FAMILY LIMITED PARTNERSHIPS

Objective

A Family Limited Partnership ("FLP") can be a useful planning device for maintaining control of family assets, consolidating those assets and providing a collective family business venture while at the same time limiting the value of the assets for transfer tax purposes.

Description

The following will provide a useful illustration of how an FLP might work:

A husband and wife could each contribute property to an FLP in exchange for a 1% general partnership interest\(^1\) and a 49% limited partnership interest. Each partnership unit, whether general or limited, would equal a pro rata share of the value of the contributed property. An FLP would provide a convenient vehicle with which to effectuate lifetime gifts, including annual exclusion gifts, since limited partnership units could be used for gifts to family members or to trusts for their benefit, and as discussed below, certain discounts may be available to reduce the value of these gifts.

The general partners manage the business affairs of an FLP, and normal distributions are at the discretion of the general partners. Limited partners are not liable in excess of their respective capital contributions for any of the losses, debts or liabilities of the FLP.

The partnership agreement can be amended from time to time upon the written consent of all of the partners, general and limited.

Generally, no partner, general or limited, may withdraw from the partnership prior to its dissolution. A general partner will be liable for any damages created by his or her unauthorized withdrawal.

\(^1\) Caution: Given a recent line of cases in the FLP arena where the IRS has been successful in arguing for inclusion of the underlying partnership assets in the estate of the individual creating the partnership in some circumstances, even with respect to limited partnership interests that may have been gifted to others, if he or she is the general partner or if he or she retains sufficient control over the general partner, it may be inadvisable at this point for that individual to be the general partner or otherwise have control over the general partner, either directly or indirectly. Several of these cases are currently on appeal. Until decisions on these appeals are rendered, one alternative might be to have the individual’s children purchase the general partnership interest at the outset, or have another entity (an LLC for example) in which the individual creating the partnership has less than a majority interest in the entity act as the general partner. In addition, one need be mindful of avoiding various factors when forming an FLP to ensure that its underlying assets are not included in one’s estate, including but not limited to the following: personal and FLP assets should not be commingled, distributions should not be disproportionate with ownership interests, FLP funds should not be used for personal expenses and “testamentary characteristics” should be avoided. All of these issues should be discussed with your estate planning attorney.
Generally, the dissolution of an FLP will occur on a prescribed date or upon the written consent of all partners. The death or withdrawal of a general partner will also result in the dissolution of the FLP, unless the remaining partners vote to continue it.

**Income Tax Consequences**

The contribution of appreciated property to a partnership on its formation will not be a taxable event, unless the transfer (i) is to an “investment company” (a partnership in which more than 80% of the non-cash assets consists of readily marketable securities), and (ii) results in a diversification of the transferor’s interest. Depending on the composition of the assets transferred, diversification may occur where two or more persons transfer non-identical assets to the partnership.

Generally, an FLP will not be separately subject to income tax although it must file a separate tax return annually. Each partner, both general and limited, individually reports on his or her own return his or her proportionate share of the FLP’s ordinary income/loss, interest and dividends and capital gains/losses. Each partner annually receives a K-1 showing the proportionate share of these items that he or she must report on his or her return.

**Gift and Estate Tax Consequences**

Transfers of limited partnership interests qualify for the gift tax annual exclusion notwithstanding the general partner’s control over the timing of distributions to partners. Post-transfer appreciation and income generated with respect to the transferred FLP units inure to the benefit of the donee without the imposition of any further transfer tax.

An FLP provides a mechanism for making discounted gifts due to the availability of certain discounts that reduce, for gift tax purposes, the value of the FLP interests to well below the proportionate value of the underlying assets.2

If a limited partner cannot require that his interest be redeemed by the partnership at its net asset value, the interest’s value for gift tax purposes will reflect a discount for a minority interest (lack of control). In addition, a lack of marketability discount, which reflects a concern that there is not a ready market available for the FLP interest, will further reduce the interest’s value for gift tax purposes. Finally, under certain circumstances, if the limited partner cannot withdraw from the partnership, such as with the case of an FLP having a fixed duration, a “lock-in” element may even further reduce the value of the interest for gift tax purposes. These discounts can significantly reduce the value of the gifted limited partnership interests. In some cases, discounts in excess of 40% have been approved. These discounts provide a means to leverage the use of the annual exclusion and the gift tax credit.

The transferred (gifted) limited partnership interests will not be subject to estate tax in the general partner’s estate on his or her death even though the general partner has maintained management control of the FLP.

2 Under current law, taxpayers who make gratuitous transfers of fractional interests in entities such as FLPs routinely claim valuation discounts. The concept of valuation discounts originated in the context of active businesses, where it has been accepted that a willing buyer would not pay a willing seller a proportionate share of the value of the entire business when purchasing a minority interest in a non-publicly traded business. This concept has been carried over into the family estate planning area via the use of FLPs with marketable securities.
Planning Considerations

Some of the **advantages** of an FLP are:

1. The ability to achieve substantial gift tax discounts while transferring property to family members and still maintaining control.

2. The partnership interest is personal property; therefore, out-of-state tangible and real property owned by the FLP will avoid ancillary probate in that state along with the attendant costs.

3. Consolidating various family members’ assets in the FLP may reduce management costs.

4. Creditors of a limited partner cannot reach partnership assets, although they can reach the partnership interest itself.

5. In many cases, the FLP may be terminated without adverse income tax consequences.

6. The general partners have the sole right to determine whether the FLP will retain income or distribute income to its partners.

7. Since it may be impractical to divide certain assets, such as a family business, among several family members, such assets may instead be transferred to an FLP with the limited partnership interests gifted to the family members.

8. Most jurisdictions will not award separate property to a divorced spouse. The FLP provides a convenient means of segregating separate property.

The primary **disadvantages** of an FLP are:

1. Based on a recent line of cases, please see footnote 1 above. Uncertainty regarding inclusion of the underlying partnership assets in the general partner’s estate.

2. Uncertainty regarding the level of discounts available for gift tax purposes.

3. Uncertainty regarding the extent to which a lapse of a voting or liquidation right, or any restriction on liquidation rights, will be recognized for estate tax purposes.

4. Possible income tax recognition of capital gains when the contributed assets consist of marketable securities and the FLP is treated as an “investment company,” as discussed above.

5. Expenses associated with start-up of FLP (e.g., legal, accounting and administrative costs) as well as hiring an independent qualified appraiser to determine appropriate, defensible discounts to be taken on valuation of the FLP interests for gift tax purposes.

6. FLP income must be reported on the individual partners’ tax returns whether or not it has actually been distributed.
Caution: The Economic Growth and Tax Relief Reconciliation Act of 2001 was signed into law on June 7, 2001. The law makes substantial changes to the estate, gift and generation-skipping transfer (GST) tax systems, including increases in the applicable credits and exemption, incremental reductions in the tax rates and ultimate repeal in 2010 of the estate and GST taxes. The gift tax will remain in modified form. It should be noted, however, that the repeal of the estate and GST taxes is scheduled to last for one year only and the transfer tax system, as we knew it prior to the enactment of the law, will, without further legislation, be reinstated on January 1, 2011. In light of these changes, prior to making any transfer that may result in a taxable gift, you should consult with your estate planning advisors.