

**FAMILY LIMITED PARTNERSHIPS
PROPER MAINTENANCE MUST FOLLOW
INITIAL FORMATION**

BEYOND THE HEADLINES - 12 ISSUES TO CONSIDER

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Family Limited Partnerships - Proper Maintenance Must Follow Initial Formation

Beyond the Headlines -- 12 Issues to Consider

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INTRODUCTION

Over recent years there has been a significant increase in the use of the family limited partnership ("FLP") as a component of estate planning for wealthier individuals. Although the Internal Revenue Service ("IRS") continues to launch attacks on the FLP concept and the legislature continues to propose changes to curtail FLP tax benefits, FLPs are still being used by practitioners as an estate planning strategy and asset protection technique. FLPs offer the ability for centralized family wealth management (a single family advisor can hold one FLP account rather than several accounts for many different family members), and allow parents to retain control, either directly, as general partners, or as officers of corporate general partners. Parents who create a trust for their children cannot retain such level of control. Many other objectives prompt the creation of a FLP, such as the following:

1. establishment of a method by which annual gifts can be made without fractionalizing family assets (but see Section VII of this outline, below);
2. continuity of ownership of family assets and limitation of the right of non-family members to acquire interests in family assets;
3. protection of family assets from future claims against members of the family;
4. prevention of transfer of a family member's interest in the FLP as a result of a failed marriage;

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5. reduction of costs associated with the disability or probate of the estate of a family member;
6. avoidance of jury trial and the expense of adverse publicity associated with litigation;
7. promotion of family's knowledge of and communication about family assets; and
8. diversification of family assets in investments of all types and kinds.

Valuation discounts have been obtained in many estate plans through the use of FLPs. The IRS has continued to challenge the FLP (and the limited liability company) by issuing a series of Technical Advice Memoranda ("TAMs"). Such IRS pronouncements serve as an alert to practitioners of the types of circumstances that should be avoided. It is important to note that such TAMs reflect only the position of the IRS and not the decision of a judge or jury.

Until valuation discounts through FLPs are legislatively prohibited, estate planners must consider for the benefit of our clients the use of FLPs; and then, once formed, must coordinate and ensure their proper administration. In addition, practitioners should consider the types of transactions that are likely to freeze the FLP benefits under existing law in light of potential future legislation. This outline highlights a variety of post-formation issues that have not received a significant amount of attention over recent years. Please be aware, however, that there are many FLP administration issues that are beyond the scope of this outline, the most significant of which are: (i) formation considerations outside the state of Florida; (ii) more extensive analysis of Code § 754 elections; (iii) funding of marital and non-marital trusts with FLPs; and (iv) comparing FLPs with other entities including limited liability companies. The issues raised in this outline as well as those beyond the scope of this outline place a significant burden on estate planners who may be exploring an arena of unfamiliar Code Sections and local state law provisions.

DISCUSSION

I Preliminary Considerations Regarding Family Limited Partnerships

The purpose of this Section is to provide a review of recent congressional proposals to eliminate valuation discounts for certain FLPs and of IRS TAMs holding that under certain circumstances, FLPs shall be disregarded in determining valuation of the underlying assets owned by the FLP. The proposed legislation discussed below, along with the TAMs provide insight as to the climate surrounding FLPs and the potential for future legislation.

A. Proposed Legislation to Curtail Use of FLPs.

1. **First Legislative Attack.** On December 29, 1994, the IRS issued Final Regulation 1.701-2, known as the "partnership anti-abuse regulations" (referred to herein as the "Anti-Abuse Regulations"). Initially the Anti-Abuse Regulations applied for both income tax and transfer tax purposes. By Announcement 95-8, issued just months after the Final Regulations were

issued, the IRS retreated from the application of the Anti-Abuse Regulations to transfer taxes, and the examples summarized below were deleted from the Anti-Abuse Regulations. The Anti-Abuse Regulations provided the following two Examples (Examples 5 and 6 prior to their repeal by the IRS), which illustrate the position of the Department of the Treasury relating to FLPs at such time:

(a) Example 5. Husband (H) and Wife (W) form a FLP by contributing their interests in **actively managed**, income-producing realty that FLP will own and operate. H holds a general partnership interest and W holds a limited partnership interest. Later, W assigns a portion of her limited partnership interest to her two children (S and D), taking valuation discounts, consistent with the taxpayer's treatment of the arrangement as a partnership. It appears that based on the facts of this example, the Commissioner could neither recast the transaction, nor treat FLP as an aggregate of its partners for purposes of valuing the gifts from W to S and D. Although FLP is owned entirely by related parties, the decision to organize and conduct business through FLP under the circumstances is consistent with the intent of Subchapter K. The Regulation states that: (i) the **partnership** was not created **immediately** before the making of the gifts by W and (ii) **a bona fide partnership holding an actively managed income producing asset** will be respected for valuation purposes.

(b) Example 6. Husband (H) and Wife (W) form FLP by contributing their respective interests in their **vacation home**. H holds a general partnership interest and W holds a limited partnership interest. Later, W assigns a portion of her limited partnership interest to her two children (S and D), taking valuation discounts, consistent with the taxpayer's treatment of the arrangement as a partnership. Based upon the facts of this example, the Commissioner could recast the transaction and disregard FLP for valuation purposes, because the asset transferred to FLP was not an actively managed income-producing asset. By analogy, Example 6, if not repealed, would most likely cause the same result for a FLP funded with a marketable securities portfolio.

2. 1999 Proposed Legislative Attack. More recently, on February 22, 1999 President Clinton made a proposal to Congress to curtail the use of certain FLPs. This proposal specifically addressed the elimination of valuation discounts for non-active businesses. The proposal was designed to require interests in entities to be valued for transfer tax purposes at a proportional share of the net asset value of the entity to the extent that the entity held readily tradable marketable securities (including cash, cash equivalents, foreign currency, publicly traded securities, realty, annuities, royalty-producing assets, and non-income producing property such as art or collectibles, commodities, options and swaps) at the time of gift or death.

3. National Press Reports on FLPs. Many tax practitioners were concerned that President Clinton's proposal would be enacted as part of the Restructuring and Reform Act of 1998 (the "1998 Act"), which was signed into law by President Clinton on July 22, 1998. However, as reported in the Wall Street Journal on July 8, 1998, the President's FLP proposal was not included in the 1998 Act. The Wall Street Journal, in an article entitled Lobbyists Celebrate The Demise Of Many Of Clinton's Tax Proposals, reported "Congress also buried Treasury proposals designed to cut back or eliminate tax benefits of popular estate planning strategies such as FLPs. ." On July 13, 1998, Time Magazine ran an article under the headline Use It or Lose It, which stressed that taxpayers should act promptly to take advantage of FLPs under existing law.

One client faxed an article entitled Clinton Targets Three Estate-Planning Techniques to our office from Nation's Business dated June, 1998. The article discussed potential repeal of Crummey powers, personal residence trusts and restrictions on the use of FLPs. Based upon the amount of national press the FLP technique has received over recent months and the President's proposal to cut back its benefits, tax practitioners must consider not only the use of FLPs, but also other estate planning strategies available under existing law to freeze values and shift wealth. (See Section XII of this outline, below).

