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Family Limited Partnerships in Estate Planning: Structuring and Income Tax Considerations, Asset Protection

TUESDAY, JANUARY 19, 2021

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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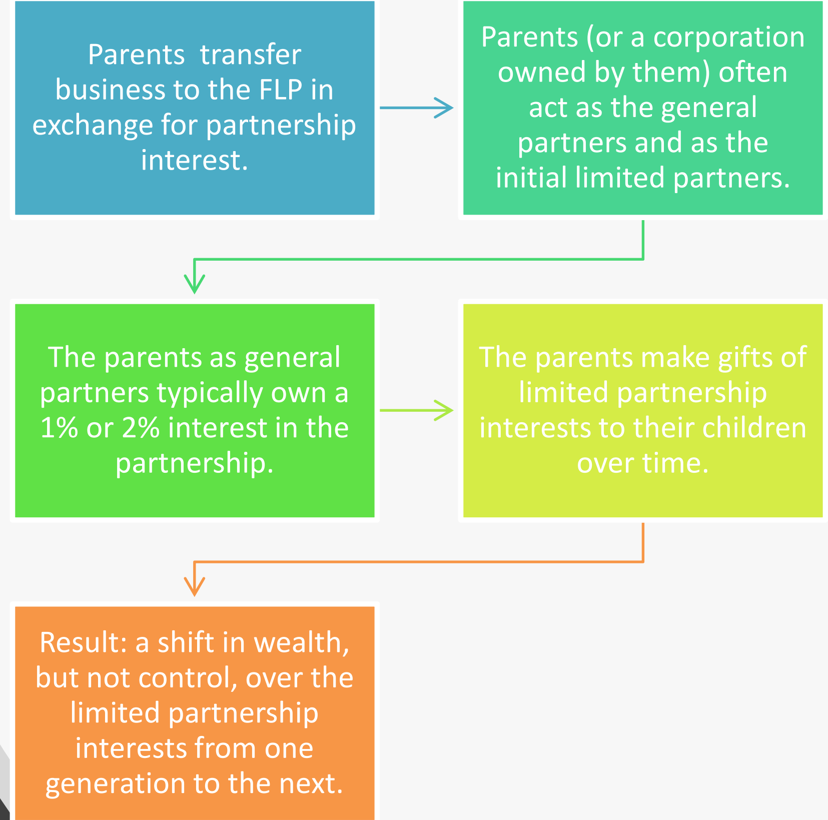
Family Limited Partnerships

In Estate Planning

Why Form a Family Limited Partnership ?

The Plan



The First Attack

Powell case 147 T.C, 18 (2017)

Internal Revenue Code ("IRC") § 2036(a)

Property transferred by a decedent during life must be included in the decedent's estate for estate tax purposes upon death if the decedent retained control over such property or its income.

Under § 2036, a decedent's gross estate will include the value of property transferred (except for bona fide sales for full and adequate consideration), in trust or otherwise, if the decedent retains: (1) the use, possession, right to income, or other enjoyment of the transferred property; or (2) the right, either in conjunction with any other person, to designate the person(s) who will possess or enjoy the transferred property or the income therefrom.

