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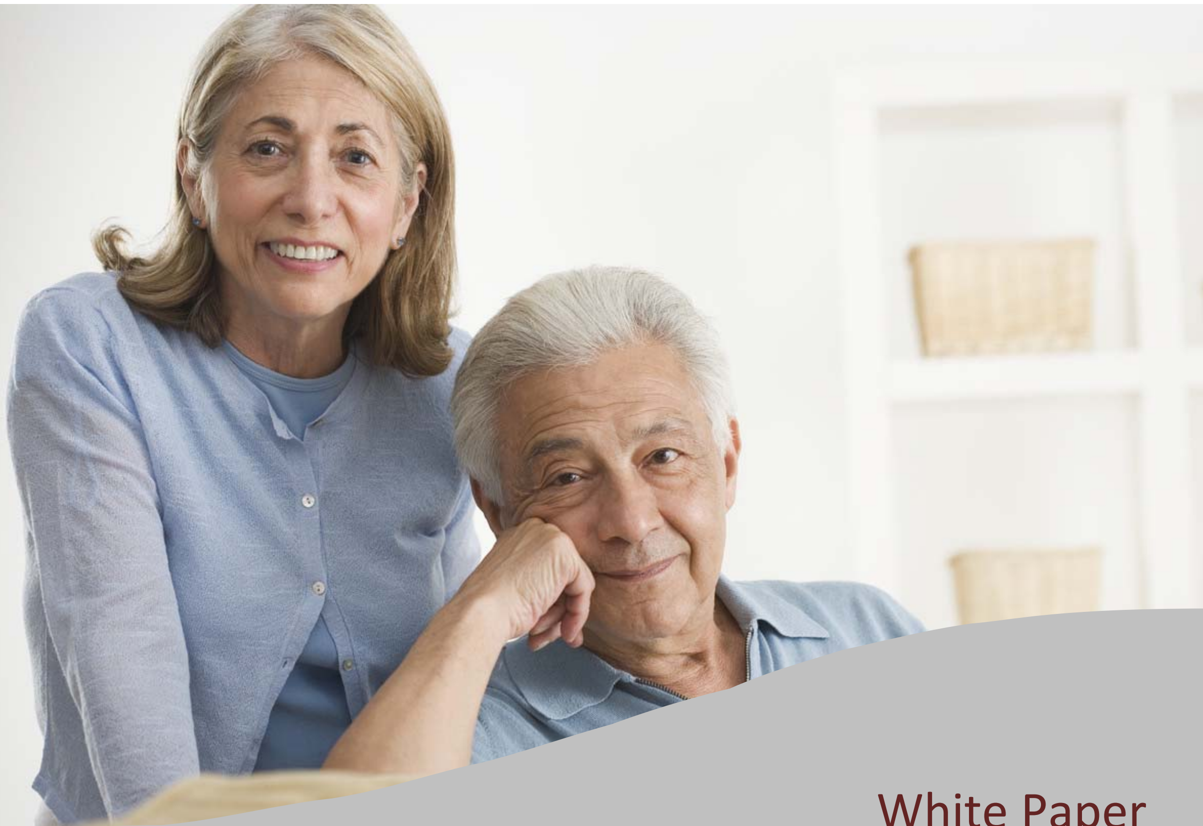

White Paper

Estate Freeze Technique:

Family Limited Partnership

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Estate Freeze Technique: *Family Limited Partnership*

What is it?

A family limited partnership (FLP) is a limited partnership created under and governed by state law and of which two or more family members serve as limited and/or general partners. It can be a powerful estate planning tool that (1) reduces income and transfer taxes, (2) permits you to distribute business assets to your heirs while retaining control of the business, (3) ensures continued family ownership of the business, and (4) provides liability protection to the limited partners.

By organizing your business as an FLP, you can shift income and future appreciation of the business assets to other members of your family. In addition, you can keep the management of the business in your own hands without causing the entire business to be included in your gross estate at death. Gifting interests in an FLP may reduce transfer taxes by letting you take advantage of certain tax laws (e.g., the federal annual gift tax exclusion). Most importantly, gifts of FLP interests qualify for discounts that can reduce the taxable value of the gifts by as much as 35 percent (or more in some cases). An FLP also guarantees that there will be continuous family ownership of the business because each family member's ability to sell or transfer his or her interest to nonfamily members is restricted. At the same time, an FLP affords all the limited partners liability protection, regardless of the extent of their participation in the business.

