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THE CASE AGAINST FAMILY LIMITED PARTNERSHIPS
By Randy Spiro

The estate planning benefits of the family limited partnership (FLP) are well known. By dividing ownership into management (general partner) and passive investor (limited partners) units, the value of the limited partnership units may be reduced through minority and marketability discount, which is part of the valuation process by a qualified appraiser. But the FLP is a big ticket item for the drafting attorney, which raises the question of whether the down side of creating a FLP will be adequately discussed.

Internal Revenue Code Section 2036, includes in a transferor's estate assets that have been transferred away where the old owner had retained control. In many FLPs the parents wish to retain control, and they do so by retaining general partnership units. Courts have re-buffed the IRS's 2036 argument on this issue by saying that the parents as general partners have to exercise their management powers in a fiduciary capacity so they don't get the normal extra benefits of retained use. But a decertified Tax Court opinion (Strangi II) has in a footnote raised the possibility that the Tax Court may reconsider this issue. If it does, the value of the entire FLP will be included in the parents estate, including the children's limited partnership units, unless the parents did not take back general partnership interests when creating the FLP.

IRC Section 2036 is been actively used by the IRS already in other contexts. If the parents personal expenses are paid from the FLP or if the parents fail to retain sufficient assets outside of the FLP to pay their living expenses, or if disproportionate distributions are made to the parent, or if the FLP was created at the parents deathbed, or if other formalities of the FLP are not adhered to, the IRS actively seeks to include the entire FLP in the parents estate for estate tax purposes.

Sometimes success can be a failure. The amount a person can die with and pay no estate tax is now $3.5 million or $7 million for a married couple with an A/B Trust. If the estate would have been under $7 million even without the FLP, then by giving away limited partnership units to the children, those units will not qualify for a step-up-in-basis for income tax purposes on the death of the parent.

A donor can change his mind. But restrictions on the parent imposed by the FLP agreement are necessary to show that what the parent has given away and retained (i.e., the limited partnership units) are undesirable and therefore entitled to a healthy minority and marketability discount. If the parent wishes he or she could unilaterally liquidate the FLP and pocket the proceeds or pull back the gifts to a child who has married someone the parent doesn't like, the parent will find out that he or she is stuck with the restrictions built into the FLP agreement.

Many people with large estates already have an A/B Trust or an A/B/C Trust under which the assets are allocated among separate trusts where one spouse had died. This provides the surviving spouse as Trustee has the ability to fractionalize real estate and business interests among the various trusts. Doing so can qualify these interests for minority and marketability discounts albeit lesser discounts than those which the FLP interests would qualify for.