

Abstract: Creating a family limited partnership (FLP) can be an excellent way for parents to pass assets to their children and other family members, while enjoying impressive tax benefits. The primary benefit, of course, is that an FLP can significantly reduce estate, gift and income tax liability. But to maximize both FLP contributions and the tax benefits derived from them, understanding the rules is a must. This article details the financial benefits of valuation discounts of FLP units.

Discounting Family Limited Partnership Units

Creating a family limited partnership (FLP) can be an excellent way to pass assets to your children and other family members, while you reap lucrative tax benefits. The primary benefit, of course, is that an FLP can significantly reduce your estate, gift and income tax liability. But to maximize both your FLP contributions and the tax benefits you derive from them, you must understand the rules.

Valuation Discounts

An FLP's tax-saving power primarily results from valuation discounts. You may discount the value of assets that you contribute to the partnership, typically by 30% or more, for gift-tax purposes. This discount allows larger tax-exempt gifts to your children each year. For example, if you have four children and you give each \$14,250 in limited-partnership units, the discounted value (using the 30% rate) is \$10,000 each. This removes \$57,000 from your estate, and you will not owe any gift tax because the gifts (after the discount) qualify for the annual gift tax exclusion. In addition, future appreciation in the value of the limited partnership units will be excluded from your estate for estate tax purposes, as with any lifetime gift's appreciation.

Other financial benefits include:

- Making substantial gifts to your children through an FLP while maintaining control of income generated from assets given away, assuming you are the general partner and your children are limited partners,
- Reducing probate costs for real estate located in other states, and
- Introducing your children to asset management and achieving economies of scale not otherwise possible by pooling family assets.

Why a Discount?

Here is the Treasury Department's rationale for allowing a discount on the value of limited partnership units you give to your children: No ready market exists for the units because they represent only a small fraction of the whole partnership, and because limited partners have little (if any) control over the partnership's underlying assets.

For example, suppose you own real estate appraised at \$10 million. You can reasonably expect a buyer to pay you close to \$10 million for it. But who would pay \$100,000 for a 1% interest in the property, especially if the buyer has no say over operating the property or how resulting income is distributed?

Furthermore, the owner of a limited partnership unit must wait until the partnership ends to receive a unit of the underlying assets and cannot pledge units as loan collateral. You can't expect to find a buyer who will pay the full 1% price for a 1% share.

Magnitude of Discounts

This example illustrates why the IRS allows you to discount the value of FLP units. But the actual discount rate will vary, usually from 20% to 40%. When you transfer an asset into an FLP, hire an appraiser -- specializing in FLPs -- to establish both the asset's market value and the discounted value of the transferred limited partnership units.

The appraiser will base the discount rate on the degree to which limited partners can:

- Own a majority or minority interest in the partnership,
- Participate in managing the partnership,
- Force a sale or liquidation of partner-ship assets,
- Withdraw their pro rata share of asset value,
- Control the distribution of income generated by the partnership, and
- Sell their units on the open market.

In general, the discount will be greater for limited partners with less control; who own smaller minority interests and participate less in management; and whose units will be difficult to sell on the open market. Limited partnership agreements typically spell out the degree to which limited partners control or participate in the partnership. Plus, some states further restrict the rights of limited partners to participate or dispose of their units.

Take a Closer Look

The government continues its quest to reduce FLP discounts. But your FLP should withstand IRS scrutiny if you properly structure it and have an expert appraise it. Although forming an FLP can be complex, if you know the rules you can maximize your FLP contributions and their tax benefits. If you would like to take a closer look at FLPs, please give us a call.