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FAMILY LIMITED PARTNERSHIPS

INTRODUCTION

The premier way for successful clients and families to remain in control of assets, make leveraged gifts to family members, lower their overall income and estate taxes, and protect assets from aggressive creditors is the Family Limited Partnership. It is a piece of a comprehensive Family Wealth System™ Estate Plan. Here's how it works and some ideas on what it can do for you and your family.

Many of our clients desire retirement income planning, asset management assistance, and a chance to avoid estate tax and / or to effectively lower family income taxes. Some clients want to involve family members in management or beneficial enjoyment of family assets or business interests over time, without surrendering total control. They see the family as a single economic unit, and may want to train the next generation in sound financial planning and decision-making. Still others want to build an asset protection and distribution system in order to bulletproof their lifestyle. One way to accomplish all of these objectives is with a Family Limited Partnership, or FLP, as a central component of your estate plan.

A family limited partnership can serve as a personalized "gifting tool." Our estate planning clients may transfer real estate, securities or any investment grade asset into a specially drafted limited partnership in order to share benefits. Parents, children, and even grandchildren can participate as either general or limited partners. Even better, trusts can also be partners, in order to control income distribution, to provide asset protection, or to create a dynasty plan for future generations.

Most of our clients are the "parents" in the family creating an estate plan, using their own assets as the basis. They prefer to serve as the sole General Partners of the FLP, with the same powers of management and control over their assets they have always had. They and their children will become Limited Partners. An irrevocable trust may also be set up for the benefit of minor grandchildren, if our clients want to include them as limited partners. Trusts provide control over proceeds, and also a layer of asset protection for creditor suits levied against a beneficiary.

FAMILY BENEFITS CREATED UNDER THE TAX LAW

There are powerful tax and personal advantages that encourage setting up an integrated estate and asset protection plan. Here is a brief summary of benefits your plan may be designed to provide.

Shift the Family Income Tax Burden to Lower Bracket Family Members

Children and grandchildren can participate in the growth of all partnership assets at income tax rates that are probably lower than your own. Instead of paying income tax, then giving away the "leftovers", it can make sense to make family members your partners so they directly receive the desired

stream of income. Let the government help you out! You get a net reduction of the cost to provide for education and certain other needs of the family.

Entitle Family Member Employees to Reasonable Salaries

Family members who manage, or who provide services for the partnership are entitled to be paid for their help. This gives you control over the benefits conveyed, the size of partnership distributions, and the manner in which benefits are actually received by each individual participating in the family enterprise.

Fringe Benefit Planning

Limited Partnerships established to operate an active business can be used to provide fringe benefits. The General Partner, usually a corporation, employs family members to perform services for the corporation and the limited partnership. Fringe benefits, deductible to the corporation, such as health care and retirement plans, may then be available to the business for its employees.

Perform Valuation Adjustment Magic With Your Limited Partnership

One of the most important benefits of the limited partnership can be your receipt of valuation adjustments. When appropriate valuation adjusting results in reduction of the taxable size of your estate at death, it is sometimes called "discounting."

The IRS values all assets owned by a decedent at the time of death using a "fair market value" formula. Fair market value is defined as the amount that a willing buyer will pay a willing seller under non-coercive business circumstances. The valuation process can prove very favorable to the taxpayer when a limited partnership is involved. Because almost all of the decedent's partnership interest has been designated as limited partnership shares, the question at death becomes: "What is the fair market value of a Limited Partner's interest?"

The Agreement itself limits the economic value of a share of the limited partnership. Since a Limited Partner has no right to demand a distribution, order a dissolution of the partnership, or in any way participate in the management of the business, the Limited Partners' interests are not as valuable since they lack the rights of a full owner. Nobody would buy your L.P. interest from you and pay full value for such a restricted property interest that lacks control. Largely due to this lack of control feature, the value of your limited partnership interest is adjusted to a more reasonable fair market value, a "discount" value, to reflect this marketplace reality. Similarly, the General Partner interest retaining the element of control would be adjusted to reflect a higher, or "premium," value.

Numerous cases abound illustrating this point. In one famous example, the family saved \$14,000,000 in estate taxes by qualifying for a \$26,000,000 reduction in value! While your savings may not be as great, every dollar saved benefits your family rather than the IRS.

Simplify Gifting to Family Members

One of the primary benefits of a family partnership is its ability to enhance and maximize your annual "tax free" gifts to family members. Congress taxes estates greater than \$650,000 at rates from 37% to 55%. The new tax bill will raise the personal exemption to \$1,000,000 over the next several years, in addition to providing additional planning opportunities. For now, though, a typical married couple's estate of \$1,000,000 would owe federal estate taxes of approximately \$150,000, absent A-B trust or other planning to utilize each spouse's individual federal estate tax exemption (\$650,000 in 1999, increasing to \$1,000,000 by 2006.)

