

How Can A Family Limited Partnership Help You?

By Stephen H. Telford

One of the hottest topics in the area of asset protection and estate planning is the use of family limited partnerships. In my practice, I have noticed that there are certain questions which are frequently asked concerning this versatile planning tool. This article addresses some of those questions. I have used a "question-answer" format to discuss the pertinent information.

What is a limited partnership? A limited partnership is a business venture composed of two kinds of partners: (1) general partners, and (2) limited partners. There must be at least one of each kind to create a limited partnership under Idaho law. General partners act as the managers of the enterprise. As general partners, they are also personally liable for all debts of the partnership. On the other hand, limited partners are "silent" participants who merely invest in the venture. As limited partners, they are shielded from any personal liability for the activities of the partnership. The most they stand to lose if the venture fails is their investment. However, if they participate in the management of the business, they will forfeit their liability protection.

What makes a partnership a "family limited partnership"? A limited partnership which is formed by a family to conduct a business enterprise or joint venture is called a family limited partnership. One of the keys to successfully creating such an entity is to have an actual "business purpose". This business purpose can be anything from conducting farming or manufacturing operations to running retail establishments or wholesale outlets. It can even be used for managing investments for a group. A limited partnership's flexibility allows it to be easily adapted to fit almost any family business situation. However, in the absence of a "business purpose", there is a serious question whether a partnership has really been formed.

Can the general partners be protected from personal liability? Sometimes, another entity, such as a corporation or a limited liability company, may be formed to act as the general partner. This additional entity's involvement will provide protection for individuals who organize that entity from personal liability for the activities of both that entity and the partnership. Since a corporation is a separate taxable entity, its participation can greatly increase the complexity of the structure's taxation. Consequently, a limited liability company has become a popular management mechanism for a family enterprise. This type of a structure should be considered whenever a venture involves real estate or business activities which may create unexpected liabilities, such as industrial accidents or defective product claims.

What are the income tax consequence of forming a family limited partnership? A partnership does not pay income taxes. However, the enterprise will be required to prepare a profit and loss information return for the IRS. The actual profits or losses of the venture are reported by the respective partners on their individual income tax returns based on the participation ratios. These ratios are typically based on capital contributions, unless the another method of calculation is used in the partnership agreement. As long as the method of calculation is reasonable, the IRS will usually honor it. Also, limited partners may be able to avoid payment of "employee" type taxes, such as FICA and FUTA, since by definition they are "passive" participants. General partners will not be so lucky due to their status as managers.

Are there any estate and gift tax benefits to forming such a partnership? So long as each partner holds a "present interest" in the partnership, that partner will be considered the owner of the interest. Consequently, one partner can make a gift of a portion of partnership interest to another partner, and there will be no gift tax consequences where the value of the gifted portion does not exceed the \$10,000 annual gift tax exclusion. Obviously, a gift can be made in excess of that amount, but if it does, then the partner making the gift will need to either pay the gift tax due on the excess or use some of the unified credit available to that partner. Either way, a gift tax return should be prepared and filed to document the choice made. Otherwise, the IRS may be able to challenge the decision years after it was actually made.

What is a "valuation" discount? There are some discounts which may be available for purposes of valuing either the remaining partnership interest held by the partner making the gift or the amount of the actual gift made to another partner. The idea is that a business held by one owner is worth more to a potential purchaser than a business owned by several individuals, particularly where less than all of them are willing to sell their interest. This impact on the marketability of the enterprise can be significant, and its magnitude may be increased by a "minority" ownership position. A qualified appraisal is needed to accurately determine the full extent of this impact, which can be realistically anywhere from 5% of the value of the interest to as much as 50% of such value, depending on the situation. A discount of between 25% and 35% is more likely to be justified and less likely to be challenged by the IRS upon audit.

Are the assets held by a partnership afforded any protection from personal creditors? Once an enterprise is formed to conduct a business or hold certain assets for the group in partnership, it can change the status of personal creditors of the individual members of the group. Unless a claim against a particular item of property contributed to the partnership predates the contribution or was foreseeable when the contribution was made, the personal creditors of a partner may be limited to attaching the profits of that partner as they are distributed from the partnership. This remedy is called a "charging order". In that regard, a "charging order" does not allow the personal creditor to attach partnership property because such property collectively belongs to the group and not any one individual partner. Nevertheless, partners should be selected with care, and capitalization should preferably occur when no claims are pending or anticipated against any of the individual partners.

What does it cost to establish and maintain a family limited partnership? The cost of establishing a family limited partnership will depend on the simplicity or complexity of the structure. Attorney's fees for drafting the formation documents can range from \$1,500 to \$10,000. In addition, there will be filing fees of \$100 per entity and recording fees for real property transfer deeds of \$3.00 per page. There may be other transfer costs associated with funding the family limited partnership with assets. Accountants fees should also be considered. As a business enterprise, the partnership will be required to prepare an information return for state and federal taxing authorities. There may also be some licensing requirements, depending on the nature of the business to be conducted by the partnership. Once the structure is in place, the cost of maintaining the structure should consist of annual accounting fees for preparing the information return and periodic attorney fees for documenting any subsequent changes in partnership composition or ownership percentages.

Can minor children be included in the partnership? Legally, minor children cannot own property. However, they can participate in an enterprise through a trust established for their benefit. In order to make a partnership interest truly theirs, it is best to use an independent trustee to establish their trust. While a child is under the age of 14, there is a severe limit on the income which will be taxable to the child at the child's rates. Currently, the annual limit is \$1,400. Once the child reaches age 14, that annual limit is increased to \$4,000. Once the child turns age 18, the entire portion should be taxed at the child's rates so long as the child really has a "present interest". Where the trust requires the trustee to allow the child to take control of the interest at age 21, the partnership interest will be considered a "present" one. The trust can permit the child to have the option of leaving the interest in trust until the child reaches age 25, but the trust must require the interest to be conveyed to the child free of trust at that time. Otherwise, it *may* not be considered a "present interest".

Are there other reasons for forming a family limited partnership? A family limited partnership offers many other benefits. It can be used to allow certain family members to manage family businesses and related family investments for the benefit of the entire family. It can also allow family members to pool their resources to participate in investments they would not otherwise be able to make on their own. A family limited partnership can also be used to simplify the process of transferring businesses and assets from one generation to the next generation and to avoid clouding of legal title to valuable assets, such as real estate, through fractionalization of interests or threats of partition. In that regard, a well drafted partnership agreement can create an excellent mechanism for making a smooth transition of ownership when a family member dies. It can also minimize interference in a family business from a family member's spouse who has become disgruntled and disenchanted with that family member due to a failed marriage.

Should you consider implementing a family limited partnership in your situation? As you can see, there are many reasons for considering the formation of a family business as a limited partnership. Obviously, it is not a panacea for all problems which may plague a family enterprise, and the quality of the relationship between the potential partners must be carefully examined. When individuals go into business together, it is very similar to entering into a marriage. Everything is great in the beginning, and all too often, problems with the relationship do not surface until after the "honeymoon". However, like a successful marriage, a family business partnership can forge a powerful link between family members through a common purpose, a link which can remain strong for generations to come. You may want to consider consulting with a qualified professional and advisor on the subject.

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