B. IRS Pronouncements Have a Chilling Effect on FLPs

The IRS has issued a series of TAMs attacking the availability of discounts in connection with the transfer of limited partnership interests in FLPs. Although these TAMs were issued in 1997 and have been discussed in many articles and at many seminars, a brief review provides insight on issues to avoid in the formation and administration of FLPs. Many of the TAMs related to egregious circumstances. In each of the TAMs, the IRS concluded that the formation of the FLP (or in one ruling a limited liability company) and subsequent transfer of interests therein (either by gift or sale), should be disregarded for purposes of valuing the underlying assets owned by the FLP. The facts of these TAMs also illustrate the need to plan ahead and document legitimate business purposes other than strictly tax avoidance when forming and operating FLPs.

1. TAM 9719006. The decedent was on life support and decedent's two children as trustees of decedent's trusts executed the FLP documents. Once the FLP was established, the children proceeded to transfer real estate and securities to the FLP, and then sold a portion of the FLP interest to themselves in exchange for long-term promissory notes. Life support was removed about the time of these transfers and decedent passed away two days later. Decedent's children were the sole beneficiaries of the estate. The remaining FLP interest held by the decedent was substantially discounted on decedent's estate tax return.

2. TAM 9723009. The decedent was 90 years old and decedent's son (the sole beneficiary of the estate) created the FLP as well as the corporate general partner in his capacity as decedent's attorney-in-fact. The decedent's residences, securities, and personal property were transferred into the FLP. Decedent passed away less than two months after the formation of the FLP. Although decedent did not transfer decedent's FLP interests, these were substantially discounted on decedent's estate tax return.

3. TAM 9725002. The decedent's revocable trust, two children and five grandchildren's trusts formed the FLP. The decedent's children signed the FLP agreement individually and as trustees. Cash and marketable securities were then transferred into the FLP. Two months later, decedent passed away, and decedent's estate tax return reflected the decedent's interest in the FLP at a substantial discount.

4. TAM 9730004. The decedent was diagnosed with terminal cancer and shortly thereafter provided written directions to decedent's only child, an attorney, to create a FLP. The written instructions cited several non-tax benefits of a FLP, all of which directly coincided with an article written by decedent's child regarding FLPs. The corporate general partner and the FLP were then formed and farmland was contributed in exchange for a FLP interest. The decedent

gifted shares in the corporate general partner to his son as well as a small percentage of limited partnership interests. The decedent died 2 months after the creation of the FLP and the estate substantially discounted the value of the corporate general partner and the FLP interest owned by the decedent.

5. TAM 9735003. Decedent's son, as trustee of decedent's revocable trust, created a FLP. Son's wife, decedent's revocable trust and another trust received limited partnership interests. Approximately one month later, son, pursuant to a power of attorney, transferred decedent's interest in yet another trust to the FLP. Son made additional contributions to the FLP by checks drawn on decedent's personal accounts and signed by son. Some of checks were not paid by decedent's bank until after decedent's death. The decedent's federal estate tax return reported all contributions and reflected the decedent's interest in the FLP at a substantial discount.

6. TAM 9736004. The decedent was suffering from cancer when she executed a durable power of attorney naming her son as attorney-in-fact. The power of attorney did not expressly provide son with the authority to make gifts of decedent's property. A few days later, son formed two limited liability companies (LLCs) and acting as attorney-in-fact transferred certain land held by a trust for the benefit of the decedent into one of the LLCs. Other assets held by such trust were transferred to the other LLC along with certain of decedent's items of tangible personal property. Three days later, son, acting as managing partner of one of the LLCs, transferred a portion of decedent's capital account in the LLC to son and daughter. Decedent died shortly thereafter and decedent's gift tax return and federal estate tax return substantially discounted decedent's capital accounts in the LLCs.

C. IRS Rationale

The IRS in the above-described TAMs raises three main arguments. For example, the analysis provided in TAM 9736004 states the following IRS positions:

1. The transactions are shams and have no purpose other than to reduce or avoid federal estate taxes. This argument is particularly strong where: (i) the transaction operates as a means to transfer assets to individuals who would have received the assets under a testamentary instrument, and (ii) there is a close proximity between the date of the formation of the FLP and the death of the decedent. The IRS position is that the transfers of assets to the FLP and the subsequent transfer of the FLP interests at death under such circumstances should be treated as one integrated testamentary disposition.

2. Under Code § 2703, particularly Code § 2703(a)(2), the value of property is determined without regard to any restriction on the right to sell or use such property. Said restriction may be contained in the FLP agreement or may be implicit in the capital structure of the FLP. This may be an overly broad interpretation by the IRS, as Code § 2703 does not necessarily dictate that a FLP is a restriction on the right to use FLP assets. This interpretation does not seem to be what Congress intended. If Congress wanted to put an end to valuation discounts for FLPs, it would appear that such a provision would be clearly expressed as compared to a broad interpretation of Code § 2703, the primary purpose of which is to address buy-sell and other

agreements. The courts may soon determine the applicability of Code § 2703 with respect to this issue.

3. Under Code § 2704(b), the limitations on decedent's withdrawal and liquidation rights should be ignored when such limitations are more restrictive than the relevant state's partnership law and the limitation can be removed by the family members. State law in those TAMs provided that if a FLP agreement does not specify the time or events upon the happening of which a limited partner may withdraw, then the limited partner may withdraw, unless prohibited by the FLP agreement, upon six months notice. The IRS' position is that the fixed term under the FLP agreement during which limited partners cannot withdraw from the FLP and liquidate their interests is an applicable restriction under Code § 2704(b). Without said restriction in the FLP agreement, a limited partner could withdraw and liquidate his or her interest with 6 months notice. Many states, including Florida, have enacted legislation whereby a limited partner may not withdraw from a FLP prior to the expiration of the term of the FLP unless so stated in the FLP agreement. See Florida Statutes § 620.143. Therefore, it is anticipated that a FLP agreement properly drafted in accordance with such statutes should be effective against an IRS attack based on Code § 2704(b).

D. IRS Audit Questions

Exhibit 1 illustrates some of the common questions and/or information requests by the IRS when dealing with a FLP audit. Because these issues will likely be addressed in the event of an audit, tax practitioners should consider them in drafting partnership agreements and advising their clients on the appropriate method to administer the FLP.

II Limited Partnership Formation Fees in Florida - When to Form

A. Formation

The formation of a Florida FLP must comply with all statutory requirements, one of which is the payment of the filing fees to the Florida Department of State. The filing fee for an original Certificate of Limited Partnership and Affidavit of Capital Contributions is based upon the amount of anticipated capital contributions of the limited partners, and is calculated at the rate of \$7 per \$1,000 of such contributions; provided that the filing fee may not be less than \$52.50 or more than \$1,750. As mentioned above, the Certificate of Limited Partnership must be filed along with an Affidavit of Capital Contributions, which sets forth the amount of current and anticipated capital contributions by the limited partners. If the amount of capital contributions exceeds the amount of anticipated capital set forth in the Affidavit of Capital Contributions, a supplemental affidavit must be filed. The filing fee for a supplemental affidavit is based upon the amount of capital contributions by the limited partners in excess of the anticipated capital contributions reported on the prior affidavit, and is also calculated at the rate of \$7 per \$1,000; provided that the filing fee may not be less than \$52.50 or more than \$1,750.

