update

Staying Ahead with Saul Ewing

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Personal Wealth, Estates and Trusts Group

Family Limited Partnerships Attacked

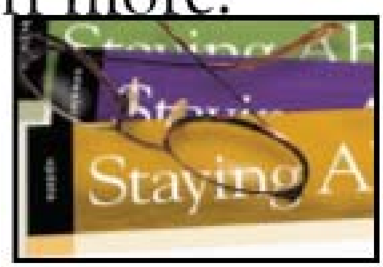
What happened?

In the past year there have been significant developments in the law pertaining to family limited partnerships (“FLPs”) and related entities such as LLCs. Because the law supports gifts and estate tax discounts in appropriate instances, taxpayers have had little, if any, adverse reaction from the IRS in most such instances. However, the IRS *has* actively contested these discounts in certain estate tax and gift tax audits and in court cases that have developed out of those audits.

What does it mean?

The result has been a strong pro IRS reaction from certain trial courts, a fact that may increase the risks to all taxpayers who have created FLPs and other discounting entities. In certain cases, lifetime gifts to children have been disregarded and all of the assets of the entity brought back into the senior family member’s estate, with unfavorable tax results for the estate. So, this is a good time to review existing FLP’s to see if changes are advisable.

Learn more.



Turn page to find out more.

In the past year there have been significant developments in the law pertaining to family limited partnerships ("FLPs") and related entities such as LLCs. As you may be aware, these entities have been very popular as family estate planning tools over the past ten years or so. A typical pattern has been for a senior family member ("Senior") to set up an FLP and make transfers to it of various assets. Senior indirectly retains control of the FLP while making gifts of passive ownership interests in it to his children and, perhaps, his grandchildren. Because the interests that the children and grandchildren receive can't be sold by them and can't be given away to a third party, the value of Senior's gift to them is "discounted". This means, for example, that if Senior put $5 million worth of assets into the FLP, a gift of a one percent ownership interest in the FLP to a child would not be valued at $50,000 (one per cent of the FLP's underlying assets) but rather the value of that gift would be discounted to, say, $30,000 or $40,000. Obviously, this makes it possible to transfer more ownership to the children each year within the $11,000 per donee gift tax exclusion ($22,000 when the gift is split with a spouse). Using this tool, many clients have been working to reduce their estates over the past few years while maintaining control of the FLP that holds the assets.

Another way that an FLP can be used to reduce estate taxes is related to the valuation placed on what Senior retains at death as shown in his or her Federal estate tax return. Senior's executor, of course, will report as a taxable asset only that portion of the FLP that is owned by Senior at his death. And, because the FLP agreement often provides that the executor cannot sell Senior's portion, or liquidate the FLP, the estate takes a discount for those factors to further reduce the estate tax value of the portion that was owned by Senior.

Because the law supports these gifts and estate tax discounts in appropriate instances, taxpayers have had little, if any, adverse reaction from the IRS in most such instances. However, the IRS *has* actively contested these discounts in certain estate tax and gift tax audits and in court cases that have developed out of those audits. In the most important of these cases, the taxpayers have abused the FLP technique and flouted sound business practices. The result has been a strong pro IRS reaction from certain trial courts, a fact that may increase the risks to all taxpayers who have created FLPs and other discounting entities. In certain cases, lifetime gifts to children have been disregarded and all of the assets of the entity brought back into the senior family member's estate, with unfavorable tax results for the estate.

Of course the question is what, if anything, should you do to respond to this? One approach is to wait to see if the IRS loses these cases on appeal. That school of thought believes that if the FLP planning technique is not abused, these troublesome new cases should not apply.

A more conservative approach, involves, among other things, restructuring the entity so that the senior family member essentially gives up most of his or her control. Whether taking precautions of this nature is appropriate will depend both on the facts surrounding the particular entity and the client's desire for certainty in his or her estate planning matters.

This update was written by John F. Meigs, Managing Director of Saul Ewing's Personal Wealth, Estates and Trusts Group. For more information, please contact Mr. Meigs at (215) 972-7812 or at jmeigs@saul.com. The information in this Update is intended for informational purposes only, and its contents should not be considered legal advice.