Current law allows each person to transfer \$10,000 tax free per recipient each year, or \$20,000 collectively from a married couple. Gifting to younger family members by their elders reduces the taxable estate, but may also reduce personal income, cause a loss of control, or may simply take too long to achieve results. Some people don't want to give up control of the asset while they are alive. They may feel that they don't have sufficient disposable cash on hand to give away. They also may not know how to make effective gifts of partial interests in other property, with the net result that they do nothing.

The Limited Partnership allows you to make annual gifts of limited partnership interests directly to your children or grandchildren, or even to a protective trust set up for their benefit. You can make the gift any size you want, but must inform the IRS for gifts exceeding the limit stated above. Since you convey only a limited partnership interest and not the asset itself, you stay in control! As the years go by, children and grandchildren can begin to accumulate an equity interest within the partnership, to be used for education, lifestyle enhancement, investment, retirement planning or other needs. As General Partner, you can reinvest their income so it will grow until they need it or you are ready to distribute it. Typically you should distribute annually enough income from the partnership so that each partner can pay his or her income tax attributable to partnership income.

Remember, you serve as General Partner individually, or own and control the General Partner if it is an entity created to serve in that capacity. Since the General Partner may be you, a child, business associate, or an entity such as a limited liability company, corporation or a trust, you can involve your family in management under a design of your own making!

Provide an Easy Mechanism for Intrafamily Loans

The General Partner may make loans permitted by the partnership agreement. You maintain control and access to your funds for the benefit of your family. Family members may need distributions for specific purposes, such as education. When their capital accounts are insufficient, you can make loans to be paid back at a later date. For example, structure loan repayment in future years from subsequent partnership distributions.

Allow both Spouses to Manage Family Finances

Where both spouses are General Partners, each will be responsible for the business of managing the investments in the partnership. In the event either of them should become disabled or die early, the other will be fully equipped to carry on the operation of the partnership. You can also use a management trust designed to cover such a contingency by selecting Trustees to serve as General Partner. The trust provides personal instructions to your successor Trustee-General Partner.

Maintain Your Privacy

The details of investment activities and the nature of the partnership assets themselves are not of public record. Only a Certificate of Limited Partnership is filed with the state, which contains basic information required by the state. Limited Partner status, coupled with disclosure of key provisions limited rights of limited partners may incidentally frighten off creditors of a partner or make them more susceptible to settlement.

Organize Your Estate For Efficient Settlement

A partnership created as a key element of the estate plan provides you an opportunity to remain organized. The partnership must file a yearly tax return with an accompanying balance sheet. Knowing what there is, where it is, and what it's worth can save countless hours of personal and professional time should a partner pass away.

Create a Family Enterprise

Use your partnership to train the younger generation and build entrepreneurial spirit. The more you get them involved, the better off they will be. While they may not initially participate in management, you can certainly "pass on" your philosophy and ideals along with the shares you gift or income you distribute. All partners, particularly children, who have an equity stake in family wealth through their partnership interest, take a greater interest in what goes on. This can be a valuable tool in preserving family ideals and welding it into an economic unit. Our clients generally conduct their partnership business meeting during the holidays, where they review the business year, their investment plan, and then distribute income or make gifts of partnership shares among their partners.

Practice Effective Investing

Pooling of assets can reduce management costs and achieve better rates of return. It is easier to manage your assets if they are collected rather than scattered. You can negotiate preferential treatment with your broker or financial advisor when you have more to offer. You can also diversify without fear that you will lose control.

Prevent Disastrous Use of Joint Tenancy Title

Use of the partnership can prevent the inadvertent use of joint tenancy with right of survivorship (JTWROS) on bank accounts and brokerage accounts. Joint tenancy is usually not the best way in which to hold title to assets for a variety of tax and estate planning reasons. It can completely frustrate the distribution of an estate. Holding title in the name of the partnership can effectively thwart the unintended use of joint tenancy.

Engineer Your Customized Partnership Agreement to Accomplish Your Specific Goals

Limited partnerships have a long legal history and are recognized in every state. U.S. limited partnership law, while it has evolved, has in many respects remained essentially unchanged for decades. You can safely use partnership law to plan for your family. To gain the desired benefits, though, it is important to work with professional advisors who understand the pitfalls inherent in the tax law and created by IRS challenges to the concepts presented here.

Your personal goals dictate our design. While limited partnerships are common in the marketplace of American business and participate in almost all types of business ventures, a family limited partnership contains specific provisions for you. It is also critically important that you treat your partnership as a separate legal entity, even though you may receive the majority of the benefits it provides, particularly in the early years of operation.

We may set up more than one class of limited partner. Another benefit of partnership law is that we may provide different rights to receive income in each "class" of limited partner. For example, a limited partnership "A" share may have rights to income and principal, while a limited partnership "B" share may only have rights to principal. If a General Partner owns all or most of the limited "A" shares, receives distributions, and receives a salary as general partner, he or she will receive most of the income. This part of the law is very technical, and results depend on the specific case and application of the law.

