# ESTATE PLANNING AND THE FAMILY LIMITED PARTNERSHIP

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***The use of family limited partnerships is an advanced estate planning technique. This memorandum will help you to understand how they operate and the many benefits they offer. Briefly, a family limited partnership is a limited partnership among family members that allows joint ownership of family-owned assets. The structure of the partnership permits a partner to transfer a portion of his ownership of the assets held within the partnership to other family members who are partners to the agreement. The use of the limited partnership to make such lifetime gifts, as well as transfers at death, lays the groundwork to obtain a potential discount (valuing a partnership interest at something less than face value) on the value of the transfers. In addition, holding family assets in a limited partnership provides a measure of protection from creditors of the partnership and of individual partners. A limited partnership provides several other advantages which this memo discusses in greater detail. After you have reviewed this memorandum, please feel free to call us with any questions that you may have.***

**What is a family limited partnership (FLP)?**

A family limited partnership is a partnership among family members that is created to allow joint ownership of family-owned assets. The existence of the partnership is evidenced by a written agreement that details the

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terms of the partnership and the rights, duties and obligations of each partner.

It is a limited partnership in that there are two classes of partners: general partners and limited partners. Limited partners have limited liability. This means that the limited partners in the partnership are only responsible for partnership liabilities to the extent of the value of their partnership interest. By comparison, in a general partnership, all of the partners have liability for all of the activities of the partnership and that liability is not restricted to the value of the partnership interest of each partner. The general partner remains liable for all partnership liabilities.

**What are the benefits of establishing an FLP?**

There are many benefits to implementing an FLP as part of an estate plan. The two primary benefits are 1) to "fractionalize" interests in property for the purpose of carrying out a gifting strategy and 2) to seek "discounts" on gifts made and on the transfer of a partner's remaining interest in the FLP at death. These benefits of an FLP also reduce death taxes.

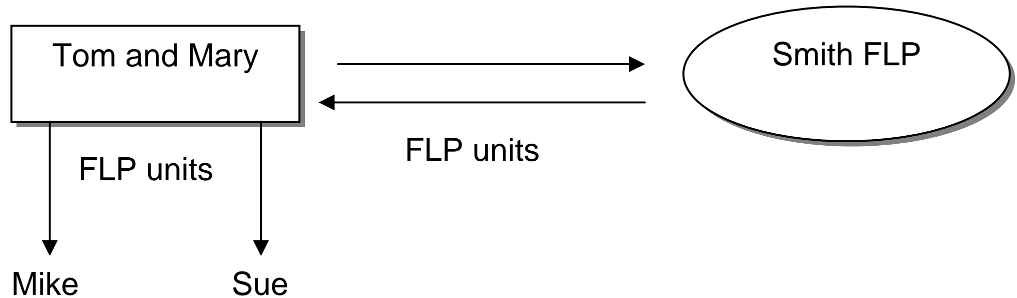
**How does an FLP "fractionalize" property interests?**

When property is transferred into a FLP, partnership units or interests are created and assigned a value. The units represent a fractional interest in all the partnership assets, the same as stock in a corporation. This makes it possible and convenient to gift assets which are not easily divisible. The FLP creates a "currency" of partnership units that can be easily transferred on an annual basis.

Fractionalization of property interests can best be explained by an example:

> Tom and Mary Smith want to give their children, Mike and Sue, a portion of an apartment building that they own. The reason for the gifts is to reduce estate taxes at death. Tom and Mary create an FLP with themselves as general partners and themselves, Mike and Sue as limited partners. Tom and Mary transfer the building into the FLP by quit-claim deed. The fair market value of the apartment building is professionally appraised to be $500,000. The partners agree that the FLP will have 500 units and that each unit is worth $1,000. Tom and Mary can now give units of the FLP to each of their children. Without an FLP, the only way to make gifts of partial interests in the real property would be to execute deeds to the children each year, which would be a cumbersome, confusing process.

apartment building




**What are "discounts" of FLP interests?**

Briefly, we take the position, where justified, that minority interests in an FLP should be valued at something less than face value because the owner of a minority interest cannot realize the full value of his partnership units if he were to sell them. In our example, assume Tom gifted 10 of the 500 units of the FLP to his son, Mike. Mike's ownership of 1/50 of the FLP should be subject to a substantial discount for several reasons including:

**a.** A discount for lack of marketability. Who would pay full value for an interest in a partnership owned and controlled by a family?

**b.** A discount for lack of free transferability. The terms of the FLP restrict the ability of partners to sell or otherwise dispose of their interests.

**c.** A discount of the interests of the limited partners because management control is in the hands of the general partner.

**d.** A minority interest discount. A minority interest is less valuable than a controlling interest.

The terms of the FLP agreement are carefully designed to maximize the ability to take a discount. Potentially, a discount can be taken both at the time partnership units are gifted from one partner to another and at the death of a partner on his remaining partnership units. A successfully taken discount can result in a large estate tax savings.

