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UTILIZING FAMILY LIMITED PARTNERSHIPS

I. ESTATE REDUCTION THROUGH GIFT GIFTING:

A. Generally: If the net value of your estate exceeds the Unified Credit Amount, currently \$675,000, your estate is potentially subject to the federal gift or estate tax. The tax rates begin at 37 % and increase up to 60 %. The Unified Credit Amount is increasing each year until 2006, when it will be \$1,000,000.

1. Under current law, each donor can give any number of recipients \$10,000 during each calendar year without requiring a federal gift tax return or requiring the payment of any tax. A gift that exceeds \$10,000 is a "taxable gift", and your Unified Credit Amount exemption is diminished. Once the \$675,000 exemption has been used up, a gift tax must be paid on each gift in excess of \$675,000.00.
2. Each donor can also reduce his or her estate by paying directly for tuition and medical expenses for family members or friends. There is an unlimited gift tax exclusion for qualifying payments of tuition or medical expenses. This is in addition to the \$10,000 annual gift tax exclusion amount and is permitted without regard to the relationship between the donor and donee. The payments can be for family members or friends. Payment must be made directly to the educational institution or the medical facility. Only direct tuition costs are included, not payment for books, or dormitory costs. The exclusion for medical care is not allowed for any amounts reimbursed by an insurance company. Allowable medical expenses include fees and costs related to diagnosis, cure, mitigation, treatment, or prevention of disease for any purpose affecting the functioning of the body. This means some physical therapies, prescriptions and qualifying living facility expenses are allowed. This is often an important consideration when providing care for an aged parent.
3. The federal gift tax and the federal estate tax are essentially the same tax, but there are some important differences. First, there is no \$10,000 exclusion for the estate tax. Second, once the exemption has been used up, the gift tax is paid in addition to the gift, whereas the estate tax is paid within 9 months of death on the entire taxable estate including the gift.

B. Gifting: Most people would rather not give their assets away, but many are willing to do so if it will save federal estate taxes. There are many types of gifts, but some are more effective than others at reducing the value of an estate for federal estate tax purposes.

1. Giving away cash is very simple and straightforward, but it is usually one of the least effective methods of reducing one's estate. A cash gift eliminates the cash and its potential earning power.
2. Giving away appreciating property is a more effective use of the exemption, since it covers the current value of the gift, the potential earning power, plus the potential appreciation.
3. Giving away undivided interests in property can be even more effective, since the value of the gift can be discounted. For example, suppose you own forty acres of land that has been appraised at \$200,000. If you give away ten acres, the gift is presumably worth \$50,000. If you instead give away a 1/4 undivided interest in the forty acres, the fractional interest would be harder to sell and could justify a discount for lack of marketability. Perhaps the discounted value of the gift would be \$40,000 depending on the property and all market conditions.
4. Giving away minority interests in family businesses is one of the most effective way that gifts can be maximized. A family business could be a corporation, but a family limited partnership or Limited Liability Company (LLC) is usually more appropriate. Limited partners or non-managing LLC members have no vote, and even the gift of a

minority interest of a general partnership is entitled to a significant discount. Using the example in paragraph 3 above: (1) if you give away ten acres out of forty, the gift is presumably worth \$50,000; (2) if you give away a 1/4 undivided interest in the forty acres, perhaps the discounted value of the gift would be \$40,000; but (3) if you place the property into a limited partnership and give away one-fourth of the limited partnership "units" (like "shares" in a corporation), those nonvoting shares can be valued at \$25,000-35,000 for gift-tax purposes, thus significantly reducing the gross value of your taxable estate.

II. FOCUSING ON LLCs AND LIMITED PARTNERSHIPS:

A. LLC and Limited Partnerships vs. Other Entities: The gift-tax consequences of minority interests can be accomplished through corporations and general partnerships, and those entities may be appropriate for your situation.

1. On the other hand, there are significant tax disadvantages that can occur when real estate is owned by a corporation, particularly at the time the corporation is liquidated. Some of those disadvantages can be diminished if the corporation elects to be taxed as an "S corporation", but it is possible to inadvertently lose S corporation status.
2. Also, most gifts are given to children and grandchildren, and the parents do not want to give the powers of a general partner to the offspring, and the children do not really want the attendant liabilities either. For both parties, the limited partner's lack of personal liability and lack of voting control are an appropriate combination.

B. Creating A Limited Partnership or LLC: A limited partnership is formed in Nevada (and in other states that have adopted the Revised Uniform Limited Partnership Act) by having two or more partners execute a partnership agreement and a certificate of limited partnership. The certificate of limited partnership is filed with the Secretary of State and in the county of the principal place of business.

1. Initially, the creators of the partnership make a capital contribution to the partnership, ideally consisting of appreciating assets. The partnership gives them back partnership interests, usually in the form of a certificate showing partnership "units", much like the shares of stock in a corporation.
2. The partnership "units" are issued in two classes: general partnership units and limited partnership units. The general partners have the control and the limited partners are entitled to income distributions. If there are several general partners, they will often select a "managing partner" to handle the partnership affairs during the ordinary course of business.
3. A Limited Liability Company (LLC) is formed by filing articles of organization (like corporate articles of incorporation) with the Secretary of State. Additionally, an operating agreement setting forth the ground rules (such as division of income, payout procedures if dissolution occurs), is signed by the members (owners). The operating agreement is not publicly filed, but is a private agreement between the members.

C. Disadvantages: A limited partnership or LLC is a separate legal entity, and certain formalities must be observed.

1. All transactions must be done in the correct order. While it is possible to gift assets to a child and then have the child contribute the assets to the LLC or partnership, the gift is not a gift of a limited partnership interest, and the gift-tax discount may not be as significant.
2. No partner can have an interest in any specific asset. Any attempt to allocate partnership assets to specific partners or members will usually frustrate the intent of the entire transaction.
3. All transactions relating to the property must be done through the LLC or partnership. The property cannot be treated as though it belongs outright to the members or partners. If a member or partner want to use property for personal use, he or she would normally be required to pay a reasonable rent for the use of the property.
4. There will be additional accounting and legal fees over the years. Federal tax returns must be filed for the entity, and each owner must report his or her share of partnership income, whether or not such income was actually distributed. State reports have to be filed annually, and a resident agent must be appointed to accept notices and summonses in the event of litigation.

III. CONCLUSION:

A. Control: A limited partnership or LLC allows you to reduce your estate without losing control. The general partners or managing members are in control of the business, and the limited partners or non-managing members have no vote except to replace a general partner or managing member whose interest is terminated under the terms of the partnership agreement.

B. Maximizing Gifts: Limited partnership interests (and sometimes LLC interests) in a family venture are unmarketable and without control, and therefore have little value. Discounts of 25-30% are considered conservative, and sometimes a greater discount can be reasonably justified.

C. Caveat: Gifts of partnership/LLC interests must be carefully structured so that the donor does not retain interests that negate the benefits of the gift. Care must be taken so that the entity is not characterized as an "estate freeze", which can happen if you, the donor, try to shift appreciation to the next generation by attempting to fix artificial liquidation values for your retained interest. If you try the "estate freeze" game, then the value of your gifted partnership interests will be valued under Chapter 14 of the Internal Revenue Code (which replaced IRC § 2036(c)), which usually results in undesirable gift tax consequences and which can even result in an assessment of gift tax and estate tax on the same transfer.