Summer 2012

Trust Connection

Bringing together tax professionals, qualified advisors and Wescott Trust Services for the benefit of our mutual clients.

A Periodic Communication Focusing on Trust Information

For the last decade, planners have increased the use of the family limited partnership (FLP) and the family limited liability company (FLLC), as tools in estate tax planning. The hoped for result is that the value of the entity, when given away in pieces, is worth less than the proportionate value of the underlying assets resulting in less gift and estate taxes (or use of the available exemption).

The use of such entities cooled when the IRS was successful in several cases in invoking Section 2036 of the Internal Revenue Code to include the undiscounted fair market value of the assets of an FLP or FLLC back into the taxable estate of the decedent who originally established the entity. This is true even with respect to partnership interests gifted prior to the decedent's death.

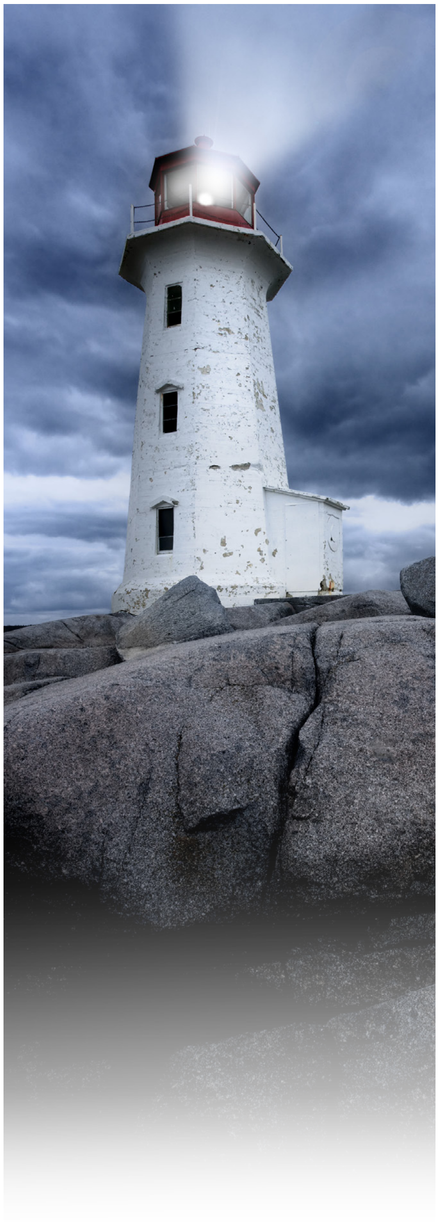
But out of those cases came a "roadmap" on what the court would consider an appropriate use of such vehicles and when the discounts would be upheld. This article will highlight some of the more important requirements and suggestions for establishing and operating a FLP or FLLC to avoid a successful IRS challenge.

Legitimate Business Purpose

The client or the client's estate must be able to establish that the formation of the entity was a bona fide transaction for adequate consideration precipitated by one or more legitimate and significant non-tax or business purposes. This purpose must exist at the time the entity was formed; simply reciting them in documents is not enough.

Non-tax purposes may include, among other things, asset protection, the centralized management of assets, the diversification of investments, the imposition of a unified investment philosophy, the formation of a voting block through pooling of shares of stock, or the imposition of arbitration provisions to settle potential family conflicts.

Thus, the establishment of the entity may be more likely to survive scrutiny as a bona fide transaction if there are multiple partners and members who each



Wescott Trust Services

Wescott Trust Services is a division of National Advisors Trust, FSB negotiate the terms and contribute assets. The pooling of assets for common management and diversification represents a legitimate non-tax purpose, particularly if the investment manager is constrained to a particular investment philosophy that is documented (e.g., "buy-and-hold" philosophy). It is also more likely to withstand challenge if the agreement looks like one that would result between two unrelated parties entering into a venture to operate a business.

Management and Operation of the Entity

The donor should relinquish control over the entity, specifically management rights. The donor should not serve as manager, should not be able to unilaterally change the manager, managing member, or general partner and should not own an interest in a corporate general partner of a FLP. Often clients transfer an interest in an entity to a trust for a child or other family member. While many estate planners relied upon the tax effects of fiduciary duties to allow the same client to serve as trustee of such a trust, recent case law suggests that this should no longer be the case.

Wescott Trust Services can work with you and your clients, establishing and operating a FLP or FLLC. Please contact Scott Poulin at 305.960.2357 or spoulin@wescott.com, or Cathy Seeber at 215.979.1642 or cmseeber@wescott.com for more information.

The parties should follow the formalities set out in the agreement and state law including required filings and meetings as well as keeping the books and records separate. Distributions to partners or members should be made in strict accordance with the terms of the entity's governing documents and distributions of available cash should be made proportionately to the partners' or members' capital accounts. The IRS has been successful in asserting that an implied agreement between the client and the other members exists if the client receives disproportionate distributions or is loaned funds by the entity.

Funding and Timing

The client should not transfer all or even most of assets to the entity and absolutely not transfer personal-use assets. Under such circumstances, the IRS has successfully argued that the client had an implied agreement with the rest of the partners or members to make distributions for the client's support – thereby resulting in a "retained interest" under Section 2036. There is no bright-line rule as to what percentage of the client's assets should or should not be transferred to the entity. Rather, an estimation must be made in light of the client's age and circumstances, as well as the terms of the FLP or FLLC agreement with respect to any mandatory distributions (e.g., distributions of available cash to cover tax liabilities of partners or members).

The transfer should not be undertaken as the client lies dying. Recent successes challenged the use of a leveraging entity based on the assertion that the real purpose of the creation of the entity was to accomplish a "testamentary" transfer with substantial tax savings.

Recent Law

In Estate of Kelly, Mrs. Kelly was an elderly widow in ill health who had succeeded to sole ownership of her family's business and investment holdings. Mrs. Kelly formed four limited partnerships and a corporation to act as general partner of each and transferred to specific properties and investments. Mrs. Kelly owned the corporation and her children acted as the corporation's officers and directors actively managing the limited partnerships' business and investment interests. Until her death two years later, Mrs. Kelly gifted limited partner interests to her children and grandchildren. At the time of her death, Mrs. Kelly had gifted all or a majority of her limited partner interests in three of the four limited partnerships.

The Tax Court held that property of a family limited partnership should not be included in a decedent's estate, even though the decedent owned 100% of the stock of the corporate general partner and a management fee was paid to the corporation which could have potentially been used to pay the decedent's living expenses. The reasoning was that the decedent's transfers of assets to the partnerships qualified for the bona fide sale exception, because the decedent had legitimate and significant nontax reasons for creating the partnerships, and she received partnership interests in proportion to the value of the assets transferred. The primary concern of the family was to ensure the equal distribution of the decedent's assets among the children, thereby avoiding litigation. In addition, the partnerships protected the family from legitimate liability concerns with respect to the real properties, as well as concerns regarding the effective management of the assets. The court noted that the Georgia court petition referenced estate tax savings, but found that there was no evidence that tax savings actually motivated the transaction.

Conclusion

The use of FLPs and LLCs as a way to leverage the estate tax exemption may become even more popular if the exemption reverts to $1 million. Recent cases show that in the right circumstances and with good planning and compliance they are effective options.