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FAMILY LIMITED PARTNERSHIPS – OVERVIEW (PART 1 OF 3)

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Family Limited Partnership (FLP) is a legal entity formed under the state's Limited Partnership law between general and limited partners.

The general partners have 100% control over and responsibility for the management of the partnership and its assets. They are also 100% liable for the acts or omissions to act of the partnership. They decide when assets are bought and sold and the timing and amount of the partnership's income and capital distribution.

The limited partners have no control over either the assets or income of the partnership, nor do they have any authority over the general partners. They are not liable for the acts of the general partners and are not liable for claims against the partnership interest.

An FLP effectively allows you to:

1. Make gifts of limited partnership units at significantly discounted values to children and grandchildren thereby removing the assets from their taxable estates while retaining control over those assets as the partnership's general partners.
2. Safeguard assets against the claims of creditors. Law significantly restricts judgment creditors' remedies against interests in an FLP. The only way that a judgment creditor can execute against an FLP is through a charging order that allows the creditor to receive the distributions in lieu of the partner receiving them. Since a general partner controls the FLP, the general partner can decide to eliminate income distributions to partners if a charging order has been issued. If a creditor obtains a charging order, the creditor becomes the assignee of the partnership interest subject to the charging order. As a result, the creditor pays the income tax upon the debtor partner's share of the income whether or not any actual distributions are made. Because of this serious tax consequence, the FLP is a powerful asset protection tool.
3. Shift income down to lower tax brackets yet keep control of assets. Segregate income and equity interests in the underlying asset, whether it be an operating business, income producing real estate, stocks and bonds, or life insurance policies, from the managerial control of these assets.

The FLP acts to reduce assets for federal estate tax due to the discounted nature of the assets when placed in the FLP. The discounts for lack of marketability and minority ownership average between 40 to 45%, making the FLP an important tool in the reduction of assets for estate tax purposes.

The partnership is a pass-through entity for income tax purposes. All income, deductions, gains, and losses are passed through to the partners, who pay taxes individually in proportion to their percentage interests. Thus, it is possible to reduce the general partners' personal income tax liability as well as the total tax paid.

The initial FLP is set up with each general partner owning about one percent general partner interest and 49% limited partner interest. The FLP is funded with income-producing property including investment real estate, stock and bonds, cash, and business interests. After the FLP is formed, the limited partnership

interests can be transferred to the children by using the annual exemption exclusion. For this reason, an appraisal must be made of the assets when interests are transferred.

Caveat 1: Interests given retain the initial tax basis. A comparison of the effect of the loss of the step-up in basis with the effect of getting the assets out of the taxable estate of the parents will almost show that the state tax savings with an FLP far outweigh the potential capital gain savings without an FLP.

Caveat 2: A recent Tax Court Case (Strangi versus IRS Commissioner) that was lost by a taxpayer spells out the dangers of setting up entities without proper planning. The issue: IRC Section 2036(a) requires the entire value of properties to be brought back to the estate. The Tax Court initially ruled in favor of the Taxpayer. IRS appealed to the 5th Circuit which remanded the case back for reconsideration. Tax Court reversed itself – in favor of the IRS. Here are some lessons as to why Strangi lost:

1. Strangi's attorney son-in-law formed an FLP one day after attending a seminar on this subject.
2. Strangi placed his personal residence inside the FLP.
3. He retained sole discretion when distributions would be made.
4. After transferring 98% of the residence, he was left with few assets to meet his daily living expenses.

He had to use FLP assets for his own benefits. He could not even pay rent for two years.

The greatest lesson here is not to place your residence inside an FLP. There has to be a business reason to create an FLP. It is rather hard to find a business reason to place your home in an FLP.

Caveat 3: The creditor of a general partner could seize the GP's share and take over control of partnership. **TIP:** Consider using an LLC to protect all members, not just limited partners.