Family Limited Partnerships: *Tax and Legal Requirements*

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A vehicle that has been used with increasing frequency in estate planning is the family limited partnership (FLP). This business entity has the potential to provide enormous benefits to anyone who wishes to transfer their wealth to family members before or after their final demise. However, an FLP is not without its pitfalls, and it takes some careful planning to avoid them all. The following guide provides some of the most important advantages of this financial tool and tips on how to avoid common problems associated with the creation and maintenance of an FLP.

Overview of Family Limited Partnerships

A partnership is a business entity whereby each partner holds full liability for the business. In order to separate personal liability from business liability, limited liability partnerships (LLPs) were established. An FLP is a type of limited partnership established through case law that can be used to hold assets for the purpose of transferring them to family members as an inheritance. Although no specific laws cover the creation of FLPs, they will pass the scrutiny of the Internal Revenue Service (IRS) as long as they are created and maintained with care.

Complex partnerships, such as FLPs, include both general partners and limited partners. As long as any income generated from the partnership flows into the hands of the limited partners, it cannot be taxed as both business income and personal income. The revenue that flows through the FLP to the partners is reported on their individual tax returns instead of being subject to business taxes.

Another benefit of limited partnerships is that limited partners cannot be held liable for any debts incurred by the business. What makes the partnership limited is that the extent of each partner’s liability is limited to the amount of his or her initial investment. This means that limited partnerships are similar to corporations except that the ownership interest in the business is not represented by stock. When established correctly, assets can be transferred to the FLP by its general partners and disbursed to its limited partners. However, it is also possible for the general partner in an FLP to be a corporation instead of an individual, which works to limit the liability of the general partner.

Advantages of an FLP for Estate Planning

The advantages of an FLP for estate planning are simple but powerful. When a general partner contributes assets to the FLP, those assets are then excluded from the partner’s personal estate for the purposes of calculating estate taxes after his or her death. Although the partner holds an interest in the FLP, that interest is much less than the value of the transferred assets. While an FLP does not totally eliminate estate tax liability, it can substantially diminish it.

One of the advantages of an FLP for estate planning is that the limited partners have no control over the assets, and even if a single limited partner owns over 50 percent interest in the FLP, he or she has no control over how the partnership operates. In an FLP, the general partner is always the controlling partner no matter how much interest he or she holds in the partnership. This prevents any of the limited partners from executing a hostile takeover of the company. In addition, the interest in the FLP held by the limited partners is not marketable like it is with publicly traded corporations.

The partnership interest of limited partners is nearly impossible to liquidate because the business is largely a family affair. Even if the general partner of an FLP is a corporation, the shareholders of that corporation are usually family members, and the other limited partners of the FLP are also family members. Because the limited partners in an FLP do not have any control over the assets, outside investors in the FLP cannot directly invest in the assets. Any outside investments are solely based on profit made through the business activities of the FLP, and very few individuals are willing to make an investment on such terms.

Another advantage of an FLP is its structure. Unlike other financial vehicles used in estate planning, there is no need to establish separate trusts or financial accounts. The entire estate can be managed through the centralized framework provided by the FLP. This unified structure also helps to provide the FLP with longevity, and it can continue to operate after the death of the general partners.

A final advantage to using an FLP is that its value must be professionally appraised for tax purposes. However, FLPs are much more difficult to valuate than individual assets, such as homes or cars. Instead of going through the meticulous process of appraising each asset, the assets may be appraised using one of several acceptable methods for businesses, and the results are usually in the favor of the limited partners. In addition, appraisers may be able to assign discounts to an FLP because the limited partners have no control over management and their interest in the company is not marketable.

Considerations in Forming an FLP

Several issues must be considered before forming an FLP for the purpose of estate planning. If the FLP does not follow state law for limited partnerships, the benefits of the FLP may be retracted before they can be applied. If the FLP is not established or managed correctly, the IRS may be able to use the FLP's assets to calculate the estate tax liability of a recently deceased partner.

Two key elements are used by the IRS to determine ownership of property: title and control. For assets held by an FLP to be exempt from being counted as personal property, it takes more than simply transferring the title to the FLP. If a general partner retains unencumbered possession and control of the property, then the IRS is likely to consider that partner as the owner of the property. However, all of the facts surrounding the property will be used to make a final determination. Some estate planners specifically guarantee that general partners will be able to use and enjoy their property as they always have, but generally, some changes will have to take place or the IRS will pull the asset back into the estate upon his or her death.

One of the basic tenets of an FLP is that it must have a genuine business purpose, and any assets sold or otherwise transferred to the FLP must conform to that purpose for the transfer to be considered legitimate. Some lawyers may try to claim that the transfer of property is legitimate because it is being traded for a stake in the FLP, but since the value of the property is greater than the value of the stake in the business, it must be shown that it was transferred for the potential income that could be generated by the FLP. However, if this income is neither paid by the FLP nor received by the partner, then the IRS will probably not recognize the transfer as legitimate. The stance of the partner is weakened even further if the value of the FLP does not increase over time.

The types of assets being transferred play a role in whether they are viewed by the IRS as legitimate. It can be difficult to prove that personal assets are legitimate transfers. Personal assets may include a primary residence, retirement savings or securities used as retirement investments.

Another way the IRS determines whether the transfer or sale of assets is bona fide is by looking at the details surrounding the transactions. For a transaction to be considered legitimate the seller must transfer the asset to the buyer and the buyer must transfer some form of payment to the seller. A partner cannot stand on both sides of the transaction. When all of the benefits of the sale belong to only one party, then it throws up a red flag that could indicate that the transfer was illegitimate. In a legitimate sale, also known as a sale in good faith, some benefit must be conferred to the partner other than the tax advantage.

Tips for Managing an FLP

Running an FLP as a vehicle for estate planning can be tricky. Organizers must strictly follow all laws and pay close attention to prior cases involving FLPs. Following are a few guidelines to successfully start and maintain a family limited partnership:

• The legitimate business purpose of the FLP should be put in writing. Legitimate uses may include family asset management, asset consolidation or avoiding asset fractionalization.

• The general partner’s home should only be transferred to the FLP if it is vacant or used as rental property. If property or personal items are transferred to the FLP, the user or beneficiary of the items should pay rental fees to the FLP.

• Personal loans should not be made from the FLP.

• All legal business requirements should be followed, including holding annual meetings, recording annual meetings and keeping detailed records of all transactions.

• Assets held by the FLP should not be comingled with personal assets.

• All assets transferred to the FLP should conform to an overall business plan or follow a written mission statement. A sudden, large transfer of assets just prior to the general partner’s death may be viewed as suspicious in the eyes of the IRS.