

### **Course Objective**

This course was created to teach advisors (CPAs, EAs, accountants, attorneys, financial planners, and insurance advisors) about the “advanced” estate planning tools that can be used to help high net worth clients. Most advisors are aware of wills, trusts, durable powers, and irrevocable life insurance trusts. This material was created to discuss topics that are mainly used by the best and most sophisticated estate planning tax attorneys in the country.

This material, once learned, will open up a new area of consulting for many advisors who, to date, have not felt comfortable approaching \$5,000,000-\$25,000,000+ net worth clients for their business.

## **“Advanced” Estate Planning**

### **Family Limited Partnerships**

Family Limited Partnerships (or Family Limited Liability Companies) can present substantial planning opportunities for wealthy families. Although challenged by the Internal Revenue Service (the “IRS”) in recent years, when properly utilized in a high net worth individual’s or wealthy family’s estate planning, a Family Limited Partnership (“FLP”) can provide substantial tax and non-tax benefits. Benefits include, but are not limited to:

1) Providing a centralized vehicle through which the family can not only manage a portion of its wealth, but also provide a governance structure through which the younger generation can learn the art of running of family business (if the FLP holds an existing family business) from the senior generation. It can also provide an environment for the senior generation to teach the nuances of managing the family’s wealth to the successors;

2) Providing a level of protection against potential creditor claims;

3) Increasing the efficiencies of both costs and administration of the family’s wealth;

4) Enhanced wealth transfer planning due to valuation discounts which may be applied to gifts or sales of limited partnership interests to family members, or to trusts established for their benefit (See the upcoming section on sales to “Intentionally Defective Grantor Trusts.”); and

5) Income and cash-flow planning across multiple generations.

## Overview

An FLP is a separate legal entity created under state law by filing a Certificate of Limited Partnership (or the home state equivalent, depending on the jurisdiction). An FLP is classified as a partnership for federal income tax purposes, and therefore, is subject to taxation only at the partner level.

Each partner is taxed according to their pro rata ownership interest in the FLP, which means that all of the income, expenses, gains and losses “flow through” to each partner in proportion to the ownership percentage in the FLP. In addition to the Certificate of Limited Partnership, the FLP is governed by the Family Limited Partnership Agreement. This is a legal document, executed by the partners, that sets forth all of the terms and conditions of the administration, management and governance of the FLP. It also details each partner’s rights with respect to withdrawal from the partnership, or the ability to transfer a partner’s interest in the FLP to another individual or family member. *Family limited partnership agreements are sophisticated legal documents that require specialized drafting to ensure that the terms and conditions of the FLP will be respected by the IRS.*

There are special tax rules that must be followed in creating the FLP. In this regard, Section 721 of the Internal Revenue Code (the “Code”) generally provides for non-recognition of gain or loss upon the contribution of assets to the FLP. Despite this general rule of non-recognition, however, special attention should be afforded when there will be multiple partners in the FLP who are contributing marketable securities to the FLP.

Care must be taken to ensure that the FLP does not fall prey to the “investment company” rules, which would trigger severe adverse tax consequences. While beyond the scope of this discussion, if an FLP is being formed by several individuals, each of whom is contributing a diversified basket of marketable securities, it should be noted that the IRS can challenge the tax-free formation of the FLP on the basis that the partnership was formed primarily to allow the individuals to diversify their investment portfolios. In such a circumstance, the built-in gains in the portfolios contributed to the FLP may be recognized by and become taxable to the contributing partners on the date of contribution.

As a practical matter, however, this should not be an issue in the family context. Because a married couple typically forms a FLP and since a husband and wife are considered to be a single individual for purposes of applying the investment company rules, the contribution of the marketable securities to the FLP should qualify for non-recognition treatment.

Typically, an FLP has two categories of partners (although it can have more):

(1) a general partner or partners who maintain control over the management and administration of the partnership, and

(2) limited partners, who have no involvement in the day-to-day management of the FLP.

The general partners are liable for all of the FLP's obligations, debts, and liabilities and often individuals create a second entity, such as a trust, company or limited liability company to serve as the general partner to further insulate themselves from liability. The limited partners are not liable for the debt or obligations of the FLP, and they are not entitled to participate in the day-to-day management of the FLP.

## Supercharging an Estate Plan with FLPs

Individuals with assets of substantial value often face the challenge of providing an orderly and smooth tax-efficient transfer of wealth from one generation to the next. This requires dealing with the issue of whether these transfers will trigger enormous gift or estate tax liabilities, which will deplete the overall amount of assets being transferred from one generation to the next. Many wealthy individuals and families are concerned that the family wealth may become subject to creditor claims if outright gifts of property are made to the children or grandchildren. Moreover, wealthy individuals and families oftentimes desire to mitigate the potential for the family's wealth to be put in jeopardy through mismanagement, and thus look to advisors to provide an appropriate family governance structure to manage the family's wealth in future years.

