

Are FLPs Still Viable?

Understanding the Current Landscape

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GROWTH, PROTECTION AND TRANSFER OF BUSINESSES AND ESTATES

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Agenda

- Introduction to MF&Z
- Family Limited Partnerships
 - The Basics
 - The Potential Benefits
 - The Recent History
 - The Current Climate
 - Putting it All Together
 - Best Practices – Formation Phase
 - Best Practices – Operations Phase
 - Bail Outs for Existing FLPs
- How we can help clients

MF&Z's Scope of Services

Trusts and Estates Law Practice

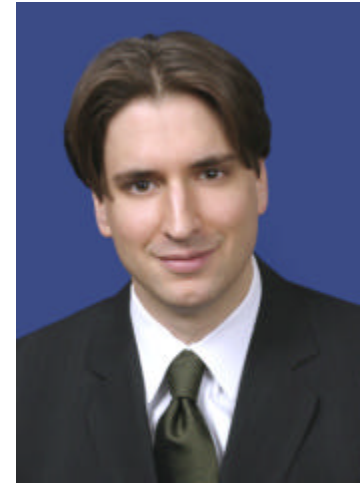
- Wills, trusts, and estate planning
- Charitable foundations and trusts
- Tax planning
- Asset protection planning
- Advanced wealth transfer techniques
- Probate and trust and estate administration

Business Law Practice

- General representation of privately-held businesses
- Business succession planning
- Tax planning
- Mergers and acquisitions

Jeffrey M. Mangieri, Associate

- ❖ Attorney at Law since 1999
- ❖ B. A. in English, University of Michigan
- ❖ Juris Doctor, Wake Forest University
- ❖ Recipient of Block Foundation Scholarship
- ❖ Selected by peers in 2007 as one of Georgia's *Super Lawyers Rising Stars*
- ❖ Recipient of the CALI Award in Tax Policy



Lawrence H. Freiman, Co-Founding Partner

- ❖ Attorney at Law since 1993
- ❖ B.A. in Economics, State University of New York at Albany, Magna Cum Laude
- ❖ Juris Doctor, University of Florida
- ❖ MBA, University of Florida
- ❖ AV-rated (Excellent to Preeminent) by his peers through Martindale Hubbell lawyers publication
- ❖ Previously selected by peers as member of *Georgia Trend Magazine's* "Legal Elite" (Taxes, Trusts & Estates)
- ❖ Director, *Estate Planning Council of North Georgia*
- ❖ Member, *American Academy of Estate Planning Attorneys, Atlanta Bar Association & Lawyer's Club of Atlanta*



Mutually Rewarding Relationships with You

- MF&Z is Your Legal Information Source
 - www.MFZlaw.com
 - Access to Law Firm for Questions
 - Education E-Alerts

Mutually Rewarding Relationships with You

- Complimentary Estate Planning Document Review For Your Clients
 - A “quick look” at your clients’ current estate planning documents
 - Our document review checklist covers the nuts and bolts of a properly executed plan in Georgia
 - Identifies important elements that are missing (or improperly dealt with) under existing plan
 - Particularly useful for clients who have not “tuned up” their plans within the last three years, and out of state clients who recently moved to Georgia

Mutually Rewarding Relationships with You

- Team Approach
 - Keeping you informed of your client's progress
 - Keeping you involved in the process
 - No Poaching Policy
 - Client's referred back to you for your expertise
 - Improve “full service” approach to your clients

Circular 230 Disclosure

The content of this presentation was not intended to be used—and cannot be used—for purposes of avoiding tax penalties, nor for purposes of promoting, marketing, or recommending to another party an arrangement involving any tax-related matters addressed herein.



“Ground Rules”



What is a “Family Limited Partnership”?

