

FAMILY LIMITED PARTNERSHIPS:

TRANSFERRING ASSETS FROM ONE GENERATION TO ANOTHER



What exactly is a Family Limited Partnership?

A Family Limited Partnership is a legal entity formed under state law, where the partners are family members.

An FLP must be formed by at least two partners, who each contribute assets. It must have at least one general partner, which can be the donor(s) or a corporation owned by the donor(s). An important requirement is that the limited partnership must operate as a trade, business, investment or income-producing venture. The partnership cannot be an S-corporation shareholder, and there are problems associated with the partnership owning voting shares of stock of a corporation that is controlled by the general partner(s).

General and Limited Partnership interests are exchanged for a transfer of assets. There is usually a 1% general interest for each General Partner and the remaining interests are issued as limited partnership units. These limited partnership units may be transferred to recipients using the unified gift and estate tax credit and the annual gift

tax exclusion, or can be sold using a variety of planning techniques.

The general partners control all assets of the FLP by making investment, business, and management decisions, while transferring up to 99% of the value to children, grandchildren, or other family members. The general partners determine the cash distributions to limited partners. They also have fiduciary responsibility to the partnership and should handle all transactions in an arm's length manner. As a result for these services the general partners should receive a reasonable management fee.

The limited partners have no control over investment, business and management decisions. Generally the Partnership Agreement prohibits them from unilaterally removing assets from the partnership (via distributions or otherwise), and from forcing its liquidation. The limited partners can be taxed on up to 98% of the income at their appropriate (often lower) tax rate.

What Are the Most Common Non-Tax Reasons for Establishing an FLP?

Retention of control over transferred assets. The most common reason for establishing a Family Limited Partnership is to give children or other beneficiaries an interest in valuable property without surrendering control over that property. By making beneficiaries limited partners and assuming the role of general partner, the person(s) establishing the partnership maintain control over its income and assets.

Protection of assets from creditors. A partner's creditors are only entitled to a claim against his partnership interest, not the underlying assets. These interests are often unattractive to the creditors and difficult for them to access. Also, the partners can be insulated from exposure to the partnership's creditors.

Protection of assets from marital claims.

These same difficulties can exist for marital claims against the partners.

Increase in size and scope of assets. The partnership can allow family members to create a larger pool of assets, reducing management and administration costs, and increasing diversity.

Continuity of business interest and investment philosophy. The partnership can be established to allow a smooth transition of assets to successors. This can provide a longer time horizon that can allow a more aggressive and beneficial investment philosophy.

What Are the Tax Advantages of FLP's?

The Family Limited Partnership must exist for legitimate business reasons, before any significant tax benefits can result from its creation.

Among the tax benefits are:

- To allow the appreciation of assets to occur outside the estates of older family members. The transfer must be done subject to the estate freeze rules, which are complex and beyond the scope of this article.
- To redistribute income of property from older-generation taxpayers in higher tax brackets to children and grandchildren in lower tax brackets. FLP's continue to be used to reallocate income, even though under the Tax Reform Act of 1986, much of the unearned income of children under 14 must be taxed at the parent's rate,
- To utilize the \$11,000 annual gift tax exclusion and the Unified Gift and Estate Tax Credit to transfer interests to the next generation .
- To facilitate avoidance of corporate double taxation and the restrictions

and complexities of regulations applying to S corporations. Income to a partnership is taxed only as income to the partners.

- To avoid the higher income tax rates that apply to trusts.
- To obtain minority interest and lack of marketability valuation discounts for gift and estate tax purposes on the value of transferred partnership interests

Valuation Discounts

This possibility of obtaining valuation discounts is one of the primary reasons for the interest in Family Limited Partnerships and for a professionally prepared valuation. The "Standard of Value" is "Fair Market Value" under Reg. 25.2512-1. Fair market value is defined as the "price at which a property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having a reasonable knowledge of all relevant facts." Fair market value, under Rev. Rul. 59-60, refers to a "hypothetical buyer and seller."

Limited Partner Rights

The *Limited Partnership interest* has no direct ownership in the underlying assets of the partnership and no ability to control distribution of income or liquidation and distribution of assets.

No Public Market

The *Limited Partner* ownership interest has no current public market in which it can be converted to cash. This reduced liquidity is a characteristic of the limited partnership ownership interest even though the underlying assets of the partnership often might have greater liquidity. Frequently partnership agreements further restrict the Limited Partner by controlling the

assignment or sale of their limited partnership interests.

These restrictions, as viewed through the eyes of the willing buyer and seller, and as determined in the *fair market value* definition, give rise to the reduction of value of these limited partnership interests. Empirical studies done in these two areas provide the insight for this reduction in value. In Revenue Ruling 93-12, the IRS changed its position of disallowing the minority interest (or lack of control) discount in family situations, and case law has historically allowed a discount for lack of marketability.

However, the importance of the documentation of the basis for the amount of the discount cannot be overstated. There is no such thing as a “standard discount.” Courts have emphasized the importance of comparable sales and applying the specific facts and circumstances of the case to determine the amounts of these discounts.

IRS attacks on FLP's

The Courts have generally been favorable in recognizing Family Limited Partnerships and allowing discounts on transfers of the limited interests. However, the IRS has had recent success in reducing the claimed discounts and even disregarding FLP's which were not operated in a business-like manner or in which the restrictions in the agreement were not followed.

Too Good to be True?

There are many variables to consider when structuring Family Limited Partnerships, which are the domain of the attorney, not the valuation professional. Addressing these can result in a number of legal and administrative costs. Additionally there are the costs of paying for an appraisal of the value of certain assets, such as real estate, and a professional valuation that determines

the appropriate minority and lack of marketability discount percentages.

Certainly the issue of the importance of the use of a valuation expert is incontrovertible. Judge David Laro was an appointee of President Bush's to the U. S. Tax Court in 1992. In the case of Bernard Mandelbaum et al. v. Commissioner C. T. Memo, 1995, Judge Laro asserted in his ruling that it was necessary in every valuation case to apply specific facts and circumstances to the case. Each case is unique, he suggested in an article in *Shannon Pratt's Business Valuation Update*, and it is improper to attempt to apply “absolutes.”

Equally critical to the effective application of family limited partnerships is the use of an attorney knowledgeable both in the areas of federal tax law and of state partnership law. For example, an issue of importance is whether the Partnership Agreement is more restrictive than state partnership law.

Genuine benefits are usually accompanied by requirements of time and money. The Family Limited Partnership offers powerful potential as an effective means of protecting assets and transferring wealth between generations, while minimizing the taxable consequences. At the same time it enables the older generation to still maintain adequate control over the management and growth of these assets.