

## Family Limited Partnership (FLP)

If you own and operate a family business, a family limited partnership (FLP) could become a vital component of your estate plan. A properly formed and maintained FLP can facilitate the transfer of your business to the next generation, protect assets from potential creditors, and minimize income, gift, and estate taxes.

### What is an FLP?

An FLP is a type of business entity known as a limited liability partnership (LLP). An FLP is a special form of LLP because only members of the same family can be partners.

All LLPs, including FLPs, consist of general partners and limited partners. The general partners run the business. The limited partners have no vote and no say about day-to-day operations. However, the limited partners also have limited liability; they aren't liable for the debts of the partnership in excess of their contributed capital.

With a typical LLP, a general partner who has experience teams up with limited partners who have capital. In the family context, however, the senior generation typically starts out as both the general and the limited partners. They then gift the limited partnership interests to the younger generation. The general partners can gift as much as 99% of the business to the limited partners, keeping as little as 1%.

This can be an ideal solution if you want to transfer ownership of your business to your children, but also want to keep control until they can gain experience and become competent enough to manage the business on their own.

**Caution:** *The percentage that must be owned by the general partners is determined by your state's laws.*

### Asset protection

An FLP can provide some measure of asset protection for the limited partners. It generally takes a court order (called a charging order) for a creditor to reach a limited partnership interest, and even this only requires the FLP to pay income to the creditor instead of the partner until the debt is paid. In this case, the

creditor does not become a substitute partner. He or she must wait until the general partner decides to distribute income (which may be a very long time). In addition, FLP assets are likewise protected from loss due to divorce. The general partner, however, does not receive the same protection and is personally responsible for the debts and liabilities of the FLP (unless the general partner is a corporation, limited liability company (LLC), or trust).

### Income tax considerations

An FLP is a pass-through entity for income tax purposes. This means that the IRS does not recognize an FLP as a taxpayer (as it does for a corporation), and income of the FLP passes through to the partners. So, you can shift business income and future appreciation of the business assets to other members of your family who may be in a lower tax bracket. The family as a whole can enjoy tax savings.

**Tip:** *The partners must report the income earned by the FLP on their personal income tax returns and are responsible for payment of any tax owed. Income is allocated to each partner based on his or her share of the contributed capital (i.e., pro-rata share).*

### Gift and estate tax considerations

One of the most powerful advantages of an FLP is that it can help minimize federal gift and estate taxes, which can reach as high as 45% for transfers made in 2007. This is accomplished in three ways:

1. Leveraging the annual gift tax exclusion and gift tax exemption: Gifts of interests in an FLP are subject to federal gift tax (and possibly state gift tax). However, you can minimize or eliminate your actual gift tax liability by transferring FLP interests in increments that are free from gift tax under the annual gift tax exclusion (currently \$12,000 per recipient). Further, every taxpayer has a \$1 million lifetime exemption from the gift tax, so transfers that do not fall under the annual gift tax exclusion will be free from gift tax to the extent of your available exemption.
2. Taking valuation discounts: You may be able to discount the value of the FLP interests given away. That's because the limited partners have very restricted rights, such as: (a) the inability to transfer interest, (b) the inability to withdraw from the FLP, and (c) the inability to participate in management. These restrictions can result in a business value that is significantly less than the



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value of the underlying assets. These discounts can be considerable, totaling as much as 35%. The discounts available include the minority interest (lack of control) discount and the lack of marketability discount.

3. Removing future appreciation from your estate: Business assets generally appreciate (increase in value) over time. Distributing your assets among family members (through the FLP) freezes the current value and keeps any growth in value out of your estate later. You may have to pay gift tax now, but it will be less than if tax is calculated on a higher future value.

### **FLPs must comply with State Law and IRS requirements**

An FLP is subject to more restrictive rules than other forms of business entities. Care must be taken to create a valid FLP in the eyes of the state and the IRS.

An FLP will be recognized only if it is formed for a valid business purpose. The FLP form will be disregarded if the IRS or the state finds that it was formed solely to avoid taxes. In fact, the IRS has enacted certain rules to prevent taxpayers from using the FLP form as a means to split family income and circumvent taxes.

Six factors must be satisfied in order to qualify as a valid FLP:

1. Distributions of interests in an FLP must be to family members only. The IRS defines family for income tax purposes as your spouse, ancestors, lineal descendants, and any trusts established for the benefit of these persons.
2. Reasonable compensation must be paid to partners who actually work for the partnership.
3. FLP income distributed to a partner can't be disproportionately greater than the capital contributed by that partner.
4. Partners must receive partnership interests through a bona fide transaction (gift or sale).
5. The FLP must own income-producing assets (e.g., inventories, machinery, equipment).
6. All formalities of existence must be observed.

### **Tips for forming and maintaining a valid FLP:**

- *Have one or more substantial nontax purposes for creating the FLP, such as asset protection*
- *Keep good records*
- *Create the FLP while you're still in good health*
- *Observe all legal formalities when creating the FLP and while operating the business*
- *Hire an independent appraiser to value assets going into the FLP*
- *Transfer legal title of assets going into the FLP*
- *Put only business assets into the FLP--don't put any personal assets into the FLP*
- *If you do put personal assets into the FLP, such as your home, pay fair market rent for their use*
- *Don't commingle FLP assets and personal assets--keep them separate*
- *Never use FLP assets for personal purposes*
- *Keep enough assets outside the FLP to pay for personal expenses*
- *Distribute income to partners pro rata*