- The “Family” in FLPs
- General Partners and Limited Partners
- General Partnerships v. Limited Partnerships

Warning: Limitations

- Assets that shouldn't be transferred to an FLP:
 - Personal residence
 - Retirement plans
 - S corporation stock
 - Stock of professional corporations
 - Cash or marketable securities (?)
- Must be created before it's needed
- Can't use it as a "fraudulent conveyance"
- Should be part of an overall estate plan
- Subject to close scrutiny by the IRS

Potential Benefits

- Asset Protection
- Avoiding probate
- Business Succession Planning
- Wealth transfers at reduced valuations

Potential Benefits

- Asset protection
 - Charging Order Protection
 - Choice of Jurisdiction

Potential Benefits

- Avoiding probate
 - Living probate
 - Death probate

Business Succession Planning

- It has been reported that 80 percent of U.S. businesses are family-owned.
- Just 25 percent of family business owners have made succession plans.
- Only 30 percent of all small businesses survive the transition from first generation to second generation.
- Only 13 percent make it to the third generation.
 - » Karen Kerrigan, The Small Business Survival Committee

The Challenge of Business Succession

- Without careful planning, there may be little left for loved ones to inherit.
- Land rich but cash poor.
- An FLP...
 - Can turn an “indivisible asset” into one that can be divided up in any way your client sees fit
 - Can be operated to encourage family members’ involvement in the business
 - Can be designed to preserve the income of the parents

Transfer Tax Benefits

- “Valuation Discount”
 - Limited partnership shares are restricted
 - Restricted shares receive a discount
 - Discounts can lower gift and estate taxes
- Annual exclusion gifts
 - Caution: Does LP unit qualify as present interest?
- Lifetime gift tax exclusions gifts
- Freeze techniques can yield transfer tax savings

The Recent History

- IRS challenges began in earnest in early 1998
- The Service's position emerges from
 - Technical advice memoranda
 - Private letter rulings
 - Arguments made in tax cases
- “Cherry Picking” cases with bad facts results in bad law.

Early Arguments Made by the IRS

The IRS met with little success using these arguments

- Murphy Argument - *Disregard Partnership Because of Single Purpose: Tax Reduction*
- Section 2703 Argument – *Ignore Entire Partnership Agreement*
- Section 2704 (b) Argument – *Ignore Certain Restrictions and Limitations in Partnership Agreement*
- Gift on Formation Argument – *Value Just Doesn't Disappear . . . Or Does It?*

The Main IRS Argument Today

- Section 2036(a) Argument – *Taxpayer's Retained Use and Enjoyment or Control over Who Enjoys Property*
- The IRS has used §2036 to successfully challenge FLPs
- This code section requires the inclusion of transferred property where, *absent a bona fide sale for adequate and full consideration*, the decedent has retained:
 - the right to possession or enjoyment of, or the income from, the property contributed to the FLP [§ 2036(a)(1)]; or
 - the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property contributed to the FLP, or the income therefrom [§ 2036(a)(2)]

How the IRS Uses the 2036(a) Argument

- The IRS identifies situations where taxpayers failed to respect the legal separateness of the FLP entity or the specific provisions of the FLP partnership agreement (bad facts → bad law), *and then*
- The IRS uses Section 2036(a) to bring the value of FLP assets back into the decedent's estate as a retained life interest and these FLP assets are subject to estate tax

Bad Facts and Practices to Avoid

- In most IRS victories the Court ruled the taxpayer followed an “implied agreement”; not the FLP partnership agreement. These cases have typically involved:
 - Commingling personal and FLP assets without separate records
 - Distributions to FLP partners non-pro-rata with FLP ownership
 - Insufficient assets retained by taxpayer for individual support
 - FLP does not adhere to partnership agreement and partnership formalities are not satisfied
 - No legitimate non-tax purposes for creating and maintaining FLP
 - FLP ownership interests not proportionate with capital contributions
 - Fair market rent not paid for personal use of FLP assets (e.g. house)

