Family Limited Partnerships

Q.

I am a DDS and operate my business as an S-corp. My wife and I own (have a large mortgage) our dental building as an LLC that the practice pays rent to monthly. We keep our rent at a reasonable rate. It was suggested to me that we set up a Family Limited Partnership (FLP) and jack up the rent so that the practice has more write-offs (minimizing taxes) and then make my two young children majority limited partners of the FLP so they would be taxed at a lower rate. We would then direct their rental profits into 529 plans on their behalf.

Is this legal? I am not a savvy investor: i just fill teeth, invest in Vanguard funds, and pay down debt.

A.

It is certainly legal, as long as the rent paid is reasonable. The question is really whether it is worth it. The vast majority of good information out there about FLPs is written by those who are paid to create them (asset protection and estate planning attorneys) so as you might imagine it tends to focus on the upsides, without focusing on the downsides. Like with anything that is generally sold, not bought, there are significant downsides to consider prior to purchase. First, let's talk about how a family limited partnership works, and why someone might want to use one.

The Family Limited Partnership Set-Up

My dad wants to pay me modeling fees. I wish he'd just get me an FLP

A limited partnership has a general partner(s) and a limited partner(s). In a family limited partnership, all of those partners are in the same family. The general partner(s) have all the control and can also be limited partners. The limited partners own everything. Like with an LLC or a trust, you have to put assets into the FLP, so the FLP owns it instead of you. All toxic assets (like a small business or rental property) should be in their own FLP. Always remember that tort law (asset protection) and estate law (estate planning) is STATE-SPECIFIC. Laws are different in different states, so you need to get local, specialized advice before doing something like this.

FLP Asset Protection Benefits

The main reason physicians buy (are sold) FLPs is as an asset protection device. Of course, the best asset protection isn't asset protection, so you have to have a non-asset protection reason to establish one. With FLPs, those reasons are usually estate planning and tax minimization. Of course, you have to have the FLP established and funded long before getting sued in order to avoid being nailed for a fraudulent transfer.

But if you do have an FLP in place, this is how it works. Let's say you are successfully sued and the judgment is above your malpractice limits. At that point, it is theoretically possible (even if exceedingly rare) that the creditor will come after your personal assets. However, if you don't actually own any assets (because the FLP does) then they can't take them. That makes the creditor (and his attorney) much more likely to accept a settlement for policy limits or less.

A non-malpractice suit runs into the same issue. For example, if someone slips on your rental property, they wouldn't be able to collect from you personally since the rental property is owned by the FLP. So the most they could get would be the equity in the property (minus sales costs.) And if they decided to name you anyway, you wouldn't actually own anything, since everything else you "own" (that isn't protected by your state, like retirement accounts or cash value life insurance) is actually owned by other FLPs.

The Charging Order

In most states, however, the creditor could place a charging order on an FLP. That means that when the FLP makes distributions, the creditor can take your share of them. Of course, as the general partner in the FLP, you get to decide when to make distributions, and you could just decide NEVER to do so. The other really fun thing about charging orders, is the phantom income issue. When the FLP makes money, taxes must be paid on it, whether that money is distributed or not. And if a creditor has a charging order entitling him to a share of the income, he gets to pay a share of the taxes, whether he gets the income or not. So you could REALLY stick it to the creditor by making him pay taxes despite never collecting anything. Kind of fun, huh? This is all supposed to make it easier to settle any suits against you and discourage plaintiffs' attorneys from proceeding.

Estate Planning

Even if the main reason you're really implementing an FLP is for asset protection, you don't tell the court that. You tell them it is for estate planning. So how is an FLP useful for estate planning? Well, like a revocable trust any assets inside the FLP pass to your heirs (the limited partners) without passing through probate. There is also an opportunity to reduce potential estate taxes (which most doctors' estates will never have to pay anyway given the relatively high exemptions, at least on federal estate taxes.)

There are basically two principles to saving estate taxes with an FLP.

The first principle is the gifting of shares. You give limited partnership shares away to your heirs. Since you and your spouse can give $14K each to each heir without any gift/estate tax implications, this is a great way to reduce the size of your estate, hopefully all the way down to below the exemption level (currently $5.34M [$10.68M married] and indexed to inflation). So every year you give a few more shares away, reducing the estate and thus the estate tax due on that estate.

However, you don’t need an FLP to give stuff away. You could just give them cash and do the same thing. The reason the FLP is helpful is the second principle, the discounting of the shares. Since your heirs have no controlling interest in the asset, and have to deal with serious liquidity issues (there’s no ready market for FLP shares), it isn’t worth as much as cash on the barrelhead. You may be able to discount these shares as much as 50%. So you can really give twice as much without digging into the estate tax exemption.

Tax Minimization

Aside from the reduction of possible estate taxes, there is also the possibility of reducing your tax burden now using an FLP. You do this by shifting income from you to someone in a lower tax bracket, i.e. your kids. So if you own a quarter of an FLP, and your three kids each own a quarter, then 3/4 of that income isn’t taxable to you. If your kids are in their 20s or 30s and working, they might be in the 15-25% bracket. If you’re in the 28-39.6% bracket, there is some real savings there. If your kids are minors, of course, you run into kiddie tax issues for investment income. That means the first $1000 is exempt from tax, the next $1000 is taxed at 10%, and beyond that, it’s all taxed at your rate.

The FLP, like any business, could also hire your family members to work for it. That salary, of course, is not subject to your tax brackets, but you’ll probably have to pay their payroll taxes on it. The family members could, however, take that earned income and put it into retirement accounts.

What Your Attorney Might Not Tell You

So now that you know the benefits of an FLP, you’re ready to run out and get one, right? Not so fast. It is important that you understand the significant downsides first.

The first downside is that attorneys don’t work for free. It isn’t free to set-up an FLP, maintain it, or fund it. It will likely cost you thousands of dollars to do so.

The second downside is that you will probably never need the asset protection benefits. Although I suppose you could think of it as an “insurance cost” you’re probably throwing away both the money and the time spent on doing this. You still need to purchase malpractice and umbrella insurance. And it is still exceedingly unlikely that you will end up having a judgment exceeding your limits. And it isn’t as if there aren’t other ways to protect assets- like retirement accounts, cheaper LLCs, and properly titling your home. Besides, your biggest asset protection risk is your spouse, not your patients or tenants.

The third downside is that you probably won’t have to pay estate taxes anyway. If you and your spouse are planning to retire on $2-5M, chances of you dying with more than $10.68M, indexed to inflation, seems pretty unlikely. This stuff made a lot more sense for physicians when there was a $1 Million federal estate tax exemption. At $5M+, it just doesn’t make much sense. That doesn’t mean Congress can’t change the rules, but it seems silly to establish an FLP just in case they do. Now, if you have a huge net worth, different story. But most docs don’t and won’t.

The fourth downside is that the tax minimization is probably pretty low. If you’ve got three kids you’re planning on giving $2K a piece to to reduce your taxes, you’ll owe $300 for them on that $6K. If you were in the 33% bracket and didn’t do the FLP, you’d owe $2K. So there’s a $1700 savings. It isn’t nothing, but it certainly isn’t on the order of maxing out a profit-sharing plan, that might save ten times that much in taxes. And hiring your kids? So now instead of you paying taxes on 33%, they’re paying taxes at 15%+15.3% payroll taxes. Is there savings there? Sure, but not that much.

For the right person, an FLP can have some huge benefits. For the typical doctor, the costs probably outweigh the benefits, especially if you have to establish multiple FLPs.

What do you think? Do you have or have you considered an FLP? Why or why not? Have you found it useful in an asset protection situation? Comment below!