Family Limited Partnerships are one of the most talked about, yet seldom-seen wealth transfer strategies, designed to reduce estate taxes and keep wealth in the family.

Mainly geared towards couples and individuals with estates of $3 million or more, a Family Limited Partnership operates very much like other limited partnerships. In a regular limited partnership, you have two types of parties: the “General Partners,” which control the trust, and “Limited Partners” who have a share in the profits (but no share of control).

A Family Limited Partnership is setup in a similar fashion. In fact, there is no legal distinction between a “Family Limited Partnership” and a traditional Limited Partnership. However, unlike other publicly-offered limited partnerships, ownership of the Family Limited Partnership units is restricted to family members. In a Family Limited Partnership, the General Partners still control the operation of the Partnership and make day-to-day investment decisions. General Partners may also receive a percentage of the Partnership’s income in the form of a management fee. And, just like other Partnerships, a Family Limited Partnership’s Limited Partners have ownership interest, but only limited control.

Reducing Estate Taxes

A Family Limited Partnership can help you reduce estate taxes by using a basic premise: transfer family assets to a Family Limited Partnership, and then gift units (or shares) to family members. By doing this, you may effectively “remove” the assets from your estate. However, you still maintain control over how these assets are managed inside the FLP as the General Partner.

A Family Limited Partnership should not be confused with a living trust or trust account. The Family Limited Partnership is a form of business, and must have a legitimate business purpose. In recent years, the
IRS has cracked down on FLPs designed solely to avoid taxes. A FLP can operate as a real estate or investment partnership, where the head of the family (acting as the General Partner) provides the expertise needed to make the Partnership successful.

**Starting the FLP**

Forming a Family Limited Partnership requires the help of an experienced attorney, who is also an expert in taxation. A married couple could form a Family Limited Partnership with the attorney’s assistance, and then place your assets within the Family Limited Partnership. Once your assets are within the Partnership’s control, the couple allocates a certain amount for the Limited Partners’ and General Partners’ shares. For example, you can place $2.0 million worth of assets into the FLP, and allocate it to the Limited Partnership side. Then, you can place an additional $20,000 in the FLP, allotting it to the General Partnership side. This aggregate $2,020,000 can comprise real estate or business interests.

If done properly, the funding of a Family Limited Partnership is **not** a taxable event. The general partners receive ‘basis’ in the partnership units equal to their basis in the assets transferred to the Partnership. However, when units are disposed of, either by sale or through gifting, a taxable event will take place.

In the initial stages of your FLP’s existence, you and your spouse own all of the units, both General and Limited. Over time, you divest yourself of the Limited Partnership units by “gifting” them to your children or grandchildren using the current gift tax exclusion ($11,000 in 2002) and the unified credit exemption ($1 million in 2002 per person, or $2 million per couple). The General Partners may own as little as 1% of the Family Limited Partnership assets and still retain control of the partnership. The remaining 99% of the FLP’s assets can then allotted to the Limited Partnership units. **This allocation is significant.**

Inherent in the General Partnership units is control of the FLP. Whoever owns the General Partnership units controls the FLP. “Control” includes:

- **The Right to Buy Assets**
- **The Right to Sell Assets**
- **The Right to Dispose of the Property Within the Partnership**
- **The Right to Declare Any Distributions of FLP Shares**

General Partners not only receive control of the Partnership. Since the General Partners actively manage the Partnership on a day-to-day basis, they are entitled to reasonable compensation from the Partnership.

Limited Partners, unlike the General Partners, have almost no say regarding the administration and control of the Partnership property. Limited Partners simply receive distributions when (and if) they are declared by the General Partners. However, one of the most important aspects of Limited Partnership units is that upon eventual dissolution of the Partnership, a proportionate amount of Partnership property passes through to each Limited Partner. As much as 99% of the appreciation of the FLP property may pass to the Limited Partners, depending on its structure.
Leveraging Your Gifts

If structured properly, you may actually pass on more than the maximum which you are permitted to transfer in a lifetime, completely estate tax-free. A gift of Limited Partnership units representing $1 million (or $2 million from two General Partners) in FLP assets may be appraised at a lower dollar amount than when gifted outright. This lower appraisal can result due to the lack of control and lack of marketability inherent in Limited Partnership units. This under-valuation is called “discounting” the value of the Limited Partnership units. The FLP’s assets are still worth the same. However, because they cannot easily be sold or transferred, the Limited Partner units are less desirable and, hence, undervalued.

