Insight on Estate Planning

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FLPs and FLLCs: To save taxes, you need a nontax purpose

It may strike you as illogical, but for a family limited partnership (FLP) or family limited liability company (FLLC) — let's refer to them collectively as FLPs — to reduce gift and estate taxes, there must be a legitimate *nontax* reason for forming one. In other words, if you set up an FLP strictly as an estate planning tool, the IRS will disallow the tax benefits. But if you can establish a bona fide business or investment purpose for the entity, tax savings can be a pleasant bonus.

How FLPs save taxes

With a typical FLP, you transfer business interests, marketable securities, real estate or other assets to a limited partnership, retaining a small general partnership interest (say, 1%) and a large limited partnership interest. Over time, you transfer limited partnership interests to your children, removing the value of those interests from your taxable estate while retaining management control.

Limited partnership interests are relatively unmarketable and provide the holder with little or no control over partnership affairs. As a result, they enjoy significant valuation discounts — often 30% or more — for gift and estate tax purposes.

Not surprisingly, the IRS is suspicious of FLPs and often rejects them as nothing more than disguised tax-avoidance vehicles. So it's critical to have — and be prepared to document — a legitimate nontax purpose for forming an FLP.

Have a good reason

Establishing a legitimate nontax purpose for an FLP isn't difficult when the entity holds a family business or other closely held business. FLPs offer a variety of business benefits, including maintaining ownership within the family, allowing the older generation to transfer ownership interests without diluting their control and providing some protection against creditors' claims.

It's more difficult — but not impossible — to establish a nontax purpose when an FLP holds marketable securities. In recent cases, for example, courts have denied tax benefits when they concluded that FLPs holding marketable securities were formed for *personal* reasons, such as tax reduction, estate planning, protection of wealth against dissipation by children or the financial education of children.

On the other hand, families have succeeded in preserving the tax benefits of an FLP when they were able to show legitimate investment objectives, such as coordinating management of family assets to preserve holdings in a particular stock, pooling assets to reduce investment management expenses or qualify for investment opportunities that require larger positions, or promoting some other investment strategy or philosophy.

Establishing a legitimate nontax purpose for an FLP isn't difficult when the entity holds a family business or other closely held business.

Actions speak louder than words

Whether your FLP holds business interests or other assets, your stated nontax purpose must be a real one, not merely a pretext. To convince the IRS or the courts of your motives, it's critical to treat the FLP as a legitimate business or investment vehicle. That means ensuring your partnership agreement and other terms of your arrangement are comparable to arm's-length transactions, respecting all partnership formalities, and segregating personal funds from partnership funds.

Avoid actions that may raise red flags, such as transferring assets to an FLP when you're in poor health, contributing substantially all of your wealth to the FLP, commingling FLP and personal assets, using FLP assets for personal expenses, or failing to keep proper FLP books and records.

Avoid IRS scrutiny

The IRS has long cast a wary eye on FLPs. To help ensure yours doesn't draw Uncle Sam's attention, be sure you have a legitimate nontax reason for forming one. You're more likely to enjoy an FLP's tax savings benefits only if you can show the IRS yours has a bona fide business or investment purpose. ▮

Don't overlook the GST tax

In 2010, Congress raised the generation-skipping transfer (GST) tax exemption to $5 million through 2012. This provides a significant planning opportunity if you wish to share your wealth with your grandchildren or other future generations.

GST tax: A brief history

Gift and estate taxes originally were intended to tax wealth once in each generation. But affluent families soon devised strategies that allowed them to avoid taxes in one or more generations. For example, rather than leaving property to their children, they would give or bequeath it directly to their grandchildren, bypassing their children's estates. Or they would set up trusts that provided their children with an income interest for life — which isn't subject to estate tax — and leave the remainder to their grandchildren.

Some families created dynasty trusts, which provided for successive life estates from one generation to the next. Depending on whether state law limits the longevity of trusts, dynasty trusts can continue to grow tax-free for decades, centuries or even forever.

To combat these tax-avoidance strategies, Congress established the GST tax, a flat tax — applied at the highest marginal estate tax rate — on transfers that skip a generation. The GST tax is imposed *on top of* any gift or estate taxes otherwise due, so it can be a powerful deterrent against GSTs.

What is a GST?

A GST is a transfer (other than a gift that qualifies for the $13,000 annual exclusion) to a "skip person." A skip person can be:

- A grandchild or other family member who is two or more generations below you,
- A nonfamily member who is more than 37½ years younger than you,
- A trust in which all beneficiaries holding a present interest are skip persons, or
- A trust in which no person holds a present interest (a charitable lead trust, for instance) and future distributions may be made only to skip persons.

Taxable transfers include:

- Direct skips — gifts or bequests *directly* to skip persons,
- Taxable trust terminations — for example, a transfer of trust assets to grandchildren following a child's life interest, and
- Taxable trust distributions — distributions of income or principal to skip persons.

