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Estate Planning for Real Estate Owners With Family Limited Partnerships

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Introduction

With the Democratic takeover of Congress in the 2006 elections, the likelihood of the Federal estate tax surviving in some form has increased. As a result, owners of large real estate holdings must again consider the impact of the estate tax on their ability to transfer their wealth to future generations free of tax. The most common estate planning vehicle available for this purpose is the family limited partnership ("FLP").

How an FLP Works

Limited partnerships can be formed for any valid business purpose in Minnesota¹, and a FLP is simply a limited partnership established for family purposes. Unlike a general partnership where all partners share equally in voting and liability, a limited partnership divides partners into two categories – general partners who possess management/voting control and who can be held personally liable for the debts and obligations of the partnership, and limited partners who possess only financial rights and who have limited personal liability.

The distinction between voting and financial rights makes it possible for a real estate owner to transfer his/her holdings to the FLP while still retaining management control over the real estate through retention of the general partnership interest. Assets transferred to a FLP are removed from the estate of the transferor during life and replaced with an ownership interest in the FLP. Once the FLP holds the real estate, transfers of limited partnership interests (rather than

direct ownership interests in the real estate) can be made to spouse and children through use of the transferor's annual gift tax exclusion (currently \$12,000.00 per donee) and these transfers reduce the value of the transferor's estate (and, by extension, any possible estate tax obligation arising from the transferor's ownership of the assets).

An additional benefit of using a FLP is that the value of the interest transferred with the limited powers can be discounted, which generates a maximization of the use of gift tax exemptions and/or a maximization of the use of generation-skipping tax exemptions, depending on the generations of the recipients². These discounts (for lack of marketability and lack of control) can be as much as 30%-40%. Hence, when combining the annual gift tax exclusion with the maximum allowable discount of 40% it is possible to transfer \$30,000 of real estate to a single donee free of gift tax by utilizing a FLP structure.

¹ These purposes include farming, as Minnesota's corporate farming law, Minnesota Statutes Section 500.24, which otherwise prohibits corporate ownership of farming, explicitly allows for the creation of a "family farm partnership", which is defined as "a limited partnership formed for the purpose of farming and the ownership of agricultural land in which the majority of the interests in the partnership is held by and the majority of the partners are natural persons or current beneficiaries of one or more family farm trusts in which the trustee holds an interest in a family farm partnership related to each other within the third degree of kindred according to the rules of the civil law, and at least one of the related persons is residing on the farm, actively operating the farm, or the agricultural land was owned by one or more of the related persons for a period of five years before its transfer to the limited partnership, and none of the partners is a corporation." M.S. §500.24, Subd. 2(j).

² Note: if the transferor retains less than a 50% limited partnership interest at the outset, the transferor has already achieved a savings in that a discount can be applied to this interest on account of it being a minority interest (any interest which alone cannot exercise control over the FLP is considered a "minority" interest).

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Example

The benefits of the FLP can be illustrated with an example. Mr. Sample is married with four adult children and seven grandchildren. He owns, in joint tenancy with his wife, four 30-unit apartment buildings. Sample establishes the Sample Family Limited Partnership (SFLP). Sample then transfers to the SFLP his and his wife's title to the four 30-unit buildings in return for a 49% limited partnership interest in SFLP to each of Sample and Mrs. Sample (note: Sample and Mrs. Sample also each retain a 1% general partnership interest in SFLP). The value of the retained minority limited partnership interests owned by each of Sample and Mrs. Sample are discounted in value due to the interests being minority interests. Sample obtains appraisals for each of the buildings. He also obtains a valuation for SFLP. Sample makes annual gifts of minority interests, in the form of limited partnership interests in SFLP, to his adult children and trusts for grandchildren in an amount designed to take advantage of his Annual Gift Tax Exclusion. Sample obtains an opinion supporting the valuation of the minority interests at a discount on the basis of lack of marketability of the financial rights and lack of voting rights and control.

The gifts of minority interests of financial rights made to the Sample children and grandchildren allow Mr. and Mrs. Sample to use their combined annual gift tax exclusion up to the maximum of \$24,000 per child or grandchild. This method of gifting still allows Mr. and Mrs. Sample to preserve their entire respective gift and estate tax exclusions³ to use during the remainder of their lifetimes or at death if they wish.

The gifts to the trust for the grandchildren are also an efficient way to make the most of the generation-

skipping transfer tax exclusion⁴ by transferring appreciating assets at the current discount to subsequent generations.

The gifts affect the valuation of limited partnership interests of SFLP and the determination of discounts, as they transfer non-voting financial rights only, leading to a lack of marketability and control. The purpose of the discount is to create the ability to transfer a larger portion of the limited partnership interest. (If the interest transferred is given a 40% discount, a transfer of \$24,000 to each child or grandchild is really a transfer of \$60,000).

As for income tax savings, interests transferred to the children reduce the income earned by Mr. and Mrs. Sample on the assets and lessens their annual tax burden. The children are paying taxes on the income that they earn from the acquired assets, but likely at a lower rate than Mr. and Mrs. Sample would have been.

Conclusion

So long as the estate tax remains in effect, the FLP will remain a powerful and effective estate planning tool for real estate owners.

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³ The gift tax exclusion is \$1,000,000.00 and the unified estate tax exclusion varies by year. In 2006-2008 = \$2,000,000.00; 2009 = \$3,500,000.00.

⁴ The GSTT for 2006 is \$2,000,000.00 and matches the estate tax exclusion in each year.

