Business Succession Planning: Family Limited Partnership (FLP)

What is a family limited partnership (FLP)?

Estate planning tool

An FLP is a limited liability business entity created and governed by state law, and it generally comprises two or more family members. It can be a powerful estate planning tool that (1) may help reduce income and transfer taxes, (2) lets you distribute assets to your heirs while keeping control of the business, (3) ensures continued family ownership of the business and (4) provides liability protection for all the limited partners.

Allows you to shift business income and appreciation to family

By organizing your business as an FLP, you can shift business income and future appreciation of the business assets to other members of your family. In addition, you can concentrate the management of the business in your own hands without causing your interest in the partnership to be included in your taxable estate. Gifting interests in an FLP may reduce taxes by letting you take advantage of the transfer tax laws (e.g., the annual gift tax exclusion). Most importantly, gifts of FLP interests qualify for discounts that reduce the taxable value. An FLP also guarantees that there will be continuous family ownership of the business because family members' ability to sell or transfer their interest to nonfamily members is restricted. At the same time, an FLP affords all of the limited partners liability protection, regardless of the extent of their participation in the business.

You and your family keep ownership interest

Upon formation of an FLP, you and your family members transfer property in return for an ownership interest in the capital and profits of the FLP. At least one family member must be designated as the general partner(s), or a corporation must be set up to act as the general partner. The general partner(s) retains exclusive control over the assets and operations of the business and determines if, when, and how much of the partnership income is distributed. However, the general partner(s) also assumes personal liability for all the debts and liabilities not satisfied by the assets of the FLP. Also, the limited partner(s) has no say in how the business is run. In return for giving up that right, the personal liability of the limited partner(s) is limited to the value of the capital account (generally, the amount of capital they have contributed to the FLP).

Often, an FLP is formed by a member(s) of the senior generation, who becomes the general partner(s) and converts the remaining interests to limited partnership (LP) interests, which are then gifted to the junior generation. The general partner(s) need not own a majority of the partnership interests. In fact, the general partner(s) can own 1% of the partnership and still be designated as the general partner. Conversely, the limited partner(s) need not own a minority interest in the partnership but can own virtually all the interest (e.g., 99%).

Caution: The general partner should own at least a full 1% of the FLP. Anything less will raise the IRS's eyebrows. The legal and tax issues relating to the FLP are extremely complex. It is imperative that you seek the advice of an experienced partnership, tax or estate planning attorney if you are considering creating a new FLP or changing the status of your current business organization (especially if death is imminent).

Example(s): Tyrone (an ex-fighter who is already very wealthy) owns a national chain of gyms. The business is growing rapidly because of his reputation. In fact, he is opening a new site almost every month. His sons, Tyrone Jr., Tyrone III and Tyrone IV, all work with him in the business. Tyrone Sr. is proud of his business and would like to see it thrive for generations to come. He wants to transfer ownership of the business to his sons now, before the assets appreciate in value even more, but he is afraid the boys aren't experienced enough to manage such a large enterprise. In addition, Tyrone Sr. wants to protect his sons against any personal liability that might arise in connection with the business. So, he contacts his attorney (an expert in partnership law), who draws up an FLP agreement.

Example(s): The terms of the agreement designate Tyrone Sr. as the general partner, owning 1% of the business, and his sons as limited partners, owning 33% each. With the help of his attorney, Tyrone Sr. transfers the business stock to the FLP and completes all other formalities of existence. Tyrone Sr. then gifts 99% of the FLP to his sons (33% to each son), reports the gifts, and pays gift tax on the value transferred, less the annual gift tax exclusion and unified credit. Tyrone Sr. runs the business for the next six years, until he is comfortable that the boys are fully able to manage on their own. During those six years, Tyrone Sr. files annual reports with the state and carefully follows all the necessary formalities. Tyrone Sr. distributes the FLP income each year — 1% to himself and 33% to each son. The family collectively saves income tax because the boys are in a much lower tax bracket than Tyrone Sr.

Example(s): At the end of the sixth year, the partners vote to name Tyrone Jr. as the general partner and Tyrone Sr. as a limited partner. Tyrone Sr. turns over the reins of the business to Tyrone Jr. and retires to Hawaii. Ten years later, Tyrone Sr. dies. The value of the business has increased dramatically over the last 16 years, but only 1% of that value is included in Tyrone Sr.'s estate for estate tax purposes.

What are the advantages of an FLP?

