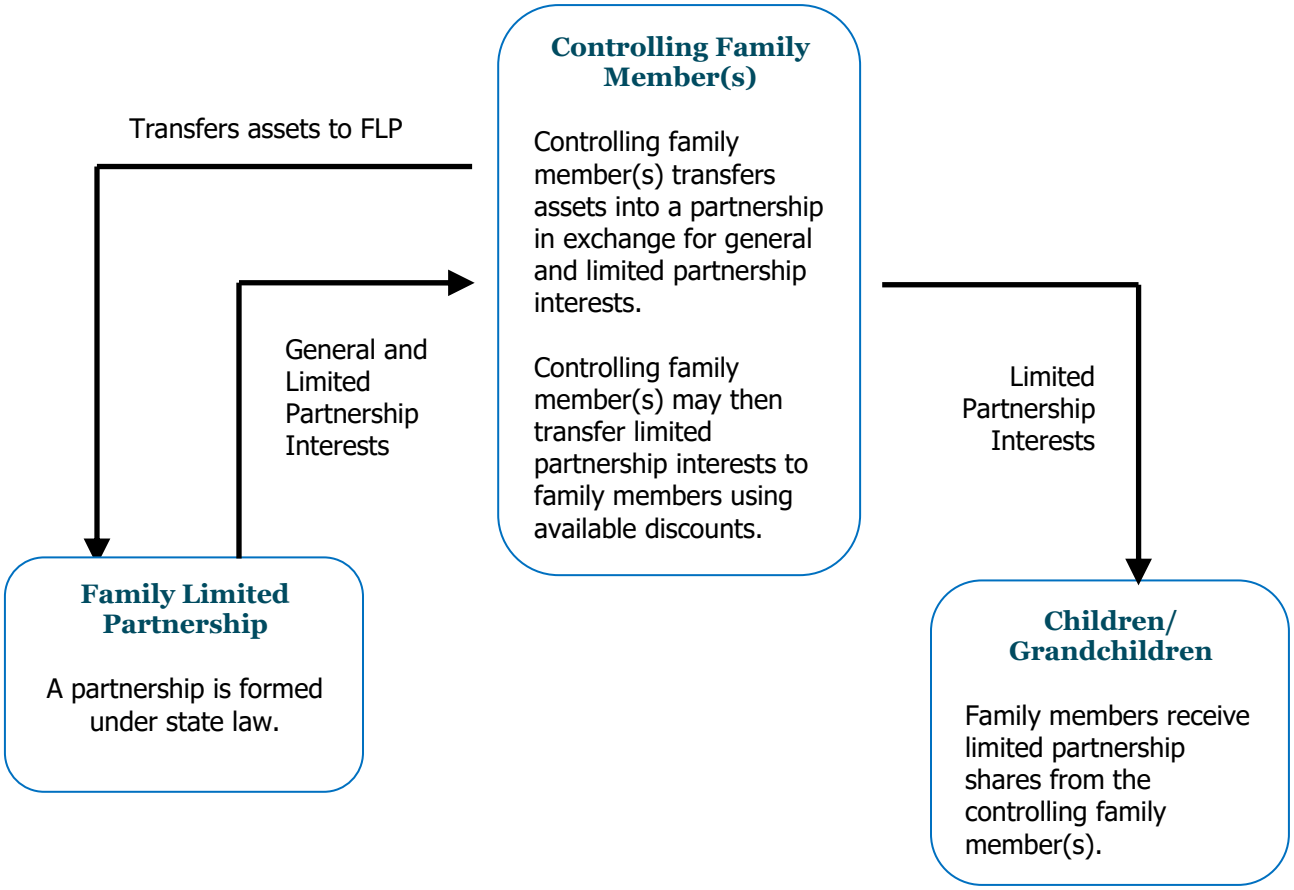
Family Limited Partnerships

A family limited partnership (FLP) can be a useful estate planning strategy for shifting and preserving family wealth.



Typically, a donor creates an FLP and initially serves as both the general and limited partners. The general partner has management and control of the partnership, as well as its assets, and is liable for partnership debts. In exchange for the partnership interests, the donor contributes assets, such as a business, real estate, or securities.

Over time, the donor gives limited partnership interests to his or her children or other family members. A major advantage of using an FLP is that the gift of limited partnership interests may be eligible for a discount to the fair market value of the assets. The FLP can also be a useful tool for a donor to instruct his or her children or other family members in running a business or in managing money. A donor must consider several tax and non-tax issues in deciding whether an FLP is appropriate.