B. Anticipated Future Capital

If it is likely that limited partners will make additional capital contributions shortly after the initial formation of a FLP, these anticipated contributions should be reflected in the initial

affidavit in order to avoid the necessity of filing a supplemental affidavit. It is important to bear in mind that if there is a creditor's claim against the FLP, there is a possibility that the creditor could allege that the partners of a FLP should be required to contribute the anticipated future capital contributions reflected in the affidavit. Accordingly, the creditor may file a claim against the partners and/or the FLP to require the limited partners to contribute the anticipated capital contribution reflected on the Affidavit of Capital Contributions. Notwithstanding the foregoing, the potential of such a creditor claim should not pose a substantial risk for FLPs owning a marketable securities portfolio or other assets subject to minimal risk of creditor claims.

C. Partnership Annual Reports

In addition to formation fees, Florida FLPs must file an annual report. The filing fee for an annual report for a Florida domestic limited partnership is based on the amount of capital contributions of the limited partners, and it is calculated at the rate of \$7 per \$1,000 of such contributions, however the annual filing fee may not be less than \$52.50 or more than \$437.50. The annual report for the FLP is due by December 31.

D. Year End Planning

Tax practitioners should exercise care when advising clients about the timing for the formation of a FLP. Because there is an annual "maintenance" fee (i.e. the annual report is due on December 31 regardless of the month in which the FLP is formed) and such fee is in addition to the initial FLP filing fee, one should consider whether forming a FLP at the end of the year is absolutely necessary. If the taxpayer forming the FLP can wait until January of the following year, a filing fee of up to \$437.50 can be saved for the prior year (e.g., a FLP formed in December of any year will be subject to the formation fee of as much as \$1,750 plus the annual report fee of as much as \$437.50 for such year, regardless of whether the partnership was formed at the end of December or was in existence for many months during such year).

III Funding of Family Limited Partnerships – Avoidance of Capital Gain Recognition

A. Upon the Transfer of Assets to the Partnership

Pursuant to Code § 721(a), transfers of property for an interest in a partnership are generally treated as non-recognition transactions such that the contributing partner, as well as the other partners and the partnership do not recognize any gain or loss at the time of contribution. The tax attributes inherent in the contributed property immediately before its transfer to the partnership in exchange for a partnership interest are transferred to the partnership so that the gain or loss is deferred and reported when the contributing partner sells his or her partnership interest or the partnership sells a contributed asset. Such non-recognition treatment applies regardless of the type of partnership interest received. It is important to note that this rule is not limited to contributions at the time of formation or initial funding of the partnership, but also applies to contributions of property at any time thereafter.

B. Contributing Property Subject to Liability

Contributing property to the partnership that is subject to a liability that exceeds its cost tax basis can result in recognition of taxable gain. Code § 752(b) and Reg. § 1.752-1(c) provide that a decrease in a partner's share of liabilities is treated as a distribution of cash to that partner.

C. Exception to Non-Recognition Where Diversification of an Investment Company Under Code § 721(b)

Code § 721(b) provides an important exception to the nonrecognition treatment of Code § 721(a) when property is contributed to a partnership that is considered an "investment company." If a partnership is classified as an investment company and there is diversification of the transferor's investment portfolio, the transferor must recognize gain on the transfer, but no loss is recognized. Although Code § 721(b) does not define what constitutes an investment company, the definition of an investment company under similar corporate formation rules is used to determine whether a partnership is an investment company. The basic requirement for a partnership to be classified as an investment company is that the partnership be principally used as a vehicle to hold the investment portfolios of its partners. (See Hesch, 710 T.M. Partnership; Overview, Conceptual Aspects and Formation, Page A-102). Thus, in structuring the funding of any partnership whose assets consist of marketable securities, the investment company diversification issue must be considered.

D. If No Diversification the General Nonrecognition Rules Apply

Notwithstanding the foregoing, the Regulations provide that even if a partnership would be treated as an investment company, the general nonrecognition rule of Code § 721(a) still applies if there has been no diversification of the transferor's investment portfolio. Diversification is found to occur if different transferors contribute different assets to the same partnership and the contributed assets are not diversified portfolios. A de minimis contribution is disregarded for this purpose. See Reg. § 1.351-1(c)(5) and Reg. § 1.351-1(c)(7) Ex. (1). Although the Regulations do not specify what qualifies as a de minimis diversification, examples in the Regulations and IRS Private Letter Rulings indicate that diversification of 1% or less may be considered de minimis. See Id; Hesch at A-104; PLRs 9544012, 9504025, 9504034-9504038. Hesch states "[s]ince the regulations do not address what a de minimis diversification encompasses, a private letter ruling request is recommended." See Hesch, Partnership Investment Company Rules for Family Limited Partnerships, 38 Tax Mgmt. Memo 247 (August 18, 1997). As an alternative and out of an abundance of caution, it is the policy of our office to be certain that even a 1% general partner contributes a diversified portfolio to the FLP. Although this procedure may not be technically required, we believe that based upon the various attacks on FLPs, the inconvenience to our clients to follow the procedures so that all parties contribute diversified portfolios (or identical assets, which is more difficult to do), is offset by the benefits of knowing that no gain will be triggered when the FLP is created. It should be noted that cash contributed to a FLP is considered a "non-identical asset" to any securities. See Rev. Rul. 87-9, 1987-1 CB 133. Therefore, if one partner contributes cash and the other contributes securities, diversification will occur unless the cash contribution satisfies the de minimis exception. The Regulations essentially provide that a transfer of stocks and securities is not treated as resulting in diversification of a partner's interest if no one

stock or security contributed to a FLP by a partner represents more than 25% of the value of the total assets being contributed by the partner and if no five or fewer securities contributed to a partnership by a partner represent more than 50% of the value of the total assets being transferred to the FLP by the partner. See Code § 368(a)(2)(F)(ii) and Reg. § 1.351-1 (c)(6).

E. Plan Ahead to Avoid Income Recognition

Before a transferor makes any contributions to a FLP, tax planning should be initiated to avoid recognition of realized gain to each transferor upon funding the FLP. In order to avoid the possibility that the IRS would assert that transfers to the FLP resulted in diversification, the proposed securities to be contributed by each transferor for the general and/or limited partnership interests in the FLP should satisfy the diversified portfolio test. Generally, a FLP would be deemed an investment company for purposes of Code § 721(b) if, immediately after the transfer of assets to the FLP, more than 80% of the value of the FLP's assets, exclusive of cash and non-convertible debt obligations, is held for investment purpose and consisted of readily marketable stocks or securities. See Reg. 1.351-1(c)(1)(ii)(c). Frequently, a FLP is being formed by a husband and wife who also form a corporate general partner. The portfolio investments can be structured so that husband and wife each contribute diversified portfolios and the 1% corporate general partner does the same. Using these procedures, all transferors should avoid income recognition upon the formation of the FLP.

IV Following Proper Procedures and Formalities in the Administration and Operation of Family Limited Partnerships

A. Required Filings

Certain required annual filings must be made to satisfy legal formalities of the limited partnership and thereby establish that the FLP was formed and operated in an arms' length manner rather than merely to generate valuation discounts. Some of the basic filings are summarized on Exhibit 1. Clients should be urged to follow each of the formalities in light of recent IRS attacks through TAMs, audits and cases.

