Family Limited Partnerships (“FLPs”)
and Limited Liability Companies (“LLCs”)

Purpose of Family Limited Partnership 1

Benefits of Forming an FLP 1

Detriments of Forming an FLP 4

Purpose of Limited Liability Company 5

Differences Between FLPs and LLCs 5

Conclusion 6

Purpose of Family Limited Partnership

An FLP is an investment entity that generally offers greater tax and non-tax benefits compared to owning assets in a corporation, living trust or non-revocable trust. FLPs have become the dominant choice of entity for owning a family’s “investments.” California law confers greater flexibility to owners of a partnership, as compared to other ownership forms. This fact, along with a person’s ability to set the rules in the initial limited partnership agreement, as well as subsequent amendments thereto, makes an FLP an appropriate estate planning device in many cases.

Benefits of Foming an FLP

Our office has formed FLPs for many clients. In our experience we have found that these entities have many benefits, both tax and non-tax in nature, that make their use appropriate for most investments. Some of the benefits associated with forming an FLP (as compared to owning such assets in trust) include:

Centralized Management of Assets

By having a managing general partner, we can identify one or more persons to control the operations and asset management. This is desirable if certain family members are unavailable for decision making or do not desire to participate in management.

Increased Creditor Protection

Limited partners are protected from *personal* liability for partnership debts. In addition, the FLP also 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

Copyright ©Miller, Monson, Peshel, Polacek & Hoshaw, 2002

satisfy their debts. In times like these, where insurance coverage is becoming more limited, this can be a valuable benefit. The “charging order” protection is probably not available, however, unless someone other than husband and wife is also a partner in the FLP.

While holding the property in an irrevocable trust may provide some creditor protection, the use of the FLP adds an extra layer of protection that can serve as an added disincentive to creditors. The largest amount of creditor protection, however, would be afforded by the use of a corporation as the general partner (*e.g.*, holding approximately a 1% interest in the FLP).

Flexibility

FLPs provide greater flexibility than irrevocable trusts because limited partnership agreements can be amended. 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 over time as desired by the partners.

Acceptance

Financial and other institutions are more willing to conduct business with FLPs than trusts. In our experience, such institutions often closely scrutinize a trustee's ability to deal with trust assets where such scrutiny is not applied to entities such as FLPs.

Donees are not Responsible for the Management of Assets

The use of an FLP allows gifts of partnership interests to be made (whether or not part of a regular gifting program) without conveying management burdens to donees. This is particularly useful in situations where the donee is not yet ready for such responsibilities.

For example, let us assume that instead of forming the FLP, a client chooses to gift an interest in one of her assets to her child and that child later desires to transfer such interest to his or her adult child (the client’s grandchild). If that grandchild is financially immature, problems could ensue if he or she received an outright interest in the asset. If, on the other hand, the grandchild received an interest in the partnership rather than in the underlying assets, he or she would be entitled to a share of the partnership distributions, *if any are made*, but would have no power over the operation of the partnership or the assets held by it.

Ease in Transferring Interests

In some instances, but not in all, the gifting of partner interests requires less paperwork and, as such, 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 agreement to reflect the new ownership interests.

Copyright ©Miller, Monson, Peshel, Polacek & Hoshaw, 2002

Certificates of ownership should also be issued to reflect the new ownership percentages. None of these documents have to be notarized and no filing fees are incurred.

Discounted Values for Estate and Gift Tax Purposes

California partnership law places certain restrictions on the transfer of voting rights to persons or entities that are not partners. These restrictions result in the owner of an FLP interest having less control over the assets held in the FLP than if such owner held the assets outright. Also, these restrictions mean that the owner of an FLP interest usually cannot sell its FLP interest as quickly and easily as he could have sold an interest in the underlying assets. For these reasons, the value of an FLP interest is usually significantly lower than the pro-rata value of the underlying assets owned by the FLP. In our experience, the IRS has accepted discounts in value of between 15% and 40% for FLP interests (note: although the IRS does not like these discounts, they have been allowing discounts of approximately 25% to 30% in recent audits, barring unusual circumstances).

Opportunity for Continued Growth

Generally, family assets will grow in value for a longer period of time if retained in one entity, for the benefit of all family members, as compared to having the assets divided up among family members. We have seen many instances where annual cash gifts are spent by donees, but FLP gifts grow in value over the years because of restrictions on transfer.

Avoidance of California Property Tax Reassessment

California Proposition 13 essentially disallows annual increases of more than 2% in the assessed value of California real property for property tax purposes, unless there is a change in ownership of such property. The effect of Proposition 13 is that property owners can continue to pay property taxes based on relatively low assessed values. A change in ownership of property does cause reassessment, but California law does provide that certain transfers of property are exempt from such reassessment.

By structuring an FLP properly, a reassessment of real property, for California property tax purposes, should be avoided upon formation. However, reassessment occurs when more that 50% of the partnership interests are transferred.

