The Opportunity of a Lifetime

Eternal Investments and Your Taxable Estate

While many families focus on being wise stewards of the wealth that God has entrusted to them while they're living, they often forfeit their greatest opportunity to impact the Kingdom by not planning wisely for the transfer of their wealth at death. While everyone knows "you can't take it with you," a majority of Americans have nevertheless failed to make wise plans for all they will leave behind. And the unfortunate reality is that most families fail to take advantage of provisions under the current tax laws that would allow them to maximize charitable giving through their estate.

THE WELL-PLANNED ESTATE: A LOOK AT ONE FAMILY'S SOLUTION

Steve and Nancy had an estate valued at $15 million. Having focused much of their time on building a successful family business, the couple had not given much thought to how their assets would be distributed at death. Although they wanted to formulate a prudent estate plan, deciding how to proceed was no simple matter. Steve and Nancy had four primary concerns:

1. They had a strong desire to leave a legacy of gifts to the Christian ministries they had faithfully supported throughout their lives.
2. With regard to inheritance, Steve and Nancy wanted their four children to benefit from their estate, but they were also concerned about their children receiving too much, too quickly.
3. They did not want their successful family business to be shut down or sold to others upon their deaths, but preferred to see that business continue to thrive under the family's management.
4. There was the issue of potential estate taxes. Planning for the estate tax is a challenge because the future of the tax is uncertain due to frequent changes by Congress. While Steve and Nancy were more than willing to pay required taxes, they did not want their lack of estate tax planning to needlessly reduce their ability to make charitable gifts from their estate.

Eventually, Steve and Nancy met with their financial advisor who introduced them to an innovative planning technique that would help them pass assets to their children, make generous gifts to their favorite charities, avoid shutting down the family business, and wisely plan for their estate tax obligations.

To begin, their advisor asked Steve and Nancy to think about an amount they would like to pass on to each of their children. He suggested they imagine their estate, in cash, and in a bowl in the middle of the table. Then he asked: "How do you want to share this estate? Would you give it all to your children? Would you give it all to charity? Or, would you want a combination of these options?"

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After prayerful consideration, Steve and Nancy reached the conclusion that it would not be wise to give each of their children one-fourth of the estate, which would be almost $4 million apiece. So they decided to divide the portion of their estate that could pass estate tax free to their children. For purposes of this example, we will assume a $3.5 million individual exemption from federal estate taxes, or $7 million total exemption for Steve and Nancy. So in this case, at Steve and Nancy's deaths, their children would receive $7 million, or $1.75 million each.

But there was a related hurdle affecting the ownership and management oversight of their family business, which had grown to a value of just over $8 million. Even though Steve and Nancy didn't want to immediately pass down all of their assets to the children, they hoped the kids could assume management, and eventually full ownership, over the family business.

Combining the couple's strong charitable intentions with a flexible planning tool known as the family limited partnership, their advisor proposed a way to avoid shutting down the family business while maximizing their charitable giving.

THE PERFECT PARTNERSHIP

A family limited partnership (FLP) is simply a traditional limited partnership in which the partners are family members. All limited partnerships are run by one or more general partners; the limited partners typically have no vote or management control of the business. Thus, a general partner might own only 1% of the business and yet manage and control 100% of the assets.

When a limited partnership interest is transferred to an individual or entity, the value of the limited partnership interest is discounted—that is, it is deemed to be worth less than the value of the underlying asset. For example, if a person received an asset worth $1,000 but was given limited control over the asset (having limited power to sell, invest, or assign the asset), its practical value would be something less than $1,000. The amount of the discount varies from case to case. In this example, we will assume that Steve and Nancy's appraiser utilized a 30% discount rate.

To address Steve and Nancy's charitable and estate planning objectives, they established an FLP and placed the majority of their business interest and other investment assets into it during their lifetimes. Then they made provisions through a separate trust for 1% of the Steve and Nancy Family Limited Partnership (S&N FLP)—representing the general partner interest and all of the voting control—to pass outside their estates to their children, which might include a lifetime transfer. This transfer would be included within Steve and Nancy's $7 million exemption from gift and estate taxes.

Their estate plans also directed that the remaining limited partnership interest of 99% be gifted after their lifetimes to a donor-advised fund. The value of the underlying assets transferred in this manner amounted to $8 million (discounted by 30% to $5.6 million for estate tax valuation purposes), representing the balance of Steve and Nancy's estate after the $7 million in estate gifts to the children. Steve and Nancy's estate received a charitable contribution receipt (potentially up to $5.6 million ($8 million less the 30% discount).

Prior to this gift, the couple faced a potential estate tax liability on $8 million of their estate. By making the gift at death, their professional advisor had explained that they now had successfully eliminated that tax because the transfer to the donor-advised fund qualified as a completed charitable contribution, thus removing that asset from their estate. Of course, their professional advisor also scheduled future meetings with Steve and Nancy to review their

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estate in light of growth of their assets, any changes in family circumstances, and changes in the laws.

This arrangement would also fulfill their desire for the children to ultimately enjoy full ownership of the family business. Upon Steve and Nancy's deaths, the children would be in a position to buy back the S&N FLP interest owned by the sponsoring charity of the donor-advised fund. This is a great option for all concerned because the sponsoring charity is typically limited in selling the partnership interest to others due to transfer restrictions, and the children desired ownership of the underlying assets, particularly the family business.

Accordingly, the children approached the sponsoring charity to negotiate a purchase of the S&N FLP interest owned by that sponsoring charity and allocated to Steve and Nancy's donor-advised fund. In exchange for a 15-year installment promissory note, Steve and Nancy's children acquired the S&N FLP interest from the sponsoring charity, repaying the promissory note with the liquid assets they inherited, as well as the future cash flow produced and distributed to them from the family business.

Since the children had already inherited the general partner interest, the sponsoring charity negotiated a price that reflected the applicable discount, in addition to any intervening growth of the business, plus a risk premium for receiving a promissory note rather than an immediate cash payment. Steve and Nancy's children agreed that a fair price for the S&N FLP interest was $6 million (just above the $5.6 million valuation), and completed the purchase.

Following this transaction, 100% of Steve and Nancy's assets were back with the family. The charity received a stream of income from the sale of the S&N FLP that was placed in the donor-advised fund so the charity could, in turn, support the ministries the family had recommended.

THE BOTTOM-LINE

Steve and Nancy's plan resulted in a charitable contribution receipt of $5.6 million for their estate; gifts of $7 million to their children immediately upon their passing; the ability for the children to purchase the business after Steve and Nancy's deaths; and over time, $6 million was granted by the sponsoring charity to the ministries they loved.

The couple thus transferred their entire $15 million estate without paying any estate tax, and the children received generous inheritances. Because the payment arrangements to the sponsoring charity's donor-advised fund were structured over a period of years—and the children were given the opportunity to make recommendations concerning the ministries to be supported—they learned to be generous in a significant and meaningful way. And of course, the children acquired full management control and ownership of the family business.

> This approach will often work with taxable estates of any size.

A PLAN FOR ANY SIZE

Remarkably, the approach used by Steve and Nancy will often work with taxable estates of any size, provided family plans include substantial charitable intentions and the family business provides enough cash flow to fund an installment purchase. For example, by carefully planning with their financial and tax advisors, even a family with an estate of $100 million or more could benefit from such a plan, yielding a current charitable contribution receipt, substantially reducing estate tax, keeping the family business in the family for future generations, and providing substantial support to the charities and ministries closest to their hearts. ■