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FAMILY LIMITED PARTNERSHIPS AND LIMITED LIABILITY COMPANIES

1.0 WHAT IS A FAMILY LIMITED PARTNERSHIP (FLP)?

An FLP¹ is a financial and state planning vehicle that helps you:

1.1. **Tax Savings.** Achieve significant estate and gift tax savings by letting you transfer ownership of assets to your children at discounted values.

1.2. **Creditor Protection.** Protect the partnership's assets from outside creditors. The FLP also insulates your non-partnership assets from the FLP's liabilities.

1.3. **Other Benefits.** An FLP can also provide for easier management, as a means of retaining family control over the FLP's assets, as a tool to facilitate business succession planning, and other business reasons. Having a valid business reason for the formation of an FLP has taken on added importance under recent cases.

You can achieve these benefits while still retaining control over both the FLP and its assets.

2.0 CAN YOU GIVE ME AN EXAMPLE?

Assume you own apartment buildings which you want to start transferring to your children. You also want to i) protect your other assets from liabilities caused by the apartments,

¹ For ease of discussion, this handout refers to a limited partnership, but the concepts are the same for both a limited partnership and a limited liability company.

and ii) better protect the apartments from your potential personal creditors. However, you still want to retain control over the assets instead of giving control to your children.

Assume the apartments are worth \$1,000,000, and you want to transfer 10% to your children. You could put the apartments in a FLP. Due to the minority and marketability discounts discussed in Question 4 below, the transfer of 10% of the FLP's limited partnership interests would be valued at less than \$100,000. By using the FLP, you will accomplish the following:

2.1. **Save Money.** You can transfer \$100,000 worth of assets, but the transfer would be valued at less than \$100,000 (sometimes as low as \$50,000) for estate and gift tax purposes.

2.2. **Creditor Protection.** By putting the assets in the FLP, you will better protect them from claims arising outside of the FLP. You will also help insulate your other assets (such as home, business interests, cash, and securities) from any liabilities generated by the apartments.

2.3. **You Can Keep Control.** Perhaps most importantly, you can retain control over the FLP's assets by controlling a corporate general partner of a limited partnership, or serving as the manager of an LLC. That means you can decide whether to buy, sell, or exchange any of the FLP's property.

The control issue is important for both economic and tax reasons. It merits careful consideration during the planning process, *because the more control you retain, the lower the ultimate discounts you will obtain for estate tax purposes.* However, significant gift tax savings are possible even if you retain control as a general partner or LLC manager.

2.4. **Additional Savings.** The FLP is an excellent "building block" for more advanced estate planning techniques, including grantor retained annuity trusts ("GRATs") and defective grantor trusts ("DGTs"). See our separate handouts on GRATs and DGTs.

3.0 **WHO ARE THE PARTNERS?**

3.1. **General Partner.** An entity controlled by you will usually serve as the general partner. In general, you should not serve as an individual general partner because doing so would expose you to unlimited personal liability for the FLP's activities. If you use an LLC, you can be its manager. In either case, you will have discretion and control over the FLP's operations.

3.2. **Limited Partners.** Your children or heirs would be limited partners. In addition, you, your spouse, your living trust, or other trusts could also hold limited partnership interests. The limited partners do not have any personal liability for the FLP's liabilities. What limited partners give up for that protection is the right to participate in the limited partnership's management.

4.0 HOW DOES THE FLP SAVE ESTATE AND GIFT TAXES?

The FLP saves estate and gift taxes because when you transfer limited partnership interests in the FLP to your children or heirs, the valuation rules applicable to estate and gift taxes require the IRS to value the FLP interests the same way other closely-held business interests are valued.

In other words, if you put a \$1,000,000 apartment building into a FLP and transfer 10% of the limited partnership interests in the FLP, the IRS must value the transfer differently than if you had merely transferred 10% of the apartment building itself. This is because of two “discounts” that are allowed by court cases. Each of these discounts is explained below.

