



# Advanced Planning Strategies

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Dear Reader,

The new budget proposed by President Bush contains many interesting proposals including \$1.46 trillion in tax relief over 10 years. Among the provisions are several savings incentives that would provide for larger contributions to tax-free accounts and simplification of the myriad retirement savings provisions under current law. One unique provision is the “Lifetime Savings Account (LSA)” that would permit up to \$7,500 of after-tax dollars to be contributed. The plan would accumulate tax free and later distributions would not be taxed. Unlike many tax savings incentives currently available, LSAs would not have income limits for eligibility or restrictions on the use of distributions.

IRAs and Roth IRAs would be replaced by “Retirement Savings Accounts (RSAs)” that would provide for \$7,500 in after-tax contributions. Conversion of current IRAs would be permitted with the income tax liability spread over 4 years. Employer-provided qualified salary deferral or reduction plans (i.e., 401(k)s, 403(b)s, 457s, SIMPLEs, and SARSEPs) would be consolidated into “Employer Retirement Savings Accounts (ERSAs) that would provide for deferral of up to \$12,000 annually (\$14,000 for participants born before 1954). This plan would also simplify the nondiscrimination rules.

With federal income tax returns due next month, it may be an appropriate time to review the average deductions taken by taxpayers who itemize these deductions on their returns. The table below gives a short summary of 2000 results provided by the IRS. Of course, your return may not avoid an audit merely because your deductions fall near the average.

<b><u>Adjusted Gross Income</u></b>	<b><u>Interest Deduction</u></b>	<b><u>Charitable Deduction</u></b>	<b><u>State and Local Tax Deduction</u></b>	<b><u>Medical Expense Deduction</u></b>
\$30,000 to \$50,000	\$6,465	\$1,904	\$3,031	\$4,688
\$50,000 to \$100,000	\$9,069	\$2,352	\$4,922	\$6,163
\$100,000 to \$200,000	\$11,301	\$3,755	\$9,263	\$12,071
Over \$200,000	\$26,326	\$22,351	\$39,892	\$35,316

*Knowledge is not power. Only knowledge in use is power.*

## **FAMILY LIMITED PARTNERSHIPS (FLPs)**

The family limited partnership (FLP) has been a popular and controversial estate and business planning vehicle for quite some time. Recent tax law changes have created uncertainty about the future of estate and generation-skipping transfer taxes, but gift taxes will continue indefinitely under current law. Because lifetime gifting is the best method to reduce estate taxes and most individuals enjoy making gifts to the next generation, it is imperative to design the gift to meet the donor's personal goals and maximize the gift's tax efficiency. Although this article will discuss FLPs, the reader should be aware that a limited liability company (LLC) might also be used to accomplish the same goals. The choice between an FLP and LLC will depend on the business owner's goals or the specific state law nuances with respect to the entities.

### **ADVANTAGES OF FLPs**

The advantages of forming and operating an FLP will vary, depending on the facts, circumstances, and goals of each situation. An FLP might be formed for one or more of the following reasons:

- to provide centralized asset management for family assets
- to create economies of scale for business or investment purposes
- to shift taxable income to younger-generation family members
- to facilitate distributions from the family business entity to family members
- to protect family business and investment assets from individual creditors
- to provide tax-efficient gifts of family wealth to the next generation(s) by structuring the FLP to justify significant valuation discounts for the limited partnership interests
- to provide an entity structure that permits the senior generation to control the management of the family business even after significant interests have been gifted or sold to the junior-generation partners
- to consolidate multi-state family real estate in one entity to avoid ancillary probate
- to protect the owners from the liability risks of operating a business. To accomplish this goal, an LLC or a limited liability partnership would be the entities of choice.

### **WHAT IS AN FLP?**

An FLP is a limited partnership formed under a selected state law. The FLP must have at least one general partner and will generally have several limited partners. The general partner is vested with sole authority to manage the FLP's everyday activities. The limited partners are prohibited from engaging in the entity's day-to-day management, but they may have voting power for certain fundamental decisions. The rights of the general and limited partners will be specified in the partnership agreement. In the typical FLP, the senior-generation family member(s) will transfer family business and/or other property interests to form the FLP. The senior-generation partner(s) will maintain control of the distributions and management by holding the general partnership interest(s) either directly or through a controlled entity, such as a corporation or trust. Limited partnership interests will be transferred to the junior-generation partners by sale or gift to shift wealth to the next generation. The value of the limited partnership interests can be discounted substantially for the limited partners' inability to control the distribution and management of the partnership (the minority discount) and the restrictions placed on the transferability of the limited partnership interests in the partnership agreement (the marketability discount). The combined discounts will reduce the value of the limited partnership interests by approximately 25 to 35 percent from the value of the underlying partnership assets. However, aggressive planners have successfully structured FLPs to create discounts in excess of 50 percent.

## **POTENTIAL INCOME TAX PROBLEMS**

For income tax purposes, an FLP is governed by the family partnership rules of Code Sec. 704(e). In the case of a family partnership, income can be shifted to a donee partner only to the extent that capital is a material income-producing factor in the partnership. All transferee family members are treated as donee partners, whether their interests were received by sale or gift. Thus, the senior-generation general partners must be adequately compensated by the partnership for their services before income can be shifted to the donee partners.

A potential income tax problem also exists at the formation of the FLP. Normally, a partner does not recognize gain when appreciated property is transferred in exchange for the partnership interest. However, Code Sec. 721 provides that gain will be recognized if the partnership is an investment company (more than 80 percent of its value consists of readily marketable stocks or securities, with some adjustments) and the contribution results in diversification of the transferor's interests. Thus, it is critical to avoid this trap if more than one individual will contribute property to form or expand the partnership.

