Morgan Stanley

FLPs and LLCs

Estate Planning Strategies

Family Limited Partnerships (FLPs) and Limited Liability Companies (LLCs) are popular estate planning vehicles for a variety of reasons. Before a spate of litigation discussed below, it had become fairly mainstream estate planning for a senior generation to (1) transfer assets to an FLP or LLC in exchange for controlling and non-controlling interests and (2) transfer--by gift or otherwise--non-controlling interests in the entity to younger generations at deep discounts in relation to the value of those assets in the hands of the senior generation. The IRS has aggressively challenged the use of FLPs and LLCs to reduce transfer taxes under certain circumstances.

Structure

An FLP is made up of one or more general partners (GPs), who manage the partnership and have unlimited liability, and limited partners (LPs) who are precluded from managing the partnership and are liable only to the extent of their investment in the FLP. LLCs usually have one or more managers who control the business of the LLC and members, all of whom are generally liable only to the extent of their investment in the LLC. Assets can be transferred to an FLP in exchange for GP and LP interests, or to an LLC in exchange for membership interests. FLPs and LLCs are governed by the limited partnership agreement or operating agreement, respectively (which, if circumstances change, can be amended in accordance with the terms of the agreement and applicable state law).

Wealth and Estate Planning Strategists

Family Office Resources

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Income Tax

There are generally no tax consequences on the formation of an FLP or LLC (if done properly) FLPs and LLCs are treated as flow-through entities for federal income tax purposes, or in the case of LLCs, they may elect to be treated as corporations. Typically, the owners are deemed to receive a pro-rata portion of the income and losses of the FLP or the LLC based on their ownership interests.

Gift Tax

As discussed, a traditional planning technique involves the formation of an FLP or LLC and then the gifting (or otherwise transferring of non-controlling interest) to younger generations. By retaining the controlling interests, a parent, for example, could retain control of the entity and its assets. When transferring the FLP or LLC interest (even intra-family), the value of the transferred interest may be worth less than the pro-rata value of the underlying assets because of its lack of marketability and the transferee's inability to control the entity and its assets. The ultimate federal gift tax value is determined by a qualified appraiser based on the facts and circumstances.

Estate Tax

Interests in an FLP or LLC gifted or otherwise disposed of during life generally are not included in the donor's gross estate for federal estate tax purposes. Only FLP or LLC interests still owned at death will be included in the owner's gross estate. The interests may be discounted for lack of marketability and control (or in the case of a controlling interest, a control premium could be applied). As discussed below, however, in some cases where FLPs or LLCs are inappropriately structured, the entities' assets may be pulled back into (and taxed as part of) the estate of the person who created them.

Asset Protection

When a debtor owns a limited partnership interest, a court can charge the limited partnership interest with the payment of an unsatisfied debt, effectively assigning the interest to the creditor. The assignment does not make the creditor a partner. Rather, the "charging order" entitles the creditor to receive any distributions that the limited partner/debtor would receive. If the formalities of the entity are respected (and depending on state law), a distribution generallly cannot be forced for the benefit of a creditor of a limited partner and creditors cannot reach the underlying assets of the FLP. Accordingly, under the appropriate circumstances, FLPs may be attractive for asset protection purposes. Many state LLC statutes have charging order provisions similar to those applied to FLPs. State law must be consulted, however, because the charging order may not be the exclusive remedy available to a judgment creditor.

Risks

The IRS has challenged the discounts applied to interests in FLPs and LLCs. While the IRS has had difficulty challenging the discounting of FLP and LLC interests where a legitimate business purpose for such entity was found, it has had some success challenging FLPs and LLCs under a provision of the Internal Revenue Code (Code) that requires the inclusion of transferred property in a decedent's estate if such decedent retained an inappropriate degree of control over the assets transferred to the entity or where the discounts applied were excessive . The IRS has not been successful in all cases, meaning there are still valid and defensible uses for an FLP or LLC. There is an exception under the Code where there is a "bona fide sale" of an asset for "adequate and full consideration" (the definitions of both terms have been much litigated). This exception may apply to a properly structured and maintained FLP or LLC. Proper planning and ongoing, careful administration is required to qualify gifts of FLP and LLC interests for the annual exclusion from the federal gift tax.

Unfortunately, there are few bright lines regarding the use of FLPs and LLCs, underscoring a need for the client to engage legal and tax advisors with the proper experience in order to determine whether the use of an FLP or LLC is appropriate for the client's estate plan.

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