Upon formation of an FLP, you and your family members transfer property to the FLP in return for an ownership interest in the FLP. At least one family member (or, more commonly, a corporation or limited liability company controlled by family members or sometimes even a trust) must be designated as the general partner. The general partner retains management control over the assets and operations of the business, and determines if, when, and how much of the partnership income is distributed. The general partner also assumes personal liability for the debts and liabilities not satisfied by the assets of the FLP.

Other family members become limited partners. These members have no say in how the business is run. In return for giving up that right, the personal liability of the limited partners is limited to the value of their capital account (generally, the amount he or she has contributed to the FLP).

Often, an FLP is formed by a member of the senior generation who becomes the general partner. This person may also own the remaining interests in the partnership as a limited partnership which he or she then gifts to the junior generation, or members of the junior generation may purchase limited partnership interests. The general partner need not own a majority of the partnership interests. In fact, the general partner can own as little as one percent. Conversely, the limited partners need not own a minority share.

Technical Note: The percentage that must be owned by the general partner is determined under applicable state law.

When can it be used?

FLPs must comply with state law and IRS requirements

An FLP is a special form of partnership that is entitled to special benefits and is also subject to more restrictive rules than other forms of business entities. Care must be taken to create a valid FLP in the eyes of the state and the IRS. An FLP will be recognized only if it is formed for a valid business purpose. The FLP form will be disregarded if the IRS or the state finds that it was formed solely to avoid taxes. In fact, the IRS has enacted certain laws (so-called anti-abuse provisions) to prevent taxpayers from using the FLP form as a means to split family income and circumvent taxes.

Six factors must be satisfied in order to qualify as a valid FLP:

- Distributions of interests in an FLP must be to family members only. The IRS defines family for income tax purposes as your spouse, ancestors, lineal descendants, and any trusts established for the benefit of these persons.
- Reasonable compensation must be paid to partners who actually work for the partnership.
- FLP income distributed to a partner can't be disproportionately greater than the capital contributed by that partner.
- Partners must receive partnership interests through a bona fide transaction (gift or sale).
- The FLP must own income-producing assets (e.g., inventories, machinery, and equipment).
- All formalities of existence must be observed.

Caution: Under the legal test established in the Kimball case, a sale is bona fide if, as an objective matter, it serves a "substantial business or other nontax purpose." However, as illustrated by the Strangi case, it is unclear what this standard means precisely, or how this standard can be satisfied. Also illustrated in the Strangi case, an FPL will be disregarded if there is an "implicit understanding" that the transferor would continue to use the transferred assets as needed. It is, therefore, additionally recommended that you state a valid, nontax purpose for creating the FLP in the FLP agreement, and do not fund the FLP with non-business property.

Strengths

Shifts income among family members and may help avoid income taxes

An FLP is a pass-through entity for income tax purposes. That means that the IRS does not recognize the FLP as a separate taxpayer (as it does for a corporation). The income earned by the FLP passes through to the individual partners who must report their share of the income and other items of the FLP on their personal income tax returns.

The special income tax characteristics of an FLP may be especially attractive if you transfer partnership interests to family members who are in a lower income tax bracket. The family as a whole enjoys the tax savings.

You may transfer interests in the FLP to a minor child as long as the child (1) is competent to manage his or her own property and (2) participates in the FLP activities. As a practical matter, minors generally do not possess this kind of maturity. Therefore, interests to minors should not be given directly, but rather to a guardian or in trust. In addition, be aware that unearned income of children under age 18 may be subject to the kiddie tax, which makes such income taxable at the parents' income tax rate.

> **Caution:** For tax years beginning after May 25, 2007, the Small Business and Work Opportunity Tax Act of 2007 expands the kiddie tax rules to apply to children who are 18 years old or who are full-time students over age 18 but under age 24. These expanded rules only apply to children whose earned income does not exceed one-half of the amount for their support.

> **Tip:** The general partner is entitled to a management fee. This fee is taxable to the general partner as ordinary income.

May help avoid transfer taxes

One of the most powerful advantages of an FLP is that it can be used to avoid transfer taxes, which are charges at rates as high as 45 percent (for 2007, 2008, and 2009). Transfer taxes include generation-skipping transfer taxes, gift taxes, and estate taxes (both on the federal and state level). Transfer tax avoidance is accomplished in four ways:

- Removes future appreciation. Business assets generally increase in value over time. Transferring assets to an FLP whose interests are then transferred to other family members freezes the current value of the assets in your estate and puts any growth in value of the assets into the estates of other family members. You may have to pay transfer taxes now, but the taxes paid now will be less than if taxes were assessed on the higher future value.
- Takes advantage of the federal annual gift tax exclusion. Generally, transfers of FLP interests are taxable gifts. However, you can minimize your actual federal gift tax liability by taking advantage of the annual gift tax exclusion, which allows you to give $12,000 to each donee free from gift tax.

