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### **FAMILY LIMITED PARTNERSHIPS**

How do you stay in control of assets, make gifts to your family, lower income and estate taxes, and avoid lawsuits? The Family Limited Partnership is being used by people all over America to protect, leverage, and control family wealth. Here's how it works and what it can do for you.

Many of our clients have a need for retirement income planning, asset management assistance, the need or desire to avoid estate tax, and a desire to effectively lower income taxes by spreading income among family members in lower tax brackets. They may also want to involve family in management or beneficial enjoyment of family assets or a business to a greater degree, without surrendering total control. They can accomplish all of these objectives with a Family Limited Partnership, which we also refer to as an "FLP".

A family limited partnership, for estate planning purposes, is a personalized gifting tool. Our clients transfer real estate and/or security investment assets into this specially drafted limited partnership. In fact, any investment grade asset may be transferred into the partnership. Parents, children, and even grandchildren may serve as the partners, either general or limited. You may create trusts to own partnership shares, which can give additional creditor protection, failed marriage protection and save estate taxes at the death of children and future generations.

Usually our clients are the "parents" in the family creating an estate plan and using their own assets. They usually serve as the sole General Partners 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 they desire to add them as limited partners in the future, since children who are not sufficiently mature cannot exercise their own legal rights.

#### **Overview of Pieces of a Limited Partnership**

The limited partnership is made up of several different components which are all structured seamlessly into a cohesive unit. We generally prefer to break the limited partnership into four different principal pieces.

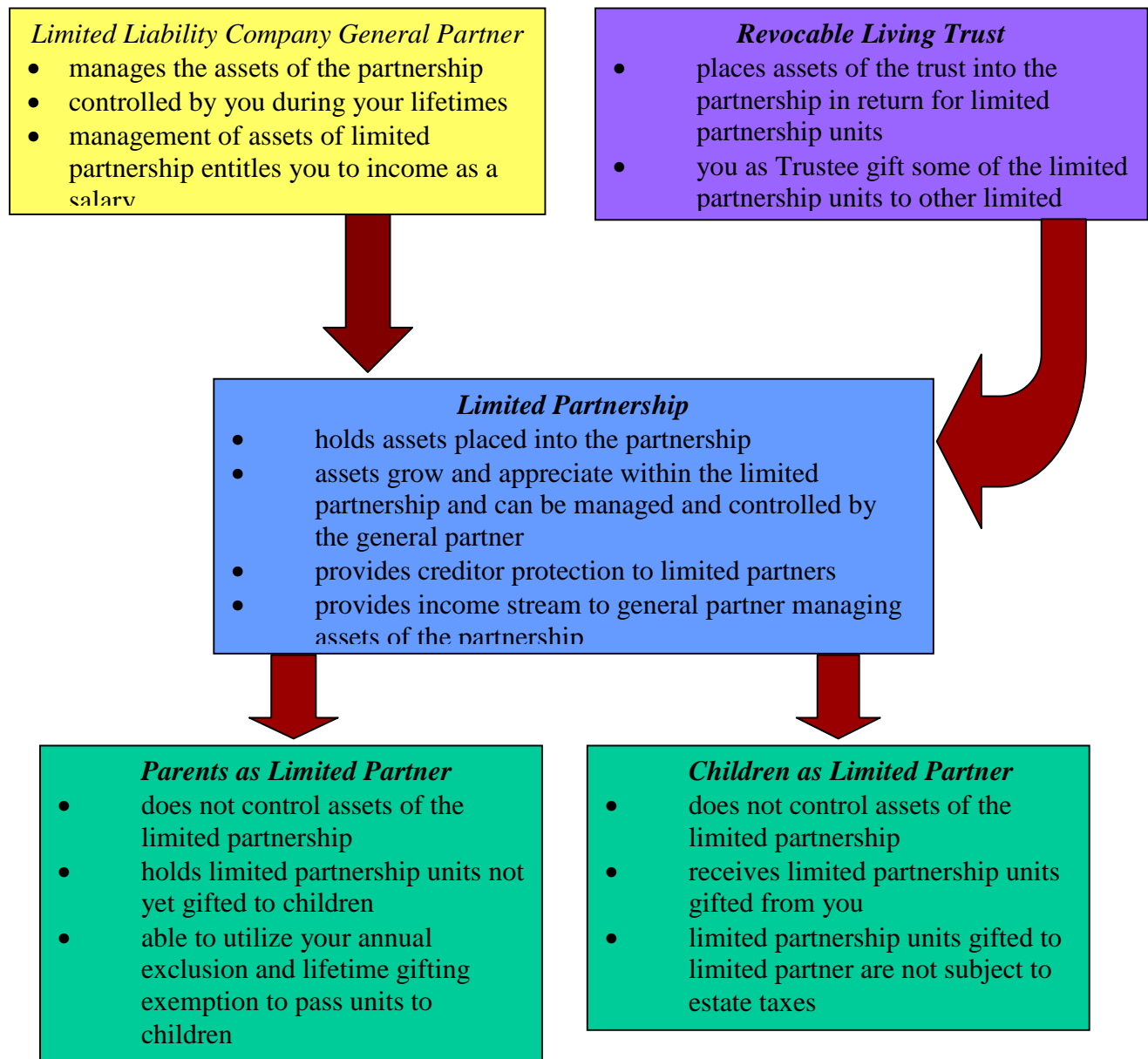
First, there is the limited partnership itself which serves as a wrapper to hold certain assets and provides the terms and conditions within which the partners conduct themselves with regards to the assets held in the partnership as well as the limited partnership itself.

