

Introduction to Family Limited Partnerships

The family limited partnership concept is fairly simple. A parent first contributes assets to a limited partnership in exchange for both general and limited partnership interests. The bulk of the initial capital contribution typically would be assigned to the limited partnership interests. For example, the partnership agreement might assign 1% of the initial capital contribution to the general partnership interests and the remaining 99% to the limited partnership interests. The parent then gifts the limited partnership interests to his children (or to trusts for their benefit) while retaining the general partnership interest.

The limited liability company is another form of business entity which can be accomplish the objectives discussed in this memorandum. The choice of limited liability company or limited partnership will depend on the circumstances and goals of each family. Most of the information discussed in this memorandum relating to limited partnerships applies equally to limited liability companies.

The Estate Planning Advantages

Discount Valuation

A family limited partnership is a very attractive estate planning tool because it permits the donor/parent to significantly discount the value of gifts to the donee/children that might not be discountable if made outright. Two discounts generally are available: a lack of marketability discount and a minority discount.

A lack of marketability discount reflects the fact that the partnership agreement will restrict the sale or transfer of the partnership interests so that there is no ready market for those interests. A minority discount reflects the inability of the limited partner to compel partnership distributions or to compel liquidation to obtain his share of the assets which the partnership owns. It also reflects the inability of the limited partner to control partnership investments. In January, 1993, the IRS reversed its long-standing position by releasing Revenue Ruling 93-12, in which it held that a minority discount is available with respect to transfers between family members despite the fact that after the transfer control exists as a family unit. This was a very significant change in position by the IRS and largely caused the popularity of family limited partnerships as estate planning tools which continues today.

The combined discounts for lack of marketability and minority ownership can be quite substantial and might range from 30% to 60%, depending upon the facts and circumstances. Therefore, the donee child receives interests in a partnership valued for gift tax purposes much less than the economic value of the assets which the interest in the partnership represents. Typically, the

partnership interests are designated as “units” with each unit having a value determined at the time of the gift. Gifts of these units could be sheltered by the federal gift tax annual exclusion of \$10,000 per donee per year. But because the partnership units are hard to value and may be subject to revaluation by the IRS on audit, the gift of a limited partnership interest might take the form of a formula. Thus, for example, a married couple's annual exclusion gift to a child might be described as 'that number of limited partnership units (including a fraction) equal in value to \$20,000. If IRS successfully challenges the valuation discount, the formula simply absorbs the extra value allocated to the transferred interest. Thus, the transfer remains fully protected by the annual exclusion.

The discounts for lack of marketability and minority permit the donor to leverage his annual gift tax exclusion, unified credit and generation-skipping tax exemption. For example, if the limited partnership interests are discounted by 40%, a married couple could give away to each child every year interests worth \$33,333, rather than the usual \$20,000, protected by the annual gift tax exclusion. Likewise, with a 40% valuation discount, a husband and wife could give away limited partnership interests worth \$2,000,000 protected from gift tax by their combined unified credits, instead of just \$1,350,000. Similarly, allocation of a married couple's combined \$2,000,000 GST tax exemption to a trust for their grandchildren would entirely exempt from the GST tax a trust funded with \$3,333,333 worth of limited partnership interests. Discounting the value of a limited partnership interest if the partnership is funded with non-business property may be challenged by IRS.

If the family limited partnership produces a significant cash flow, a gift of limited partnership interests to a grantor retained annuity trust (“GRAT”) is a particularly effective way to leverage the donor's unified credit. The discounts available with respect to the limited partnership interests mean that the amount of the annuity, expressed as a percentage of the fair market value of the property transferred to the GRAT, will be significantly higher, resulting in a significant reduction in the amount of the gift.

The use of family limited partnerships is not for everyone. A gift of property valued at a discount must be specifically identified on the gift tax return and will be closely scrutinized by the IRS. Transactions with little or no business substance will be attacked by the IRS and in some circumstances such attack can disallow any discount valuation. A thorough discussion of the risks and advantages should be had before the technique is undertaken.