In this regard, therefore, FLP represents a unique solution for a wealthy family to consider. By transferring a portion of the family's assets to an FLP, the **family can maintain control over the income, management and divestiture of the assets**. In a typical estate plan, a married couple transfers assets to a FLP and, in return, receives both general partnership and limited partnership interests. At some point in the future, the couple will make gifts of the limited partnership interests to their children or grandchildren, or to trusts for the benefit of their children or grandchildren. In this way, the family is capable of maintaining the management of the assets in one centralized vehicle, and is able to fractionalize the ownership (and the income generated by the assets) among a broader group. This could have the impact of both assisting future wealth accumulation for the next generation in a creditor protected environment (i.e., through the use of trusts), and also allow for income that would otherwise be taxed in the highest tax brackets (i.e., the senior family member's tax bracket), to be transferred to individuals in a lower tax bracket.

## Supercharged Gifting

A key attribute of FLP planning is the impact that the FLP can have in coordinating a family's gifting strategy. Because the lifetime gift tax exemption provided under the current federal gift tax law is capped at \$1,000,000 per individual (every individual is entitled to gift up to \$1,000,000 worth of property during his or her lifetime), the ability for individuals to leverage the use of the lifetime gift tax exemption as much as possible has become increasingly important.

A significant advantage of utilizing a FLP is the opportunity for the senior generation of a family to transfer (either by gift or by sale) **limited partnership interests to the next generation at a discounted value**. Because the limited partnership interests being transferred are typically the non-controlling interests and, in some instances, subject to a number of restrictions with regard to transferability, withdrawal, liquidation, etc., the value of such interests for gift tax purposes is compressed (discounted).

The use of an FLP in connection with a family's overall gift planning allows the family to "supercharge" its gifting due to the fact that the value of the gift for gift tax purposes is the **fair market value of the limited partnership interest** being gifted (taking into consideration all of its negative attributes), and not the underlying assets of the FLP. Thus, because what is being gifted (the limited partnership interest) is most often a non-controlling, unmarketable and nontransferable (subject to limited exceptions) interest in a family entity, the value of the interest for gift tax purposes is subject to valuation discounts.

### ***Example:***

A married couple contributes \$1,000,000 worth of assets to an FLP and, in exchange takes, a 1% general partnership interest and 99% limited partnership interests. At some point after the FLP is formed and the agreement is executed, the couple gifts all of the limited partnership interests to their children and grandchildren, or to irrevocable trusts for the benefit of their children or grandchildren.

Had the couple simply gifted the assets directly, the value of the assets for gift tax purposes would be \$1,000,000. Because the assets being gifted are limited partnership interests in the FLP, which conveys **no rights of management or control** in the FLP and **are subject to transfer restrictions**, it is likely that the limited partnership interests would be discounted to reflect these negative attributes.

If one assumes that a qualified appraiser would value the limited partnership interests as having a 30% discount, then the value of the gift for gift tax purposes would be \$700,000 instead of \$1,000,000. The use of the FLP has therefore *preserved* \$300,000 worth of the couple's lifetime gift tax exemption for future transfers.

## Keeping it Within the Family

FLPs can ensure that the family's wealth stays in the family. This is so because the FLP Agreement can contain restrictions on the transferability of the FLP interests which will ensure the family that no family member who is a partner (general or limited) can use the FLP interest to satisfy a personal debt; nor can any individual hypothecate, pledge, mortgage, sell, transfer or assign his or her limited partnership interest **without the consent of the other partners**. This ensures the family that no outside third parties will become partners in the FLP, and that the family can control the extent to which transfers of the limited partnership interests are made.

An additional benefit to the FLP structure is that it provides a level of creditor protection for the individual partners. If an individual partner is sued by a creditor, generally the creditor's only recourse is to enforce a charging order against the FLP with respect to that partner's interest. This means that if the FLP does not make annual distributions to its partners, the creditor may receive nothing in connection with its claim for a long period of time. (For more information about charging orders, please see the educational modules on asset protection)

## Managing the General Partner's Liability Exposure

As mentioned earlier, the general partner of the FLP is typically a trust, a corporation or a limited liability company. The purpose of using a separate legal entity to serve as the general partner is to insulate the general partner from liability exposure with regard to all of the FLPs debts, obligations, etc. As a rule, the general partner or general partners can control the FLP regardless of their percentage of ownership in the FLP.

If a general partner has a 1% ownership interest in a FLP, the other 99% of which is owned by limited partners, then the general partner will control 100% of the FLP's activities. The limited partners have no vote or control over the assets of the FLP, nor do they have any control over the day-to-day operations or management of the FLP. Limited partners only have the limited rights granted to them by the state limited partnership act and under the limited partnership agreement.

## **Estate Tax Issues When the Senior Generation Wants to be the General Partner**

Recently, the IRS has taken the position that when an individual establishes a FLP and retains 100% control over the partnership based on his or her retention of the general partner interest; Section 2036 of the Code applies and pulls the assets contributed to the FLP back into the individual's estate for estate tax purposes. Thus, in structuring a FLP, special attention should be paid to who will serve as the general partner, and the extent to which the senior generation, who are typically contributing most of the assets to the FLP and gifting the limited partnership interests away, can maintain a level of control over the entity.

