

White Paper on
Family Limited Partnership Overview

Nicolosi & Associates White Paper

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Introduction

A family limited partnership (“FLP”) is a statutory limited liability entity created under state law. FLPs are named because ownership of partnership interests typically is limited to members of the same family. Because of the many tax and non-tax benefits provided by a FLP, it is frequently used as the foundation of a well-organized estate plan. With proper planning, a FLP ensures the orderly distribution of assets to subsequent generations at values that are reduced for estate and gift tax purposes.

The purpose of this article is to provide a general overview of the use of FLPs in estate planning. The concepts underlying FLPs are easy to understand and can be used to create a powerful strategy for asset protection. We hope that this article will be a useful source of information.

Purposes And Uses

FLPs serve a number of legitimate business purposes; for providing continuous ownership of property within the family unit; consolidating ownership; providing a deterrent against postmortem asset ownership among family members; deterring claims of creditors and spouses; limiting personal liability for contract and tort damages; decreasing probate and estate administration costs; and minimum guardianship costs for interests held by minors. State law as modified by the FLP agreement governs ownership rights in the FLP.

Typically, parents form FLPs and contribute some of their assets to the entity. The parents or one of the parents act as the general partners. Children and or spouses are typically the limited partners. Often times the limited partnership the founders of the FLP gift interests to the limited partners. The FLP agreement sets out who will be responsible for managing the FLP assets and assuming

personal liability for FLP debts (“General Partner”). The personal liability of those family members who give up day-to-day management rights and duties (“Limited Partners”) is limited to the amount of capital which they contribute. Since Limited Partner’s interests are typically gifted; they generally do not have any liability to the creditors of the FLP.

Given that the underlying purpose of most FLPs is to plan for the transfer of assets from parents to children, many parents are not willing to part with control over their assets when the FLP is created. In some cases the parents simply desire to continue managing the assets contributed to the FLP and in other cases the children lack the maturity or business skills required to manage the assets.

In the latter case, a FLP usually provides the parents with the time and opportunity to educate their children about managing the assets of the FLP.

In reviewing the various purposes for creating a FLP, the following reasons are often cited:

- To adopt a succession plan for the ownership, management and control of assets.
- To ensure the orderly transfer of property interest to family members while retaining control over the assets.
- To simplify annual gifting by parents.
- To reduce income, estate, gift and/or generation skipping taxes.
- To ensure that arbitration will be the method for resolving family disputes over assets rather than costly litigation.
- To protect assets from creditors and from waste by the heirs.
- To consolidate asset ownership into a single entity.
- FLPs are more flexible than trusts in their operation and amendment.

Benefits

The major benefits provided by a FLP are:

- Centralized management and continued control over assets by parents.
- Preventing undesired transferees from acquiring FLP interest.
- Ensuring continuous family ownership of assets.
- Reducing value of FLP interests for transfer tax purposes.
- Avoiding attachment of FLP assets by personal creditors of the partners.
- Providing income tax advantages as compared to other ways of holding property.
- Decreased investment and management costs for assets.

Centralized Management and Continued Control

Control over assets contributed to the FLP is achieved by retaining ownership of the General Partner/Managing Partner interest.

Managing Partner

The most important decision to be made in creating a FLP is who to name as the Managing Partner. The Managing Partner exercises exclusive control over the partnership business operations and determines when, and how much of the partnership income to distribute to the partners. As part of the FLP's succession planning, a Non-Managing General Partner will be named to succeed in the duties of management and control upon the removal, resignation, bankruptcy, dissolution, death or incompetence of the Managing Partner.

Possible Managing Partners include one or both parents (or the trustee of their family living trust, corporations, limited liability companies (controlled by one or more parents), children or grandchildren (or trusts for their benefit). However, generally it is not recommended that children be given management powers unless the parents expressly desire to relinquish control over their assets and the child has sufficient experience and maturity in managing the FLP assets.

Even though much of the value of the FLP may be gifted away by transferring limited partner interests to the children, the Managing Partner maintains control of the assets in the FLP.

Duties and Responsibilities

The Managing Partner should have the necessary willingness, knowledge and experience to do the following:

- Manage and invest partnership assets.
- Make decisions as to distributions of partnership income and/or assets.
- File income tax returns on behalf of the partnership.
- Furnish annual partnership income tax information (schedule K-1) to the partners.
- Make necessary filings with the Secretary of State.
- Give or withhold consent to transfers of partnership interests and amendment of the agreement.

Ensuring Continuous Family Ownership

Continuous family ownership of the FLP is guaranteed by restricting each partner's ability to sell or otherwise transfer his or her interest to non-family members. Because most FLPs are used by parents to transfer partnership interest to their children at reduced transfer tax values, the existence of rights of first refusal, buy-sell provisions, or other restrictions on transfer are of paramount concern and require considerable attention.

