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**Estate Planning Tools  
and Tips**

*Timely Information for Advisors and Clients  
About Advanced Estate Planning  
and Family Wealth Strategies*

## **An Introduction to Family Limited Partnerships**

**M**any of our clients have a need for retirement income planning, asset management assistance, a desire to avoid estate taxes, a desire to spread income among family members in lower tax brackets and/or a desire to allow the family to participate in beneficial enjoyment of family assets or a business without our clients surrendering control. One way to accomplish all of these objectives is with a Family Limited Partnership, or FLP.

The following article explains in plain English the advantages of implementing effective estate planning through the power and flexibility of family limited partnerships.



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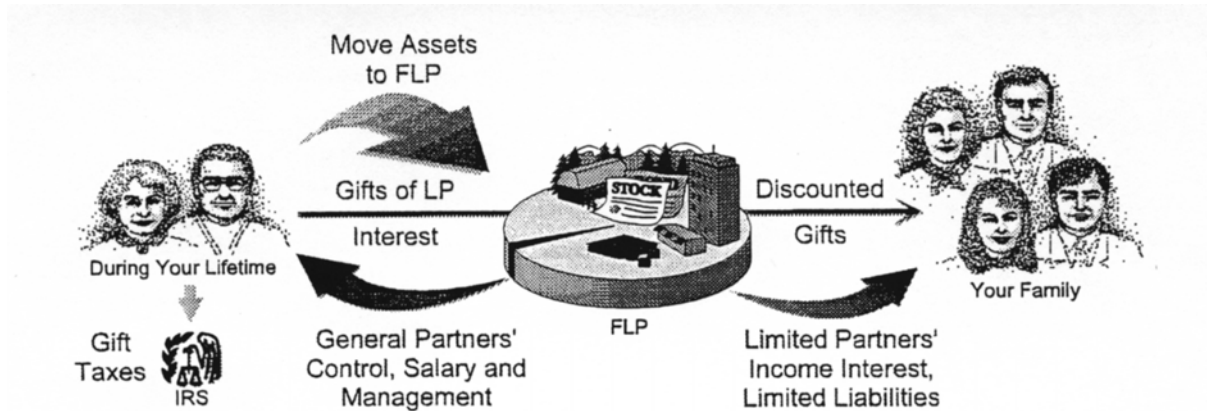
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# Family Limited Partnership

## Protecting the Family Wealth



*FLP can protect the family wealth, provide a tool for reducing the size of your estate, And still let you retain control and management of the assets as the general partner.*

### OVERVIEW

You create the Family Limited Partnership and then transfer marketable assets to it. The FLP is comprised of General Partner (GP) interests and Limited Partner (LP) interests. You retain the GP interest. The GP has management responsibilities and unlimited liability. GPs can pay themselves a salary for these managing duties. The LPs have no management responsibilities. The LP interest usually cannot be sold or transferred without the complete agreement of all partners. This lack of control and marketability causes the FLP to have a discounted value.

You make discounted gifts of the LP interest to your children. The discounted value of the LP interest lets you leverage your transfers for gift tax purposes. If the discount (determined by an independent appraiser) is 25%, \$1,800,000 of assets would have a value in the FLP of only \$1,350,000 of LP interest. Each parent's applicable exclusion amount can be used to avoid gift taxes. Thus, \$2,000,000 in 2003 (and \$3,000,000 in 2004-5) of assets could be removed from your estate without any gift taxes.

The GPs control the business. This is one of the features that helps provide additional protection from outsiders.

Advantages of a family limited partnership:

- Parents' taxable estate and transfer costs are reduced
- Parents retain control
- Gifts to children are made simple and more effective
- Assets, especially family business, are protected
- Assets are kept in the family!

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## AN INTRODUCTION TO FAMILY LIMITED PARTNERSHIPS

How do you stay in control of assets, make gifts to your family, lower income and estate taxes, and avoid lawsuits? A popular tool available for today's estate planner is the Family Limited Partnership. Here's how it works and what it can do for you.