Second, there is the general partner which takes on all control and management of the limited partnership. The general partner is almost always managed by the parents who want to preserve control over the assets held in the limited partnership during their lifetimes. We generally structure the general partner so that the younger generations are able to step in and take control of it following the death of the last living parent.

Third, the parents hold limited partnership interests and serve as a limited partner, generally through the entity of their revocable trust.

Finally, the younger generations serve as the limited partners of the limited partnership, either outright, or through trusts created for their benefit.

In all, the four primary pieces of the puzzle fit together as follows:



## **Asset Protection**

A major advantage of an FLP is the protection of 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 any distribution from the partnership actually made but not the assets inside it. Furthermore, since the creditor does not become a partner, there is no way for the creditor to force the general partner to do anything, including making any distributions. The creditor is forced to wait until a distribution is actually made to the debtor-partner.

Sometimes, the partnership permits the General Partner to discontinue making any partnership distributions to a partner, for the reasonable needs of the partnership. This would increase that partner’s capital account, but other partners may still get distributions. Moreover, under IRS rules, even though a creditor doesn’t receive payments from the withheld partnership share he is 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 may never receive. You now have a negotiation opportunity for settling the issue with the creditor.

## **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. This is because a General Partner remains liable for the unsatisfied liabilities of the partnership (not of individual partners, though). To avoid this kind of liability, we often 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.

## **Additional Tax and Family Benefits**

There are powerful tax and personal reasons, potentially far more important than lawsuit protection, for setting up an integrated estate and asset protection plan. The following is a brief summary of some of the legitimate business purposes for creating an FLP:

### ***Gifts to Family Members Made Easy***

One of the primary benefits of the partnership is its ability to maximize annual tax-free gifts to family members. Current law taxes estates greater than \$1,000,000 at rates from 37% to 55%.

Gifts to family members while the parents are alive reduces the estate, but causes a loss of control, and may take too long. At present, an individual may transfer \$11,000 tax free to any person each year, or \$22,000 for married couples. Many of our clients do not wish to give up control of the asset while they are alive, or do not have sufficient disposable cash on hand to give the asset away.