Be aware that, if your child dies before you make a transfer, his or her children "move up" a generation, allowing you to share wealth with them without triggering GST tax.

Leveraging the exemption

Fortunately, with careful planning you can shield substantial amounts of wealth from GST tax — potentially more than the $5 million exemption amount — by leveraging your exemption. Even if your estate is under the exemption amount, it pays to do some GST tax planning to "freeze" the value of generation-skipping gifts and avoid GST tax on future appreciation.

A powerful tool for leveraging the GST tax exemption is an irrevocable life insurance trust (ILIT). A properly structured ILIT allows you to remove the value of insurance proceeds from your taxable estate. You can make contributions to the trust to cover the premiums. These contributions are taxable gifts, but you can reduce or avoid gift tax by using your lifetime gift tax exemption. Of course, if the beneficiaries are skip persons, the GST tax also comes into play because it applies to taxable trust distributions.

With careful planning you can shield substantial amounts of wealth from GST tax — potentially more than the $5 million exemption amount — by leveraging your exemption.

(ILIT distributions attributable to annual exclusion gifts made to the ILIT will avoid the GST tax. But bear in mind that special planning is required to apply the annual exclusion to a gift to a trust; plus, the annual exclusion may not be sufficient to cover policy premiums.)

Although your GST tax exemption can be used to shield ILIT *distributions* from tax at the time those distributions are made, you can leverage your exemption by allocating a portion of it to your ILIT *contributions*.

There are two reasons for this. First, there's no guarantee that the GST tax exemption will still be $5 million when distributions are made to skip persons. It's scheduled to drop to $1 million — approximately $1.4 million after inflation adjustments — in 2013. By applying it to contributions to an ILIT now, you can potentially lock in some or all of the higher exemption amount. Second, you need to use only enough of your exemption amount to cover contributions (to the extent they're unprotected by the annual exclusion) to shield distributions — no matter how large — from GST tax. (See "The GST tax exemption at work" at right.)

Allocation strategies

You have the option of choosing the transfers to which your GST tax exemption is allocated. To use your exemption most effectively, review each gift to grandchildren or other skip persons — whether direct or in trust — and allocate your exemption where it will do the most good.

Suppose you establish a trust for the benefit of your children and grandchildren. You should consider the ages, health and childbearing prospects of your children — as well as the appreciation potential of the trust assets — to estimate the probability that the trust will actually distribute assets to grandchildren.

If ultimately assets aren't distributed to your grandchildren, any allocation of your exemption to the trust will be wasted. Unless you have more than enough exemption to go around, you're better off allocating it to trusts for the benefit of only the grandchildren.

You may want to avoid naming skip persons as beneficiaries of trusts in which you retain an interest — such as grantor retained annuity trusts or qualified personal residence trusts. For these trusts, the exemption can't be allocated until the end of the trust term. In other words, to avoid triggering GST tax, you'll need to use your exemption to cover the assets' appreciated value at the end of the term rather than your initial contribution.

Don't try this at home

The rules regarding allocation of the GST tax exemption are complex, and mistakes can be costly. To avoid an unexpected tax bill, consult your estate planning advisor if you're considering gifts to, or for the potential benefit of, your grandchildren or other skip persons. ■

The GST tax exemption at work

Proactively planning how to use your $5 million generation-skipping transfer (GST) tax exemption can be worth your while down the road. Consider this example:

Victor sets up an irrevocable life insurance trust (ILIT), which purchases a $3 million insurance policy on his life. He contributes $25,000 per year to the trust to cover the premiums, allocating his GST tax exemption to each contribution. (For purposes of this example, assume that Victor's annual exclusion is unavailable.) When Victor dies 10 years later, the trust has used up only $250,000 of his exemption.

The ILIT receives the $3 million death benefit tax-free and, under its terms, provides income to Victor's daughter, Alexandra, for life. When Alexandra dies 20 years later, the trust assets are worth approximately $8 million (assuming a 5% growth rate net of distributions and expenses), all of which is distributed to Alexandra's children free of GST and estate tax.

Who covers the estate tax bill?

Spell it out in an apportionment clause

A primary goal of your estate plan is to reduce your estate tax liability. But no matter how sophisticated your plan is, if your estate is large enough, tax may be owed to Uncle Sam after your death.

To ensure the estate tax bill doesn't fall to the wrong beneficiaries, it's important that your will or living trust include a carefully crafted tax apportionment clause.

