

Family limited partnerships: The pros and cons

A new approach to managing family wealth, the family limited partnership (FLP) has become popular in recent years. As an alternative, a Family Limited Liability Company may be used with similar results. These techniques offer several possible advantages:

- consolidation of assets for convenient management;
- segregation of assets for liability protection;
- gift tax valuation discounts.

In a typical FLP the parents transfer assets in exchange for general and limited partnership interests. Interests in closely held businesses, real estate, marketable securities or other appreciated assets may be placed in the partnership. As general partners, the parents continue to have complete control and responsibility for the partnership assets. Limited partners typically have only a right to receive a proportionate share of partnership income. Furthermore, the limited partnership interests are usually subject to significant restrictions on transferability.

The parents transfer the limited partnership interests to their children, usually over a period of years. The gift of a limited partnership interest qualifies for the \$11,000 annual exclusion from gift tax, so there will be no tax due on small transfers.

Example: Parents transfer property worth \$4 million to an FLP in exchange for a 25% general partnership interest and 3,000 limited partnership shares. Each limited share thus would be worth \$1,000 (but see farther on concerning the issue of discounts). Each parent may transfer 11 shares each year to each of as many beneficiaries as desired before a gift tax is due. If there are two children and three grandchildren, that means that \$110,000 in value may be gifted tax free.

After the transfer each limited partner will owe income taxes on his or her proportionate share of partnership income. The parents will continue to manage the property. There is no gain or loss to the parents upon the contribution of assets to the partnership. Built-in gain in an asset will be recognized by the parent if the asset is sold—it is not possible to shift such gains to the other partners.

Asset protection

In most FLPs the restrictions on the limited partnership interests are such that the partnership assets are fully protected from the claims of creditors of the limited partners. With its many restrictions the limited partnership interest is not typically awarded to a divorcing spouse in the event that a marriage fails. If a nonfamily member should acquire a limited partnership interest as a result of divorce, the partnership agreement can require that the interest be sold to the remaining partners.

The parents also may acquire some protection of the assets from their future creditors.

The implicit leverage of valuation discounts

At one time IRS argued that all the shares held by family members should be valued as a single large block, because the family members did not have interests adverse to one another. However, this position was rejected by the courts, opening up the possibility of discounts for gifts within the family.

With the severe restrictions on transferability and the absence of any control over the business enterprise, the limited partnership interests are usually eligible for significant valuation discounts, ranging from 15% to 50%. In our example, if a 50% discount is appropriate, each parent could transfer 22 shares to each child or grandchild each year without gift tax, a total of 220 shares. If the shares did not increase in value, over a ten-year period, 2,200 limited partnership shares could be transferred, and over 15 years all the limited partnership shares, initially worth \$3 million, could be transferred tax free.

If the shares rise in value, the tax-free gift program would take longer to complete. But then all postgift appreciation in value would completely escape estate and gift taxation.

Problems

There are many potential tax traps associated with FLPs, so the advice of tax specialists is a must. In addition, there are significant costs associated with setting up and monitoring a family limited partnership, including an initial appraisal and additional appraisals every time that a gift is made.

The IRS has been scrutinizing FLPs closely and challenge the size of the valuation discounts applied to the limited partnership shares. The burden of proving the

appropriateness of the discounts (and the costs of expert opinions in support of them) falls on the taxpayer. In some cases the Service has denied valuation discounts altogether, eliminating all tax benefits. IRS is looking for a valid business purpose for the creation of the partnership, other than to secure tax benefits.

Although family limited partnerships may be a sound way to manage family wealth so long as the parent is alive and in good health, they do not always provide a mechanism to resolve the conflicting objectives of the children. Some of the limited partners may want to liquidate the partnership, while others prefer to have an ongoing investment. Some sort of succession plan needs to be put into place.

One approach to problem resolution is to give each partner the right to sell or withdraw from the partnership, taking a share of the partnership assets. But there's a paradox: The more flexible and convenient such an arrangement is, the more it encroaches on the valuation discounts, which should not be so steep if limited partners have easy access to the exit.

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Any developments occurring after January 31, 2006, are not reflected in this article.