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Family Limited Partnerships In Estate Planning

Many comprehensive estate plans include an organized schedule of lifetime giving. Making annual gifts during life is desirable for a number of reasons; but the two primary reasons are that the gift is accelerated to a time when the taxpayer's beneficiaries can better use the gifts, and the taxpayer is allowed to witness the enjoyment of the gifts.

From an estate planning perspective, however, the most valuable tool lifetime giving provides is the ability to leverage gifts; that is, by giving them away during life, the taxpayer is able to remove assets from his taxable estate before they increase in value or earn income. Likewise, annual giving allows the taxpayer to use the annual gift tax exclusion under Section 2503(b) of the Internal Revenue Code (IRC), which is currently $11,000 per recipient per year.

By making such annual exclusion gifts each year, over time a taxpayer can pass a great deal of value on to his beneficiaries (including all growth and income attributable to the asset after the gift) without incurring any gift or estate tax. Similarly, judicious lifetime use of the unified credit (now called "the applicable exclusion amount") under IRC Section 2010, even beyond annual exclusion giving, can place appreciating assets outside the taxpayer's estate before they become more valuable and increase the estate tax.

Lifetime giving can be an important part of an estate plan for taxpayers with smaller taxable estates and lots of beneficiaries. Although reducing the estate subject to estate tax at the taxpayer's death is an attractive goal, for various reasons some taxpayers resist giving up control of their assets. The family limited partnership (FLP) is an estate planning vehicle very commonly employed by sophisticated estate planners to address such concerns, allowing the taxpayer to further leverage lifetime gifts while retaining (or directing) exclusive control of the assets given away.

What Is a Family Limited Partnership?

A FLP is a business entity created and governed by the provisions of the limited partnership laws of the state in which it is set up. *(See Revised Uniform Limited Partnership Act, 6 U.L.A. 346, upon which many state limited partnership statutes are based.)* In practical effect, a FLP is no different from any other limited partnership, except that the partners are members of a family. Although the form and vernacular vary slightly from state to state, generally speaking a limited partnership differs from a general partnership primarily in that at least one of the partners is a *limited* partner and at least one is a *general* partner. The general partner or partners hold the power; they make and execute all the decisions about how the business is going to be run. The limited partners are part owners of the partnership and share in the income produced by it, but they do not participate in running the business and have no voice in making business decisions.

Not all partners need own an equal share in a partnership, either. A partnership may be owned equally by all partners or the ownership interests may vary widely in proportion to the whole. One person may own both general partnership interests and limited partnership interests.

Example: Thomas and Susie Mullins are in their early fifties and have four children ranging in age from 18 to 29. Thomas and Susie started a small publishing house 25 years ago and have built it into a thriving business currently worth about $2.5 million and growing in value by about 5 percent each year. Thomas and Susie are the sole owners of the family business. It is clear that the family business will be worth about $12 million at Thomas and Susie's life expectancy of 32 years, and passing it on to the children at the death of the surviving spouse would result in more than $5.5 million of estate taxes. If Thomas and Susie tried to give the business away to their children using their annual gift tax exclusion, they would still own more than $5 million of the business at their life expectancy, and still incur estate taxes of about $1.5 million.

The Mullins family's advisors have recommended that their estate plan would benefit from the leveraged giving and retained control afforded by an FLP. Thus, the Mullins family limited partnership was created and owned originally in the following proportions: Thomas and Susie each own a 1 percent general partnership interest and a 49 percent limited partnership interest. Thomas and Susie transfer ownership of the family business into the Mullins FLP. The parents now own exactly what they owned before, but now they are set up to do some estate planning work.

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Traditional Uses of FLPs in Estate Planning

Leveraged Giving. As mentioned already, FLPs can be useful in leveraging the transfer of assets from one generation to the next. In simple terms, this means that a taxpayer can increase the amount given away, sometimes dramatically, without increasing the gift or estate tax implications. This leveraging is accomplished by giving "discounted" partnership interests and depends on the concept that a partnership interest has a lower fair market value than the proportionate share of assets owned by the partnership. Remember that as a general rule the value of a gift for tax purposes is the fair market value of the asset given, at the time of the gift.

For example, assume that X owns real estate worth $1 million and gives a quarter of it to his son, Y. If Y is free immediately to sell his one-quarter interest in the real estate and, presumably, the price he could get on the open market is $250,000, then the value of the gift for tax purposes is $250,000.

