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Structuring and Operating Family Limited Partnerships: Asset Protection and Income Tax Reduction

Shifting Income Tax Burden to Lower-Taxed Family Member Partners, Application of Section 199A, Valuation Discounts

TUESDAY, AUGUST 28, 2018

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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Introduction to Family Business Entities

- May consist of traditional FLP, FLLLP, LLC, and other entities
- Formation Objectives
  - Asset protection
  - Estate and gift tax planning
  - Income tax management
  - Succession planning
- Roadmap: Funding and Operational Challenges, Asset Protection Planning, Income Tax Planning and 199A, Discounting and 2704, Conclusions and Case Study

Funding and Operational Challenges

- Formation and Funding
  - Choice of Entity
  - Assets
  - Financing/funding
  - Fraudulent transfers
  - Cash flow considerations
  - “Curing” before subsequent transfer
- Ownership – outright vs. trust
- Treat your business like a business
  - Maximize asset protection
  - Distributions/Turner v. Comm’r (T.C. Memo. 2011-209)

Choice of Entity

- Suitability for purpose
- Asset protection considerations
- Taxation
- Choice of law/nexus
- Unauthorized practice

Funding - Assets

- Operating Businesses
  - Succession planning
  - Liquidity/exit considerations
  - Discounting opportunities
- Real Property
  - Fractionalization
  - Cost of carry
  - Discounting considerations
- Marketable Securities
- Cash/cash equivalent

Funding - Financing

- Equity
- Debt
  - Bona fide sale
  - Retained cash flow
- Unrelated party involvement

Funding – Fraudulent transfers

- Always a consideration
- Matter of local law
- Solvency certificate
- Attorney due diligence

Funding – Cash flow

- Based on analysis of assets and obligations
- Insufficient operating capital a cause of comingling
- Operating businesses, real estate, and non-productive assets key offenders

Treating Your Business Like a Business

- Essential to preclude veil-piercing for asset protection purposes
- Undesirable tax implications may result
- Best practices
  - Avoid comingling with personal assets and maintain separate books
  - Valid non-tax business purpose
  - Adequate capitalization
  - Comply with operating documents
  - Minimize non-pro-rata distributions
  - Commercially-reasonable transactions
  - Maintain adequate records – especially capital accounts

