CHAPTER 73

Family Limited Partnerships

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Family limited partnerships (FLPs) are one tool in the estate planning attorney's toolbox and are primarily used by people with estates large enough to be subject to federal estate tax. If you have such an estate and have a desire to retain control over your assets for the remainder of your life, as most do, it is something to consider.

One way to obtain a quick understanding of the benefit of an FLP as an estate planning tool is to imagine you owned a painting by Pablo Picasso worth exactly $10 million. You were about to sell it for that amount. Then the evening before the sale, the bottom right corner of the painting was cut off. It was a small cut, amounting to less than 3% of the painting. Obviously, the painting would no longer be worth $10 million. It is highly unlikely that the painting would sell for $9.7 million, which is 3% less than $10 million.

What would be the value of the painting now? While we are not certain what someone would pay for it, one thing that we do know is that it would be worth substantially less than $10 million. It might be worth $8 million, which is 20% less, or $7 million, which is 30% less, or maybe $6 million, which is 40% less. Similarly with an FLP, because you have family members who are limited partners and you no longer own 100% of the assets, the value of your interest is reduced by more than the amount owned by the other family members and therefore the value of your estate is decreased. Discounts for FLP interests are typically based on lack of marketability and lack of control of the partnership interest.

WHAT IS AN FLP?

Just as the name implies, an FLP is a partnership entered into between at least one general partner and at least one limited partner. Frequently the general partner is the person who owns the assets, but it can be a limited liability company, a corporation, a trust, or someone else in the family. The law requires that the partners in an FLP be family members and that includes spouses, ancestors, lineal descendants, and trusts for such family members.

The general partner has complete control over the partnership and is actively engaged in the management of the partnership. As such, if you serve as general partner, no one can order you to do anything. While your limited partners are your financial partners, the FLP agreement provides them with no ability to manage the underlying business. This can be of benefit to the limited partners in that they have limited liability for the acts of the partnership.

The major drawback to serving as the general partner is that you have unlimited liability. That means that you are exposed to being sued personally. For those concerned about personal liability, one alternative is to have a limited liability company of which you are a member, serve as the general partner.

WHY ENTER INTO AN FLP?

The primary reason people enter into FLPs is to reduce the size of their estate and therefore reduce estate taxes. This is done because of what is known as valuation discounts. To put it as simply as possible, and as the Picasso painting example illustrates, the value of all of the partnership interests in the partnership always add up to less than the value of the underlying asset(s).

However, there are a variety of other reasons to create an FLP. These reasons include protecting and conserving your family's assets and investments, protecting your children's property and inheritance from loss to a divorce or creditors, maintaining control of your assets, and creating a succession plan for the family business.

HOW DO FLPS WORK?

Jack Johnson is a 73 year old widower. He has four children and five grandchildren. Jack is concerned about maintaining family ownership of what he has worked hard to acquire. He receives a pension from work in the amount of $7,500 per month with cost of living increases, and also collects social security, and lives very comfortably on his income from those two sources. He has the following assets, all of which are in his living trust except for his IRA:

Banks Accounts and Certificates of Deposit	$ 375,000
IRA	$ 925,000
Mutual Funds/Marketable Securities	$ 800,000
Apartment Complex	$ 1,500,000
Additional Rental Real Estate	$ 700,000
Personal Residence	$ 700,000
Total	**$5,000,000**

Mr. Johnson's estate planning attorney suggests an FLP. Mr. Johnson agrees and decides to take an aggressive approach to funding the partnership. He places the real estate (other than his residence) and his securities/mutual funds into the FLP so that the FLP contains assets valued at $3 million. Mr. Johnson receives a 1% general partnership interest and the Jack Johnson Living Trust receives a 99% interest.

About six months after creating the FLP, Mr. Johnson gifts 12.5% limited partnership interests to each of his four children. To determine the value of the underlying gifts, Mr. Johnson hires a qualified appraiser to perform a qualified appraisal to determine valuation discounts. The appraiser determines that a 33.33% discount should be applied for lack of control and lack of marketability.

Mr. Johnson is therefore able, by applying the discount to the proportionate value of FLP assets, to give limited partnership interests valued at $250,000 instead of $375,000 to each of his children. Assuming Mr. Johnson has 100% of his lifetime gift tax unified credit of $1 million available, there is no gift tax required.

Shortly thereafter, Mr. Johnson dies before any appreciation of the assets in the FLP, and prior to having an opportunity to do any additional gifting. The appraiser determines a 20% discount should be applied to his general partner interest and a 30% discount should be applied to his limited partner interest on the estate tax return. Had Mr. Johnson died without an FLP, all $3 million of the assets transferred to the LLC would have been included in his estate. However, by utilizing an FLP, his taxable estate was reduced by approximately $445,000. Assuming a 45% estate tax rate, $201,000 in estate tax is saved.

The estate tax savings would have been significantly larger had Mr. Johnson lived longer, made annual gifts to his children and grandchildren, and had the assets in the FLP appreciated.

WHAT ARE THE DISADVANTAGES TO FLPS?

One of the most significant disadvantages of an FLP is that for highly appreciated real property, the gifted limited partnership interests do not receive a step up in basis. Rather, they have a carry over basis. Therefore, there may be capital gains taxes that would have been avoided had, for example, Mr. Johnson's children been beneficiaries of the real property at Mr. Johnson's death rather than gifted with the property during his lifetime.

Moreover, in certain states, including California, care must be taken so that real estate transferred to the FLP is not reassessed for property tax purposes. In other states, documentary transfer taxes may be an issue to consider.

The financial costs associated with an FLP include the initial fees paid to the attorney to create the partnership, state filing fees, appraisal fees, and the cost for preparing a tax return every year the FLP is in existence.

CONCLUSION

A Family Limited Partnership is a great estate planning tool that not only reduces estate taxes, but is also an asset protection tool, promotes family harmony, and may provide a business succession plan. Each person's situation requires an analysis of different factors, so working with an experienced estate planning attorney is therefore extremely important.

Michael Burstein's practice is focused on estate planning, elder law, estate administration, and probate. He has prepared more than 3,000 estate plans and probates 50+ estates per year.

Family Limited Partnerships: Advantages and Disadvantages

ADVANTAGES	DISADVANTAGES
Income tax advantages	Administration expenses
Estate freeze	"Real" discounted value
Estate and gift tax valuation adjustments	Potential family disharmony
Some degree of control over assets	IRS scrutiny
Facilitate family gifting	Reduced fringe benefits
Management flexibility	Restrictive income tax rules
Avoiding probate	Difficult trust administration
Avoiding fractionalization of title	Loss of basis step up
Creditor protection	Underfunded marital deduction
Some degree of control over donees	Liquidity concerns
Economies/diversification investments	Potential legislation
Keep assets within family	S corporation incompatibility
Flexibility to adapt	Uncertain estate tax implications
Dispute management	Investment company rules
Avoidance of guardianship	Maintain partnership formalities
Family communication in harmony	
Certainty of income tax treatment	