Shifts income among family members
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. 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 to the extent of their share attributable to the contributed capital (or pro rata share).

Example(s): Alan establishes an FLP with his children, Bob and Carol. Alan contributes $40,000 to the partnership — $20,000 for himself (50%) and $10,000 each for Bob and Carol (25% each). If the FLP has $100,000 of income (assume no expenses), Alan will be taxed on $50,000 of this income (50%), and Bob and Carol will be taxed on $25,000 each (25% each).

Caution: The general partner is entitled to a management fee, which is taxable to the general partner as ordinary income. Tip: This may be especially attractive if you are transferring interests to family members in a lower tax bracket. The family enjoys the tax savings. In addition, you can transfer interests in the FLP to your minor children as long as they are competent to manage their own property and participate in FLP activities. As a practical matter, minors generally do not possess such maturity. Therefore, interests to minors should not be given directly but rather to a guardian or in a trust. Be aware, however, that unearned income of children may be subject to the kiddie tax and taxable at your (the parent's) income tax rate.

Caution: The kiddie tax rules apply to (1) children who are under 18 years old, (2) children aged 18 whose earned income does not exceed one-half of their support, and (3) children over age 18 but under age 24 who are full-time students and whose earned income does not exceed one-half *of their support.*

May help avoid transfer taxes
One of the most powerful advantages of an FLP is that it can help avoid transfer taxes, which may include generation-skipping transfer taxes (GSTT) and federal gift and estate taxes. This avoidance is accomplished in three ways:

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

B. Takes advantage of the annual gift tax exclusion — Gifts of interests in an FLP are subject to gift tax. However, you can minimize or eliminate your actual gift tax liability by taking advantage of the annual gift tax exclusion. The annual gift tax exclusion allows you to give $15,000 per donee without incurring gift tax. Generally, a gift must be a present interest gift in order to qualify for the exclusion. A present interest gift means that the recipient can immediately use, possess or enjoy the gift. If the FLP agreement is properly drafted, an outright gift of interests in an FLP will qualify for the exclusion. To qualify the gift as a present interest gift, the FLP operating agreement can't place too many restrictions on the donee (the limited partner) to presently derive some economic benefit from the gift. The key here is to draft the FLP agreement to allow some ability for the limited partners to reach the gift when it is given. An agreement that is too restrictive may cause the IRS to rule that the gift is a gift of future interest, and the annual exclusion will be disallowed.

You must be even more careful if you put the interests in the FLP into a trust. Gifts made into a trust are usually considered to be gifts of future interest and do not qualify for the annual exclusion. However, you can qualify the gifts in trust if you structure the trust to include Crummey withdrawal rights. A Crummey withdrawal provision gives the beneficiaries of the trust (the limited partners) the unrestricted right to demand, for a reasonable period, any amounts you place into the trust. The inclusion of such a provision will enable the trust to pass the IRS's inspection, and the transfer of the interests in the FLP will qualify for the exclusion as gifts of present interest. Of course, so as not to defeat the purpose of the trust, the limited partners should not actually exercise their Crummey withdrawal rights.

In structuring the trust to take advantage of the annual gift tax exclusion, you should follow these rules:
1. Include a Crummey withdrawal provision in the trust document.
2. Carefully draft the trust document to clearly state that Crummey withdrawal rights are given.
3. Fulfill all notice requirements.
4. You must carefully follow the notice requirements of the Crummey withdrawal provision. The basic requirement is that actual written notice must be made in a timely manner. It is best to give written notice to each beneficiary at least 30 to 60 days before the expiration of the withdrawal period.

5. The Crummey withdrawal power is treated as a general power of appointment. This means that if the power is not exercised, the power is treated as a lapse. The lapse may be considered a taxable gift by the IRS if the value of that power exceeds the greater of $5,000 or 5% of the value of the trust fund (this is the so-called “five or five” power). To avoid this situation, construct the Crummey withdrawal correctly so that it does not exceed $5,000 per year or include a so-called hanging power, which pushes the excess value into future years.

Caution: Whether you give interests in the FLP outright or in a trust, you must be very careful when drafting the FLP agreement so that it does not completely restrict the right of the limited partners to immediately enjoy some economic benefit from the contributions made into the trust. An agreement that is too restrictive will cause the IRS to disallow the annual exclusion.

