Morgan Stanley

Family Limited Partnership

Wealth and Estate Planning Strategists
Family Office Resources

Family Limited Partnership

INTRODUCTION

- A Family Limited Partnership or "FLP" (or Family LLC) is a business entity which can facilitate business succession, gifting and estate planning. A properly created and administered FLP potentially allows you to leverage your lifetime gift tax exemption by making gifts of limited partnership interests, in trust or outright, to your family members on a discounted basis. Limited partnership interests generally qualify for valuation discounts for lack of marketability and lack of control.

OVERVIEW

- There are many reasons to form an FLP or LLC. In addition to creditor protection, centralization of management, training younger generations in the management of assets, and limiting outside ownership, an FLP or LLC can be used to facilitate estate planning. The FLP is structured to protect you from personal liability and to facilitate capitalization, while preserving a degree of control of the enterprise (although retaining this control puts the FLP interests at risk of inclusion in the taxpayer's estate).
- Typically, the FLP is formed by older-generation family members (for purposes of our discussion, the parents) who contribute assets to the partnership in return for general partnership units and limited partnership units. The general partners have management control and unlimited personal liability for the partnership's acts, although limited liability can be achieved by forming a Limited Liability Company ("LLC") to act as general partner. The limited partners have no personal liability with respect to the debts of the FLP (beyond their capital contributions) and, through the partnership agreement, usually have very few rights related to partnership operations and significant restrictions on their ability to transfer their partnership interests to others.
- The partnership agreement will govern how partnership income and expenses are divided among the partners. Typically, both general and limited partners share taxable income and cash flow based on their percentage interests in the partnership. The general partner controls the distribution of cash to the partners, but the partnership's taxable income and resulting tax liability passes through to all partners automatically, even if cash distributions are not made.
- FLPs are required to have a business purpose and should not be created for tax reasons alone.

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Family Limited Partnership: Illustration

- Clients form and fully fund a Family Limited Partnership by contributing carefully selected assets to the Family Limited Partnership in exchange for all of the general and limited partnership interests
- Clients must obtain an appraisal for the limited partnership interests from a qualified appraiser in order to substantiate the validity of discounts given to the limited partnership interests

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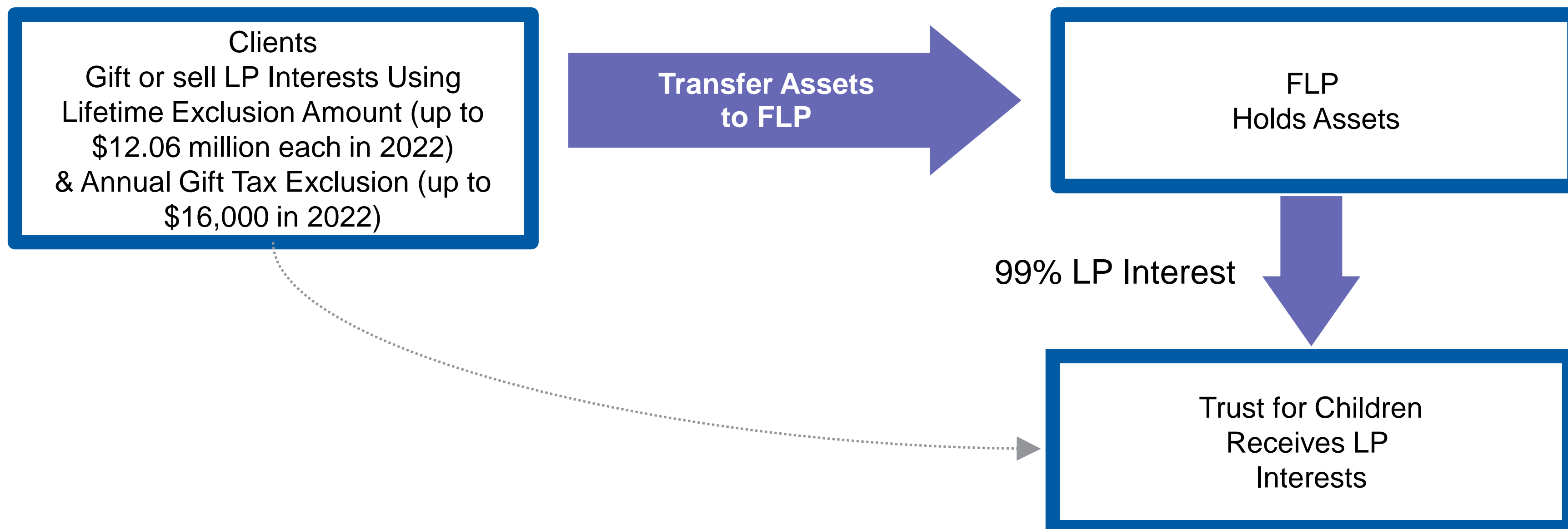
Family Limited Partnership: Illustration

