Warner Norcross + Judd LLP

FAMILY LIMITED PARTNERSHIP

INTRODUCTION

Partnerships are one of the oldest forms of conducting business or investment activities. Partnerships are very flexible and generally have a favored income tax status over other business or investment entities. A partnership may serve many goals of families with wealth, and recent developments have made it possible to obtain significant discounts for gift and estate tax purposes when family wealth is transferred to descendants or others by means of a family limited partnership.

DESCRIPTION

A family limited partnership ("FLP") is a partnership formed principally among family members under Michigan's or another state's limited partnership laws. A family limited partnership must have business purposes and a fixed duration of many years (20 or more). The FLP remains in existence until the earlier of the unanimous consent of all partners, the expiration of the term, or death, incapacity, or insolvency of the last remaining general partner.

The general partners manage and control the partnership activities. The general partners decide when to make distributions to partners which, when made, must be proportionate to each partner's interest in the partnership. Often, the partnership agreement will provide for a managing general partner who alone controls most partnership activities including distributions to partners.

A typical FLP might be initially owned by the family after formation as follows:

Partners	General Partners	Limited Partners
Parent No. 1	1%	49%
Parent No. 2	.33%	49%
Child No. 1	.33%	
Child No. 2	.33%	

The FLP may own closely held businesses (other than corporations that have made an election to be taxed as an "S" corporation), real estate, marketable securities, or almost any other investment asset. Homes, cottages, or other personal use assets are normally not suitable for a family limited partnership.

The family's control of the partnership assets will remain vested in the managing partner or general partners, yet the parents may easily gift during lifetime or transfer at death their interests in the partnership. Under current law, the value of partnership interests should be less than the value of the assets the family contributed to the partnership. This discount can be substantial.

ATTRACTIVE ATTRIBUTES

An FLP is a very flexible planning tool. Its advantages may include some or all of the following:

- Preservation of a family's wealth in the family.
- Partnership meetings may promote or facilitate family communication regarding wealth, family investment philosophies, and other family values.
- Control of partnership assets will be vested in the general partners, and the partnership agreement may further consolidate that control to one managing general partner. The successor to any managing partner will also be determined by the partnership agreement.
- The passing of limited partnership interests by gifts or at death will not disturb the general or managing partner's control of the FLP.
- Despite gifts, the family's wealth remains consolidated in the FLP for management and investment purposes (e.g., investment advisers may be employed to manage all family wealth).
- Families with diversified investment portfolios are able to gift partnership interests to younger generation family members without breaking up the diversified portfolio.
- An FLP may minimize or eliminate the corrupting influence wealth can have upon younger generation family members during their formative years.
- Spouses may use the membership interests to "split estates" to avoid the wasting of generation-skipping tax exemption.[1]
- An FLP is much more flexible than irrevocable trusts when dealing with family wealth.

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[1] The GST exemption is $5,430,000 by 2015 and indexed for inflation thereafter.

- When compared to trusts, partnership activities are judged by the business purpose test, instead of the more stringent prudent person rule. Partnership assets may be invested using modern portfolio theories.

- An FLP provides some asset protection against failed marriages of family members.

- An FLP protects partnership assets from the creditors of partners. A creditor of a partner may only obtain a charging order against the partner's interest in the partnership and not underlying partnership assets.

- Properly planned, the partners may be insulated from the liability of FLP activities.

- An FLP can eliminate the need for probate of real property located outside of a partner's domiciliary jurisdiction.

- The formation of the FLP and capital contributions to the partnership will normally be income tax free.[2]

- An FLP may distribute cash or other assets proportionately to its partners without triggering gain or loss.[3]

- The FLP agreement may require that partnership disputes are settled confidentially by arbitration rather than litigation. To discourage frivolous disputes, the agreement may require the losing party to pay both sides' legal expenses.

- An FLP should reduce the estate or gift tax burden that is imposed on wealth that is transferred to family members because the FLP should be valued as a going concern, rather than at its liquidation value.

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[2] Careful planning is required when a diversified investment portfolio or encumbered assets are contributed to the FLP.

[3] Careful planning is required if an encumbered or low basis asset is distributed to partners.

