

## **Family Limited Partnerships (FLP)**

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### Objective

The objective of a Family Limited Partnership (FLP) is to transfer interests in real estate and other assets to family members at a reduced tax value and to possibly reduce the tax value of any interest in such assets retained at death.

### What is a Family Limited Partnership?

A FLP is a legal entity generally formed to manage family wealth and to serve as a building block for wealth transfer planning. It is often times referred to as an estate planning technique that allows families to transfer assets in a coordinated manner while achieving tax benefits.

### Structure and Control of Family Limited Partnership

A FLP is a limited partnership controlled by members of a family, which consists of two types of partners: general and limited. General partners control all management and investment decisions and ordinarily have a very small percentage interest in the partnership (usually one percent). Limited partners do not participate in the management of the FLP and have a very large percentage interest in the partnership (usually 99 percent). The partnership itself isn't taxable; however, the owners of a partnership report the partnership's income and deductions on their personal tax return, in proportion to their interests.

The partnership agreement governs how partnership income is divided among the partners. Generally, both the general and limited partners share income and cash flow based on their percentage interest in the partnership. It is important to realize that although income tax liability passes through to the partners automatically, cash is not distributed to partners until the general partners determine to make a distribution. As a result, the general partners retain control over the assets in the FLP, whereas limited partners are granted very limited rights. In addition, the limited partners' ability to transfer their partnership units to others is restricted, so that the general partners can prevent the units from being transferred outside of the family.

### Can I Form a Family Limited Partnership?

One must have a legitimate business purpose to form a FLP, such as managing a small business, rental property or even a portfolio of investments. You cannot form a FLP for the sole purpose of reducing taxes or dodging creditors.

To begin the FLP process, a written limited partnership agreement must be prepared. After the agreement is prepared, assets such as real estate, corporate stock, or cash, may be transferred. It is important to realize that FLP's are not designed for the transfer of an individual's home, life insurance, or retirement plans.

## Tax Benefits

When a FLP is formed, the general partners are permitted to give partnership shares to their kids or grandkids. The main benefit of an FLP is its significant impact in reducing a transferor's gift and estate tax. Through a FLP, the owner can take advantage of gift and estate tax valuation rules relating to lack of control and management that can reduce taxes on a transfer. Due to the significant restrictions imposed on the limited partnership units, the partnership units are typically valued approximately 30 percent less than what they were valued when originally transferred to the partnership.

The value of the discount is generally greater for parcels of real estate and less for publicly traded securities. Furthermore, the discount is generally greater when the property does not produce cash flow. When a partner dies, their share of the partnership may be valued at much less than the actual value of the partnership as a whole. As a result, the partner is provided with additional tax benefits.

### *Discount for Lack of Control*

The discount for lack of control is determined mainly by the degree of control that the limited partners have over the assets in the FLP. This degree of control, or lack thereof, is often determined by state law and is generally addressed in the partnership agreement entered into by the partners. The impact of the discount for a non-controlling interest can be considerable when a minority business interest is transferred to a family limited partnership. While a general partner can place the entire value of a business in the partnership, the discounting benefit is greater if a minority stake is transferred. If a non-controlling share of the business is transferred into the partnership, those shares are subject to a discount. The partnership interests are also subject to a discount; for the minority status and the lack of marketability of the units being gifted. However, where the donor (general partner) owns all or substantially all of a business and contributes only a minority interest to the limited partnership, they may face difficulty demonstrating bona fide business reasons for use of the FLP.

### *Discount for Lack of Marketability*

The discount for lack of marketability derives from the limited liquidity of the limited partnership interest or how readily it can be converted to cash. If a parent gifts shares of an investment portfolio to their children, the recipients may sell the shares at their discretion. The same portfolio of shares held in a FLP represent a unit of the partnership that cannot be sold as readily. The discount for lack of marketability is subtracted from the value of an asset that is otherwise comparable but carries greater liquidity.

## Example

### *Facts:*

Assume H and W have 4 children and are in the 55% marginal estate tax bracket. Assume H and W own real estate worth \$1,000,000 and it is expected that the real estate will substantially appreciate in value in the coming years. To the extent H and W can reduce their estates during their lives by making tax free gifts of limited partnership interests valued at \$10,000 to each of their children every year, there will be much less estate tax to pay in the future. The gifts of the limited partnership interests will take advantage of the entity discounts and prevent future appreciation on the gifted assets from building up in H's and W's estates.

### *Do Nothing Approach*

If H and W decide to continue to hold the \$1,000,000 worth of real estate jointly and do not make gifts of interests in the land, when H and W die in 10 years, assuming a 4% yearly appreciation factor, the land will be worth approximately \$1,480,000. The estate tax associated with the real estate will be \$814,000.

### *Family Limited Partnership Approach*

By contrast, if H and W fund a FLP with the same parcel of real estate and make yearly gifts to their children of limited partnership interests, after 10 years all of the limited partnership interests will be transferred to the children and there will be no estate tax associated with the real estate. If H and W wish to retain control of the real estate during their lifetimes, they may retain a one percent general partnership interest and give away the remaining ninety-nine percent limited partnership interests. Under this approach, only one percent of the value of the partnership will be subject to estate tax.

### *Additional Considerations*

Anyone considering in forming a FLP should consider the following:

- ❖ The required documentation to form an FLP must be carefully drafted.
- ❖ Reporting requirements include the annual filing of income tax returns of the FLP with the IRS and with each state in which the FLP does business. The partners of the FLP have to file returns in those states, even if they don't live there. An accountant should be retained for these purposes.
- ❖ The IRS may impose penalties for using an excessive discount rate. The penalty can range from 20 to 40 percent of the understatement of the tax arising from the valuation misstatement.
- ❖ Filing a gift tax return setting forth the nature of the gift and the basis for the value applied to the gift should be considered for years when gifts are made, even if there is no gift tax due. Proper disclosure of such information may prevent the IRS to revalue the lifetime gift at the time of the donor's death.