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Financial Planning

Financial Planning With Family Limited Partnerships

Substantial transfer tax savings are possible through the use of an FLP if extra care is taken to treat it as a separate entity

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Family limited partnerships can provide benefits for both business and tax reasons. But the partnership must be created to meet specific needs and goals, and the operation of the entity must strictly adhere to the rules and regulations governing the partnership's proposed activities.

An FLP is a limited partnership where most of the partners are members of the same family. The law does not distinguish between a family limited partnership and any other type of limited partnership.

In an FLP, someone in the family is usually the general partner with control being retained by that family member. The children, a spouse or other family members are usually limited partners.

When the FLP is used to own family investments, the spouse and children are often the limited partners and a family member who is not susceptible to lawsuits is usually the general partner.

Formation and Operation

All the same requirements of a limited partnership must be followed to establish a valid FLP. Upon formation, the assets of the family are assigned or transferred into the FLP for ownership, management and control.

In most FLPs, the general partner retains a 1 percent interest, while the other family members share the remainder 99 percent interest as limited partners. Thus the general partner's exposure to risk of loss of property held by the FLP is greatly minimized.

Upon formation, the assets of the family are assigned or transferred into the FLP for ownership, management and control.

The general partner controls the operations of the FLP and makes all day-to-day management decisions. They can also receive a percentage of the FLP's income in the form of a management fee.

While limited partners have an ownership interest in the FLP, they have limited control. They share in the income generated by the FLP depending on how many shares of the FLP they own. But, as far as control goes, they have no say.

When the FLP is dissolved, a proportionate amount of FLP property will pass to each limited partner.

Typically, the terms of the partnership state that the partnership shall continue in existence until terminated upon the occurrence of the earliest of the following events:

- the bankruptcy, liquidation, dissolution or withdrawal of the general partner;
- the unanimous written agreement of the partners to dissolve the partnership;
- upon the sale or disposition of substantially all of the assets of the partnership and the cessation of business; or
- upon a specified date.

In addition, all distributions of cash flow shall be distributed to the partners based upon the sole discretion of the general partner.

Every agreement should include language which states that no limited partner may sell, assign, transfer, pledge, hypothecate, encumber or otherwise dispose of all or any portion of their interest without the prior written consent of each other partner.

A family limited partnership is typically taxed like a partnership whereby all income and deductions flow to the partners pro rata, based upon their respective interest. This can be changed by agreement, and IRS regulations may affect the income and deductions that flow through to each partner.

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The partnership must file tax returns with the federal government and distribute K-1s to the individual partners so that their share of the income and deductions of the partnership can be shown on their individual 1040s.

Unlike a regular corporation, there is no tax imposed on a limited partnership and, unlike an S Corporation, there is generally no tax when assets are conveyed from the entity to its partners. Limitations that apply to S Corporation ownership do not apply to family limited partnerships.

Financial Planning

By transferring a family business or family investments to a family partnership, the older members of a family are able to share the value of the assets with the younger members of the family while maintaining control over the assets and lowering their income and estate taxes.

In addition, the use of a family limited partnership serves as an effective tool for introducing the younger members of a family to the family business or investments while limiting any liability generally associated with the operation of such business or investment portfolio.

While maintaining as little as 1 percent of the equity in the partnership, the general partners can maintain full and complete control over the business or investment portfolio while gifting as many of the limited partnership units to the children as they desire. And, as discussed above, the general partner decides when and how to make distributions of profit and income to the limited partners.

The concentration of wealth into one investment entity may help to reduce investment costs and fees and may also allow for greater investment opportunities. By combining investments into one entity you may also be able to maximize your income tax and capital gains strategies.

Asset Protection

A certain degree of creditor protection is inherent in owning interest in a limited partnership. A limited partner's creditor cannot directly levy upon partnership assets and cannot take a limited partner's interest in a partnership.

Current law only allows for a charging order which requires that any financial distributions from the partnership to a particular partner be given to that partner's creditor. The response to such an order can be that the partnership simply reinvests earnings instead of making distributions.

Because of their lack of control, limited partner shares are very undesirable to creditors. Creditors will find it difficult to take hold of limited partner shares since they are not publicly traded.

If the partnership has earned income, but the general partner does not declare a distribution, each general and limited partner is required to report a proportionate share of the earned income on his or her personal tax return, without actually receiving any dollars with which to pay the tax. If a creditor is able to take hold of limited partner units, the creditor would be deprived of control, income and dissolution rights, and pay tax on a significant amount of income that technically does not even exist.

Another attractive feature of the family limited partnership is the ability to protect the partnership assets from your children's creditors or other persons who may have claims against their assets.

For instance, if one of the children were to declare bankruptcy or be put into receivership, his or her creditors would be severely limited in their ability to attach any of the partnership assets. The child's creditors could not order the liquidation of the partnership, disposition of partnership assets or a partition of any part of the partnership assets.

One of the biggest creditors in today's world is that of the soon to be ex-spouse. In the event a limited partner has a failed marriage, the FLP can be structured to protect assets and keep them in the family. The partnership can be used as a means to segregate the spouse's property.