“Implied Agreement” Cases – IRS Won

- *Schauerhamer Estate (T.C. Memo 1997-242)*
- *Reichardt Estate (114 T.C. 144 (2000))*
- *Harper Estate (T.C. Memo 2002-121)*
- *Thompson Est. (T.C. Memo 2002-246, aff'd. 3d Cir. 2004)*
- *Strangi Estate (115 T.C. 478 (2000), aff'd in part, rev'd and rem'd in part, 5th Cir. 2002)*
- *Strangi Estate #2 (T.C. Memo 2003-145, aff'd, 5th Cir. 2005)*
- *Bigelow Estate (T.C. Memo 2005-65)*
- *Korby Estate (T.C. Memo 2005-102)*
- *Bongard Estate (124 T.C. 95 (2005))*
- *Rosen Estate (T.C. Memo 2006-115)*

How Taxpayers Have Succeeded

- Recall the “Bona Fide Sale” exception in §2036(a)
- Even if the decedent retained strings which would usually cause §2036(a) to apply, inclusion of FLP assets can be avoided if the transfer is “a bona fide sale for adequate and full consideration”
- **Note:** Courts have split on the proper standards for the bona fide sale exception and proper definition for “full and adequate consideration”

Good Facts and Practice to Follow

- Successful taxpayers have shown:
 - Bona fide business purposes for the FLP
 - FLP not formed solely to reduce estate taxes
 - FLP did not follow an implied agreement
 - FLP was not a testamentary arrangement
 - Arm's length transactions in use, management and distribution of FLP assets
 - Sufficient assets retained by taxpayer for individual support
 - Contributed assets were timely conveyed to FLP

Bona Fide Sale Cases – Taxpayer Won

- *Church v. U.S.* (W.D. Tex. 2000), *aff'd*, 268 F.3d 1063 (5th Cir. 2001)
- *Stone Estate* (T.C. Memo 2003-309)
- *Kimbell v. U.S.* (N.D. Tex. 2003), *vacated and rem'd*, 371 F.3d 257 (5th Cir. 2004)
- *Schutt Estate* (T.C. Memo 2005-126)

Standards for Bona Fide Sale Exception

- 5th Circuit – “objective facts” supporting “full and adequate consideration” (*Kimbell Case*)
 - Partner interests should be proportional to contributed assets
 - Contributed assets should be credited to partners’ respective capital account
 - Partners should be entitled to distributions equal to their relative capital upon termination of the partnership
- Tax Court & 3rd Circuit – “full and adequate consideration” (*Thompson and Bongard Cases*)
 - Transfer must not have been “a mere recycling of value” from individual assets to a partnership interest
 - There must be 1) an arm’s length transaction; 2) “a legitimate and significant non-tax reason” for creating the FLP; and 3) FLP interests must be proportionate to transferor’s contributions.

§2036(a)(2) Unresolved

- In Strangi II, the Tax Court held that 2036(a)(1) and (a)(2) both applied, but on appeal, the 5th Circuit ruled on 2036(a)(1) without dealing with the (a)(2) issue
 - 2036(a)(1) concerns the taxpayer's retained use and enjoyment of FLP assets after contribution to the FLP
 - 2036(a)(2) concerns the taxpayer's retained "control" over who enjoys benefits and income of the taxpayer's transferred assets
- 2036(a)(2) could conceivably apply even where the transferor retains a non-controlling LP interest in the FLP
 - Consider a FLP in which a majority vote of all partners, GP and LP, controls distributions or liquidation decisions or the removal and replacement of the GP. 2036(a)(2) could apply to a 51% LP
 - Part II will address rehabilitating FLPs to guard against such weaknesses
- Will 2036(a)(2) be applied by the courts in future cases?

Best Practices – Formation Phase

- Expressly identify and document the non-tax reasons for the FLP
- Control structure must be carefully evaluated
- Conduct a financial analysis to ensure adequate assets retained outside of the FLP
- Operative documents should not waive fiduciary duties of GP
- Material capital contributions from all partners
- Interests in proportion to contributions
- Careful attention to sequence of formation activities
- Partners should actively negotiate FLP documents, if possible

Best Practices – Operations Phase

- Refrain from making non-pro rata distributions to the owners
- Refrain from commingling the FLP's funds with personal funds
- Maintain accurate books which reflect the operative agreements of the FLP and the entity's operations
- Encourage the GPs to actively manage the assets in the FLP
- Proactively and steadfastly ensure operational integrity with operative documents and compliance with law

Part II – Practical Application

- Practical Uses for Creating a New FLP
 - Traditional Business Purposes
 - Estate Planning and Gifting Purposes
 - Protect Trust Distributions from Creditors and Spendthrift Beneficiaries
- Techniques for Rehabilitating an Existing FLP
 - Transfer Partnership Interests to New Partners or Gifting Trust
 - Recapitalize FLP With Proportionate Ownership
 - Amend Partnership Agreement

Why Create a New FLP?