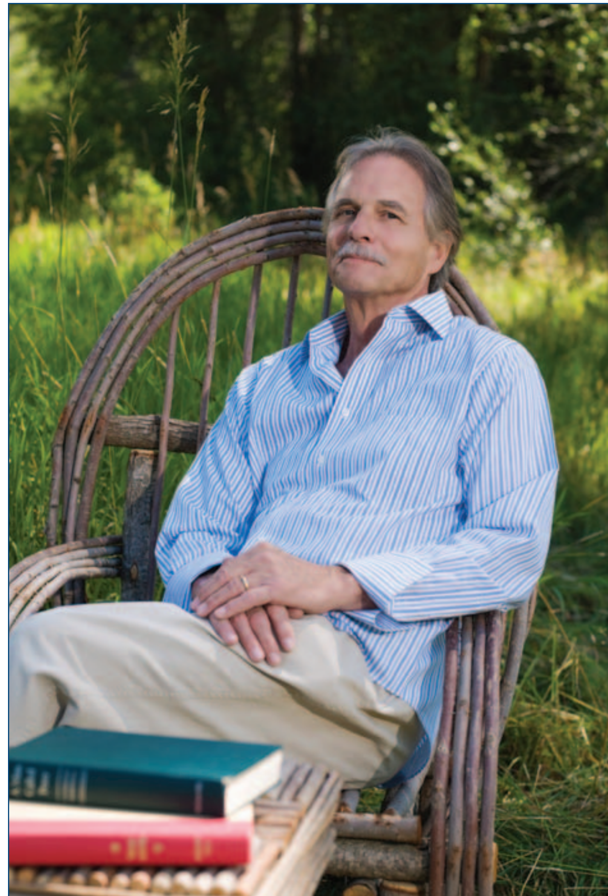
Apportionment clause defined

In a nutshell, a tax apportionment clause details who is responsible for paying your estate's tax burden. A poorly drafted clause may result in unintended outcomes, such as the collection of estate taxes from unintended beneficiaries or ambiguity over the payment of taxes, resulting in disputes or litigation. If you fail to plan for estate tax apportionment, the government has a plan for you.

Federal law

If you don't have a tax apportionment clause or the clause isn't appropriately drafted, federal law will cover apportionment in certain situations. If, for example, life insurance proceeds or other assets transferred outside of your will are included in your estate for federal tax purposes, your executor can collect the estate taxes attributable to those assets from the recipient. This can happen if you transfer a life insurance policy to an irrevocable life insurance trust or to a beneficiary within three years before your death or if you retain certain "incidents of ownership" in the policy.

Another example is property transferred to a qualified terminable interest property (QTIP) trust. This trust allows a married couple to take advantage of the marital deduction for interspousal



transfers while still preserving the trust principal for their children. For the transfer to the trust to qualify for the marital deduction, the surviving spouse must receive all of the trust income for life and the assets must be included in his or her estate for federal estate tax purposes.

Federal law also covers apportionment when assets are included in your estate because:

- You held a general power of appointment over the assets under the terms of your spouse's or someone else's estate plan, or

- You previously transferred the assets to your children or other beneficiaries but retained a lifetime interest in them.

In either case, your executor can seek reimbursement of estate taxes from the recipients of this property unless you waive that right in your estate plan.

State law

For assets other than the ones described above, apportionment of both federal and state estate taxes is governed by state law unless your plan provides otherwise. Apportionment law can vary significantly from state to state. Historically, most states provided for estate taxes to be paid from the residual estate.

Some states continue to take this approach, but most now require "equitable apportionment." In other words, estate taxes are distributed among beneficiaries according to the amount of tax generated by the assets they receive.

Clarity matters

You've taken great pains to ensure that your family will be financially taken care of after you're gone. Carefully wording a tax apportionment clause in your will or living trust can ease your mind that your estate tax obligations also will be paid according to your wishes. ▮

Estate Planning Pitfall

You're cashing in a life insurance policy

There may come a time in your life when you no longer need a life insurance policy. Your children may have become financially independent. Perhaps paying the premiums is putting a strain on your finances. Or maybe you'd just like to use the money for something else.

You have some options when cashing in a life insurance policy. Each has different financial and tax implications, however, so it's important to know the outcomes before you take action.

You can surrender the policy for its cash value, for example, but you'll receive only a fraction of the policy's face value and you'll pay tax on any excess over your basis (generally, the premiums you've paid).

One potential alternative is to donate your policy to charity in exchange for a charitable gift annuity (CGA), which provides a lifetime income stream. Generally, here's how it works: The charity receives your policy now and takes over the premium payments. It also agrees to make fixed annuity payments for the rest of your life or for the combined lives of you and your spouse.

Typically, the annuity amount is based on the value of the gift and on suggested annuity rates published by the American Council on Gift Annuities (ACGA). You're entitled to an immediate charitable deduction equal to the amount by which your gift's value exceeds the present value of your expected annuity payments.

Other options to consider include making a tax-free partial surrender, taking a tax-free policy loan or trading the policy for an immediate annuity.

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