An FLP can save tax in a family business

One of the biggest concerns for family business owners is succession planning — transferring ownership and control of the company to the next generation. Often, the best time tax-wise to start transferring ownership is long before the owner is ready to give up control of the business.

A family limited partnership (FLP) can help owners enjoy the tax benefits of gradually transferring ownership yet allow them to retain control of the business.

How it works

To establish an FLP, you transfer your ownership interests to a partnership in exchange for both general and limited partnership interests. You then transfer limited partnership interests to your children.

You retain the general partnership interest, which may be as little as 1% of the assets. But as general partner, you can still run day-to-day operations and make business decisions.

Tax benefits

As you transfer the FLP interests, their value is removed from your taxable estate. What's more, the future business income and asset appreciation associated with those interests move to the next generation.

Because your children hold limited partnership interests, they have no control over the FLP, and thus no control over the business. They also can't sell their interests without your consent or force the FLP's liquidation.

The lack of control and lack of an outside market for the FLP interests generally mean the interests can be valued at a discount — so greater portions of the business can be transferred before triggering gift tax. For example, if the discount is 25%, in 2018 you could gift an FLP interest equal to as much as $20,000 tax-free because the discounted value wouldn't exceed the $15,000 annual gift tax exclusion.

To transfer interests in excess of the annual exclusion, you can apply your lifetime gift tax exemption. And 2018 may be a particularly good year to do so, because the Tax Cuts and Jobs Act raised it to a record-high $11.18 million. The exemption is scheduled to be indexed for inflation through 2025 and then drop back down to an inflation-adjusted $5 million in 2026. While Congress could extend the higher exemption, using as much of it as possible now may be tax-smart.

There also may be income tax benefits. The FLP's income will flow through to the partners for income tax purposes. Your children may be in a lower tax bracket, potentially reducing the amount of income tax paid overall by the family.

FLP risks

Perhaps the biggest downside is that the IRS scrutinizes FLPs. If it determines that discounts were excessive or that your FLP had no valid business purpose beyond minimizing taxes, it could assess additional taxes, interest and penalties.

The IRS pays close attention to how FLPs are administered. Lack of attention to partnership formalities, for example, can indicate that an FLP was set up solely as a tax-reduction strategy.

Right for you?

An FLP can be an effective succession and estate planning tool, but it isn't risk free.

Please contact Ceschini, CPAs at (631) 474-9400 for more information about this topic and other tax and business developments – such as new IRS regulations and court decisions.