

The ESTATE PLANNER

MARCH/APRIL 2009

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Recent court cases offer insight on how these estate planning tools will hold up against IRS scrutiny

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Your power of attorney
isn't all that powerful

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GIVE AND RECEIVE

Charitable gift annuities can benefit
both you and your favorite charity

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WHAT'S NEW WITH FLPs AND FLLCs?

RECENT COURT CASES OFFER INSIGHT ON HOW THESE ESTATE PLANNING TOOLS WILL HOLD UP AGAINST IRS SCRUTINY

Family limited partnerships (FLPs) and family limited liability companies (FLLCs) can be powerful tools for consolidating and managing family wealth while reducing gift and estate taxes. Unfortunately, the potential for significant tax savings makes FLPs and FLLCs targets for the IRS. But with careful planning and a solid defensive strategy, you can protect these entities against attack. Recent court cases provide invaluable guidance on designing and operating an FLP or FLLC that can help you achieve your financial and estate planning goals.



HOW THEY WORK, HOW THEY'RE CHALLENGED

The tax-saving power of FLPs and FLLCs comes from valuation discounts available for transfers of limited partnership interests, which are relatively unmarketable and provide the limited partner with little control over partnership affairs. For example, in a typical scenario the older generation transfers assets into the partnership or LLC and retains both general and limited shares. The limited shares are then gifted to the younger generation, using both annual exclusion and lifetime exemption amounts. The valuation discounts are a function of the fact that the limited shares have no control over the partnership or LLC activities, and because there are, in most cases, transfer restrictions on those shares.

Naturally, the IRS is suspicious of entities it believes were formed merely to avoid taxes. So the agency has repeatedly attacked what it considers abusive FLPs and FLLCs. One strategy has been to charge that the entity's assets should be included in the taxable estate of the person who set it up. (See "IRS's most effective FLP and FLLC killer: Sec. 2036(a)" on page 3.) Another has been to challenge the valuation discounts applied to the gifts of interests in the entity.

HOLMAN

In *Holman v. Commissioner*, a married couple formed an FLP, which they funded with almost \$3 million in publicly traded stock. Six days later, they gifted limited partnership interests to trusts and custodial accounts for the benefit of their four children, applying valuation discounts for lack of control and lack of marketability totaling nearly 23% for that initial gift. Be aware that gifts in subsequent years were subject to different discount amounts. Specifically, the judge determined that all of the gifts were eligible for a marketability discount of 12.5%, but the discount for lack of control was 11.32% for the initial gift, 14.34% in the second year, and just 4.63% in the last year in question.

The IRS claimed that the transfers were indirect gifts of the stock to the limited partners, and that gift tax should be applied to the full value of the underlying shares. It argued that the transfer to the FLP and the subsequent transfer of limited partnership interests should be viewed as a single transaction under the "step-transaction" doctrine.

The Tax Court disagreed, finding that each transfer had independent significance. In reaching this conclusion, the court noted that the stock was heavily traded and highly volatile, and that the parents assumed the risk that the stock's value would change during the six days before they transferred the limited partnership interests.

The court wouldn't establish a "bright line" standard for the amount of time that must pass for a series of transactions to be deemed independent. In this case, six days was enough, but the court noted the result might be different if more stable assets were involved.

IRS's most effective FLP and FLLC killer: Sec. 2036(a)

The IRS has had success challenging family limited partnerships (FLPs) and family limited liability companies (FLLCs) under Section 2036(a) of the Internal Revenue Code. This section permits the IRS to disregard an FLP or FLLC for estate tax purposes and bring the assets back into the transferor's estate if the transferor retains "possession or enjoyment of, or the right to the income from, the property" or the right to determine who will do so. There's an exception, however, for assets transferred in a "bona fide sale for adequate and full consideration."

Practically speaking, the IRS and the courts examine the same set of factors in determining whether there was a bona fide sale as they do in determining whether the transferor retained possession or enjoyment of the property or its income. Factors that tend to support an IRS challenge include:

- ◆ Failure to observe FLP or FLLC formalities,
- ◆ Commingling of entity and personal assets,
- ◆ Failure of the transferor to retain sufficient assets to meet his or her living expenses,
- ◆ Deathbed transfers of FLP or FLLC interests, and
- ◆ Failure to establish one or more legitimate and significant nontax reasons for forming the FLP or FLLC.

The last factor is probably the most important one, in part because it involves questions of subjective intent and can be difficult to prove.

In *Estate of Mirowski v. Commissioner*, the taxpayers prevailed in large part because they were able to provide convincing evidence that the transferor formed an FLLC for legitimate, nontax reasons:

1. To facilitate joint management of the family's assets by the transferor's daughters,
2. To maintain the bulk of the family's assets in a single pool to allow for investment opportunities that otherwise wouldn't be available, and
3. To provide for each of the transferor's daughters and eventually each of her grandchildren on an equal basis.