The corporate general partner should maintain minutes of meetings (both annual and special, if any), and the FLP should operate in accordance with the terms of the FLP agreement and a plan of operation. The formulation of a plan of operation for the FLP should include the participation of all partners. Investment strategies should be developed as well as a proposal to determine procedures to establish distributable cash from year to year. However, all final decisions regarding the formulation of the plan of operation should be made solely by the general partner considering the general partner's fiduciary duty of loyalty to the FLP.

B. Fifty Percent (50%) Rule

Code § 708(b)(1)(B) provides that a partnership is terminated for tax purposes if there is a sale or exchange of fifty percent of or more of the total interest in partnership capital and profits. For purposes of calculating whether there has been such sale or exchange, all sales or exchanges within a twelve (12) month period are aggregated. Notwithstanding the foregoing rule, Regulation § 1.708-1(b) provides that transfers such as (i) gifts, bequests and inheritances, (ii)

liquidation of a partnership interest, and (iii) contribution of property in exchange for a partnership interest do not constitute sales or exchanges. Thus, a properly drafted FLP agreement should always require the general partner's approval of any transfer.

C. What Not To Do – Estate of Schauerhamer v. Comm'r

A fairly recent case, Estate of Schauerhamer, TCM 1997-242, filed on May 28, 1997, exemplifies how important it is to properly manage and follow the formalities and requirements of a FLP. In that case, the Tax Court disregarded a FLP and held that the value of certain assets transferred to the FLP created by the decedent was includible in the decedent's gross estate under Code § 2036(a)(1). The decedent was diagnosed with cancer in November of 1990. In December of 1990, the decedent executed three substantially identical FLP agreements, one for each of decedent's three children. Each FLP was funded with an undivided one-third interest in the decedent's business holdings (consisting of realty, partnership interests and notes receivable). The decedent and each child were the general partners of each child's FLP, and the decedent was the limited partner of each FLP. The decedent was the managing partner of each FLP. On December 31, 1990 and then on January 1, 1991, decedent made a total of 66 assignments of her limited partnership interests to 33 family members. The FLP agreements required that all income from the FLP be deposited into an FLP account. The decedent deposited the FLP income into her **own** account, and did not maintain any records to account separately for FLP and non-FLP funds. The decedent used the account as her personal checking account and paid personal and FLP expenses from said account.

In reaching its conclusion, the court in Schauerhamer noted that Code § 2036(a)(1) provides that a decedent's gross estate includes the value of all property interests transferred by a decedent during her life where she has retained for life the possession or enjoyment of the property, or the right to the income therefrom, and further, that the retention of a property's income stream after the property has been transferred evidences the decedent's retention, possession and enjoyment. The court reasoned that although the FLP agreements required that each FLP maintain a bank account into which all income would be deposited, the decedent violated the terms of the FLP agreements and **deposited the income as it was earned by each FLP into her own account, where she commingled it with income from other sources**. Consequently, the value of the FLP assets was includible in the decedent's gross estate.

V *Allocation of Income and Deductions – Reasonable Management Fees and Shifting of Income, Deductions and Losses*

For federal income tax purposes, items of income, gain, loss and deduction should be allocated among the partners in proportion to the partner's interest in the FLP. Although special allocations and preferential cash distributions are technically possible, such planning may not be advantageous in the FLP arena for typical clients. See Spero, at 8-90.

FLP profit allocated to a donee is taxable to that partner if the general partner is reasonably compensated for services rendered to the FLP and partnership allocations do not proportionately favor the donee's capital interests. Code § 704(e)(2) allows allocations in accordance with the FLP agreement; however: (i) donor/partner must take reasonable compensation for services rendered to

the FLP, and (ii) the distributive share of partnership income of donee cannot be disproportionately greater than that of the donor/partner (based on each share's fair market value). See Treanor, 346-2nd T.M. Family Partnerships, Page A-24. These two exceptions are designed to prohibit the donor from shifting more than a proportionate share of partnership income to the donee. See Code § 704(e)(2); Reg. §§ 1.704-1(e)(3)(i)(a) and (b); See also Howard M. Zaritzky, Tax Planning for Family Wealth Transfers (3rd Ed., 1997) ¶10.02[7][f]. Accordingly, the FLP's total income must be first reduced by reasonable compensation to the donor/partner, and then the remaining income can be allocated to the partners in proportion to their partnership interests. See Treanor, Page A-24. Reg. § 1.704-1(e)(3)(i)(b) provides for reallocation if the donor/partner has so shifted a disproportionate share of partnership income to the donee. It appears that net income can be defined as income remaining after contribution to reserves for the reasonable business of the FLP, considering factors such as the current needs for operating capital, prudent reserves for future operating capital, current investment opportunities, and potential future expansion of the FLP's business and/or investments, provided these are in line with the purposes of the FLP. See Zaritzky, ¶10.02[7][c][ii].

Usually, in a FLP, the general partner is vested with primary responsibility for the management of the partnership and the making of day to day decisions. In order to not run afoul of the provisions of § 704(e), the agreement should specifically state that the general partner should receive fair and reasonable compensation for services rendered to the partnership, as well as permit reimbursement for expenses incurred in the performance of those services. See Vogelsang & Bertles, Effective Drafting Strategies for Family Limited Partnerships, 23 Est. Plan. 401, 403-406 (Nov. 1996). Compensation is "reasonable" if, taking into consideration all relevant facts and circumstances, the donor is paid as much as the FLP would have to pay in order to obtain comparable services from an unrelated person who is not a partner. As a general partner in a FLP must render all managerial services a partner ordinarily renders in addition to other services such as brokering purchases and sales of partnership assets, the general partner should be separately compensated for such additional services. See Zaritzky, ¶10.02[7][f].

Although family partnership rules, specifically Code § 704(e)(2), do not restrict special allocations favoring the donor/partner, Code § 704(b) may be applicable if the allocation does not have a "substantial economic effect" as defined in Reg. § 1.704-1(b)(2)(ii)(a). See Treanor, Page A-25. In addition, a disproportionate allocation of income to the donor/partner may raise questions as to donee's real ownership of his or her interest. See Id. Actual distributions to the donee of all or a portion of net income constitutes evidence that a donee's interest is "real," provided that the general partner or the donor has not retained powers or control inconsistent with traditional business norms which interfere with said donee's ownership. See Zaritzky, ¶10.02[7][c][ii].

VI Follow Partnership Procedures When Assigning Partnership Interests

When assigning partnership interests, practitioners should ensure that all of the requirements and steps stipulated in the FLP agreement are closely followed. Typically, an assignment of interest in the FLP is made and duly executed by the "transferor" partner. Thereafter, the proposed transferee, by written instrument, acknowledges receipt of a copy of the FLP agreement and agrees to assume all of the obligations and undertakings of the transferor and to abide and be bound by the terms of the FLP agreement. In the event of a proposed corporate

transferee, a certified copy of a resolution of its board of directors authorizing it to become a partner of the FLP and documentation evidencing compliance with the terms and provisions of the FLP agreement should be submitted. In some FLPs, the transferee is required to pay the general partner a fee in order to cover the costs associated with the preparation, execution, and recording of all pertinent documents, which fee can be waived by the general partner. Once the proposed transferee agrees to comply and be bound by the terms of the FLP agreement, the general partner is normally required to provide a written consent to the transfer. However, the FLP agreement frequently allows the general partner, in his, her or its sole and absolute discretion, to withhold such consent.

