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## FAMILY LIMITED PARTNERSHIPS

### What is a Family Limited Partnership?

A family limited partnership (“FLP”) is a partnership that is created by family members and funded with assets expected to appreciate in value and that the family members desire to maintain and control. In general, partners pool their assets and share income and loss from any enterprise or investment in which the partnership has an interest. Holding assets in a family limited partnership may entitle the partners to discounts for estate and gift tax purposes on the transfer of assets to the next generation. Following is a summary of how a family limited partnership is structured, and a discussion of some of the reasons for establishing a family limited partnership and the risks that should be considered when establishing a family limited partnership.

### Structure of Family Limited Partnerships

A limited partnership consists of general partners and limited partners. It may have one or more general partners, who may be individuals, corporations, limited liability companies, or other entities, depending upon state law. The general partners are the managers of the limited partnership and have unlimited liability for the activities of the partnership. If there are multiple general partners, one or more of the general partners may be designated as the managing general partner. The general partners usually have the right to determine who can be admitted as a new partner and the requirements for the transfer of a partnership interest to a third party. The general partners also decide how the assets will be invested, when distributions will be made, and the amount of such distributions.

A limited partnership may have one or more limited partners, who may be individuals, corporations, limited liability companies, or other entities, depending upon state law. The limited partners are passive investors with few, if any, management rights, and their liability is strictly limited to the amount of their investment in the partnership. Limited partners generally cannot transfer their interests without the approval of the general partners. Additionally, limited partners may not be able to withdraw from the partnership.

A family limited partnership is commonly created by parents, who serve, either in their individual capacities or through an entity, as the general partners of the family limited partnership. The parents transfer assets to the family limited partnership in exchange for general and limited partnership interests. The children may become limited partners by either transferring assets to the family limited partnership in exchange for a limited partnership interest or by receiving a gift of a limited partnership interest from a parent.

The partners generally share in the income and losses of the limited partnership in proportion to their respective percentage interests in the partnership.

Depending upon the terms of the partnership agreement and state law, a limited partnership may terminate upon the death of the general partner, upon a vote of all partners, after a specified term of years, upon the completion of its purpose, or in accordance with other provisions set forth in the partnership agreement.

### **Reasons for Creating a Family Limited Partnership**

The family limited partnership offers both tax and other advantages. Set forth below is a brief explanation of some of the benefits of establishing a family limited partnership.

***Control.*** While many parents wish to insure the financial security of their children, they do not want to give up complete control of an asset to their children. Therefore, they do not want to make any outright gifts to their children. A family limited partnership allows the parents to make a present gift of valuable assets while at the same time retaining control over those assets. As the general partners of the family limited partnership, the parents have the ability to determine how the assets will be invested, when distributions will be made, and the amount of such distributions.

***Facilitate Gifts.*** Creating a family limited partnership simplifies the making of gifts to the next generation. The parents may make gifts of their limited partnership interests rather than direct gifts of the underlying assets. The gifts can be made by simply signing a form without the necessity of reregistering securities or accounts. A gift of partnership interests will qualify for the gift tax annual exclusion and, if the gift is structured correctly, the exemption from the generation-skipping transfer tax. In addition to annual exclusion gifts, the donor can use a portion or all of the donor's remaining gift tax exemption to transfer more partnership interests to family members during the donor's life.

***Investment Vehicle.*** A family limited partnership can serve as an investment vehicle to consolidate assets and reduce the costs associated with the management of an investment portfolio for the family of the partnership's creator. A larger pool of assets also may allow the family limited partnership to gain access to investment opportunities that would not be available to single investors. The parents can also use the family limited partnership to provide their children with a financial education.

***Protection from Personal Creditors.*** A family limited partnership provides protection from creditors because the limited partnership interest is not an attractive asset to a creditor. It is more difficult for personal creditors of family members to gain recourse against their interests in limited partnerships than to attach investment assets that are directly owned by family members. Creditors generally cannot force the general partners to make distributions from the partnership or compel a liquidation, nor can creditors acquire the rights of a limited partner. A creditor's recourse is to obtain a charging order against a partner's partnership interest. The partnership agreement may also prohibit pledging of a limited partner's interest and may provide for a buy-out of the limited partner's interest in the event of any involuntary transfer of the limited partner's interest.

In addition, the partnership interest may be considered separate property of the partner in the event of dissolution of a partner's marriage. As extra protection in the event of divorce, the partnership agreement can require an assignee spouse to sell his or her assigned interest to the other partners.