The most conservative approach is that the senior generation should, if at all possible, not serve as the general partner. This approach may not be feasible, however. In such a situation, you should consider having an irrevocable trust, with an independent third-party trustee (as defined under Section 642(c) of the Code), act as the general partner and provide, within the terms of the trust, the power for the senior generation to appoint and remove the trustee within the confines of Rev. Rul. 95-58, 1995-2 C.B. 1. Another solution might be to have the senior generation establish a corporate general partner (typically a subchapter S corporation) and retain a minority stake in the entity (i.e., not enough to dissolve the corporation).

The importance of properly addressing this issue at the outset is critical. The IRS has challenged and won in litigation by asserting that the retained power to control the FLP, through the general partnership interest held by the individual who established the FLP, resulted in the assets of the FLP being included in that individual's estate despite the individual having gifted all of the limited partnership interests away. Falling prey to this trap can have dire tax consequences that could be avoided through proper planning.

### **Limited Partners**

The limited partners of an FLP tend to be either individual family members or trusts created for the benefit of the family members to which the limited partnership interests have been transferred, gifted, or sold. Generally, these include an individual's revocable living trust; and/or certain types of irrevocable trusts established for children or grandchildren.

An attractive attribute of the FLP is its flexibility in use in connection with number of different types of family holdings and assets that can be contributed to it. There are very few types of assets that cannot (or should not) be transferred to a FLP to take advantage of the FLPs wealth transfer planning advantages. FLPs can be used to:

- (1) operate a family business;
  - (2) hold the stock or assets in the family business;
  - (3) hold rental real estate or other income producing property;
  - (4) hold marketable securities or other portfolio assets; and
  - (5) hold other tangible or intangible personal property,
- to name a few options.

**FLPs cannot, however, hold stock in a subchapter S corporation** because the FLP is not a qualified shareholder under the subchapter S corporation rules of the Code, and would jeopardize the corporation's subchapter S status. Finally, as a general rule, personal residences or vacation homes should not be transferred to the FLP.

## Estate Planning with FLPs: What's all the Hubbub About?

### IRS Challenges

Although probably a topic large enough to warrant its own separate chapter, it should come as no surprise that FLPs have been, and continue to be, a heavily litigated area of estate planning. The IRS has attacked the use of FLPs in an effort to negate their planning benefits under two broad lines of attack:

- (1) challenges to the legal status, business purpose, and operations of the FLP, and
- (2) statutory challenges under Sections 2036 and 2701–2704 of the Code.

A significant amount of litigation has recently been seen involving the IRS's use of Sections 2036(a)(1) and (2) of the Code as a means to challenge FLPs. Sections 2036(a)(1) and (2) provide as follows:

**General rule.** The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life, or for any period not ascertainable without reference to his death, or for any period which does not, in fact, end before his death –

(1) the possession or enjoyment of, or the right to the income from, the property, or

(2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

While the discussion on any one of the tactics used by the IRS could fill many pages, the following will provide a thumbnail sketch of FLP planning, and provide advisors with a sense of the “dos and don’ts” involved in implementing such a strategy. The author acknowledges that this section is not intended to be a recitation of these Code sections, but rather a summary of the positions taken by the IRS that should provide some insight for advisors regarding the use of a FLP as part of a client’s wealth transfer planning. In any event, an advisor considering recommending a FLP should review the cases cited in the various footnotes as well as the relevant statutory authority and rulings in light of the fast changing legal landscape concerning FLPs.

## **Challenges to the Legal Status and Operations of FLPs: Respecting the Entity**

For the FLP to be respected by the IRS and not disregarded as simply a vehicle with no other purpose than to provide tax advantages, the FLP must have a **valid business purpose and economic substance**. The sole purpose for the FLP cannot be to simply apply discounts to gifts of the FLP interests.

Several purposes may be used to satisfy the business purpose requirement, including, but not limited to; the use of the FLP to pool assets for investment purposes; centralizing the management of the investments; creating increased efficiencies with regard to the costs of administration of the assets, including illiquid or unmarketable assets; and providing a level of creditor protection for the family’s assets. Although most carefully drafted FLP agreements state these reasons and others as the purposes for forming the FLP, the IRS has routinely litigated this issue, arguing that the FLP should be disregarded because it is a sham with no other purpose than to provide a tax benefit.

Courts, however, have consistently disagreed with the IRS’s position that the FLP, in and of itself, should be disregarded. For example, in *Estate of Strangi v. Commissioner*, 115, T.C. (2000), *aff’d on other this issue sub nom, Guilig v. Commissioner*, 293 F.3d. 279, despite the fact that the court did not recognize the validity of various non-tax reasons put forth for a decedent’s FLP, the court nevertheless stated that the FLP was validly formed under state law, and therefore, should be recognized for tax purposes. In fact, in *Estate of Dailey v. Commissioner*, T.C. Memo 2002-31, the court not only concluded that the partnership should be respected for tax purposes, but also concluded that the IRS’s position in challenging the validity of the FLP was not justified.