4.1. **Marketability Discount.** Because a limited partnership interest in a FLP cannot be easily sold, you are allowed a discount for “lack of marketability”. The rationale for marketability discounts is based on the premise that because an owner will have difficulty reselling interests in a closely-held FLP, the value of the partnership interest is lower than if the owner held direct ownership of the FLP’s assets. The discounts that have been allowed for this adjustment generally range from 10% to 30%.

4.2. **Minority Interest Discount.** The rationale for the minority interest discount is that a prospective purchaser will pay less for a minority interest in a business than for a direct share of the underlying assets. That is because a minority owner cannot control the business entity that owns the assets. This is especially true with a limited partnership interest where the owner is restricted from exercising any management rights. Reported court decisions have allowed discounts averaging from 15% to 35% for this discount.

5.0 DO THESE DISCOUNTS WORK WITH FLPs?

Yes. In fact, FLPs are one of the best tools for claiming these discounts.

The use of the minority interest discount is especially powerful. With a FLP, so long as the transfers occur over a period of time, you can transfer 100% of the ownership of the FLP, yet still claim a minority interest discount for each and every transfer. That is because the tax laws treat each transfer separately, even if the overall result is to transfer the entire business interest to your children.

6.0 DOES THE IRS ACCEPT THESE DISCOUNTS?

Reluctantly. The reason is because the IRS has lost so many court cases that have upheld the discounts. In fact, in Revenue Ruling 93-12, the IRS acquiesced to the validity of these discounts even when family members control the whole entity.

However, the discounts are not automatic. They must be substantiated by appropriate appraisals. In addition, under recent cases, the FLP must be appropriately structured and operated. See Section 15 below about “Risks of FLPs”.

7.0 HOW ARE THE DISCOUNTS SUBSTANTIATED?

7.1. **Value Underlying Assets.** First, the FLP's underlying assets must be valued. For publicly-traded property like stocks and bonds, you would simply use their market prices. However, for assets like apartment buildings, an appraisal is necessary.

7.2. **Get Business Appraisal.** Next, a qualified business appraiser is given the asset values and other information, including the FLP's income. The business appraiser then makes a separate determination of the value of the FLP interests. This separate valuation is what substantiates the separate percentages for each discount.

7.3. **Example.** For a FLP that owns real estate, the business appraiser might compare the ownership of the FLP to publicly-traded REITs (real estate investment trusts). REITs usually trade at a discount to their net asset value.

The business appraiser determines the appropriate discount based on market comparisons with comparable REITs and uses this number for the minority interest discount. The appraiser then determines a separate percentage for the marketability discount because REITs are publicly traded while interests in FLPs are not.

7.4. **The IRS Does Not Automatically Accept What the Appraiser Says.** The IRS will try to argue for a higher value for the underlying assets and a lower discount for the limited partnership interests transferred. As with all valuation questions involving the IRS, it can become a matter of negotiation. However, with a properly drafted FLP agreement and a good business appraisal, you will still end up with substantial discounts. Assuming you start out claiming 50% in discounts and are audited by the IRS, even if you end up with "only" 35% or 40%, you are still ahead by that amount.

Under some recent cases, the IRS was successful in completely disallowing valuation discounts by successfully including all of the FLP's assets in the taxpayer's estate. Effectively, the FLP was disregarded, even though the cases did not say that. Although each of the unfavorable cases involved very bad facts, because the IRS arguments in these cases represent one of the few IRS victories with FLPs, we expect more IRS attacks on FLPs. However, with proper planning and operation, the arguments that were successful in the unfavorable cases should be inapplicable.

7.5. **Additional Discounts Are Possible.** Depending on what provisions are drafted into the partnership agreement, additional discounts may be applicable.

8.0 IS A FLP FLEXIBLE?

A FLP is one of the most flexible income and estate tax planning vehicles available.

