

## Your Family Limited Partnership: Hoping it Worked . . . ?

March 2013

Family Limited Partnerships (FLPs) have been used for decades as a planning tool for a variety of reasons. FLPs initially were designed to serve several non-tax purposes for families seeking:

- » Asset protection
- » Investment consolidation
- » Management control
- » Wealth transition

Over time, FLPs became more popular as a tax planning tool as well. For this purpose, families could use FLPs to transfer family wealth to future generations while saving gift, estate and income taxes along the way.

The discounted transfers arose because FLP interests carried lower values when passed to minority owners who lacked management control. These discounted transfers provided gift and estate tax benefits to families.

Families also enjoyed income tax planning benefits to the extent that FLP income could pass to minority owners paying income tax at lower rates.

Family Limited Liability Companies (FLLCs) arose later but serve similar purposes. Since FLLCs did not require a general partner, they offered greater asset protection and more streamlined organizational structure to accomplish the same goals.

I will refer to FLPs and FLLCs collectively as Family Investment Businesses (FIBs) for purposes of this discussion.

▾ As families and their advisers use FIBs more as a tax planning tool, some families have focused less on the non-tax reasons for creating them.

### Over Time ...

Over time, as you might imagine, families and their advisers enjoyed the wealth transfer advantages that FIBs provided to them. The higher gift and estate tax exemption amounts of the past few years also offered an incentive to families who could shift wealth to future generations at a reduced cost. Increasing income tax rates may provide further incentive to families to shift wealth to future generations who still pay those taxes at lower rates.

As families and their advisers use FIBs more as a tax planning tool, some families have focused less on the non-tax reasons for creating them. The original business purpose may have become lost, business formalities may have been ignored and lines may have blurred between business and personal assets.

### Congress Frowns

As you might imagine, Congress has frowned upon discounted inter family wealth transfers for decades as well. During the late 1980s, Congress enacted a law to include gifted property in an estate when someone still retained a substantial business interest afterwards. This law proved ineffective and was repealed within a few years. *See, former Internal Revenue Code Section 2036(c).*

During the early 1990s, Congress enacted even more laws designed to prevent gift and estate tax advantages when someone transferred family business interests to other family members.

*See, Internal Revenue Code Chapter 14.*

The current laws have not discouraged families from using FIBs as part of their wealth transfer plan. So, Congress continues to discuss legislation to eliminate the tax planning benefits to families who create FIBs.

### Hindsight is 20/20

In the meantime, however, the Internal Revenue Service has won more tax court cases challenging FIBs over the past several years. It therefore has increased its efforts to audit FIBs and to eliminate the tax benefits associated with them more regularly.

Many of these court cases involve FIBs that involve “bad facts”, informal operations or even a lack of any business purpose from inception. These court cases have examined FIBs for a variety of reasons to verify whether they were formed properly under state law and then funded soon after formation.

These court cases also have examined FIBs to determine whether they maintain:

- » Separate accounts
- » Appropriate books and records
- » Formal meetings and operations
- » Annual reports and tax returns
- » Routine business documents

They also have examined FIBs to determine whether there has been any:

- » Commingling of assets
- » Payment of personal expenses
- » Disproportionate or irregular distributions
- » History of active versus passive investments
- » Strict adherence to the operating agreement
- » Ongoing formal business operations

They further have examined FIBs to ensure they were created for appropriate non-tax reasons, including actual asset protection, management consolidation, investment consolidation and promotion of a family succession plan that may not otherwise have been achieved effectively without the FIB.

### Even When Making Annual Gifts

Families often gift small fractions of their FIBs to future generations each year based on their annual gift tax exclusion amount (currently \$14,000 for 2013). In theory, they may not need to file gift returns to report these transfers ... provided that they qualify as annual exclusion gifts in the first place.

*See, Internal Revenue Code Section 2503(b).*

Some recent tax court cases have held that gifts of FIBs did not qualify as annual exclusion gifts when the recipients did not receive any present interest from the gift. That is, the gift recipients could not withdraw any part of the FIB's assets after they received their gifts, so they only received an expectation of some future benefit. As a result, the families should have filed annual gift tax returns reporting the transfers and used part of their lifetime gift tax exemption amounts in the process.

*See, Price v. Commissioner, TC Memo 2010-2 (2010); Fisher v. U.S., 105 A.F.T.R. 2d 2010-1347 (2010).*

▸ Families often gift small fractions of their FIBs to future generations each year based on their annual gift tax exclusion amount

Some families may amend their FIB operating agreement to provide gift recipients with more access to FIB assets when they receive a gift. However, this solution may not be popular for other reasons. Families also may provide gift recipients with temporary rights to receive a distribution from the FIB which they must exercise by a specific date following the gift.

This second solution is similar to the types of notices provided to beneficiaries of insurance trusts that receive gifts. It could provide the beneficiary with an immediate right to access property (so it can qualify as an annual exclusion gift) even if they forego that right because they stand to receive more benefits from the future property of the FIB. See, *Crummey v. Commissioner*, 397 F.2d 82 (1968 U.S. App.).

Regardless, these cases show FIBs being challenged to unwind some of the tax planning benefits they have provided in the past.

## Foreshadowing Change?

Currently, taxpayers can transfer interests in family-owned businesses on a discounted basis with appropriate planning. Congress continues to discuss eliminating these opportunities. The President's current budget proposal even discussed eliminating the ability of families to transfer family-owned business interests on a discounted basis. Time will tell whether Congress can create a permanent solution to this ongoing discussion.

Sources: Internal Revenue Code, Section 2503(b), former Section 2036(c) and Chapter 14; Price v. Commissioner, TC Memo 2010-2 (2010); Fisher v. U.S., 105 A.F.T.R. 2d 2010-1347 (2010); Crummey v. Commissioner, 397 F.2d 82 (1968 U.S. App.); Family Limited Partnerships: Current Valuation Issues, John W. Porter, Esq. (2012); President Obama's 2013 Budget Proposal

Opinions referenced are as of January 23, 2013 and are subject to change due to changes in the market, economic conditions or changes in the legal and/or regulatory environment and may not necessarily come to pass. This discussion is intended to be informational only and is not exhaustive or conclusive. While Calamos Wealth Management has used reasonable efforts to obtain information from reliable sources, we make no representations or warranties as to the accuracy, reliability or completeness of third party information presented herein. Calamos and its representatives do not provide tax or legal advice. Each individual's tax and financial situation is unique. You should consult your tax and/or legal advisor for advice and information concerning your particular situation. This information is provided for informational purposes only and should not be considered tax or legal advice.

For more information about federal and state taxes, please consult the Internal Revenue Service and the appropriate state-level departments of revenue, respectively.

CWM and its representatives do not provide accounting, tax or legal advice. Each individual's tax and financial situation is unique. You should consult your tax and/or legal advisor for advice and information concerning your particular situation. This information is provided for informational purposes only and should not be considered tax or legal advice. Please refer to important disclosures on last page.

Calamos Wealth Management LLC is a federally registered investment advisor. Form ADV Part 2A, which provides background information about the firm and its business practices, is available upon written request to:

Calamos Wealth Management LLC

2020 Calamos Court  
Naperville, IL 60563-2787

Attn: Compliance Officer

©2013 Calamos Investments LLC. All Rights Reserved.

# CALAMOS®

Calamos Wealth Management LLC  
2020 Calamos Court | Naperville, IL 60563-2787  
800.582.6959 | www.calamos.com/wm | caminfo@calamos.com

© 2013 Calamos Investments LLC. All Rights Reserved.  
Calamos® and Calamos Investments® are registered trademarks of Calamos Investments LLC.