- Clients Begin Gifting LP Interests
- In 2022, Clients may combine their remaining lifetime gift exclusion amounts (up to $12.06 million each in 2022) for a total tax free transfer in the first year of up to $24,120,000 (in 2022)
- Clients could also allocate their remaining generation skipping transfer (GST) tax exclusion amount (up to $12.06 million each in 2022) to the transfer if the Trust for Children is meant to be held for future generations



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ESTATE AND GIFT TAX BENEFITS

- A significant benefit of a FLP is its potential to reduce a transferor's gift and estate taxes. By using a FLP, the owner can take advantage of gift and estate tax valuation rules relating to “lack of control" and “lack of marketability" that can reduce transfer taxes. Due to the significant restrictions imposed on limited partnership units, these partnership units typically will have a valuation discount that can range from 5% to 60%, but any discount has the potential to be challenged and/or denied.

INCOME TAX BENEFITS

- An income tax benefit is often created in a FLP by shifting income to individuals in lower tax brackets. Generally, each partner is liable for taxes on his or her distributive share of partnership income. Over several years, the allocation of taxable income to family members in lower tax brackets can substantially reduce overall family income taxes.

MANAGEMENT BENEFITS

- A FLP can provide several management benefits, especially when the family owns multiple distinct assets. Consolidating separate properties into one entity can make the assets easier to manage efficiently. For example, pooling the assets may reduce the number of tax returns one needs to file, may allow greater access to investment opportunities and may create greater leverage with lenders. These advantages can also help to establish the required business purpose for FLPs.

SELECTION OF ADVISORS

- Especially in this age of potential challenge against FLPs, you should engage attorneys experienced in the formation and maintenance of family limited partnerships. In addition, the attorneys will need to coordinate their efforts in structuring the FLP with the appraisal of gifts of the limited partnership interests.

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ADVANTAGES

- Reduced asset values for estate and gift tax purposes through valuation discounts
- Ability of the general partners to make substantial gifts yet maintain a degree of control of partnership assets for the time being. Note, however, that the retention of control risks inclusion of gifted interests in the taxpayer's estate
- Consolidation of family assets and enhancement of future investment opportunities
- Institutionalization and enhancement of family communication on family business and investment matters
- Reduced probate costs with respect to real estate located in other states. No ancillary administration is required
- Asset protection for personal assets from liabilities stemming from business activities, and for partnership assets through the charging order rules

DISADVANTAGES

- Potentially subject to challenge by the IRS on several points: the valuation of assets transferred to the entity, the valuation discounts applied to gifts of FLP interests, and the exclusion of gifted interests from the taxpayer's estate
- One should be willing to eventually give up control of the FLP in order to preserve exclusion from the estate for estate tax purposes
- The entity must be created with a valid business purpose, and risks IRS challenge if created solely for tax reasons
- The FLP is a legal entity and its creation will result in administrative costs, appraisal costs for transfers of entity interests, record keeping requirements, and the preparation of partnership, gift, and/or trust tax returns
- Careful consideration should be given to the decision to transfer certain assets to the FLP, including (1) stock or securities and (2) a principal residence. These actions could undercut the business purpose, create investment company rule problems and disqualify the potential exclusion of gain upon a sale. In addition, qualified plan assets should not be contributed to a FLP since doing so requires the transferor to recognize income upon receipt of the assets from the qualified plan

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