VII Annual Exclusion Gifting Using Family Limited Partnerships - TAM 9751003 Requires your Attention

Many taxpayers making gifts of FLPs intend the gifts to qualify for the annual exclusion. On December 19, 1997, the IRS ruled in TAM 9751003 that gifts of FLP interests did not qualify for the annual exclusion because they were classified by the IRS as gifts of future interests. The IRS ruling concludes that although title in the limited partnership interests was vested in the donees, the gifted limited partnership interests lacked the “tangible and immediate economic benefit required under Code § 2503(b) for a present interest in property.”

In TAM 9751003, the donor claimed annual exclusions in her gift tax returns for each gift of limited partnership she had made to family members and to trusts for the benefit of minor family members. The issue was whether the limited partnership interests gifted by the donor were gifts of present interests in property; that is, whether the donees have the right to a substantial present economic interest. In its analysis, the IRS stated that for purposes of Code § 2503(b), a gift may be separated into its component parts, one of which may qualify as a present interest, others of which may not. TAM 9751003 states that if the component comprising the corpus of the gift does not satisfy the present interest requirement but the element comprising the income gifts does, an annual exclusion may be allowed for the gift of the income rights. However, according to TAM 9751003, a right to income is a present interest only if at the time of the gift there is a requirement for a steady and ascertainable flow of income to the donee.

In denying the annual exclusions claimed against the donor’s gifts of limited partnership interests, the IRS noted that the FLP agreement provided that: (i) income would be distributed to the limited partners in the “complete discretion” of the general partner; (ii) the general partner could retain funds within the partnership for future partnership expenditure; and (iii) the general partner could retain funds for **any reason whatsoever**. The IRS pointed out that such authority in the general partner is extraordinary and outside the scope of a business purpose restriction. The TAM states that the power in the general partner “effectively obviates the fiduciary duty ordinarily imposed on a general partner and clothes the general partner with the authority to withhold income for reasons unrelated to the partnership.” Due to such authority in the general partner, the IRS reasoned, it was uncertain, at the time of the gifts, whether any income would be distributed to the limited partners. Accordingly, the income component of the limited partnership interests did not entitle the donees to the immediate use, possession or enjoyment of the income and was not a present interest for purposes of Code § 2503(b).

Further, the TAM stated that there were certain restrictions in the FLP agreement that prohibited certain actions that could otherwise be taken by limited partners. The FLP agreement provided that a donee partner could neither assign a gifted partnership interest, nor could he or she withdraw from the partnership or receive a return of capital contributions until the year 2022. Although all partners had consented to certain payments to the partners and to certain transfers, such consents did not void the provision in the FLP agreement. Therefore, the IRS stated the donees were given an economic right requiring joint action with others, which constitutes a future interest.

Certain provisions in a FLP agreement, such as retained management rights which substantially limit rights ordinarily provided to limited partners in normal business relations, restrictions on distributions of net income, limitations on sale, liquidation, assignability or transferability of FLP interests, and/or restrictions on limited partner withdrawal rights, should be avoided to the extent they may result in causing the transfer to be characterized as future interests based upon TAM 9751003. However, such provisions are sometimes desired by the persons creating the FLP for non-tax purposes (such as asset protection or enhancement of valuation discounts).

Some ways of avoiding an IRS position that gifts of FLPs are future interests are the following: (i) providing in the FLP agreement that the general partner is required to make annual distributions of dividend and interest income to the partners if funds are available, or to distribute net cash flow to the general partner and the limited partners on a pro-rata basis to cover the partner's federal and state income tax liability attributable to the FLP, (ii) expressly stating in the FLP agreement that the general partner owes a duty of loyalty to the limited partnership, such that the general partner's determination to make annual distributions be made taking into account said duty of loyalty, and (iii) vesting the general partner with fiduciary obligations to the donees and requiring limited partner approval for any amendment to the agreement of FLP. However, care should be exercised not to include language that, while ensuring qualification for annual exclusion gifting, could cause a great reduction in valuation discounts. Providing a right of first refusal may assist in qualifying a gift for annual exclusions, but such a provision may be contrary to the donor's objectives of maintaining control over family members' dispositions of gifted limited partnership interests and protecting family members from creditors' claims.

There have been numerous recent articles written on the potential consequences of the position of the IRS in TAM 9751003. See, e.g., Mulligan, Dealing With the IRS' Arguments Against Family Limited Partnerships, 26 Est. Plan. 5 (June 1999); Adler, Wrong Wording Kills Exclusion for Limited Partnership Interest Gifts, 27 Tax'n for Lawyers 98 (September/October 1998); Kalinka, Should Gifts of Limited Partnership Interests Constitute Future Interests?, 98 Tax Notes Today 85-131 (May 4, 1998); Kove & Koskow, Gifts of Family Limited Partnership Interests Did Not Qualify For Annual Exclusion Rules IRS, 25 Est. Plan. 185 (May 1998); Hausman, Family Limited Partnerships, 98 Tax Notes Today 2-72 (Jan. 5, 1998).

TAM 9751003 can be distinguished from Private Letter Ruling 9415007, released on April 15, 1994. In that ruling, the IRS held that gifts of limited partnership interest will constitute gifts of a present interest that qualify for the annual exclusion under Code § 2503(b). In that ruling, the general partner had exclusive management control over the FLP, including full discretion to

determine the amount and timing of distributions to the Partners, provided that if the general partner directs a distribution of partnership funds to the Partners, distributions must be made to all partners at the same time in accordance with each partner's percentage interest in the FLP, based upon such partner's capital account. PLR 9415007 stated that under the terms of the FLP agreement and applicable state law, the general partner had a fiduciary duty to the limited partners to manage and operate the FLP in the best interests of the FLP and its partners. Under the terms of the FLP agreement, no partner was entitled to demand a distribution or a return of his capital account. However, the **partners were granted the right to sell their interests to third parties, subject to a right of first refusal** granted to the other partners. PLR 9415007 held that the management powers possessed by the general partner under the FLP agreement, including the power over partnership distributions, are similar to the powers possessed by general partners in most limited partnerships. Thus, the general partner's powers were not the equivalent of a trustee's discretionary authority. PLR 9415007 also notes that each donee will receive the immediate use, possession enjoyment of the limited partnership interest, "including the right to sell or assign the interest (subject to the right of first refusal)." PLR 9415007 concludes that the proposed gifts constitute gifts of present interest.

Tax practitioners should be certain that FLP agreements are reviewed to determine whether an amendment may be advisable in light of TAM 9751003, assuming that ongoing gifts of limited partnership interests are anticipated to be made to take advantage of annual exclusion gifting. Certainly, a more conservative approach would be to have taxpayers make gifts of assets other than FLP interests in order to take advantage of annual exclusion gifting. However, many clients have formed FLPs with an express view towards making leveraged annual exclusion gifts and accordingly, a dilemma exists based upon TAM 9751003 and the potential that the IRS may take the position that gifts of limited partnership interests do not qualify for the annual exclusion.

