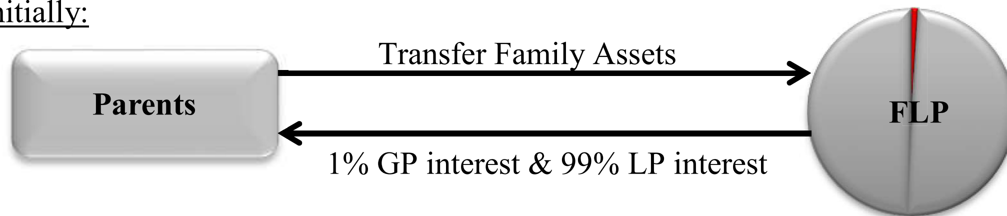
#13: Family Limited Partnership (FLP)

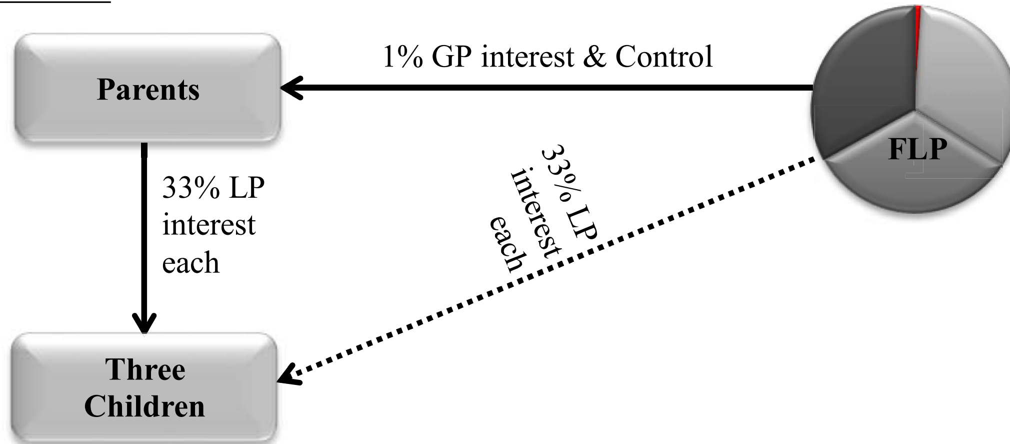
Another tax efficient way to shift wealth to future generations is by using a family limited partnership (FLP). By transferring family assets to a FLP, the senior members of a family are able to share the value of the assets with the younger members of the family while simultaneously maintaining control over the assets. In addition, by transferring the assets to a FLP, it takes them out of the senior family member's estate, generally at a substantially reduced transfer tax value.

One or both parents create the FLP and serve as the general partner(s), while the children and/or grandchildren serve as the limited partners. Initially, the parents hold both the general partner interests and the limited partner interests. Typically, the general partner interest will be as little as 1% of the total equity in the FLP and the limited partner interest will be the remainder of the equity in the FLP so it can be divided up among the children and/or grandchildren by the parents.

Initially:



End Goal:



The parents, as general partners, maintain full and complete control over the FLP while gifting as many of the limited partner units to their children as they desire; thus, reducing their taxable estates. Furthermore, gift tax and use of the applicable exclusion amount (formerly known as the unified credit) can be avoided if the value of the units transferred to each child does not exceed the annual exclusion amount ($18,000 per donee in 2024).

> ***Example 1.*** Parents transfer an asset with a fair market value of $1,000,000 to an FLP. In return, Parents receive a 1% general partner interest and a 99% limited partner interest. Parents wish to split the 99% interest evenly among their three children. To avoid paying gift tax or using any applicable exclusion amount (AEA), Parents gift $36,000 per year to each child (2024 annual gift exclusion of $18,000

x 2 parents). Therefore, in the first year, Parents will transfer 3.6% of the FLP in limited partner interests to each child (3.6% x $1,000,000 = $364,000 for each child, a total of 10.8%). That accounts for10.8% of the FLP in limited partner interests per year. At this rate, assuming no increase in the annual gift tax exclusion amount and no increase in the value of the asset, it will take Parents 10 years to transfer the entire limited partner interest to their children tax-free (99% / 10.8% = 9.166). Remember, even when the children own the entire 99% limited partner interest, Parents will still have exclusive control over the asset and the FLP because they are the only general partners.

If Parents wish to transfer assets faster, they can still avoid gift tax by using their AEA. For 2024, this amount is set at $13,610,000 per donor.

Valuation Discounts

The limited partner interests have no control over the FLP or its underlying assets, cannot be transferred without the general partner's permission, may represent only a minority position in the FLP, and have low marketability. As a result, their fair market value is lower than their proportionate share of the underlying partnership assets, making it appropriate to apply valuation discounts. This allows the parents to increase the amount of property that can be transferred with each annual exclusion amount. Combining all of these discounts could reduce the value of a limited partner interest by as much as 30-50% depending on the circumstances.

Example 2. Assume the same facts as in Example 1, except that a 30% valuation discount applies to the limited partner interest. Instead of Parents only being able to gift $36,000 per year to each child, they will be able to gift $51,429 per year to each child ($36,000 / .7). That accounts for 15.732% of the FLP in limited partner interests per year. Assuming everything else stays equal, it will take Parents 7 years to transfer the entire limited partner interest to the children tax-free (99% / 15.73% = 6.294).

Most assets change in value each year. This requires the limited partner interests to be revalued on an annual basis before making any gifts. If the value goes up, it will take the parents longer to gift the entire interest to their children; if the value goes down, it will not take the parents as long to gift the entire interest to their children. Furthermore, one must be careful with the type of discount rate they use – this is one way the IRS may try to disregard the FLP. The discount should be determined by experts and well documented.