> **Caution:** Too many restrictions imposed on the holders of the limited partnership interest may cause the IRS to disallow the annual gift tax exclusion for transfer of such interests. The FLP agreement must be drafted to allow donees receiving limited partnership interest as gifts some ability to benefit from such interests immediately upon receipt. This may be especially tricky if the interests are put in a trust. Be sure to have an experienced attorney draft the FLP agreement and any associated trust documents.

- May be entitled to valuation discounts. This is one of the most attractive features of the FLP form. The transferor is generally able to discount the value of the limited partnership interests he or she gives away. The value of the limited partnership interests can be discounted because the limited partner has restricted rights, such as (1) the inability to transfer or sell the interest, (2) the inability to withdraw from the FLP, (3) the inability to force distributions, liquidation, or dissolution, and (4) the inability to participate in the management of the FLP. These restrictions result in a business value that is significantly less than the value of the underlying assets. These restrictions may result in valuation discounts (referred to as the lack of control discount and the lack of marketability discount) which can be considerable and can be used for purposes of calculating federal gift tax, GSTT, and estate tax.

Caution: The IRS may claim that some discounts are offset by a control premium. The control premium represents an increase in the value of an interest and may be applicable to the interest of a partner who has voting control or a swing interest. The IRS bases its position on the fact that such centralized control increases the value of the interest to a partner who holds such an interest.

Allows you to maintain control of the business

Another attractive aspect of an FLP is that it gives you the ability to transfer your business assets to your heirs now and, at the same time, continue to control the business. As long as you designate yourself as the general partner, you can control the business even if you own as little as one percent. You control the cash flow, distribution of income, investment of assets, and other managerial decisions. This may be advantageous if you are afraid the younger generation may mismanage, waste, or otherwise dissipate the business assets. This may also be advantageous if you're the only family member who is truly interested in running the business, but must share ownership with other family members, or if family members don't get along and cooperation seems unlikely.

Keeps the business in the family

You may be concerned about your hard-earned assets winding up in the hands of persons outside of the family. Limited interests in an FLP are restricted by the terms of the FLP agreement. Such restrictions may include the inability to transfer a limited partnership interest (by gift or sale) unless the other partners are first given the opportunity to purchase (or refuse) the interest. This is referred to as a right of first refusal. This virtually guarantees that outsiders cannot obtain or share in ownership of the business.

Tip: Be sure to include a right of first refusal provision in the FLP agreement.

Provides for children not in the business

The FLP form is a great way to evenly distribute your estate among all of your children, even though some of them may not want to be involved in the business. Through ownership of limited partnership interests, children who are not involved in the family business can benefit from the income distributions that are made from time to time, or on an as-needed basis.

Protects assets

Asset protection may be achieved in two ways:

- A corporate general partner provides liability protection. If asset protection is a strong concern, you may want to set up a corporation to function as the general partner. In this way, personal liability that attaches to the general partner may be averted since a corporation is a limited liability entity. However, this strategy may fail if a party is able to successfully argue that the corporate entity is a sham, established merely to escape liability, and that it should be ignored (this is known as piercing the corporate veil). In order to avoid this result, it is vital that you keep the corporation completely separate from the FLP. Do not commingle funds or assets (e.g., do not let the corporation pay the FLP's bills). Scrupulously observe all the formalities required to maintain corporate status (e.g., keep records and minutes, hold directors and shareholders meetings, file annual reports). It is recommended that you seek the advice of an experienced corporate attorney if you are considering this strategy.
- Puts asset beyond the reach of certain creditors. An FLP can provide some measure of asset protection to the limited partners. Because the limited partners no longer own the assets contributed to the partnership, the ability of a limited partner's creditors to attach those assets becomes severely limited. It generally takes a court order to reach a limited partnership interest, and even this only requires the FLP to pay income to the creditor instead of the partner(s) in question until the debt is paid. In most cases, the creditor is not permitted to become a partner and is not entitled to demand distribution from the partnership. He or she must wait until the general partner decides to distribute income (which may be a very long time). In addition, the assets are protected from loss due to divorce. The general partner, however, does not receive the same protection and is personally responsible for the debts and liabilities of the FLP (unless the general partner is a corporate entity, as previously described).