8.1. **Easy to Terminate.** It can be terminated at any time. The termination date can be fixed in the partnership agreement, can be at the general partner's discretion, or can be based on a vote by the partners.

8.2. **Income Tax Planning.** For income tax purposes, partnerships are very flexible. For example, if certain requirements are met, "special allocations" of the partnership's income can be made among the partners. In addition, the partners can take fees and other expenses from the partnership.

8.3. **Works Well With Other Estate Planning.** A FLP works extremely well with other estate planning techniques, including GRATs, DGTs, charitable lead trusts, and charitable remainder trusts. See our separate handouts addressing each of these techniques.

8.4. **Important for Asset Protection Planning.** FLPs are also an excellent basic asset protection vehicle. Even the most sophisticated asset protection plans -- those utilizing foreign structures -- typically make use of FLPs as part of the plan.

9.0 WHY USE A LIMITED PARTNERSHIP RATHER THAN A GENERAL PARTNERSHIP?

Even though a limited partnership must pay an \$800 annual minimum franchise tax (plus a gross receipts tax in the case of an LLC), FLPs are much better vehicles for estate and gift tax planning, income tax planning, and creditor protection. Although partners in a general partnership have management rights, they also have unlimited liability. With a limited partnership, the limited partners have no management rights and no liability.

The fact that limited partners, as a matter of state law, have no management rights helps support higher minority discounts. For that reason, we always recommend the use of a FLP. The extra taxes are a small price to pay to allow you to retain control and limit liabilities to potential creditors.

10.0 WHAT ASSETS SHOULD BE USED WITH A FLP?

Generally, investment or business assets. For example, real estate, other partnership interests, and even securities would be good choices.

10.1. **Not for Personal Assets.** A FLP is inappropriate for personal assets. For example, for a personal residence, you can use a qualified personal residence trust ("QPRT") instead.

10.2. **Tax Analysis.** You must also make sure that the correct income tax analysis is done for any assets you transfer to the FLP. For example, if you contribute other partnership interests, you need to make sure there is no taxable termination of those underlying

partnerships. Similarly, you must be careful about contributing assets with liabilities in excess of their tax basis.

10.3. **Are Discounts Attainable For Liquid Assets?** If the FLP is properly structured and has business justification, discounts can even be obtained for liquid assets like marketable securities. Recent cases have upheld total discounts of approximately 30%. If you would like to use a FLP for marketable securities, proper planning is more critical because a valid business purpose (such as limiting liability) is more difficult to justify.

11.0 CAN A FLP SIMPLIFY MANGEMENT ?

Yes. For example, you can transfer title to real property to the FLP and then give interests in the FLP to your children. If a FLP were not used, a gift of real estate would require a separate deed to be prepared for each gift. With a FLP, you only need to prepare an assignment of each gifted FLP interest. No recording is necessary. This also protects your privacy because the assignment is not recorded.

In addition, using a FLP helps avoid potential reassessments for property taxes. Under California law, a transfer of a partial interest in real estate generally triggers reassessment of the real property. There are certain exemptions, such as the parent-child exclusion, but assuming exemptions are not available or have already been used, each separate transfer of real estate would result in a reassessment. By contrast, if real estate is transferred into the FLP, fractional interests in the FLP can be transferred without reassessment until such time as over 50% of the FLP interests have been transferred. (However, at that time, all of the FLP's property would be reassessed).

12.0 HOW DOES THE FLP PROTECT ASSETS FROM CREDITORS?

FLPs are an excellent asset protection tool. They offer the following creditor protection advantages:

12.1. **Retaining Control Without Ownership.** Assume you control the 1% general partner in a FLP and your children own the remaining 99% of the FLP's limited partnership interests. Even though you control the FLP's management (i.e., you can buy and sell the partnership's assets and take other action without even obtaining the limited partners' consent), you "own" only 1% of the FLP for tax and creditor purposes.