VIII Filing of Gift Tax Return to Start Statute of Limitations

Code § 6501(c)(9) was enacted as part of the Taxpayer Relief Act of 1997. This Code Section provides that if the gift tax statute of limitations expires, it also expires for estate tax purposes, provided that the gift was reflected on a gift tax return or in a statement attached to a gift tax return in a manner adequate to apprise the IRS as to the nature of such item. The Restructuring and Reform Act of 1998 (the "1998 Act") modified Code § 6501(c)(9) as well as Code § 2001(f). According to the Explanation to these Code Section revisions, the new provisions clarify that in determining the amount of taxable gifts made in preceding periods, the value of prior gifts is the value of such gifts as finally determined, even if no gift tax was assessed or paid on such gift. Final determinations include: (i) the value reflected on a gift tax return (if not challenged by the IRS prior to expiration of the statute of limitations); (ii) in a case not described in (i) the value determined by the IRS (if not challenged in court by the taxpayer); or (iii) the value determined in court or in a settlement agreement by the IRS and the taxpayer. However, if the gift is not shown on the return or is not "adequately disclosed," the statute of limitations never runs. This provision became effective for gifts made after August 5, 1997. See Code § 2001(f) and 6501(c)(9).

According to the Committee reports to the 1998 Act, it is intended that in order for the IRS to revalue a gift that was adequately disclosed on a gift tax return, the IRS must issue a final notice of redetermination of value (a "final notice") within the statute of limitations applicable to the gift

(i.e., generally within three (3) years from the filing of the return adequately disclosing the gift). It appears that for annual exclusion gifts to be subject to the three (3) year statute of limitations rule, such gifts must be reported and adequately disclosed on a gift tax return based upon Code § 6501(c)(9). With regard to what constitutes adequate disclosure for purposes of Code § 6501(c)(9) in order to trigger the running of the statute of limitations period, the Conference Committee Reports to the 1997 Act amending Code § 6501(c)(9) state that the rules governing the statute of limitations under Chapter 14 shall be extended to all gifts. Accordingly, based upon Reg. § 301.6501(c)-1(e), it appears that a gift will be regarded as adequately disclosed on a gift tax return if the return includes, with respect to the transfer or a series of transactions of which a transfer is a part:

- (i) a description of the transferred interest and its value;
- (ii) the identification of all persons involved in the transaction, including their relationship;
- (iii) a detailed description of how the transferred asset is valued, including any relevant actuarial factors and discount rates; and
- (iv) with respect to non-actively treated assets, the financial and other data used in determining value, including balance sheets and statements of net earnings, operating results, and dividends paid for each of the five years immediately before the valuation date.

It appears that until new Regulations are written, very detailed disclosure will be required. See Blattmachr & Zaritzky, Estate Taxpayer Relief Act of 1997, 87 J. Tax'n 133 (Sept. 1997). This type of disclosure will be essential to grant any degree of certainty that, after the passage of three years, the issue of valuation for gift tax purposes is settled. Blattmachr and Zaritzky suggest that in order to assure the broadest commencement of the statute of limitations, taxpayers should consider attaching a copy of their income tax returns to the gift tax returns. This procedure arguably would put the IRS on notice of all transfers that are disclosed on the income tax return, including those which the taxpayer believes not to be taxable gifts. See Id.

Based upon Code §§ 2001(f) and 6501(c)(9), taxpayers now have an incentive to fully disclose gifts on a gift tax return. Many taxpayers who make taxable gifts are willing to do so only to the extent that they are not obligated to pay gift taxes. However, some may desire to also take advantage of potential valuation discounts. The new legislation may permit a strategy for making fully disclosed gifts. For example, a conservative taxpayer may consider forming a family partnership and gifting limited partnership units having a liquidation value of \$625,000 (in 1998, assuming no prior taxable gift), but an appraised value of approximately \$400,000 (net of valuation discounts). If fully disclosed on a gift tax return for a gift made after August 5, 1997, it would appear that the IRS would have to challenge the valuation within three (3) years of the date of the filing of the gift tax return, even if the value of the gift as shown on the gift tax return does not result in any gift tax payable (i.e., because of the unified credit). Assuming the IRS does not timely challenge the gift tax return, then the taxpayer can make use of his or her remaining unified credit (applicable exclusion amount) by making an additional gift without having to be concerned that the first gift could be revalued for gift or estate tax purposes. Further, to fully benefit from this rule,

annual exclusion gifts (especially those taking advantage of valuation discounts) or gifts of assets that are difficult to value with absolute certainty should be adequately disclosed on gift tax returns so the taxpayer can assert that valuations of such gifts cannot be challenged after the three (3) year statute of limitations period. Clients should consider making annual exclusion gifts for amounts slightly in excess of \$10,000 (after discounts) to avoid an IRS argument that a gift tax return is not required to be filed for gifts of \$10,000 or less, and that, accordingly, the statute of limitations with respect to such gifts did not commence when the gifts (of \$10,000 or less) were initially reported on a gift tax return. This is particularly recommended in cases where no other gifts requiring the filing of a gift tax return were made by the taxpayer for such year.

IX Payment of Florida Documentary Stamp Taxes on Transfers of Real Property

According to Florida Statutes § 201.02(1), a purchaser of real estate is required to pay documentary stamp tax at the rate of \$.70 on each \$100 of consideration paid for the property. Moreover, “consideration” is defined to include, but is not limited to, money paid or agreed to be paid, discharge of an obligation, amount of a mortgage, purchase money lien or other encumbrance, whether or not the underlying indebtedness is assumed. If the consideration paid or given in exchange for real property or any interest therein includes property other than money, it is presumed that the consideration is equal to the fair market value of the real property or interest therein. Pursuant to the provisions of the Florida Administrative Code, a conveyance of real property to a corporation in exchange for shares of its capital stock or as a contribution to its capital is subject to tax and a conveyance of real property to a partnership in exchange for a share in its capital is subject to tax. See Fla. Admin. Code Rule 12B-4.013(7) and (10). Depending on the county where the real estate is located, there may be other fees in addition to the documentary stamp tax. Miami-Dade County, for example, assesses a surtax for commercial properties at the rate of \$.40 on each \$100 of consideration paid.

On May 15, 1998, the Court of Appeal of Florida for the Second District decided the case of Kuro, Inc. v. State of Florida Dep’t of Revenue, 713 So.2d 1021 (Fla. 2d DCA, 1998), rehearing denied ___ So.2d ___ (June 24, 1998), petition for review denied ___ So.2d ___, Lexis 2352 (Fla. November 23, 1998), where Kuro, Inc. (“Kuro”) challenged a final order of the Department of Revenue (“DOR”) assessing additional documentary stamp tax on certain conveyances of realty to Kuro from its two stockholders. In Kuro, father and son owned certain realty. In order to avoid exposure to potential personal liability arising from the management of the realty, they incorporated Kuro and transferred the realty thereto by warranty deed. The deed recited nominal consideration of \$10 and minimum documentary stamp taxes were paid on the transaction. DOR conducted an audit and determined that additional documentary stamp taxes should be assessed. Upon Kuro’s protest, a hearing was held before an administrative judge who found that a taxable exchange had occurred and recommended the assessment of additional documentary stamp taxes. DOR entered a final order assessing additional documentary stamp taxes and Kuro appealed.

