The Family Limited Partnership

The term "Family Limited Partnership" is the common name for a limited partnership created primarily to shift ownership of assets, and sometimes income, to family members. The Family Limited Partnership is an established estate-planning tool that, when properly established, can:

- Maintain 100% control of the assets in the partnership;
- Immunize assets from future creditors;
- Allow income from assets to be split among family members in lower tax brackets;
- Create a significant reduction in federal estate and gift taxation;
- Make annual gifting and lifetime gifting significantly easier.

The mixture of which benefits are most important or appealing to a particular individual varies.

A Family Limited Partnership ("FLP") is a partnership consisting of two classes of partners, general and limited. The general partners have 100% control and management of the partnership so long as they continue to own at least a 1% general partnership interest in the partnership. The limited partners are family members or trusts created for the benefit of family members. The limited partners have no control or participation in the day-to-day management of the FLP regardless of their percentage ownership.

The General Partner

The general partners of the FLP control the operation of the partnership. Even as little as a 0.10% general partnership interest gives the general partners 100% control.

General partners can be:

- Individuals
- A Corporation
- A Limited Liability Company
- Revocable Trusts
- Irrevocable Trusts

There are good reasons to avoid using individuals as general partners. If the limited partnership owns assets that could involve risk, the general partner assumes that liability exposure personally. Further, if the individuals die or become incapacitated, the law generally provides that the partnership terminates. A termination of the partnership can inadvertently destroy many of the estate planning benefits of the FLP. For that reason, we generally recommend that the general partner be an entity rather than an individual. There is no single best choice of entity for every situation.

In your particular situation, we believe that a corporation offers the most benefits as a general partner in view of the potential benefit programs that may be sponsored by a corporation.

The Limited Partners

The limited partners can be individual family members, but in most cases, we suggest alternatives to individual ownership which offer additional benefits. These are just a few examples of trusts that may own a limited partnership interest:

- Irrevocable Life Insurance Trusts
- Children's Dynasty Trusts
- Spousal Legacy Trusts

By making irrevocable trusts the owner of the partnership interests, an additional measure of asset protection is achieved. In addition, by proper allocation of your Generation Skipping Tax exemption to gifts to these irrevocable trusts, all of the future growth of the assets inside the partnership can escape estate taxation for several generations. The compounded effect of a multi-generation tax-free transfer can be very dramatic.

Appropriate Assets

Most assets can be transferred to an FLP and, generally, no gain or loss is recognized when assets are transferred to an FLP. There are, however, some assets which should not be transferred to an FLP. These include:

- Your Residence
- IRA's, Annuities, and Other Tax Qualified Retirement Accounts
- "S" Corporation Stock
- Professional Corporation Stock
- High Risk Assets
- Negative Equity Assets

The transfer of these assets into a limited partnership creates some adverse tax consequences.

Asset Protection Benefits

An FLP can protect assets from creditors in a lawsuit. When a judgment is entered against a limited partner of a limited partnership, state law provides that the creditor has no right to seize the assets inside the partnership or the partner's limited partnership interest. Creditors have no right to manage the partnership or to demand that distributions be made from it. Partnership law provides a creditor with only one way to collect his judgment: a "charging order".

A charging order allows the creditor to seize any distribution that is actually made to the limited partner, but not the assets inside the partnership. Since the creditor does not become a partner, there is no way for the creditor to force the general partner to take any action. This means that the creditor would be forced to wait until a distribution was actually made to the debtor-partner. There is an IRS ruling, Revenue Ruling 77-137, which strongly suggests that a creditor would have to pay income tax on the debtor-partner's share of partnership income, *even though* no distribution of cash was made from the partnership. This puts the creditor in the position of paying income taxes on money he never received. This is referred to as "Phantom Income."

The asset protection benefits of a partnership are not available, of course, when a judgment is entered against the partnership itself. For this reason, we often consider creating multiple partnerships to isolate risk-producing assets. We have recommended that you maintain your existing limited liability company ("LLC") to continue to hold its assets. This structure will prevent any liabilities associated with the LLC's assets from "infecting" the other assets of the FLP.

Estate Tax Discounts

One of the most important benefits of the limited partnership is a discount in the value of the taxable estate for gifting purposes and at death. The IRS values all assets owned by the decedent at the time of death at their fair market value. Fair market value is defined as the value at which property would change hands between a willing buyer and a willing seller.

Because limited partners have so few rights and so little control over partnership activity, limited partnership interests are not as valuable as the underlying assets held inside the partnership. This "discount" effect can allow you to move more assets to younger generations by gift during your lifetime. It can also reduce your estate tax liability at death.

Risks of the Strategy

FLPs offer significant estate planning advantages. They must, however, be structured very carefully in order to be fully effective. Every FLP must be established for legitimate, recognized business purposes other than estate and gift tax avoidance. In most cases, we recommend that any gifts made based on assumed discounts be documented by an independent appraisal. That represents an additional cost in creating the FLP.

When FLP interests are gifted, the donee family members receive the gift at the donor's basis on that portion of the FLP interest. When the donor dies, the interests of the FLP that have been gifted do *not* receive a step-up in basis to fair market value. In most situations, the ability to eliminate the estate tax is much more beneficial than the capital gains savings, but this factor should always be considered before gifts of partnership interests are made.

There are special considerations that must be taken into account when marketable securities comprise more than 80% of the partnership capital.

Limited partnership interests will generally not be acceptable collateral for any kind of a loan with a commercial lender. The FLP requires a yearly income tax return and you will incur accounting fees for the required tax return and bookkeeping. However, FLPs do offer tremendous estate and gift tax planning opportunities as well as asset protection benefits when structured properly.

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