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Family Limited Partnership (FLP) or Limited Liability Company (FLLC)

A properly formed and maintained FLP or FLLC can facilitate the transfer of your business to the next generation, protect assets from potential creditors, and minimize income, gift, and estate taxes.

An FLP can also guarantee that there will be continuous family ownership of the business because each family member's ability to sell or transfer his or her interest to nonfamily members is restricted.

If you own and operate a family business, a family limited partnership (FLP) or family limited liability company (FLLC) could become a vital component of your estate plan. A properly formed and maintained FLP or FLLC can facilitate the transfer of your business to the next generation, protect assets from potential creditors, and minimize income, gift, and estate taxes.

What is an FLP/FLLC?

An FLP is a special form of limited partnership where members of a family serve as general and limited partners. An FLLC is a corporate entity owned by family members who may or may not serve as managers.

With an FLP, general partners run the business. Limited partners have no vote and no say about day-to-day operations, but, they have limited liability; they aren't liable for the debts of the FLP in excess of their contributed capital.

With an FLLC, all of the family members, even if they serve as managers, have limited liability (as with any corporate entity).

Note: *The rest of this discussion will refer to an FLP; however, the underlying principles apply to FLLCs as well.*

With a typical limited partnership, a general partner who has experience teams up with limited partners who have capital. In the family context, however, the senior generation typically starts out as both the general and the limited partners. They then gift the limited partnership interests to the younger generation. The general partners can gift as much as 99% of the business to the limited partners, keeping as little as 1%. This can be an ideal solution if you want to transfer ownership of your business to your children, but also want to keep control until they can gain experience and become competent enough to manage the business on their own.

Asset protection

An FLP can provide some measure of asset protection for the limited partners. It generally takes a court order (called a charging order) for a creditor to reach a limited partnership interest, and even this only requires the FLP to pay income to the creditor instead of the partner until the debt is paid. In this case, the creditor does not become a substitute partner. He or she must wait until the general partner decides to distribute income (which may be a very long time). In addition, FLP assets are likewise protected from loss due to divorce. The general partner, however, does not receive the same protection and is personally responsible for the debts and liabilities of the FLP.

Income tax considerations

An FLP is a pass-through entity for income tax purposes. This means that the IRS does not recognize an FLP as a taxpayer (as it does for a corporation), and income of the FLP passes through to the partners. So, you can shift business income and future appreciation of the business assets to other members of your family who may be in a lower tax bracket. The family as a whole can enjoy tax savings.

Tip: *The partners must report the income earned by the FLP on their personal income tax returns and are responsible for payment of any tax owed. Income is allocated to each partner based on his or her share of the contributed capital (i.e., pro-rata share).*

Gift and estate tax considerations

One of the most powerful advantages of an FLP is that it can help minimize federal gift and estate taxes. This is accomplished in three ways:

1. Leveraging the annual gift tax exclusion and gift and estate tax exemption: Gifts of interests in an FLP are subject to federal gift tax (and possibly state gift tax). However, you can minimize or eliminate your actual gift tax liability by transferring

FLP interests in increments that are free from gift tax under the annual gift tax exclusion ($14,000 per recipient). Further, every taxpayer has an exemption from the federal gift and estate tax of $5,450,000 (in 2016, $5,430,000 in 2015) plus any deceased spousal unused exclusion amount, so transfers that do not fall under the annual gift tax exclusion will be free from gift tax to the extent of your available exemption. Both the annual exclusion and the exemption are indexed for inflation and may increase in future years.

2. Taking valuation discounts: You may be able to discount the value of the FLP interests given away. That's because the limited partners have very restricted rights, such as: (a) the inability to transfer an interest, (b) the inability to withdraw from the FLP, and (c) the inability to participate in management. These restrictions can result in a business value that is significantly less than the value of the underlying assets. These discounts can be considerable, totaling as much as 35%. The discounts available include the minority interest (lack of control) discount and the lack of marketability discount.
3. Removing future appreciation from your estate: Business assets generally appreciate (increase in value) over time. Distributing your assets among family members (through the FLP) freezes the current value and keeps any growth in value out of your estate later. You may have to pay gift tax now, but it will be less than if tax is calculated on a higher future value.

FLPs must comply with state law and IRS requirements

An FLP is subject to more restrictive rules than other forms of business entities. Care must be taken to create a valid FLP in the eyes of the state and the IRS. An FLP will be recognized only if it is formed for a valid business purpose. The FLP form will be disregarded if the IRS or the state finds that it was formed solely to avoid taxes.

Some specific purposes for creating an FLP include:

- To adopt a family succession plan
- To simplify annual gifting by the senior generation
- To minimize income, gift, and estate taxes
- To protect assets from potential creditors
- To protect assets from waste by heirs
- To consolidate assets into a single entity
- To keep the business in the family
- To decrease estate and probate costs

Additionally, an FLP may own a closely held business (other than a corporation that has made an election to be taxed as an "S" corporation), real estate, marketable securities, or almost any other investment asset. Homes, cottages, or other personal use assets are normally not suitable for an FLP.

Tips for forming and maintaining a valid FLP:

- *Have one or more substantial nontax purposes for creating the FLP, such as asset protection*
- *Keep good records*
- *Create the FLP while you're still in good health*
- *Observe all legal formalities when creating the FLP and while operating the business*
- *Hire an independent appraiser to value assets going into the FLP*
- *Transfer legal title of assets going into the FLP*
- *Put only business assets into the FLP--don't put any personal assets into the FLP*
- *If you do put personal assets into the FLP, such as your home, pay fair market rent for their use*
- *Don't commingle FLP assets and personal assets--keep them separate*
- *Never use FLP assets for personal purposes*
- *Keep enough assets outside the FLP to pay for personal expenses*
- *Distribute income to partners pro rata*

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