FAMILY LIMITED PARTNERSHIP

(Asset protection and discount gifting)

HIGHLIGHTS OF THE PLAN

IN GENERAL

A family limited partnership is a flexible business and investment entity that permits income shifting and discount gifting among family members, as well as protection from the claims of creditors for assets that are placed in the partnership.

HOW THE PARTNERSHIP IS STRUCTURED

A family limited partnership must have one or more general partners, usually the parents, and one or more limited partners, usually the parents and/or the children or grandchildren. These partnerships are capital-based rather than service-based. That means that income produced by the partnership comes primarily from capital investments rather than personal services of the general partners.

General partners manage and control the partnership and, in certain circumstances, can have personal liability for debts and obligations of the partnership in excess of their investment. Limited partners, on the other hand, cannot be involved in the day to day operations of the partnership, neither can they have personal liability beyond their investment in the partnership.

ASSET PROTECTION

The family limited partnership affords some degree of protection from creditors. Suppose, for example, that a limited or general partner is sued by a creditor on a matter unrelated to the partnership. Further suppose that there are assets in the partnership worth $1,000,000, and the creditor obtains a $200,000 judgment against Partner A, who is a 1 percent general partner and a 60 percent limited partner, with other partnership interests being held by other family members.

In most states, the most the creditor can do is obtain a charging order against Partner A's interests in the partnership. This means that the creditor can assume Partner A's right to receive distributions from the partnership. However, if, according the terms of the partnership agreement, no distributions are made, the creditor must recognize the income that Partner A would have otherwise had to have recognized but not receive any distributions from the partnership. Obviously, this is a very unfavorable position for the creditor to be in, having to recognize income without actually receiving any distributions from the partnership. Even if under state law a creditor could eventually reach the underlying assets of the partnership, the extra steps required to do so might make the creditor think twice before making the attempt.

DISCOUNT GIFTING

The basic precept that underlies discount gifting of partnership interests is that the whole is more than the sum of its parts. Suppose that a family limited partnership is established with $1,000,000 of capital contributions. Suppose also that Father and Mother each own a 1 percent general partnership interest and a 48 percent limited partnership interest, with Son and Daughter each owning a 1 percent limited partnership interest. A gift of partnership interests worth $10,000 from Mother and Father each to Son and Daughter would be achieved by giving Son and Daughter each a gift of about 1.67 percent, instead of 1 percent. This result occurs because the interest received each by Son and Daughter is subject to a discount of approximately 30 percent. The interest received by Son and Daughter is worth less because their interest is a minority interest, and, due to certain restrictions placed on the transfer of the interest in the partnership agreement, the stock is not generally marketable. A family limited partnership is an excellent way to transfer property from one generation to the next at a substantial discount.

ADVANTAGES OF A FAMILY LIMITED PARTNERSHIP

It is taxed as a partnership, with all income and deductions passing directly through to the partners.

There is no double taxation as there would be with a corporation.

The possibility of income splitting among family members exists.

There is no recognition of gain on the part of the partnership for distributions of appreciated property.

There is transfer tax leverage due to discount gifting.

Since title to property transferred to the partnership vests in the partnership, creditors cannot reach the underlying assets. In the absence of fraud, the burden of proving which is on the creditor, transfers made for legitimate purposes will be beyond the reach of creditors.

The creditor can only obtain a charging order that permits taxable income to flow through without any actual distributions. The creditor cannot become a substitute limited partner.

If life insurance on the life of a partner is owned by the partnership, only that portion of the proceeds equal to the insured's pro rata interest in the partnership will be includible in the insured's estate for estate tax purposes.