Family Limited Liability Companies (FLLCs); Family Limited Partnerships (FLPs) and Limited Liability Companies (LLCs)

Lower Estate Taxes by Using FLLCs, FLPs and LLCs

It is absolutely amazing how few clients who can benefit by FLPs, LLCs, and FLLCs actually have them.

For purposes of this section of the material, we will use FLP (Family Limited Liability Partnership) as an interchangeable acronym for Family Limited Partnerships (FLP) and Limited Liability Companies (LLCs).

FLPs are not a primary estate planning tool (those are your wills and marital or A&B trusts), but FLPs can nicely supplement an estate plan and save your heirs sometimes millions of dollars in estate taxes if done correctly.

Lifetime Gifting

As you are probably aware, parents can gift to their children $12,000 per spouse per child each year (2006 and beyond) without incurring gift taxes (50% tax in 2006 for gifts in excess of $12,000 per spouse per child). Many clients do not like the concept of gifting during their life to children because, once money or property is gifted, it is gone forever (even though the parent can dictate to some extent how the gift is used when gifted to an irrevocable trust).

Who is a candidate for gifting to reduce estate taxes? Any individual or couple with an estate over $2,000,000. That is about 80% of all clients with wealth over the age of 50. Why? Because in 2005, there is only $1,500,000 per spouse in estate tax exemptions available (if used correctly with marital trusts) and, therefore, every dollar in the estate not passed to the heirs via the estate tax exemption will get taxed at approximately 50%. Now you could die in 2010 and avoid all estate taxes, or a miracle could happen where the Congress prior to 2010 re-enacts the estate tax repeal; but putting those two issues aside, the estate tax exemption will remain at $1,000,000 per spouse from 2011 and beyond.

The FLP allows for accelerated gifting through the use of substantial discounts on assets in the FLP.

How Does an FLP Work?

An FLP is simply a limited partnership made up of family members. An FLP is really not too much different than the corporation except the FLP usually owns family assets like a house or vacation home or even a brokerage account.

A client with assets and an estate tax problem would set up an FLP and then capitalize the FLP with an asset or multiple assets. Again, usually we are talking about a piece of property (although a brokerage account can get discounts up to 20% of their value). Then, through gifting of the interest in the FLP and through discounting of the stock, discussed next, the children, eventually, end up owning the majority (upwards of 99%) of an asset they would receive anyway when the parent(s) die. The value of the asset for gift tax purposes and estate tax purposes is less than market value, thereby making the entire transaction worthwhile.

General vs. Limited Partner Interest

Typically, the FLP is formed by the older generation family members (i.e., the parents) who contribute assets to the FLP in return for general partnership units and limited partnership units. Normally, the general partners have a 1% interest in the FLP (commonly held by a C-Corp to avoid personal liability) and limited partners have a 99% interest. The parents can then embark on a plan of giving limited partnership units to their children and grandchildren, while retaining the general partnership units that control the FLP.

General partners **retain control** over the assets in the FLP, whereas limited partners are granted very limited rights. Limited partners also have restrictions on their ability to transfer their partnership units to others so that the general partners can prevent the units from being transferred outside of the family.

Discounting of the Assets in an FLP

The entire concept of using an FLP for estate planning revolves around discounting of the FLP interest. Depending on the law firm, CPA firm, and valuation firm involved, assets can be discounted upwards up to 40% of their normal market value. (Except when using a "freeze" partnership which can obtain upwards of a 90% discounts. See page 163 for an explanation of a freeze partnership).

There are two basic discounts available to FLPs. The <u>first</u> discount comes from the fact that the interest in the partnership is no longer marketable in the open market due to the fact that the children's interest in the partnership has restrictions on to whom the interest in the partnership can be sold, (i.e., the interest in the partnership can only be sold to another family member). The <u>second</u> discount comes from the fact that the interest held by the children is considered a "minority interest" in that the children have no voting rights (a non-controlling interest). Taking the two discounted issues into account, a total discounted value is given to the interest in the partnership.

Practical Example –

Assume Mom and Dad have 2 children over 18 years old.

FLP owners	Percentage Owner
Mom and Dad (general partner)	1% each
Mom and Dad (limited partner)	98%

Mom and Dad capitalized (transferred into) the FLP their vacation condo in Naples, Florida (value $500,000) and their cottage on Traverse Bay in Michigan (value $500,000). Assume for purposes of this example that the couple has a $1,000,000 personal residence, $2,000,000 in stocks, and $1,500,000 in an IRA for a total estate worth of $5.5 million.

The couple has just enough life insurance to cover the estate taxes on the rest of their estate which, after using their marital deductions, is $3.5 million.

Now assume that the interest in the new FLP gets a 40% discount on its value.

Here is the math when looking at the value of the asset per its interest in the FLP

	Original Value	Value after all Discounts
Naples Condo	$500,000	$300,000
Traverse City Cottage	$500,000	$300,000
Total Value	$1,000,000	$600,000

* *If* Mom and Dad died before the gifting was complete, the value for estate tax calculations still creates a savings of 40% of whatever interest of the FLP that is still in the parents' names. *If* Mom and Dad are able to gift out 98% of the interest in the FLP before they die, then only $12,000 or 2% of the value of the discounted asset will pass through the parent's estate. (Assuming the value of the 2% general partnership interest at the parents' death is $12,000).

