

## TAX/ESTATE PLANNING

### **FAMILY LIMITED PARTNERSHIPS:**

### **SHARING THE WEALTH WHILE RETAINING CONTROL**

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The hottest idea in tax planning today is the family limited partnership (or "FLP") which can be used to shift assets from one generation to the next with a minimum of tax consequences. By conveying a family business or portfolio of family investments to a family partnership, the senior members of a family are able to share the value of the assets with the younger members of the family (thus facilitating the continuity of a family business or investment portfolio) while simultaneously maintaining control over the assets and lowering both their income and estate taxes. In addition, the use of a family limited partnership serves as an effective tool for introducing the younger members of a family to the family business (or investments) while limiting any liability generally associated with the operation of such business (or investment portfolio).

A family limited partnership generally consists of one or both parents creating a partnership and serving as the general partner(s) and the children and/or the grandchildren serving as the limited partners. Initially, one or both of the parents hold both the general partnership interest(s) and the limited partnership interests with the general partnership interest(s) consisting of as little as one percent of the total equity in the partnership assets and the limited partnership interests (which can be divided into a large number of units) accounting for the remainder of the equity in the partnership assets.

While maintaining as little as one percent of the equity in the partnership, the parents, as the sole general partners, can maintain full and complete control over the business or investment portfolio while gifting as many of the limited partnership units to the children as they desire. Thus, the parents can successfully shift much of the value of their assets to their children in order to reduce their taxable estates for estate tax planning purposes. In addition, a family limited partnership can be used in conjunction with a gift-giving program structured to accelerate the reduction of the taxable estate through valuation discounts. When used in combination with other estate planning tools such as charitable remainder trusts or irrevocable life insurance trusts the results can be significant.

Assume for instance that the parents have a large parcel of real estate which they wish to transfer out of their combined taxable estates. The net fair market value of the property is \$1 million. The parents are interested in utilizing their \$10,000 annual gift tax exclusions to provide gifts of a portion of the real estate to each of their three children. If they had to make gifts of the real estate outright, they would have to deed fractional interests in the property to their children, a costly and time-consuming affair.

In the alternative, the parents could contribute the real estate to a newly-formed family limited partnership. The parents could then serve as the general partners of the partnership, initially owning all of the general and limited partnership interests, and then gift the limited partnership units to their children over a period of years using their \$10,000 annual gift tax exclusions. The parents could combine gifts in order to give each child \$20,000 worth of limited partnership units each year.

In order to accurately reflect the value of the annual gifts, it will be necessary to appraise the property (or family business) and then distribute a sufficient portion of the partnership to reflect the \$10,000 (or \$20,000 combined) annual gift. Thus, in our example, the parents could gift limited partnership units to their three children (valued at \$60,000/year) and remove the entire \$1 million asset from their estates over a seventeen year period without tax consequences and without ever losing management control over the real estate. In the alternative, they could take advantage of their combined \$600,000 unified credits to gift all of the limited partnership units in one year (a technique which can be very beneficial in situations where marital assets are appreciating rapidly).

Furthermore, because the children will never have any control over the property and will never be able to sell off their interests in the partnership without their parents' permission, the parents will be able to gift even more than \$20,000 worth of real estate each year by utilizing the partnership structure. For example, the net value of the property contributed to the family limited partnership in the example above is \$1 million. However, the value of the limited partnership interests gifted to the children do not equal the proportionate interests in the underlying real estate because the limited partners have no control over the operation of the partnership and are prohibited from selling their partnership interests.

Limited partners, by law, are prohibited from participating in the daily operations of a partnership. They may not appoint managers, decide on the future direction of the partnership, declare distributions, determine compensation or force liquidation or sale of the underlying assets. Both the IRS and the tax courts have recognized that a minority interest ownership position such as a limited partnership interest is worth less than a proportionate percentage of the underlying assets because of this lack of control. Not having direct access to the underlying assets of the partnership or the ability to control those assets allows for a discount of the limited partners' percentage interest of the partnership's aggregate value.

The other factor to consider in valuing the limited partners' interests in the partnership is the marketability of such interests. Unlike a publicly traded security, there exists no ready means for limited partnership interests. Furthermore, in the context of a family limited partnership, the partnership agreement will generally provide additional restrictions on the transferability or disposition of limited partnership units such as the right of first refusal by the general partners or an outright prohibition on transferability (without the general partner's approval). Thus, the limited partners' interests in the partnership should be assessed an additional discount to reflect this lack of marketability.

The combined discounts for lack of control and lack of marketability can conservatively reduce the value of a limited partnership interest for gift tax purposes by as much as 30 to 50 percent depending on the circumstances. Consequently, a large percentage of the net equity of a family limited partnership can be gifted utilizing the annual gift tax exclusion and the unified credit.

