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

Lower Estate Taxes by Using FLLCs, FLPs and LLCs

I have given seminars to over 1,000 physicians over the years; and out of those physicians, I can count on one hand the number of physicians who had FLLCs, FLPs or LLCs for estate planning purposes. You can read starting on page 69 of this book why every physician should have an LLC, FLP or FLLC for asset protection purposes, but these entities can provide substantial savings when it comes to estate taxes.

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

FLLCs are not a primary estate planning tool (those are your wills and marital or A&B trusts), but FLLCs 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 $14,000 per spouse per child each year without incurring gift taxes. 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? If the estate tax exemption stays in excess of $5 million per spouse, any individual or couple with an estate over $10,000,000.

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

How Does an FLLC Work?

An FLLC is simply a corporation made up of family members. An FLLC is really not too much different than the corporation you work under in a medical practice except the FLLC usually owns family assets like a house or vacation home or even a brokerage account.

A physician with assets and an estate tax problem would set up an FLLC and then capitalize the FLLC 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 FLLC 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.

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General partners **retain control** over the assets in the FLLC, 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.

Side note:

For asset protection purposes, I advise using a limited partnership or an FLLC. If you, for some reason, choose to use a general partnership instead of a Family Limited Partnership (FLP) or FLLC, I strongly advise that the 1% general partnership interest be owned by a corporate entity (such as an LLC). General partners in a general partnership are personally liable for the debts and liabilities of the partnership. Therefore, if a physician owned 1% of a general partnership, he/she would be liable for all debts and liabilities of the general partnership personally.

Discounting of the Assets in an FLLC

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% discount. For information on "Freeze" Partnerships, please contact me at info@thwpi.org.

There are two basic discounts available to FLPs. The first 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 second 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 two children over 18 years of age.

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, valued at $500,000, and their cottage on Traverse Bay in Michigan, valued at $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 $5.5 million. Also assume that they die after 2013 and have an estate tax problem due to the lowering back down of the estate tax exemption.

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

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

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

	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

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* *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 FLLC that is still in the parents' names. *If* Mom and Dad are able to gift out 98% of the interest in the FLLC 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 $52,000 worth of their interest in the FLLC each year ($26,000 per child in limited partnership interest) then, after 11.5 years, 98% of the FLLC 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 FLLC (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 FLLC?

If you did not really follow everything in the preceding paragraphs, I 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 FLLC where they owned 2% as general partners and 98% as limited partners, they would have saved the estate $200,000 in estate taxes (combined before putting the assets into the FLLC, the properties were worth $1 million, and after the transfer the interest in the FLLC 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 **11.5 years after** starting to gift their FLLC 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 FLLC, it would have taken 17.6 years; and the parents would have lost control of the asset.

Property that Appreciates

It makes much more sense to use an FLLC 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 FLLC, the estate would have to come up with $1,000,000 in estate taxes upon death ($2,000,000 x 50%). Because of the FLLC, Mom and Dad were able to retain control of the assets (live in them for life); and when they died, 98% of the FLLC (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 FLLC. It's a beautiful thing.

Conclusion

Besides the fact that all of a physician's major assets should be in an LLC, FLP, or FLLC for *asset protection* purposes (other than possibly the primary residence), if a physician intends on passing wealth to his/her children upon death, the FLLC 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.

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