Equally as important as having a valid business purpose for the FLP is the need for families who establish a FLP in connection with their estate planning to respect the formalities of the FLP. The FLP should be operated and administered like a partnership and not as an alter ego of the founders. It is important that the FLP make distributions on a pro rata basis to the partners, and, typically, the general partner of the FLP should make distributions of the FLP's net cash flow (the cash not needed to run the business). In so doing, maintaining and respecting the operations of the FLP will help counter the IRS's challenges under Sections 2036 and 2701 of the Code.

Furthermore, the family should **not commingle assets** with the FLP and should not allow one partner to operate the FLP as if the assets held by the FLP were his or her own personal assets. In other words, members of an FLP should not use the assets as if they were owned individually and should not use the FLP bank account as a personal checking account.

Once the FLP is created, each partner is entitled to a share of the income based on his or her pro rata ownership of the FLP. When the senior generation that established the FLP gifts its FLP interests to the next generation, it should respect the new ownership structure and make FLP distributions in accordance with that structure. No disproportionate distributions should be made to any one partner, and the senior generation should not expect to have access to the assets contributed to the FLP in the same manner that it did prior to contribution.

In cases where this concept has been violated, the IRS has argued successfully that an "implied agreement" existed between the senior generation and the next generation regarding to the use and control over the assets of the FLP; that is, there was an implied agreement that the use and context were not to change post contribution. Thus, the IRS argued, the assets should be included in the senior generation family member's estate under Section 2036.

Early in the planning process, attention should be given to the amount of assets that should be transferred to the FLP by the senior generation. It is **not** prudent to have an individual contribute all of his or her assets to the FLP and thus, be left with an insufficient amount of wealth outside of the FLP to provide financial security after the contribution is made.

It should be noted that in several cases in which the decedent transferred most, if not all, of his or her assets to the FLP, the court viewed the transfer of such extraordinary amounts to the FLP as a critical fact in arriving at the conclusion that an implied agreement existed between the decedent and the other partners that the decedent had the right to the income from the assets held by the partnership during the decedent's lifetime, and that the creation of the FLP did nothing to change the decedent's relationship with the assets from the manner in which he or she held the assets prior to contribution.

It should also be noted that the FLP should, in fact, be run like a partnership, with its own separate bank account and regular meetings. The FLP should not have commingled funds with the senior generation's or any other partner's personal assets. Likewise, the FLP should not hold personal assets, such as a personal residence or vacation home, unless fair market value rent is paid for its use. The FLP should file its own income tax returns (a federal Form 1065 and the sole equivalent) and pay all returns and taxes (such as property taxes and sales taxes), and should *not* allow the partnership to pay any personal expenses for the partners.

## **Challenges Involving Gifts of FLP Interests: Respecting the Formalities of the Gifts**

The **most common challenge** raised by the IRS with respect to gifts of FLP interests from one generation to the next concerns the **valuation discounts** claimed with respect to the gifted interests, or whether the restrictions contained in the FLP Agreement were so broad as to render the transfer ineffective for gift tax purposes. The cases involving valuation discount litigation are numerous, and it should come as no surprise that where the FLPs had sufficient business purposes and were operated with the appropriate formalities, the IRS has had a tough time in having the discounts claimed by the taxpayer disregarded. This has been the case whether the IRS challenged the overall discount applied to the limited partnership interest transferred, or to the underlying assets held by the FLP. For specific case law sites, please contact The Wealth Preservation Institute.

An area where the IRS has won in litigation regarding gifts of FLP interest concerns additional contributions to the FLP made by the senior generation after gifts of the FLP interests have been made. If a partner makes an additional contribution to the FLP, the IRS views such contribution as resulting in an increase in the overall value of the other partners' interests. The additional contribution is recast by the IRS as if the individual making the additional contribution first gifted an undivided interest in the property to each of the other partners, then they contributed it to the partnership. Depending on the type of property involved, this can result in substantially smaller discounts being applied for gift tax purposes. Prior to any additional contributions being made, a careful analysis should be made to determine the most effective way to contribute the property to the FLP to minimize gift tax issues.

## **“Freeze Partnerships” An Interesting Planning Opportunity**

So where is the next generation of FLP planning headed? While not new, the concept of using a derivation of the traditional FLP appears to be making a comeback. The concept of a “freeze partnership” is again receiving attention as an alternative to the traditional FLP structure.

A “freeze partnership” is a partnership in which there are two classes of interests: a preferred interest and a common interest. The preferred interest is typically limited partnership interest but could be the general partnership interest (in very rare circumstances). The preferred interest is considered “preferred” **because it is entitled to preferred dissolution rights**, the preferred interest holder has a fixed dissolution value based on the value of the property contributed to the partnership; and preferred income rights, the preferred interest holder is entitled to receive preferred distributions of net cash flow from the partnership equal to a set percentage of the value of the dissolution value.

