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Familiy Limited Partnership (FLP) - Business Succession Planning

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SPM SELECT PORTFOLIO MANAGEMENT, INC.
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Minimizing Taxable Value of Business (Estate Freeze)

What is minimizing the taxable value of your business?

Estate taxes can erode value of your business

As a business owner, you may be concerned about what will happen to your business after you die. Most business owners want to ensure that their businesses pass on to their children intact, but with high funeral costs and other final expenses, this may not happen unless they plan ahead. If you do not provide for adequate liquidity (i.e., your estate must have enough cash) to pay these costs, your business may have to be sold or otherwise disposed of, and your heirs may not receive what you intend for them to have.

For example, when you die, a variety of taxes may be imposed on the assets in your estate, including state death taxes, the state gift tax, the federal gift and estate tax, the state generation-skipping transfer tax (GSTT), and the federal GSTT (collectively referred to as estate taxes). Planning for estate taxes is essential because, with rates as high as 45 percent for estates of persons dying in 2008, this could be one of the largest expenses your estate will pay.

Estate is valued

In order to plan for estate taxes, you must have some understanding of how they work. Estate taxation works much like income taxation, except that, of course, estate taxes are imposed on your estate, not on your income. Generally speaking, your estate is defined as:

- Property owned by you (or deemed to be owned by you) at the time of your death (gross taxable estate), and
- Certain gifts you made during life (taxable gifts)

Basically, this is what happens: A value is established for the assets that are included in the gross taxable estate and taxable gifts. For further information, see Valuation. These values are added together, resulting in the gross taxable value of your estate. The subsequent application of certain allowable exemptions, exclusions, and deductions results in the net taxable value. The net taxable value is then multiplied by the appropriate tax rate, resulting in the tentative tax owed. Allowable credits are then subtracted from the tentative tax to compute the net tax owed. The lower the taxable value of your estate, the lower the tax. For more information on computing estate taxes, see Estimating Estate Tax Liability.

Estate tax liability illustrated

The following table illustrates the calculation:

1.	Gross Taxable Estate	+	Taxable Gifts	=	Gross Taxable Value
2.	Gross Taxable Value	-	Applicable Exemptions/ Exclusions/Deductions	=	Net Taxable Value
3.	Net Taxable Value	x	Applicable Tax Rate	=	Tentative Tax

4. Tentative Tax - Applicable Credits = Net Tax Owed

If your business is the largest asset in your estate, the greatest portion of estate taxes that may be imposed on your estate will be based on your business ownership interest. It is especially important for you to understand the strategies and techniques available that may help reduce the taxable value of your business and thus help to reduce any estate taxes that may be owed.

Possible to reduce taxable value of business

There are strategies that you can implement now while you are still living that may reduce the taxable value of your business. These are called inter vivos strategies. There are also techniques that can be used after your death, such as special use valuation or deferred payment of estate taxes (Section 6166). These are called post-mortem techniques. The following discussion does not concern post-mortem techniques and refers to inter vivos techniques only. For more information on post-mortem techniques, see Minimizing Estate Taxes through Post-Mortem Techniques.

Estate freeze

There are many inter vivos strategies that reduce the net taxable value of your estate (e.g., maximizing the available tax exemptions, exclusions, deductions, and credits). But probably the most obvious strategy is simply to remove an asset from your estate while you are living so that it is not included in your estate at death. This reduces the gross taxable value of your estate. This strategy is called an estate freeze.

An estate freeze places a ceiling on the value of your business and controls your estate's tax liability. In addition, the estate freeze may also result in income tax savings. It is, therefore, a powerful estate planning tool that allows you to ensure adequate liquidity to preserve your business and pass it on to your children. For more information on estate freezing techniques in general, see Estate Freeze.

A quick lesson on the estate tax system

To understand the strategies and techniques available to help minimize the taxable value of your business, it is useful to have some understanding of how the estate taxation systems work. What follows is a quick lesson. For a comprehensive discussion, see Estimating Estate Tax Liability and State Death Taxes.

Federal taxes

Federal taxes are imposed on wealth that you transfer to others either during your life as gifts (gift tax) or at your death through bequests (estate tax). Together, gift tax and estate tax are referred to as transfer taxes.

This is how the federal transfer tax system works: Generally, taxable gifts are reported, and any gift tax owed is paid annually (generally, you must file a gift tax return, Form 709, and pay gift tax due, if any, by April 15 of the year following the year in which you make a taxable gift). Upon death, taxable gifts are added together with your gross taxable estate for estate tax calculation purposes, even though a gift tax return may already have been filed and gift tax paid (gift tax paid is deducted from estate tax owed). The value of gifts brought back into your estate is the gift property's fair market value(FMV) at the time the gift is made. Or, in other words, the property's value is frozen when the gift is made. The federal transfer tax system works this way so that (1) you can't avoid estate tax by giving your wealth away before you die, and (2) you pay tax on the cumulative amount of wealth you give away (this pushes your estate into a higher tax bracket).

> **Example(s):** George owned property valued at $200,000. He gave $100,000 to his friends, paying gift tax on $100,000 in the amount of $1,800 (assume no other variables). George kept the other $100,000. Two years later, George dies, and the $100,000 he kept is now worth $125,000. The IRS adds the gift George made to George's current assets to compute his taxable estate. George's taxable estate is $225,000 ($100,000 + $125,000). The tentative estate tax owed on $225,000 is $4,050. The gift tax George paid at the time of the gift is subtracted from the tentative tax, so George's estate owes $2,250 in estate tax ($4,050 - $1,800). There is also a transfer tax called the

generation-skipping transfer tax (GSTT). This is an additional flat tax (at a rate equal to the highest current estate tax rate) that is imposed on transfers you make (either during life or at death) to skip persons--persons who are two or more generations below you (e.g., your grandchildren).