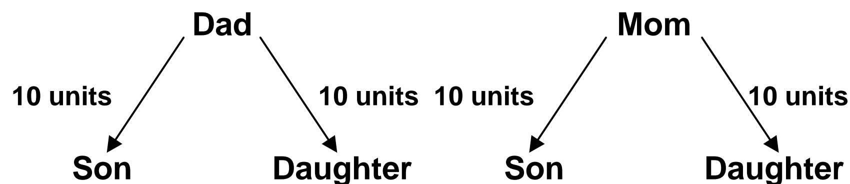
**Why is the valuation discount so important?**

Discounts can potentially be taken at the time a gift of a partnership interest is made from one partner to another and also upon the death of a partner on his or her remaining partnership interest. Many factors, including the terms of the written partnership agreement itself as well as the type of assets owned by the partnership, contribute to the determination of the appropriate discount to be applied. It is very common

to see a discount between 30-40% and discounts as high as 75% (and greater) have been successfully applied to limited partnerships.

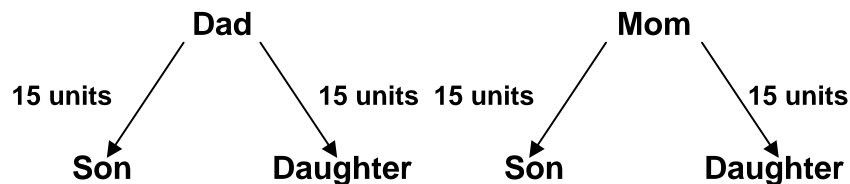
**a. Using the discount with annual gifts of units.** Under current tax law, the annual exclusion to gift taxes permits a donor to give up to $10,000 per year to as many donees as he chooses. Thus, if each partnership unit is valued at $1,000, a partner could gift 10 units to each other partner and have each gift qualify for the exclusion. However, if a 33% discount is taken on the value, the donor partner could gift 15 units to each other partner and still have each gift qualify for the annual exclusion. This helps to reduce the value of the donor's taxable estate more rapidly, thereby reducing the amount of estate taxes that may be owed upon his death. The impact of the discount applied to annual exclusion gifts can be significant if annual gifts are made for several years. However, to qualify such gifts of partnership units for the annual exclusion, the partnership agreement must be carefully drafted. The agreement cannot unfairly restrict a limited partner's ability to sell or assign his partnership interests or allow the general partner to act against the best interests of the limited partners, such as withholding income distributions without a valid business purpose.

**Without a discount:**




**Total units gifted: 40**

**With a 33% discount:**




**Total units gifted: 60**

**b. Using the discount at a partner's death.** A FLP can produce a large estate tax savings in that a discount potentially can be taken on a partnership interest owned by a partner at his death. If the partnership agreement is carefully drafted, this may be true even

for the general partner's estate. For example, if a partner owns 750 partnership units each valued at $1,000 at his death, the deceased partner's estate would include $750,000 of partnership units with no discount. If a 33% discount were successfully taken, the estate would only include $495,000 of partnership units which will reduce estate taxes by approximately $127,500 for an estate being taxed in the 50% tax bracket.

The specific circumstances surrounding each FLP must be evaluated when deciding how much of a discount can reasonably be taken. The IRS may challenge the amount of a discount so tax savings are not guaranteed. However, asserting a discount and documenting the reasons supporting the discount can lay the groundwork for substantial tax savings.

**Who is the general partner and what are the rights and obligations of a general partner?**

The general partner is usually the owner of the asset(s) being transferred into the FLP. There may be more than one general partner. Ordinarily, the general partner retains only a small percentage of his or her units as a general partner, holding the majority of his or her units as a limited partner.

The general partner is responsible for the day to day operations of the FLP and maintains full control even though he or she may own only a small percentage of the partnership units. The ability to control property transferred to the partnership is one of the attractions of creating an FLP.

**Is the general partner entitled to be compensated for his services?**

Yes, if the general partner believes that it is either necessary or advisable to be compensated. If the income from the property transferred to the FLP is needed, then a reasonable amount of compensation may be paid to the general partner. This is taxable income.

However, one of the benefits of the FLP is to shift income to other partners of the FLP who may be in a lower tax bracket. Also, remember that income paid to a partner is not only taxed as income, but the remaining distributions (including any growth in those assets) will be taxed in such partner's estate at death.

A decision as to whether or not a general partner should take compensation for his or her services will take these factors into consideration.

**What happens if a general partner resigns, becomes incapacitated or dies?**

The terms of the FLP either 1) designate co-general partners to serve, so the remaining general partner will continue to serve, 2) directly names who is to serve as successor general partner, or 3) allows for a successor general partner to be named by agreement of the remaining limited partners voting their shares.