The court also observed that there was no evidence of an implied understanding that the transferor would have access to the FLLC's assets.

The IRS also argued that the limited partnership interests should be valued for gift tax purposes without regard to certain transfer restrictions. Had the judge decided to disregard such restrictions, including the right of the partnership to buy back an interest from an assignee in the event of an unpermitted assignment, the discount for lack of marketability likely would have been much lower. Internal Revenue Code Sec. 2703 permits the IRS to ignore the impact of such restrictions on value unless a transferor can prove, among other things, that the transaction:

- ◆ Is a bona fide business arrangement,
- ◆ Isn't a device to transfer shares to family members for less than full and adequate consideration, and
- ◆ Has terms comparable to similar arrangements entered into by persons in an arm's-length transaction.

In this case, the court found that the parents' reasons for establishing the transfer restrictions were *personal*—including asset preservation and long-term growth. There was no *business* purpose for the transfer restrictions, as there would be if the FLP had been established to preserve family control of a family business. Thus, in this case the transfer restrictions included in the partnership document didn't create any additional discount. Without saying so, the judge intimated that the discounts that were allowed would have been greater had the partnership included a business purpose for including the restrictions.



ASTLEFORD

One of the issues in *Astleford v. Commissioner* was whether an FLP was entitled to “tiered” discounts based on multiple levels of ownership. The transferors in this case gifted limited partnership interests in an FLP that owned farmland and other assets.

One of the assets was a 50% interest in a real estate general partnership, raising an issue as to whether the general partnership interest was entitled to valuation discounts for lack of control and marketability within the FLP.

In other words, did valuation discounts available for interests in the FLP apply to the *discounted* value of the FLP’s general partnership interest?

The Tax Court rejected the IRS’s argument that only one tier of valuation discounts applied. The limited partnership interests were entitled to combined discounts of 35.6% in addition to a 30% discount for the general

partnership interest. The two tiers of discounts effectively reduced the value of the general partnership interest by around 55%.

In this case, the general partnership accounted for less than 16% of the FLP’s net asset value. The Tax Court noted, however, that tiered discounts might not be available when an interest constitutes a “significant” portion of the parent entity’s assets.

ARM YOURSELF

As the above cases demonstrate, whether an FLP or LLC achieves your estate planning objectives depends on several factors, including the type of assets involved, the structure of the transaction, and the reasons for establishing and funding the entity. You can arm yourself against an IRS attack with careful planning and by documenting one or more legitimate, significant nontax purposes for an FLP or LLC. ❀

ESTATE PLANNING RED FLAG

Your power of attorney isn’t all that powerful

Your estate plan probably includes a power of attorney that appoints another person to manage your investments, pay your bills, file your tax returns and otherwise handle your property when you’re unable to do so. But not all powers of attorney are created equal.

It’s a good idea to review the document periodically with your attorney to ensure that it serves its intended purpose. These documents are often called “powers of attorney for finances” or “powers of attorney for property” to distinguish them from health care powers of attorney. The person who holds your power of attorney is usually referred to as your “attorney-in-fact” or your “agent.”

Here are some things to consider:

When does it take effect? If you live in a state that permits “springing” powers of attorney, your attorney-in-fact is authorized to act only on the occurrence of the event stated in the power of attorney. Typically, the power is designed to “spring” when you become incapacitated. When a power of attorney isn’t a springing power, the attorney-in-fact can act at any time after you’ve executed the document.

Is it durable? A durable power of attorney is one that continues in force after you’ve become incapacitated. Some states’ laws presume that a power of attorney is durable, but others don’t, in which case a power may be unenforceable unless it expressly states that it’s durable.

Is it powerful enough? Careful planning is required to ensure that your attorney-in-fact has the authority he or she needs to carry out your wishes. There are certain powers that you should expressly include to ensure such authority. For example, you must specify whether your attorney-in-fact has the power to make gifts or to make estate planning decisions, such as transferring assets to a trust.

Is it too old? Your attorney-in-fact’s ability to act on your behalf depends on whether third parties are willing to honor the power of attorney. Sometimes banks and others are reluctant to rely on a power of attorney that’s several years old. It’s a good idea, therefore, to sign a new one every two or three years.

SPENDTHRIFT TRUSTS AREN'T JUST FOR SPENDTHRIFTS

Now that the estate tax exemption has reached \$3.5 million, fewer estates are subject to federal tax. And even though as of this writing there's some uncertainty over the future of the estate tax, it's widely believed that Congress will preserve it, maintaining the current exclusion amount or possibly increasing it.



No matter what happens to the estate tax, however, estate planning will continue to be essential for most families. That's because tax planning is only a small component of estate planning — and usually not even the most important one at that. The primary goal of estate planning is to protect your family, and saving taxes is just one of many strategies you can use to provide for your family's financial security.