FEDERAL TAX ATTRIBUTES

The FLP will be taxed as a partnership; the FLP is not subject to income tax. Each partner reports his or her proportionate share of partnership income or loss on his or her tax return each year regardless of whether a distribution is made to the partner. Likewise, cash distributions proportionately to the partners will not create taxable income because the partners are taxed directly on partnership income or loss.

If the FLP pays a wage or salary to anyone, it must report and pay all normal employment-related taxes.

The FLP must annually file partnership tax returns.

STATE TAX IMPLICATIONS

An FLP that is situated in Michigan will be required to file state income tax returns.

Most transfers of Michigan real property to the FLP will permit the local tax assessor to adjust in the year of the transfer the property's assessed value to one-half of fair market value. When property is transferred to the FLP, the assessor may not be limited by Michigan's new 5% cap on annual assessment increases.

Michigan real estate that is contributed to the FLP may be subject to state and county real estate transfer taxes, which total .86% of the property value. The application of exemptions from these taxes for a conveyance of real estate to an FLP is presently unclear. The fees or taxes for recording deeds for real estate in other states varies.

The FLP conducting business or owning property in other states may be subject to taxation in that state.

WHY NOT CREATE A FAMILY LIMITED LIABILITY COMPANY?

Michigan and almost all states now have limited liability companies ("LLCs") and an LLC may be used for family wealth planning. An LLC is a business entity that insulates its owners from the liabilities of the entity like a corporation but is taxed for income tax purposes like a partnership.

Michigan's LLC statute was amended in July 1997, and a properly formed Michigan LLC should now enjoy the same valuation discounts as an FLP. No member of a Michigan LLC may withdraw from the entity unless specified in the operating agreement. However, Michigan's LLC act has not been tested by the courts. If control of an entity is an essential concern, then the FLP provides more certainty that limited partners may not control an entity because the FLP has withstood the test of time and court challenges. Thus, despite improvements in Michigan's LLC act, an FLP will continue to be used in some circumstances.

UNDER WHAT STATE LAW SHOULD THE LLC OR FLP BE CREATED?

The FLP or LLC may be formed under Michigan or the law of another state. The flexibility and features of each state's laws will be a consideration when choosing the law for the entity. The costs of formation and operation of the entity and any real property transfer tax or other ramifications should be considered when making the choices of law. We will help a client choose the entity and state of formation that is best suited to the client's circumstances.

IS THE FLP "RISK FREE"?

The FLP valuation discounts arise out of valuation principles. When an asset is given or owned at death, its fair market value must be determined. Fair market value is the price a willing buyer would pay a willing seller when both are reasonably aware of relevant facts. In early 1993, the Internal Revenue Service abandoned its long-held position that family relationships must be considered when determining fair market value. Since that abandonment, FLP interests should be valued at the price strangers would pay for the interest.

It is this price which produces the substantial discounts. Because liquidation of the FLP is remote, a "stranger" would value an FLP interest as an interest in a going concern. However, the value of an FLP interest that appears on a gift tax or estate tax return may be challenged by Internal Revenue Service auditors, and there may be changes in tax law.

Planning techniques may help blunt a gift tax valuation challenge. A gift of FLP interests to a Grantor Retained Annuity Trust ("GRAT") greatly reduces current gift tax exposure because of the nature of a GRAT and the GRAT must contain a valuation adjustment clause. A GRAT shifts to children, almost tax free, growth on GRAT assets above a certain rate. Another technique to reduce gift tax exposure involves a formula gift. The formula gift defines the amount of the gift to family members as a fixed dollar amount with any value in excess of that amount to charity or a spouse. Because any value above a family member's defined amount (e.g., a gift of $20,000 to a child) passes to charity or a spouse, any valuation increase on a gift tax audit should produce a charitable or marital gift tax deduction instead of the payment of gift tax. Any charitable benefit should also qualify as an income tax deduction, subject to normal rules regarding deductibility for income tax purposes.

Careful planning, a properly drafted partnership agreement, and a competent appraisal whenever significant FLP interests are subject to gift or estate taxation mitigates, but cannot eliminate, the risk of an Internal Revenue Service valuation challenge.

CONCLUSION

An FLP or LLC is a very attractive tool that may be used to serve many goals of families with wealth.

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