Estate Tax Law

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Planning to Pass the Baton: Family Wealth Transfers

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If you have accumulated a substantial investment portfolio, or you own a successful business, there may come a time when you start planning to transfer ownership of the investments, or business, to younger generations of your family.

Many investors and business owners who wish to transfer family investments or a family business to younger generations do so through the formation of a family limited partnership (FLP) or similar entity. As the name suggests, an FLP is typically a partnership that consists of family members. When an FLP is formed, senior members of the family transfer their investments or business to the FLP, and receive a majority ownership interest in the FLP. Younger generations may also contribute property, such as cash, to the FLP, and receive a minority ownership interest. Over a period of years, the senior family members may transfer to junior family members incremental ownership interests in the FLP. Eventually, through annual or other periodic transfers to junior family members, ownership of the investments or business is transferred to the junior members. The annual or periodic transfers can be in the form of gifts, sales, or a combination of both.

If one already owns investments or operates a business through an existing legal entity (such as a corporation, partnership or limited liability company), it is often possible to readily convert the entity into an FLP or similar arrangement, and proceed with a gradual transfer of ownership to younger family members.

FLPs offer many benefits. They can give younger generations a direct but noncontrolling interest in a family business or investment pool, help educate the younger generation with regard to business and investment matters, and enable younger generations to participate in business and investment management. FLPs can also address, in advance, the disposition of family property in the event of death, divorce or disability.

FLPs offer another substantial benefit. Typically, business or investment assets held in an FLP effectively have a reduced value for estate and gift tax purposes. This is because a business or investment asset that one can readily sell has a value equal to its fair market value; if a senior family member places the business or investment asset in an FLP, and cannot unilaterally cause a sale of the asset, the value is diminished. When ownership interests in the FLP are transferred to younger generations, and when the senior family member dies, the value of the FLP interests transferred or held at death is often considerably less than the value of the underlying assets held in the FLP.

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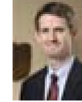

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The recent case of *Petter v. Commissioner* (9th Circuit, 2011) illustrates how an FLP may be used. In that case, Ms. Anne Petter formed the Petter Family LLC (a family limited liability company is similar to an FLP) and transferred to the family LLC United Parcel Service stock worth approximately $22 million, in exchange for ownership interests in the family LLC. Some days later, she transferred a portion of those LLC ownership interests to trusts for her children. In determining the value of the LLC ownership interests, an independent appraiser applied a significant discount, apparently in excess of 45%, to the value of the underlying UPS stock. The IRS subsequently audited the transaction, and Ms. Petter and the IRS eventually settled on a 35% discount. As a result, Ms. Petter was able to transfer considerable family wealth to or for her children, at a reduced tax cost.

Despite their many benefits, FLPs are not appropriate or worthwhile for everyone. Nevertheless, if you own substantial investments or a successful business, and wish to transfer ownership of the investments or business to younger generations, the FLP method should be considered.

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