

FAMILY LIMITED PARTNERSHIPS AS ESTATE PLANNING TOOLS: PITFALL CHECKLIST

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This issue of the WKBK&Y newsletter addresses Family Limited Partnerships as Estate Planning Tools.

For a while, practitioners can still use family limited partnerships or limited liability companies as vehicles to accomplish estate planning goals (both referred to as "FLPs" herein). While the IRS keeps litigating the validity of FLPs under a variety of theories there are wins and losses on each side. This Newsletter is not intended as a complete review of FLPs but rather as a "Dummies Guide to FLPs" which will enable the reader to be conversant in the use of FLPs and be able to determine whether the attorney advising the client is up to snuff or not.

There are many non-tax reasons to use FLPs. Primarily, they can be used as a vehicle to manage assets and limit liability while developing a "board" which will be able to provide management functions after the death of the founders.

There are tax reasons to use FLPs also. By having assets held in the name of an entity, it enables the founders to sell or gift minority interests in the entity thereby devaluing the percentage share of the underlying assets as a result of lack of marketability and lack of control discounts.

The usual structure is that the parents, G1, transfer assets to either: (i) a limited partnership in which the general partner is a limited liability company; or (ii) a limited liability company. In either case, there is limited liability. Initially, the entity(ies) are owned 100% by the G1. G1 then sells or gifts interests in the entity(ies) to the children, G2, or grandchildren, G3. Minority discounts are taken in valuing the interests sold or given and transfer tax returns are filed to start the statute of limitations. The sales/gifts can be structured via a number of ways such as GRATs, GRUTs, IDITs, installment sales, private annuities, outright gifts etc. The selection of the LP or LLC structure depends largely on the state income tax issue relating to the gross receipts tax. If there is a lot of income, it might be better to use the LP structure even though two tax returns will be required for the entity, otherwise the LLC structure is easier.

The IRS often attacks the FLPs on the basis that G1 did not give up enough control and therefore the assets are still included in G1's estate under IRC Section 2036 and/or that the formation of the entity lacked business purpose and was a sham transaction.

A recent case which demonstrates the IRS' attacks and, in that case, one of the IRS' successes, is *C. Turner, Sr. Est*, TCM Paragraph 45,578(M). In that case, in 1992, the decedent created a life insurance trust for the benefit of his children and grandchildren. From 2000 until 2003, the decedent paid the insurance premiums directly. According to the trust agreement, after any direct or indirect transfer to the trust, the beneficiaries

had the right to withdraw the lesser of the amount of the transfer divided by the number of beneficiaries or \$10,000 (\$20,000, if married), less the total amount previously withdrawn during the calendar year. In April of 2002, the decedent and his wife created an FLP. They contributed cash, marketable securities, and assets in investment accounts to the FLP, totaling over \$8.6 million. In return they each received a 0.5 percent general partnership interest, and a 49.5 percent limited partnership interest, which was proportionate to the fair market value of their contributions. The couple retained over \$2 million in assets outside of the partnership. According to the partnership agreement, the couple was entitled to a "reasonable management fee," which they determined to be \$2,000 a month. In December of 2002 and January of 2003, the couple made two separate gifts of limited partnership interests to their children and grandchildren. Due to one grandchild's drug and legal problems, his gifts were made in trust. From 2002 through 2004, the FLP only made distributions to the decedent and his wife. At one point, the FLP distributed money to the decedent in order for him to pay the life insurance premiums for the life insurance trust. On February 4, 2004, the decedent died. Gift tax returns for the 2002 and 2003 transfers were not filed until October 13, 2004.

There are several bad facts in the case that might have caused the loss. But there are a few points which we believe are relevant in every situation. These are as follows:

1. Get very good appraisals for the underlying assets and for the discount analysis.
2. Don't take management fees for the G1.
3. Develop a board of directors that includes G2 or G3 and don't have the entire management under the G2 control.
4. Don't have "clever" multiple classes of ownership except for maybe voting and non-voting, but avoid that if you can.
5. Distributions have to be made pro rata to every owner.
6. Don't commingle assets with personal assets.
7. Set up separate accounts, file tax returns, keep separate books, etc.
8. Don't allow amendments to the governing documents at the whim of G1, inset hi vote requirements.
9. Emphasize the business purposes of the transaction whatever they might be in all documents and correspondence that is discoverable.
10. Avoid just funding the FLP with securities—it is hard to justify the business purpose for just securities, although there have been some taxpayer victories.
11. Get separate counsel for the FLP and/or any trusts for the G2 or G3 when appropriate.

We are in a unique period in which asset values are low and it makes good sense to form entities that will continue the family businesses/investments after the death of G1. But the formation of such entities has to be done right. When you are looking at a deal for a client, if it is too good to be true, it is. It cannot be just an extension of the clients own portfolio, under its own management. WKBKY believes that it is likely that the IRS will convince Congress that intrafamily gifting of interests in business entities should not be subject to discounting. So there may be a short window here to get the advantages of a good multi-generational business structure with tax advantages.