Many of our clients have a need for retirement income planning, asset management assistance, a desire to avoid estate taxes, and/or a desire to spread income among family members in lower tax brackets. Our clients may also desire to allow the family to participate in beneficial enjoyment of family assets or a business to a greater degree without surrendering control. One way to accomplish all of these objectives is with a Family Limited Partnership, or FLP.

A family limited partnership, for estate planning purposes, is a personalized "gifting tool". Our clients may transfer real estate, family business interests or other investment-grade assets into this specially drafted limited partnership. Parents, children, and even grandchildren can serve as the partners, either general or limited. Assuming that our clients are the parents in the family creating an estate plan using their own assets, they will usually serve as the General Partners with the same powers of management and control over their assets that they have always had. They and their children will both serve as Limited Partners. An irrevocable trust may also be set up for the benefit of minor children or grandchildren if the parents desire to add them as limited partners in the future, since minors cannot exercise their own legal rights.

## ASSET PROTECTION

An FLP can protect assets from creditors in a lawsuit. When a judgment is entered against a limited partner of an FLP the creditor has no right to seize the assets inside the partnership. The creditor has no right to manage the partnership or to demand that distributions be made from it. In fact, under partnership law a creditor has only one way to collect his judgment and that is through the use of a charging order. A charging order allows the creditor to seize any distribution which is actually made from the partnership, but the creditor cannot reach the underlying assets in the partnership. The creditor would have to wait until a distribution was actually made to a partner before he could use it to satisfy his judgment.

As you might imagine, if a judgment existed against a limited partner, the General Partner would discontinue any partnership distributions to that partner. All partnership payments would be directed instead to unaffected partners who could spend the funds as they saw fit. Moreover, under IRS rules, even though a creditor doesn't actually receive payments from the withheld partnership share, *he is required to pay all of the income taxes associated with that share*. This leaves the creditor in the unenviable position of paying taxes on money he will never receive.

The one caveat is when a judgment is entered against the partnership itself. In that event, the creditor may satisfy his judgment with partnership assets, including insurance. If those assets are not enough to satisfy the judgement, the General Partner is personally liable. If this is a concern, we make sure that we use a corporation, a trust, or some other business entity as the General Partner rather than our clients personally, as discussed below.

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## **PROTECTING GENERAL PARTNERS**

Usually, our clients serve as the General Partners of an FLP. Sometimes, when a possible lawsuit against the partnership is itself a concern, a greater degree of asset protection is required. Because a General Partner remains liable for the unsatisfied liabilities of the partnership (not of individual partners, though), we can structure a corporation, an irrevocable trust or a limited liability company to serve as the General Partner in order to cut off this kind of liability. This technique reduces our client's personal risk for partnership debts or liabilities.

## **ADDITIONAL TAX AND FAMILY BENEFITS**

In addition to lawsuit protection, there are sound income tax and estate tax reasons to set up an integrated estate and asset protection plan. The following is a brief summary of some of these legitimate business purposes:

### **● Gifts to Family Members Made Easy**

One of the primary benefits of the FLP is its ability to maximize annual tax-free gifts to family members. Current law taxes estates greater than \$1,000,000 at rates from 37% to 49%. This means that an estate over \$1,000,000 would owe federal estate taxes unless our clients have done appropriate estate tax planning.

One way to reduce the size of the estate is to gift assets to family members while the parents are alive. At present, a person may transfer up to \$11,000 gift tax-free each year to each of an unlimited number of gift donees. This amount can be increased to \$22,000 per year per donee if both spouses join in the gift (referred to as spousal gift-splitting). We find that some of our clients would like to make gifts to their children but do not want to give up control of the asset while they are alive. Others do not have sufficient disposable cash on hand to give away and do not know how to make gifts of partial interests in other property.