As a practical matter, preferred interests operate very similarly to preferred stock in a corporation. The “common” interests in the partnership are subordinate to the preferred interests **with regard to dissolution and income rights, but the common interest holders tend to have voting and managerial control over the partnership**. The common interest holders will share proportionately in the partnership’s income distributions, but only to the extent that the preferred interest holders have received the preferred income or dissolution payments.

**Example:**

A preferred family limited partnership is formed in which \$2,000,000 worth of assets are contributed to the partnership. In return for the contributions, parents retain a **preferred interest** equal to a \$1,000,000 dissolution value and a 10% preferred income distribution, the balance of the interests are **common interests** and are either sold or gifted away by the parents to their children or trusts for the benefit of their children.

In this case, the preferred interest is entitled to the first \$100,000 of distributable income (i.e., net cash flow). Once this \$100,000 is distributed, the balance of the distributable income will be distributed to the common interest holders based on each partner’s pro rata ownership of the partnership. If upon the death of the preferred interest holder the partnership is liquidated, the preferred interest holder’s estate will include the full \$1,000,000 liquidation value, **but the balance of the assets and all the appreciation from the date of inception would be allocated and distributed to the common interest holders**.

The planning implications of using preferred family limited partnerships are several:

First, because the liquidation values of the preferred interests are “frozen”, the common interests will receive all of the growth and appreciation of the assets held by the FLP. **This can result in substantial amounts of wealth being shifted to the common interest holders.**

Second, since the common interests are subordinate to the preferred interests in many respects, especially with regard to cash flow, it is possible that the **common interests would be subject to valuation discounts** for gift or sale purposes. Thus, depending on the types of assets which the FLP is intended to own, there are substantial planning opportunities to use the preferred and common interest structure to provide significant wealth transfer planning benefits.

For example, suppose the assets held by the FLP are capable of producing more than the \$100,000 of income as set forth in the above example. For arguments sake, suppose that the assets held by the FLP produce \$150,000 worth of income, thus, leaving \$50,000 of income remaining after the preferred distribution has been made. Assuming that the FLP would make tax distributions to each of the common interest holders equal to the tax they owe on the \$50,000 of income, the balance of the income not distributed could be used to purchase life insurance or other assets to increase the overall value of the FLP.

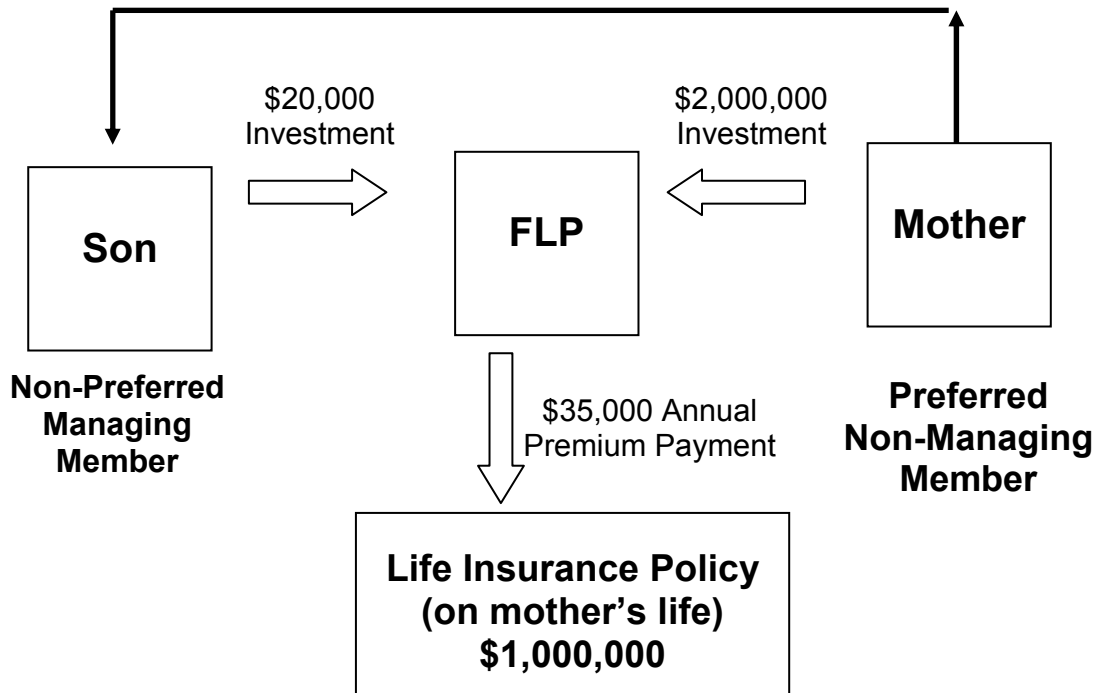
Thus, if a \$1,000,000 life insurance policy could be purchased with the remaining cash in the FLP after the preferred and the tax distributions are made to the preferred and common interest holders, and the preferred interest holder died the next day, *all of the assets in excess of the frozen \$1,000,000 liquidation value (i.e., the balance of the \$1,000,000 of assets and the \$1,000,000 of death benefit proceeds) would be allocated to the common interests holders.*

Oftentimes, a preferred limited partnership has multiple classes of interests (i.e., senior preferred, junior preferred, participating common, and non participating common), the planning can be very creative. The ability to use the preferred and common interest FLP in connection with a family's overall wealth planning can present substantial planning opportunities.

