BNY MELLON
WEALTH MANAGEMENT

It is often practical for families to form a limited partnership (LP) or limited liability company (LLC) to hold their family business, real estate or other assets for a legitimate business purpose. For wealthy families, especially those whose business or real estate portfolio is rapidly appreciating, it is often non-business purposes — such as tax planning, creditor protection planning and succession planning — that ultimately compel them to choose the family limited partnership as their preferred organizational structure.

WHAT IS A FAMILY LIMITED PARTNERSHIP?

A family limited partnership (FLP) is a holding company owned by two or more family members, created to retain a family's business interests, real estate, publicly traded and privately held securities, or other assets contributed by its members. The purpose of creating such an entity is generally to achieve creditor protection and reduce gift and estate taxes while maintaining control over the management and distribution of the partnership's assets.

This arrangement establishes two classes of owners. The first are general partners (GPs), who are responsible for the management of the FLP and its assets. They are typically the business-owning parents, or a limited liability company owned by these parents to shield them from the unlimited liability of the operational risks of the business.

The second are limited partners (LPs), who have an economic interest in the partnership, yet lack the ability to control, direct or otherwise influence the operation of the FLP. In fact, the LPs typically lack the ability to sell their interest in the FLP, unless it is to an immediate family member. These are typically the children and grandchildren of the business-owning parents, or trusts established for the benefit of these descendants. They have the right to their pro rata share of partnership income and, as the name suggests, are liable only to the extent of their investment in the partnership.

Effectively, the GPs are the operators of the partnership and the LPs are the passive owners.

PRESERVING CONTROL, SAVING TAXES

Generally, the senior generation will create and donate assets to a FLP in exchange for GP and LP interests, and then gift those LP interests to their children and grandchildren over time.

Due to the lack of control and lack of marketability that LPs possess, an opportunity arises to transfer these interests to future generations at a discount to their otherwise unencumbered fair market value. It is not unusual for these non-controlling, illiquid interests to receive a discount ranging from 15 to 30%.

To put that in perspective, as a result of the Tax Cuts and Jobs Act of 2018, an individual can pass along $11.18 million to their heirs and a married couple can pass along $22.36 million free and clear of federal estate taxes. Assets above those exemption limitations are subject to a 40% federal estate tax rate. Many states will impose an additional estate or inheritance tax as well.

For this reason, enterprising families often will choose to gift large portions of their estate to their heirs through the use of a FLP while they are still alive. By doing so, they can avoid state estate and inheritance taxes entirely and stretch out their available federal estate tax exemption by transferring property at a discount to its fair market value. If executed thoughtfully, one could reasonably pass 115% to 130% of the value of their exemption to their heirs, free and clear of estate taxes, by encumbering assets in the wrapper of a family limited partnership. In 2018, this amounts to an additional $3.3 to $6.7 million in assets that a married couple could shield from federal estate taxes, or $1.32 to $2.68 million in savings. Encumbering assets is often exactly what a first-generation wealth creator desires. It is not uncommon for a business owner to maintain control of the family business or real estate portfolio within a family limited partnership by retaining the general partnership interests. This enables the children to own an economic interest in the business while the parents retain full control over its operations and sale.

As an added bonus, once the transfer of LP interests is made to future generations, any growth in the value of the underlying property of the FLP occurs free of estate and inheritance taxes as well. So if a business, real estate or investment portfolio is particularly fast-growing, this can be a very effective way of avoiding future estate and gift taxes.

When the senior generation is no longer in a position to exercise control over the FLP, they can determine who will receive their GP interests in the future. This can be a specific family member — for instance, a daughter who serves as president of the operating business, a son who is an experienced investment professional, a grandchild who specializes in real estate transactions — or a trusted, third-party advisor.

This flexibility is important, as FLPs are often created well in advance of having recognized one's final successors.

CASE STUDY: TRANSFERRING AN OPERATING BUSINESS

Consider the following: Jim and Susan are a married couple in their late 60s, with two children and four grandchildren. They wish to transfer their family business equally to their children, Bob and Sara, upon their death, but for now, Jim does not plan to retire. To further complicate things, his daughter Sara is actively employed in the family business and a likely successor, while his son Bob works at a regional accounting firm and has not expressed interest in joining the family business.

The business's estimated value is $15 million, and continues to grow. Jim and Susan also have $10 million in investments and other assets for a combined net worth of $25 million. With a lifetime exemption of $22.36 million, a portion of their estate will clearly be taxable.

However, by transferring their business and investment interests into a FLP and gifting the LP interests to their children, Jim and Susan are able to receive a 30% discount to fair market value due to lack of control and marketability. Their $15 million business is valued at only $10.5 million, which reduces their total estate to $20.5 million, thus avoiding future estate and inheritance tax. And as the business and its valuation continue to grow, this growth continues to occur outside of Jim and Susan's estate. When the time comes, Jim and Susan can transfer their GP interests over to their daughter Sara and still enable both children to share in the economic ownership of the business by splitting their LP interests 50/50.

CHARGING ORDERS AND CREDITOR PROTECTION

It is not uncommon for matriarchs and patriarchs to express concern around a descendant's ability to manage their own financial affairs. When that descendant inherits a LP interest in a family business or other illiquid asset, such as real estate, they fear this debtor partner's actions may force a sale of the assets, negatively impacting their legacy, and the remaining responsible LP siblings and cousins.

Fortunately, charging order laws have been created that limit creditor rights to any economic benefit the debtor partner has in the family limited partnership but does not give the creditor any control or access to the underlying property within the partnership. Should the general partner choose not to make distributions from the FLP, all the creditor can do is wait to collect what is owed to them. This puts the debtor partner in a strong negotiating position with their creditor to settle for less than fair value.

REGULAR MEETINGS, INCOME TAXES AND DISTRIBUTIONS

FLPs are real business arrangements, and must demonstrate the attributes of a business partnership or face being classified as a gift made to the children by the IRS. Regular meetings must be held, formal minutes taken and reasonable compensation paid to the general partner for their services to the partnership in accordance with the Internal Revenue Code.

A partnership is a pass-through entity, which means that LPs will be responsible for paying taxes on their share of the income from the FLP. This often necessitates making annual distributions to LPs to cover those tax liabilities, and often an additional distribution to the extent this complies with the intent of the general partner. Income taxes and distribution policy are often key discussion items at the annual meeting.

A POWERFUL TOOL FOR BUSINESS OWNERS

Family limited partnerships are powerful estate planning tools for business owners to consider. Their structure enables the transfer of ownership from one generation to the next without giving up control of the underlying property, affords opportunity to reduce or avoid income and transfer taxes, ensures continuity of family ownership in a business and provides liability protection for the partners.

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