- Traditional Business Purposes
 - Consolidated Asset and Investment Management
 - Asset Protection
 - Business Succession Planning

Why Create a New FLP?

- Estate Planning and Gifting Purposes
 - Avoiding Probate
 - Asset Protection
 - Wealth Transfers at Reduced Valuations
 - Ability to Transfer Partial Interests in Illiquid Assets

Why Create a New FLP?

- Protect Trust Distributions
 - From Creditors
 - From Spendthrift Beneficiaries

Rehabilitating an Existing FLPs

Why consider rehabilitating an existing FLP?

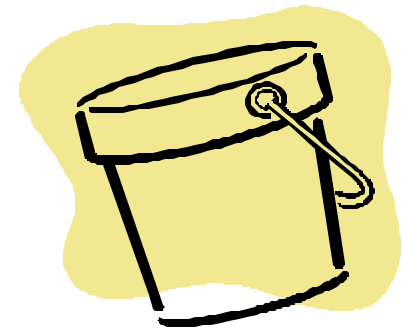
- If your FLP is flawed, you could face estate taxes on the full value of all the FLP assets you contributed
- Other planning objectives (asset protection, etc.) may also be compromised

Triggers for rehabilitating:

- You have identified “Bad Facts” in the formation or operation of your FLP and need to “reset”
- You are concerned over the uncertainty of 2036(a)(2) attack by IRS and possible unfavorable Tax Court rulings encourages you to divest GP or LP interests

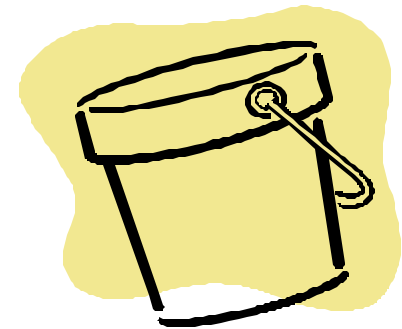
Bail Out Concepts for Existing FLPs

- Transfer the Interests to Spouse



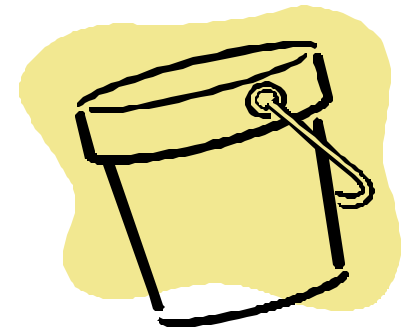
Bail Out Concepts for Existing FLPs

- Transfer the Interests to Spouse
- Transfer the Interests to Children



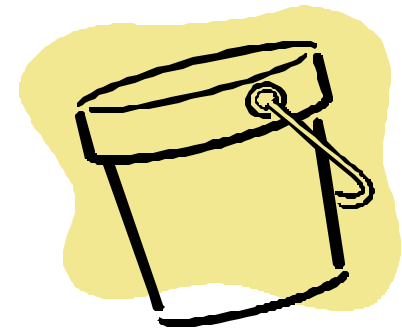
Bail Out Concepts for Existing FLPs

- Transfer the Interests to Spouse
- Transfer the Interests to Children
- Recapitalize the FLP and Transfer Interests to Children