C. May be entitled to valuation discounts — This is one of the most attractive features of the FLP form. The transferor (the one making the gift of the FLP interests) is able to discount the value of the LP interests given away. The value of the LP interest can be discounted because the limited partner has very restricted rights, such as (1) the inability to transfer interest, (2) the inability to withdraw from the FLP and (3) the inability to participate in management. These restrictions result in a business value significantly less than the value of the underlying assets. This discount can be considerable and is available for GSTT, gift and estate tax purposes.

The discounts available include:
1. Minority interest (lack of control) discount.
2. The minority interest discount is allowed because no limited partner can force distributions or a liquidation or dissolution of the partnership. In other words, the limited partner can’t cash in their interest.
3. Lack of marketability discount. The lack of marketability discount is allowed because the limited partner is generally unable to sell or transfer their interest in the FLP.

Caution: The IRS may offset these discounts by a control premium. The control premium will attach if there is a partner who has voting control (a partner with a majority general partnership interest) or a swing interest (the power to swing the majority either way). This is based on the IRS’s position that such centralized control increases the value of the business.

Tip: The discounts you take should be reasonable, or you will be inviting the IRS to challenge them. It is recommended that you hire an appraiser experienced in valuing business property for tax purposes to appropriately value the business assets and discounts.

Allows you to maintain control of the business
Another attractive aspect of an FLP is that it gives you the ability to distribute your assets now and, at the same time, to continue to control them. As long as you designate yourself as the general partner, you control the business, even if you own as little as a 1% interest. You control

the cash flow, distribution of income, investment of assets and other management decisions. This may be advantageous if you are afraid the younger generation may mismanage, waste or otherwise dissipate the partnership assets.

This may also be advantageous if you are the only one really interested in running the business but must share ownership with other family members, or if family members don't really get along with each other and cooperation seems unlikely.

Keeps the business in the family
You may be concerned about your hard-earned assets winding up in the hands of people outside the family. Limited interests in an FLP are restricted by the terms of the partnership agreement. Such restrictions may include the inability to transfer an FLP interest (by gift or sale) unless the other partners are first given the opportunity to purchase (or refuse) the interest (this is called a right of first refusal). This virtually guarantees that outsiders will not own the business.

Tip: Be sure to include a right of first refusal provision in the FLP agreement.

Provides for children not in the business
The FLP form is a great way to evenly distribute your estate among all your children, even though some of them may not want to be involved in the business. Through ownership of limited partner interests, children who are not employed in the family business can still derive the economic benefit from the income distributions made from time to time, as they may need.

Protects assets
A. A corporate general partner provides liability protection — If asset protection is a strong concern, you may want to set up a corporation to function as the general partner. The personal liability that attaches to the general partner may be averted since a corporation is a limited liability entity. However, this strategy may fail if a party is able to successfully argue that the corporate entity is a sham, established merely to escape liability, and that it should be ignored (this is called piercing the corporate veil). To avoid this, it is vital that you keep the corporation separate from the FLP. Do not commingle funds or assets (e.g., do not let the corporation pay the FLP's bills). Scrupulously observe all the formalities required to maintain corporate status (e.g., keep records and minutes, hold directors and shareholders meetings, and file the annual reports). It is recommended that you seek the advice of an experienced corporate attorney if you are considering this strategy.

B. Puts assets beyond the reach of creditors — An FLP can provide some measure of asset protection for the limited partners. Because the limited partner no longer owns the assets contributed to the partnership, a creditor's ability to attach those assets becomes severely limited. It generally takes a court order (called a charging order) to reach a limited partnership interest, and 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. They must wait until the general partner decides to distribute income (which may be a very long time). In addition, the assets are likewise protected from loss due to divorce. The general partner, however, does not receive the same protection and is, by nature, personally responsible for the debts and liabilities of the FLP (unless the general partner is a corporate entity — see above).

Offers flexibility
Unlike an irrevocable trust or a corporation, an FLP can be amended by a vote determined under the terms of the FLP agreement. As long as you hold the necessary percentage ownership interest, you can easily change the rules that apply to the partnership.

Ownership of assets may be consolidated and simplified
All the assets of the general and limited partners are consolidated in an FLP. This simplification of the management of the assets results in cost savings and more efficient and productive use or investment.

Avoids probate
Assets that have been transferred to the younger generation before you die do not pass through probate (the court-supervised process of administering your will). The probate process can be quite lengthy and costly. Only the interest you hold in the FLP will pass through probate. The FLP remains intact and continues to operate under the terms of the FLP agreement after you die. In addition, probate costs will be saved.

