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Estate Planning & Elder Law

The Pros and Cons of the Family Limited Partnership

A new world for estate and post-mortem planning

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With the unexpected era of a $5 million federal estate-tax exemption upon us for at least the next year and a half, both estate and post-mortem planning have suddenly taken on added considerations. For years, estate-planning attorneys have assisted wealthy clients with techniques to centralize the management of their various investment holdings, while also attempting to reduce their taxable estates. One such technique is the formation of a family limited partnership (FLP).

The FLP provides in part an opportunity to maximize lifetime gifting through the discounting of partnership interests (for lack of control and marketability), which ultimately allows clients an opportunity to reduce the size of their taxable estate faster than if they made outright gifts of individual assets to their descendants. In previous years, with federal estate tax exemption amounts of only $675,000 to $3.5 million, and federal tax rates reaching upwards of 55 percent, many clients would gladly take this opportunity to avoid paying federal taxes on these gifted assets, even if it meant surrendering the potential step-up in basis on these assets upon their death. Similarly, in an attempt to minimize the estate-tax burden upon death, the fiduciaries of these estates have also typically pursued aggressive discounts on the FLP interests remaining in the estate.

However, in the era of a $5 million exemption, many clients with modestly sized estates are suddenly no longer concerned with the federal estate tax — and might now find gifting less desirable. While these clients may continue to instinctively reduce the size of their taxable estates by way of gifts (which might still be beneficial for *state* estate or inheritance tax purposes, or beneficial if the federal estate tax exemption amount decreases after 2012), the clients are continuing to lose the potential stepped-up basis for appreciated assets upon their deaths, which will result in higher income taxes incurred upon the sale of the assets than if they had left the assets in their taxable estates. Therefore, although the state estate or inheritance tax liability is being reduced, such tax is potentially the lesser of two evils when compared to the eventual capital gains taxes to be paid upon the sale of assets, and thus these clients might be unintentionally exposing their families to higher taxes upon their deaths.

Imagine a married New Jersey couple, Stan and Phyllis Morgan, who have a combined estate worth $4 million, of which their children are all equal beneficiaries after they both pass away. In 2001, when the federal exemption amount was $675,000, the Morgans' estate planning attorney assisted them in establishing an FLP, which would provide the Morgans an outlet to gift limited partnership units to their children at a discounted value. The Morgans understand that while making these gifts, their descendants will not receive a step-up in basis on the gifted FLP interests (and thus may pay greater capital gains taxes on the eventual sale of these interests), but will avoid the federal estate tax on these interests, which could be as high as 55 percent. Therefore, the Morgans gladly gift, reducing their interests in the FLP, and thus also in their taxable estate, which should ultimately save their family tens (if not hundreds) of thousands of dollars in eventual federal and state estate taxes.

However, now the federal exemption amount is $5 million ($10 million

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per couple). Suddenly, the Morgans, now with a combined estate of $3.5 million (after gifting), have no concern for paying a federal estate tax (assuming the exemption amount does not decrease in the future) and a question will arise as to whether they should continue gifting.

Instinctively, the Morgans will likely decide that since New Jersey still retains an exemption amount of $675,000, they will continue to gift FLP interests to minimize the New Jersey estate tax liability upon the passing of the second of them to die. While this strategy should save their beneficiaries state estate tax upon their passing, their estate planning attorney must step in and make the Morgans aware of the unintended consequences they have likely not considered. In most instances, the New Jersey estate tax rates may be l*ower* than the combined federal and New Jersey capital gains income tax rates, and thus the Morgans will have to decide whether they wish to continue with lifetime gifting so that their children pay less state estate tax upon their passing, or instead halt the lifetime gifting plan, which will result in larger estates and larger New Jersey estate tax liability, but enable the beneficiaries to receive a possible step-up in basis on inherited FLP assets. With an estate between $3 million and $4 million, the Morgans must concern themselves with New Jersey estate tax rates of roughly 8 to 10 percent for increases in the sizes of their estates, whereas the combined federal and New Jersey capital gains tax rates may well be 20 percent.

Once the Morgans have made their decisions, the fiduciaries of their estates will have similar decisions to make upon their eventual deaths, as the executors must determine whether to take a liberal or conservative discount on the FLP interests remaining in the Morgans' estates. Just as during life, liberal discounts will offer more state estate tax savings but likely higher eventual capital gains taxes, whereas conservative discounts will result in higher state estate taxes but also a higher step-up in basis (and thus likely lower eventual capital gains taxes).

As an alternative approach to continued or altered gifting, the Morgans may consider buying back some, or all, of the FLP interests that they gifted to their children. This would be a potential opportunity to allow the Morgans a step-up in the basis of the interests upon their deaths, while leaving the value of their taxable estate relatively unchanged. However, this is perhaps the most complex of all possible approaches, as it involves many considerations which are beyond the scope of this article. For example, such a buyback may trigger capital gains taxes on the gain realized from the purchase of the FLP interests and the Morgans might find themselves paying immediate federal and state income taxes on something they gifted away just years before.

Additionally, from a practical standpoint, the Morgans must ensure they will retain enough liquid assets to live on after buying back the FLP interests, and this is not always simple to project. Moreover, should the Morgans repurchase what was previously gifted, not only would they likely pay capital gains taxes on assets which were theirs prior to gifting, but they will also risk once again exposing the interests to future federal estate taxes, should the federal exemption amount decrease again after 2012.

It is imperative that estate-planning attorneys review with all their clients the uncertainties surrounding the future of the federal and state estate tax laws, the pros and cons to implementing the possible plans discussed above, and how these plans could affect their previous planning. Many clients are uncertain how to proceed in this new era of planning, and it is the job of the estate-planning attorney to lay out the possible paths their clients can take, while remaining frank about the uncertainties of the future. ■