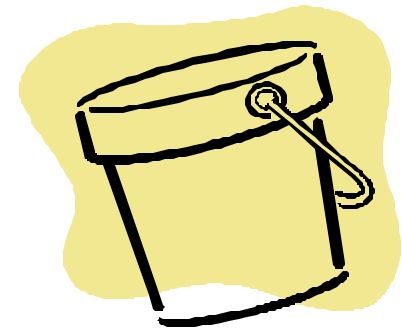
Bail Out Concepts for Existing FLPs

- Transfer the Interests to Spouse
- Transfer the Interests to Children
- Recapitalize the FLP and Transfer Interests to Children
- Transfer the Interests to Incomplete Gift Trust



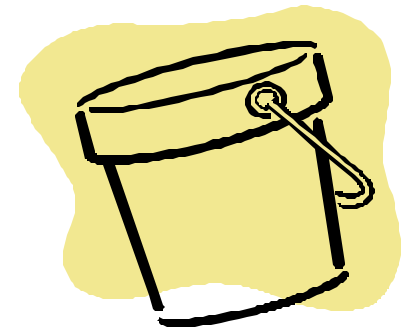
Bail Out Concepts for Existing FLPs

- Transfer the Interests to Spouse
- Transfer the Interests to Children
- Recapitalize the FLP and Transfer Interests to Children
- Transfer the Interests to Incomplete Gift Trust
- Transfer the Interests to a QTIP Trust



Bail Out Concepts for Existing FLPs

- Transfer the Interests to Spouse
- Transfer the Interests to Children
- Recapitalize the FLP and Transfer Interests to Children
- Transfer the Interests to Incomplete Gift Trust
- Transfer the Interests to a QTIP Trust
- Sell Rather Than Gift

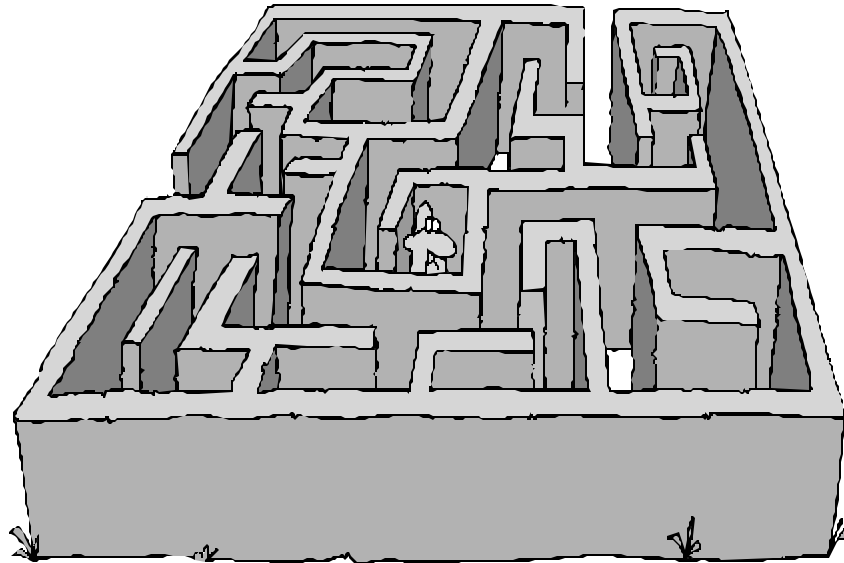


Fail to Plan = Plan to Fail

- Just like basic estate planning documents, our clients FLPs are not meant to be implemented and then forgotten
- Regular review and, if appropriate, recalibration of the plan is mandatory

