

Horizons

AN EXCLUSIVE PUBLICATION FOR LOYAL SUPPORTERS OF THE PI KAPPA ALPHA EDUCATIONAL FOUNDATION

Family Limited Partnerships Are An Important Weapon In The Financial and Estate Planning Arsenal



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Traditionally, family limited partnerships (FLP's) have been used to effect income-splitting and the shifting of wealth among family members, while keeping control in the hands of the older generation or family patriarch. These multi-purpose planning vehicles have been in use for over forty years. Because older generations typically have the wealth, they are able to retain control through use of an FLP while accomplishing important tax and financial objectives such as:

- ♦ **Income Tax Planning** - minimization of tax rates by shifting income to children and/or grandchildren in lower tax brackets.
- ♦ **Asset Preservation Planning** - pushing assets outside the reach of creditors and litigations.
- ♦ **Estate Planning** - minimization of estate taxes by using the \$10,000 per year per donee annual gift tax exclusion, unified credit exemption amount of up to \$600,000 for an individual or his estate, and nuances in the IRS valuation rules.
- ♦ **Financial Planning** - allowing the orderly, centralized and cost-effective management of family portfolios, real estate, life insurance and/or businesses,

It should come as no surprise that family limited partnerships have become *extremely* popular in the last few years due to their unique ability to accomplish some or all of these often elusive and competing objectives. As income tax rates and estate tax rates have climbed, tax deductions have been curtailed, and trusts have been subjected to a 39.5% income tax bracket, taxpayers have been racing to use FLP's in addition to, and in lieu of, trusts and other financial planning vehicles.

A limited partnership is a form of business authorized under state law, much like a corporation. Under state statutes, limited partnerships are protected from liability, provided that they do not materially participate in the management of the partnership. In the last three years, a majority of states have enacted laws creating similar entities called limited liability companies and limited liability partnerships. These new vehicles can be used as an alternative to the FLP, and carry the additional benefit of no

liability or reduced liability for the managing member or managing partner.

An FLP has one or more general partners who have the authority to manage the enterprise. General partners have no protection from a liability, which compels many of them to become incorporated in order to avoid liability. In a typical family limited partnership, only family members will own the partnership interests, although this is not a requirement. The partnership interests can be held by the grandparents, parents, and children. In fact, trusts for the benefit of these individuals may be partners and trusts which can "sprinkle" (allocate) cash distributions among children or grandchildren are allowable partners.

After the FLP is established, the persons who funded it, typically the grandparents or parents, hold the general partnership interests either outright or through a corporation in which they own shares and thereby control its Board of Directors. These structures give the older generation complete control over the FLP's operations even though they may own as little as one percent of the whole partnership. Consequently, control and centralized management can be maintained even where the general partners' (parents' and grandparents') economic interest is a fraction of the total economic value. An important feature of the FLP is that the general partner is entitled to receive compensation from the partnership for its management services. The greater the assets and activities of the partnership, the greater reasonable compensation becomes. Through such compensation, some measure of liquidity is provided to the parents serving as general partners.

In addition, there is no restriction on the amount of limited partnership interest which can be owned by the parents or grandparents. In some cases, parents may own 100% of the limited partnership interests. This allows the parents to fractionalize their assets and make gifts eligible for the annual gift tax exclusion (currently \$10,000 per donee per year) to their children via the limited partnership interests. In this manner, assets which are difficult to divide (such as land, family farms or family businesses) or those which require coordinated management for diversification or cost minimization objectives (such as a family stock and bond portfolio) can be "retained" for control and management purposes while "transferred" for income tax and estate tax purposes.

The parents or grandparents can make gifts of the limited partnership interests as they deem appropriate on a

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annual or periodic basis. One of the biggest advantages of using this approach is the highly favorable valuations given to the interests transferred in this manner. Under generally accepted valuation principles and Internal Revenue Service guidelines, the limited partnership units can be valued at a discount from their economic values. Parents can, therefore, transfer more assets faster to the younger generation without adverse estate and gift tax consequences. This discount obtains due to the lack of marketability of these units and lack of control afforded to the limited partners. Such discounts generally fall in the range of 20% to 40% and should be supported by written appraisals from a valuation firm or public accounting firm. Discounts of this magnitude and concomitantly low valuations may be warranted because independent third party buyers would not pay more for the same investment which they cannot sell or otherwise control, and on which they get taxed whether or not cash distributions are made. The IRS is currently considering the validity of these valuations and the "business purpose" justifications for these rules and the statute authorizing family limited partnerships.