ASSET PROTECTION

Domestic (U.S. based) limited partnerships are the centerpiece of asset protection planning for U.S. citizens, since limited partnerships can help protect assets from creditors in a lawsuit! With an FLP, when a judgment is entered against a partner the creditor has no right to seize the assets inside the partnership. Creditors have no right to manage the partnership or to demand that distributions be made from it. Partnership law generally provides a creditor with only one way to collect his judgment: a "charging order."

A charging order allows the creditor to seize a distribution when it is made from the partnership, but partnership assets themselves are inviolate. Furthermore, since the creditor does not become a partner, there is no way for the creditor to force the general partner to do anything. He would be forced to wait until a distribution was actually made to the debtor-partner. The status of a creditor as a mere assignee means that the General Partner does not need to treat the creditor as a partner.

The partnership may permit or require the General Partner to discontinue making any partnership distributions to a partner under certain conditions, or allow a General Partner to retain income for the reasonable needs of the partnership. This would increase that partner's capital account, but other partners may still get distributions. Moreover, under certain IRS rulings, even though a creditor doesn't receive payments from the withheld partnership share, he may be required to pay all the income tax associated with that share!. This leaves the creditor in the unenviable position of paying taxes on money he will never receive. You now have a negotiation opportunity for settling the issue with the creditor.

One caveat applies when a judgment is entered against the partnership itself. A partnership creditor may satisfy his judgment with partnership assets, including insurance. Beyond partnership assets, the General Partner is personally liable.

Protecting General Partners

Usually, our clients serve as the General Partners. When a potential lawsuit against the partnership is itself a concern, a greater degree of asset protection is required. A General Partner remains liable for the unsatisfied liabilities of the partnership, although not of individual partners. In order to cut off this kind of liability, we can structure a corporation, irrevocable trust, or a limited liability company to serve as the General Partner. This technique reduces the personal risk to our client for partnership debts or liabilities.

Trustmaker Asset Protection Trusts with Your FLP

An FLP may be used in concert with various types of irrevocable trusts to magnify the benefits discussed above. Several approaches are discussed here to give you some idea of what can be done for you and your loved ones.

High risk clients involved in business activities such as medicine, law, real estate development, accounting, or manufacturing, where the likelihood of involvement in suit for money damages is high may be in danger of losing all that they own in a single lawsuit. In many cases, the prospect of such suits causes the client to work and live in fear of losing the fruits of their life's work in an instant. This need not be the case.

Two jurisdictions, the Cook Islands and the State of Alaska, provide incredible asset protection opportunities through special statutory asset protection trusts to our clients who face the prospect of becoming the targets of civil lawsuits. Delaware has enacted some recent legislation as well, but does not appear to offer the same benefits at present. Offshore and Alaska Trusts are two possible ways for a client to protect and continue to receive the benefits of their property and investments even if otherwise subject to creditor claims and judgments. The key is to do such planning early, before the client has any reason to suspect that a lawsuit is pending or foreseeable.

This type of planning uses an irrevocable trust, created in an asset protection jurisdiction such as

the Cook Islands or Alaska, designed for the client's benefit and which holds limited partnership shares. Both the Cook Islands (which is not subject to U.S. law) and Alaska, under certain conditions, limit or effectively eliminate a creditor's right to reach trust assets. For further information on this approach, please request our handout discussing these trusts in detail.

Asset Protection Gift Trusts with Your FLP

Irrevocable Children's Trusts for the benefit of minor children or grandchildren may be created to hold partnership shares. These irrevocable trusts can be named as limited partners of the limited partnership, allowing you to shift income and assets to lower tax rate beneficiaries. Each trust has an independent Trustee who is in charge of management of the assets until a child reaches an age when the trust directs distribution of assets. Since the trust controls all limited partnership shares gifted to it, there would be no problem of trust assets being dissipated before the trust distributes them.

Where the trust was established to make use of the donor's generation-skipping exemption, called a "Dynasty Trust", the value of the partnership interest transferred to children or grandchildren may be entirely or partially free of taxation in their own estate until the trust terminates. It will also avoid probate and be safe from creditor claims. Trust distributions made to children or grandchildren will be taxed at their (potentially lower) income tax rate. This shifting of income can provide substantial income tax relief for the family as a whole. (Care must be taken to avoid the imposition of trust income tax brackets on income should it be retained in the trust rather than distributed.)

SUMMARY

The Family Limited Partnership is your opportunity to gain better control over your assets and to more efficiently share the benefits of your hard work. Most clients can dramatically lower income and estate taxes, and even lessen lawsuit exposure or eliminate such concerns entirely. You can be creative with partnership design and benefits, and help your family to work together as a single economic unit.

Our planning team is dedicated to assisting you in using these tools properly! It takes considerable time, effort, and technical expertise, just as it took you time and effort to build your optimum family estate plan. We look forward to discussing your goals and planning opportunities with you in the near future.

Thank you for your interest,

Dallas W. Jolley