The FLP agreement should prohibit the partners from selling or transferring their interest in a manner which is disruptive to the continuation of the family asset arrangement plan or disruptive to family harmony.

Typically the FLP agreement will provide the partners a right of first refusal to deal with a circumstance where one partner wishes to sell his or her interest to a nonfamily member. In such cases the nonselling partners will have the right to purchase the interest of the selling partner for cash or with an unsecured long-term promissory note which bears an interest rate favorable to the buyer. Only if the nonselling partners fail to exercise their purchase rights may the interest then be sold to the non-family member.

If the family members do not wish for the new partner to possess any voting rights, then the agreement should permit them to treat the new partner as a mere

assignee who is only entitled to receive income distributions and a proportionate share of partnership income, expenses, deductions and credits.

This mechanism provides the family members with protection from the influence of undesired active partners. In this way the FLP agreement promotes continued family ownership and does not disrupt good asset management.

Reducing Values For Transfer Tax Purposes

An incidental but important benefit of a FLP is its reduction of values for estate and gift tax purposes. Such reduction is a byproduct which accompanies indirect ownership of assets in the FLP. As a general rule, the value of a FLP interest is worth less than direct ownership of the same percentage interest in the underlying assets of the FLP. This is because ownership of a FLP interest does not convey any rights of management or control over the underlying assets (except to the Managing Partner) and the agreement prohibits the partners from freely transferring their interest to non-family members. Conversely, transfer tax values are reduced by the application of discounts (determined by appraisal) to reflect these restrictions.

Discount For Lack of Control

A discount for lack of control may be applied in establishing estate and gift tax values of FLP interest. This discount reflects the inability of a limited partner to control the operations of the FLP or to invest its assets in a manner which is of greatest benefit to the limited partner. Because management and investment decisions (including the decision as to when to distribute partnership income) are outside the control and influence of the limited partners, the value of a limited partner's interest is reduced to reflect such lack of control.

Typical discounts for lack of control (minority interest) generally range between twenty percent (20%) and thirty percent (30%). This discount is sometimes referred to as a minority interest discount.

Discount For Lack of Marketability

An underlying purpose of the family limited partnership is to maintain ownership of assets for the benefit of members of one or more selected families. Thus, the transfer of partnership interest to persons outside the family unit is disfavored and, in extreme cases, may even be prohibited by the partnership agreement. Furthermore, private limited partnership interests generally lack access to a readily available exchange for trading. For this reason it is said that a

limited partnership interest lacks marketability and is not easily convertible into cash or cash equivalents.

This circumstance has resulted in further discounts in the range of 20% to 40%.

Lock-in Discount

Inability of partners to “cash out” their interests, restrictions on liquidation of the partnership, rights of refusal and other transfer restrictions in the FLP agreement reduce the value of a FLP interest for estate and gift tax purposes. Based upon the number and severity of the transfer restrictions and on applicable state laws a “lock-in” discount may also be applied in determining the value of the FLP interest for transfer tax purposes.

This type of discount may range from 10% to 30%.

Asset Protection

FLPs provide a limited degree of protection for assets of the partnership since these assets generally cannot be directly attached to satisfy personal debts of the limited partners. Instead, the remedy of a personal creditor of one of the limited partners is to obtain a “charging order” from a court against the interest of the limited partner. The charging order entitles the creditor to receive the distributions which would normally be paid to the limited partner until the debt is fully paid.

A charging order, however, does not give the creditor any voting rights in FLP matters. Further, the creditor is not assured that the Managing Partner will elect to pay out the FLP income to the partners. Even though the Managing Partner does not pay out any income to the creditor and other partners, the responsibility for paying the income tax attributable to the attached limited partner’s interest will fall upon the creditor. Thus, a creditor of a limited partner may be persuaded to accept a lower settlement offer in satisfaction of the debt rather than pursue a charging order.

How long this unique benefit will continue to exist is not clear. However, the laws of most states continue to afford partnership assets this substantial degree of protection.

Income Tax Benefits

FLPs also provide a number of valuable income tax benefits to the partners. Among these benefits are the following:

- Allows pass through of items of income, expense, credit and deduction to the partners.
- Permits “step-up” in income tax basis in FLP assets for interests received from a deceased partner
- Generally permits contribution, withdrawal of assets or partnership liquidation without recognition of taxable gain, unlike corporate ownership.
- Allows income shifting since gifted FLP interests carry with them the responsibility for a proportionate share of the partnership income.

These income tax benefits make FLPs extremely attractive in planning for income tax responsibilities of the partners. If properly structured, the FLP will not increase income taxes and may even reduce income taxes in some cases.

