ESLICK FINANCIAL GROUP
How wealth works.™

M Financial Group™
Member Firm

June 2016

M Intelligence

Enhancing understanding of sophisticated planning strategies and their applications.

Family Limited Partnerships

A Family Limited Partnership (FLP) is a legally organized business arrangement among family members that allows assets to be jointly owned by family members. As with other types of limited partnerships, an FLP is required to have at least one general partner and one or more limited partners. The general partner is responsible for all liabilities of the entity, while limited partners are only exposed to liability up to the value of their interest in the partnership. An FLP is used to combine the assets of a family into a business entity, of which family members own shares. FLP units representing fractional interests in the partnership can be transferred between family members in a manner that may reduce income, gift, and estate tax implications. Generally, FLPs are established to allow the general partner, which usually consists of the family's senior generation, to retain management control over the partnership assets.

In addition to these management benefits, FLPs are commonly used to accomplish four major risk and tax-related objectives:

- **Asset Transition**—An FLP can be used to begin the transfer of assets to younger generations prior to their readiness to accept complete independent control. The FLP structure allows operational and management decisions to remain with the older generation, safeguarding the assets into the future.
- **Asset Protection**—Transfer of assets into an FLP structure can protect them from personal creditors or create an additional corporate entity to shield interest-holders from liability.
- **Minimization of Estate Tax**—An FLP is often set up to transition proportionate shares of assets to second and third generation family members, primarily through gifts of partnership interests.
- **Minimization of Transfer Tax**—Asset discounting is frequently employed, to reflect a reduced valuation following the change in ownership structure. This reduced valuation often results in a reduction of taxes due upon transfer.

- **Minimization of Income Tax**—FLPs frequently spread income generated by partnership assets among the partners. This practice allows some income to be taxed at the lower tax rates of some partners, who are usually second or third generation family members, rather than all income being taxed at the higher marginal income tax rates of the senior generation. Internal Revenue Code section 704 requires that income allocation bears reasonable connection to the individual's activities; FLP managers should be mindful that the economic activities of partners must be used to assign income, as the FLP should not be designed solely to shift income tax responsibility.

The Role of Life Insurance

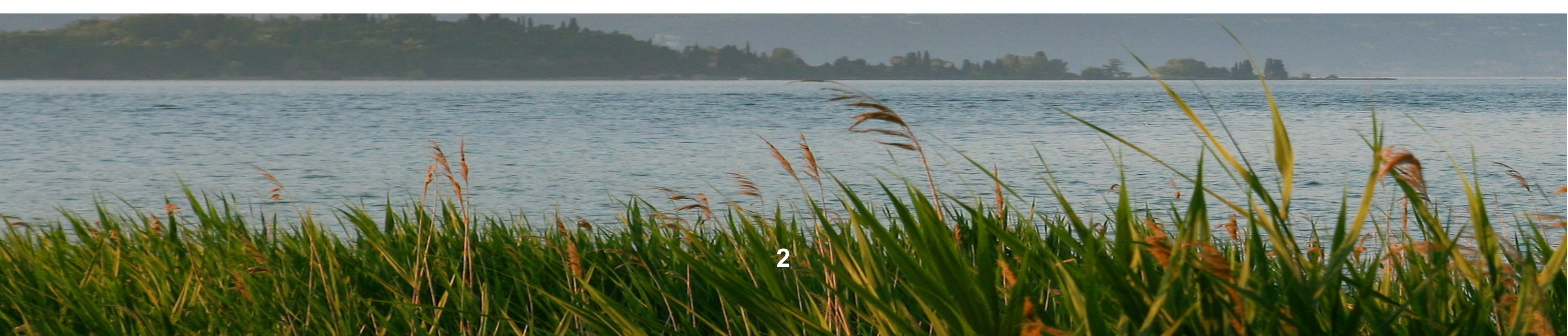
Similar to other types of business entities, an FLP can own and control a wide variety of assets. In addition to assets designed for transfer to future generations, life insurance can be especially useful as it provides predictable future liquidity to fund operational and transfer costs.

However, a key consideration in the use of an FLP is the degree to which underlying partnership assets will be included in a partner's estate. Internal Revenue Code 2036 provides that any retention of control over assets transferred to the FLP could lead to at least partial estate inclusion. When life insurance is an asset of the FLP, the portion of the death benefit included in a partner's estate is generally equal to their proportionate share of FLP ownership.

An additional caveat—as explained in more detail below—FLPs must be established primarily to accomplish business objectives. Therefore, life insurance should not be the only asset owned by the FLP. Estate planning alternatives, such as the more commonly used Irrevocable Life Insurance Trust, can be useful if an FLP is not an ideal owner of a life insurance policy. A sophisticated life insurance advisor can provide a client's legal team guidance related to the most beneficial type of insurance designs.

The IRS is aware of attempts to utilize the potentially advantageous taxation of FLPs as an overly aggressive tax minimization technique. As such, when considering the appropriateness of such structures, the IRS reviews a few key factors:

- **Bona Fide Business Purpose**—The FLP must exist for a legitimate business purpose, aside from simply being organized to acquire insurance or to reduce tax. The partnership should be managed as a business entity, with regular meetings and professional financial administration. Personal and FLP assets should not be co-mingled, and any distributions from the partnership should be supported with adequate documentation.
- **Aggressive Valuation Discounts**—As described above, upon transfer, asset values are often discounted to reflect their reduced marketability and control. The magnitude of an appropriate discount is subject to much judgement and professional discretion, often including the services of a valuation expert, as the IRS has not provided strict guidance on an appropriate level of discounting. An owner of an FLP interest may be motivated to employ overly aggressive discounting to reduce the value of assets held in the FLP, and therefore reduce their tax burden. The IRS reviews the appropriateness of valuation discounts, and contests discounts that are deemed overly aggressive. The IRS will review partnership documents to determine the rights afforded to both limited and general partners under the agreement.



M Intelligence

Family Limited Partnerships

Conclusion

Family Limited Partnerships can be very useful to achieve the operational objectives of a family business, with the potential to offer additional estate and income tax planning benefits. However, due to the complex nature of these entities, a thorough understanding of the continuously evolving tax and legal impacts of these structures will require the involvement of a team of qualified advisors. These advisors can assist in structuring an FLP that will appropriately address a client's operational objectives, risk tolerance, and tax planning goals.

Contact Information

Dennis L. Eslick, ChFC®, CLU®, RICP®
deslick@eslickfinancial.com
319.833.5555

Kevin M. Eslick
keslick@eslickfinancial.com
319.833.5555

Eslick Financial Group, Inc.
999 Home Plaza, Suite 201, Waterloo, IA 50701
319.833.5555
www.eslickfinancial.com