Offers flexibility

Unlike an irrevocable trust or a corporation, it may be possible to amend the terms pursuant to which the FLP operates by a vote conducted according to the terms of the existing FLP agreement.

Ownership of assets may be consolidated and simplified

All of the business assets of the general and limited partners are consolidated in an FLP. This simplification of the management of the assets results in cost savings and more efficient and productive use or investment of those assets.

Avoids probate

Assets that have been irrevocably transferred to the younger generation, or to anyone before you die do not usually have to pass through probate. The probate process can be quite lengthy and costly. Interests you hold in the FLP must pass through probate; however, interests in the FLP that were irrevocably transferred before your death are not included in your estate and are not probate assets, so probate costs will be saved.

May avoid ancillary probate

Generally, the probate process occurs in the state in which you reside at the time of your death. However, if you own real estate in another state, your estate will also have to go through the probate process in that state. This is known as ancillary probate. Most states treat FLP interests as personal property, even if the FLP owns real estate. Thus, if you transfer real estate located in a state other than the one in which you live to an FLP, you may avoid ancillary probate for that real estate.

Maintains your privacy

Assets that pass through probate become a matter of public record, available for inspection by anyone who cares to look. Because FLP interests transferred prior to your death pass outside of probate, this distribution of your property remains private (unless, of course, you choose to tell someone).

Ensures continuity of business operations

If the FLP remains intact after you die, it will continue to operate and should not suffer from any disruption due to transfer of ownership details.

Tradeoffs

Is a relatively complex form of business entity

Although most legal and tax issues surrounding creation and operation of family limited partnerships (FLPs) are settled at the federal level, this may not always be the case. In addition, these issues are extremely complex and technical. It is highly recommended that you seek the advice of a competent, experienced attorney.

May be subject to generation-skipping transfer taxes (GSTT) and/or gift taxes

Gifts of interests in an FLP are taxable transfers for GSTT and/or gift tax purposes, and may result in tax liability (federal and state) subject to the applicable deductions, exclusions, and credits.

Can be costly

Setting up an FLP can be expensive. You will need to hire an attorney to advise you, draft the FLP agreement, and perhaps set up a trust or a corporation to act as general partner. Other costs may include: (1) the cost to transfer titles to assets, (2) appraiser's fees, (3) state and local filing fees, and (4) tax accountant's fees.

May create a state gift tax problem in some community property states

In some community property states, compensation income from interests in an FLP acquired before marriage is classified as community property, but income distributed to partners from FLP profits is classified as separate property. If separate property income is used for the benefit of both spouses, this may be a taxable gift. This is not a problem on the federal level because gifts to spouses are subject to the unlimited marital deduction. However, depending on the gift tax laws in your state, state gift tax may be incurred.

How to do it

Hire an attorney

The first thing you should do is hire a competent and experienced attorney, preferably one with knowledge of partnership, tax, and/or estate planning law. The attorney should advise you about the legal issues and complexities of a family limited partnership (FLP). In addition, your attorney should (1) carefully draft all the necessary documents to effectively create the FLP under your state's laws, (2) help you file all the necessary forms with the appropriate state agencies, and (3) help you transfer title to all assets contributed to the FLP.

> **Tip:** You may want to hire a tax accountant to give you advice on the future tax consequences of the FLP.

Hire an appraiser

You should have the value of the assets contributed to the FLP professionally appraised in order to assign a reasonable value to the partnership interests and discounts that may be used for tax purposes. If the IRS questions these values, the burden is on you to prove that they are legitimate. The best proof is a written appraisal from a reputable appraiser that backs up your numbers.

Observe all formalities of existence

FLPs must observe certain formalities of existence. Disregarding these formalities can have disastrous consequences; the IRS may disregard the FLP and all your tax savings plans will go down the drain. Be sure to follow all of these rules:

- Execute a written agreement setting forth all the rights and duties of the partners

- File all necessary certificates and documents with the state
- Obtain all necessary licenses and permits
- Obtain a federal taxpayer ID number for the FLP
- Transfer title to all the assets contributed to the FLP
- Open new accounts in the name of the FLP
- Transfer title to all the assets contributed to the FLP
- Amend any existing contracts relating to assets transferred to the FLP to reflect the FLP as the real party in interest
- File annual federal, state, and local reports
- Do not commingle partnership assets with the personal assets of any individual partner
- Keep appropriate business records
- Include partnership interests on personal annual income tax returns

Tax considerations

Income Tax

FLP is a pass-through entity

Because an FLP is treated as a pass-through entity, the partnership itself is not recognized as a separate taxpayer and does not pay income taxes. The income, along with some deductions and credits from the partnership's activities, are passed through to the partners, who must report the FLP's income and other tax items on their own personal income tax returns. The partnership must, however, file an information return (Form 1065) showing the share of income, expenses, deductions, and credits that has been allocated to each partner. Schedule K1, which is part of this return, is distributed to the partners so they know what partnership items must be reported on their personal income tax returns.