In the following schematics, keep in mind the following assumptions: the mother capitalized the FLP with \$2,000,000 and her son capitalized the FLP with \$20,000. The mother is issued a preferred interest representing 49.5% ownership and a non-preferred interest equaling the same 49.5% interest. The Son has a 1% non-preferred interest but is the managing member of the FLP. Also assume that the FLP interests receive a 30% discount for the various restrictions put in place via the FLP documents.

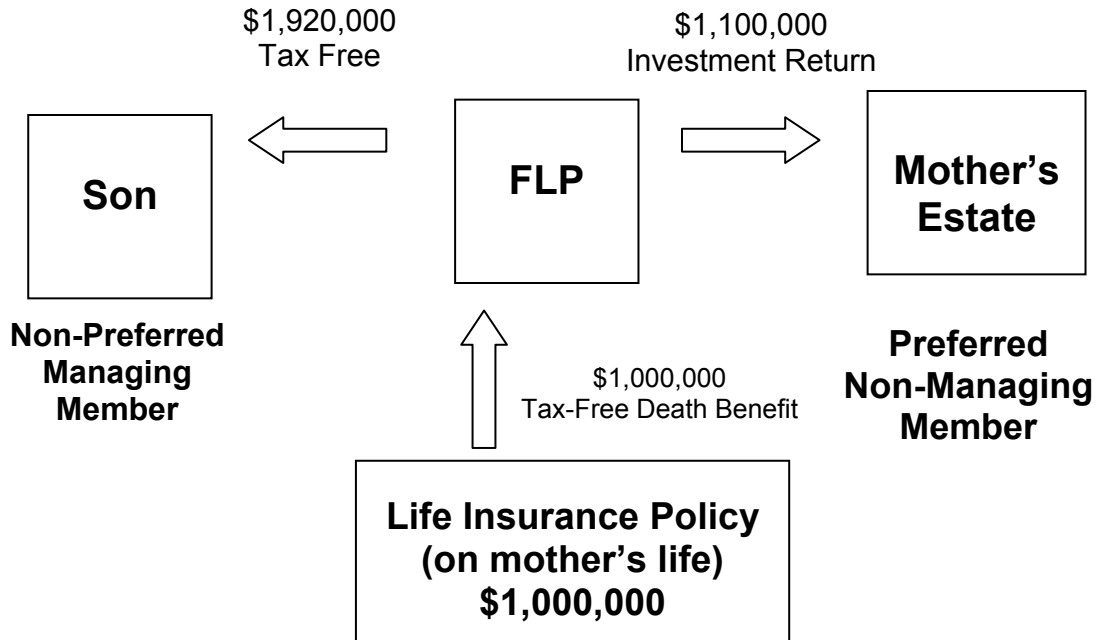
In this example, the FLP generates \$150,000 in income from investments. \$100,000 goes to the mother via her preferred interest, \$15,000 is distributed to the son to pay for the taxes on the remaining \$50,000 income and \$35,000 stays in the FLP and is used to purchase a life insurance policy for \$1,000,000 on the mother's life.

Mother gifts \$700,000 in non-preferred interest To Son which because of the 30% discount equals her entire 49.5% non-preferred interest.



What happens after Mother dies one (1) year later?

- 1) The FLP would be dissolved
- 2) The Mother's estate would receive as a preferred investor in the LLC, the remaining \$1,000,000 preferred interest plus a 10% rate of return (\$1,100,000)
- 3) The son receives via the dissolution his initial \$20,000 investment, \$1,000,000 in assets via the gifted non-preferred interest from the mother and the \$900,000 of the death benefit which was paid income tax free to the FLP prior to dissolution. The son owes no estate taxes on these assets and no income taxes.