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Structuring an FLP

An FLP is simply a limited partnership created under state law. Each state has its own statutes governing limited partnerships, although many states have adopted the Revised Uniform Limited Partnership Act (RULPA). The "family" part of the name simply refers to the fact that most limited partnerships established for estate planning purposes involve family members. There is no reason why a donor could not give partnership interests to non-relatives, such as friends or key-employees.

In a limited partnership, there are two kinds of partners: general partners and limited partners. General partners manage the partnership and are the only partners who can legally bind the partnership in contracts. Limited partners cannot participate in management but can be employees of the partnership or a business it controls. The drawback of being a general partner is that each general partner is personally liable for all partnership debts. The partnership's creditors can attach the personal assets of the general partners. Limited partners are generally only liable to the extent of their interest in the partnership. If the creditors seize the partnership assets, the limited partners lose their equity, but the creditors cannot pursue the limited partners personally. In an FLP, the family can have a family-controlled corporation or limited liability company (LLC) serve as general partner. If the partnership's creditors pursue the general partner, they can only get the assets in the corporation or LLC.

Typically, a donor will transfer assets to the partnership in exchange for all the general and limited partner interests. The donor can be an individual or a married couple. The donor will often give the limited partner interests to his or her children or other family members or trusts for their benefit, either all at once or over time. The parties can also structure the arrangement so that the children also contribute assets in exchange for their interests in the partnership. The partnership agreement can provide for the children to be successor general partners when the donor dies or becomes incapacitated.

The structure of an FLP is very flexible. The donor can tailor the partnership to suit the donor's goals and needs. For example, the agreement may include a confidentiality provision to ensure privacy or an arbitration clause in anticipation of future disputes between family members. The parties can amend the agreement if circumstances change.

Income Tax Issues

Normal Income Tax Rules

Subchapter K of Chapter 1 of the Internal Revenue Code (I.R.C. or Code) sets out the income tax rules for partnerships. Generally, a partnership is not a taxable entity; rather, it is a pass-through entity. The partners report items of partnership income, gain, loss, deductions, and credits on their individual tax returns. I.R.C. § 701. A partnership can elect C corporation tax treatment (where there is a tax on the entity itself as well as the owners), but this is rare. Treas. Reg. §§ 301.7701-1(f), 301.7701-2(e), 301.7701-3(f). Ordinarily, neither the partnership nor any of the partners will recognize gain or loss when a partner contributes property in exchange for a partnership interest. I.R.C. § 721(a).

Investment Company Rules

As noted above, a partner's contribution of property in exchange for a partnership interest normally will not require the partnership or any of the partners to recognize gain. Under Section 721(b) of the Code, there is an exception to this non-recognition rule if the partnership is an "investment company" as defined in Section 351 of the Code. If the partnership is an investment company, the contributing partner has to recognize gain (but cannot recognize losses) upon the contribution. I.R.C. § 721(b). Congress designed this rule to prevent a partner from using a partnership to diversify his or her portfolio without recognizing income. Generally, a partnership is an "investment company" if, after the contribution, more than 80 percent of the value of its assets (excluding cash and non-convertible debt obligations) is held for investment and consists of readily marketable stocks or securities (or interests in regulated investment companies or real estate investment trusts). Treas. Reg. § 1.351-1(c)(1)(ii). Section 351(e) of the Code states that one must determine whether an entity is an investment company by considering all the "stocks and securities" held by the company. The definition of "stocks and securities" is very broad and includes:

(i) money;
(ii) stocks and other equity interests in a corporation, evidences of indebtedness, options, forward or futures contracts, notional principal contracts and derivatives;
(iii) any foreign currency;
(iv) any interest in a real estate investment trust, a common trust fund, a regulated investment company, a publicly traded partnership (as defined in § 7704(b)) or any other equity interest (other than in a corporation), which pursuant to its terms or any other arrangement is readily convertible into, or exchangeable for, any asset described in any preceding clause, this clause or clause (v) or (viii);
(v) except to the extent provided in regulations prescribed by the Secretary, any interest in a precious metal, unless such metal is used or held in the active conduct of a trade or business after the contribution;
(vi) except as otherwise provided in regulations prescribed by the Secretary, interests in any entity if substantially all of the assets of such entity consist (directly or indirectly) of any assets described in any preceding clause or clause (viii);
(vii) to the extent provided in regulations prescribed by the Secretary, any interest in any entity not described in clause (vi), but only to the extent of the value of such interest that is attributable to assets listed in clauses (i) through (v) or clause (viii); or
(viii) any other asset specified in regulations prescribed by the IRS.

