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Covering Your Assets

Family limited partnerships are getting renewed attention, thanks to recent tax-court victories

By MARK KLIMEK

Recent tax-court victories have breathed new life into family limited partnerships, a strategy that affluent families have used for years to shelter assets and reduce gift and estate taxes.

Indeed, some financial advisers are telling their clients that when such partnerships are used for what they were originally intended -- to protect the assets of a family-owned business, instead of being used as a family piggy bank or for shielding personal property -- they stand a much better chance of avoiding challenges from the Internal Revenue Service.

The IRS has increasingly challenged suspected misuses of family limited partnerships in recent years. But tax-court rulings in the past few years have again endorsed the practice when it is clearly used to help preserve a family business for future generations.

"There is now a better roadmap for practitioners to follow and advise their clients accordingly," says Douglas Moore, managing director of family office, U. S. Trust, Bank of America Private Wealth Management.

Setting up such a partnership could be especially useful right now for families with businesses. The Obama budget calls for the estate tax to be restored next year at a rate of 45% for estates worth more than $3.5 million, or $7 million for couples. Income-tax increases for high earners are on the agenda as well.

"There's a realization that any kind of estate planning you can do this year is good, because 2009 will probably end up being the most favorable year for taxes ever," says Jay Adkisson, co-founder of Newport Beach, Calif.-based law firm Riser Adkisson LLP.

What follows is a look at how family limited partnerships work, what their advantages are, and what a family needs to know to set one up properly.

What the Partnership Is

The partnership is typically set up by a husband and wife. They place the assets in the partnership and serve as its general partners. The couple can then grant limited-partnership interests (as much as 99% of the assets) to their children. This removes assets from the general partners' estates for tax purposes. The general partners retain control of the assets even if, after gifts to their children, their own interest amounts to as little as 1% of assets.

The limited partners can benefit from distributions. There also are tax benefits for the limited partners: Assets held in the partnership are generally eligible for a valuation discount because they're illiquid and because the limited partners aren't allowed to make decisions about the assets. So for example, $10 million in business assets might be valued at just $7.5 million for tax purposes.

Asset protection is another important feature. A lawsuit filed against a limited partner, for example, can't pull money from the partnership. Similarly, a creditor to a limited partner can only receive money from the partnership if the general partners make a distribution. If assets aren't distributed, the creditor -- even an ex-spouse -- receives nothing.

Uses, Abuses and Mistakes

Many partnerships have fallen short of their goals, or run afoul of the IRS, either because of the way they were set up or because the partners misused them.

Families need to proceed with caution when considering and implementing these partnerships. Some key rules to keep in mind include:

KEEP PERSONAL ASSETS OUT. Reasonable types of assets to transfer to a partnership include closely held stock -- shares that typically are few in number and usually not tradeable -- in a family-owned business. Interests in commercial real estate and oil and gas partnerships typically aren't challenged by the IRS as assets in a family limited partnership. Personal property like cars or homes, meanwhile, are not acceptable. Nor is it smart to use the partnership to pay for any personal expenses, small or large.

Family limited partnerships "are business entities that are meant to fulfill business purposes," says Mr. Adkisson. The IRS has been very successful at refusing the benefits of these entities "when people start loading them up with personal assets or start treating them as the family piggy bank," he says.

DON'T MAKE IT ALL ABOUT TAXES. Those who can show a legitimate and significant nontax reason for creating a partnership stand the best chance of avoiding a challenge by the IRS. For example, some wealthy families have argued that combining assets in a partnership helps them better protect their wealth from lawsuits or negotiate lower management fees. Another motivation the IRS has accepted is getting younger generations interested in the family business.

"Tax savings can still be a factor in the decision to create a family limited partnership, but there's got to be other reasons involved," says Scott McCue, a partner at the law firm Mayer Brown in Chicago.

DON'T OVERSTUFF. The tax- and asset-protection benefits prompt some to pack as much of their assets into the partnership as possible. Bad idea. If a partnership is challenged and overturned by the courts, a huge chunk of a partner's wealth could suddenly be exposed to taxes or lawsuits.

"I hate to see more than half of somebody's wealth go into any one vehicle," says Mr. Adkisson. "Assets and wealth need to be diversified just like investments need to be diversified."

HAVE THE ASSETS VALUED BY A PROFESSIONAL. Partners shouldn't decide the appropriate valuations and discounts for any of the interests transferred to the partnership. It's vital to have them valued by a qualified, trustworthy appraiser to stand up to IRS scrutiny. Partners should also be wary of an appraiser or adviser who insists that those limited-partnership interests deserve a discount of 50% or more. There's no magic number to shoot for, but recent court cases suggest that discounts of 20% to 30% will pass muster.

"It's the old saying that 'pigs get fat, hogs get slaughtered,' " says Mr. Adkisson. "If you're not greedy, your discount will probably hold up. Otherwise you run the risk of getting called on the carpet."

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