

Family Limited Partnerships and Limited Liability Companies

Ray Quinney and Nebeker P.C.*

Estate planning includes a variety of distinct yet often closely related areas of law, including wills, trusts, taxes, insurance, property, retirement plans and business entities. The objective of estate planning is to secure to you during your lifetime the maximum benefits available from the possession and use of your property, and to provide for the orderly transfer of your property at your death to family members (or other desired beneficiaries) with a minimum of death taxes and probate and associated transfer costs.

Because individuals and families have different needs and objectives, every estate plan is different. In fact, there may be several different ways of accomplishing a particular estate planning objective. This article is one of a series of concise articles designed to inform you of basic issues, techniques and governing rules of estate planning to assist you in formulating an estate plan that is appropriate for you. This article discusses the use of family limited partnerships and limited liability companies.

Family limited partnerships and limited liability companies are attractive estate planning tools because, if they are carefully designed and operated, they permit the donor parent or parents to make gifts of partnership or membership interests to younger generation family members while permitting the parent or parents to retain substantial control of the gifted assets. Great care must be exercised in the design and operation of both limited partnerships and LLCs, however, because of recent aggressive enforcement positions taken by the IRS and upheld by the federal courts. Gifted interests in these entities may be includible in the donor parents' estates if they retain too much control, if they retain too large a share of the current benefits of ownership or if they retain personal use of real estate or tangible assets placed in these entities.

Suppose, for example, that you have assets that you would like to have retained in the family, perhaps a family farm or business, or real estate. While maintaining substantial control of the asset, you would also like the asset to be protected as much as possible from creditors and remove all or part of the value of the asset from your taxable estate.

In this situation, it may be advantageous for you to contribute the asset to a family limited partnership or limited liability company. Parents can contribute assets to a limited partnership in exchange for limited and general partnership interests or, in the case of a limited liability company, membership interests in the LLC. The parents can then gift away limited partnership interests or membership interests in case of an LLC, to their children or grandchildren, using the \$13,000 annual exclusion (\$26,000 if the gift is split by husband and wife). Although retaining all of the general partnership interest, or management responsibility in case of an LLC, to insure the retention of outright

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control, used to be conventional wisdom, it is probably no longer advisable in view of recent IRS court victories.

Since the value of a partnership or LLC interest may be less, for transfer tax purposes, than the fair market value of the underlying assets, and because the partnership or LLC agreement generally restricts the partners' or members' enjoyment of the assets, it may be possible to discount the value of the interest being gifted. A minority discount may also be available, reflecting the fact that a noncontrolling limited partner or LLC member cannot compel a distribution nor compel a liquidation to obtain his or her share of the underlying assets held by the entity. A lack of marketability discount may also be available to reflect the fact that there is no ready market for a closely held partnership or LLC interest. Availability of discounts can make a gifting program particularly attractive.

There are a number of additional benefits associated with a family limited partnership or LLC. Some assets, for example, such as real estate or a family business, may be difficult to divide, which is an obstacle when you want to split portions of the asset among several heirs. With a family limited partnership or limited liability company, you can easily divide the partnership or LLC interests among your heirs in any manner you see fit.

In addition, the ability to gift ownership interests in the assets, without outright control of the assets, permits you to transfer wealth to individuals, such as younger children and grandchildren, who may not yet be ready for the management responsibilities associated with those assets. You, usually together with other mature and responsible family members, as the general partners of a limited partnership, or managers of a limited liability company, can retain substantial control over the operation of the partnership or LLC.

A family limited partnership or limited liability company also provides a degree of protection from creditors. While a creditor may obtain a "charging order" against the interest owned by an individual partner or member, the creditor is only entitled to receive cash distributions the individual partner or member would otherwise have received. The creditor is not permitted access to the underlying partnership or limited liability company assets.* Your partnership or operating agreement may also prohibit the pledging of interests to cover debts, and may provide family members a priority right to purchase the interest of any member who wishes to sell his or her interest.

If you transfer partnership or limited liability company interests to others during your lifetime and if you design and operate the partnership or LLC carefully, the interests transferred will not be included in your taxable estate at death. The value of the assets, and any appreciation which may accumulate after the time of the transfer, is thereby excluded from estate tax. With respect to income tax, all income generated by the partnership or limited liability company is taxed directly to the partners or members, even if cash is not distributed to them. Losses and deductions are also passed through to the partners or members.

Because of successful recent IRS attacks on family limited partnerships and LLCs, you should expect that some or all of the tax benefits described above may be lost if you violate one or more of the following listed requirements:

* Warning, this limitation on rights of creditors does not apply to one member LLCs.

- i. Do not place prohibitions on transfer by the donees of gifted partnership or LLC interests;
- ii. Do not distribute all income/cash flow of the partnership or LLC to yourself, the donor, as general partner or manager;
- iii. Do not retain exclusive personal use and possession of the assets of the partnership or LLC;
- iv. Do not hold a power of attorney to exercise the ownership or governance rights of donee partners or members in the partnership or LLC;
- v. Do not retain exclusive control and management powers over the partnership or LLC;
- vi. Do retain sufficient assets for your own support and care outside the partnership or LLC; and,
- vii. Do make sure that some present value flows to donee partners or members of the partnership or LLC during your lifetime.

Finally, it should be noted that the IRS and certain members of Congress view the ability to discount the value of gifts and transfers at death of family limited partnership interests and LLC membership interest as tax loopholes. Legislation has been introduced in early 2009 to eliminate such discounts. Whether this attempt to curtail this popular tax planning tool will prove successful is speculative. However, it seems likely that the Democratic controlled Congress will continue to see attempts to shut down this planning opportunity and that the window may close on discounts in the near future. Such a change would probably be prospective only, so transfers completed before the effective date should still be subject to discounts.

To determine whether a family limited partnership or limited liability company is right for you, and for further advice regarding the types of assets that should be placed into a FLP or LLC, we encourage you to consult with an estate planning attorney in our firm.

Edited and updated by Narrvel E. Hall

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