I.R.C. § 351(e)(1)(B)

Although not expressly stated in Section 721, the legislative history indicates that the investment company rules should apply only if the contribution results in the diversification of the contributing partner's investment portfolio. S. Rep. No. 938, 94th Cong., 2d Sess., pt. 2, at 43, 44 (1976). While not directly applicable to partnerships, the IRS regulations interpreting Section 351 of the Code state that diversification occurs if two or more parties contribute non-identical assets. Treas. Reg. 1.351-1(c)(5). The regulations make an exception if the amount of non-identical assets is "de minimis." *Id*. The regulations do not, unfortunately, define what constitutes a "de minimis" amount. The regulations also provide that there is no diversification if each person contributes an already diversified portfolio. Treas. Reg. § 1.351-1(c)(6). This is the multi-stock exception. The legislative history of Section 721 indicates that there might not be diversification if the partnership agreement allocates the income and gains from the specific property to the contributing partner and provides for a withdrawing partner to receive the property he or she contributed originally. S. Rep. No. 938, 94th Cong., 2d Sess., pt. 2, at 44 (1976).

Partnership Tax Accounting

Each partner must have a capital account that reflects the "book value" of the partner's interest in the partnership. The partnership must keep the accounts in compliance with IRS regulations. Treas. Reg. § 1.704-1(b)(2)(iv)(a). Generally, the partnership must credit a partner's account with the value of property the partner contributes to the partnership and the partner's share of the partnership income and gain. The partnership must debit a partner's account by the partner's share of losses and distributions to the partner. Treas. Reg. § 1.704-1(b)(2)(iv)(b).

While a partner must generally report his or her share of the partnership income, there are several parts of the Code that may prevent the partner from deducting his or her share of partnership losses. For example, a partner cannot deduct partnership losses in excess of the partner's basis in his or her interest in the partnership. I.R.C. § 704(d). Unlike a shareholder of a corporation, a partner can include his or her share of the partnership liabilities in computing the basis in his or her ownership interest. Treas. Reg. § 1.752-3.

FLP-Specific Rules

As noted above, a person establishing an FLP will typically give partnership interests to his or her children or other family members. Congress has created special rules to address when the donees who receive partnership interests will be "real" partners for income tax purposes. I.R.C. § 704(e). For purposes of these rules, the law treats a family member who purchases his or her partnership interest from another family member as having received the interest by gift. I.R.C. § 704(e)(3). If a person owns a capital interest in a partnership in which capital is a material income-producing factor, the law will treat the person as a partner, even if the person acquired the interest by gift. I.R.C. § 704(e)(1). If the partner meets this test, his or her share of the partnership income will be includible in his or her gross income rather than the donor's gross income. I.R.C. § 704(e)(2). If the donee partner fails this test, the donor might be subject to tax on the donee's share of the income. The IRS will not recognize the donee as a partner unless the donee has real control over the partnership interest and acquired such interest in a bona fide transaction. The transaction must not have been a mere sham transaction for tax avoidance or evasion purposes. Treas. Reg. § 1.704-1(e)(1)(iii).

According to IRS regulations, "Capital is a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the business conducted by the partnership." Capital is generally not a material income-producing factor if the partnership generates the bulk of its income from fees, commissions, or other compensation for personal services. Treas. Reg. § 1.704-1(e)(1)(iv). The IRS can tax the donor on some of the income attributable to a donee's share if the partnership does not pay the donor reasonable compensation for services rendered to the partnership. The IRS can also tax the donor if the donee's share of the partnership income is disproportionate to the donor's share from comparable amounts of property. I.R.C. § 704(e)(2). In other words, the family cannot shift all income to the donees and ignore the donor's services and ownership interest.

Anti-Abuse Rules

The partners must be careful to ensure the FLP is bona fide and that all partnership transactions have a legitimate business purpose. The IRS has created "anti-abuse" regulations under Subchapter K that address this issue. If the IRS believes a principal purpose of the partnership was to substantially reduce the partners' income tax liability in a manner inconsistent with Subchapter K, then it can disregard the partnership or transactions involving the partnership. Treas. Reg. § 1.701-2(b). A partnership can avoid the anti-abuse regulations if it meets three tests: (1) the partnership is bona fide and there is a substantial business purpose for each

partnership transaction, (2) the form of partnership transactions reflects the substance of what is actually happening, and (3) the income tax consequences to each partner of partnership operations, and of transactions between that partner and the partnership, reflect the partners' economic agreement and that partner's income. Treas. Reg. § 1.701-2(a). While the anti-abuse regulations do not apply for gift or estate tax purposes, the IRS could still try to disregard the partnership for purposes of those taxes if it believes the partnership was a sham or has no legitimate business purpose.

