A R T I C L E

The 95% family-owned test for family limited partnerships

By Dan W. Holbrook

The Achilles heel of the federal transfer tax system is that, constitutionally, it is a tax on the *transfer* of property, not a tax on the property itself. Estate planners routinely organize their clients' assets in such a way as to minimize the value of any transfer, even if the underlying assets are unchanged. Trusts can often do this. Since 1993, another popular vehicle for this purpose has been a family limited partnership, or FLP (or sometimes an LLC). Their use has been like a series of good news/bad news jokes.

Bad news: When a majority business owner gave away only a minority interest, the IRS invoked a theory of "family attribution" to deny any discount in value for the transferred interest, despite such interest, when viewed by itself, clearly lacking control and lacking marketability.

Good news: In Revenue Ruling 93-12, IRS acquiesced after a series of court losses, largely eliminating the threat of family attribution, and permitting significant discounts in the value of asset transfers. Overnight, FLP's became standard estate planning tools. Assuming a valid partnership under state law, that very law defines the rights of the limited partners, who are genuinely limited indeed. When those limited interests are viewed in isolation, their fair market value is often substantially less than their proportionate liquidation share of the underlying assets of the FLP. Only a qualified appraiser could determine the effect on value of all those limitations on rights, so the appraisal industry boomed after 1993, and the "battle of the appraisers" became routine.

Bad news in Tennessee: As of Jan. 1, 2000, Tennessee extended its Franchise and Excise Tax (F&E tax) to all limited liability entities, even those with little or no actual business operations. For FLP's created primarily for estate planning, that created an immediate annual cash drain, of 1 percent of asset values, plus 6 percent of net income, which had to be weighed against the other tax and non-tax benefits of the FLP. In reaction, some Tennessee taxpayers eliminated their tax exposure by converting to a general partnership before Dec. 31, 1999, while others reduced their exposure by creating out-of-state FLP's, or by accelerating gifts of FLP interests, after which they hoped in a few years to terminate the FLP.

Good news in Tennessee: Under Section 59 of Chapter 982, signed by Gov. Sundquist on June 28, 2000, adding new *Tenn. Code Ann.* Section 67-4-2008(a)(8), an FLP is exempt from the F&E tax if it meets two conditions: (1) 95 percent family-owned; and (2) substantially all the activity of the entity is the production of passive investment income. Many estate planning FLP's should be able to meet these tests.

Bad news: The effective date is uncertain. Section 53 of the Act makes the entire Act effective for tax years *ending* on or after June 28, 2000, so for most FLP's the effective date should be Jan. 1, 2000. In that case, no F&E tax return would ever be due. On the other hand, Section 60 of the Act quite inconsistently makes Sections 39 through 42, and 44 through 59, effective "upon becoming law," *i.e.*, June 28, 2000. This would make FLP's pay the tax for a partial year through June 28, presumably pro-rated on some equitable basis. In the face of such legislative inconsistency, the Department of Revenue has graciously construed Section 60 to allow Section 59 to apply to tax

years *ending* on or after June 28, 2000, as well.

Good news: Section 18 of the Act adds other exemptions, one of which could be used by an FLP as an alternative means to avoid the F&E tax if the effective date is not retroactive. Specifically, another new exemption, also labeled *Tenn. Code Ann.* Section 67-4-2008(a)(8) [there must have been some late-night eleventh-hour drafting going on here], allows the partners to file an election to have all partners fully liable for the obligations of the entity, in which case the F&E tax is inapplicable for that year. This is apparently a year-by-year election, although the Department of Revenue has indicated it does not view it that way. Either way, this does provide a mechanism to opt in or out of the F&E tax in different years.

Bad news: In order for Section 18 to apply for the year 2000, the election had to be filed by Sept. 15, 2000. Only a fortunate few were filed by that date.

Good news: Even if Section 60 applies, and an FLP fails to make the Section 18 election for the year 2000, the amount of F&E tax is still much less than it would have been, and the tax is no longer applicable after June 28, 2000. Presumably the taxpayer was already willing to pay the F&E tax anyway in order to obtain whatever benefits were expected from the FLP's existence.

Bad news: To be exempt, the FLP must be 95 percent family-owned. This may appear simple, but it is not. One must first draw a family tree, and then find any individual on that tree (what I would call the measuring life) where enough other family members within the prescribed degrees of kinship from that measuring life collectively own at least 95 percent of the partnership interests. If no such measuring life can be found, the test is not met. Must the measuring life be an owner? The statute does not require it, although without that limitation one might be tempted to use Adam or Eve as the measuring life, since all descendants of the measuring life are included. Perhaps genealogy, and proofs of distant common ancestors, will play a vital role in the F&E tax! More importantly, "Members of the Family" does not include trusts, except trusts and estates created at death by an existing owner. This limitation is appalling to estate planners, for whom trusts are as vital as oxygen. Another exemption under Section 18, adding new Section 67-4-2008(a)(6), exempts farms and personal residences owned in an FLP where at least 95 percent is owned by "relatives," defining "relatives" to include trusts for the benefit of individuals, proving that the legislature could have expanded its definition to include trusts, but did not.

Good news: The solution in many cases where the 95 percent test is not met will be to divide the FLP into two or more new FLP's, with at least one FLP exempt. Of course, this may be good news only for the attorneys who must draft more FLP's. Another solution when a trust is already an owner is to distribute the FLP interests to the beneficiaries. Where a beneficiary is a minor, the distribution can be under the Uniform Transfer to Minors Act, to age 21, or perhaps to age 25 under the special exception of *Tenn. Code Ann.* Section 35-7-221.

Bad news: To be exempt, substantially all the *activity* of the FLP must be the production of *passive investment income,* defined as rents, royalties, dividends, interest, annuities, and sales or exchanges of stock or securities to the extent of any gains therefrom. Again, this seems simple, but it is not. What is "substantially all"? The Department of Revenue has interpreted this to mean 2/3 of gross receipts, but "activity" could occasionally be quite different from "receipts." Or consider that raw land is a common asset of FLP's. If there is no income, and therefore no "activity," does the exemption apply? Should an FLP with raw land negotiate a lease of at least $10 per year for hunting or grazing, or perhaps purchase an annuity paying the FLP $10 per year, to prove "activity"? Why is receipt of annuity payments considered activity anyway [the insurance lobby may have had something to do with this]? Why is sale or exchange of stock or securities an exempt

activity but not sale or exchange of real estate? Do interests in other family partnerships qualify as "securities"?

Good news: The obvious purpose of this exemption is to carve out from F&E taxation those FLP's that are not really operating a going concern, and exist primarily as a vehicle for collective family investment, family buy-sell agreements, and other family purposes, including transfer tax savings. In that light, one would hope the Department of Revenue will take an enlightened and expansive view of the exemption where it is intended to apply. The department has recently provided guidance on its web site, and we may also see legislative clarification later this year.

Dan W. Holbrook practices estate law with Holbrook & Peterson, PLLC, in Knoxville. He is certified as an Estate Planning Specialist by the Tennessee Commission on Continuing Legal Education and Specialization, is a Fellow of the American College of Trust and Estate Counsel, and serves on the TBA Probate Study Committee reviewing and recommending legislation involving trusts and estates in Tennessee. He can be reached at dholbrook@hpestatelaw.com.

Tennessee Bar Journal
January 2001 - Vol. 37, No. 1

© Copyright 2001 Tennessee Bar Association