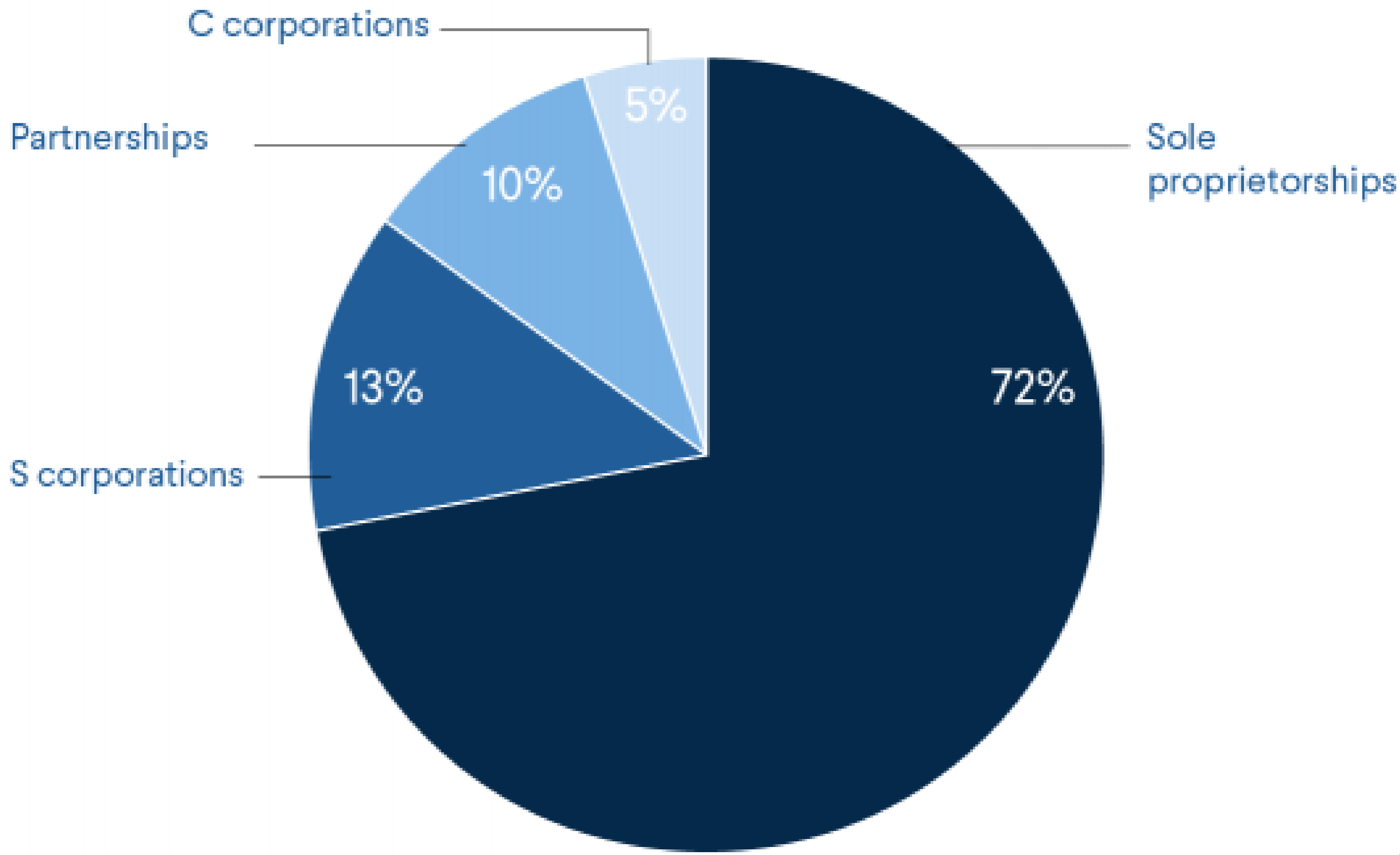
Turner v. Commissioner

- Estate of Clyde W. Turner, Sr., Deceased, W. Barclay Rushton, Executor, Petitioner, V. Commissioner of Internal Revenue, Respondent T.C. Memo. 2011-209, August 30, 2011
- Relevant Holding: Decedent's transferred partnership interests were includible in his taxable estate without discount under IRC § 2036
- Factors considered:
  - No bona fide non-tax business purpose
  - Comingled assets
  - Unreasonable salary
  - Non-pro-rata distributions to transferor
  - Continued use and enjoyment of assets