To illustrate the mechanics, a gift qualifying for the annual gift tax exclusion made by two parents jointly to a child would generally be limited to \$20,000. If this gift were made via a limited partnership interest, subject to the minority position and lack of marketability discounts, the parents would be able to transfer approximately \$25,000 to \$33,000 depending on the valuation discount employed. This is a significant benefit to owners of family farms and family businesses who often have a difficult time passing them on to the next generation due to the magnitude of estate taxes (55% top marginal bracket). Because these assets are generally illiquid, the family is often forced to sell the farm or business to pay the estate taxes, even though the Internal Revenue Code contains some relief provisions. Conversely, by gifting limited partnership interests to children, parents can have their cake and eat it too. Specifically, they can (1) transfer ownership in "pieces" without cutting up the underlying family assets; (2) such transfers can avoid estate and gift taxes; and (3) future appreciation on the assets transferred (from the date of the gift to the date of death of the parents) can avoid estate and gift taxes. These financial and estate planning objectives are in and of themselves compelling; however, the advantages of FLP's don't end there.

Because the ownership interests (either initially or at the end of an annual gifting program) of the parents or grandparents in an FLP are typically small, there is little or nothing to be reached by future creditors. Moreover, any creditor who attaches a partnership interest is generally taxed on their share of partnership "income" whether or not any cash is distributed. The unwary and unhappy creditor would have to pay part of the family's income tax bill out of its own pocket. This potential result serves as a strong disincentive to litigation and creditor's collection efforts. Given the litigiousness of society in general and the inherently risky aspects of certain businesses (for example, manufacturing) and professions (for example, surgeons), sound financial planning warrants taking reasonable approaches to preserve the family estate from such litigation and risks.

Income tax benefits can also be derived because the FLP can effectively shift income to children who may be in lower income tax brackets than their parents. Generally, children under age 14 are taxed at the same income tax rates as their parents; however, from age 14 on, they are taxed at their own brackets which can result in significant savings to the family. For example, the parents may be in a 39.6% tax bracket while the children are in a 15% tax bracket. By having the income taxed to the children, the family will pay only 38% of the taxes they would have otherwise paid on at least some of the income. Until the children are fully employed and established in their careers or the family business, as the case may be, the tax savings to the family can be significant. If the children pursue graduate or post-graduate educations, these income-splitting benefits can go on from age 14 to age 25 or longer.

Family limited partnerships are excellent vehicles for holding securities portfolios, land, ranches, farms, and family businesses, which are the typical funding mechanisms. They are also an excellent repository for whole, universal, and variable life insurance. In fact they may be superior to the very popular irrevocable life insurance trust because the transferor (parent) insured retains almost absolute and unfettered control over the insurance policy even though the policy has been removed from his taxable estate. The parent general partner of an FLP does not have to go through a trustee or convince the trustee as he would if an irrevocable life trust were used. The parent with an FLP can act unilaterally on his own accord whenever he chooses to do so. Even greater tax and financial benefits can be achieved by establishing qualified and nonqualified benefit plans and executive compensation vehicles for the corporate general partner, and by combining an FLP with a grantor retained annuity trust (GRAT) which serves as a receptacle for gifts.

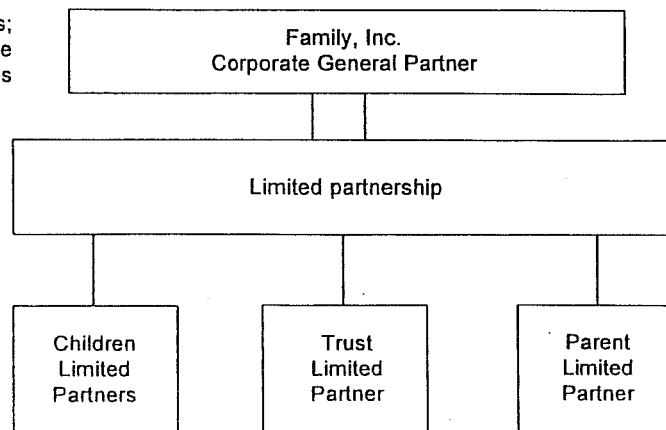
FLP's can also be used to effect estate freezes. An estate freeze is a financial planning technique for locking in the value of assets for estate and gift tax purposes held by the older generation. Conversely, the appreciation and growth potential associated with such assets are shifted to the younger generation so it accrues to them free of the estate taxes which would have been imposed if retained by the older generation. This bifurcation of assets is accomplished by creating different classes of partnership interests, which resemble preferred stock and common stock, respectively. This planning, although viable, is complex and is attended by several tax hurdles.

There is little downside to planning with family limited partnerships. They are, however, expensive to establish and require a measure of discipline to administer and maintain. Of course, there is always the threat of an IRS challenge or legislative changes. The wary taxpayer can greatly minimize these risks by adopting a reasonable approach in establishing an FLP, following the required formalities, and utilizing reasonable valuations.

The flexibility, attributes and advantages of FLP's clearly explain why they are so popular. Few vehicles, if any, can accomplish so many legitimate objectives which are typically competing within the tax, financial, and estate planning arena. FLP's may not, however, work in every family's case and each individual should consult with his own financial advisor and attorney before setting off in this direction. If you are interested in making a planned gift or bequest to the Pi Kappa Alpha Educational Foundation as part of your comprehensive financial and estate plan, please contact Foundation Executive Director Patrick F. Haynes.

Typical Structure of Family Limited Partnerships

* employees are parents; children can also be employees



* shares owned by family patriarch who is president and director