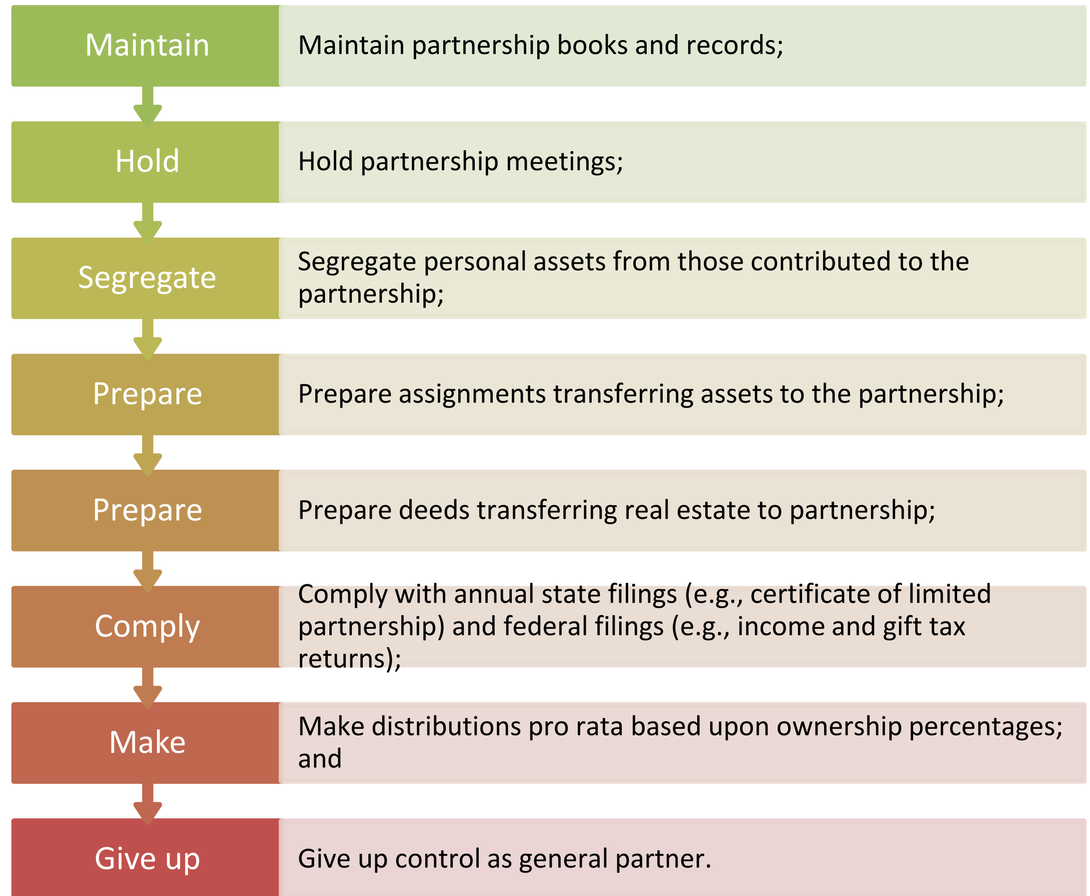
Estate of Albert Strangi, Deceased, Rosalie Guilig, Independent Executrix v. Commissioner of Internal Revenue,T.C. Memo 2003-145 ("Strangi II")

- Tax Court found that the decedent retained the right to income over the transferred assets
- 1) Decedent retained the same relationship with the transferred assets that he had before establishment of the FLP.
- 2) The decedent contributed nearly all of his assets to the FLP.
- 3) The corporate general partner had sole authority over distributions.
- 4) Retained the right to control the enjoyment of the property and income from the FLP and its general corporate partner.
- Result: All valuation discounts were disallowed on the estate tax return, and the entire value of the assets transferred to the FLP were included in the decedent's estate.
- Prior to Strangi II, donors acting as general partners of a FLP did not worry about retained control issues because the existence of state law fiduciary duties owed by the general partner to the limited partners negated such issues.
- The court found that the other partners would not realistically be able to enforce any such fiduciary duties to limit the decedent's control over the FLP or corporate general partner.

Lessons From Strangi II

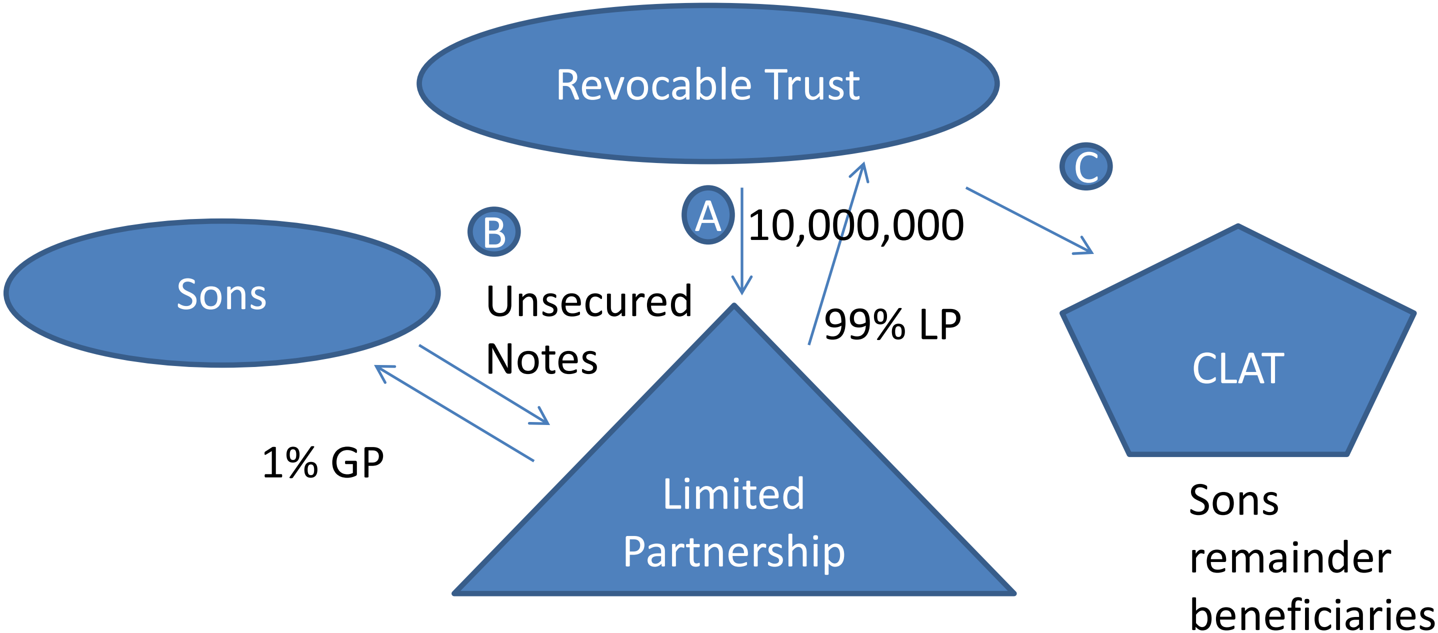
Avoid	Avoid deathbed establishment of and transfers to FLPs;
Ensure	Ensure that the partnership agreement is properly structured in order to achieve appropriate discounts and carry out the family's intentions;
Avoid	Avoid transferring assets that may be used for a partner's personal use (e.g., residence) unless a written lease arrangement is made and fair market value rates and rents are actually paid;
Avoid	Avoid transferring virtually all of a partner's assets to the FLP;
Respect	Respect all partnership formalities at all times;
Comply	Comply with the terms of the partnership agreement;

