



Family Limited Partnerships Continue to Increase in Popularity

by Thomas Handler, Esq

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Family limited partnerships (FLPs) have become extremely popular in the last few years due to their unique ability to accomplish multiple financial planning objectives. In addition to their well-publicized ability to minimize estate taxes, FLPs can minimize income taxes, preserve assets from divorce or creditors and facilitate family portfolio management and gifting.

A limited partnership is a form of business authorization under state law, much like a corporation. Under state statutes, limited partners are protected from liability, provided they do not materially participate in the management of the partnership. In recent years, 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. These new vehicles are becoming increasingly popular, and for some purposes are superior to FLPs.

An FLP has one or more general partners who have the authority to manage the enterprise. General partners have no protection from liability, which compels many of them to become incorporated in order to, avoid such 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 grandparents, parents, or 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 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 generations 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' interest is a fraction of the total economic value.

In addition, there is no restriction on the amount of the limited partnership interests, 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 more 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 family stock and bond portfolio), can be “retained” for control and management purposes while “transferred” for income tax and estate purposes. The parents or grandparents can make gifts of limited partnership interests, as they deem appropriate on an annual 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 valuation principles, 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 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.

By gifting partnership liability interests to children, parents can have the best of both worlds. Specifically they can both: (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 the death of the parents) can avoid estate

and gift taxes. These financial and estate planning objectives are in themselves compelling; however the advantages of FLPs do not 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 the cash is distributed. The unwary or 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 litigate the creditor's collection efforts.

Income tax benefits can also be derived because the FLP can effectively shift income to children or grandchildren who may be in a lower income tax brackets. Generally, children under the age of 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 for 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 only pay 38% of the taxes they would have otherwise paid on at least some of the income. Until the children are fully employed and established their own careers or the family business, as the case may be, the tax savings to the family can be significant. If the children pursue post-graduate educations, these income-splitting benefits can go from age 14 to age 25 or longer. FLPs can be one of the best vehicles to fund educational or wedding costs.

Family limited partnerships are excellent vehicles for holding securities portfolios, land, ranches, farms, and family businesses, which are the typical assets contributed. 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 or her taxable estate. Even greater tax and financial benefits can be achieved by establishing qualified or nonqualified benefit plans and executive compensation vehicles for the corporate general partner, or by combining an FLP with a grantor retained annuity trust (GRAT) which serves as a receptacle for gifts. In addition, limited partnership interests can be used to make sales on a discounted basis to intentionally defective grantor trusts.

There is little downside to planning with family limited partnerships. Of course, there is always the threat of an IRS challenge or legislative changes. To date the Tax Court has supported taxpayer discounts in virtually all cases, which are not shams. Moreover congress has been unwilling to consider the Treasury's proposals to limit the use of discounts in some cases. Consequently, it appears FLP will be around for another 50 years.

The flexibility, attributes and advantages of FLPs 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.