These valuation discounts also enable Parents to leverage the amount of their applicable exclusion amount (AEA). Again, assuming a 30% valuation discount, the value of each AEA increases to $19,442,857 ($13,610,000 /.7) and the total AEA for both parents becomes $38,885,714. If Parents transfer limited partner units with a discounted value in excess of $38,885,714, gift tax will be payable.

Other Benefits

In addition to the valuation discounts and the non-tax benefits of a FLP already discussed above – parents retain full control over the assets, the assets are excluded from the parent's estate, and the children receive the assets tax-free – a FLP also has the ability to protect the assets from the children's creditors. A creditor can attach to the child's limited partner interest and usually obtain a "charging order" but that would only give a creditor the right to receive distributions if and when the child received them from the FLP. Since the child's parents are the general partners of the FLP, they control distributions. If a child owes money to a creditor, the parents can decide not to make distributions to the child. Therefore, if the creditor acquires the child's limited partner interest, it will not receive any money but will still be taxed on its share of partnership income. As a result, it is unlikely a creditor would even try to go after the child's limited partner interest.

FLPs can also provide the following additional non-tax benefits:

(1) Ensuring the continuation of a business after the senior members die;
(2) Limiting the liability of individual owners;
(3) Consolidating management of family businesses across a single entity;
(4) Enabling family members to pool their assets;
(5) Simplifying estate administration;
(6) Creating joint family management of assets;
(7) Helping children learn how to manage assets;
(8) Facilitating gifting;
(9) Protecting assets from irresponsible family members; and
(10) Reducing the expenses of managing assets.

Potential IRS Challenges

As noted above, the IRS is hostile toward valuation discounts on transfers of FLP units to family members and has used numerous strategies in an attempt to disallow or reduce discounts. These include:

- Taking the position that the FLP lacks economic substance and should be disregarded;
- Arguing that a gift occurred on formation of the FLP, resulting in a transfer of the FLP's underlying assets rather than a transfer of discounted partnership units;
- Using IRC § 2036(a) to bring the entity's assets back into the parents' gross estates if they retained too much control over the property transferred to the FLP;
- Using IRC § 2703 to disregard value reducing restrictions in the FLP agreement;
- Using IRC § 2704(a) to argue that the conversion of an ownership interest into an assignee's interest is a taxable transfer;
- Using IRC § 2704(b) to disregard any restrictions on liquidation that would otherwise reduce the value of the partnership interests; and
- Using their own valuation experts to challenge the amount of discounts claimed by the taxpayer's appraiser.

Furthermore, the FLP must be specifically designed to accomplish a valid business or investment purpose in order to pass muster. Some acceptable purposes are to:

- Conduct a family business;
- Pool family wealth and manage it in a coherent, structured way;
- Combine family wealth in order to have more opportunities for growth and investment; and
- Implement a succession plan for transferring management of the business from one generation to another.

The transfer tax benefits from using a FLP can be significant, but if it is not set up properly, the tax consequences can be very unfavorable. An experienced expert should always be consulted when setting up a FLP.

Income Shifting Benefits

In addition to the wealth shifting benefits of a FLP, it also provides various income shifting benefits. As the parents shift more and more of the limited partner interest in the FLP to their children, they are also shifting FLP income to their children. This can help lower the parent's taxable income, potentially allowing them to avoid the higher tax brackets and the net investment income tax (NIIT). However, remember to consider the Kiddie Tax.

> ***Example 3.*** In 2024, parents have $481,200 of salary income and $300,000 of net investment income (NII) from family assets (assume for ease of explanation that there are no deductions or other adjustments). After they retire, the parents will have adequate income from their 401(k) plans and IRAs. Parents also have three adult children filing joint returns who each have income of $95,000/year. Consider the following scenarios:
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> > Scenario 1: Parents do nothing. Therefore, they are subject to the highest income tax bracket (37%) on the last $50,000 of income ($18,500 of tax) and the NIIT (3.8%) on $300,000 of NII. This makes the NIIT payable $11,400 (.038 x $300,000).
> >
> > Scenario 2: Parents set up a FLP and transfer their yield producing assets to it. Assume for purposes of this example that 33% is transferred outright to each child with no other tax consequences. This shifts $99,000 of income to each child and leaves Parents with $484,200 of salary income and only $3,000 of NII ($300,000 NII from the FLP x 1%). Thus, they are no longer in the highest tax bracket because they are below the $731,200 threshold amount. Their highest tax bracket is now 32%. Moreover, their NIIT liability is reduced from $11,400 to $114. The additional income will be taxable to the children in the 22% marginal bracket and they will not be subject to the NIIT.

Family LLCs

Family LLCs can be used in the same way as family limited partnerships. LLCs are hybrid business entities that combine the limited liability of a corporation with the pass-through tax advantages of a partnership. The LLC owners are referred to as members. The parents can retain control over the entity by designating themselves as managing members or by creating a separate management entity.

LLCs are often preferred over a limited partnership because they provide the same favorable tax treatment as limited partnerships with the following advantages:

> *Limited Liability for All Members*. All members of an LLC have limited liability, including the managing members. With a limited partnership, only the limited partners have limited liability.
>
> *Governance Flexibility*. In a limited partnership, limited partners lose their liability shield if they participate in management decisions. In an LLC, participation by non-managing members is permissible if the parents want the children to have a voice in management. LLCs also eliminate the problems sometimes caused by the use of a corporate general partner.
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> *Estate Tax Advantage*. Using an LLC will generally make it possible to do a post-death, non-taxable liquidation of the entity.

One possible disadvantage of using an LLC instead of a limited partnership is that valuation discounts may be somewhat lower. However, if the entity is formed in a state with a favorable LLC statute, valuation discounts should be similar.

Disclosures

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