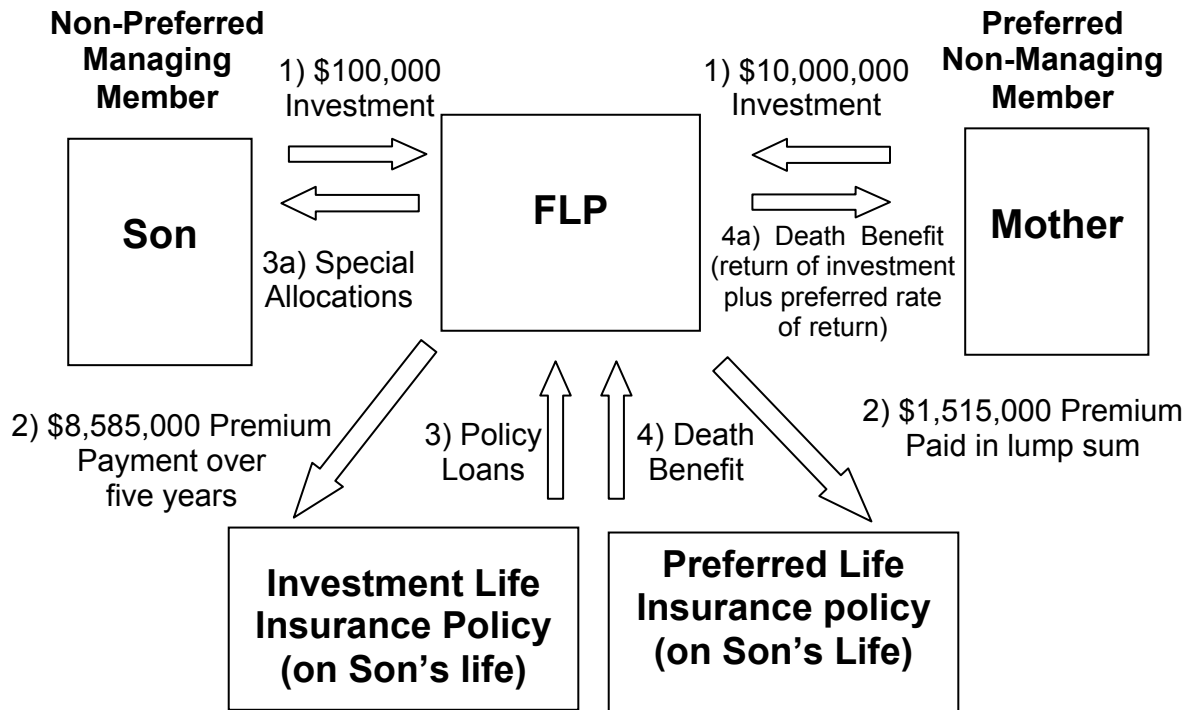


### Multiplying the Discounts

The previous example is a great way to show a client how to freeze the value of a preferred interest in an FLP and how to use life insurance as a nice way to pass wealth income and estate tax free to the heirs without incurring gift or estate taxes.

The following is a much more interesting example that will illustrate how to use the same structure to dramatically increase the discounts available for estate tax purposes. We need to assume some additional facts.

- 1) Assume the client (mother) has **no need for a future flow of income**.
- 2) Assume the client has a 25 million dollar estate and has \$10,000,000 in bank accounts, CDs or securities. Further assume that much of the entire 25 million is includable in the client's estate for estate tax purposes.
- 3) Assume the client is totally uninsurable and can not purchase life insurance (which would be owned by an irrevocable life insurance trust) to pay for estate taxes.
- 4) Assume the son is 45 years old and in good health
- 5) Finally, let's assume an additional goal is to create a situation where the heirs could have access to cash (tax-free) at some point in the future before the mother dies, rather than waiting.



Steps for the above schematic

1) Mother and Son both capitalize the FLP (no gift tax issues). Mother is the preferred non-managing member and the son is the non-preferred managing member (who controls the investments of the FLP). Because this is a related party transaction, mother's rate of return on her preferred interest can be limited to a reasonable rate of return (like the long term Applicable Federal Rate (AFR) based on simple vs. compound interest). Let's assume the long term AFR is 5%.

2) The FLP invests in two separate life insurance policies using the son's life. The "preferred" policy is strictly used to pay back mother her preferred investment plus a simple interest rate of return (therefore the FLP will purchase an increasing death benefit policy).

With the remaining money, the FLP will purchase a "cash building" life insurance policy as an investment (in the example an indexed equity life policy is used). The premium is paid into the policy over a seven year period so the policy does not become a modified endowment contract (which would prevent tax free loans from being taken from the policy).

3) When and if the son needs cash, he would have the FLP take a "policy loan" from the cash building policy. There is no income tax due when an owner of a life policy takes a loan (assuming the policy stays in force until death).

3a) The son then would take a “special allocation” from the FLP in an equal amount to the loan. The special allocation is an income tax free transaction due to the fact that the son will assume the debt of the FLP to the life insurance company.

A complete explanation of a special allocation and adjusting the member’s capital accounts is outside the scope of this material. For more information, please contact The Wealth Preservation Institute.

4) When the son dies, a death benefit will pay from the preferred policy to the mother, if still living and, if not, it will pass to the heirs.

