot have centralized management. Instead, all members should have the right to vote to remove the Manager(s). A member should also have the right to liquidate their interest at will. However, the FGE can have a right of first refusal to purchase the liquidated membership interest, provided the purchase price is equal to fair market value.

3. Maintain Sufficient Outside Assets to Maintain Lifestyle. Commentators often state that grantors should maintain sufficient assets outside of the FGE to maintain their lifestyle. This is because some grantors transfer all of their assets to an FGE in which they maintain a small interest or no interest whatsoever. At the same time, these same grantors often receive disproportionate distributions from the FGE or from the other FGE members to pay their bills. It is not hard to figure out why the IRS regards this is a sham transaction.

On the other hand, we have not seen any precedents implying that a grantor cannot transfer most, if not all of their assets (other than personal use property), to an FGE if their proportionate share of the income from the FGE will be sufficient to maintain their lifestyle. This is especially true if distributions are made on a regular or periodic basis rather than being required only when the grantor has bills to pay.

4. Obtain a Qualified Appraisal for the Gifted Interest. A discount for the gifted interests due to lack of control or a minority interest must be supported by a qualified appraiser. Without a valid appraisal, a grantor will have no support for any claimed valuation discounts. This could result in the grantor being held liable for unpaid gift taxes, penalties and interest. A qualified appraiser will generally charge several thousand dollars for a valuation discount appraisal. Given this cost, gifting of small dollar value interests in an FGE does not make financial sense.

Conclusion. When used properly, FGEs provide valuable asset protection and estate tax reduction benefits. The guidelines set forth herein highlight certain issues to be aware of when creating and operating an FGE. If you have any desire to create or use an FGE for yourself or the benefit of any other person, please contact our office or another competent advisor to assist you.

Trademark Protection: Is Your Business Safe?

Paul Chmielewski, Esq., LL.M.

Commentators generally focus on asset protection and tax strategies when discussing the issues to consider when forming a business entity. For example, in our previous newsletter we discussed the asset protection provided by various forms of business entities. Unfortunately, even the best structured business entity may be forced to cease use of its name due to trademark issues. Trademark disputes are becoming more common due to the advent of internet marketing.

As a preliminary matter, it should be noted that a trademark infringement can exist even if the Colorado Secretary of State (“Secretary”) accepts and registers the name of your business entity. The Secretary is not concerned with trademark infringement, it is merely concerned that two entities do not use the identical name. For example, the Secretary will accept and register a company using the name “Widgets, Inc.” even though “Widgets, LLC” is already registered with the Secretary’s office. It should be clear that the registration of these two names could result in confusion and a claim of trademark infringement. Furthermore, if Widgets, LLC, a Colorado limited liability company, starts a website that markets its products on a nationwide basis, Widgets, LLC, a Maryland limited liability company, may have a valid claim for trademark infringement even though they are not registered to do business in Colorado.

In the past few years, our firm has prosecuted and defended numerous claims of trademark infringement. Most of these cases involved disputes between companies in different states. Most of these claims were based upon use of a company website for nationwide sales and marketing.

This gives rise to a simple question - what is trademark infringement? A trademark is simply a phrase or a logo (that may or may not include a phrase) that is distinctive and clearly associated with a company’s products or services. A trademark can describe either a service or a product. A mark that describes services is classified as a “service mark.” For example, the name Lennar is a service mark that designates a company that provides the service of homebuilding. A mark that describes a certain product is referred to as a “trademark.” For example, Snickers is a specific brand of candy bar. Trademark infringement occurs when a competitor uses an existing service mark or trademark to the detriment of the trademark holder. For example, if Pulte Homes started using the name Lennar when marketing its homes, Lennar would likely have a claim for infringement of its service mark. On a smaller scale, if someone started up Regis College, Regis University might have a claim for trademark infringement.

“A trademark can describe either a service or product.”

You might think this is fairly simple but what if Widgets, Inc., recently started up in Denver and planned to expand into the Northeast portion of the country within the next couple of years. At the same time, assume Widgets, LLC, a New York limited liability company, had been in business for several years, obtained a federal trademark registration and was expanding into the Denver market. Which company would have rights to use of the name in Colorado? Could Widgets, Inc., be forced to stop using its name even though it is registered with the Secretary? Which company would have right to use the name in the rest of the country? These are the types of issues that we are starting to encounter on a frequent basis.

Trademark protection can be established in several ways. For example, common law may provide trademark protection even if a company does not have a federal trademark

(Continued on page 4)

Mallgren & Ferrell, P.C.

200 Spruce Street, Suite 201
Denver, Colorado 80230
Phone: 303-341-0700
Fax: 303-341-0701
Email: office@mallgrenferrell.com

Our goal is to provide cost-effective legal assistance to help our clients achieve their personal and financial goals.

Is Your Business Safe?, Cont.

(Continued from page 3)

registration. However, common law protection may limit both the geographic and evidentiary scope of protection. State trademark registration also has limitations. The best way to protect your company's name is by filing an application for a federal trademark. Federal trademark registration requires use of the mark in commerce (we will discuss this in more detail in the next newsletter). If approved, a federal trademark (which includes a service mark) may create a presumption that the trademark holder has nationwide rights to the registered trademark. The total cost to file a federal trademark application in one industry class is generally between \$1,000 to \$1,500. Additional costs may be incurred if the Trademark Office challenges the mark, requires additional information or has any questions regarding the trademark application. Nevertheless, the cost of obtaining federal trademark registration generally outweighs the cost of losing a business name that has been built up over several years at great expense.

Please contact us if you have any questions regarding trademarks, including whether your business name is eligible for trademark registration.

Mallgren & Ferrell, P.C. has a new satellite office!
Our new additional location is:
8480 East Orchard Road, Suite 6500 (the building south of Del Frisco's Steak House)
Greenwood Village, Colorado 80111