Asset Protection Planning with FLPs

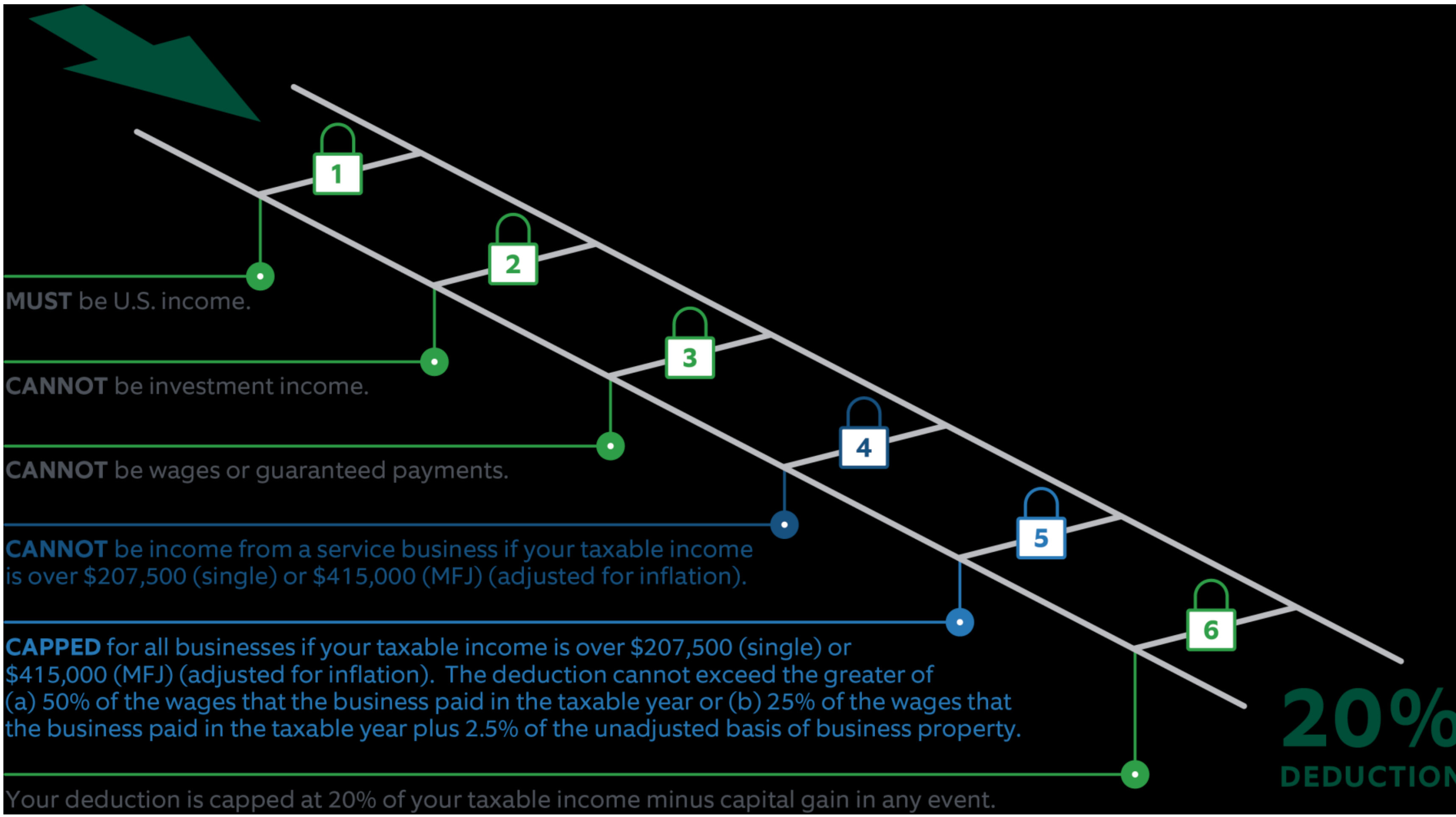
- Objective: Protect family assets from creditors
  - Inside Creditors
  - Outside Creditors
- Considerations
  - Sources of risk
  - Creditor Remedies
  - Choice of Entity/Nexus