As long as the initial transfer of the FLP interests to your children did not constitute a "fraudulent conveyance," your creditors will have a hard time attacking that transfer. Thus, they can only reach the 1% of the FLP that you own.

12.2. **Creditors Cannot Reach the FLP's Assets Directly.** Continuing the above example, even if a creditor obtains a judgment, all the creditor is entitled to is a "charging

order.” A “charging order” allows a creditor to obtain distributions of income, but only as they are made out of the FLP to the debtor partner.

The creditor is not entitled to proceed directly against the FLP’s assets. If the charging order does not satisfy the liability, the creditor can attempt to foreclose on the partnership interest. However, courts are split on exactly what creditors are entitled to in a foreclosure. In addition, if a creditor has foreclosed on a FLP interest, they will have to pick up their pro rata share of the taxable income attributable to that interest, even though they can not force cash distributions to pay the tax. Thus, as compared to direct ownership of assets by a debtor, FLP interests are much less desirable to a creditor, increasing the likelihood that matters can be settled on more favorable terms.

12.3. **Flexibility**. The FLP is also easily combined with other asset protection devices, including foreign and domestic trusts.

FLPs also have other advantages. For example, because the use of the FLP helps segregate assets and income, it helps protect your children if they should ever get a divorce. By gifting them a FLP interest over which they have no control, it makes it more difficult for your child’s spouse to claim that the FLP interest is community property.

By contrast, if you gave your children direct ownership in the assets, they could commingle those assets with their community assets and convert what otherwise would have been their separate property to property in which their spouse can claim an interest.

13.0 WHAT IMPACT DOES A FLP HAVE ON MY EXISTING ESTATE PLAN?

If you have a living trust, the living trust should already hold title to your investment assets. When you set up your FLP, some of the assets will be transferred from your living trust to the FLP. Your living trust will then hold (either directly or, in the case of a general partnership interest, through an intermediary S Corporation which is owned by your living trust) your interest in the FLP. No amendments to your living trust would be necessary unless your living trust leaves specific assets to certain beneficiaries.

14.0 CAN I USE A NEVADA FLP TO AVOID CALIFORNIA INCOME TAX?

If your assets are in California and you are a California resident, establishing a Nevada FLP still requires the filing of a California income tax return and the payment of the \$800 minimum franchise tax, plus the payment of California income taxes on your share of the FLP’s income. Also, regardless of the type of non-California entity that you use, any California – source income is subject to tax in California.

15.0 RISKS OF FLPS.

As noted above, the IRS has won several recent court victories (the Strangi, Harper, Thompson, and Kimbell cases are all good examples) involving FLPs.

However, all of these cases involved very bad facts, including the formation of the FLP just before the taxpayer died, failure to adhere to proper accounting and operational guidelines which showed the taxpayers were not respecting the FLP they had created, and the transfer of almost all of the taxpayer's assets to the FLP.

Even though all of these cases had very bad facts, we can expect the IRS to be more aggressive in attempting to attack FLPs. As a result of these attacks and other factors, FLP discounts have been trending downward.

In the worst case scenario, an improperly planned and operated FLP can, if successfully attacked under the arguments the IRS won on in the above cases, result in greater estate taxes than if you had simply gifted the underlying assets without using the FLP. However, if the FLP is properly planned and implemented, the unfavorable cases should not pose a problem.

16.0 HOW SHOULD THE FLP BE PLANNED AND IMPLEMENTED?

In order to avoid the unfavorable result of the cases discussed above, the following steps should be taken in planning and operating a FLP.

16.1. **Timing.** Most importantly, the FLP should be formed as soon as possible. The longer the period of time between the FLP's formation and the date anyone dies, the lower the likelihood that the IRS will be successful in including the FLP's assets in your estate.

16.2. **Business Purpose.** There should be a valid business purpose for the formation of the FLP. Generally, the transfer of any operating business or real estate can be justified because of the asset protection benefits provided by a limited liability entity.