Another equally important strategy is asset protection. And a spendthrift trust can be an invaluable tool for preserving wealth for your heirs.

“SPENDTHRIFT” IS A MISNOMER

Despite its name, the purpose of a spendthrift trust isn't just to protect profligate heirs from themselves. Although that's one use for this trust type, even the most financially

responsible heirs can be exposed to frivolous lawsuits, dishonest business partners or unscrupulous creditors.

A properly designed spendthrift trust can protect your family's assets against such attacks. It can also protect your loved ones in the event of relationship changes. If one of your children divorces, your child's spouse generally can't claim a share of the trust property in the divorce settlement.

Also, if your child predeceases his or her spouse, the spouse generally is entitled by law to a significant portion of your child's estate, including property you left the child outright. In some cases, that may be a desirable outcome. But in others, such as second marriages when there are children from a prior marriage, a spendthrift trust can prevent your child's inheritance from ending up in the hands of his or her spouse rather than in those of your grandchildren.

SAFEGUARDING YOUR WEALTH

A variety of trusts can be spendthrift trusts. It's just a matter of including a spendthrift clause, which restricts a beneficiary's ability to assign or transfer his or her interest in the trust and restricts the rights of creditors to reach the trust assets.

Despite its name, the purpose of a spendthrift trust isn't just to protect profligate heirs from themselves.

Keep in mind that in most states you can't create a spendthrift trust that provides for your own benefit, though a few states permit so-called “self-settled spendthrift trusts.”

It's also important to recognize that the protection offered by a spendthrift trust isn't absolute. Depending on applicable law, it may be possible for government agencies to reach the trust assets — to satisfy a tax obligation, for example.

Generally, the more discretion you give the trustee over distributions from the trust, the greater the protection

against creditors' claims. If the trust requires the trustee to make distributions for a beneficiary's support, for example, a court may rule that a creditor can reach the trust assets to satisfy support-related debts. For increased protection, it's preferable to give the trustee full discretion over whether and when to make distributions.

A WORTHY TRUST

Spendthrift language is a simple yet powerful way to build some creditor protection into a trust. But if your beneficiary is in a high-risk profession or is otherwise exposed to potentially devastating legal liabilities, consider more sophisticated options, such as domestic asset protection trusts or even offshore trusts. ❀

GIVE AND RECEIVE

CHARITABLE GIFT ANNUITIES CAN BENEFIT BOTH YOU AND YOUR FAVORITE CHARITY

Because of volatile financial markets, an investment that offers guaranteed fixed income for life has great appeal. A charitable gift annuity (CGA) offers an attractive combination of a secure income stream, an immediate income tax deduction and the opportunity to benefit a charity you care about.

HOW DOES IT WORK?

Charities with CGA programs allow you to donate assets — usually cash or stock — in exchange for fixed annuity payments for the rest of your life or for the combined lives of you and your spouse. You're also entitled to a current charitable deduction equal to the

difference between the amount of your donation and the present value of your expected annuity payments.

Most charities determine your annuity payments based on suggested rates published annually by the American Council on Gift Annuities (ACGA). For example, let's say you donate \$500,000 in exchange for a single-life CGA. If you're 50 years old, your annuity payment, based on current ACGA rates, might be 5.1%, or \$25,500 per year. If you're 70, the rate might instead be 6.1%, or \$30,500 per year.

ACGA rates are lower than those paid by commercial annuities because they're designed to ensure that the charity receives a benefit. On the other hand, commercial annuities don't provide a current tax deduction.

If you don't need the income right away, a deferred payment CGA may be an attractive option. You still enjoy a current charitable deduction, but instead of receiving annuity payments immediately, your donation is invested and earns interest, resulting in higher annuity payments down the road.

IS IT SAFE?

Like any investment, a CGA depends on the financial strength and staying power of the organization that backs it up. Before you invest, it's important to investigate the charity and its CGA program so you're



comfortable that the organization will have the ability to meet its annuity obligations.

Some, but not all, states require organizations that issue CGAs to be licensed and to maintain investment reserves.

HOW DOES IT COMPARE TO A CRAT?