Most courts are reluctant to award a partnership interest to the other spouse in a divorce proceeding. In the event that the court does award a partnership interest in a divorce proceeding, such events could trigger a buy-out provision that would enable the partnership interest to remain in the family.

Estate and Gift Tax

Another potential benefit of an FLP is the possible estate tax savings. If, aside from asset management, you also intend to gift or transfer partnership interests to other family members, there may be a tax savings opportunity.

Currently, each U.S. Citizen can pass $1,500,000 free of federal estate tax by using the estate tax credit (exemption equivalent). This credit against estate tax increases incrementally to $3,500,000 in 2009 until the tax is repealed in 2010, and then re-emerges in year 2011 as a $1,000,000 exemption once again. FLPs may allow you to pass on more than the current estate tax credit.

A major benefit of contributing assets to the FLP is that the values of the FLP interests are often less than the value of the assets held by the FLP. For example, real property held in an FLP and which is valued at $1,000,000 may be valued at only $750,000 if a 25 percent "discount" is applied. This $250,000 discount is worth $122,500 in estate tax savings to an estate in the 49 percent marginal tax bracket.

The discount in value is attributable to the fact that the FLP agreement, as outlined above, imposes restrictions on the sale of FLP interests and may reduce a limited partner's right to control the partnership assets. These restrictions may be control features that are desired because they help promote family unity, centralize control and, at the same time, reduce transfer taxes.

Careful planning is essential when applying estate or gift tax discounts to a transfer of a family limited partnership unit. There must be a business purpose other than simply tax savings to form a FLP. If the taxpayer does not have a nontax business purpose for forming the FLP, the estate and gift tax valuation benefits may not be allowed.

Some of the nontax business purposes for forming an FLP are as follows:

- provide resolution of any disputes that may arise among members of the family to preserve family harmony and avoid the expense and problems of litigation;
- maintain control of family assets;
- consolidate fractional interests in family assets;
- increase family wealth;
- establish a method by which annual gifts can be made without fractionalizing family assets;
- continue the ownership of family assets and restrict the rights of persons who are not members of the family to acquire interests in family assets;
- provide protection to family assets from claims of future creditors against family members;
- prevent the transfer of a family member's interest in the partnership as a result of a failed marriage;
- provide flexibility in planning not available through trusts, corporations or other entities;
- facilitate the administration and reduce the costs associated with the disability or probate of any estate of family members; and
- promote the family's knowledge of, and communication about, family assets and related investment decisions.

Recent Developments

Rather than challenging gifts of FLP interests, recent case law now indicates that the Internal Revenue Service is focusing its efforts on challenging the validity of FLPs as separate legal entities. IRS challenges have been successful where actions taken (or not taken) by a family cast doubt on the legitimacy of the FLP.

Although it is unlikely that a single activity, or lack thereof, will be decisive, a pattern of activity that indicates that a family has failed to treat the FLP as a separate legal entity may prove costly for an FLP. This could mean that the underlying value of the FLP assets, rather than the FLP interests, would be subject to transfer taxes.

In other words, the IRS would ignore the FLP for transfer tax purposes, and the entire value of the FLP could be subject to transfer taxes.

In *Estate of Strangi v. Commissioner*, an elderly client worth over $10 million transferred nearly all of his assets to a family limited partnership in exchange for a 99 percent limited partnership. The Tax Court allowed a 31 percent discount in valuing the interests for estate tax purposes. However, the government persuaded the Fifth U.S. Circuit Court of Appeals to remand so the Tax Court could consider the application of Internal Revenue Code section 2036(a).

The Tax Court decided sections 2036(a)(1) (retention of income) and 2036(a)(2) (retention of control over income) applied. This meant the partnership was ignored and the transferred assets were brought back into the taxpayer's taxable estate.

However, in *Lappo v. Commissioner*, decided after *Strangi*, the taxpayer made gifts of all the limited partnership interests in an FLP that held municipal bonds and two pieces of commercial real estate in Michigan. While, the court was critical of the expert witnesses for both the taxpayer and IRS, it ultimately determined a 15 percent minority interest discount from the partnership's net asset value and a 24 percent discount for lack of marketability. The combined discount was 35.4 percent.

To decrease the chance of an IRS audit, transfer assets to the FLP that require ongoing management — real estate, or interests in a closely held business. If only passive investment assets (marketable securities) are available, make sure there are reasons to continue the FLP's existence after the general partner's death, such as to centralize investment authority or to take advantage of investment opportunities not available on a smaller scale. And make sure: that you do not transfer personal use assets (a personal residence) to the FLP; you do respect the FLP as a separate legal entity; and that you never use FLP funds to pay personal expenses of the partners.

Due to the potential for challenge by the IRS, family members should try to follow as many of these suggestions as possible to substantiate the validity of the FLP. Given the substantial transfer tax savings that are possible through the use of an FLP, taking the time to manage and treat the FLP as a separate entity is worth the extra effort. ■