With the Family Limited Partnership our clients can make annual gifts of limited partnership interests either directly to their children or grandchildren, or to a trust set up for their benefit. They can make a gift of any size they desire (up to \$22,000 from both parents) per child each year without using any applicable exclusion amount by simply transferring a partnership interest of that dollar amount. They will be conveying only a limited partnership interest and will not lose control of the underlying asset since General Partners have the sole authority to manage and control partnership affairs. If a client does not wish to be involved in management, the General Partner may be a child, business associate, corporation or even a trust. Moreover, such a transfer does not require extensive documentation and assets are not required to be divided.

As the years pass, children and grandchildren can begin to accumulate an equity interest within the partnership. The child's limited partnership share will be available to fund future distributions for education or other needs. For now, their capital accounts will grow undisturbed without requiring any distributions of cash to them, except an amount necessary to pay any income taxes attributable to their shares.

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- **Income Tax Burden Shifted to Other Family Members**

Children and grandchildren can participate in the growth of all assets in the partnership at income tax rates which are lower than the client's. They will enjoy the benefit of spreading income among various taxpayers, which can reduce the total tax paid by the family. This can result in a net reduction of the cost to provide for education and other needs of the family. In other words, the government will effectively subsidize some of the costs through lower tax rates.

- **Both Spouses Manage Family Finances**

If both spouses are General Partners, they will be responsible for the business of managing the investments in the partnership. In the event either of them becomes disabled or dies early, the other spouse will be fully equipped to carry on the operation of the partnership. It is important that both spouses learn to make investment decisions jointly. This is especially important because as their income and wealth grow, their financial affairs are likely to become more, not less, complex.

- **Estate Will be Organized at Death**

At the death of one or both parents, heirs will have an organized record of their investment assets since the partnership must file a yearly tax return with an accompanying balance sheet. The list of assets on the balance sheet may save the heirs hours of professional time and expense locating and appraising the assets in the estate. The Trustee of the estate will immediately know what assets were owned by the partnership and where they are located. This will accelerate the process of distributing assets to the heirs after death.

- **Entire Family Can Participate in Building The Estate**

The Family Limited Partnership is an ideal vehicle for training the entire family in investments and other financial matters. As children or grandchildren grow older, they can become more educated about investment decisions. Because they have an equity stake through their partnership interest, the children are likely to take an increased interest in learning more about financial matters. Their economic involvement with the partnership is often the "glue" which keeps families closer together. This is particularly true for older children who move away. It is comforting to know that they can remain as partners during their parents' lifetime.

- **Investment Assets Can Be Pooled for More Effective Management**

Assets managed within the partnership structure can be pooled for more effective and efficient management, control and administration. This can help maximize the rate at which the assets earn investment income for retirement and other goals. A single, larger pot of assets will often generate a higher rate of return than a fragmented investment portfolio held by multiple family members or trusts.

Centralized management of all partnership investments provides an opportunity to diversify the portfolio and monitor its overall performance. The annual balance sheet required of the partnership makes these management decisions easy. Because everything is under one structure, certain economies of scale should be available, including lower overall commissions and fees.

- **Prevents Use of Joint Tenancy Title**

Use of an FLP can prevent the misguided titling of bank accounts and brokerage accounts in joint tenancy with right of survivorship (JTWROS). For a variety of tax and estate planning reasons joint tenancy is an unwise way to hold title to assets. Such titling can completely frustrate the distribution of an estate and undermine overall planning. Holding title in the name of the FLP can effectively thwart the unintended use of joint tenancy.

- **Allows Privacy in Investment Activities**

The details of investment activities and the nature of the partnership assets themselves can normally remain private and confidential within the partnership structure.

- **Special Allocations Can Be Made to Family Members**

When family members need distributions for specific needs and their capital accounts are not sufficient, special partnership allocations can be made and paid back at a later date. For example, if a child's educational expenses exceed the amount of his or her capital account, the partnership may distribute the excess as a special allocation. The child will then make up the shortage in future years from subsequent distributions.

