

Trusts & Estates

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Family Partnerships and Limited Liability Companies

CASE SUMMARY

This article examines creating family partnerships and limited liability companies to reduce the taxable estate.

Family Limited Partnerships (FLPs) can be great vehicles to transfer property out of a taxable estate at a large discount which may greatly reduce or eliminate the amount of estate taxes due upon death.

The family limited partnership (FLP) and the limited liability company (LLC) are excellent estate planning techniques to reduce the taxable estate. The estate planning advantages of the FLP also apply to the LLC so this article will simply refer to FLP's for clarity. A FLP is a limited partnership comprised of family members. FLPs have become very popular during the last few years because the valuation discounts of FLP assets has been so substantial.

The primary estate planning benefit of a FLP is to reduce the value of assets held in a taxable estate by transferring the assets into the FLP. The assets may receive a valuation discount for lack of marketability, lack of control, and real property can receive capital gain discounts. The

assets may receive a discount for lack of marketability because a third party will require a discount as they will not own the entire asset and are forced into a partnership with the other owners. The assets may receive a discount for lack of control because the limited partner of a partnership does not have the ability to make partnership decisions; they only have the right to review the books. Real property with a low tax basis may receive a built in capital gain discount because under partnership tax laws the partner is responsible for the future tax on the gain of the sale of the real property because the tax will flow through the partnership to the partner.

The above discounts can reduce the value of the assets transferred to the FLP by an estimated thirty percent. An appraiser will need to be retained to appraise the value of the original assets and also to appraise the assets after they are transferred into the FLP. The amount of the discount

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will depend upon the appraiser's analysis of the type of assets, amount and frequency of distributions, the size of the interest, and other factors.



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The appraisals are necessary to validate the discount to the IRS.

The FLP should have a legitimate business purpose in addition to the avoidance of taxes. Asset protection by limiting liability, managing control over the assets, creating an efficient manner to manage assets, and restricting the rights of others from gaining interests in family assets are all legitimate business purposes. The FLP partners must treat the FLP as a business. The FLP must be validly created under state law and comply with all formalities. The FLP must have its own bank account, tax identification number, and must file separate tax returns. The FLP must not simply distribute all its income because businesses will generally retain some income.

The client creating the FLP must retain enough assets outside of the FLP to support their lifestyle because people do not invest all of their assets into a single business. A personal residence should not be transferred into a FLP because businesses generally do not own residences unless they are being rented. Also, the transfer of a personal residence into a FLP will cause the owner to lose their Internal Revenue Code Section 121 capital gain exclusion. FLPs are an excellent estate planning tool to use upon the death of the first spouse because the assets will have received a full step-up in basis upon the first spouse's death.

FLPs require careful planning and drafting because the Internal

Revenue Service has been attacking FLPs using two arguments under Internal Revenue Code section 2036. The FLP must be constructed so that the party transferring the assets into the FLP receives fair and adequate consideration for those assets to overcome the argument that there was an implied agreement that the decedent was able to use the property. Also, the IRS attacks FLPs where all a person's assets are transferred into the FLP and deems such a transaction to create a life estate.

Property taxes are another important consideration when creating a FLP. The parent-child reassessment exclusion will not apply to the transfer into the FLP because the shares in the FLP is the transfer of a personal property interest, not a transfer of real property. Also, the real property will be reassessed once more than fifty-one percent of the property is transferred into the FLP. It is also important to realize that FLPs can be expensive to establish because appraisals are required and the FLP must be maintained as a business which requires annual tax returns and state partnership filings.

FLPs can be great vehicles to transfer property out of a taxable estate at a large discount which may greatly reduce or eliminate the amount of estate taxes due upon death. It is important to remember that they need to be drafted carefully and maintained as a business in order to survive an attack by the IRS.