The IRS has been paying special attention to abusive FLPs that discount beyond what is reasonable. Some FLPs have been structured with such a dramatic discounting of assets that they have triggered attention by IRS auditors. A trained attorney with experience in taxation will be able to provide guidance in this area.

Thanks to the theory of discounting, General Partners can expect to gift more to heirs as Limited Partners, and still have gifts qualify as estate tax- and gift tax-free under the gift and estate tax unified transfer. And as the current Unified Credit amount is increased over the next decade, the actual amount of assets you may gift through a FLP will increase even higher.

Undesirable to Creditors

Limited Partnership units tend to be very undesirable assets to creditors, since Limited Partner shares have no inherent control of the assets within the Family Limited Partnership. If a judgment is declared against an individual who owns Limited Partner units, the creditor may not want to pursue those Limited Partner units. After all, these units have no right to income until declared by an independent third party (the General Partner), nor do these units have an individual right to demand dissolution.

Creditors have a distaste for Limited Partnership shares for other reasons. Because Limited Partner units are not publicly traded, there is virtually no market for them. If the Partnership has earned income, but the General Partner does not declare a distribution, each General and Limited Partner unit holder will be required to report a proportionate share of the earned income on his or her personal tax return, without actually receiving any dollars with which to pay the tax.

This technique creates what CPAs often refer to as “phantom income.” Imagine how upset a creditor would be to learn that Limited Partnership units seized from Family Limited Partnership have no control, income, or dissolution rights, PLUS are also responsible for income taxes on a significant amount of income that technically doesn’t even exist yet.

General Partner Shares

As much as creditors dislike Limited Partnership units, they love General Partnership units. After all, the General Partnership units offer all of the items missing in the Limited Partnership shares. Thus, if a creditor can seize both General and Limited Partnership units, the creditor will be in control and can effectively “get to the assets” to settle the liability.

To help alleviate concern over litigious creditors, some General Partners have
discovered ways to retain control of General Partnership units, while keeping other at arm’s length. Some travel down a very risky path by contributing General Partnership units to an “Offshore Trust.” Held outside of the United States, an Offshore Trust makes it difficult (but not impossible) for creditors to attach because of sovereignty issues. Some General Partners contribute their General Partnership shares to a Charitable Remainder Trust. **Neither method is recommended, and will not protect your assets from the IRS and judgments.** However, some General Partners use these options to enable the opportunity to negotiate a better settlement with creditors.

Every situation is unique. As a rule of thumb, most attorneys usually recommend that clients do not combine General Partnership shares with another strategy when first establishing the Family Limited Partnership. After all, the Family Limited Partnership main purpose is not asset shielding and protection.

**State Inheritance Taxes**

Another important aspect of Family Limited Partnerships is that they are deemed an “intangible asset.” Thus, chances are that only the state of your domicile will be able to impose an inheritance tax on Partnership units. This is particularly important if you own real estate in a state which imposes an inheritance tax in excess of the allowable federal credit.

For instance, the state of Ohio might impose an inheritance tax of approximately 10% of the value of any real estate which you hold in Ohio, even if you pass away while residing in the state of Florida. The allowable federal credit may be only 6 percent. Therefore, your estate will pay the difference (an extra 4 percent of the value of the property) in inheritance taxes. If your estate is made up of significant amounts of real estate, this tax could easily reach tens of thousands of dollars.

In the above scenario, if you own Partnership units rather than real estate, you would be taxed in Florida’s 6 percent state inheritance tax rate, not Ohio’s 10 percent rate. Thus, it might be a wise estate planning step for you to establish a FLP to hold your out-of-state assets. Consult with a tax advisor or attorney, familiar with the specific laws of your state, to see if this applies to your situation.

While using a FLP to avoid state inheritance taxes sound wonderful, there are large and small pitfalls of which you must be aware. In many instances, an “excise tax” or other form of penalty may be imposed on the transfer of property into the partnership. Additionally, because setting up a Family Limited Partnership means you have created a new legal entity, it will be necessary for the Partnership to file its own tax returns. The preparation and filing of this tax return will create an additional annual expense for the General Partners.