The limited partnership allows our clients to make annual gifts of limited partnership interests either directly to their children or grandchildren, or to a trust set up for their benefit. A gift is made of up to \$22,000 (\$11,000 from each parent) per child per year by simply transferring a partnership interest of that dollar amount. Furthermore, under present law, every person is given a \$1,000,000 lifetime gifting exemption. While it is true that the use of a portion of this exemption during life will reduce the amount that can be passed at death by the same portion, some clients feel that they are better to remove the assets as well as any appreciation on those assets during their lifetime instead of waiting to pass those assets at death. Since the client conveys only a limited partnership interest and not the asset itself, the client stays in control as the General Partner.

As the years go by, the gifts to children and grandchildren will begin to accumulate an equity interest within the partnership, which can be used for education or other needs. You can retain their income within the partnership so it will grow until they need it or you are ready to distribute it. However, you should distribute annually enough income to pay income tax attributable to each partner.

### ***Income Tax Burden Shifted to Other Family Members***

Income of the partnership is “passed through” to the partners whether full distributions of income are or are not made. This can allow for some wonderful income tax reduction because the tax will be paid at each partner's tax bracket, rather than yours, which may be substantially higher.

Children and grandchildren may participate in the growth of all assets in the partnership at income tax rates, which should be lower than yours. Family Members are entitled to Reasonable Salaries

### ***Family Members are Entitled to Reasonable Salaries***

Family members who manage or who provide services for the partnership may be paid for their help. Again, this gives the client control over the size of partnership distributions and the manner in which they are actually received.

### ***Easier to Make Family 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. When family members need distributions for specific needs, such as education, and their capital accounts are not sufficient, loans may be made to such family members. The loans may be repaid in future years from subsequent distributions.

### ***Both Spouses Will Manage Family Finances***

Spouses, if both are General Partners, 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. A management trust, an LLC or C Corporation may also be the General Partner, and

provide personal instructions to the successor. Such entities may provide greater creditor protection for the General Partner.

### ***Maintains Privacy***

The details of investment activities and the nature of the partnership assets themselves are not in the public record. Only a Certificate of Limited Partnership is filed with the state, which contains some information required by the state, but does not give financial details of the partnership.

### ***Estate Will be Organized at Death***

A partnership, particularly used within the context of the estate plan, provides you an opportunity to remain organized. The partnership must file a yearly tax return with an accompanying balance sheet. By knowing what there is, where it is, and what it's worth, countless hours of personal and professional time can be saved.

### ***Family Can Work Together***

Use your partnership to train the younger generation. The more you get them involved, the better. While they may not participate in management, you can certainly "pass on" your philosophy and ideals, along with the shares you gift or income you distribute. We find that persons with an equity stake through their partnership interest, take a greater interest in what goes on. This can be a valuable tool in keeping the family together. Our clients generally have a partnership business meeting during the holidays, where they review the business year and distribute income or make gifts of partnership shares.

### ***Effective Investing***

Pooling of assets means that management costs may be reduced, and may achieve better rates of return may be achieved. It is also 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 assets under management. You can also diversify without fear that you will lose control.

### ***Prevents 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 an unwise way 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.

### ***Estate Tax Discounts With Limited Partnership***

One of the most important benefits of the limited partnership is a valuation adjustment (or discount) in the size of the taxable estate at death. The IRS values all assets owned by the decedent at the time of death using a fair market value formula, which means what a

willing buyer will pay a willing seller under non-coercive business circumstances. The valuation process is 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 Partner's interest is not as valuable since they lack the rights of a full owner. Nobody would buy your interest from you and pay full value for such a restricted partnership interest. Therefore, your limited partnership interest is "discounted" to a more reasonable fair market value at death to reflect this reality. Cases abound throughout the land illustrating this point.

