

## **SWEET, MAIER & COLETTI, S.C.**

### **FAMILY LIMITED PARTNERSHIPS**

Family Limited Partnerships (FLPs) have become an extremely popular way to transfer assets to children and grandchildren at a reduced gift tax cost. An FLP is a standard limited partnership comprised solely of family members as partners. A limited partnership is a partnership which has two classes or types of partners: general partners and limited partners. The general partners manage the partnership and have some ownership rights. The limited partners have no management rights and do not participate in running the partnership. The only interest that the limited partners have is financial.

An FLP is typically created by the parents transferring assets likely to appreciate rapidly to a newly formed limited partnership, pursuant to the limited partnership laws of their state, in exchange for a small general partnership interest (typically from 1 or 2 percent up to 10 percent) and the balance as limited partnership interests. The parents will retain the general partnership interest and, over time, transfer most or all of their limited partnership interest to their children and/or grandchildren. By retaining the general partnership interest, the parents retain management and control over the assets in the FLP and by giving the limited partnership interests to their children and grandchildren, they transfer to them the future income and appreciation of the assets.

***Advantages of a Family Limited Partnership.*** The limited partnership interests given to the children/grandchildren are worth significantly less for transfer tax purposes than the same proportionate interest in the underlying assets held by the FLP. The holder of a minority interest in a limited partnership cannot make decisions about how the business is run, demand distributions, or force a liquidation of the partnership. In addition, an interest in a family limited partnership may be far less marketable than an interest in the underlying assets held in the FLP. As a result, minority interest and lack of marketability discounts are generally available to reduce the value of the limited partnership interests given to the children and grandchildren, thus lowering the gift tax on those transfers. The combined discounts which have been allowed by the IRS and the courts range between 20 percent to 40 percent, and can, at times, be greater.

Transferring assets to a partnership can also make it more difficult for creditors of the partners to reach the underlying assets held by the partnership. Other advantages of FLPs include:

- Simplification of probate (the partnership interest replaces all of the underlying assets formerly owned by the transferors, thus making probate somewhat more simple),
- Simplifying a gifting program: giving limited partnership interests can be more simple and easy than giving the underlying assets to family members.

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- Ease of amendment: most state laws allow the partnership agreement to be amended and changed easily.

***Disadvantages of FLPs.*** Family Limited Partnerships are not for every person and situation. Some of the drawbacks of FLPs include the following:

- ***Cost.*** Legal, accounting and appraisal fees for setting up an FLP could be substantial depending on the particular facts and circumstances. These costs must be weighed against the value of the assets to be transferred.
- ***Loss of Stepped-up basis.*** Although the transfers of assets using an FLP is advantageous, the tradeoff is that the donee, will receive a much lower basis in the transferred assets by taking the carryover basis (that of the transferor/parent) than he or she would if they inherited the property at the death of the parent (stepped-up basis at the fair market value of the asset at date of death).
- ***Integrity of the FLP.*** Unless the limited partners (children and grandchildren) have legitimate capital interests in the FLP, their interests will be disregarded for income tax purposes, and all of the partnership income will be taxed to the donors.
- ***Sham Transactions.*** The IRS has long campaigned against the use of FLPs which, in their opinion, are not legitimate partnerships and are used only to avoid the payment of taxes. They have been successful in challenging certain FLPs which were established within hours or days of the death of the donor. However, if properly set up, a FLP should withstand the attack of the IRS.
- ***Inclusion of gifted interests in donor's estate.*** The retention of too much control over gifted partnership interests may cause inclusion of those interests in the donor's (parent's) estate for estate tax calculation purposes under the Internal Revenue Code Section 2036(a). It is important that once the partnership interest is given to the children, it is theirs to hold. In addition, excessive or unusual control or powers retained by the general partner over the partnership may also raise gift and estate tax problems.

***Conclusion.*** Family Limited Partnerships are not for every estate or person who desires to transfer property to their family. However, for certain taxpayers who have significant wealth or difficult assets to manage or gift, family limited partnerships can be a very attractive vehicle in which to make gifts to family members at a discounted or reduced gift tax cost.

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