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What is a Family Limited Partnership? Can it Help Reduce Estate Taxes?

Families often establish FLPs for three key reasons:

- To share in business ventures,
- To preserve generational wealth, and
- To take advantage of gift tax-free transfers of assets that allow those assets to grow outside the estate of the first generation.

Ownership within an FLP is divided into two categories:

- General Partners—Manage the daily business activities and bear personal liability for any debts the partnership may accumulate. General partners may pay themselves a management fee if that is written in the partnership agreement.
- Limited Partners—Do not participate in business management and have no influence over investments or other business decisions. Their financial responsibility for partnership debts is limited to the amount of their invested capital. Limited partners’ shares afford them the ability to share in the profits generated by the FLP.

How an FLP is set up depends on the nature of the business and the goal of the family. A family may choose the FLP structure by establishing a family business in which the family members all put in capital to purchase shares of the partnership. The capital can then be used to fund the business venture, with the general partners running the business and the limited partners receiving a share of the profits in exchange for the capital they contributed. All profits are shared with all partners in accordance with the percentage of shares they own.

If effective and efficient wealth transfer is a goal, an FLP can serve as an effective estate planning strategy. Depending on the specifics of your financial situation, it may:

- lower income and transfer tax burdens,
- enable you to pass ownership interests to family members while maintaining control over the

business,
- help preserve family ownership across generations, and
- offer liability protection for the limited partner or partners.

This type of FLP structure is typically created by one or more senior family members who contribute existing business and income-generating assets to the partnership in return for both general and limited partnership interests. Portions—or all—of the limited partnership interests are subsequently gifted to younger family members.

Ultimately, the general partner(s) do not have to hold a majority of the partnership interests. In many cases, they may own just 1 or 2 percent, while the majority of the interests belong to the limited partner(s).

Benefits of Structuring a Business as an FLP

Choosing an FLP structure offers several advantages for your business. Individuals can gift shares of the FLP to heirs during their lifetime every year, gift-tax free, up to the annual gift-tax exclusion limit. These shares are often valued below the full fair market value of the underlying assets, because reasonable discounts are allowed for lack of marketability and lack of control. As a result, gifting assets through limited partnership interests, instead of directly transferring the assets, can allow you to move more assets outside your estate, using little to none of your lifetime exemption.

At the time of your death, only the value of your interest in the partnership is counted in your gross estate. All growth on shares gifted during your lifetime occurs outside your estate and is not subject to state or federal estate taxes. Heirs receiving shares of the FLP that are part of your estate receive a step-up in basis at your passing.

Maintaining assets in the family line is also often a concern. FLP partnership agreements can be written in such a way that they restrict the transfer of partnership interests to family members only, or even to specific family members, thereby protecting assets from divorcing spouses, individuals who marry into a family, etc., and thus maintaining continuous family ownership of the business.

Using the partnership structure also enables you to shift some of the business income and future growth in value to other family members while retaining management control over the business. Younger individuals, including children or grandchildren, may pay income taxes at a lower rate than their older family members. Transferring shares of an FLP to those in a lower tax bracket will lower the overall taxes the whole family pays on interest, dividends, income, and capital gains.

As with all financial planning strategies, there are always disadvantages that should be considered. Creating and maintaining an FLP can be costly, requiring legal assistance to set up, plus yearly professional tax compliance and advice. Members can be subject to liabilities in the case of mismanagement. Rules governing FLPs are often complex and therefore require understanding and adherence to take advantage of the benefits.

Your CAPTRUST financial advisor can help you understand more and decide if an FLP is right for you.

Sources:

Understanding the ins and outs of a Family Limited Partnership – Littorno Law Group

Unlocking Tax Savings: Family Limited Partnerships in Estate Planning | American Heart Association

Resource by the CAPTRUST wealth planning team

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