

Maintaining the integrity of the FLP

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Family limited partnerships (FLPs) continue to be one of the most effective estate planning strategies in the new millennium. They offer a singular advantage dear to many people - the ability to retain control over assets (including a family business) while reducing estate and gift taxes. For it is usually a person's need to keep control, rather than the actual need for income or principal, that impedes much estate planning. Also, unlike many estate planning strategies, FLPs can offer the donor some benefits during his or her lifetime.

Family partnerships are especially useful for estate planning for clients whose assets include real estate and family businesses. In recent years, FLPs have even been formed to hold marketable securities. This latest application has incurred the IRS's wrath due to its perceived abuse. In fact, FLPs have many non-tax motivated uses.

While particulars vary by state statute, certain features are common to all FLPs. The owner of a business or a stock portfolio contributes the property to an FLP, retaining a 1% interest as a general partner. The rest can then be gifted to his children or grandchildren. The general partner retains control over decisions with respect to distributions and investments and can also take a "reasonable" management fee.

The limited partners are limited in both their rights and their obligations. They cannot make investment

decisions, remove assets from the partnership while it is in existence or force the liquidation of the partnership.

Nor can a limited partner's interest itself be liquidated by his or her individual creditors. A creditor's remedy would be restricted to a relatively unappealing "charging order." That is, if there are no distributions made to the limited partner, the creditor receives nothing. Because of their creditor protection features, FLPs have also been used as asset protection devices, in combination with or in addition to estate planning.

The optimal compromise

The following example illustrates an effective use of FLPs. Mr Senior had more than enough income, but felt uncomfortable giving his assets to his three adult children and felt especially concerned about giving up control of his business to his children, who he believed still had much to learn.

Mrs Senior had recently died, prompting him to review his own estate plan. He realised that if he did not start making gifts, his US\$2 million estate would be substantially reduced by hefty federal (and state) estate taxes. Mr Senior decided to form an FLP with US\$1,000,000 in assets, including his business. He retained a 1% general partner interest and gifted 33% limited partnership interest to each of his children. The FLP strategy appealed to Mr Senior because only he, as general partner, could manage his assets, and his children, the limited

partners, would have no decision-making authority.

There are two other advantages to Mr Senior's transfer of FLP interest. He can reduce the value of his gifts by applying discounts for minority interest and lack of marketability, and all future appreciation of the gifted partnership interest has been removed from his estate.

Non-tax reasons

A similar structure can be used for individuals who wish to make annual exclusion gifts. Federal and state law permits a donor to currently give US\$11,000 a year per donee (US\$22,000 for a married couple) without the donor needing to pay gift tax or file a gift tax return. Many taxpayers use Uniform Gifts to Minors accounts (UGMA accounts) to make such gifts to their minor children. However, as these accounts accumulate large sums, the parents are concerned with their children's access thereto. We have used FLPs successfully where the parents want to maintain continued control by contributing the funds to an FLP which will then be owned by the child but will remain under the parent's control as the general partner. In one Private Letter Ruling, the IRS confirmed that transfers of limited partnership interests do qualify for the annual exclusion. In a more recent Court decision ([Hackl](#), 118 T.C. No. 14), however, the transfers of FLP interests did not qualify for the annual exclusion due to the unfortunate way the agreement was drafted. These

rulings reflect the uncertainty that exists in this area and the need for careful drafting.

FLPs are also useful where real property is to be gifted. By transferring title of real property to the partnership, a person can gift interests in property through assignments, instead of having to prepare and record new deeds each year. Moreover, ownership of out-of-state property by the partnership can avoid the expense and delays of an “ancillary probate proceeding” (effectively, another probate for your will in each state where you own property). Lastly, it offers some protection against the children’s creditors or claims of future ex-spouses.

Discount: the added advantage

For gift tax purposes the value of an asset is the price at which a hypothetical willing buyer will pay a willing seller. Qualified appraisers suggest that discounts ranging between 20% and 50% can be applied in valuing limited partnership interests. Although not free from IRS challenge, such discounts have even been applied where the partnership’s underlying assets consist solely of marketable securities.

Although the IRS has challenged this technique under various theories, most of the cases have been decided in the taxpayers’ favour, provided the agreements were properly drafted and ongoing administration of the partnership was strictly adhered to. In many instances, the Court’s determinations were driven by the credibility (or lack thereof) of the appraisers. In the Estate of Dailey v Commissioner (T.C. Memo. 236), the Service’s appraiser argued that a 40% discount was excessive and instead applied a 15% discount. The decedent formed a limited partnership into which she transferred solely cash and marketable securities. The decedent retained a 1% general partnership interest and assigned a substantial amount of her limited partnership interest to her son and daughter-in-

law. The Court sustained the 40% discount taken by the taxpayer and rejected the appraisal submitted by the IRS. In Baird v Commissioner (T.C. Memo 2001-258), the decedent and his wife transferred fractional interests in Louisiana timberland owned by them into a family trust. Experts who testified on behalf of the taxpayers opined that the limited market for partial interests in timberland and the restrictions regarding the exploitation of timberland under state law warranted a 60% discount. The Court sustained the full discount taken by the taxpayer opining that the IRS expert’s testimony lacked weight because he was not qualified to value fractional interests in timberland. In Strangi v Commissioner (115 T.C. No. 35 (2001)), the taxpayer’s son-in law, through a power of attorney, formed an FLP two months before his death in which the decedent received a 99% interest as a limited partner. The general partner was a corporation wherein the decedent owned a 47% interest. The Tax Court rejected the IRS’s arguments that: (i) the transfers lacked economic substance and, (ii) a gift resulted on formation of the partnership. The Court, however, reduced the discount from 44% to 31%. On appeal, the case was remanded with direction to consider whether the decedent retained the right to the beneficial enjoyment of the assets transferred. If the Court ultimately determines that the decedent retained such right, the partnership’s assets will be included in the decedent’s estate without a discount.

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Although some of the discounts in the cases cited were reduced by the court, in most instances the Courts did recognise the FLP as a valid business entity. It is important, however, that a high level of integrity is maintained for the establishment of the entity. Otherwise, this will open the door for the IRS to challenge the transfers.

In the Estate of Schauerhamer v

Commissioner (T.C. Memo. 1997-242), for example, the decedent created three FLPs approximately one year prior to her death. In each of two calendar years, the decedent assigned 33 units of partnership interests to various family members. Each unit was valued at approximately US\$10,000. The decedent deposited the income from the partnership into a bank account which she owned jointly with one of her children and did not maintain separate records for partnership and non-partnership funds. The partnership income was commingled with the decedent’s income from other sources. The Tax Court held that the value of the assets transferred by the decedent was includable in her estate because there was an implied agreement among the partners that the decedent would retain possession and enjoyment of the assets. Similarly, the IRS was successful in Reichardt (114 T.C. No. 9 (2000)), Harper (T.C. Memo 2002-121) and Thompson (T.C. Memo 2002-246) where the Court found an understanding existed among the parties that the economic benefits of the transferred property would still be available to the transferor. Specifically, in each instance, the Court found evidence of “commingling of funds, disproportionate distributions and testamentary characteristics of the arrangement.”

Therefore, as practitioners, one of the most important factors to consider is to ensure that clients understand that, although they may continue to manage the assets, the assets are no longer owned by them. That is the key to successfully integrating the FLP into the estate plan.

Conclusion

Although some roadblocks to reducing estate taxes have developed along the way, those advisors and clients who adhere to the rules and take counsel from the recent decisions should be successful in reaching their destination.

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