BUSINESS NORTH CAROLINA

Your Source for Business News in North Carolina

LAW JOURNAL 2006

FLPS ARE STILL VIABLE TO SAVE TRANSFER TAXES

An estate planning technique that has grown in popularity is the use of a family limited partnership or family limited liability company. Using this technique, wealthy taxpayers, typically parents, transfer a substantial portion of their assets to a partnership. The assets could include real estate holdings (other than a personal residence) and/or investment property (including cash and securities). Over time the parents gift or sell ownership interests in the FLP to their family members either outright or in trust.

Tax Benefits

A properly designed FLP allows parents to receive a valuation discount not only on the value of gifts made during life but also on the value of the FLP interests retained at death. This is a double tax benefit that can result in substantial transfer tax savings. For tax purposes, the FLP interests transferred have generally been valued at substantial discounts from the fair market value of the underlying partnership assets based on lack of marketability and minority interest discounts. Historically, the valuation discounts have ranged from 25% to 45%. A properly structured FLP has the potential to cut transfer taxes by 25% to 45%.

> **Using an FLP has the potential to cut transfer taxes by 25% to 45%.**

IRS attacks

Until recently, taxpayers enjoyed tremendous success defeating challenges to the valuation of the FLP interests transferred. As more taxpayers prevailed, the use of FLPs became accepted and taxpayers became overconfident. Unfortunately, the IRS has found success attacking FLPs based on a theory of retained control by the creator of the FLP.

William R. Culp, Jr.
John J. Carpenter

Bill Culp and John Carpenter are partners in Culp Elliott & Carpenter, PLLC, a Charlotte law firm specializing in tax law. A graduate of UNC Chapel Hill, where he also earned his law degree, Culp received a master's in taxation from New York University. He is the author of *Don't Be Caught Dead Paying a Voluntary Tax!* and co-author of *Valuation Practice in Estate Planning and Litigation*. Carpenter is a graduate of Wake Forest University, where he earned his accounting and law degrees. His practice focuses on advanced real estate tax strategies and estate planning. Both Culp and Carpenter are North Carolina certified public accountants and board certified specialists in estate planning and probate law.

Estate of Strangi

The 5th Circuit Court of Appeals recently ruled in the Estate of Strangi that the decedent's taxable estate included 100% of the assets held in the FLP due to the continued beneficial enjoyment exercised by the decedent. This case is a classic example of the old saying that bad facts make bad law. From the facts, it appears that Mr. Strangi created the FLP two months before his death, funded it with personal and investment assets (including his residence) and retained 99.5% of the beneficial ownership. The Court found that the FLP was formed when the decedent was in poor health, that it paid many of his expenses, that he continued to live in the residence after transferring it to the FLP without paying any rent, that his 99.5% retained ownership made it seem

testamentary, rather than a real business venture, and that the canned forms used to create the FLP were implemented with little input from the other partners. The creation of the FLP was found not to be a bona fide sale because it did not serve a "substantial business or other non-tax purpose."

Proper Planning Required

Despite the IRS's successes, FLPs continue to be an attractive planning alternative. To defeat an IRS attack, the taxpayer must be able to prove that the transfer was a bona fide sale for full and adequate consideration. Having substantial non-tax business reasons for forming the FLP, respecting partnership formalities and not having the parents retain too much control or beneficial enjoyment from continued use of the partnership assets, are essential to achieve a successful result. The following guidelines should be followed:

- **Retain sufficient assets outside of the FLP.** The parents should be able to to maintain and pay for their accustomed standard of living (including all household, health care and medical expenses) without relying on contributed assets. Under no circumstances should a personal residence be used to fund the FLP.

- **Partnership legal formalities.** The parents must not continue to treat the FLP assets as their own. Facts and circumstances considered by courts have included whether partnership meetings were held on a regular basis, whether proper books and records were maintained, whether partnership and personal assets were commingled, whether partnership distributions made pro rata, whether other partners were given an opportunity to provide input in the FLP's formation and management and whether estate taxes and administration expenses of the decedent were paid directly by the FLP.

- **Document the business purpose.** The purpose clause of the partnership agreement should contain detailed explanation of the nontax business purpose of the FLP. Detailed partnership resolutions stating the parties' intent in forming the partnership should be executed. Nontax business purposes approved in recent court cases include centralized management, liability protection, consolidation of family-owned business assets and perpetuation of the parents' investment style. Recent examples of non-tax business purposes rejected by the courts include no active management of partnership assets because of the proximity of the decedent's death to the formation of the FLP and) no meaningful pooling of assets to achieve diversification and centralized management, since the FLP never engaged in any substantial business transactions.

- **Change in control.** If possible, there should be a real change in the control and management of the assets contributed to the FLP. It is best if taxpayers demonstrate that the FLP requires active management.

- **Disposition of ownership prior to death.** Ideally, the parent should not own any of the FLP interests at death. This should avoid a fight with the IRS altogether. This can be achieved by having the parent gift or sell his entire partnership interest in the FLP prior to death. With proper planning, in most cases this can be achieved on a tax-free basis.

In summary, to achieve a successful result there must be a balance between nontax and tax motivated reasons in establishing a FLP. Taxpayers should properly plan and document their intent and nontax-motivated business reasons for the FLP. In addition, it is essential to strictly adhere to partnership formalities.