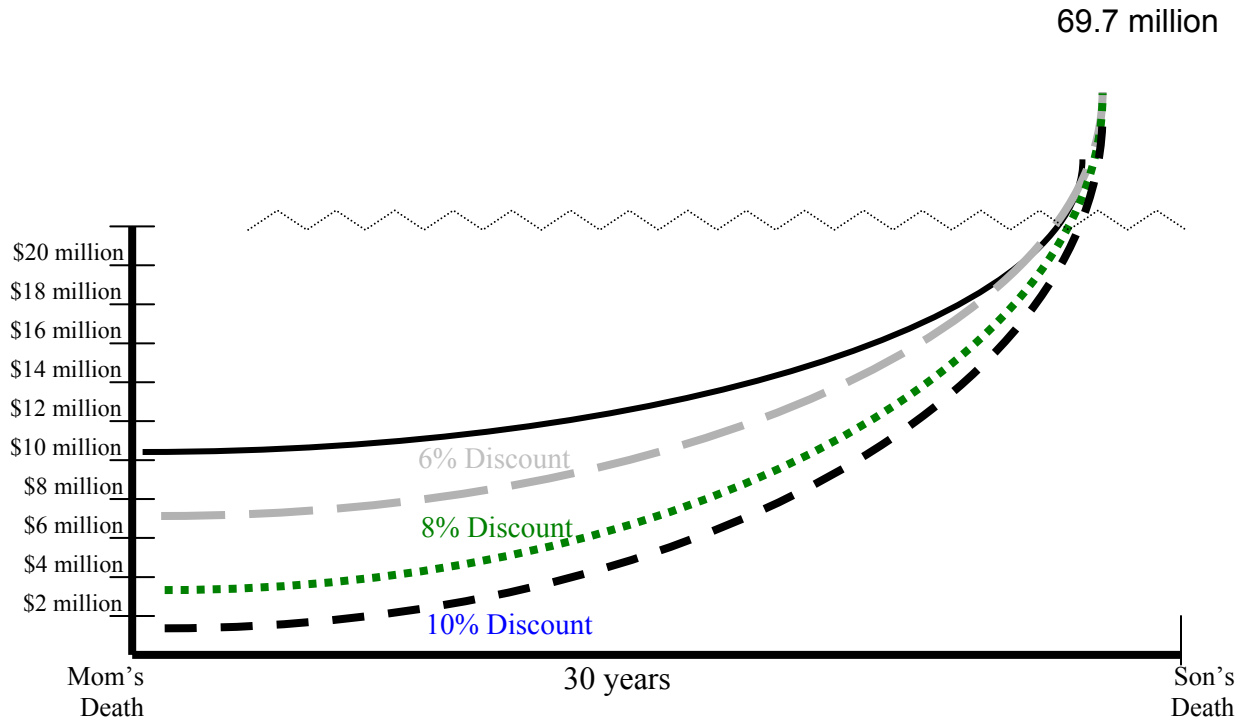
Explaining the benefits of the previous transaction

1) There are **no gift taxes with this transaction**. The mother was able to transfer \$10,000,000 into an FLP and have \$8,500,000 invested into a cash building life insurance policy where the son will have access to the cash through special allocations both gift and income tax free.

Multiplying the discounts

2) While living, the mother owns a very interesting asset from an estate tax point of view. The mother now owns FLP units that will not pay unless and until the son dies. The son is 45 when the preferred life policy is purchased, and his life expectancy is age 82. If the 75 year old mother dies next year; or in five, ten, or twenty years, the question for evaluation purposes is **what is the current value of her interest in the FLP when she dies** (taking into consideration the son’s life expectancy is 82)?

The following chart will illustrate the power of this technique for estate tax planning by illustrating different discounting percentages.



Projected value of ownership interest in mother's estate at the time of formation and purchase of the preferred life insurance policy:

At a 6% discount	\$6,692,614
At an 8% discount	\$2,510,710
At a 10% discount	\$1,815,664
At a 12% discount	\$925,210
At a 14% discount	\$464,209

Most attorneys who understand this strategy are comfortable with at least a 10%-14% discount. Therefore, if mother died in year one, the value of the FLP interest in her estate would be \$1,815,664 (using a 10% discount), NOT the \$10,000,000 she capitalized the FLP with. Why? Because the FLP units are not liquid and will not pay off from the investment in the FLP until the son dies. The calculation is to find out the current value of a future interest and, when discounted, the number becomes very low.

The reason typical **20-40% FLP discounts are not used** is due to the fact that the mother's interest is "preferred" and therefore the value of her interest can not be discounted to the same degree as FLP interests in a "traditional" FLP set up for estate planning purposes.

Even if mother dies in five, ten or twenty years, there is always a sizable discount in the value of the FLP interest due to the fact that the interest is always going to be discounted based her son's projected life expectancy.

## **Summary of the preferred non-manager/non-preferred manager LLC structure**

This structure is one of the most powerful and little known estate planning techniques in the estate planning industry. It is very flexible, depending on the needs of the clients, and can not only significantly reduce the size of a taxable estate (without gift taxes), but can also create a situation where a young heir can have access to income and gift tax free loans from a life insurance policy years before a parent passes away.

While at first glance, the schematic is not the simplest to grasp, after going through the material a few times, most advisors will be comfortable enough with the techniques to discuss them with clients and other advisors.