

Planning Ideas—Family Limited Partnerships

The family limited partnership (FLP) has emerged as an important technique for helping clients minimize federal transfer taxes and shift future appreciation to younger-generation family members. Although FLPs have been subject to IRS attack, recent case law shed light on how to properly set up and operate the FLP to obtain the hoped-for results.

How it Works

The FLP can make a huge difference in how much heirs receive.

Example

Steve D., a widower, is a successful entrepreneur and investor. His estate is currently valued at \$10 million. Steve wishes to see his wealth benefit his daughter, Gail, and her family. If Steve does no planning and his estate appreciates at 6 percent annually over the next 20 years, the value included in his estate is \$36,850,325. After federal estate taxes (45 percent marginal rate) of \$16,582,646, Gail receives \$20,267,679. (The example assumes that the 2010 estate tax repeal is not permanent and that rates return and continue at the 2009 level; the exemption is ignored for purposes of comparison).

On the other hand, Steve could utilize a FLP. In exchange for a contribution of his \$10 million in assets, he acquires a 2 percent general partnership interest and a 98 percent limited partnership (LP) interest in the FLP. Due to restrictions in control and marketability, a qualified appraiser applies a 40 percent discount to the LP interests. Thus, when Wayne transfers the entire 98 percent LP interest to Gail, he is treated as having made a gift of only \$5,880,000 (98 percent of \$10 million discounted by 40 percent).

Assuming a 45 percent marginal gift tax rate, the gift taxes on the transfer of the LP interests amount to \$2,646,000 (ignoring the gift tax exemption). However, upon Steve's death, the appreciated value of the LP interests escapes estate taxation. If the LP interests appreciate at 6 percent over the next 20 years, the amount transferred (without discount) amounts to \$32,359,997.

The following table summarizes the results.

	No FLP	FLP
2030 Taxable Estate*	\$36,850,325	\$641,427
Marginal Estate Taxes**	(\$16,582,646)	(\$288,642)
Amount to Heirs through Estate***	\$20,267,679	\$930,069
Amount to Heirs through FLP****	\$0	\$31,429,928
Net to Heirs	\$20,267,679	\$32,359,997

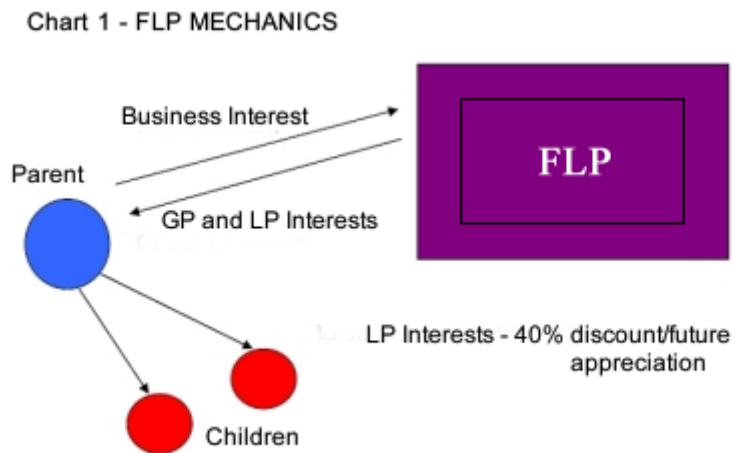
* The taxable estate No FLP is the future value of the \$10 million business interest at 6 percent, plus the amount of cash in necessary to pay the gift taxes if the limited partnerships were transferred (\$2,646,000) invested at three percent after-taxes for 20 years. The taxable estate FLP is the 2 percent general partnership interest valued without discount (\$200,000) growing at 6 percent for 20 years.

**The Marginal Estate Taxes are the amount of federal estate tax in a 45 percent rate on the 2030 Taxable Estate.

***The amount to heirs is the difference between the 2030 Taxable Estate and the Marginal Estate Taxes.

****The Amount to Heirs Thru FLP is the future value of the non-discounted underlying value of the limited partnership interests at 6 percent passing outside of the estate.

The figure below provides a graphic illustration of the FLP mechanics.



Tax and Legal Considerations

That's how the FLP is supposed to work. Unfortunately, over the last several years, the IRS has had considerable success challenging FLP valuation discounts. Essentially, the IRS has argued that the assets contributed by taxpayers to FLPs during their lifetimes should be fully includible in their estates at the date-of-death fair market value under IRC Section 2036(a)(1) relating to property transferred with a retained interest. Applying that argument to our example, the benefit of the FLP planning is lost. Instead of the value of the LP interests passing outside of the estate, they are included in Steve's gross estate without discount. We're basically where we would have been if we'd done no planning.

The good news is that Section 2036(a) contains an exception for bona fide sales made for adequate and full consideration. Finding protection under this exception has not been easy for taxpayers, however, several recent cases have shown promise. In each of these recent cases, the taxpayer's success hinged upon demonstrating legitimate and significant non-tax business purposes for the transfer of assets to the FLP.

Consequently, if it can be demonstrated that the transfer of assets to the FLP was to preserve a family business (not solely from taxes, but from claims of creditors, disjointed management, or resolution of family disputes, for example), the taxpayer's position is strengthened. Similarly, if the taxpayer has assets outside of the FLP sufficient for support and partnership formalities are respected the taxpayer's case is improved.

The most recent case in which a court held that a transfer of assets to an FLP satisfied the bona fide sale exception was *Murphy v. U.S.*, decided on Oct. 9, 2009. The decedent, Charles H. Murphy, Jr., became involved in his family's businesses at an early age, and continued his involvement as an adult. Charles tried to engage his children in the management of the family wealth, but they were less than enthusiastic and some even experienced personal financial difficulties notwithstanding the help they received from their wealthy father.

In 1997, Charles transferred about \$90 million to an FLP and retained about \$130 million for himself. The idea was to transfer management over time to younger-generation family members and protect family assets from claims of creditors. After Charles died, the IRS assessed a deficiency and took the position that the transferred assets should be included in his estate at the then full fair market value. However, the estate won the case due the fact that Charles had legitimate business goals in forming the FLP, retained substantial assets outside of the FLP, and observed appropriate formalities in the operation of the FLP.

Bottom Line

Planning with FLPs continues to make sense. In fact, with values currently depressed compared to a few years ago and with proposals looming on the horizon that could adversely impact discount planning, arguably they never made better sense. The challenge is to follow the guidelines provided by recent case law.

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