Now, assume instead that X has transferred all of the real estate into his FLP, and X (and spouse) own all the FLP interests, comprising a 1 percent general partnership interest and a 99 percent limited partnership interest. Further assume that the partnership agreement limits the ability of a partner to sell a partnership interest, perhaps only to another member of the family. X transfers a 25 percent limited partnership interest to Y. Although Y owns the same proportion of the real estate as before, in fact all he owns is a minority interest in a partnership that carries with it no power to manage the partnership, with restrictions on what the owner can do with the interest. Quite predictably, the open market would give Y much less for his FLP interest than it would for the land because of the restrictions imposed. The value of this gift for gift tax purposes is the reduced, or discounted, fair market value.

If we examine the discounting another way, we can see another aspect of the power of discounting. If X wished to give his land to Y over time, making annual gifts in the amount of his annual gift tax exclusion to avoid gift taxation of the transfer, it will take him 91 years to pass the land entirely to Y. (For simplicity of illustration, assume no appreciation of the fair market value of the land.)

If, instead, X makes annual transfers

of limited partnership interests of the family limited partnership that owns the land to Y, and we assume a 40 percent aggregate discount (for the minority interest, lack of transferability, etc.), it will take only 55 years for X to completely transfer the land to Y. *(The 99 percent limited partnership interest is worth only $594,000 after the 40 percent aggregate discount. If X gives 1.85 percent of the limited partnership interest to Y each year, valued at $11,000 and therefore free of gift tax under the annual gift tax exclusion, it will take 54 years to completely transfer the limited partnership interest. In year 55, X gives Y the 1 percent general partnership interest, worth $10,000, also free of gift tax.)*

Retained Control. As we have seen, only the general partners in a limited partnership have control of the day-to-day management of and decision-making for the partnership. Thus, the FLP provides a mechanism by which a taxpayer can transfer virtually all of the legal ownership of an asset without surrendering control of the asset. This is an especially attractive feature where the recipients of the gifts, often the children of the taxpayer, are too young or inexperienced to manage the assets effectively themselves, or are likely to be subject to creditors' claims or claims in divorce. Actual control of the assets underlying the FLP can be retained by the taxpayer indefinitely or transferred to reliably responsible hands. *(See later discussion of the Hackl case and the dangers of too much of the wrong kind of control.)*

Consolidated Ownership. A single FLP can serve as the vehicle to simplify the management and transfer of ownership of a wide range of family assets. A program of scheduled lifetime outright gifts of cash and various other assets can be complicated and fraught with the peril of error. The FLP provides a consolidated container into which all such assets can be transferred. Only one transfer of partnership interest to each intended beneficiary need be made at the end of each year. In the meantime, control of all partnership assets is concentrated in the hands of the owner of the general partnership interest.

"The family limited partnership remains a powerful estate planning tool with broad applicability to many family circumstances."

Transfer of Future Income and Appreciation. As noted above, advisors commonly recommend lifetime giving as a part of estate planning to "freeze" the value of the assets for gift and estate tax purposes. From our example above, if we assume that X's real estate was appreciating at 5 percent each year and producing income of $100,000 each year, the value of the property (including income attributable to it) for gift tax purposes would grow to almost $2.9 million in ten years. If, instead, X makes annual gifts of land and attributable income to Y in the amount of $220,389, he will have given the land away to Y entirely by gifts aggregating $2,203,890. *(Ten annual gifts of $220,389.)* The difference is due entirely to the gradual movement of the income and appreciation to Y over time. Of course, by employing the discounting of restricted limited partnership interests, X need only make annual gifts of $167,647 for ten years, or aggregate gifts of $1,676,470.

Example: Let's get back to the Mullins family and see how all this works. The Mullins' family limited partnership now owns the family publishing house, and Thomas and Susie own all of the general and limited partnership. Thomas and Susie make combined annual gifts to each of their four children of limited partnership interests valued at $22,000. Because the value of these interests is discounted, each gift to each child actually transfers ownership of underlying assets with a value of $36,667.

