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FAMILY LIMITED PARTNERSHIPS AND LIMITED LIABILITY COMPANIES AS ESTATE PLANNING TOOLS

What is a Family Limited Partnership?

A partnership, generally, is an entity created by agreement of two or more persons for the purpose of holding property or operating a business. The partnership agreement will spell out the respective rights of the partners, and it will usually restrict the partners' ability to transfer their interests or admit additional partners. For income tax purposes, a partnership is a "pass-through entity," meaning that each partner is taxed on his or her share of the income.

A partnership may be either a general partnership or a limited partnership, and both types are governed by state law. In a general partnership, all partners are general partners. All general partners have equal rights to manage partnership business, and each general partner is personally responsible for all debts of the partnership. In a limited partnership, the limited partners do not have the right to participate in management, and the liability of each limited partner is limited to his or her investment in the partnership. The limited partnership must have at least one general partner. The general partners of a limited partnership are responsible for managing the partnership and are liable for the partnership debts.

A family limited partnership (FLP) is simply a limited partnership whose partners are all family members. There are many variations, but a typical FLP might be formed by parents who own a farm, rental real estate, or other business or investment assets that they wish to pass on to their children while retaining control over management of the assets.

What are the Benefits of Forming a FLP?

Forming a FLP allows individuals to gradually transfer ownership of assets to family members while maintaining control over the business for as long as they desire. For example, if parents transfer the assets of the family farm to a partnership in exchange for a 2% interest as general partners and a 98% interest as limited partners, they can then make gifts of their limited partnership interests to their children, making annual gifts of fractional partnership interests calculated to take advantage of each parent's annual exclusion from gift tax (\$15,000 per donee in 2019) and lifetime exemption from gift taxes (\$11,400,000 as of 2019). The parents would continue as general partners as long as they wish to maintain control of the business. These lifetime gifts would benefit the parents by removing appreciating property from their estates, thus reducing the size of their taxable estates and transferring income to the children.

As an additional benefit, using a FLP to make gifts of partnership interests, rather than making outright gifts of assets, might allow the parents to transfer the limited partnership interests to their children at a discounted value. This is possible because the value of a limited partnership interest is less than the value of a fractional interest in the underlying assets the partnership holds due to the limited partners' lack of control over the assets. For example, if the partnership owns assets worth \$130,000, a 10% limited partnership interest would not be worth \$13,000—it might have a discounted value of only \$10,000. For the same reason, the partnership interest retained by the parents until their deaths may be subject to valuation discounts for estate tax purposes. Be aware, however, that the Internal Revenue Service has complex rules and regulations that affect valuation and has challenged the use of discounts in certain circumstances. A professional appraisal is generally required to support the use of valuation discounts, and the possibility of an IRS audit should always be taken into consideration.

What Is a Limited Liability Company?

A limited liability company (LLC) is another form of entity that family members can use for estate planning purposes. The owners of an LLC are called members, and their rights and obligations are governed by state law and an operating agreement entered into by all the members. One advantage of an LLC over a FLP is that no member of a LLC is personally liable for the obligations of the LLC. Due to differences in the governing law, and depending on the rights of the members under the operating agreement, the valuation discounts available for interests in a LLC might be lower than those available for FLP interests.

How Is a FLP or LLC Formed?

FLPs and LLCs require a certain amount of initial and ongoing administrative work. Creation of the entity requires an agreement, a certificate filed with the Secretary of State, and deeds or other documents to transfer assets into the partnership or LLC. Annual maintenance requirements include filing an annual report with the Secretary of State and paying an annual filing fee, filing partnership income tax returns with the State and the IRS, and providing K-1 reports to the partners. Gift tax returns must be filed each year that interests are gifted.

Conclusion

The FLP and the LLC are powerful estate planning vehicles with both tax and nontax benefits. They allow convenient gifts to other family members, while maintaining centralized control and reducing estate and gift taxes. They can help preserve the family business and limit exposure of the family assets to outside creditors. Their complexities, however, require that FLPs and LLCs be created and administered with care to avoid undesired consequences.

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