Lessons From Strangi II (cont)



Summary of *Powell* Facts

148 T.C. 18 (2017)



Summary of Powell Facts (cont’d)

- Sons transferred 99% to CLAT under a Power of Attorney.
- CLAT paid an annuity to Decedent’s private foundation.
- Timing
  - A done two days after Partnership Agreement signed.
  - C done same day as the transfer to the FLP of cash and securities.
- Decedent was determined to be incapacitated on same day as transfer to CLAT.
- Decedent died seven days after FLP funded.

Summary of Powell Analysis

- Decided under I.R.C. § 2036(a)(2) and I.R.C. §2038
- Court held that a power to liquidate a Partnership causes inclusion.
  - Power exercisable by decedent's agent and other family members.
  - Results in control by decedent over possession or enjoyment of transferred assets or the income.
  - Value of LLP includable because sons lacked authority to transfer to 99% LP interest to CLAT under §2038(a)(1)- right to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3-year period ending on the date of the decedent's death.

Lessons Learned From Powell

Don’t do deathbed planning.

If broadly applied will valuation discounts be gone in FLPs?

Bad facts make bad law.

Need valid business purpose.

Tax motivation cannot be main reason.

Other purposes:

- Asset Protection
- Consolidation of Assets
- Perpetuation of management philosophy
- Succession Planning

Fiduciary duties cannot be illusory.

What To Do After *Powell*

How to establish a legitimate business purpose

- Use legitimate property or business not just cash and securities (e.g. real estate or business).
- Person managing should have more than a nominal interest.
- Capital contributions should be legitimate and equivalent to interest received; not an unsecured note.
- Have outside owners who are not seen as controlled by decedent.

What To Do After Powell & Strangi

- How to establish a legitimate business purpose-
  - Use legitimate property or business not just cash and securities (e.g. real estate or business).
  - Person managing should have more than a nominal interest.
  - Capital contributions should be legitimate and equivalent to interest received; not an unsecured note.
  - Have outside owners who are not seen as controlled by decedent.
    - Possible to use a charity as a beneficiary (See Kerr v. Comm, 133 TC 449 (1999), aff'd 292 F.3rd 490 (5th cir., 2002)

What To Do After Powell & Strangi (cont'd)

- Review terms of Partnership Agreement
  - Having non-family member to consent to distribution and termination.
  - Check boilerplate language.
- Don't have same person in too many conflicting fiduciary roles.
- Although not decided under I.R.C. §2036(a)(2) Power of Attorney may be a factor in analysis.

Do Gifts of Partnership Interest Qualify for the Annual Gift Tax Exclusion?

