
# Avoid Estate Taxes With Family Limited Partnerships

## New Cases Provide Guidelines for Tax Benefits

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In the March 2004 issue of *MD Net Guide*, I broadly and briefly described some of the popular legal strategies for asset protection. This article will focus more closely on one specific strategy, known as the Family Limited Partnership (FLP). This strategy has been popular for asset protection and tax planning for many years, but the full scope of what could be accomplished through its utilization has been a source of considerable debate among legal professionals because some of the relevant case law has lacked a desirable level of clarity and direction. On the tax side, the IRS has consistently challenged the available tax benefits—losing most of the time, but with just enough success to add a dose of uncertainty into the planning process.

This somewhat murky picture has, however, gotten decidedly clearer in recent months. In its May 20, 2004 decision regarding the case of *Kimbell vs. United States* (www.ca5.uscourts.gov/opinions/pub/03/03-10529-CV0.wpd.pdf), the Fifth Circuit Court of Appeals soundly rejected the IRS arguments against FLPs and, in the process, created definitive law and delivered clear instructions for achieving remarkable tax savings and asset protection.

### Family Limited Partnerships

A complete discussion about FLPs can be found online at www.rjmintz.com/appch5.html. Stated briefly, a FLP is a type of limited partnership that is formed by an official filing with the Secretary of State of the state in which the Partnership is to be created. The FLP is a separate, legal entity, with its own tax identification number. Any income or loss flows through to the partners and is reported on their tax returns. The key provisions for accomplishing tax savings and asset protection are set forth in an FLP agreement prepared by your legal advisor based upon your particular circumstances and objectives.

In the typical scenario, family savings, investments, and titles to business and real estate interests are transferred into the FLP, which, if properly structured, protects these assets from potential claims and lawsuits. Even if a plaintiff were to win a judgment against you, they would be unable to reach into the FLP to seize this property. The ownership of the interests in the FLP is usually protected in a trust designed for this purpose (see www.rjmintz.com/ownership-trust.html).

### Tax Savings

To get a better idea of how this all works, consider the following example of how one family might set up a FLP. Suppose our hypothetical parents transfer assets worth $1 million to an FLP and then give 40% of the limited partnership interests to their children. This allows the parents to maintain full control over the property. In this situation, these gifted FLP interests are not valued at $400,000 for tax purposes. Instead, since these limited partnership interests cannot control or affect management decisions made regarding the dispensation of the assets, and cannot be sold or otherwise converted into cash, tax law says that they are not worth $400,000. They are instead worth something less, maybe $250,000. By using this technique, the parents have transferred $400,000 in value out of their estate to their children and reduced future estate taxes by as much as $75,000 or more. The actual savings realized through this strategy depends upon the actual value of the assets transferred into the FLP, the size of the gifting program adopted, and the amount of the discount applied.

As might be expected, the IRS has consistently opposed this strategy, although the results of court cases have been mixed until recently. Generally, when an FLP was established near the time of death for the sole purpose of reducing estate taxes, or when the FLP was treated like the owner's personal pocketbook, without regard for legal formalities, the challenge by the IRS has been successful. For more information, see *Estate of Albert Strangi vs. Commissioner* (TC Memo 2003-145) at www.ustaxcourt.gov/ InOpHistoric/ Strangi.TCM.WPD.pdf. A summary of this decision may be found at www.mpbcpa.com/library/ newsletters/valuation/ Fall%202003%20FLP.pdf. In *Strangi*, the Tax Court ruling significantly restricted the circumstances under which the FLP could achieve meaningful tax reduction. Many advisors felt that the new burdens imposed by the Tax Court would dampen the use of the FLP for these purposes.

## Kimbell vs. United States

Then came the Kimbell case, wherein the Fifth Circuit Court of Appeals handed the IRS a massive defeat. The case illustrates the savings that can be produced by FLP planning in even the most basic form. Mrs. Kimbell, a 96-year-old woman, transferred property worth $2.5 million to an FLP in exchange for a 99.5% limited partnership interest. Her son Bruce (through a limited liability company) was the general partner with the right to manage partnership assets. He had managed his mother's financial matters prior to the time the FLP was established. Mrs. Kimbell retained the right to remove the general partner and replace him with anyone else (including herself), since she owned almost all of the limited partnership interests. As recited in the Kimbell FLP Agreement, the stated purpose of the FLP was to:

*"…increase Family Wealth; establish a method by which annual gifts can be made…continue the…operation of the Family Assets and* ***provide protection to Family Assets from claims of future creditors against a Family member…****"(emphasis added.)*

When Mrs. Kimbell died, soon after creating the FLP, her estate valued the 99.5% limited partnership interests at $1.25 million—a 50% discount from the value of the property she transferred—claiming that the lack of control and marketability associated with limited partnership interests reduced their value significantly. The Court did not discuss the specific amount of claimed tax savings, but in general, a reduction in value of this amount saved the estate approximately $500,000 in taxes. The IRS took the position in the case that Mrs. Kimbell had not engaged in a significant business transaction and that she had merely changed her form of ownership over the property. According to the IRS, Mrs. Kimbell did not relinquish any substantive management or control over her property and therefore the transfer to the FLP should be disregarded for tax purposes.

## Kimbell Guidelines

The Court disagreed with the IRS and held that Mrs. Kimbell's estate was entitled to the full benefit claimed. The Court detailed the analysis to be applied in these cases and the rules which must be followed:

**1.** The limited partnership interests in the FLP that Mrs. Kimbell received were proportionate to the amount of her contribution. If you form an FLP and contribute $90 and your children contribute $10, you must receive a 90% interest in the FLP. The records of the partnership must properly account for the contributions of each partner.

**2.** Partnership formalities must be satisfied. The FLP must be properly organized, the FLP Agreement must specify the rights and responsibilities of the partners, and assets contributed to the FLP must be properly and legally transferred.

**3.** The FLP must serve a valid business purpose, such as asset protection.

The Court noted that the FLP was established because Mrs. Kimbell's "…living trust did not provide legal protection from creditors as a limited partnership would. That protection was viewed as essential by [Mrs. Kimbell's business advisor]…because she was investing as a working interest owner in oil and gas properties and could be possibly liable for any environmental issues that arose in the operation of those properties." Other business purposes besides asset protection could be the desire to consolidate management of family assets and to provide for a continuity of ownership for younger generations.

**4.** To avoid weakening the FLP for tax, business, and asset protection purposes, assets and income from the FLP should not be used for personal or household living expenses. Use the income from your practice or set aside sufficient other assets to meet recurring expenses.

An additional point is that Mrs. Kimbell did not give away her ownership of the limited partnership interests. No transfer to her children took place (as reported in the case). She transferred substantially all her assets into a newly formed FLP and then claimed that the limited partnership interests that she received in exchange were 50% less than the property itself. We will need to see how this issue is handled by other courts in the future, but for the present it represents a loophole of such significant proportions that the estate tax can almost be said to be voluntary in its application.

When the guidelines offered by the Court are followed and a solid business purpose such as asset protection is the foundation of the plan, the Family Limited Partnership may serve as the cornerstone for most advanced financial plans.

A complimentary copy of the book *Asset Protection for Physicians and High-Risk Business Owners* (2002) by Robert J. Mintz is available from the Asset Protection Law Center (www.rjmintz.com) or by calling 800-223-4291. MDNG