THE NAUTILUS GROUP®

GUIDEPOST

Planning with a Family Limited Partnership

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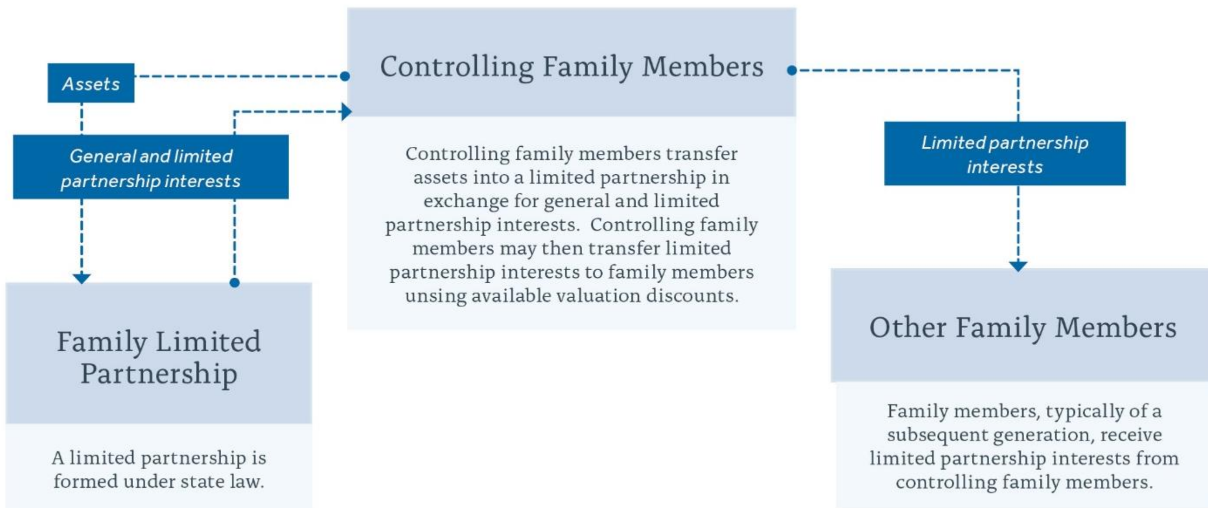
A family limited partnership (FLP)—or similarly a family limited liability company (FLLC)—can be a useful estate planning tool for shifting and preserving family wealth, as well as providing ancillary benefits such as creditor protection and convergence of goals among family members.

Creation and Funding of a Family Limited Partnership

Typically, a donor creates a FLP, initially serving as both its general partner (GP) and limited partner (LP). In exchange for partnership interests, the donor contributes assets to the partnership, such as a closely held family business, intellectual property, marketable securities and/or real estate, and the donor, as the GP, has management responsibilities of the partnership and control of its assets. Over time, the donor transfers, either outright or in trust, LP interests to his/her children and grandchildren. An FLP can be a useful device for a donor to educate such children and grandchildren on how to operate a business or manage assets. Furthermore, such transfers may be eligible for a discount to the fair market value of the assets, providing a major advantage to using an FLP. Therefore, consideration must be given to both tax and non-tax issues when deciding if an FLP is appropriate for a donor's family.



Valid Business Purpose

An FLP is subject to more restrictive rules than other forms of business entities. Great care should be taken to create a valid FLP for state law and Internal Revenue Service (IRS) purposes. An FLP will be recognized only if it is formed for a valid business purpose. The FLP form will be disregarded if the IRS or the state finds that it was formed solely for tax avoidance. Some specific purposes for creating an FLP include:

- To adopt a family succession plan.
- To simplify annual gifting by the senior generation.
- To protect assets from potential creditors.
- To protect assets from waste by heirs.
- To consolidate assets into a single entity.
- To keep a family business in the family.
- To decrease estate and probate costs.

Partnership Design

An FLP is nothing more than a limited partnership created under state law. Most states have adopted what is known as the Revised Uniform Limited Partnership Act, although some states still have their own statutes governing limited partnerships. The reference to a "Family" is not statutory, but rather just acknowledgement that typically partners are members of the same family, although there exists no reason why a key employee or another non-relative also couldn't be a partner of an FLP.

As mentioned previously, an FLP has two types of partners. GPs manage the day-to-day operations of the FLP, while LPs cannot participate in management of the FLP assets or business (although LPs may be employees of the FLP or of any business owned by the FLP). The major disadvantage to being a GP is that the GP is personally liable for all FLP liabilities; FLP creditors can reach and apply a GP's personal assets to satisfy partnership debts. LPs, however, are liable for debts only to the extent of their equity in the FLP. Creditors cannot pursue LPs personally. To combat the personal liability of the GP, often an entity such as a limited liability company (LLC) or an S corporation will serve as GP, so that if FLP creditors pursue the GP, then only the assets of the LLC or S corporation will be at risk.

Maintaining an FLP

An FLP may own a closely held business (other than a corporation that has made a Subchapter S election to be taxed as a pass-through entity), real estate, marketable securities, or almost any other investment asset. Second homes, vacation properties, or other personal use assets are normally not appropriate assets for ownership by a FLP. Tips for forming and maintaining a valid FLP include:

- Have one or more substantial nontax purposes for creating the FLP, such as asset protection.
- Keep accurate records.
- Create the FLP while still in good health.
- Observe all legal formalities when creating the FLP and while operating the business.
- Hire an independent appraiser to value assets going into the FLP.
- Transfer legal title of assets going into the FLP.
- Put only business assets into the FLP—don't put any personal assets into the FLP.
- If you do put personal assets into the FLP, such as your home, pay fair market rent for their use.
- Don't commingle FLP assets and personal assets.
- Never use FLP assets for personal expenses.
- Retain a satisfactory amount of assets available outside the FLP to pay for personal expenses.
- Distribute income to partners pro rata.