- IRC § 2503(b) requires that the gift be a present interest in property.
  - See Hackl v. Cir, 118 T.C. 279, aff'd, 335 F3d 664 (7th Cir, 2003) and Fisher v. US, 2010-1 USTC ¶ 60, 588 (SD Ind. 2010)
  - Donees must have a substantial present economic interest or financial benefit.
  - Distributions were made at discretion of the manager.
  - Although there could be an economic benefit, this does not make the gift a present interest.
  - One solution, use a put option vested in a donee to require the sale of the partnership interest.

Leveraging a Spousal Lifetime Access Trust ("SLAT")

- Irrevocable Trust created for a spouse and other family members.
- Must enter into a valid Post Marital Agreement to create separate property for each spouse.
- Each spouse creates a Trust for the other using the "donor spouse's" gift tax exclusion.
- Beneficiary spouse is current beneficiary.
- Can include provisions for children or grandchildren can be contingent beneficiaries.
- Allocate donor spouse's GST Exemption.

Tax Advantages/Disadvantages of a SLAT

- Recommendation- use appreciating assets.
- Good Assets to use include:
  - Real estate.
  - Life insurance.
  - Securities.
  - Closely held business interests.
  - May also want to include cash.
- Taxed as Grantor Trusts-
  - Allows growth without being taxed.
  - Payment of taxes by “donor spouse” not a gift.
- No step up in basis.
- Subject to I.R.S. scrutiny.

Factors to Consider When Using a SLAT

Irrevocable

Grantor has no retained beneficial interest

not included in Grantor’s estate.

Donor spouse cannot be a Trustee.

Beneficiary Spouse can be a Trustee, with power to distribute to him or herself subject to HEMS.

Either spouse (and future beneficiaries) can remove and replace a Trustee (subject to FRC §672(c)).

Beneficiary spouse can have a limited power of appointment.

Allow investment portfolio to be leveraged to use assets to acquire new assets.

Divorce is a major risk: Do not have any assets available for former or estranged spouse.

Structure for non reciprocal GST exempt gift trusts in Delaware benefitting spouse (with creditor protection)

Trust #1

Wife
Irrevocable Trust 2021

Creator:	Husband
Trustee:	Corporate Trustee co/wife (Co-Trustee)
Investment Director:	Husband
Beneficiary:	Wife (Non spouse co-trustee discretionary income and principal) • Limited Power of Appointment at death? • Grandchildren(in trust to preserve GST and asset protection value)?
Contribution:	Up to $11,700,000 in value
Taxation:	Grantor trust

Trust #2

Husband
Irrevocable Trust 2021

Creator:	Wife
Trustee:	Corporate Trustee Co/husband (Co-Trustee)
Investment Director:	Husband
Beneficiary:	Husband (Non spouse co-trustee discretionary income and principal) • Grandchildren(in trust to preserve GST and asset protection value)?
Contribution:	Up to $11,700,000 in value
Taxation:	Grantor Trust

* Must avoid reciprocal trust doctrine, also Code §§ 2036,2038

Avoid Reciprocal Trust Rule in SLAT

- Trust created at same time.
- Trust has nearly identical terms.
- Result- each settlor created as in the same economic position and included in estate.
  - See U.S. v. Grace, 395 U.S. 316 (1969), Lehman v. Comr., 109 F.2d 99 (2d. Cir. 1940), Bischoff Estate 69 T.C. 39

Techniques to Create Non-Reciprocal Trusts

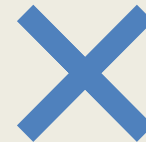
- Lifetime Power of Appointment in only one Trust.
- Testamentary Power of Appointment in only one Trust:
  - Wife's contingent beneficiary's are children.
  - Husband's Trust's contingent beneficiaries are grandchildren.
- Use different Trustees:
  - H Trustee of Trust W creates.
  - Independent trustee for trust H creates.
- Distribution Standards:
  - One that has spouse Trustee- HEMS.
  - One that has independent Trustee- discretionary.

FLP as an Asset Protection Tool

Insurance is the first line of defense against liability

Asset protection FLP compliments insurance coverage

Claim Exceeds the limits of insurance coverage



Claim is not covered by the policy

Creditor Claims Against FLP Partners

Seizure of the Limited Partnership Interest

Seizure of Profits or Liquidation Distributions

Recovering Assets Transferred to the Limited Partnership

Inside and Outside Creditors

Protecting Against Inside Liability

Protecting Against Outside Liability

Outside Liability and Single-Member LLCs

Charging Order

Court-authorized lien placed on distributions

Allows creditor to garnish distributions from Partnership

Used by claimants against limited partnerships (LPs) and limited liability companies (LLCs)