Distribution of Business Types

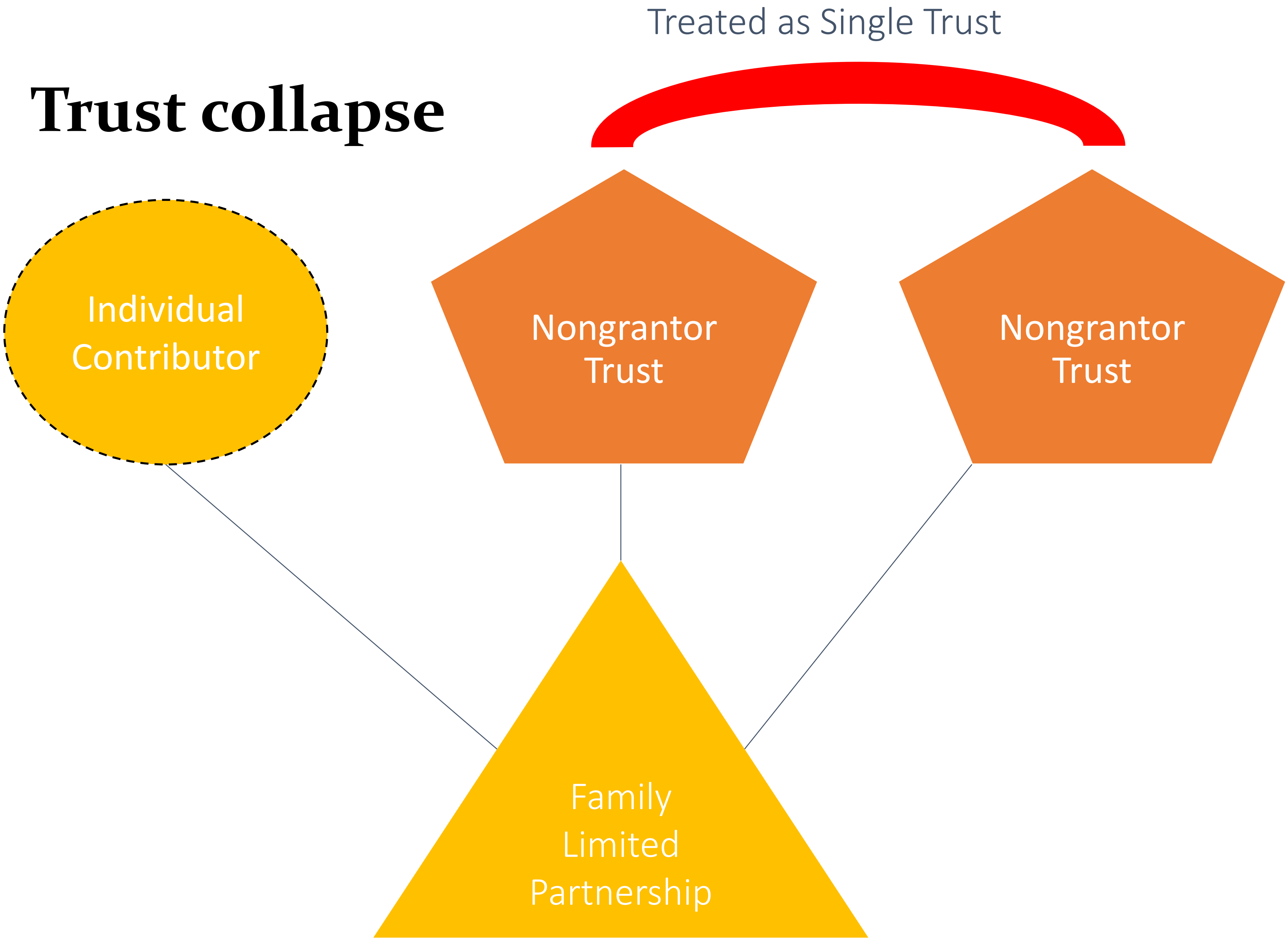


Sources: Internal Revenue Service; Congressional Research Service.

Passthrough business income tax deduction



Trust collapse



Introduction to Valuation Discounts

- Business entities are often used to justify discounts for intrafamily wealth transfer
- Minority interests in businesses often justify discounts for lack of control
- Transfer restrictions often justify discounts for lack of marketability
- Additional discounts may result from type of underlying assets
- Subject to IRS scrutiny for some time, attempted reform of Treasury Regulations in 2016 (REG-163113-02) was reversed by Trump administration (Executive Order 13789, IRS Notice 2017-38)

Valuation Discount - Example

<u>Without Discounting</u>

- Client transfers family ranch appraised at $10m to three trusts, one for each of adult children
- Client consumes $10m of FEGT Unified Credit

<u>With Discounting</u>

- Client transfers family ranch appraised at $10m to LLC
- Client transfers LLC interests to three trusts, one for each of adult children
- Qualified Appraisal reports available discount of 30%
- Client consumes $7m of FEGT Unified Credit

Valuation Discounts and IRC § 2704

- IRC § 2704 is designed to limit the use of intrafamily business arrangements to transfer wealth at below market values
- IRC § 2704(a) imposes tax liability on intrafamily transfer of wealth associated with lapses in voting and liquidation rights
- IRC § 2704(b) designates "applicable restrictions" which are generally disregarded when valuing intrafamily asset transfer
- IRC § 2704(b)(3) contains notable exceptions
  - Commercially reasonable restrictions imposed by third parties
  - Restrictions imposed by Federal or State law