Certain Types of Assets Inappropriate for FLP

Certain types of assets may not be suitable for an FLP. As discussed above, the IRS will carefully scrutinize an FLP to ensure it has a legitimate business purpose. For this reason, personal assets like family homes, cars, planes, boats, art, or jewelry may not be appropriate.

Taxpayers must also be cautious when transferring closely held stock to an FLP. If a taxpayer transfers closely held stock to an FLP while retaining the right to vote the stock through ownership of the general partnership interest, the stock may be includable in the taxpayer’s estate at death. I.R.C. § 2036(b). This result can easily be avoided if the taxpayer only transfers non-voting stock to the FLP. Encumbered assets with liabilities exceeding basis may not be appropriate because contributing them to the FLP might trigger taxable income. Lastly, an FLP cannot own stock in an S corporation because a partnership is not a valid S corporation shareholder. I.R.C. § 1361(b)(1).

Gift and Estate Tax Issues

Discounts for Limited Partner Interests

In calculating the gift and estate tax, the value of the assets transferred is the fair market value at the time of the gift or the decedent's death. Specifically, the value is the price on which a hypothetical willing buyer and seller would agree if neither was under any compulsion, and both had all the relevant facts. Treas. Reg. §§ 25.2512-1, 25.2512-3, 20.2031-1(b), 20.2031-3.

A major benefit of using an FLP is that a donor may be able to give away limited partner shares at a discount to the fair market value of a proportionate share of the underlying assets. In order to achieve the discount, the donor may need to have a qualified appraiser value the underlying assets and the partnership interests. The amount of the discount will depend on the facts. Anyone considering an FLP should be aware that the IRS might challenge the amount of discount a donor takes. This makes it crucial to obtain a valuation of the underlying assets and the partnership interests. There are two possible types of discounts: (1) a discount for lack of control, and (2) a discount for lack of marketability.

Control Discount

The theory behind a control discount is that a limited partner interest is less attractive to a hypothetical buyer because limited partners have little control over the partnership or the underlying assets. The discount may be even greater if state law or the partnership agreement provides that a transferee receiving a limited partner interest is only an assignee. An assignee typically cannot become a true partner without the consent of the other partners. This could drive down the market value of a limited partner interest.

Marketability Discount

Limited partnership interests may be much less marketable than the underlying assets. Anyone trying to sell a limited partner interest might find it difficult to locate a willing buyer, unless the

seller was willing to give the buyer a deep discount. The partnership agreement can also put restrictions on the ability of a limited partner to sell his or her interest or upon the ability of a limited partner to withdraw from the partnership. These restrictions may allow for a larger marketability discount. However, if the restrictions were too severe, the IRS might attempt to argue that the donees were not really partners for income tax purposes, as discussed above. The IRS might also argue that Section 2703 of the Code allows the IRS to ignore such restrictions in valuing the partnership interest.

Section 2703 generally provides that in valuing property, one must ignore: (1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right) or (2) any restriction on the right to sell or use such property. I.R.C. § 2703(a). There is an exception for any restriction that: (1) is a bona fide business arrangement, (2) is not a device to transfer wealth to family members for less than full fair market value, and (3) has terms comparable to those third parties would agree to in an arm's length transaction. I.R.C. § 2703(b). The IRS has sought to ignore restrictions on transferability of a limited partner's interest and a limited partner's ability to withdraw. The IRS theory is that no third party would ever agree to eliminate his or her ability to get out of the partnership. If this argument is correct, the restrictions might fail to qualify for the exception under Section 2703(b), allowing the IRS to ignore the restrictions in valuing the partnership. Further, the IRS has argued that Section 2703 allows it to completely ignore the existence of a partnership and use the fair market value of the underlying assets. See, e.g., T.A.M. 97-23-009 (Feb. 24, 1997); T.A.M. 97-19-006 (Jan. 14, 1997). T.A.M. 97-25-002 (Mar. 3, 1997). Many commentators view this position as unreasonable and well beyond the intent of Section 2703, but the issue is still uncertain. The parties can try to avoid the IRS arguments by selecting restrictions common to partnerships involving unrelated parties in the same business or by tracking the default provisions of state law.