Charging Orders Protect FLP Assets

FLP can convert attractive assets (e.g., cash) into unattractive assets

Creditor only receives what general partner decides to distribute

Judgment creditor's attorney, if on a contingency fee arrangement, may not collect

Creditor will have significant tax issues: IRS Rev. Rul. 77-137

Charging Order Limitations

Not allowed to:

Join in Partnership’s management

Dissolve the FLP

Sell its assets without the other members' consent

Drafting FLPs for Asset Protection

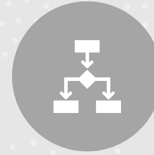
- Super majority required for certain actions.
- 100% required to permit withdrawal
- Limit right to demand distribution
- Limit transferability of interests.
- Do not allow assignee as automatic substitute partner
- Use an entity (perhaps an LLC) as the general partner to prevent any partner having personal liability
- Authorize mandatory capital contributions
- Permit the redemption of interests seized by creditors (foreclosure) or subject to a charging order

Charging Orders Issues

- Single Member LLCs
- Entity Jurisdiction
- Business formalities – no "piggy bank" approach
- Operating agreement
- Not for personal expenses – keep separate books
- Distributions to follow OA protocol

Business Succession Objectives

MISSION STATEMENT FOR THE BUSINESS.



LIST OF GUIDING PRINCIPLES.

GOALS FOR THE BUSINESS.

IDENTIFY STAKEHOLDERS

PERSONAL GOALS.

RETIREMENT GOALS.

TEAM OF ADVISORS FOR THE SUCCESSION PLAN

Business Exit Strategy Option Comparison

- Family Transition
- Employee Buy-Out
- Arms Length Transaction
- Wind Up

Family Transition

- Continue Owner Legacy
- Strategic Planning Required
- Competing Family Interests
- Reorganize Business Structure
- Plan for Tax Deductions

Employee Buy-Out

IDENTIFY KEY EMPLOYEES

INCENTIVIZE EMPLOYEES

SHAREHOLDERS AGREEMENT

Arm's Length Transaction

Business operates independently from the owner

Each party is acting in their own interest with equal bargaining power

The business may not be sold as a unity

Negotiations

may damage business

Identify saleable,

non-saleable

and inactive assets

Sales agreement identifies key considerations: IP workforce

non-competes

Wind-Up Business

- Business relies entirely on the current owner
- Business is unsaleable
- Lowest return on investment
- Creditors have priority

Family Limited Partnership Valuation Discounts

- Lack of control
- Lack of marketability
- Key person discount
- Tiered discounts
- Portfolio discount
- Built in gains discount
- Non-voting discount
- COVID discount

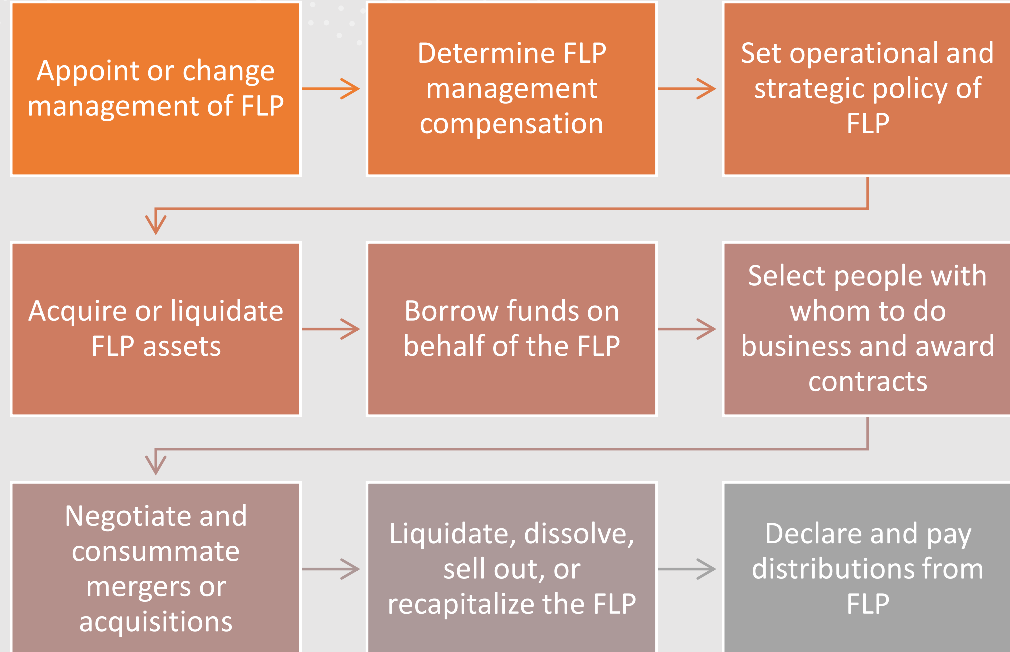
Discounts for Lack of Control (DLOC) Family Limited Partnerships

