



# Advanced Planning Strategies

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February 2006

Dear Reader,

A number of budget issues will probably be addressed in the near future. Several expiring tax provisions were not renewed at the end of 2005. We expect action on some or all of these in 2006 with retroactive application. Among the provisions that were not extended are alternative minimum tax relief through higher exemptions and the income tax deduction for state and local sales taxes. A tougher debate will be the extension of the 15 percent rate for long-term capital gains and qualified dividends. This relief will not expire until the end of 2008, but its extension was discussed seriously in 2005. The tax relief provisions passed in 2001 and 2003 have had an impact. The Congressional Budget Office reported that the effective tax rate for all individuals fell to 19.8 percent in 2003 from 20.7 percent in 2002. The top 20 percent of earners had the lowest effective tax rate (25 percent) in 2003 since 1986.

Additional hurricane-related tax relief was passed before the end of 2005 (Gulf Opportunity Zone Act of 2005 (HR 4440)). Some of the provisions of the hurricane relief provided as a result of Katrina (discussed in this letter last fall) were extended for Hurricanes Rita and Wilma, effective after September 23, 2005, generally for 2005 tax returns. These provisions include (1) tax-favored withdrawals from retirement plans for qualified hurricane distributions, (2) permitted recontribution to retirement plans for funds withdrawn for a home purchase cancelled by Rita or Wilma, and (3) a tax credit for retention of employees for employers affected by Rita or Wilma.

Congress is expected to enact modifications to the Medicaid system to reduce its costs. The cost of the system and administration is shared with the states. Federal law and regulations provide standards that the states often interpret and administer differently. Individual state statutes also impose rules stricter than the federal rules in some instances. This is a critical issue because of the aging population of the U.S. Recent surveys reveal that over 60 percent of nursing home resident beds are paid for by Medicaid. Some issues in the current legislation include (1) increasing the lookback period for asset transfers by gift to disqualify a Medicaid applicant from 36 to 60 months, (2) beginning the disqualification penalty period at the later of the date of the transfer or the date Medicaid-provided services begin, and (3) disqualifying certain individuals from Medicaid-provided nursing or long-term care benefits if their home equity exceeds \$500,000.

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

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

The family limited partnership (FLP) has been a popular and controversial estate and business planning vehicle for some time. Recent tax law proposals 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 letter 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.

### **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 multistate family real estate in one entity to avoid ancillary probate
- to protect the owners from the liability risks of operating a business

### **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. 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. Junior-generation partners will obtain limited partnership interests in exchange for capital contributions or by sale or gift from the senior 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. Aggressive planners, however, 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. Generally, 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 \$12,000 (2006 indexed amount) per donee annual gift tax exclusion. The IRS has taken the position 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 one appellate court decision, the seventh circuit court upheld the IRS's position and denied the annual exclusion for gifts of family LLC interests (*Hackl v. Commissioner*, 92 AFTR 2d 2003-5254 (335 F3d 664)). In this instance, the LLC could have not provided annual distributions to its members for many years 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.

**Indirect Gift on Formation.** Another argument raised in recent cases is that a gift occurs at the formation of the partnership interest when the FLP is created and an improper sequencing of the transfer of the property and gifts of the limited partnership interest occurs. In two cases (*Senda v. Commissioner*, 97 AFTR 2d (8th Cir. 2006) and *Shepherd v. Commissioner*, 89 AFTR 2d 2002-1251 (283 F.3d 1258) (11th Cir. 2002)), the courts have held against the taxpayer when the property was transferred to the FLP subsequent to the gifts of FLP interests to the next generation. Most recently in *Senda*, the transfers were apparently made the same day and the records maintained did not prove the proper timing of the transfers. The result of the improper timing is that the junior generation is treated as receiving an indirect gift of the property without the minority and marketability discounts applicable to the FLP structure.

**Validity of the Valuation Discount.** The validity of the size of the valuation discount is a factual issue determined on a case-by-case basis under normal valuation principles. In addition, 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 perhaps the most famous of this line of cases (*Kerr v. Commissioner* (89 AFTR 2d 2002-2838 (292 F.3d 490) (5th Cir. 2002))), the court held that the discounts were permissible because the transfer restrictions were not applicable restrictions.

Recent cases that avoid the other traps discussed here have generally upheld the validity of a valuation discount for limited partnership interests. For example, a recent case (*Kelley v. Commissioner*, TC Memo 2005-235) provided for a valuation discount of over 32 percent when property transferred to the partnership consisted solely of cash and certificates of deposit.

## **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, including many last year (*Schauerhamer v. Commissioner*, TC Memo 1997-242, *Reichardt v. Commissioner*, 114 T.C. 9, *Kimbell v. U.S.*, 93 AFTR 2d 2004-2400 (5th Cir. 2004), *Bigelow v. Commissioner*, (TC Memo 2005-65), *Bongard v. Commissioner*, 124 T.C. 8, *Korby v. Commissioner*, T.C. Memo 2005-102, *Schutt v. Commissioner*, T.C. Memo 2005-126, *Abraham v. Commissioner*, 95 AFTR 2d 2005-2591 (1st Cir. 2005), *Turner v. Commissioner*, 94 AFTR 2d 2004-5764 (3d Cir. 2004), and *Strangi v. Commissioner*, AFTR 2d 2005-6895 (5th Cir. 2005)), 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, failure to follow the normal fiduciary duties of a general partner, disproportionate distributions, and the failure of the FLP's founder to keep adequate assets for living expenses outside of the FLP. The Sec. 2036 attack has resulted in the highest rate of success for IRS challenges of 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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