***Flexibility.*** The partnership agreement can provide that the agreement can be amended or the partnership terminated by the consent of the partners without adverse tax consequences. This attribute makes a family partnership a more flexible estate planning tool than, for example, an irrevocable trust.

***One Level of Federal Income Taxation.*** Unlike a corporation, in which the corporation pays federal income tax at the corporate level and the shareholders are again taxed on the individual level, the partners of a family limited partnership are subject to federal income tax only at the individual level. Partnerships do not pay federal income tax. Instead, they "pass-through" all taxable items to their partners, who are then obligated to report such times on their personal income tax return and to pay any federal income tax due. Some states, however, may impose a state income tax on the partnership entity itself.

***Transfer Tax Discounts.*** Gifts of limited partnership interests may be discounted for valuation purposes, thereby permitting the donor to leverage the amount of wealth he or she is able to give away to family members. The characteristics of the partnership that might be regarded as negatives, for example, the lack of management control over assets and the inability to transfer partnership interests without the consent of the general partners, are the characteristics out of which substantial discounts may flow for transfer tax purposes. Discounts for lack of control and lack of marketability result from the restrictions on the limited partner's interest in the family limited partnership and the lack of a ready market for the purchase of the limited partner's interest. In determining the amount of the discount, several factors must be considered, including the specific provisions of the partnership agreement, the level of distributions to be made, and the financial risk to the limited partner.

The discounts can produce substantial transfer tax savings. For estate and gift tax purposes, discounts generally range from 25% to 40%, and can be even higher, depending on the circumstances. If the assets held in a family limited partnership are passive investments, such as stock, bonds, cash, or undeveloped real property, however, the discount may be lower.

The Internal Revenue Service has challenged these discounts and will doubtless continue to do so. Therefore, a family limited partnership must have a valid business purpose and not have as its sole purpose the reduction of transfer taxes. Some of the valid business purposes of a family limited partnership include the coordination of investments and protection of assets discussed above.

## **Costs and Risks**

There are certain potential disadvantages and costs of which donors should be aware in contemplating the creation of a family limited partnership.

***Determination of Valuation Discount.*** The partnership interests must be valued prior to any gifts of partnership interests, and gift tax returns must be filed when gifts of partnership

interests are made. As discussed above, the Internal Revenue Service reviews discounted gifts of family partnership interests diligently and has challenged many such discounts. If the valuation discount is challenged by the Internal Revenue Service and is not sustained upon audit or subsequent litigation, the donor may be subject to potential transfer tax exposure, and the donor may be required to apply a portion of his or her gift or estate tax exemption or generation-skipping transfer tax exemption to those gifts above the annual exclusion amounts that are then deemed to have been made to the donees.

***Contribution of Appreciated Property.*** Generally, contributions of appreciated property to a partnership do not cause immediate capital gains to the contributing partner. If, however, the partnership is treated as an “investment company” under the Internal Revenue Code, the general rule does not apply. For example, if the assets transferred to the family limited partnership by the parents differ substantially from the assets transferred by the children, the Internal Revenue Service could find that “diversification” had occurred. As a result of such diversification, a capital gain on the appreciated assets would be recognized, and the contributing partner would be subject to the resulting capital gains tax.

***Operation of Partnership.*** Caution is required with respect to the method in which the family limited partnership is funded. For example, in California, if the children contribute cash and the parents contribute real property, a change of ownership of the real property will be deemed to have occurred, resulting in a reassessment of the property and usually, an increase in real property taxes.

The existence of the partnership will create some additional accounting expenses and require the filing of an additional tax return. The partnership will also be subject to the limited partnership filing requirements under state law, as a family limited partnership must also comply with the formalities required by state law for the formation and maintenance of limited partnerships.

## **Conclusion**

Once a determination has been made to create a family limited partnership, a specialist should be consulted. The partnership agreement must comply with the requirements of state law, and, if obtaining a minority interest discount and a discount for lack of marketability is an objective, specific provisions should be incorporated into the partnership agreement. The method for transferring assets to the partnership must be designed to avoid triggering income or property tax problems. Finally, the partnership formalities must be followed and the transaction must be properly reported to the Internal Revenue Service.

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Please Albertson & Davidson, LLP at (951) 686-5296 for further information regarding family limited partnerships or any other estate planning options.

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