

### Hidden Added Leverage in a Family Limited Partnership

When most advisors think of Family Limited Partnerships they often focus on the leverage of valuation adjustments. But, are valuation adjustments the only source of leverage in them?

Consider Bill and Doreen Frugal. They are a happily married couple in their 60's who own a very successful real estate company with 20 employees. They have three children, only one of whom is involved in the family business. Their net worth is \$5 million dollars, consisting of \$3 million in rental real estate, \$1 million in securities, a \$500,000 home, and \$500,000 in cash.

The Frugals are very unhappy. They have been talking with their friend who works for a large corporation about his fringe benefit package. The corporation provides him with a lucrative pension, great health benefits, long term disability insurance, dental insurance, and the list goes on. The more Bill hears about his friend's long list of perks, the more upset he becomes. Bill has none of these benefits in his business because the employee cost of installing these plans would be enormous. The Frugals settled instead for an average health insurance plan.

The Frugals are currently earning \$350,000 per year. Their income consists of \$100,000 salary from their business, \$200,000 from the rental properties, and \$50,000 from their portfolio. Their lifestyle requires \$200,000 per year including taxes. The \$150,000 of earnings in excess of their lifestyle is currently being taxed at the combined 45% federal and state tax rates. Out of their \$150,000, \$67,500 is consumed in taxes annually. The Frugals just accept this as a fact of life.

The Frugals want to reduce current income taxes and pass on money to their kids in a tax efficient manner, but have no one to show them how, until they meet their local Family Wealth Counselor. They were asked if they would like to pay less income taxes on their unneeded lifestyle income and create an environment where a pool of money could be given to their children's estate income tax free. They were very interested.

## *Hidden Added Leverage...continued from page one...*

Family Wealth Counselors recommended that they set up a Family Limited Partnership with the \$3 million in real estate and the \$1 million in securities. A “C” Corporation is set up as the general partner. The partnership will have earnings of \$250,000 annually. The general partner will charge a management fee of \$225,000 to the partnership to manage these assets.

Properly structured and owned, the general partner now has \$225,000 of income to spend the following way: \$80,000 in salary to Bill, \$10,000 to Doreen, \$2,500 to each child, \$15,000 in payroll taxes, \$12,500 in Cadillac employee benefits (such as \$0 deductible health insurance, reimbursed auto expenses, the cost of an annual stock holders meeting and other meetings, and \$100,000 to a defined benefit pension plan).

This defined benefit plan is designed to provide a life only annuity to a participant upon his retirement. If Bill works for 10 years, his pension plan will be worth \$1.56 million. Upon his death, nothing is included in his estate. The plan benefits will be reallocated to the other plan participants, his wife, and kids. This money passes estate tax free, and it is in a tax-deferred environment. Their annual tax savings are \$112,500 x 45%, which equals \$50,625 minus \$15,000 in additional payroll taxes, for a net of \$35,625. They also save 55% (\$550,000) of the \$1 million funded into the plan because of estate tax savings.

When thinking of valuation adjustments, think beyond to added income tax savings as well. The Frugals were glad that they met someone who helped them maximize their planning leverage.