The DLOC measures the difference in price between:

Controlling ownership interest

Otherwise comparable noncontrolling ownership interest

Discount for Lack of Control Factors



Discount for Lack of Marketability (DLOM) FLP

Empirical models

Theoretical models

Empirical Models

Studies of price discounts on sales of restricted shares of publicly traded companies

(“restricted stock studies”)

Studies of price discounts on private stock sale transactions prior to an initial public offering (“pre-IPO studies”)

IRS Challenges to FLP Valuation Discounts

- Business purpose
- Liquidation restrictions
- Gift on formation
- Appropriateness of the specific discounts

Tiered Discount Allowed in Real Estate FLP Gift Tax Case

Astleford, TC Memo 2008-128, RIA TC Memo 2008-128, 95 CCH TCM 1497

Tax Court permitted a taxpayer to apply a tiered discount in the context of a family limited partnership owning interests in real estate

Built-In Gains Taxes on Business Valuation

Estate of Davis v. Commissioner (110 T.C. 530, 110 T.C.)Tax court holds willing buyer and a willing seller would not have agreed upon a price that did not take into account the company's built-in capital gains tax liability.

Eisenberg v. Commissioner (155 F.3d 50, 1998) the court held: "We find …a hypothetical willing seller and a hypothetical willing buyer would not have agreed on that date on a price for each of the blocks of stock in question that took no account of the corporation's built-in capital gains tax."

Estate of Richard R. Simplot (112 T.C., No.13) Tax court allowed a full discount for built-in gains.

Dunn v. Commissioner (CA-5, 2002-2 USTC) the Appellate Court held: "The Tax Court made a significant mistake in the way it factored the 'likelihood of liquidation' into its methodology, a quintessential mixing of apples and oranges"

Non-Voting Discount

Entity has both voting and non-voting stock/units

Discount of a few percentage points is usually warranted

COVID Discount

COVID-19 make some methods potentially more appropriate than others

Discounted Cash Flows (“DCF”) Valuation is based on company’s future financial performance over a discrete period of time (usually five years)

Under Capitalization of Cash Flows (“CCF”), Valuation based on a single income stream, generally based on historical results, to project future income.

Because of COVID-19 pandemic, DCF may be a more useful method, because it models future years individually as the business returns to more “normal” operations over time until it stabilizes.

Defined Value Clause ("DVC")

Wandry, T.C. Memo. 2012-88, approved a DVC where the "excess" was returned to the donor, and not to a charity.

Taxpayers gifted LLC interests to their issue

Phrased the gift in terms of "that number of units which had a value equal to the taxpayers' remaining exemption amount" (in other words, a fixed dollar amount)

Tax Court ruled that what the taxpayers had gifted was LLC units having a specific dollar value – the exemption amount – and not a specific number of LLC units

McCord v. Commissioner, 461 F.3d 614 (5th Cir. 2006) “net, net gift”

The Tax Court had previously ruled in that a net, net gift payment obligation could not reduce the value of a gift for gift tax purposes

Tax Court was reversed by the 5th Circuit Court of Appeals in Succession of which allowed the reduction for “net, net gift”

A net gift, the donee pays the taxes – usually, but not always, from the assets that are gifted and the amount of the gift subject to gift tax is reduced

A “net, net gift” the donee also agrees to pay any increase in estate taxes imposed on the donor’s estate under Code §2035(b) relating to the gift snf back to the gross estate any gift taxes paid on a gift if the donor dies within 3 years of the gift

Taxation of Partnership Income

Partnerships are "pass-through" tax entities

profits and losses of the partnership "pass through" the business to the partners, who pay taxes on their share of the profits

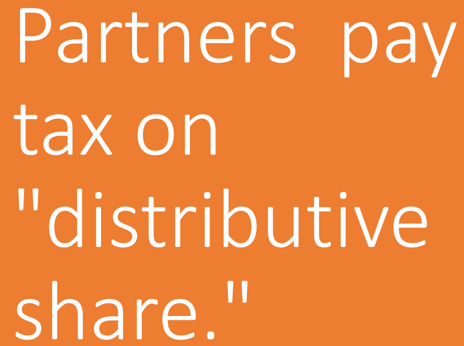
Each partner's share of profits and losses is usually set out in a written partnership agreement