For instance, in the example above, if the parents were to use a very conservative 30% discount, instead of a combined annual gift to each of their three children of \$20,000 worth of real estate, they could give away limited partnership interests worth \$28,571 to each of their three children or \$85,713 worth of real estate each year without any gift tax consequences, thus enabling them to gift away the entire value of the \$1 million parcel of real estate in less than twelve years. In the alternative, the parents could utilize a portion of their \$600,000 unified credits to gift all of the limited partnership units in one year, using only \$700,000 of combined unified credits. In fact, utilizing only the couples' unified credit and taking advantage of the 30% discount, the parents could remove over \$1,700,000 from their combined estates in a single year, potentially saving over \$900,000 in federal estate taxes.

Since the value of property varies from year to year, it is important to review the value of the limited

partnership interests on an annual basis prior to making any gifts that are intended to qualify for the \$10,000 annual gift exclusion. Also, the amount of discounting available may be affected by the type of property owned by the partnership. If the partnership owns mostly marketable securities, the discounting allowable for the partnership units will generally be less than for illiquid assets such as real estate. Whereas, if the partnership owns a closely-held business or a parcel of real estate, the discounts applied to the partnership units will most likely be higher.

For instance, one well-respected appraisal group is currently providing minority interest discounts of as much as fifty (50%) percent, combined with marketability discounts of as much as thirty-five (35%) percent on illiquid assets such as real estate for a blended discount equal to sixty-seven and one-half (67.5%) percent. Thus, in the example above, if the parents were to utilize such an aggressive approach, they could gift away limited partnership interests worth \$61,538 to each of their three children, or \$184,614 worth of real estate each year, without any gift tax consequences. This would enable the parents to gift away the entire value of the \$1 million parcel in less than six years.

Probably one of the most attractive features of the family limited partnership is the parents' ability to retain control over the assets even after they have gifted the underlying value to their children. Since limited partners are not permitted to participate in the management of a partnership's business, total control over the assets of the partnership is vested in the general partner(s). Thus, by acting as the sole general partners, the parents can retain total control over the assets transferred to the partnership while retaining as little as one (1%) percent of the partnership's equity interests.

If the parents' intent is to direct the future control over a family asset or business, they may do this by directing, in their wills, or other appropriate documents, the disposition of the general partnership interests. Under state law, the death or bankruptcy of a general partner generally terminates a partnership. Although the partnership agreement may permit a majority of the remaining partners to vote to continue the partnership if the general partner dies, there is no guarantee they will do so. Therefore, if the parent acts as a general partner in his or her individual capacity, there may be some limit on the ability of the partnership to continue.

Therefore, if business continuity is important, the parent should consider structuring the limited partnership with a corporate general partner. Instead of owning the general partnership interest directly, the parent(s) would form a corporation which would own the general partners' interest. The parent(s) would own the stock of the general partner so that upon the death of either parent the partnership would not terminate. The parent(s) could direct future control of the business by leaving the stock to the particular family members that they wish to control the business after they are gone. This may enable the parent(s) to equitably distribute the assets of their estates to a group of children while allowing them to vest control in one or more children who will then manage the partnership property.

Note, however, that when a corporate general partner is used in a family limited partnership, careful attention must be paid to the classification issue -- whether the partnership will, in fact, be taxed as a partnership, or whether it will be treated as a corporation for federal income tax purposes. Proper planning avoids an improperly drafted partnership agreement that could result in the partnership being subjected to corporate-level taxation.

Another attractive feature of the family limited partnership is the ability to protect the partnership assets from the children's creditors or other persons who may have claims against their assets. For instance, if one of the children were to declare bankruptcy or be put into receivership, his or her creditors would be severely limited in their ability to attach any of the partnership assets. The child's creditors could not order the

liquidation of the partnership, disposition of partnership assets or a partition of any part of the partnership assets.

Often, the best result a creditor can expect is merely the right to receive distributions attributable to the limited partnership unit if and when they are distributed by the partnership. The parent, as general partner, has a great deal of control over the amount and timing of their distributions. As a result, creditors are hesitant to take partnership units which could result in the creditor receiving "phantom" income for federal income tax purposes and no cash to pay the tax liability. Such limitations may facilitate the child's ability to reach a favorable settlement with his/her creditors.

Furthermore, a limited partnership agreement can protect the integrity of the family business by giving the partners or the partnership the right to acquire the interests of any bankrupt partner. This is generally accomplished by permitting the partnership or other partners the right of first refusal to acquire any assets that might fall into the hands of any outsider.

### Conclusion

As provided above, family limited partnerships can provide numerous benefits for both tax and business reasons. However, the issues involved in establishing such an entity to meet these goals are numerous and complex. Accordingly, anyone who is considering setting up a family limited partnership should always consult counsel in order to properly implement the techniques described above.

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