The Court of Appeal disagreed with the DOR’s conclusion that the stock issued by Kuro in exchange for the realty was consideration equal to the fair market value of the realty, and therefore held that the assessment of the additional documentary stamp tax was improper. In reversing, the Court of Appeal concluded that Kuro was not a purchaser within the meaning of Florida Statutes § 201.02(1) and that no additional taxes were due. The court stated that a “purchaser” is “one who

obtains or acquires property by paying an equivalent in money or other exchange in value,” and Kuro had paid nothing for the transfer of the realty. The court further stated:

Kuro paid nothing for the transfer of the condominiums. Though the transactions affected a change in the legal ownership of the property, the beneficial ownership of the land remained unchanged. These were mere book transactions and, otherwise, were not sales to a purchaser as contemplated by Section 201.02(1). . . At the time the deeds herein were transferred and recorded, the Rabaus owned all of the real estate and all of Kuro’s stock. They thus received nothing from the corporation that they did not already have. The fact that the stock issued by Kuro acquired a value equivalent to that of the real property transferred does not change our opinion.

Frequently, real property is conveyed into a FLP in exchange for no consideration other than an interest in the FLP (on occasion, as in Kuro, the transferor already owns an interest in the partnership). Many times when a person creates a FLP and conveys real property into it, such person’s beneficial interest in the real property conveyed to the FLP is exactly the same as it was before the transfer. Such facts are somewhat analogous to those in Kuro. Accordingly, when transferring Florida real property to FLPs, practitioners should consider the holding in Kuro and determine whether the client’s situation is analogous to the facts of Kuro. Clients who have already paid documentary stamp taxes on transfers in reliance on the Florida Administrative Code in situations analogous to those in Kuro should consider applying for a refund. The Assistant Counsel for the Department of Revenue stated that an application for a refund might be submitted on behalf of a taxpayer who believes he or she may be entitled to a refund based upon Kuro. While it is unclear whether and to what extent Kuro will be followed in other districts, the Department of Revenue, in a recent denial of a claim for refund in a FLP transaction, took the position that “Kuro will not be applied as being determinative of partnership transactions, it will be limited to shareholder-corporation transactions.” Nonetheless, if the transaction fits the material facts of Kuro (other than the distinction between an FLP and a corporation), it appears prudent to file a claim at this time for any documentary stamp tax payments on the transfer of real property to the FLP.

For those establishing FLP’s with real property, steps should be followed so that at the time the deeds are transferred and recorded, the transferors own all of the real property and all of the partnership interests in the FLP on a pro-rata basis in order that they, like Kuro, receive nothing from the partnership they did not already have. These issues will ultimately be resolved in the courts.

X Step Up in Basis of FLP’s Assets Upon Transfer by Owner.

A comprehensive discussion on Code § 754 is beyond the scope of this outline. However, § 754 must be considered in forming and administering a FLP. Section 754 provides that if the FLP elects, the underlying assets of the FLP can be adjusted with respect to: (i) the purchaser of an interest; or (ii) transferee by reason of death. The basis adjustment applies only to the transferee partner. The election under Code § 754 (“754 Election”) must be made by filing a written

statement along with the FLP return for the taxable year during which the distribution or transfer (such as a transfer resulting from the death of a partner) occurs. For the 754 Election to be valid, the return must be filed no later than the time prescribed for filing the return for such taxable year (including extensions). In order to file the 754 Election resulting from the death of a partner, the FLP must have the fair market value of the FLP reported on the deceased partner's estate tax return. Appraisals may be necessary to support the fair market value determination.

XI Fiduciary Accounting Issues for Partnerships Held in Trust

As the use of FLPs has increased in popularity, trustees will be faced with difficult decisions in allocating FLP distributions between principal and income. Potential conflicts can arise as described below:

Florida Statutes § 738.08 provides that if a trustee continues a "business" in which the donor was a partner, the net profits of the partnership computed in accordance with "accounting principles" of a comparable business, are income. Net profits are typically computed on the accrual basis and include capital gains. Whether Florida Statutes § 738.08 applies to a FLP may depend on whether the FLP was a "business." If so, a fiduciary must determine the appropriate meaning of the term "net profits computed in accordance with accounting principles."

If Florida Statutes § 738.08 does not apply (i.e., because the donor was not a partner in the FLP during his lifetime - such as an after-acquired FLP interest - or because there was no "business"), receipts from a FLP should be allocated as provided in Florida Statutes § 738.02(1)(c) between income and principal in a reasonable and equitable manner considering the interests of those entitled to income as well as those entitled to principal, taking into account the manner in which men of ordinary prudence would act in the management of the property of another. As illustrated by the following example, a potential problem under the Principal and Income Act can arise during FLP administration.

Example: H and W are married, both for the second time. Both have two children from a prior marriage. H creates a FLP and a will leaving his children \$312,500 of marketable securities each and the remainder of his estate in a QTIP trust for W. During H's lifetime, the FLP invested in raw land that was subdivided. The parcels were about to be sold at a substantial profit about the time H passed away. The successor general partner was able to finalize the sale and the land, which had a basis to the FLP of \$500,000, was sold for \$5 Million. If the marital QTIP trust was fully funded prior to the sale of the land, it seems that W would expect that \$4.5 Million as FLP income be distributed to her. However, H's children are likely to protest because if the property had been owned by H outright rather than in a partnership, the gain would be principal and not income. Florida Statutes § 738.03(1)(f) and 738.08 appear to be the controlling provisions. Florida Statutes § 738.08 provides that if a trustee uses any part of the principal in the continuance of a business of which the settlor was a partner, the net profits of the business, computed in accordance with accounting principles for a comparable business, are income. A literal reading of the statute would result in all ordinary as well as capital gain income of the FLP being allocated to income. However, H's children are likely to challenge said result by arguing that the proceeds of the sale are attributable to a distribution of substantially all the assets of the FLP, and that, accordingly, said proceeds should be allocated to principal.

This area presents difficult issues due to the uncertainties resulting from the existing Florida Statutes. Any trust intended to hold interests in FLPs or other pass-through entities, the treatment of which is not clearly addressed by the Principal and Income Act, should provide guidance through the trust instrument. For example, the trust instrument could include language giving the trustee discretion to determine whether items not expressly governed by the Principal and Income Act should be charged or credited to income or to principal, as the trustee may deem equitable and just under all circumstances. Practitioners, however, should be extremely careful that the marital or charitable deductions are not adversely affected when a trustee is granted discretion to allocate amounts between income and principal.

Some previously unresolved issues in the Principal and Income Act are clarified by the 1997 Principal and Income Act, which was approved by the National Conference of Commissioners on Uniform State Laws on July 31, 1997. For example, the 1997 proposed revisions to the Act explain how such partnership income is to be allocated. Nevertheless until the 1997 revisions are adopted into law by each state, many such issues remain uncertain. Furthermore, to avoid disallowance of the Marital Deduction, the changes to the 1997 Principal and Income Act have limited applicability to FLP interests owned by Marital Deduction Trusts.

XII Freezing of Valuation Discounts

There have been numerous articles published recently which address existing options that are available to freeze the FLP benefits under existing law. Some of these articles are listed below.

Hesch, Installment Sale, SCIN and Private Annuity Sales to a Grantor Trust: Income and Transfer Tax Elements, 23 Tax Mgmt. Est., Gifts & Tr. J. 114 (May 1998).

Oshins, King III & McDowell III, Sale to a Defective Trust: A Life Insurance Technique, 137 Tr. & Est. No. 5, 35 (Apr. 1998).

Smith, A Sale to an Entity Trust Will Have Better Results Than a Sale to an Intentionally Defective Grantor Trust or a Transfer to a GRAT, 23 Tax Mgmt. Est., Gifts & Tr. J. 86 (Mar./Apr. 1998).

