FAMILY LIMITED PARTNERSHIPS

William C. Staley
ATTORNEY
www.staleylaw.com
(818) 936-3490

Foothill Chapter
SOCIETY OF CALIFORNIA ACCOUNTANTS
Arcadia

October 22, 2008

FAMILY LIMITED PARTNERSHIPS

TABLE OF CONTENTS

William C. Staley, Attorney
6303 Owensmouth Avenue, 10th Floor
Woodland Hills, CA 91367
www.staleylaw.com
(818) 936-3490

This outline should be viewed only as a summary of the law and not as a substitute for legal or tax consultation in a particular case. Your comments would be appreciated and are invited.

FAMILY LIMITED PARTNERSHIPS

William C. Staley
Attorney
www.staleylaw.com
(818) 936-3490

October 22, 2008

1. **Assumptions:**

   1.1. Mom and Dad own a securities portfolio and/or one or more parcels of real property or interests in existing partnerships that own securities and/or real property.

   1.2. The assets or projects throw off positive cash flow.

   1.3. Mom and Dad do not need all of the income from the properties to maintain their lifestyle and to provide for their medical expenses.

   1.4. The estate of the last-to-die of Mom and Dad will be subject to estate tax.

2. **Benefits of the Family Limited Partnership (or Limited Liability Company)**

   2.1. Permits Mom and Dad to make gifts of portions of the economic benefits of ownership without giving up control of the properties.

   2.2. Because valuation discounts will apply, a 10% LP interest might be valued at only 5% of the value of the partnership assets.

   2.3. The children never have their names on title, and so minimize their personal exposure to environmental obligations arising out of ownership of the property. (If this is a concern, Mom and Dad should use an LLC, not an LP.)

2.4. It is harder for a creditor of a partner to reach the partnership property than if the family members owned their interests in it as tenants in common.

2.5. The partnership is a pure pass-through entity and does not have the eligibility and operating restrictions of an S corporation.

⇨ When there is a basis step-up in a partnership interest, the partner can get an immediate tax benefit if the partnership make a Section 754 election.

2.6. The partnership can achieve several of the objectives usually met by an irrevocable trust:

2.6(a) The responsible relative (like a trustee) can run the partnership, while the economic benefits flow to all of the children (or to those who did not receive stock in the active family business), as they would to the beneficiaries of a trust.

2.6(b) The LP interests can be divided into a separate class for each child and the GP can choose which class receives distributions. Mom and Dad might require the distributions to be equal on a cumulative basis, taking liquidating distributions into account.

2.6(c) As an alternative to a trust, FLPs can be used to hold insurance on the lives of Mom and Dad and to keep the insurance proceeds out of their estates.

2.6(d) However, the FLP must distribute cash to the partners to pay their taxes on their pass-through income, while a trustee can pay the trust's taxes.

3. Value Engineering

The objective of value engineering is to reduce the value of assets for tax purposes with the least interference with the transferors' plans and flexibility, and without affecting the price that the owner could get for the property.

- The courts recognize that if an entity owns an asset worth $100, the value of a 20% interest in the entity is less than $20.

- If a 30% discount applies for lack of control over the entity and another 30% discount applies for the lack of marketability of the interest, it may actually be worth only $10.

- Similarly, an 80% interest may be worth $56 if a 30% discount for lack of marketability applies.

- However, 100% of the entity is probably worth $100, less the non-tax costs of distributing the asset from the entity.

- So if Dad owns 100% of the entity, he can immediately reduce its aggregate value to $66 ($10 + $56) by gifting a 20% interest to his daughter.

Example

Assume that the value of a 10% interest before discounts is $1 million. If a 25% discount for lack of control applies and there is a 30% discount for lack of marketability, then the discounts would be applied as follows:

Control

$1,000,000 x (100% - 25%) =
$1,000,000 x 75% = $750,000

Marketability

$750,000 x (100% - 30%) =
$750,000 x 70% = $525,000

Discounted Value = $525,000

To assure that these discounts will be respected if challenged by the Service, use an **appraiser** who knows how various assets are valued for tax purposes (and can defend the valuation in an estate tax audit).