State taxes

Your estate may also be subject to state gift tax and/or state death taxes. These tax systems vary from state to state. Generally, you pay gift tax on lifetime gifts (currently, only a handful of states impose gift tax), and your estate pays estate tax (called death taxes) only on property in your estate at the time of your death (all states have some form of death tax). Some states also impose a GSTT. For more information, see State Death Taxes.

How does an estate freeze minimize taxes?

Removing assets from your estate before death may not avoid taxes altogether, but it may help to minimize these taxes. This may be accomplished in several ways.

Eliminates future appreciation from your estate

Probably the biggest tax savings result from removing future appreciation from your estate. This happens because gifts that are brought back into your estate for estate tax purposes are valued at the gift property's FMV at the time the gift is made (its frozen value).

Generally, businesses increase in value over time. Removing the business today keeps the appreciated value out of your estate later. The amount subject to tax will be less today than it will be in the future.

Example(s): Darcy purchased improved real estate for $150,000. Five years later, the property is now worth $300,000, and she expects that it will double in value during the next five years. Darcy wants to give the property to her daughter Ellen. If Darcy wants to save estate tax, she should make the gift now instead of later. Now, $300,000 will be subject to gift tax. In five years, $600,000 will be subject to gift tax.

The following table further illustrates this point:

Darcy's Property	Value Today	Value in Estate in FiveYears
Real estate (gifted)	$300,000	$300,000 (FROZEN)
Real estate (not gifted)	$300,000	$600,000 (APPRECIATED)

Takes advantage of the annual gift tax exclusion

The annual gift tax exclusion allows you to give $12,000 per donee to an unlimited number of donees without incurring federal gift tax. Generally, married couples can double the exclusion amount. This exclusion allows you to distribute your property tax free and potentially put your estate into a lower tax bracket.

Tip: Some states may have the equivalent of the federal annual gift tax exclusion.

Takes advantage of the applicable exclusion amount and GSTT exemption

The applicable exclusion amount (formerly known as the unified credit) offsets lifetime gifts and bequests (death-time gifts). The GSTT exemption works like the applicable exclusion amount for gifts made to skip persons. You may want to use the applicable exclusion amount and the GSTT exemption during your lifetime instead of waiting until your death because of the time value of money (i.e., money is worth more today than it will be tomorrow).

> **Tip:** Some states may also have the equivalent of the GSTT exemption and/or the applicable exclusion amount.

Shifts income to a lower income tax bracket

Because the income tax rate schedules are graduated, your total federal and state income tax burden may be reduced if income-producing assets are distributed among several family members rather than being concentrated in your hands only.

> **Caution:** Be careful if you are distributing business interests into the hands of minor children, however. Your potential federal income tax savings of transferring income-producing property to your minor children may be reduced by the kiddie tax.

Shifts capital gains to a lower income tax bracket

Federal and state capital gains tax on the sale of appreciated property may be reduced by transferring the property to a family member who is in a lower income tax bracket or who has losses to offset the gain.

What are your options?

There are many inter vivos techniques that can be used to implement an estate freeze in order to ensure adequate liquidity and preserve your business for your children.

Family limited partnership (FLP)

A family limited partnership (FLP) is currently a very popular technique for reducing the taxable value of your business. An FLP is a limited liability business entity created and governed by state law and is generally limited to members of a family. Besides the tax-saving results discussed previously, an FLP also qualifies for certain significant discounts. In addition to the tax-saving benefits, an FLP (1) lets you keep control of the business and (2) provides liability protection for all the limited partners. However, an FLP is a relatively complex form of entity, and it should be organized with care. In addition, because an FLP is a separate entity, all formalities of existence must be carefully followed and maintained.

Private annuity

A private annuity is the sale of property in exchange for a promise to pay you income for the rest of your life. You (the seller or annuitant) transfer complete ownership of the property to the other party (the purchaser or obligor). A private annuity avoids transfer taxation because it is classified as a sale, not as a gift. Property removed from your estate through a bona fide sale is not subject to transfer taxes, although the sale may be subject to capital gains taxes. A private annuity is a good technique if you have no other source of income and need the income from the business to support yourself.

Buy-sell agreements

A buy-sell agreement is a legal contract common in closely held businesses. It is an agreement you can enter into now that provides for the future sale of your business interest. Under the terms of a buy-sell agreement, the buyer may be legally obligated to buy your interest in the business from you (or your estate), and you (or your estate) may be legally obligated to sell your business interest at the occurrence of a specified triggering event. When the triggering event occurs, there is a ready buyer for the share of the business. The buy-sell agreement may, under the right circumstances, set the FMV of an interest in the business when the agreement is executed. When the agreement is structured properly, the IRS will accept the taxable value as FMV as long as certain conditions are met.

Gifts

A gift is simply the act of transferring your business interests to another party without receiving something of at least equal value in return, no strings attached. You can gift your business outright or in a trust. As well as enjoying tax savings, gifting your business to your children can result in many personal rewards (e.g., seeing your children enjoy your generosity). However, giving away your business also means giving up control, so you must be prepared to let go of the business.

How do you choose which option is right for you?

You should consider your personal goals in conjunction with your tax-saving goals in order to choose which option may be right for you. Some of the things you might want to think about include the following:

- Will your estate have enough cash to pay for your funeral and other final expenses?
- Do you want to reduce income taxes?
- Are you uncomfortable about giving up control of your business?
- Are your children capable of managing the business on their own?
- Do you need income from the business to support yourself?
- Do you trust your heirs to make annual payments to you?
- Do you mind formalities?
- Do you want to keep the cost of implementation down?
- Do you want to protect your business assets from the claims of creditors?
- Do you want to see your children enjoy the benefit of your generosity?

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