private clients

Family Limited Partnerships

A new approach to wealth succession planning

RAWLINSON & HUNTER

1 Inheritance Tax and Trusts

Until changes introduced in the Finance Act 2006, trusts were regarded as the vehicles of choice in effective succession planning for wealthy families. Versatile and flexible, they provided the means of moving wealth out of an individual's personal estate into a secure structure for the benefit of other, probably younger and more vulnerable, family members. The trustees would retain discretion as to the timing and extent of distributions of capital and, in some instances, of income to beneficiaries. It was not unusual for the donor to act as a trustee of the trust, perhaps alongside a professional trustee.

UK trusts were never especially tax efficient. However, gifts to most types of trust were, until 22 March 2006, treated as Potentially Exempt Transfers so that no Inheritance Tax (IHT) would be charged on the gift provided that the donor survived for seven years. With effect from 22 March 2006, almost all gifts to trusts are chargeable lifetime transfers, giving rise to an immediate 20% IHT liability on asset value which, when aggregated with other chargeable lifetime transfers by the same donor in the previous seven years, exceeds the nil rate band.

The immediate IHT charge has discouraged individuals from establishing and funding lifetime trusts since March 2006. These changes have not, however, removed the demand for a method of making controlled gifts, without immediate IHT, which stops short of placing capital at the outright disposal of young family members. The Family Limited Partnership (FLP) is a vehicle which, whilst very different to a trust, is intended to meet this demand.

2 What is a Family Limited Partnership?

The FLP has no distinct legal personality, but is a contractual arrangement between the General Partner, who manages and controls the FLP, and the limited partners who are essentially investors. The basic proposition is that the donor will contribute capital to the FLP, and will then gift partnership interests to family members who will be limited partners. There is no reason why minor children should not be included as limited partners, provided that another adult, acting as bare trustee for the minor, enters into the FLP agreement as principal. The partnership will then invest, as determined by the General Partner, in a range of assets which may include, but is not restricted to, stock market investments, private equity, real estate etc. If a UK structure is adopted, the FLP is likely to be either an English Limited Partnership under the Limited Partnership Act 1907, or a Scottish Limited Partnership. Other jurisdictions, such as Jersey, also offer limited partnership structures which may deliver potential benefits in terms of lighter reporting and regulatory requirements than the UK equivalents.

3 How do FLPs work?

The FLP is managed and controlled by the General Partner, which will often be a limited company. The business of the partnership will thus be run by the board of directors of the General Partner. Provided that he is not also one of the limited partners (who are not generally permitted to participate in the management of the partnership business) the donor may wish to serve on the board of the General Partner.

The share capital of the General Partner will often be owned by a small trust established for the purpose. The General Partner will have a small interest in the capital of the FLP and also an income entitlement which will be sufficient to cover its running costs.

It is crucial that the FLP throughout its life (it can continue indefinitely or for a fixed period) is a genuine partnership where the partners carry on a business together with a view to profit.

The limited partners will have fixed interests in the capital of the FLP. However, the assets of the FLP will be held subject to the terms of the partnership and in most cases the intention would be that limited partners cannot withdraw their capital or sell their interests without the consent of the General Partner. Each limited partner would, however, be entitled to his share of partnership income, unless the General Partner determined that the income should be retained for reinvestment.

4 What is the tax treatment of the FLP?

The most important feature of the FLP is that a gift of interests in the capital of the partnership to the limited partners by the donor is a Potentially Exempt Transfer, so no IHT would be payable on the gift provided that the donor survives for seven years. In this respect, the FLP offers similar IHT benefits to those enjoyed with respect to gifts to most trusts prior to March 2006.

The FLP is tax transparent for the purposes of income tax and Capital Gains Tax, so each limited partner is taxed annually on his proportionate share of partnership income and capital gains. If the General Partner determines to reinvest rather than distribute partnership income or gains, it will

probably be necessary to retain sufficient funds to distribute to the limited partners to enable them to pay their tax liabilities on partnership profits.

If the donor contributes capital to the FLP by way of a transfer of assets standing at a capital gain, and he is the only limited partner initially, the tax transparency of the FLP prevents a disposal taking place. This is because the donor is regarded for tax purposes as the owner of the assets both before and after the transfer. However, a subsequent transfer of limited partnership interests to family members would be treated as a disposal for Capital Gains Tax purposes of fractional interests in the underlying assets, deemed to take place at full market value. Tax on the gains realised would be payable by the transferor. Any transfers of partnership interests between the limited partners will have Capital Gains Tax consequences.

5 What are the commercial implications of FLPs?

The key commercial issues to consider in relation to a limited partnership interest are:-

- Provided that the limited partners play no active role in the business of the FLP, their personal liability in relation to any claim against the partnership is limited to their partnership capital and should not affect assets which they own outside the partnership.

- The interests are held subject to the terms of the partnership. Thus it would be possible to preserve the wealth by the inclusion of an expulsion clause in the event of bankruptcy of a limited partner.

It is possible that the FLP may prove more robust than trusts in the event of the divorce of a limited partner. Although the English courts would regard the FLP interest as an asset of the limited partner in deciding on a settlement, some protection may be achieved by the restrictions placed on access to capital under the limited partnership agreement. A divorced spouse might only be able to access a proportion of the income rather than the capital itself.

6 Regulatory and reporting issues

The FLP is less 'private' than a trust and, in most instances, more costly to run. If an English or Scottish law FLP is adopted, this will constitute a 'UCIS' (unregulated collective investment scheme) under the financial services regulations. In consequence, certain management responsibilities of the General Partner will need to be undertaken by an FSA regulated operator. This will involve costs of compliance. Furthermore, most FLPs formed under the Limited Partnership Act 1907 will be required to place on public record a register of partners and also to file accounts for the partnership at Companies House.

Whilst some clients may welcome the reassurance of greater regulation, others may prefer to maintain a lower profile in relation to family wealth structures. The Jersey Limited Partnership provides a similar structure which achieves the same tax objectives and commercial protection as the onshore models. At the same time, there is no requirement for the involvement of an FSA regulated operator and no requirement to place on public record details of the partners and the partnership's assets. It is also possible for a limited partner to play a restricted role in the business of the FLP, including the approval of the purchase and sale of partnership investments, without losing the commercial benefit of limited liability. This facility might prove valuable for the donor who wishes to participate as a limited partner as well as giving away interests to family members.

7 For whom are FLPs suitable?

FLPs should be considered by high net worth clients who wish to reduce the value of their estates by passing wealth to family members, but are concerned at the implications of unrestricted access to capital. Trusts should still be regarded as a preferred option where the initial IHT on the transfer can be avoided, such as where the assets transferred qualify for IHT relief as business property. In other cases, the FLP may be the more appropriate and less costly option.

FLPs will generally be of interest to individuals who are either UK domiciled or, although foreign domiciled, are deemed UK domiciled for IHT purposes.

They may also be of interest to high net worth families living in civil law jurisdictions in Europe or elsewhere which do not recognise the concept of trusts. For such families, the FLP may offer an effective and prudent means for the transfer of wealth between generations through a structure potentially recognised as tax transparent under local law.

What to do next...

If you are interested in FLPs and wish to explore them in more detail, please call the Rawlinson & Hunter partner who normally acts for you. If you are not one of our regular clients but would like more information or advice, a full list of partners is provided on this page and any of them will be delighted to help you.

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