

# ***Family Limited Partnerships***

***Presented by:***

**RALPH MINTO, JR.**

***Attorney and Counsellor at Law***

COPYRIGHT 2004, RALPH MINTO, JR. & ASSOCIATES

## ***FLPs Have Become Popular Due To:***

- **Their ability to pass assets to succeeding generations at a reduced tax cost.**
- ***The relative ease of their establishment***
- **Gaining acceptance among estate planning practitioners**

# ***What is an FLP?***

- **General partners**
  - **Control day-to-day operations**
  - **Personally liable**
- **Limited partners**
  - **No right to control operations**
  - **No right to transfer ownership**
  - **Limited exposure to liability**
  - **No right to direct distributions to pay income tax on earnings**

# ***What is an FLP?***

**Capital must be material income producing factor for FLP income tax advantages to apply.**

# ***Non-Transfer Tax Motives for FLP Planning***

- **Efficient gifting**
- **Maintaining control**
- **Promoting family unity**
- **Protecting family wealth from failed marriages**
- **Managing family assets efficiently**
- **Protecting family wealth from creditors**

# ***Asset Protection Motives for FLP Planning***

- **Internal Liabilities -  
claims vs. the partnership**
- **External Liabilities -  
claims vs. a partner**

# *The Charging Order*

- **Undistributed income is taxable to the judgment creditor - “Phantom Income”**
- **Limiting Provisions must be carefully crafted in order to maximize asset protection**

# *Valuation Adjustment Motives for FLP Planning*

**The value of the FLP interest owned at death is included in the estate - not the value of the FLP's assets.**

## ***What is the “fair market value” of an interest in an FLP?***

**Fair market value is “the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having knowledge of all relevant facts.”**

# *What is the “fair market value” of an interest in an FLP?*

**“Valuation adjustments” are applied to the fair market value of the underlying assets to determine the fair market value of the FLP interest.**

# ***Valuation Adjustments***

- **Lack of Marketability -**  
An adjustment applicable to minority interests
- **Lack of Control -**  
An adjustment applicable when a partner owns less than a controlling interest

## ***Lack of Marketability***

**The IRS will consider the following:**

- Restrictions imposed by the partnership agreement**
- Restrictions imposed by State or Federal law**
- Amounts paid for interests in publicly traded companies in similar industries**
- Reasonable costs to sell the FLP interest**

# ***How Valuation Adjustments Are Determined and Applied***

- **Value the underlying assets**
- **Determine the discount percentages**
- **Multiply the pro-rata value of underlying assets by the discount percentages**

# ***Valuation Adjustments and the IRS***

- **The IRS is required to disregard Buy-Sell restrictions unless the restrictions are comparable to restriction in arms' length transactions**

# ***Fundamental Income Tax Principles of FLPs***

**The apple is taxed to the tree from whence it falls**

- An FLP must have a business purpose for it to be recognized for income tax purposes**

# *Income taxation of the FLP entity*

- **Subchapter K**
- **Form K-1**
- **IRS Form 1065**
- **“Pass-through”**

# ***Family Limited Partnerships***

## ***Case Study***

***Mr. & Mrs. Jones and their three children  
Peter, Paul & Mary***

# The Jones

- Mr. & Mrs. Jones have a total estate of \$6 million.
- We've used up the unified credit equivalent in our planning through the credit shelter trust which has sheltered \$3 million (1.5 million each for Mr. & Mrs. Jones).
- Now, what else can we do?

# Here's the Jones Estate

■ Home	\$ 350,000
■ Business	2,500,000
■ Securities account	1,650,000
■ Real Estate	1,500,000
■ Total	\$ 6,000,000

# Mr. & Mrs. Jones

- Mr. & Mrs. Jones have three children, Peter, Paul & Mary and all are interested in the business.
- Mr. & Mrs. Jones are interested in passing the business on to PP& M at the lowest possible tax cost while, of course, maintaining a high degree of control while they are alive.

# Here's how the Family Limited Partnership Works

- Mr. Jones forms the Jones Family Limited Partnership (the "JFLP"), with Mr. & Mrs. Jones as the sole 2% general partners, and as the 98% limited partners.
- They transfer the ownership interest in the land, worth \$1.5 million, and the shares of stock of the business, worth 2.5 million, to the JFLP in exchange for the 2% general partnership interest and 98% lp interest.
- The JFLP now has a value of \$4 million.

# Next they make a gift of a 75% interest in the limited partnership interests to PP & M.

- Total value of partnership is \$4 million
- 75% Limited partnerships would be worth \$3,000,000 (.75 times \$4,000,000)
- The Jones' obtain a valuation discount of 40% for lack of marketability and lack of control discount because of the onerous terms they have included in the JFLP limited partnership agreement.
- Thus the value of a 75% interest would be \$1,800,000 (\$3,000,000 times 60%).

# THE NET EFFECT!

- Peter, Paul & Mary would each receive a gift. The gift would be equal to a 25% limited partnership interest each in the JFLP with a gift tax value of \$600,000 each.
- The actual value of the gift will be \$3,000,000.
- Mr. & Mrs. Jones will have to report only a gift of \$1,800,000 instead of \$3,000,000 saving \$1,200,000 in gross estate and \$600,000 in taxes.
- They will owe no gift tax because the transfer is still less than their unified credit equivalent exemption amount.

# THE BOTTOM LINE

- That's what all the fuss is about in family limited partnerships, nothing more, nothing less. The passing of values on to the next generation using valuation discounts at the entity level.

# RECENT DEVELOPMENTS

- A case called Stangi, and all of its variations
- Some say it's the end of FLPs others have been planning their way around.
- All Stangi says is that in certain instances an FLP may be included in the grantor's estate if certain precautions have not been taken.

# Thanks for Attending!

## Please Complete the Feedback Form

COPYRIGHT 2004, RALPH MINTO, JR. &  
ASSOCIATES