## **GIFT TAX ISSUES**

The primary concerns for the senior-generation family member(s) forming the FLP are whether (1) the valuation discounts will be sustainable for gift-tax-efficient gifts and (2) the FLP will be respected as an entity for estate tax purposes at the time of the founder's death. The IRS has employed several arguments against the validity of the valuation discounts taken for gift or estate tax purposes.

**Annual Exclusion Issue.** One gift tax issue related to the transfer of FLP interests is whether such gifts qualify for the \$11,000 (2003 indexed amount) per donee annual gift tax exclusion. The IRS has taken the position in a private ruling that gifts of FLP interests will not qualify for the annual exclusion unless the partnership interest provides the limited partners with some reasonable expectation of current distributions or the ability to transfer the interest. In other words, the limited partner must receive something that could result in a present interest. In a recent court decision, the tax court upheld the IRS's position and denied the annual exclusion for gifts of family LLC interests (*Hackl v. Commissioner*, 118 TC 279). In this instance, the LLC would have not provided annual distributions for many years to its members and the donee members were prohibited from transferring their interests without the donor's consent. Clearly, an FLP agreement must be designed to permit transfer of the limited partnership interests to preserve the gift tax annual exclusion.

**No Business Purpose.** One argument against gift or estate tax discounts is that the FLP can be ignored if it is not a valid partnership under state law. This argument is generally raised against a partnership formed with passive investment assets that performs no active business activities. This argument seems to ignore the fact that valid investment partnerships have existed throughout history and that state law would undoubtedly recognize the validity of such partnerships. This attack has been largely unsuccessful in court.

**Additional Gift on Formation.** Other arguments raised in recent cases are that the transfer restrictions on the partnership interest can be ignored for valuation purposes under Code Sec. 2703 and that a gift occurs at the formation of the partnership interest when the business owner receives partnership interests valued significantly less than property he or she contributes to create the FLP. The courts have rejected the Sec. 2703 argument, saying that Sec. 2703 was never intended to apply to the formation of an FLP. Sec. 2703 states that restrictions on the rights to transfer property can be ignored for valuation purposes unless the restrictions (1) have a bona fide business purpose, (2) are not a device to transfer property to family members for less than full and adequate consideration, and (3) are comparable to similar agreements entered into at arm's length. The courts have also rejected the gift-on-formation argument by reaffirming that property interests are determined under state law and that the intentions of the parties control property ownership. In the case of an FLP, a gift will not occur on formation because each partner

will receive interests relative to his or her contribution and have that contribution appropriately reflected in his or her partnership capital account.

Validity of Marketability Discount. Code Sec. 2704 provides another argument that can be used against valuation discounts in an FLP case. For valuing interests in an FLP transferred to family members, “applicable restrictions” on liquidation or transfer can be disregarded for valuation purposes. If this argument is successful, the marketability discount for limited partnership interests would not apply. Applicable restrictions effectively eliminate the partnership’s ability to liquidate and are more restrictive on the transfer of partnership interests than the limitations imposed by state law. Careful drafting and a watchful eye over state law can avoid this problem. In some instances, state law permits the partners to determine such termination events in the partnership agreement in lieu of the state law default provisions. For example, in *Kerr v. Commissioner* (113 T.C. 30, affirmed 5th Cir. 2002), the court held that the discounts were permissible because the transfer restrictions were not applicable restrictions.

Recent cases have generally upheld the validity of a marketability discount but have provided one lesson. It is important to include a well-substantiated appraisal with the gift tax return when making discounted gifts of FLP interests. The courts will carefully scrutinize the valuation methods used by the taxpayer, and the appraiser must justify the discount based on the facts and circumstances of the FLP in question. In some instances, the tax court has permitted, but reduced, the amount of the discount taken on the gift tax return.

## **ESTATE TAX TRAP**

One final problem to consider is that senior-generation general partners will often act as if they continue to personally own the property transferred to the FLP. For the partnership to be respected as a legitimate entity for estate tax purposes, the family members involved must follow the normal operating formalities for a partnership contained in both the partnership agreement and state law. In several cases (*Schauerhamer v. Commissioner*, TC Memo 1997-242, *Reichardt v. Commissioner*, 114 T.C. 9, 3/1/2000, *Thompson v. Commissioner*, TC Memo 2002-46, and *Kimbell v. US*, 91 AFTR 2d, 2003-585), the IRS was successful in raising the argument that the decedent general partner retained a life estate in both the assets transferred to the FLP and the FLP interests transferred to junior-generation family members. Code Sec. 2036 causes property transferred by gift during the decedent’s lifetime to be included in the gross estate at date-of-death value if the decedent retains a life estate (the right to continue to use or enjoy the property or receive income from property). The evidence of the retained life estate was demonstrated in these cases by the decedent’s control of the partnership assets and failure to follow the normal fiduciary duties of a general partner. The Sec. 2036 attack has resulted in the highest rate of success for the IRS for challenging FLPs. The downside for failing to avoid this trap is that the discounts vanish and the entire property (including additional appreciation) will be taxed in the estate of the FLP’s creator.

This letter prepared, with the help of a nationally recognized tax authority, intends to promote interest in more comprehensive tax and estate planning. References are intentionally brief. If a topic interests you, you should investigate it more thoroughly with your qualified tax advisor. Effective tax and estate planning should involve competent advisors in relevant law, accounting, trusts, life insurance and investments. The knowledge and experience of each in their specialties can make the difference between a wealth transfer that works as intended and one that does not. Please seek competent counsel to determine and satisfy your individual needs.

***Positioning our clients  
for the future***



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