Family Limited Partnerships – An alternative to Trusts?

Trusts – the classic estate planning vehicle
Historically, trusts offered a means of passing assets on to the next generation in a controlled and sensible manner, tailored to each child's circumstances and financial maturity.

In a trust, the management and control of the assets are segregated from the beneficial ownership. So, in other words, the money is there for the benefit of the younger members of the family but they cannot access it or control the funds unless and until the trustees permit them to do so. This means that:-

- Beneficiaries are protected from their own financial immaturity and (to some extent) from divorcing spouses and creditors.
- The stewardship of the assets is managed by persons (the trustees) qualified for that role.
- Inheritance tax savings can be secured by passing on the beneficial ownership to the next generation.

Finance Act 2006 – An attack on trusts
The last Labour Government considered that trusts established specifically to look after funds for the benefit of young beneficiaries (under the age of 25) were "a good thing" and were given a favourable inheritance tax treatment ('A&M' trusts). By contrast, the current administration views trusts with suspicion and considers them to have no role other than as a means of avoiding tax and starting from the Finance Act 2006, up until the recent budget has introduced a range of measures which mean that trusts are now expensive in terms of tax.

The Finance Act 2006 imposed a 20% up front inheritance tax charge on the value of assets above the nil rate band (currently £325,000) transferred into trust. The legislation also imposes inheritance tax at a maximum rate of 6% when capital is distributed from the trust and on each 10 yearly anniversary of the creation of settlement. The recent budget has slapped a 50% income tax rate on trusts – even if they produce very little income – again an indication on how trusts are perceived by this government.

For wealthy families who wish to take advantage of trusts as being in the best interests of their children, the tax cost may be too high and it will be necessary to consider other options.

Family Partnerships
The use of a partnership as an estate planning vehicle is not new – it is a common structure in US succession planning. In the UK, it is most commonly used as a means of gradually transferring the ownership and ultimately the control of a family trading business (such as a farm) to the next generation but in a controlled manner. This is done by:

- The senior partners (the parents) introducing junior partners (the children) and transferring to their capital accounts a proportion of the value of the business. This is a gift for inheritance tax.
- The senior partners retain voting control until the junior partners are ready to take on more responsibility.

There is no reason why this model could not be used in the context where the business is not, say, a farm but investing family assets with a view to generating income and capital growth.

Controlled access to family assets
A partnership is governed by contract and the partnership agreement regulates the rights and obligations of each partner. The partnership agreement could provide:-

- The partnership continues for say a 15 year rolling term;
- Capital cannot be extracted from the partnership during that term or without the consent of all the partners; and
- The senior partners have voting control and discretion as to payment of profits.

Just as the trust deed confers on trustees powers to manage trust assets and to distribute funds to the beneficiaries, the partnership agreement could do much the same and effectively restrict a junior partner's access to his capital until the senior partners are confident that the young person is growing into maturity.

Asset protection
It can no longer be said that trusts protect assets on divorce in the UK. It is difficult to say with any certainty what would be the Family Court's approach to an FLP. However, it is likely that the court would strive to respect the interests of third parties (the other partners) and, provided the partnership agreement is carefully drafted, this should mean the partnership would not be dissolved by the court. This is not to say that the value of the junior partner's interest would be entirely left out of account on divorce, rather there should be scope be arguing that the inaccessibility of the assets should be a factor in negotiating a financial settlement.

Financial education of junior partners
It is generally considered that a gradual acquaintance with the fact of family wealth, and the privileges and responsibilities that go with it can be much healthier than a sudden inheritance of capital even at an age where one might consider the beneficiary to be financially mature. A junior partner can therefore gradually become more involved and be encouraged to learn about the stewardship of the family assets until such a time he or she is able to become a senior partner in his or own right. At that point it may be that they will have children of their own who would be introduced as junior partners.

Tax
Although a partnership could operate along similar lines to a settlement, it is not a settlement for inheritance tax purposes. This means that the entry charge of 20% and the other charges which apply to settlements will not apply to the partnership. Despite not being subject to the draconian inheritance tax regime, the vehicle is not a particularly aggressive form of tax planning as a gift by a senior partner to a junior partner's capital account would be taxed under principles applying to gifts to individuals, resulting in inheritance tax being payable, should that senior partner die within seven years within the date of gift.

As with trusts, there may be CGT consequences if assets standing at a gain are introduced. Again, as with trusts, if a junior partner is the minor child of a senior partner who transfers money to him, any income arising on those gifted funds will be taxed on the senior partner during the child's minority. However, because the partnership is look through for income tax, the higher rate of 50% will not apply as it would to a trust, unless each adult partner was a high earner (£150,000+).

Child partners
A partnership which is intended to mirror an A&M trust has one fatal flaw - a minor partner can, upon reaching majority, repudiate the partnership. In other words, on his 18th birthday, he can rip up the partnership agreement which purports to restrict his access to capital until the senior partners consider him mature enough. That being so, there would seem little point in setting up the partnership in the first place as it is nothing more than elaborate bare trust if the child can get his hands on the partnership assets as soon as he attains his majority.

It is therefore necessary to ensure the partnership structure is created in such a way as to avoid the child partner (or even his nominee) being required to sign up to the partnership agreement. The mechanism for locking a child partner into the partnership adds a layer of necessary complication but does not impact on the ability of the senior partners to manage and control the family assets for the benefit of the family during the term of the partnership.

FSA regulation
The nature of a partnership's business arguably brings the structure within the definition of a collective investment scheme. In practice, the solution is for the partnership to contract out to a suitably authorised body (such as the investment advisors) the role of operating the collective investment scheme.

Conclusion
While the changes to the taxation of trusts initially forced advisers to consider other vehicles, it may be in the long run, that Family Limited Partnerships prove to be more suitable than trusts to this generation. These days, trusts can seem inflexible and paternalistic especially to those potential settlors who wish to remain involved in the management of their family assets and to educate the younger generation in the business of investment management, rather leaving the beneficiaries dependant upon the decisions of sometimes distant trustees - even when the beneficiaries have reached the age of being able to contribute sensibly to the strategy of family asset management.

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