Gift Tax

Gifts of interests in FLP may be subject to gift taxes

When the general partner (usually the senior generation) gifts the limited partnership interests to the limited partners (usually the junior generation), the transfer may be a taxable gift upon which federal gift taxes are assessed. The transfer will be a taxable gift if the fair market value of the interest transferred is greater than the annual gift tax exclusion; however, gift tax on the transfer may be offset by the transferor's $1 million gift tax applicable exclusion amount (formerly known as the unified credit), if it is available. The value of the limited partnership interests transferred may be discounted for purposes of determining the amount of the taxable gift.

Estate Tax

FLP may help to freeze value of estate

The use of an FLP can be an excellent way to freeze the value of the assets owned by the senior generation. When a senior family member contributes appreciating assets to an FLP and then gifts limited partnership interests, any appreciation after the date of the gift in the value of the assets contributed to the partnership is not included in the donor's gross estate for estate tax purposes.

Variations from State to State

FLP interests owned prior to marriage may cause problems in certain community property states

In certain community property states, income on the separate property of one spouse is considered separate property income. In these states, if interests in an FLP are owned prior to marriage, are received as a gift or through an inheritance, or are otherwise considered the separate property of one spouse, the income from partnership profits that is received on such interests after marriage will be considered the separate property of the owner/spouse. However, compensation paid to the owner/spouse based on the owner/spouse's activities on behalf of the partnership will generally be considered community property. In other community property states, the income from the separate property of one spouse is considered community property. In these states, if interests in an FLP are owned prior to marriage, are received as a gift or through an inheritance, or are otherwise considered the separate property of one spouse, the income that is received on such interests after marriage (whether it is income on profits or compensation income) will be considered community property.

> **Tip:** The FLP agreement should state whether the partnership interests are community or separate property. If the agreement does not designate the nature of the interests, then this may be a source of contention and litigation if the spouses should divorce.

Questions & Answers

Can a life insurance policy be transferred to an FLP?

Yes. A life insurance policy on the life of a partner may be transferred to an FLP.

> **Caution:** An FLP must be engaged in valid business or financial activities. There is some question as to whether an FLP that holds only a life insurance policy meets this test. Consult an experienced attorney.

Can the voting stock in a closely held corporation be transferred to an FLP?

There may be a problem if voting stock in a controlled corporation is transferred to an FLP. If the transferor of the stock is also the general partner of the FLP (which is often the case), and the transferor

as the general partner votes the stock of the controlled corporation, the value of the stock will be included in the transferor's gross estate for estate tax purposes. This could have disastrous estate planning results for the transferor. One way to avoid this result is to transfer nonvoting stock to the FLP. It should also be noted that a subchapter S corporation cannot have a partnership as a stockholder.

Can you fund an FLP solely with marketable securities?

With the tremendous increase in equity values since the early 1980s, many individuals with substantial stock portfolios have searched for ways to more efficiently (from a tax perspective) transfer their stock to their heirs. Some aggressive estate planners have recommended that these clients set up an FLP and fund the partnership with marketable securities. However, there is some question as to whether the IRS will challenge the use of an FLP that holds only marketable securities. First, there is some question as to whether a partnership that passively holds a portfolio of equities and owns no other assets has a valid business purpose. Second, such a partnership may run afoul of the investment company rules causing the transferor to realize capital gains in the portfolio at the time of the transfer.

Disclosures

This material does not constitute the rendering of investment, legal, tax or insurance advice or services. It is intended for informational use only and is not a substitute for investment, legal, tax, and insurance advice.

State, national and international laws vary, as do individual circumstances; so always consult a qualified investment advisor, attorney, CPA, or insurance agent on all investment, legal, tax, or insurance matters.

The effectiveness of any of the strategies described will depend on your individual situation and on a number of other factors. After reviewing your personal situation, we may recommend that you not use any strategy in this document but instead consider various other strategies available through our practice.

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