Income tax returns are not the only recurring expenses. State certification fees for limited partnerships vary greatly. States such as Nevada and Colorado charge insignificant certification fees, while the state of Florida charges thousands of dollars annually for its certification.

Perhaps the most expensive (and often overlooked) potential pitfall stems from the necessity that Partnership units be valued each time you dispose of them. That equates to new appraisal fees every time you wish to distribute shares to your Limited Partners.
FLPs, like all partnerships, are controlled by state law. Therefore, the generalizations made in this Special Report may require slight modification in order to comply with the laws of your home state. Should you wish to establish a Family Limited Partnership, it will be necessary to retain legal counsel familiar with your local laws in order to be certain that each and every aspect of your partnership is thoroughly and completely addressed.

General Partners and Their Management Fees

Often, the General Partner(s) wish to receive a stream of income from the Family Limited Partnership they created. As mentioned earlier, General Partners may be entitled to receive a management fee for managing the Partnership, depending on state law. This fee must reflect actual work you do as the General Partner. Of course, any fees received from the FLP are considered earned income, and you are responsible for paying income tax and Social Security tax on that income.

Another very effective way to draw income from your Family Limited Partnership is through a Preferred Payment Provision. Suppose you desired $50,000 per year in income from the FLP, in addition to the fee you earned as General Partner. The terms of the FLP may be structured to pay you a preferred payment of $50,000 per year for 10 years, for a total of $500,000. Just like the management fee, those preferred payments are subject to income tax.

Any unpaid portion of the $500,000 would be included in your estate if you were to die within the 10 years. Conversely, as long as the preferred payments meet the criteria for “qualified” status pursuant to Internal Revenue Code §2701(a)(3), the commuted value of the $500,000 (approximately $350,000) is subtracted from the value of the Partnership when the Partnership is initially established.

This means that if the original value of the Limited Partnership units is $1.9 million (before the lack of control or minority discount), the FLP’s tax advisor could subtract the $350,000 commuted value of the income payment stream and bring the value of the Limited Partnership units down to $1.55 million. By applying these discounts, you might be able to bring the Limited Partnership units’ worth to under $1 million, leaving enough allowance intact to utilize additional wealth transfer strategies.

Preferred Payments Serve Two Purposes

The preferred payment method of receiving income from a Family Limited Partnership serves two purposes: 1) it offers the General Partner a stream of income, without any deductions for payroll taxes; and 2) it reduces the value of the partnership for gift tax purposes. Keep in mind that these preferred payments must be made even if the partnership does not produce income. Therefore, income produced by the Partnership assets through dividends, interest, rents collected, etc., should be relatively certain for the term of the preferred payments.

A Word Of Caution

FLPs, while creating tax-advantages, are by no means perfect. Property transferred to your heirs through a FLP (instead of the traditional method of transferring at your death) does not receive a step-up in
cost basis at the time of transfer. And as mentioned before, FLPs have been under increasing scrutiny by the IRS, as the agency is cracking down on abusive trusts and tax havens (including offshore trusts). It is crucial that you consult a trusted tax advisor and estate attorney to determine if FLPs are appropriate in your situation. If implemented properly, the FLP may provide a significant estate planning advantage to both you and your loved ones.

To find an attorney close to you, speak with one of our SaveWealth estate experts about establishing your own estate plan. After asking a few questions about your estate and family make-up, they can help point you to a qualified attorney that can help.

To help determine if FLPs are appropriate for your family, call SaveWealth at 800-500-0037.

This Special Report is meant to be a starting point down the complex road of estate planning. No legal or tax advice is intended, and your family’s situation may not be appropriate for the strategies mentioned herein. Effective estate planning, with the help of an experienced tax and legal professional, is crucial if you wish to preserve your assets for your family.

Any mention of interest rates or rates of return are purely hypothetical, and not intended to represent any assurances or guarantees.

SaveWealth does not practice law. You should always seek the advice of a knowledgeable tax expert or attorney when implementing any retirement or tax planning strategy. Because laws vary from state to state, your advisor needs to be aware of state and local laws that may affect any retirement or tax planning strategy.

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