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FAMILY LIMITED PARTNERSHIPS

The Family Limited Partnership is one of the wealth transfer strategies available to reduce overall estate taxes and help keep wealth in the family.

A Family Limited Partnership operates very much like other limited partnerships. The biggest difference between a Family Limited Partnership and the more common investment limited partnerships, is that only family members will own Partnership Units in the Family Limited Partnership.

The Family Limited Partnership is designed to transfer assets to your heirs while allowing you to retain control and protect the value of the asset being transferred.

In the initial stages you, and your spouse if you so desire, will own all of the units, both general and limited. You may fund your partnership by transferring any asset(s) of your choosing into the partnership. The funding of a partnership is not a taxable event. You will simply receive "basis" in your Partnership Units equal to the value of the asset(s) which you transferred to the partnership. When you dispose of the units, either by sale or more likely by gift, only then will a taxable event occur.

Gifts of Partnership Units may be offset by your $16,000 annual exclusion and $12,060,000 (in 2022) unified credit exemption. The plan would be for you to divest yourself of the Limited Partnership Units by using your annual exclusion and unified credit exemption, or by selling gifts to your children and/or grandchildren (or to a trust for their benefit).

The Family Limited Partnership is usually designed to have one percent (1%) General Partnership Units, with the remainder being Limited Partnership Units. The difference between General Units and Limited Units is of tantamount importance.

General Units have inherent within them control of the Partnership. The owner of the General Partnership Units controls the partnership. Control includes the right to buy, sell and otherwise dispose of the property held within the partnership. Control of the partnership also provides the ability to dictate partnership distributions. Thus, only the General Partner(s) can declare distributions. Moreover, the General Partner(s) alone determines matters regarding partnership dissolution. Finally, the General Partner(s) is entitled to a reasonable fee for managing the partnership.

Limited Partners on the other hand, have almost no say regarding the administration and control of the partnership property. Limited Partners simply receive distributions when declared by the General Partner(s) and will eventually receive a proportionate share of partnership assets upon dissolution. Limited Partnerships may also be attractive because the Limited Partner has limited liability. However, liability for matters occurring within the partnership is not normally of great concern in family situations. After all, the property held within the partnership is intended to provide income and growth for the family. It must be assumed that the General Partner(s) will not take risks likely to cause liability.

One of the most important aspects regarding Limited Units is that upon eventual dissolution of the partnership, a proportionate amount of partnership property passes through to each Limited Unit. Thus, ninety-nine percent (99%) of the appreciation of the partnership property will pass to the Limited Partnership Unit holders. Therefore, if you were to completely divest yourself of the Limited Partnership Units, while retaining only the General Partnership Units, you would remain in complete control of the underlying property, while divesting yourself of ninety-nine percent (99%) of the partnership assets and the appreciation thereon. Effectively you will own only one percent (1%) of the Partnership Units, but will still retain complete control and a sizable portion (if not all) of the income, based upon a reasonable standard.

One last feature about Limited Partnership Units is that because they have no management control, as opposed to the complete control held by the General Partnership Units described above, Limited Partnership Units tend to be very undesirable assets to creditors. If judgment should be declared against an individual who happens to own Limited Partnership Units, the creditor, in all likelihood, will not want to seize the Limited Units. As noted previously, these units have no right to income until declared by the General Partner(s). There is also no right to demand dissolution. Additionally, because these units are not publicly traded, there will be almost no market for them.

Therefore, if the partnership has earned income, but the General Partner(s) does not declare a distribution, each unit holder, both general and limited, will be required to report a proportionate share of the earned income on his or her personal tax return, without actually receiving any dollars with which to pay the tax. This is known as phantom income. Imagine how upset a creditor would be to learn that he has seized your Limited Partnership Units only to be deprived of control, income, and dissolution rights and then to learn that he must pay tax on a significant amount of phantom income.

While using a partnership to reduce inheritance taxes may be sound planning, there are often pitfalls, both large and small, of which you must be aware. In California, transfer of real estate to a partnership may constitute a "change of ownership" for property tax purposes. Additionally, because a new entity is created (a partnership) it will be necessary for the partnership to file its own tax return and pay franchise minimum taxes ($800/year in California). This tax return will obviously be an additional annual expense. Perhaps the most important potential pitfall to making use of a partnership is that it will be necessary for the Partnership Units to be valued each time they are transferred. Thus, if you plan to make annual gifts of Partnership Units to your children in order to reduce the number of units you own, it will be necessary for an independent appraisal to be conducted just prior to making such gifts.