- **Family Members Are Entitled to Reasonable Salaries**

To the extent that a General Partner or family member acting as a partnership manager performs services for the partnership, he or she is entitled to a reasonable salary. By regulating the amount of their own salaries, our clients can effectively control the size of any partnership distributions.

- **Family Members Can Borrow Money From the Partnership**

Our clients or other family members who are partners have the right to borrow money from or loan money to the partnership at any time, with the permission of a General Partner. This can be very useful because each of the family members will need additional cash at different times. It also provides family members with a convenient additional way to withdraw funds from the partnership.

- **Estate Tax Discount Valuation**

One of the most important benefits of the Family Limited Partnership is a discount, or reduction, in the size of the taxable estate at death. The IRS values all assets owned by the decedent at the time of death using a fair market value formula, which translates into what a willing

buyer would pay a willing seller for the estate's assets under normal business circumstances. The valuation process is very favorable to the taxpayer when a limited partnership is involved. Because almost all of the decedent's partnership interest has been designated as limited partnership shares, the question at death becomes: "What is the fair market value of a Limited Partner's interest?"

Since a Limited Partner has no right to demand a distribution, order a dissolution of the partnership, or in any way participate in the management of the business, the Limited Partner's interest is not as valuable as a General Partner's interest. No third is going to pay full value for such a restricted partnership interest. Therefore, the fair market value of the decedant's partnership interest at death must be discounted to accommodate these marketplace realities. In one court decision the value of the estate was reduced by \$26,000,000 using this partnership discounting method. It resulted in a \$14,000,000 estate tax saving for the family.

- **Partnerships Are Flexible**

Limited partnerships make up a large segment of the American economy and are recognized as legitimate business entities. Such partnerships can participate in almost all commercial business ventures. It is easy to amend or terminate the structure when the partners agree to do so. When all parties are in agreement it is also easy to invest cash or property in the partnership or to withdraw the value of a share of the partnership.

It is also possible for the partnership agreement to establish more than one " class" of limited partner with different rights to receive income assigned to each class. For example, a limited partnership "A" share may have rights to income and principal, while a limited partnership "B" share may only have rights to principal. If a General Partner owns all or most of the "A" shares and receives a salary as a General Partner, he or she will receive most of the income. This part of the law is very technical, and results will vary depending upon the application of the law to a specific case.

- **Stable Laws Govern Partnerships**

The limited partnership as a legal entity was established under laws which have remained essentially unchanged for decades. These partnership laws are similar in all jurisdictions and have a long legal history stretching back to the early common law in England. Unlike tax laws that get rewritten almost every time Congress meets, there are no indications that these laws will change in the future. Although the IRS has increasingly scrutinized and invalidated overly aggressive valuation discounting and other abusive FLP practices, our clients can continue to strengthen their family's financial and estate planning by effective and lawful use of an FLP.

## **IRREVOCABLE GRANDCHILDREN'S TRUSTS**

Trusts for the benefit of grandchildren may be created to hold partnership shares for minor grandchildren. These irrevocable trusts may be named as limited partners of the Family Limited Partnership to provide our clients with a structure to shift income and assets to lower tax bracket beneficiaries. Each trust has an independent Trustee who is in charge of management of the assets until a grandchild reaches an age when the trust directs distribution of assets. Since the trust owns the limited partnership shares gifted to it, there is no problem of trust assets being dissipated before the trust distributes them.

Our clients remain as General Partners with complete management and control of partnership property. The value of the partnership interests transferred to grandchildren will not be counted as a part of our client's estate for estate tax purposes, for probate or for creditor claims. All distributions to grandchildren will be taxed in the grandchildren's lower income tax bracket. This shifting of income can provide substantial income tax relief.

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Just as it took you considerable time, effort and care to build your family's estate, the planning process demands time, effort, and significant technical expertise on the part of your professional advisors. Our law firm is dedicated to assist you in understanding, designing and implementing effective estate planning tools such as Family Limited Partnerships to achieve your planning goals. We can be reached at 425.451.3583. Please do not hesitate to let us know how we may assist you in planning to protect your family wealth.

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