Be sure the report makes logical sense and is based on recent, persuasive authorities. If you can poke holes in the logic of the appraisal report, it is unlikely that the discounts will be respected.

The FLP is an ideal vehicle for value engineering.

The limited liability company is the ideal vehicle for value engineering with liability-prone property that would otherwise require an FLP with a corporate general partner.

4. Tax Issues

4.1. Terminating Existing Partnerships

Selling or exchanging partnership interests totaling 50% or more in any year will trigger a termination of the partnership for tax purposes. The termination could have several negative tax consequences. However, this rule does not apply to transfers by gift, bequest or inheritance.

4.2. Property Taxes

4.2(a) If appreciated California real property will be transferred to a partnership, to avoid a reassessment the partners must own partnership interests that correspond exactly to their interests in the real property.

4.2(b) A reassessment will occur if a single person obtains a majority ownership interest in the FLP.

4.2(c) If the California real property is already in a partnership, the transfer of an existing partnership interest to the FLP might trigger a reassessment is the property was contributed to the existing partnership and the transfer to the FLP results in transfers of more than 50% of the partnership interests, on a cumulative basis, since the contribution.

4.2(d) The step transaction doctrine can apply for California property tax purposes.

4.2(e) For California real property with an actual value less than its assessed value, the transfer might be structured to trigger a complete reassessment to lock in the current low value as the assessed value.

4.3. **Sales Tax**

Transfers of equipment (or vehicles, aircraft or other tangible personal property not held for resale) to the FLP might trigger sales tax payable by the transferor if the FLP assumes liabilities, the equipment is transferred subject to liens, or the real or ultimate ownership of the FLP is not substantially the same after the transfer to the FLP.

4.4. **Chapter 14 Issues**

Attempts to freeze the value of a class of FLP interests, to further reduce the value of the partnership interests with lapsing rights or to distribute to the parents and not to the children must run the gauntlet of the Chapter 14 valuation rules.

4.5. **Valuation Penalties**

Overly aggressive valuations might trigger special estate and gift tax valuation penalties.

4.6. **Implementation Issues**

- Separate FLPs should be used to isolate liability-prone projects from less risky properties. The FLP for a liability-prone property should be a limited liability company.

- For FLPs holding securities and notes, the LP interests (or minority LLC interests) might be held by irrevocable trusts designed to implement the family's overall investment diversification strategies.

4.7. **Estate Planning Strategies**

- While Mom and Dad are both alive, they should give their children cash to fund life insurance trusts (and, possibly, generation-skipping or dynasty trusts) and interests in high-basis properties that are rapidly appreciating. Charitable remainder trusts should also be considered to avoid immediate taxable gain on the sale of the property. If one spouse is uncomfortable with financial issues, the other spouse should set in place the basic structure for a gifting program (FLPs, and possibly GRATs and charitable lead trusts).

- When the first spouse dies and there is a full basis step-up for all community property, begin a major gifting program to eliminate the surviving spouse's control of assets, and to use minority discounts and other value engineering techniques (including house GRITs, GRATs, and charitable lead trusts) to permit the maximum valuation discounts for the estate of the surviving spouse.

- Mom and Dad should consider using the full generation-skipping transfer tax ("GST") exemption of $1 million per donor. This can be done during their lives or at the death of the surviving spouse.

5. **Implementing the Strategy**

5.1. Form the LLC and get an EIN for it.

5.2. Open a bank account for the LLC.

5.3. If needed, open a brokerage account for the LLC.

5.4. Sign the operating agreement with more than one “partner.”

5.5. Transfer the assets to the LLC soon after it is formed.

5.5(a) Keep enough money to pay living expenses.

5.6. File an income tax return for the LLC.

5.7. Make gifts.

  5.7(a) Get a good appraisal.

  5.7(b) File a gift tax return to start the statute of limitations on the value.

5.8. File income tax returns consistent with the gifts.

5.9. Change the investment strategy of the LLC.

5.10. Implement the new investment strategy.

5.11. Make distributions per the operating agreement.

  5.11(a) Do not pay personal expenses with LLC funds.

5.12. Consider a GRAT for additional gifts of LLC interests.

[End of outline.]