May avoid ancillary probate
Generally, the probate process occurs in the state in which you reside. However, if you own real estate (but not personal property) in another state, your estate will also have to go through the probate process in that state. This is called ancillary probate. Most states treat FLP interests as personal property, even if the FLP owns real estate, so ancillary probate is usually avoided.

Maintains your privacy
Assets that pass through probate are a matter of public record, open to anyone who cares to look at it. Because the FLP assets pass outside of probate, this distribution of your property remains private (unless, of course, you choose to tell someone).

Ensures continuity of business operations
Because the FLP is a separate entity that remains intact after you die, it will continue to operate and should not suffer from any disruption due to transfer of ownership details.

What are the tradeoffs?

Is a complex form of business entity
The FLP is a complex type of business organization. It is highly recommended that you seek the advice of a competent, experienced attorney.

May be subject to GSTT and/or gift tax
Gifts of interests in an FLP will be a taxable transfer for the GSTT and/or gift tax purposes and may result in tax liability subject to the application of the annual exclusion, deductions and the unified credit.

Can be costly
Setting up an FLP can be expensive. You will need to hire an attorney (which is never cheap) to advise you, draft an FLP agreement, and perhaps set up a corporation to act as the general partner. Other costs may include: (1) the cost to change title to assets, (2) appraiser's fees (3) state and local filing fees, and (4) tax accountant's fees.

May create a state gift tax problem in some community property states
In some community property states, compensation income (wages earned) from interests in an FLP acquired before marriage is classified as community property, but income distributed to partners from FLP profits is classified as separate property. If separate property income is used to benefit both spouses, a taxable gift is created. This is not a problem on the federal level because these gifts are fully deductible under the unlimited marital deduction. However, depending on the gift tax laws in your state, state gift tax may be owed.

Tip: If you are married and live in any community property state, you should designate in the FLP agreement if FLP property is community or separate. This may avoid potential conflicts in case of divorce.

What qualifies as an FLP?

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

- Distributions of interests in the 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.
- Reasonable compensation must be paid to partners who actually work for the partnership.
- FLP income distributed to a partner cannot be disproportionately greater than the capital contributed by that partner.
- Partners must receive partnership interests through a bona fide transaction (by gift or sale).
- The FLP must own income-producing capital (e.g., inventories, plants, machinery and equipment).
- All formalities of existence must be observed.

Caution: Under the legal test established in the Kimball case, a sale is bona fide if, as an objective matter, it serves a "substantial business or other nontax purpose." However, as illustrated by the Strangi case, it is unclear what this standard means precisely or how it can be satisfied. Also illustrated in the Strangi case, an FLP will be disregarded if there is an "implicit understanding" that *the transferor would continue to use the transferred assets as needed. It is, therefore, additionally recommended that you clearly state your business purpose for forming the FLP in the FLP agreement, and do not fund the FLP with nonbusiness property.*

How do you implement an FLP?

Hire an attorney

The first thing you should do is hire a competent and experienced attorney, preferably one with knowledge of partnership, tax or estate planning law. The attorney should advise you about the legal issues and complexities of an FLP. In addition, the attorney will carefully draft all the necessary documents to effectively create the FLP, file all necessary forms with the appropriate state agency and transfer title to all assets. You may need to hire a tax accountant as well to give advice on future tax consequences.

Hire an appraiser

You should have the value of the assets contributed to the FLP professionally appraised in order to assign a reasonable value to the partnership interests and the discounts that may be used. If the IRS questions these values, the burden is on you to prove that they are legitimate. Therefore, you should have a written appraisal from a reputable appraiser to back up your numbers.

Observe all formalities of existence

Disregarding the formalities of existence can have disastrous consequences. The IRS will disregard the FLP, and all your tax-saving plans will go down the drain. Be sure to follow these rules:

- Execute a written agreement (called a partnership agreement) setting forth all the rights and duties of the partners
- File all necessary certificates and documents with the state
- Obtain all necessary licenses and permits
- Obtain a federal ID number for the FLP
- Open new accounts in the name of the FLP and transfer title to all the assets contributed to the FLP
- Amend any existing contracts to reflect the FLP as the real party in interest
- File annual federal, state and local reports
- Maintain all formalities of existence
- Do not commingle partnership assets with the personal assets of any individual partner
- Keep appropriate business records
- Include partnership interest on personal annual income tax returns

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