Mulligan, Sale to an Intentionally Defective Irrevocable Trust for a Balloon Note – An End Run Around, 32 U. Miami Est. Plan. Inst., Chapter 14 (1998).

Covey, Practical Drafting, pp. 4833 to 4835 (Apr. 1997), pp. 4746 to 4747 (Jan. 1997), and pp. 4365 to 4370 (Apr. 1996).

Budyak, Estate Freeze Rules Affect Partnership Valuation Discounts, 25 Tax'n for Law. 228 (Jan./Feb. 1997).

Shore & McClung, Beyond the Basic Superfreeze – An Update and Additional Planning Opportunities, 75 Taxes 41 (Jan. 1997).

Nicholson, Sale to a Grantor Controlled Trust: Better Than a GRAT?, 37 Tax Mgmt. Memo 99 (Apr. 15, 1996).

Mulligan, Sale to a Defective Grantor Trust: An Alternative to a GRAT, 23 Est. Plan. 3 (Jan. 1996).

Hamill, Intrafamily Sales of Appreciated Assets Offer Attractive Wealth Transfer Opportunities, 13 J. of Tax'n of Inv. 153 (1996).

CONCLUSION

As discussed in this article, there are myriad of issues that must be considered, not only with regard to the creation of a FLP, but also, and more importantly, with the proper administration, operation and management thereof. As practitioners, we must closely follow the continued development of this area of law by monitoring pertinent statutes and rulings as well as IRS pronouncements in order to determine whether revising existing documents and/or instituting new procedures may be necessary or desirable. The process is, undeniably, a challenging one to all parties involved. However, as long as clients have a clear understanding that the use of FLPs involves administrative complexities and legal uncertainties, they can make an informed business decision as to whether the anticipated tax benefits surpass the cost, expense and complexities associated with the use of a FLP.

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Exhibit 1
IRS Questionnaire

1. All documents relating to the creation of the partnership (including bills) from any attorney, accountant or firm involved in recommending the creation of the partnership or in drafting the partnership agreement. If a claim is made that any of these documents are [sic] privileged, identify each privileged document by date, source, audience, and reason for the privilege.
2. Original partnership agreement and all amendments thereto.
3. Articles of incorporation of the general partner, if the general partner is a corporation.
4. All documents that were prepared to meet state law requirements on the formation and operation of the partnership (i.e., Certificate of limited partnership which has the filing date stamp on it and all amendments thereto; stamped copies of annual reports; supplemental affidavits on capital contributions, etc.).
5. All partnership financial statements and tax returns prepared and/or filed since inception.
6. All of the partnership's bank and other records (i.e., general ledger, cash receipts and disbursements journals, check registers, etc.) which reflect the amount and nature of all deposits and distributions, including distributions to partners, for the period since the partnership was formed to the date of death/current date.
7. Minutes of all partnership meetings; if none, indicate the dates of all meetings and the business discussed.
8. Evidence showing how the value of each partnership asset was arrived at as of the date:
 - a. it was contributed to the partnership;
 - b. of each gift of a partnership interest; and
 - c. of the death of the donor; provide all appraisals and supporting workpapers obtained of the partnership's assets, including partnership interests and any discounts.
9. Evidence to substantiate all initial and subsequent capital contributions and the source of all contributions by partners other than the donor/decedent.
10. For any partnership asset that has been sold or offered for sale since the formation of the partnership, provide evidence which documents the sale or attempted sale (i.e., sale agreement, listing agreement, escrow statement, etc.)

11. For each partnership asset, explain/provide:
 - a. evidence that the partnership owns the asset (i.e., deeds, bills of sale, other title changes, and account statements);
 - b. when the donor/decedent acquired the asset;
 - c. how the asset was used by the donor/decedent since its acquisition and how the partnership has used the asset since (i.e., held for rent; personal residence, investment, etc.); and
 - d. who managed the asset prior to and after its contribution; explain in detail what the management consisted of and how it changed after the partnership was formed.
12. Brokerage statements reflecting the ownership and activity of the securities and mutual funds contributed to the partnership for the period beginning one year prior to the formation of the partnership and continuing through the current date, and copies of any other tax returns and financial statements which reflect the activity of the partnership assets, if different from the foregoing.
13. For each gift or transfer of a partnership interest, provide:
 - a. evidence that the partnership interest was legally transferred under state law and under the partnership agreement;
 - b. any assignment of partnership interest prepared;
 - c. the terms of the assignment, if not indicated in a written assignment;
 - d. the amount and source of any consideration paid;
 - e. an explanation of how the amount of the consideration was arrived at.
14. Provide the following with respect to the donor/decedent, all other original partners and any recipients of gifts or transfers of partnership interests:
 - a. date of birth;
 - b. education and occupation;
 - c. experience and expertise in dealing with partnerships, real estate, financial affairs and investments; provide tangible evidence thereof;
 - d. extent of the donor's/decedent's investments as of the date of the formation of the partnership, including a summary of assets that were not contributed to the partnership; provide tangible evidence thereof; and
 - e. any personal financial statements and credit applications which were prepared in connection with loan applications after the partnership was created.
15. Indicate whether the partnership is currently in existence, and, if so, provide the current ownership interests.
16. Provide a summary of any other transfers of partnership interests not reflected in the gift tax returns filed.

17. A statement describing the donor's/decedent's state of health at the time of the formation of the partnership and for the six-month period prior thereto, including a description of any serious illnesses. Please also provide the names, addresses and telephone numbers of all doctors who would have knowledge of the donor's/decedent's state of health during this period to the present date and provide these doctors with authorization to respond to the Service's future requests for information, including a copy of the medical records, if necessary.
18. The Donor's/Decedent's will, revocable trust, and any executed power of attorney, if not submitted with the return.
19. A statement indicating the identity of the parties recommending the use of the partnership, when the recommendations were made, and the reasons set forth in support of the partnership.
20. Names, addresses, and current telephone numbers of the representatives of the Donor/Estate, all donees/beneficiaries, all partners, accountants/ bookkeepers, and brokers/investment advisors.

**Exhibit 2
Filing Checklist**

Corporate General Partner

| Item | Date Due | Date Completed |
|------------------------|--|-----------------------|
| Tax Return (Form 1120) | March 15 | |
| Intangible Tax Return | To receive discount, return must be filed by the end of the following months as follows: February (4%), March (3%), April (2%) or May (1%). To avoid penalties, return must be filed by June 30. | |
| Annual Report | May 1 | |
| Annual Minutes | It is suggested that they be completed in December. | |
| Special Minutes | Whenever there is any meeting at any time other than that of an annual meeting. | |

Family Limited Partnership

| Item | Date Due | Date Completed |
|--|--|-----------------------|
| Tax Return (Form 1065) | April 15. Note: Partners have to file personal income tax return (April 15) or corporate income tax return (March 15), as the case may be, on their distributive shares of partnership taxable income. | |
| Intangible Tax Return | To receive discount, return must be filed by the end of the following months as follows: February (4%), March (3%), April (2%) or May (1%). To avoid penalties, return must be filed by June 30. | |
| Annual Report | December 31 | |
| Meeting to: (i) confirm annual distributions to partners and management fees to general partner made during the course of the current year, and (ii) formulate a plan of operation for the coming year | December | |

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