Tax Return Filing

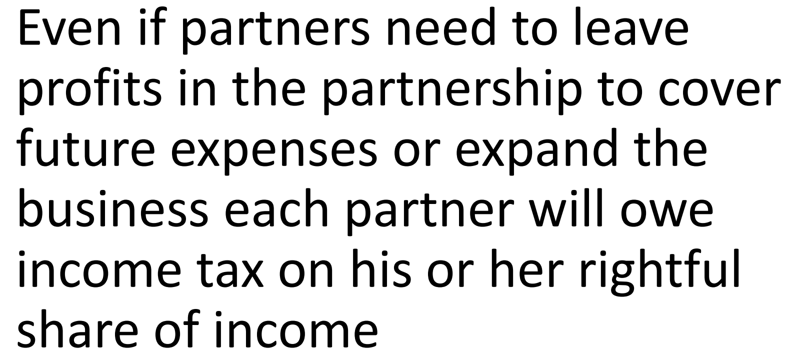
Informational return the IRS reviews to determine whether the partners are reporting their income correctly

The partnership must also provide a Schedule K-1 to the IRS and to each partner, which breaks down each partner's share of the business's profits and losses.

Each partner reports this profit and loss information on his or her individual tax return



Partners pay tax on "distributive share."



Even if partners need to leave profits in the partnership to cover future expenses or expand the business each partner will owe income tax on his or her rightful share of income

Establishing the Partners' Distributive Shares

A written partnership agreement

State law usually allocates profits and losses to the partners according to their ownership interests in the business

State law assumes that each partner's interest in the business is in proportion to the value of his or her initial contribution to the partnership

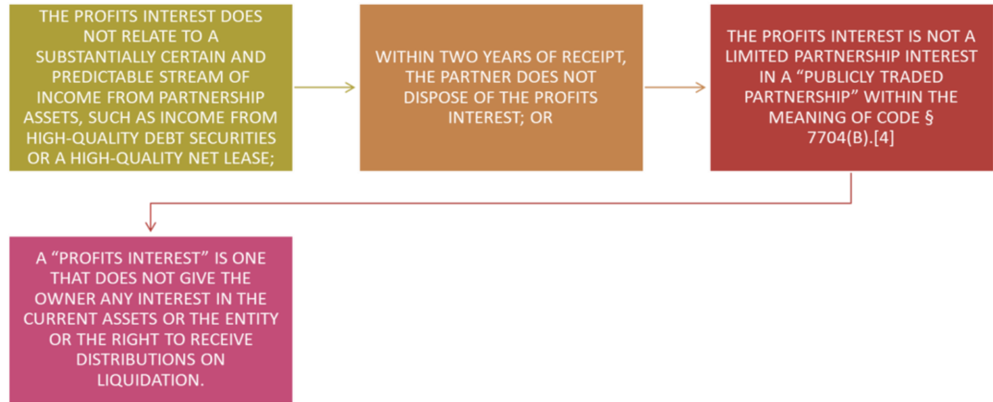
Special allocations allow disproportionate distribution, but require carful drafting

Income Tax Consequences of Partnership Formation

Contributions to a partnership are generally tax free.

No gain or loss is recognized by a partnership or any of its partners as a result of a contribution of property by a partner to the partnership in exchange for a partnership interest.

Profits interest in exchange for services is Non-Taxable if:

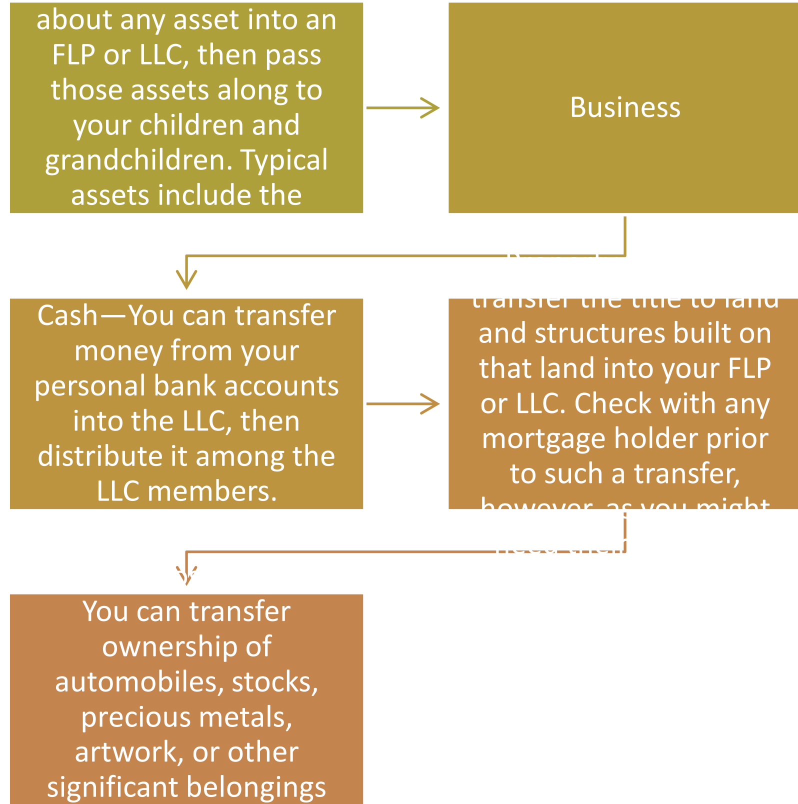


Reporting Partnership Income

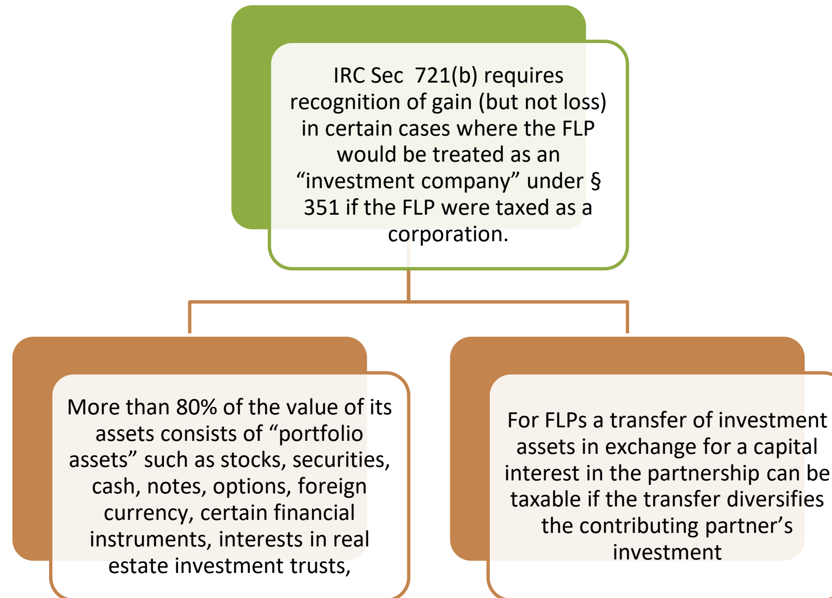
A partnership must file an annual information return to report the income, deductions, gains, losses, etc., from its operations, but it does not pay income tax. Instead, it "passes through" profits or losses to its partners. Each partner reports their share of the partnership's income or loss on their personal tax return.

Partners are not employees and shouldn't be issued a Form W-2. The partnership must furnish copies of Schedule K-1 (Form 1065) to the partner.

Which Assets Can be Transferred Into a FLP or LLC?



Investment Company Partnerships



Avoiding the Investment Company Rules

Be sure that marketable securities and other portfolio assets comprise no more than 80% of the total value of the assets to be contributed to the partnership

Real estate and collectibles do not count as portfolio assets

But contributing nonportfolio assets to the FLP will increase the risk of gain recognition upon a distribution of marketable

Qualified Business Income IRC Sec 199A

Sec. 199A provides individual taxpayers a deduction of up to 20% of QBI from a U.S. trade or business operated as a sole proprietorship or through a partnership, S corporation, trust, or estate

The QBI net income or loss with respect to such trade or business, provided it is effectively connected with the conduct of a trade or business in the U.S

Sec. 199A rules are applied at the level of the partner or shareholder, with each partner or shareholder taking into account their share of the business entity's QBI

QBI Deduction Limits

(1) 50% of the W-2 wages with respect to the trade or business, or

(2) the sum of 25% of the W-2 wages, plus 2.5% of the unadjusted basis immediately after acquisition of all qualified property (generally, tangible property subject to depreciation under Sec. 167).

May not exceed(1) taxable income for the year over (2) net capital gain plus aggregate qualified cooperative dividends.

Qualified Trade or Business

A taxpayer must be engaged in a "qualified trade or business" to claim the Sec. 199A deduction

Sec. 199A defines a qualified trade or business by exclusion; every trade or business is qualified, other than:

The trade or business of performing services as an employee

A specified service trade or business

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