**What are the rights of a limited partner?**

The FLP agreement sets forth the basic rights of the limited partners. They are to be consulted with regard to all major decisions and have a right to inspect and examine the books and records of the partnership. However, they do not have the right to make decisions on behalf of the FLP or to control the general partner.

**What types of property can be contributed to an FLP?**

Almost all types of property can be contributed. Most frequently, we will recommend that real property interests such as commercial property or vacant land be used to fund an FLP. An FLP can hold a vacation home and investments such as stocks, bonds and mutual funds, as well.

However, S corporation stock cannot be transferred to an FLP because of legal restrictions on the ownership of this type of stock. Also, it is not advisable to transfer shares of stock in a family owned business that is a C corporation. The retention of voting rights of that stock by the general partner can cause inclusion of the stock held in the FLP in the estate of the general partner at his or her death. Further, qualified plans cannot be transferred into an FLP.

**Can an FLP own life insurance?**

An FLP can own life insurance; however, the agreement should be drafted very carefully to avoid inclusion of the proceeds of a policy in the estate of a deceased partner. This is a very real possibility when the insurance is on the life of the general partner. The Internal Revenue Service could take the position that the general partner's powers create "incidents of ownership" over the policy that cause inclusion of the proceeds in the general partner's estate at death. This problem can most likely be avoided by careful drafting of the partnership agreement to include specific language prohibiting the general partner from exercising any powers or ownership rights over life insurance on his life that is owned by the partnership.

Even if the "incidents of ownership" issue is resolved, there will still be included in the estate of the deceased partner an amount of the proceeds equal to his percentage interest in the partnership.

Currently, we usually do not recommend that life insurance be placed in your FLP. We still find the use of an irrevocable life insurance trust to be preferable for a number of reasons, including our greater confidence that all insurance proceeds will be kept out of your estate for estate tax purposes.

**How is property transferred to an FLP?**

If real property is being transferred, a quit-claim deed transferring title to the partnership must be prepared and recorded. If investments are being transferred to an FLP, they should be put in the name of the partnership using its tax identification number. Any non-titled property can be assigned to an FLP by a simple assignment.

**Is a gift made when property is transferred to an FLP?**

No, because a transfer of property to an FLP is treated as a contribution of capital to the contributing partner's capital account. A gift does not occur until a partner transfers a portion of his or her units in the partnership to other partners.

**Is the transfer of property to an FLP a taxable event?**

No. The transfer of property to the partnership is not a sale and the transferor does not realize any capital gains or losses. The basis in the property (i.e. what was paid for it plus the cost of capital improvements less any depreciation) remains the same and there are no tax consequences that arise because of the transfer. However, when one partner transfers units to another, the partner receiving the gift takes the transferring partner's basis in the property.

**Should the property contributed to an FLP that does not have a readily ascertainable value be valued by a qualified appraiser?**

We believe that property such as this should be appraised. If gifts of this property are going to be made and if we are unsure of the underlying value of this property transferred to the partnership, we cannot be sure of the value of each partnership unit. For example, if real property is going to be transferred, then it should be appraised by someone competent to appraise real property.

Sometimes, clients do not want to go through the expense of an appraisal. In this circumstance, the partners will agree on the value of property so contributed. However, we cannot be responsible for any problems or missed opportunities that may result. For example, if property is overvalued for gifting purposes, then smaller gifts than intended may be made during lifetime and this may result in larger taxes at death. Conversely, undervaluation of property could result in larger gifts being made than believed. This could result in gift taxes during lifetime.

The client's decision regarding this will be final but you need to be aware of these potential consequences.

**Should a valuation be undertaken if a discount is being taken on the value of the partnership units being gifted?**

A professional valuation should probably be undertaken if we are taking a discount on gifts being made so that the amount of the discount can be defended if ever challenged by the IRS. The valuation would determine the amount of the discount. The determination of the amount of the discount is usually expressed as a percentage discount from the value of a partnership unit. Whether or not to take a discount needs to be determined on a case-by-case basis.

**How are units of an FLP gifted to other partners?**

Ease of transferability is one of the attractions of the FLP. The partner desiring to make a gift of units of the FLP executes a simple one page assignment indicating the number of units he or she desires to gift and to whom the units are gifted. A unit ledger of the partnership is maintained and updated to reflect the transfer of ownership. The gift of units, however, must be to a person who is allowed to be a recipient of FLP units (another partner to the partnership).

**What are the benefits of limited liability?**

If a partnership is sued because of its activities, the limited partners' liability is limited to the value of their partnership interests and no more. They are not personally liable and their other assets are protected from the claims of a partnership creditor. The general partner, however, remains liable for all such liabilities.

Protection from creditors is built into the terms of an FLP agreement. If there are any special circumstances involving a real or potential creditor, please bring this to our attention so that we may determine if anything else should be done beyond our standard approach to creditor protection planning.