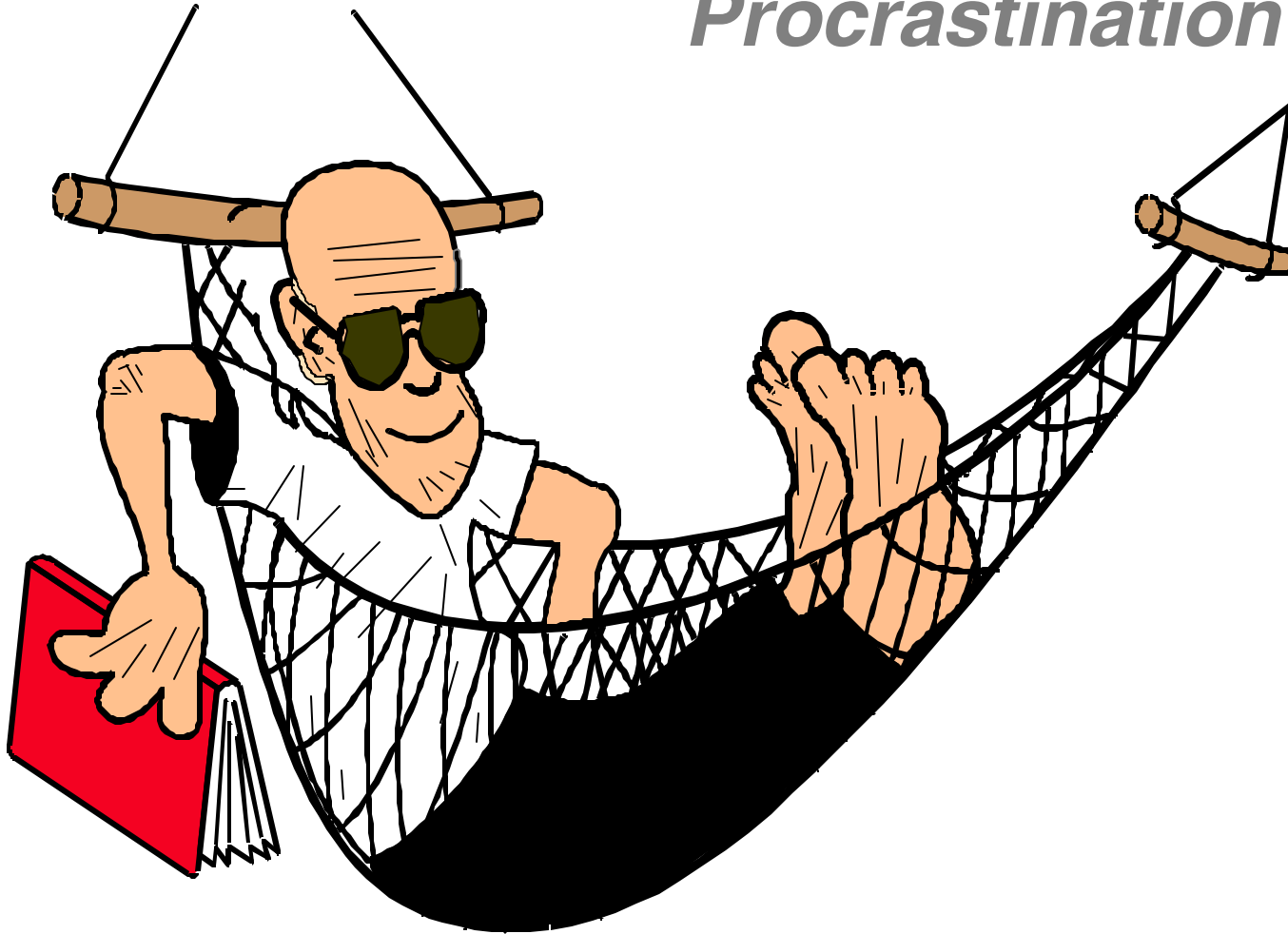
Why People Fail to Maintain a Plan

Confusion



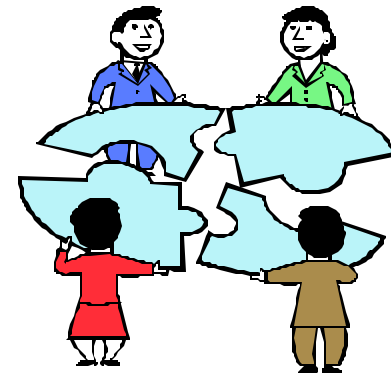
Why People Fail to Maintain a Plan

Procrastination



Let's Work Together

- Contact us to:
 - Set up an FLP review appointment for one of your clients
 - Grab breakfast or lunch to get to know each other better



Any Questions?

What's the meaning of life?