For example, let us assume that husband and wife own a community property fee simple interest in a piece of land and contribute such property to an 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 husband's and wife's percentage ownership in the property prior to and after the transaction are identical. If husband and wife 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 property tax purposes.

To avoid reassessment when husband and wife want to pass their assets to their

Copyright ©Miller, Monson, Peshel, Polacek & Hoshaw, 2002

children, we can structure the overall transaction so that husband and wife first transfer more than 50% of their interest (*e.g.*, 52%) in the property to their daughter. (Most transfers of property between parents and children are exempt from reassessment.) Then, husband and wife and their daughter can contribute their respective shares in the property to the FLP in exchange for proportional interests in the FLP. In this case, husband and wife will take a 48% interest in the FLP and their daughter will take a 52% interest. Because all partners own the exact percentage interest in the property both before and after the contributions, such transaction is exempt from reassessment. Further, husband and wife can transfer up to their entire 48% FLP interest to their daughter, without triggering reassessment of the property owned by the FLP, because no more than 50% of the FLP will change hands in this scenario. (Of course, if the daughter transfers more than 50% of her FLP interest to anyone, the property will be reassessed.)

Resolution of Family Disputes

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 fees, actual litigation is expensive. FLPs provide an incentive to amicably resolve legal disputes among family members, thereby encouraging harmony rather than division.

Stewardship as to Investment Maturity of Donees

FLP planning allows a form of stewardship in that the clients, or someone designated by the clients, can oversee and guide the beneficiaries' activities until such time as they are capable of managing the FLP's assets. By holding annual meetings, these beneficiaries can observe the client's management style and learn how to manage wealth.

Added Protection Through Use of Gift Trusts

By transferring interests to a Gift Trust (as opposed to making the children partners individually), another layer of creditor protection is added for them. This also can provide tax minimization at their deaths and the deaths of their children.

Detriments of Forming an FLP

The major detriments to forming an FLP include the following:

1. The FLP will have to pay a minimum franchise tax in most states in which it operates, even if the assets in the FLP earn little or no income.

2. The FLP is a separate entity and therefore will have to maintain separate records and prepare and file separate tax returns.

3. As indicated above, if not structured properly, the formation of an FLP and/or the transfers of FLP interests can cause the reassessment of property values for California

Copyright ©Miller, Monson, Peshel, Polacek & Hoshaw, 2002

property tax purposes.

4. Of course, there are additional costs in forming and maintaining the FLP.

5. Only the limited partners in an FLP are shielded from liability with respect to the FLP's assets and actions. General partners (and there must be at least one general partner) ARE personally liable for the assets and actions of the FLP.

Generally, however, the benefits of forming an FLP often outweigh the detriments.

Purpose of Limited Liability Company

Although LLCs have not been around as long as FLPs, the benefits of forming an LLC (including obtaining discounts on the transfer tax value of LLC interests) are similar to those for an FLP. The most common use of LLCs is for holding income-producing real property. LLCs have not reached the same popularity as FLPs for estate planning purposes, however, probably due to some or all of the following reasons.

Differences Between FLPs and LLCs

Less Case Law

As alluded to above, LLCs have not been around as long as FLPs, and therefore, there is less case law regarding LLCs. Thus, the operation and treatment of LLCs is less certain than for FLPs.

Liability

An important distinction between FLPs and LLCs is that all members of an LLC have limited liability, while only limited partners of an FLP have such protection (assuming they do not participate in the management of the FLP). The general partners of an FLP, as discussed above, remain personally liable for the actions of the FLP.

Extra Gross Receipts Tax

In California, both FLPs and LLCs are subject to a minimum franchise tax of $800 each year. For LLCs, however, there is an additional "gross receipts tax" incurred by LLCs making $250,000 or more in gross income, based on the following table:

If the total income of the LLC is:		
equal to or over:	but not over:	The fee is:
$250,000	$499,999	$900
$500,000	$999,999	$2,500
$1,000,000	$4,999,999	$6,000
$5,000,000	and over	$11,790

Copyright©Miller, Monson, Peshel, Polacek & Hoshaw, 2002

Appointment of Officers

California law provides for the appointment of officers in an LLC. This can be useful when obtaining "directors and officers" insurance coverage for the principals in a company. There is no similar provision in California partnership law, making it more difficult to obtain insurance for the management of FLPs.

Number of Owners

An FLP must have at least one general partner and one limited partner and at least two different partners. An LLC can have only one member, but such LLC will be disregarded for tax purposes.

Owner Participation in Management

Unless an LLC is manager-managed, the members of an LLC participate in the management of the LLC. In an FLP, the limited partners are generally restricted from participating in the management of the FLP or else they may become personally liable for the actions of the FLP.

Conclusion

Although an FLP or an LLC can provide desirable tax and non-tax benefits, it is important to consult with your attorney before deciding which choice of entity (FLP, LLC, corporation, trust, etc.) is right for you.

Click the back button on your browser to return to the Miller, Monson, Peshel, Polacek & Hoshaw web site.

Copyright ©Miller, Monson, Peshel, Polacek & Hoshaw, 2002