Benefits of a Family Limited Partnership

<u>Purpose of a Family Limited Partnership ("FLP")</u>.

A FLP is an investment entity that generally offers greater tax and non-tax benefits compared to owning assets in a corporate entity, living trust or non-revocable trust.

FLP's have become the preferred vehicle for owning a family's "investments" rather than Sub s corporations.

California law allows tremendous flexibility to owners of partnerships, especially FLPs.

The general partner sets ALL the rules and controls the FLP, even with as little as a 1% general partnership interest, including ALL cash distributions.

<u>Benefits of Forming a FLP.</u>

FLPs have many benefits, both tax and non-tax, that make its use so unique and especially for real estate and highly appreciated assets. Some are:

<u>Centralized management</u>. Increased creditor protection, as a limited partner, limits your personal liability. This serves as an incentive for creditors of the partners to settle their disputes because such creditors are usually only entitled to a charging order and, as such, will not likely be able to require that the partnership distribute income or assets to satisfy their debts.

<u>Flexibility</u>. Provides greater flexibility than irrevocable trusts because limited partnership agreements can be amended very easily. Irrevocable trusts may not be amended or may require court approval to do so. By having assets owned by the FLP, the terms of asset management and distributions can be changed each year and over time as desired by the partners.

<u>Acceptance</u>. Financial institutions now accept ownership of assets by FLPs much more readily than in the past.

<u>Donees are NOT responsible for management of the assets in the FLP</u>. The use of a FLP allows gifts of partnership interests to be made without conveying management burdens to such donees.

<u>Ease in Transferring Interests</u>. Generally the gifting of a partnership

interest requires less paperwork and is less costly than the gifting of interests in the individual assets contributed to the partnership. A transfer of a partnership interest requires only an assignment and a small amendment to the partnership a;greement to reflect the new ownership interests. I recommend that certificates of ownership should be issued time there is a gift of a partnership interest and individual ownership percentages change. None of these documents require a notary and no filing fees are incurred.

<u>Discounted Values for Estate and Gift Tax Purposes</u>. California partnership law places certain restrictions on the transfer of voting rights to persons or entities that are not partners. Theses restrictions result in the owner of a FLP interest having less control over the assets in the FLP and less control over the management of the FLP. These restrictions also require that a limited FLP partner cannot sell his or her interest in the FLP to anyone other than another FLP partner in the same FLP. For these reasons, the value of a FLP limited partnership interest is usually significantly lower that the pro-rata value of the underlying assets owned by the FLP. In my experience, the IRS has accepted discounts from between 15% to almost 50%. Although the IRS does not like these discounts, the IRS has consistently lost all cases it has brought to court. Moreover, the IRS has been consistently allowing discounts in the 25% to 30% range in audits, barring unusual circumstances.

<u>Opportunity for Continued Growth</u>. Generally, family assets will grow in value if under a protective umbrella such a FLP (or even an LLC).

<u>Avoidance of California Property Tax Reassessment</u>. California Proposition 13 (passed in 1978) essentially disallows annual increases of more than 2% in the assessed value of California real property for property tax purposes, unless there is change of ownership of such property. The effect of prop 13 is that property owners can continue to pay property taxes based on relatively low assessed values. A change of ownership of property does cause reassessment, but California law does provide that certain transfers of property are exempt from such reassessments.

By structuring a FLP properly, a reassessment of real property, for California property tax purposes, can and should be avoided upon formation.

Reassessment does occur when more than 50% of the partnership's interests are transferred.

For example. Joe and Mary, husband and wife, own a community property fee simple interest in a piece of land and building. They contribute such property to a FLP in exchange for a 100% community property interest in such FLP. The transaction does not trigger a reassessment of the property, it is merely a change in the form of ownership because Joe and Mary's percentage ownership in the property prior to and after the transaction are identical. If Joe and Mary then transfer more than 50% of their interest in the partnership to anyone, then the entire property will be reassessed to its current value for California property tax purposes.

To avoid this reassessment disaster when Joe and Mary want to pass their assets to their children, you structure the overall transaction so that Joe and Mary first transfer more than 50% of their interest (e. g. 80%) in the property to their 4 children. Most transfers of property between parents and children are exempt from reassessment. Then, Joe and Mary and their 4 children contribute their respective shares in the property to the FLP in exchange for proportional interests in the FLP. In this case, Joe and Mary will take a 20% interest and their 4 children will each take a 20% interest, to total 100%. Further, Joe and Mary can transfer up to their entire 20% interest to their 4 children without triggering a reassessment of the property owned by the FLP because no more than 50% of the FLP will change hands in this scenario.

<u>Resolution of Family Disputes</u>. Limited partnership agreements allow disputes over assets to be settled through arbitration in a private manner. Also, because the loser of the case is required to pay the winner's legal and other fees, actual litigation is becomes more expensive. FLPs provide an incentive to amicably resolve these legal disputes among family members, thereby encouraging harmony rather than division.

<u>Gift trusts</u>. Joe and Mary can also transfer interests to their grandchildren through gift trusts. This provides for another layer of creditor protection and tax minimization at their deaths and the deaths of the 4 children.

Some of the detriments of a FLP.

1. **The FLP will have to pay a minimum franchise tax.**
2. **The FLP is a separate entity and therefore will have to maintain separate records and prepare and file an annual income tax return.**
3. **If not structured properly, the formation of a FLP and the transfers into the FLP, can cause the reassessment of property values.**
4. **The cost of forming a FLP, and the annual tax return.**
5. **Only the limited partners are shielded from creditor charging orders, not the general partners and there must be at least one general partner.**