IRC § 2704(a) - Lapses

- IRC § 2704(a)(1) - A lapse in voting or liquidation right in a corporation or partnership results in transfer tax liability if the transferor's family holds control the entity both before and after the lapse
  - Voting rights – Treasury Reg. 25.2704-1(a)(2)(v) - Voting rights are broadly construed to include voting on any matter or participation in management
  - Liquidation Rights - Treasury Reg. 25.2704-1(a)(2)(v) - Liquidation rights include the right to compel the entity to buy out the holder even if the entity is not liquidated in its entirety
  - § 2704(c)(2) defines family as the transferor's spouse; ancestors and descendants of transferor and transferor's spouse, transferor's siblings, and spouses of the foregoing

IRC § 2704(a) cont'd

- Control - § 2701(b)(2) defines control as 50% of stock in a corporation, 50% of capital or profits interests in a partnership, or any GP interest in an LP
  - Treasury Reg. 25.2701-6(a)(4) – a person is considered to hold an equity interest held by a trust to the extent the person's beneficial interest may be satisfied by the equity held by the trust, or the income or proceeds thereof assuming maximum exercise of discretion
- Treasury Reg. 25.2704-1(a)(2)(iii) - An asset is directly or indirectly held only if the asset is included in the holder's taxable estate prior to the lapse

- IRC § 2704(a)(2) – The value of the taxable transfer is calculated as the greater of:
  - The value of the interests immediately before the lapse, or
  - The value of the interests immediately following the lapse
  - Effect is to disregard lapses of rights for valuation purposes

IRC § 2704(b) – Disregarded Restrictions

- IRC § 2704(b) – Restrictions on liquidation are disregarded if
  - IRC § 2704(b)(1) – "applicable restrictions" are disregarded for transfers of interest to or for the benefit of a family member where the family controls the entity prior to transfer
  - IRC § 2704(b)(2) – "applicable restrictions" are limitations on liquidation, which lapse upon transfer, or are revocable by any member of the transferor's family, alone or collectively
  - Treasury Reg. 25.2704-2(c) provides that transfers are valued as if the applicable restriction does not exist

IRC § 2704(b) cont'd

- Exceptions – IRC § 2704(b)(3)
  - Commercially reasonable restrictions arising as part of financing by the entity with an unrelated third party
  - Restrictions imposed by Federal of State Law
- Treasury Reg. 25.2704(b)
  - Applicable restrictions are more restrictive than limitations imposed under generally-applicable State law
  - Only to the extent it will lapse and members of the transferor's family can remove the restriction immediately after the transfer
  - Commercially reasonable restriction imposed by unrelated third parties

2704 Conclusions

- Planners should exercise care when drafting for valuation discounts
- Restrictions which lapse are generally disregarded
- Restrictions exceeding default state rules are generally disregarded
- Variance in state law provides an opportunity for greater discounts

Estate Tax Planning Strategies

- Valuation Freeze
- Trust strategies
  - Valuation discounts
  - Sales to IDGT
  - BDOT/BDIT
  - Estate Burn
    - Grantor trust tax payments
    - Retained uses at FMV

Putting it all together

- Client forms FLP during lifetime
  - Lifetime benefits
    - Income tax management
      - Income shifting
      - Maximizing 199A deduction opportunities
    - Asset Protection
  - Post mortem benefits
    - Succession planning
    - Estate tax management
    - Asset protection

Hypothetical case study

- Client and spouse have two adult children
- Client and spouse have collective assets of $50m
  - $35m of commercial real estate
  - $10m of marketable securities
  - $5m of personal real estate, cash, and personal property
- Commercial real property
  - Annual net income: $2.5m
  - Annual depreciation: $1m
- Securities
  - $500k/yr @ 5% return

Case study – income tax management

Without FLP

- All income is attributable to client and spouse at top marginal rate + NII
- All depreciation deductions go to client and spouse

With FLP

- Income is distributed pro rata between client/spouse and two children (or trusts for their benefit)
- Depreciation deductions can offset outside income of children

Case study – estate planning considerations

Without FLP/gifting

- All assets included in Federal taxable estate
- All assets transfer at date of death FMV
- Annual Exclusion Gifts are burdensome
- Client retains no control over interests gifted during lifetime
- No asset protection

With FLP/gifting

- Transferred assets excluded from taxable estate (along with subsequent appreciation)
- Valuation discounts for transferred interests
- Annual exclusion gifting simplified
- Retained client control during lifetime
- Enhanced asset protection

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