If Mom and Dad gift $44,000 worth of their interest in the FLP each year ($22,000 per child in limited partnership interest) then, after 13.5 years, 98% of the FLP will be completely out of the parent's estate and not subject to estate taxes. Mom and Dad have retained the rights to do what they want with the assets in the

FLP (i.e., they can live in the house or cottage until death) because they are still the controlling general partners with their 2% interest.

What was Accomplished with the FLP?

If you did not really follow everything in the preceding paragraphs, we will leave you with the following thoughts. If Mom and Dad in the above example did nothing and then both died in a car crash, the estate would have to find $500,000 to pay the estate taxes on the Naples condo and the Traverse City cottage. Most likely the children would sell one to pay for the estate taxes of the other and hope they had enough after capital gains taxes (if any) to accomplish that goal.

If Mom and Dad died **the day after** they funded and set up the FLP where they owned 2% as general partners and 98% as limited partners, they would have saved the estate approximately $200,000 in estate taxes (combined before putting the assets into the FLP, the properties were worth $1 million, and after the transfer, the interest in the FLP was worth approximately $600,000. The difference is $400,000, and the estate taxes on that $400,000 would be $200,000).

If Mom and Dad died **13.5 years after** starting to gift their FLP interest, they would have saved their estate approximately $500,000 in estate taxes. Basically, the entire asset (the real estate) was gifted to the children; and since the two properties were worth $1,000,000, the estate would have had to pay $500,000 in estate taxes on the death of the parents.

FYI, if Mom and Dad simply tried to gift the property over a period of time to their children without using the FLP, it would have taken 22.7 years and the parents would have lost control of the asset.

Property that Appreciates

It makes much more sense to use an FLP with assets that will appreciate. In our Mom and Dad example, if Mom and Dad did not die for 30 years, the two vacation properties could be worth $1,000,000 or more **each** at the time of their deaths. If the properties were not gifted via the FLP, the estate would have to come up with $1,000,000 in estate taxes upon death ($2,000,000 x 50%). Because of the FLP, Mom and Dad were able to retain control of the assets (live in them for life); and when they died, 98% of the FLP (and, in turn, the property) is already owned by the children; and, therefore, NO estate taxes are due on 98% of the value of the assets in the FLP. It's a beautiful thing!

Reduce Income Taxes with FLPs

We will bet the following statement rings true for a good majority of clients reading this material:

> My son (18-30 years old) called the other day and said he was not doing too well with his new job and wondered if I could help out financially.

We cannot tell you how many times we have heard of clients giving massive amounts of money to children who are 18-30 (and sometimes older) to help with living expenses or to buy a car or to fix a car. Parents, in general, are giving people; and clients with sizable income take giving up a notch due to their income.

What is wrong with giving money to your children when they need help? Nothing, except that, for a client in the 38.6-48% income tax bracket (state and federal), to give a child $1,000, the client has to take home $1,628-$1,923 in taxable income to have that $1,000 left over to give to the children.

A better way

If you have any kind of asset that <u>creates income</u>, that asset can be transferred to an FLP where the children can have a minority non-voting interest in the FLP. When income is generated from the FLP, some of that income can go to the children where they can pay taxes on the money in their tax bracket. If the child has no real income, they will effectively pay no income tax on the distribution from the FLP.

Example:

Dr. Smith has three children, ages 14, 22, and 27. The 22-year old is in college, and the 27-year old graduated from college but is currently unemployed and not particularly motivated to make a good living.

Dr. Smith is paying for the 22-year old to go to college out of his income each year (since he did not pre-pay the college tuition or fund a 529 Plan), which is costing him a bundle since he has to pay tax on his income before paying the college tuition. Tuition, books, and room and board cost $30,000 a year.

Dr. Smith is also paying the rent and car payment for the 27-year old child until he "finds himself." Total costs to keep the 27-year old in "chips" is $20,000 a year.

Total cost to keep the two older children going a year is $50,000; and so Dr. Smith needs to take home $81,433 in order to pay for those bills with post-tax money.

Through the use of an FLP, Dr. Smith can save $9,437 in federal taxes on the 27-year old and $13,553 on the 22-year old (each year). How? Look at the numbers:

	Income	Taxes (federal)	What is left
Dr. Smith	$48,859	$18,859	$30,000
22-year old child (from FLP)	$35,306	$5,306	$30,000
Tax Savings		**$13,553**	
Dr. Smith	$32,573	$12,573	$20,000
27-year old child (from FLP)	$23,136	$3,136	$20,000
Tax Savings		**$9,437**	

In the above example, we used a graduated income tax scale for the unmarried children (which scales up from 10% to 27%); and for Dr. Smith, we used the 38.6% federal tax rate.

The FLP accomplished the unthinkable goal of saving Dr. Smith $22,990 in pre-tax income or $14,115 in take-home pay to give his children the same $30,000 and $20,000 respectively.

The above example is a bit over the top in that giving $50,000 a year to children post-tax is a lot of money. Further, not every FLP is going to be able to generate $68,000 in income to slide to the children each year. But one thing is clear—using an FLP to slide income to the children so they can pay tax on it in their tax bracket is a topic worth looking into.

Conclusion on FLP Planning

Besides the fact that all of a client's major assets should be in an LLC, FLP, or FLP for ***asset protection*** purposes (other than possibly the primary residence), if a client intends on passing wealth to his/her children upon death, the FLP is a terrific way to do so in a manner that can significantly lower the estate taxes the children will have to pay on the death of their parents.

To find a pre-certified attorney who can setup your FLP, please contact us and we will help facilitate the process.