**How does an FLP protect the partners from a partner's personal creditors?**

The terms of the agreement prohibit the transfer of partnership units to a creditor of any of the partners. Creditors only remedy is to require the partnership to distribute to them any partnership distributions that a partner would otherwise receive. If any such distribution is made, the creditor becomes responsible for the taxes owed on the distribution, making most creditors reluctant to pursue a partnership interest as a form of payment.

If a partner become aware of any real or potential problems concerning a creditor of any of the partners, we should be notified promptly so that we may advise if anything further should be done to protect the partnership or its partners.

**Who is entitled to receive the profits and share in the losses of an FLP?**

Income of the partnership is taxed to each of the partners in accordance with each partner's percentage ownership of units of the FLP. Income is the gross income of the partnership less its expenses. Losses are shared in the same manner as profit. The shares of the general partner are usually treated the same as limited partnership units for purposes of allocating profits and losses.

For estate planning purposes, it is advisable to shift income to the other partners. These are family members and the income shifted to them is frequently taxed at a lower rate. Additionally, transferred income will not be taxed in the transferring partner's estate at death. Shifting income is like making additional gift tax free transfers to your family members

**Does a partnership have to distribute all of its income to the partners?**

Any partnership, including an FLP, may retain income for future needs of the partnership. It is not required to distribute all available income to the partners. The agreement gives the general partner the right to determine if income should be retained in the partnership.

This is important to remember. A business plan for a partnership entity can still be followed and all of the income earned is not required to be distributed each year to the partners.

Income retained is still taxed to the partners in the same manner as stated above and they also retain their rights to a distributive share of this income if later distributed.

**Does a FLP have to file a tax return?**

This is dependent on the activity that takes place in the partnership during the course of a calendar year. If necessary, it will be filing a partnership return using its own tax identification number. Each partner receives a form K-1 which states the portion of partnership income attributable to him or her and this form is attached to the partner's own personal tax returns.

Preparation of the return is not difficult as it uses the same information as is used on the partners' personal returns. Preparation of the partners' personal returns is simplified because the same information is provided on the partnership return instead.

**Does a FLP need to have insurance for potential liabilities?**

Keep in mind that the FLP is a business enterprise and should carry insurance for potential liabilities. In that there is a lot of variety in the types of property owned by FLPs, it is difficult to generalize as to the insurance that is appropriate. Your insurance advisor should be consulted at the time of the creation of the FLP as to the appropriate coverage and coverage amounts.

**What happens if a partner wants to sell his partnership interest or withdraw from the FLP?**

The terms of the FLP agreement dictate what is to happen in the event of a sale of partnership units. Any offer by a third party to buy a partner's units is subject to a right of first refusal by the other partners. The specifice terms and conditions of a sale are set forth in the partnership agreement.

Restrictions on the sale and transfer of partnership units are an important part of a partnership agreement. They not only insure that the only partners are those persons whom are mutually agreeable to all partners, but also sets up the conditions that allow for the tax planning and benefits that are an important aspect of having an FLP.

If a partner wishes to withdraw from the partnership, the written agreement will specify how that is to be done and how the determination is made as to the value of the withdrawing partner's interest.

**Why would an FLP be established instead of a corporation or a limited liability company (LLC)?**

We currently believe that the FLP is a more flexible tool for achieving many estate planning goals. For an existing operating business, we would

probably recommend an LLC because of the full liability protection it offers to all participants

**Is the existence of an FLP recorded anywhere?**

In Ohio, a certificate of limited partnership is filed with the Secretary of State's office in Columbus. We prepare the certificate and then file it after execution by the general partner.

**Do partnership units have to go through probate if a partner dies or becomes incapacitated?**

No. The provisions of an FLP can state that partnership interests are allocated to a trust of the deceased or incapacitated partner. This is to insure the orderly transfer of all assets at death and to maximize tax planning opportunities.

If not otherwise provided for though, partnership interests are part of the estate of a deceased partner and pass through probate. Members of the partnership whom we have not prepared an estate plan for may want to have this issue addressed. One of the advantages of having a partnership is that it can be used to avoid probate if the partnership agreement provides how units are to otherwise pass at death.

**How are a partner’s interests in an FLP coordinated with his or her overall estate plan?**

As stated above, the agreement can provide that units of a deceased partner pass to his or her revocable trust. This avoids probate. The units are then allocated in accordance with the terms of the deceased partner’s trust to maximize his or her personal and tax planning goals.

**Why do not more persons use a family partnership?**

More people probably would if they understood all of the partnership’s benefits. It is a great estate planning tool that we use frequently for our clients.

However, it is not appropriate for everyone and should only be used where clearly indicated by a family’s personal and financial circumstances and goals.

**Do you have any other questions?**

Please feel free to give us a call!

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