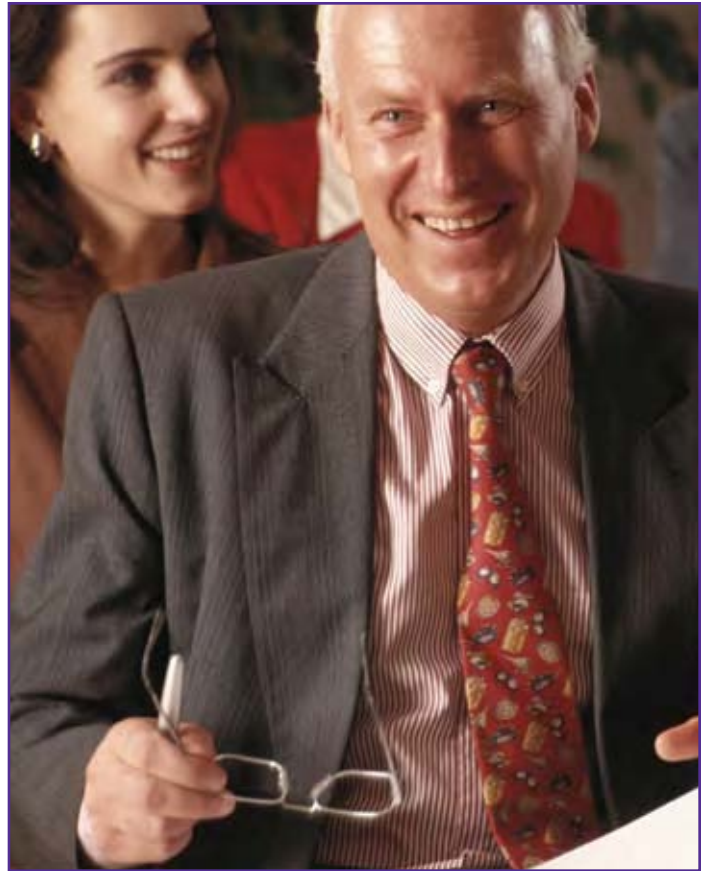
Charitable remainder annuity trusts (CRATs) offer benefits that are similar to those of CGAs. A CRAT is an irrevocable trust that pays you or your beneficiaries an annuity for life or for a specified number of years and then distributes what's left (the "remainder") to a qualified charity.

Like a CGA, a CRAT provides you with fixed income and a current charitable income tax deduction based on the present value of the charity's expected remainder interest. And both are vehicles for deferring capital gains taxes on highly appreciated assets.

Charities with CGA programs allow you to donate assets in exchange for fixed annuity payments for the rest of your life or for the combined lives of you and your spouse.

Despite the similarities, however, there are several important differences between CGAs and CRATs. One advantage of a CRAT is greater flexibility. It can have multiple beneficiaries, for example, while a CGA generally isn't desirable if you want to name beneficiaries other than you and your spouse. Also, you can fund a CRAT with a variety of assets, including real estate and closely held stock, while CGAs are generally limited to cash or publicly traded stock.

On the other hand, CRATs involve significant setup and administration expenses, so they're not suitable for smaller investments. CGAs generally don't require any investment beyond the initial donation.

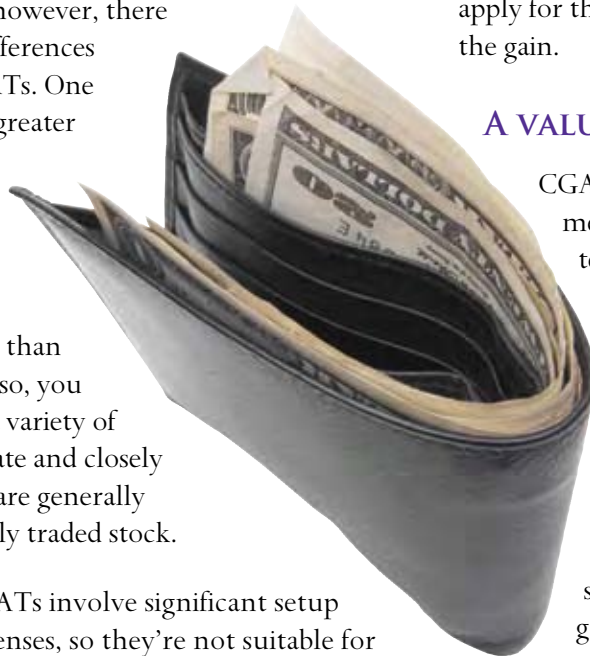


CGAs also offer an income tax advantage. With a CRAT, ordinary income — which is taxed at the highest rates — is distributed first. But with a CGA, a portion of each annuity payment is treated as a tax-free return of principal and, if applicable, capital gain. If the assets used to fund the CGA are long term, the long-term capital gain rates will apply for the portion of the payment that is attributable to the gain.

A VALUABLE TOOL

CGAs and CRATs are no substitute for other investments that generate higher returns over the long term. And they won't provide tax deductions as high as an outright charitable gift does. But if you're interested in supporting charities while gaining the peace of mind that comes with guaranteed fixed income for life, they can make an excellent addition to your estate planning arsenal.

The right vehicle depends on your financial situation, your planning and philanthropic goals, and the types of assets you wish to contribute. Your estate planning advisor can help you design a strategy that works for you. ❀



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M&J is committed to continuing its tradition of delivering excellent, personalized legal services by working together to provide effective solutions for its clients.

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