An example of the benefits that can be obtained through the use of a limited partnership is as follows:

Assume that a husband and wife own real property that is worth approximately \$4,000,000 and liquid investments worth \$1,000,000, for a total estate of \$5,000,000. If this family was to do no planning other than the minimal tax planning necessary to ensure that both husband and wife's exclusion amounts were utilized, they would have a taxable estate of \$3,000,000 under the present laws (using both of their \$1,000,000 exemption to shelter assets at their death). However, let's say that they placed the \$4,000,000 worth of real property into a limited partnership, retaining a 1% general partnership interest for themselves. By retaining this 1% general partnership interest, husband and wife would retain total control over the assets in the limited partnership. Let's also assume that husband and wife have two children who are made limited partners of the limited partnership.

By virtue of the fact that the limited partners have no control over the assets and no ability to transfer their limited partnership interests it is realistic to assume that the limited partnership interests would receive a discount for lack of control and lack of marketability in the realm of 49%. This would then cause the fair market value of the 99% of the limited partnership interests to go from \$3,960,000 ( $\$4,000,000 \times 99\%$ ) to \$2,019,600 ( $\$3,960,000 \times 51\%$ ). By simply placing the real property into the limited partnership, husband and wife have removed \$1,940,400 in value from their estate. The estate tax savings by simply removing this value from husband and wife's estate is in of itself a huge benefit to their heirs.

Now, let's take things one step further and make a substantial gift of limited partnership interests to the two children. If husband and wife were to gift \$1,500,000 of the limited partnership units using their annual gift exclusions and a portion of their lifetime exemptions, they would now only have \$440,400 worth of limited partnership units in their estate at their death. This would leave them

with \$1,440,400 (\$1,000,000 of liquid assets and \$440,000 of limited partnership units). Using the remaining exemption amount, husband and wife could shelter another \$500,000 (their combined exemption amount of \$2,000,000 less the \$1,500,000 lifetime gift of limited partnership interests) from estate taxes at death, leaving them with a taxable estate of \$940,400. In essence we've taken husband and wife's taxable estate from \$3,000,000 (\$4,000,000 in real property plus \$1,000,000 in liquid assets, less their combined exemption amount of \$2,000,000) to \$940,000, or in other words have removed \$2,059,600 from their estate for estate tax purposes.

### ***Your Partnership Can Create and Income Stream For You***

If you need, we can structure your limited partnership so that we can maximize an income stream to you. One example of a means for creating an income stream for a husband and wife is to have the younger generations "buy" limited partnership units from their parents. Oftentimes we will have a husband and wife gift appreciating liquid assets into trusts set up for their children. The income earned off of these appreciating liquid assets is then used by the children's trusts to purchase limited partnership units from the parents. Not only does this create an income stream for the parents, but it also freezes the value of the partnership units being sold for estate tax purposes. In essence, the appreciation factor on the limited partnership interests is removed from the parents' estate altogether.

### ***Your Partnership Agreement Is Dependable and Can be Customized***

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.

Your personal goals will dictate our design. While limited partnerships are common in the marketplace of American business and participate in almost all commercial business ventures, a family limited partnership contains specific provisions for you.

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 "A" shares, between salaries as a general partner and distributions as a limited share "A" 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.

### **Irrevocable Children's Trusts**

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 to provide you with a way 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.

If the trust is drafted to be “dynasty” or “generation skipping” trusts, the value of the partnership interest transferred to children or grandchildren will not be counted as a part of their estate for estate tax purposes, for probate for creditor claims, or as property subject to division in a divorce proceeding. All distributions to children or grandchildren will be taxed at their (potentially lower) income tax rate. This shifting of income can provide substantial income tax relief.

### **Summary**

The Family Partnership is your opportunity to dramatically lower your lawsuit exposure, income and estate taxes, and gain better control over your assets. You can be creative with it, and help your family to work and benefit together.

Our planning team is dedicated to assisting you in using these tools properly. It does take time, effort, and significant technical expertise, just as it took you time and effort to build your family and your estate. Please contact our firm to discuss your own estate planning opportunities without delay.