In the case of passive investment assets such as stocks and bonds, valid business reasons may include providing for an easier means of managing a family securities portfolio or establishing a family hedge fund.

16.3. **Distributions.** All cash and other distributions from the FLP should be made in strict accordance with each partner's ownership percentage. For example, if you have gifted 10% of a FLP to your children, they should receive 10% of any and all distributions from the FLP.

16.4. **Distribution Policy.** In addition, distributions from the FLP should be made on a regular basis, not just when the party controlling the FLP needs cash.

16.5. **Sound Documentation and Accounting Practices Must Be Maintained.**

For example, if a piece of real estate is transferred to the FLP, a deed to the real estate should be recorded in the name of the FLP, separate FLP bank accounts should be opened as soon as possible, insurance policies should be in the FLP's name, and the FLP should collect all rents and pay all expenses.

16.6. **Ownership.** At least under some cases, it appears the courts are more likely to respect significant ownership interests, as opposed to *de minimis* ones. Thus, a 10% FLP interest that is transferred to your children is more likely to pass muster than a 1% interest.

16.7. **Assets.** The FLP should not be funded with any personal assets (such as residences) that are used by the donor.

16.8. **Outside Holdings.** The FLP should not hold most of the donor's wealth. Asset should be retained outside the FLP that are sufficient for the donor to meet his or her financial needs.

16.9. **Drafting.** The FLP documents should expressly hold the general partner (of a limited partnership) or manager (of an LLC) to a fiduciary standard.

16.10. **Formation.** Some recent cases indicate that a FLP is more likely to be respected if, as opposed to you forming the FLP by contributing your assets and then gifting FLP interests to your children, all family members instead make a joint contributions of their respective assets to form the FLP. This may not always be possible, but if desirable, you can make gifts of assets to your children in advance of the formation of the FLP.

16.11. **Negotiation.** At least some of the cases have indicated that where all of the FLP partners have some say in the negotiation of the FLP documents, it is more likely the FLP will be respected. These means, for example, that if you form the FLP by having both you and your children contribute assets, your children (or better yet, separate counsel for your children) should have a say in negotiating various provisions of the FLP agreement. These negotiations be documented if possible.

16.12. **Ultimate Control.** If possible, the FLP should be structured in such a manner that, on your death, i) you are not the general partner, or in control of the general partner, and ii) the percentage of FLP interests that you own is not sufficient to remove or replace the general partner. Again, this is not always possible, but if it is accomplished, it maximizes the potential estate tax discounts.

This principle illustrates why FLPs are such flexible vehicles. You can establish a FLP today and continue to retain current control, but transfer control of the FLP to your children over time to maximize tax savings.

17.0 WHY SHOULD I ESTABLISH A FLP NOW?

Acting now helps make sure you complete transfers for both tax and non-tax reasons. In some cases, waiting too long to implement asset transfers for estate planning purposes negates their effectiveness, even if the transfers are completed before you die. For example, in Estate of Murphy, 60 T.C.M. 645 (1990), the taxpayer's attempt to create a minority interest discount eighteen days before she died was unsuccessful.

More importantly, the sooner you establish the FLP, the sooner you can establish strong facts showing that the FLP is being respected and actually operated as a separate entity. You show this by taking such actions as collecting income and paying expenses in the FLP's own name, making distributions in accordance with FLP ownership interests, and following proper accounting protocols.