Detriments

As exists with the formation of any entity, a FLP has some detriments. For example, the following issues will generally be encountered:

- The FLP will have to pay minimum franchise tax fees for the privilege of doing business in each state (approximately \$300 annually in Illinois).
- The FLP must file annual income tax returns and keep separate accounting records.
- The cost of formation and transferring title of assets into the FLP is expensive.
- Transfer of Subchapter S corporation stock to a limited partnership will terminate the Subchapter S. election.

For the most part, the detriments which accompany the use of a FLP are heavily outweighed by its benefits and the decision to implement a FLP should not be materially affected by these issues.

Summary

A FLP can serve as an integral part of an estate plan and provide great flexibility in transferring assets to subsequent generations. FLPs offer considerable tax and non-tax benefits to family members and their use should be seriously considered by those individuals having taxable estates (over \$1,000,000) and/or individuals who desire to pass ownership of assets to their children or spouse without giving up immediate control over the assets.

Example 1

In 1987, Mr. and Mrs. Timothy Taxpayer were each age 60. They had four children and six grandchildren and their estate consisted of the following assets held in trust:

<u>Asset</u>	<u>Value</u>
Marketable Securities	\$ 1,500,000
Apartment Complex	\$ 1,000,000
Other Real Estate	\$ 1,500,000
Residence	<u>\$ 500,000</u>
Totals	\$ 4,500,000

Later that year, Mr. and Mrs. Taxpayer met with their attorney and agreed to implement a FLP to maintain ownership of their property in the family. The securities, apartment and other real estate (but not the residence) was contributed to a FLP, constituting a total value of partnership assets of \$4,000,000. In return for their capital contributions, Mr. and Mrs. Taxpayer each received a 1% Managing Partner interest and the Taxable Family Trust received a 98% Limited Partner interest. The FLP agreement gave the Managing Partners the discretion to accumulate partnership income for future business needs and

restricted the partners' ability to transfer their interests to persons outside the Taxpayer family.

In December 1987, the Taxpayers implemented a gifting program in which they each gifted a 6.25% limited partner interest to each of their four children, thereby transferring away a total of 50.00% of the gifted limited partner interest and \$2,000,000 of the underlying asset value. An appraiser was hired to determine the value of the gifted limited partner interests. The appraiser concluded that a combined 40% discount for lack of control and lack of marketability was appropriate for the limited partner gifts to the four children. After applying this discount to the proportionate value of FLP assets, Mr. and Mrs. Taxpayer were found to have each gifted limited partner interests worth \$150,000 to each child for a total gift by each parent of \$600,000. Because the Unified Transfer Credit of each of the Taxpayers was enough to pay the tax on the gifts no cash payment of gift tax was required. At the end of 1987, ownership of the Taxpayer Family Limited Partnership was as follows:

General Partner Limited Partner

Mr. Taxpayer	1.00%	0.00%
Mrs. Taxpayer	1.00%	0.00%
Family Trust	0.00%	48.00%
Child No. 1	0.00%	12.50%
Child No. 2	0.00%	12.50%
Child No. 3	0.00%	12.50%
Child No. 4	<u>0.00%</u>	<u>12.50%</u>
Totals	2.00%	98.00%

In 1998 and each year thereafter, the Taxpayers made annual gifts of limited partner interests worth \$10,000 to each of the four children and six grandchildren. They plan to keep making them through 1998. The same 40% discount to value was applied to the gifts. From 1987 to now, the assets in the Taxpayer FLP grew at a 5% annual rate and they are expected to continue to grow at that rate. The gifting program significantly reduced their ownership interests in the FLP although they remain in control as the Managing Partners.

Let us assume that first Mr. Taxpayer and then Mrs. Taxpayer die in 1998, having carried out their ten-year annual gifting program. At that time, the underlying value of the FLP assets would be \$6,205,313 and ownership would be as follows:

	General Partner	Limited Partner
Mr. Taxpayer	1.00%	0.00%
Mrs. Taxpayer	1.00%	0.00%
Family Trust	0.00%	18.40%
Child No.1	0.00%	15.46%
Child No. 2	0.00%	15.46%
Child No. 3	0.00%	15.46%
Child No. 4	0.00%	15.46%
Grandchild No. 1	0.00%	2.96%
Grandchild No.2	0.00%	2.96%
Grandchild No. 3	0.00%	2.96%
Grandchild No. 4	0.00%	2.96%
Grandchild No. 5	0.00%	2.96%
Grandchild No. 6	<u>0.00%</u>	<u>2.96%</u>
Totals	2.00%	98.00%

The residence of Mr. and Mrs. Taxpayer, still held directly in their family trust, would have increased in value to \$700,000.

