Family Limited Partnership

Family limited partnerships (FLP) can be used with business, personal or investment assets. Their traditional purpose has been to divide investment income with children in lower income tax brackets and increase the family's net spendable income.

They have also been used for long-range estate planning. Closely held businesses, along with other assets, are subject to Federal estate and generation skipping transfer taxes. These taxes can effectively prevent the transfer of a family business from one generation to the next. The FLP provides a valuable estate planning tool to lessen these tax burdens.

In recent years, such partnerships have also been employed as a method of protecting family assets from creditors.

IRC Sec. 704(e) effectively limits FLPs to business/investment activities where capital is a material income-producing factor, as contrasted with activities which earn income by providing services.

How It Works

The parents set up a FLP and transfer capital assets into the partnership. Within the partnership structure, the parents act as the general partners; the children (or grandchildren) are the limited partners.

In a limited partnership, the general partners often own only a small proportion of the partnership (for example 5%), while the limited partners own the majority interest. The general partners have complete responsibility and control of partnership activities, as well as the liability for partnership debts and losses.

The limited partners have no control or management rights. Their liability is limited to the amount of their contribution to the partnership.

One of the most attractive features of the FLP is its flexibility. Some estate planning strategies must be irrevocable in order to be effective. Once set up, these irrevocable tools cannot be changed or undone. By contrast, the FLP document can be modified to respond to changes in the family or business structure.

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Reasons to Consider a Family Limited Partnership

There are three primary reasons for creating an FLP.

- **Income tax benefits:** Income generated by a limited partnership is often allocated according to ownership. With the limited partners (the children or grandchildren) owning the majority interest, most of the income generated could flow through to them and be taxed at their lower marginal tax rate.
- **Estate planning benefits:** When the parents contribute assets to the partnership, they are transferring asset value and shifting asset growth from themselves to a younger generation.

Consider the following hypothetical example in which a business has a current value of $200,000 and is expected to grow by 10% per year. Over time, the parents transfer 90% of the business to the children.

	Retain for Parents	Contribute to FLP
Current value	$200,000	$200,000
Amount transferred to children	$0	$180,000
Amount remaining in estate	$200,000	$20,000
Asset value in 20 years	$1,345,500	$134,550
Federal estate tax assumed at 45%	$605,475	$60,548
Potential estate tax savings	**$544,928**	

Often a gifted ownership interest can receive a discounted value because the interest is either a minority interest or lacks marketability. This minority interest issue should be carefully reviewed with your legal advisor.

- **Protecting assets from lawsuits:** Most state limited partnership statutes prevent the creditors of a limited partner from attaching partnership assets. While the creditors may get a charging order against the debtor's partnership interest, as a practical matter it is very difficult to collect the debt. The FLP may provide one of the most effective asset protection structures available today.

Family Limited Partnerships Are Not for Everyone

Before considering a FLP, there are a number of questions that the parent or parents must answer. Do they really want to have a child involved in their business? Will the income shared with the child affect the parents' lifestyle? Will a gift tax be due and payable when the transfer is made to the child? Will the income tax savings compensate for the increased complexity?

Additionally, legal counsel must be obtained. Because of the complexity involved, FLPs are not appropriate for every situation. The documentation for such a partnership must be carefully designed to avoid problems with both federal law and the law of the state under which the limited partnership is being created.