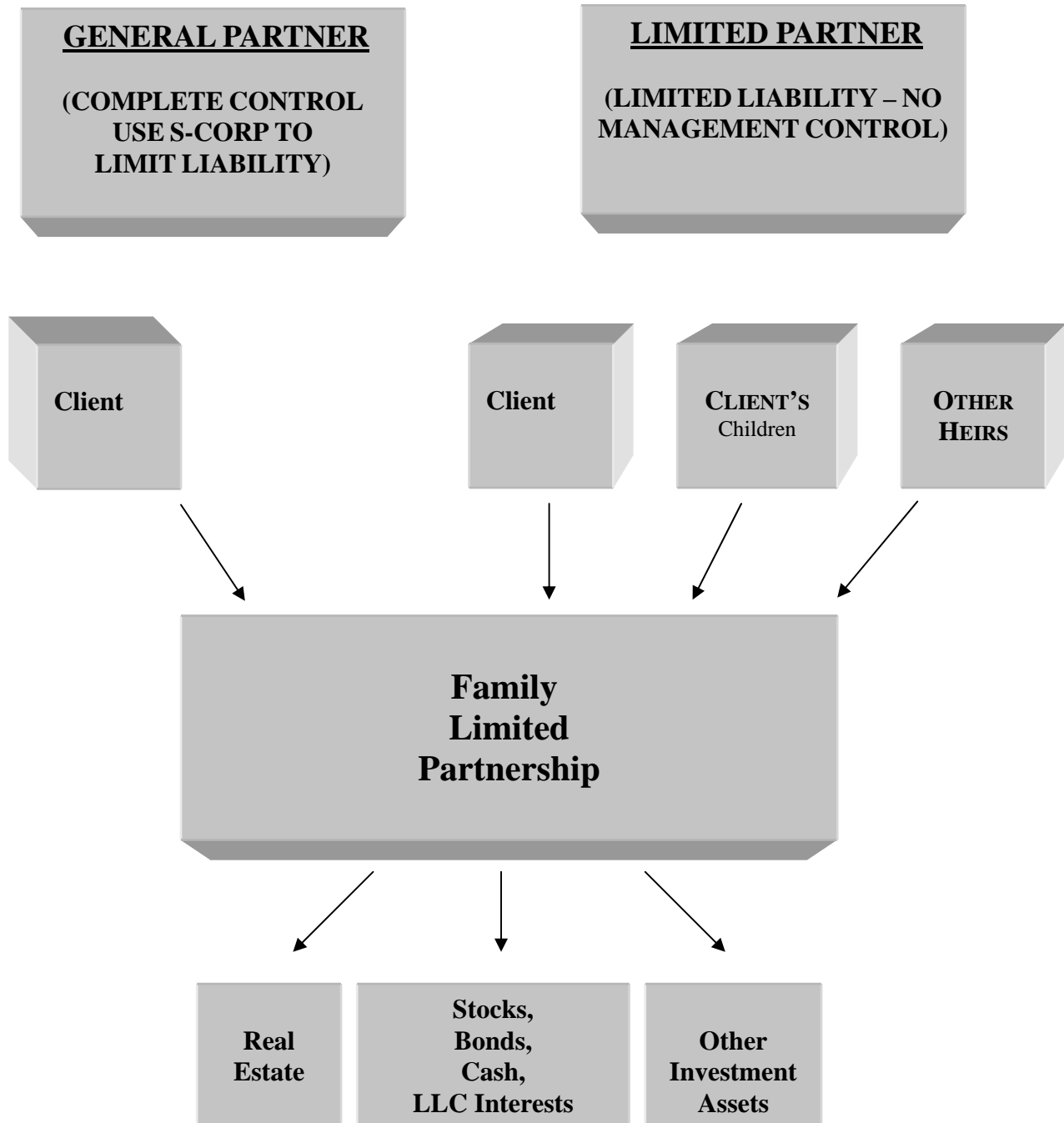
Acting sooner also provides you with greater savings and more protection. For example, many of your assets may appreciate in the future. Making transfers now helps shift appreciation out of your estate.

Finally, if you want creditor protection, the sooner you transfer assets out of your name, the more difficult it will be for future creditors to reach them.

18.0 DIAGRAM. The following page contains a simplified diagram of how a FLP works.

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FAMILY LIMITED PARTNERSHIP



BENEFITS:

- **Control**
- **Gifts of LP Interests Subject to Valuation Discounts**
- **Limits Liability**