At Mr. Taxpayer's death (assuming he is the first to die), his share of the FLP and the residence would go to the marital deduction trust for the benefit of Mrs. Taxpayer, resulting in no estate tax being due.

The residence and the FLP interests would be taxed in Mrs. Taxpayer's estate. The table below shows the comparative estate tax result on the basis of both carrying out the partnership and gifting program and the results if the assets had continued to be held by the taxpayers, ignoring the greater build-up of income that accumulated in the taxable estate if not gifting had occurred.

In determining the value of the FLP interests includible for estate tax purposes, a 25% discount was applied to the General Partner interest and a 40% discount was applied to the Limited Partner interest.

	Results with Partnership and Gifting Program	Results With No Partnership or Gifting Program
<u>Taxable Estate</u>		
1. Residence	\$700,000	\$700,000
2. Assets appropriate to put into the partnership	0	\$6,205,313
3. General Partner interest (2.00%)	\$ 93,080	0
4. Limited Partner Interest (18.40%)	\$ 684,474	0
5. Prior Taxable Gifts	\$1,200,000	0
6. Less: Unified Credit of Deceased Spouse	(\$1,000,000)	(\$1,000,000)
Taxable Estate of	<u>\$1,677,147</u>	<u>\$5,905,313</u>
Estate Tax Due	\$ 505,001	\$2,733,922
Savings	\$2, 228,921	

There were three important elements to this overall plan, in addition to avoiding probate and using trusts as effectively as possible.

One aspect was using the annual gift tax exclusion over a significant period of time to remove taxable value from the estate.

A second important element was using the Unified Transfer Credit early (making the \$2,000,00 gift to the children) and eliminating a large portion of the ensuing growth from taxation.

The third important part of the plan was using the FLP to obtain big discounts on values transferred, while still retaining control over all of the partnership assets and keeping the assets within the family group in a way that will permit centralized management of the asset that will benefit all family members.

Example 2

Paul and Barbara Peterson, both age 52, have several rental real properties owned free and clear. Based on a 9% annual rate of return, four of the real properties are appraised at a total of \$1,000,000 and produce \$90,000 of income each year. Paul and Barbara expect that these properties will increase in value at a 7% annual rate for the foreseeable future.

Their attorney suggests that Paul and Barbara place the properties into a FLP and obtain a 40% discount on the value of their limited partnership interests. The attorney points out that now is the best time to shift some of the property values before they increase more in value.

The attorney does calculations to see if the properties may provide sufficient income so that Paul and Barbara's four children can acquire 90% of the limited partner interests because of the discount in value created by the FLP structure (producing an effective yield of 15%). Using Paul and Barbara's IRS table life expectancies of 31 years each, their advisor and attorney summarize the comparative tax savings which would be achieved in the event that Paul and Barbara both die unexpectedly in 20 years, if the 90% interest is transferred using a (1) private annuity, (2) self-canceling installment note or (3) regular term installment note over 40 years.

This summary is shown in Figure 1.

Figure 1.

Comparison for
PAUL PETERSON and BARBARA PETERSON

Discount Pct 40.00%

Death Year 2015	No Sale	PrvAnn	SCINInt	Install
Payments to Seller				
Annual Payment	0	68,230	69,510	59,110
Ordinary Inc.	3,746,323	1,271,727	1,495,770	1,345,241
Capital Gain	0	334,840	148,316	0
Depreciation	0	0	0	0
Total Inc. Tax	1,723,309	678,752	729,584	
638,825				

Income to Buyer

Ordinary Inc.	0	3,269,546	3,497,662	3,546,127
Depreciation	0	210,000	210,000	210,000
Interest Ded.	0	0	1,218,738	1,099,550
Total Inc. Tax	0	1,407,391	951,707	1,028,834

Tax at Death

Est. Value	4,329,606	784,235	745,859	1,177,302
Death Tax		2,380,983	431,329	410,222
				647,516
Inc. Tax/Death		0	0	103,792
				0
Total Tax/Death	2,380,983	431,329	514,014	647,516
TOTAL TAXES	4,104,292	2,517,472	2,195,305	2,315,164
TO HEIRS	1,948,077	3,425,047	3,982,405	4,081,885

Obviously, making a transfer of the 90% limited partner interest at the current date makes good sense in view of the fact that the children can use their prorate share of income to make the required payments to Paul and Barbara (note that the self-canceling installment note results in capital gain on the amount of gain in the note as of the date of death). Based on this information, Paul and Barbara decide to go forward and use a self-canceling installment note to sell 90% of the limited partner interests to their two children with the expected tax results presented in the graphic form in Figure 2.

Clearly using the FLP to discount the value of the assets is the key to getting the price down to the level that will permit the purchase price to be paid for by the income produced by the interests purchased.