Asset Protection Aspects

An FLP can provide a degree of protection to partnership assets from the claims of a partner's creditors. Typically, such creditors can only reach the partnership interest by obtaining what is known as a charging order, which at best entitles the creditor to distributions made by the partnership to the debtor-partner. Furthermore, an FLP can allow, in the event a charging order is obtained against a debtor-partner, the other partners to purchase the interests in jeopardy at fair market value subject to discounts.

Tax Considerations

Income Tax

Generally, a partnership is referred to as a pass-through entity for income tax purposes because the partners typically receive pro rata allocations of partnership income, gain, loss, deductions, credits, and other tax items on their individual returns, unless special allocations are made pursuant to the partnership (or operating) agreement. While partnerships file income tax returns (U.S. Form 1065), that return typically has a separate Schedule K-1 for each of its several partners. If profits and losses are split in a manner that does not correspond to the partner's ownership percentage, this is referred to as a special allocation. The IRS scrutinizes special allocations to ensure partners aren't avoiding potential taxes, for example, by allocating losses to the partner who occupies the highest marginal income tax bracket. If the IRS rejects a special allocation, then partners are taxed as if profits and losses were divided in proportion to ownership interests, regardless of terms and provisions of the partnership (or operating) agreement.

When a partner contributes property to the partnership in exchange for a partnership interest, neither the partner nor the partnership will recognize gain or loss on such contribution. An exception to this general rule exists where the partnership is defined as an investment company under the Internal Revenue Code. Generally, a partnership is an investment company if, following a contribution, more than 80% of the value of the partnership's assets, excluding cash and non-convertible debt obligations, is held for investment. If readily marketable stocks and securities are contributed to a partnership that is treated as an investment company, then the partner contributing assets to the partnership must recognize gain (but not loss) upon the contribution. The definition of stocks and securities is quite comprehensive and includes money and foreign currency among several other financial assets.

Gift and Estate Tax

Perhaps the most powerful advantage of an FLP is its ability to help minimize federal gift and estate taxes. This can be accomplished via three basic methods:

- **Leveraging the annual gift tax exclusion and gift and estate tax exclusion:** Gifts of interests in an FLP are subject to federal gift tax (and potentially state gift tax). However, the actual gift tax liability can be minimized or eliminated by transferring FLP interests in increments that are free from gift tax under the annual gift tax exclusion (in 2020, $15,000 per donee).

  Further, every taxpayer has a basic exclusion from the federal gift and estate tax of $11.58 million (in 2020) plus any deceased spousal unused exclusion amount, so transfers that exceed the annual gift tax exclusion amount will be free from gift tax to the extent of the donor's available exclusion. Both the annual exclusion and the basic exclusion are indexed for inflation and may increase in future years. The basic exclusion amount, however, is scheduled to revert to its pre-2018 level (as adjusted for inflation) on January 1, 2026. To the extent the current $11.58 million basic exclusion amount "sunsets," prudence suggests that high net worth individuals ought to utilize the temporarily increased lifetime exclusion through lifetime asset shifting techniques, such as a FLP.

- **Utilizing valuation discounts:** A donor may be able to discount the value of the FLP interests transferred to LPs as the interests they receive have very restricted rights, such as: (a) the inability to transfer an interest, (b) the inability to withdraw from the FLP, and (c) the inability to participate in management. These restrictions can result in a business value that is significantly less than the value of the underlying assets. These discounts can be considerable (often totaling as much as 25% to 40%). The discounts available include the lack of control discount (sometimes referred to as the minority interest discount) and the lack of marketability discount.

- **Removing anticipated future appreciation:** Business and investment assets generally appreciate over time. Distribution of such assets by a donor among family members (via the FLP) will freeze the current value and will remove from the estate any future growth in value. While gift tax may have to be paid currently, the tax likely will be less than if calculated at a higher future value.

Generation Skipping Transfer Tax

GST exemption may be allocated to any LP interests upon the initial transfer of such assets. Any appreciation to the value to such assets would also remain GST exempt, thereby leveraging the GST exemption.

As a result of the Tax Cuts and Jobs Act of 2017 (TCJA) the estate, gift and generation skipping transfer (GST) tax exemption amounts increased to approximately $11.58 million per person (approximately $23.16 million for a married couple), effective in 2020. For assets transfers in excess of the applicable exemption amount and otherwise subject to such taxes, the highest applicable federal tax rate remains at 40 percent. While the exemption amounts are indexed for inflation, current law provides for an automatic sunset of these increased exemption amounts after 2025. As a result, the exemption amounts available in 2026 and beyond could be reduced to a level provided under prior law ($5.49 million/single and $10.98 million/couple in 2017, indexed for inflation) absent further action by Congress. In addition, under different rates, rules and exemption amounts (if any), there may be state and local estate, inheritance or gift taxes that apply in your circumstances. Please consult your own tax or legal advisor for advice pertaining to your specific situation.

This tax-related discussion reflects an understanding of generally applicable rules and was prepared to assist in the promotion or marketing of the transactions or matters addressed. It is not intended (and cannot be used by any taxpayer) for the purpose of avoiding any IRS penalties that may be imposed upon the taxpayer. Unless otherwise noted in the material, tax specific information, such as rates, credits, exclusions, exemptions and deductions are specific to 2020. New York Life Insurance Company, its agents and employees may not provide legal, tax or accounting advice. Individuals should consult their own professional advisors before implementing any planning strategies. The Nautilus Group® is a service of New York Life Insurance Company. SMRU 1797792 Exp. 3.10.2022