Inclusion of Limited Partner Interests in Donor's Estate

In many cases, a donor will give away all limited partner interests in an FLP but will retain the general partner interest. On its face, this type of transaction could allow the IRS to include the limited partner interests in the donor's estate under Sections 2036 or 2038 of the Code. Section 2036 requires inclusion of assets transferred in the donor's estate if the donor retained a beneficial interest in the asset or the right to control who can use or enjoy the assets. I.R.C. § 2036(a). Section 2038 allows inclusion if the donor retained a right to alter, amend, terminate, or revoke the terms of the donee's enjoyment of the property. I.R.C. § 2038(a)(1). The IRS has ruled, however, that Section 2036 and 2038 do not require inclusion because the general partner owes a fiduciary duty to the limited partners. See, e.g., P.L.R. 95-46-007 (Aug. 17, 1995).[1] As long as the partnership agreement does not eliminate this fiduciary duty, there appears to be less of a chance of inclusion. Obviously, if the donor died before giving away all limited partner interests, the remaining limited partner interests would be includible in the donor's estate.

Recently, however, the IRS has had some success in litigating the Section 2036 issue. Attacks against FLPs by the IRS have been successful when a pattern of certain actions or omissions by family members active in the FLP indicates a failure to treat the FLP as a separate legal entity, thus causing inclusion of the undiscounted value in the decedent’s estate. Care should be taken when creating and operating an FLP to help prevent a successful Section 2036 challenge by the IRS.

Asset Protection

An FLP can protect assets from the claims of the partner's creditors to some degree. Usually, a partner's creditors can only reach the partner's interest in the partnership by getting a court to issue a "charging order." Even so, a charging order at best entitles the creditor to distributions

made by the partnership to the debtor partner. Unless the creditors can show the partner fraudulently conveyed assets to the partnership to avoid creditors' claims, the creditors typically cannot reach partnership assets. Creditors naturally cannot force distributions of either income or principal. In addition, the partnership agreement can provide that an involuntary transfer of a partnership interest invokes buy-sell provisions that allow the other partners or the partnership to buy the partnership interest for fair market value. In addition, the agreement can prevent a partner from pledging the partnership interest to obtain personal loans.

Other Non-Tax Issues

Apart from the tax planning and asset protection purposes, a family partnership may be an excellent way for parents to pass along their business acumen, experience, and advice to their children. Thus, in addition to enjoying the family wealth, the children could receive a significant lesson in how to manage this wealth and preserve it for the generation to come.

An FLP typically restricts the limited partners' ability to sell their partnership interests. This can be good for parents creating an FLP who wish to limit a child's access to readily convert assets into cash. Conversely, these restrictions can make it difficult for a partner to get cash in the event of an emergency. Each partner may need marketable assets outside the partnership to handle any emergency. The partnership could also loan money to a partner.

An FLP can also contain provisions to help resolve any future disputes between family members. For example, the agreement can contain an arbitration clause requiring partners to take disputes to an arbitrator instead of filing a lawsuit. In order to discourage frivolous claims, the agreement could require a partner who files an unsuccessful arbitration action to pay all arbitration costs.

The family should consider the setup costs, administrative expenses, possible state franchise taxes, and the cost of a business valuation from a qualified appraiser in determining whether to establish an FLP. On a positive note, an FLP may reduce probate costs for out-of-state assets transferred to the partnership.

Conclusion

An FLP can be an effective estate planning tool. Not only does the FLP afford an opportunity to keep the wealth within the donor's family, it can allow a significant transfer of tax savings. The FLP also allows the senior generation to maintain control over the assets. There are significant tax and non-tax issues involved in creating an FLP. Anyone considering an FLP should consult with his or her own legal and tax advisors about these issues.

The American Taxpayer Relief Act of 2012, enacted on January 2, 2013, permanently extends the $5 million federal, gift, estate, and generation-skipping transfer (GST) tax exemption amount (indexed for inflation) and establishes a top gift, estate, and GST tax rate of 40%. These considerations apply only to the federal estate tax. Any state level estate or inheritance tax should be evaluated separately.

[1] A private letter ruling (PLR) is issued by the IRS National Office in response to a specific request from a taxpayer as to the tax consequences of a proposed transaction. A PLR applies tax laws to specific facts only, is solely for the taxpayer who requested it and should not be relied upon as authority by other taxpayers. Additionally, PLRs may later be revoked by the IRS. As such, PLRs do not carry the stamp of law, but they do give an indication of the IRS's current thinking towards a specific type of transaction. All references to PLRs in this current comment are for informational purposes only.