Financial Planning Newsletter

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Family Limited Partnerships

Hello!

For this month's newsletter, Family Limited Partnerships (FLPs) are highlighted as they are one of the most beneficial but seldom used strategies of transferring wealth from one generation to another. They enable individuals to reduce the value of their estate while still maintaining full control of the assets held within the partnership.

Family Limited Partnerships (FLPs)

An FLP is a limited partnership controlled by members of a family. A limited partnership agreement is drafted and then assets (such as real estate, family business, stock, etc.) are transferred into the FLP. It should be structured in such a way to protect the interests of both current and future generations. Typically, the elder family members transfer assets to an FLP in exchange for a small general partner interest and a large limited partner interest. They then give all or a percentage of the limited partner interest to younger family members (children and grandchildren) which can be a direct transfer or held in a trust.

There are two parties involved in an FLP. The general partners (usually parents) make gifts of limited partner shares to family members and control the day-to-day operations of the FLP including investments and distributions, but also maintain most of the liability. The general partners receive a percentage of the income generated by the FLP through a management fee. They can also make withdrawals through a Preferred Payment Provision which provides for a pre-determined amount from the income generated by the partnership. These withdrawals, as well as those received in the form of management fees, are taxable.

The limited partners (the heirs) have an ownership interest in the FLP through gifts over time by the general partners. They share in the income but have no control over the investments or distributions and, therefore, have limited liability.

Income and gain is allocated among the various partners in accordance with their percentage interests in the partnership. The partnership itself is not taxable - instead, the owners of a partnership report the partnership's income and deductions on their personal tax return, in proportion to their interests.

When the FLP is dissolved, each limited partner will receive a proportional percentage of the FLP assets.

Advantages of FLPs

- **Annual Gift Tax Exclusion** – In transferring limited partnership interests, they are eligible for the annual gift tax exclusion, which can reduce income, gift, and estate taxes.
- **Estate Planning** – By transferring limited partnership interests to family members, it reduces the taxable estate of the general partners even though they retain control over the investments and distributions. Due to the limited partners having no authority or control, they may be eligible for valuation discounts at the time the asset is transferred.
- **Flexibility** – Owners within FLPs can usually amend the terms of the partnership agreement if and when family circumstances change.

- **Protection from Creditors** – They protect assets from claims of future creditors since creditors cannot force cash distributions, vote, or own the interest of a limited partner without the consent of the general partners. If the general partner is sued, in most cases, creditors cannot seize his or her partnership assets provided the partnership was set up before the creditor problems ensued.
- **Protection in Event of a Divorce** – If a limited partner is no longer part of the family that set up the FLP, the terms of the partnership can require a transfer back to the family for fair market value, thereby keeping the asset within the family.

Disadvantages of FLPs

- **No Step Up in Basis** – Property transferred to an FLP is not eligible to receive a step-up in basis which inherited property would receive. This could result in the limited partners (heirs) facing significant capital gains tax liability in the future due to assets transferred being eligible for a discount at time of transfer.
- **Set Up Costs** – There are costs, including legal fees and appraisals, which must be done to set up an FLP which can be costly depending on the type and number of assets to be transferred.

This is only a broad overview of FLPs. If you are interested in learning more about how this may potentially benefit you given your current situation, it is highly recommended that you discuss this further with a tax advisor as well as an estate planning attorney.