Retain Control of Property After Gift

The general partners in a family limited partnership have exclusive control over, and management of, the partnership assets. The limited partners, on the other hand, are entitled to a proportionate part of the income distributed by the partnership, if any, and to their proportionate share of the partnership assets upon termination of the partnership, but they have no right to control and manage the partnership assets.

Because the general partner has exclusive management and investment control over the partnership assets, a parent may reduce his taxable estate by making gifts of the limited partnership interests while maintaining control over the underlying assets by virtue of retaining the general partnership interest. Such control includes the power to invest and reinvest partnership assets. More importantly, it includes the power to control the timing and amount of distributions, as a general partner is under no obligation to distribute partnership income.

Usually, the grantor's retention of the power to control the timing and amount of distributions, even if retained in a fiduciary capacity as trustee, will result in the transferred property being included in the grantor's gross estate for federal estate tax purposes. However, the retention of this power as a general partner will not cause the transferred limited partnership interests to be included in the donor/general partner's gross estate, unless the partnership is funded with stock in a 'controlled corporation.' In that event, the donor's retention of the right to vote the stock by virtue of the retained general partnership interest would cause the stock to be included in the donor's gross estate.

Moreover, the general partner (together with the limited partners) may retain the right to amend the partnership agreement without causing the partnership assets to be included in the general partner's gross estate. In contrast, if the grantor of a trust had retained the right to amend the trust, the trust property would be included in his gross estate. In drafting the family limited partnership agreement, the parent will wish to restrict the limited partner's transfer of their interests and their ability to draw upon their capital accounts. While it is possible to accomplish this, care must be taken so as not to jeopardize the availability of the annual exclusion for gifts of the limited partnership interests. If the restrictions are too great, the gifts of the limited partnership interests might not be considered present interest gifts, which is necessary to qualify them for the annual exclusion. The IRS has ruled that gifts of limited partnership interests were present interest gifts, qualifying for the annual exclusion, even where the limited partners had no right to draw on their capital accounts and their ability to sell their partnership interests to third parties was subject to a right of first refusal.

The Family Limited Partnership As An Asset Protection Device

Another advantage of the family limited partnership is that it is difficult for creditors of the limited partners to reach the underlying partnership assets. This is significant for parents who want to transfer assets to their children but are concerned a child might be sued or that a child's former spouse might obtain such assets in the event of a divorce.

Assuming the partnership agreement is drafted to prohibit transfers of partnership interests without the consent of the other partners, a creditor's remedy against the interest of a partner (general or limited) is limited to a 'charging order' against the partner's partnership interest and the creditor cannot attach the partnership interest itself. A charging order allows the judgment creditor to receive the debtor partner's share of distributions made from the partnership, but only if and when such distributions are made. Because the general partner controls the amount and timing of partnership distributions, the value of the charging order may be minimal. The judgment creditor, lacking the

vote to do so, cannot replace the general partner, force a liquidation of the partnership or compel distributions by the partnership. Finally, a 'poison pill' to applying for a charging order is that the judgment creditor would be treated as the owner of that portion of the partnership interest for income tax purposes and thus would incur a phantom income tax liability.

Fraudulent conveyance laws may permit the judgment creditor to attach the partnership interest itself if the creditor can prove that the creation of the partnership, and transfers of property to it, were intended to defraud or hinder creditors. If the debtor partner can demonstrate that the partnership has a valid purpose other than protecting assets from creditors, e.g., estate planning, the judgment creditor's success seems unlikely. Note, however, that some state courts, e.g., California, have not limited the judgment creditor's remedy to a charging order, but have permitted the judgment creditor to liquidate the partnership interest of the debtor.

Income Tax Implications

A limited partnership is a pass-through entity and partnership income and deductions are attributed directly to the partners. Since a proportional share of the partnership's income will pass through and be taxed at the limited partners' rates, the family limited partnership can shift income from the parents to the children, who may even enjoy lower income tax rates. This is so even if partnership income is not distributed to the children. However, if the child is under age 14, the income with respect to the gifted limited partnership interest will be taxed at the parent's income tax rates.

Generally, no gain will be recognized on forming a family limited partnership. However, if the property contributed to the partnership is mortgaged and the mortgage exceeds the property's basis, gain equal to the difference will be recognized.