The business in the FLP continues to grow through the years, so each annual gift represents a diminishing percentage of the overall value of the FLP. Over time, however, the work is done. At the end of Thomas and Susie's joint life expectancy of 32 years, they have transferred almost 93 percent of the FLP (more than $11 million) to the four children free of gift tax. The surviving spouse can dispose of the remaining interest in his or her will. *(This example assumes for simplicity that both spouses die in the thirty-second year. The example also makes no accounting for the shifting of income of the business over time, which would further leverage the gifting.)*

Where You Can Go Wrong

The Internal Revenue Service has long regarded family limited partnerships with an attitude moving at times between suspicion and open hostility. It has over the years repeatedly attacked discounting of the value of transferred interests in family limited partnerships, especially where it discerned no independent business purpose for the partnership. Consequently, where the IRS found no *business* being done by the partnership (e.g., where the partnership simply owned and managed securities or life insurance, much as the donor had owned and managed the assets), it would disregard the partnership, at least for valuation purposes.

Although the IRS has recently suffered a string of losses in cases before the tax court where the IRS had attempted to disregard a family limited partnership for valuation discount purposes, prudence is strongly recommended. *(Knight, 115 TC 506; Estate of Strangi, 115 TC at 487-489; Estate of Jones, 116 TC 121; Kerr, 113 TC 449; and Harper, TC Memo 2000-202.)* Many of these cases have not exhausted all appeals and therefore may still be decided in favor of the IRS.

Likewise, in several notable cases, the IRS has considered the partnership to be a sham based on the behavior of the parties, even where the partnership could be said to have clear business purpose. A recent such case, with exaggeratedly egregious facts, serves as a clear example of the cost of playing fast and loose with the formalities of the partnership. In Estate of Reichardt, 114 TC 144 (2000), the tax court disregarded a family limited partnership and held that the assets owned by the FLP were includible in the estate of the general partner for which the case is named.

In Reichardt, the general partner taxpayer transferred much of his personal assets to his FLP, including his home, personal assets, and cash. The taxpayer then transferred 30.4 percent limited partnership interests to each of his two children. At the time of these transactions, the taxpayer was terminally ill.

The taxpayer, as general partner, continued to live in his residence, but did not pay rent to the partnership. He paid his own personal expenses from partnership accounts and commingled partnership income and assets with his own. The court noted that the taxpayer was solely responsible for conducting the partnership's business activities and that the children took no action to prevent the mismanagement of the partnership. The court concluded that the taxpayer's enjoyment of his assets was not curtailed after the taxpayer transferred the assets to the FLP, and concluded that he enjoyed what amounted to a retained life estate in the assets. Consequently, the court held that the value of the assets was includable in the taxpayer's estate for estate tax purposes. *(See also Estate of Schauerhamer, TC Memo 1997-242. The facts in Schauerhamer are that a parent, after transferring assets to a FLP and giving FLP interests to the children, deposited income from assets owned by the FLP into her own bank account and used the funds for personal purposes.)*

The IRS recently denied the application of the annual gift tax exclusion to transfers of LLC interests from parents to their children and grandchildren, which denial was upheld by the tax court on appeal. The *Hackl* court agreed with the IRS argument that the operating agreement of the LLC placed such onerous restrictions on the rights of the members that any "enjoyment" by the members of the property transferred was, in essence, a future interest rather than a present interest. Because IRC Section 2503(b)(1) affirmatively excludes future interests from the annual exclusion, the court held that the transfers did not qualify *(Christine M. Hackl, et vir v. Commissioner; 118 T.C. No. 14; No. 6921-00; No. 6922-00 March 27, 2002.)*

It should be mentioned that the restrictions of members' rights imposed by the LLC operating agreement were, in fact, extensive. The manager retained virtually absolute discretion regarding the operation (and even the existence) of the LLC, the transfer of the members' individual interests, and distributions to the members. The operating agreement authorized the manager to appoint his successor by his will. Thus, the holding may be considered one limited to the unique facts of the case. Furthermore, a number of commentators have argued that the restrictions in the *Hackl* case can properly serve to grossly reduce the value of owning the LLC interests currently, but they do not transport such current ownership into a future interest. *(See Leimberg Information Services, Estate Planning Newsletter #397, Stephan R. Leimberg, March 28, 2002 (http://www.leimbergservices.com).*

Conclusion

The family limited partnership remains a powerful estate planning tool with broad applicability to many family circumstances. It can provide a centralized vehicle for the consolidated management and control of a wide range of assets, simplifying and streamlining the transfer of such assets to the next generation. A taxpayer's ability to make deeply discounted transfers over time gradually freezes the value of the underlying assets, while leveraging tax-free annual exclusion or unified credit giving. With a little planning and continued attention to detail, the FLP can continue to add a great deal of value to the well-rounded estate plan. ❑