

FAMILY LIMITED PARTNERSHIPS

Steve R. Akers
Bessemer Trust Co.
300 Crescent Court, Suite 800
Dallas, Texas 75201
www.bessemer.com

Elizabeth M. Schurig
Giordani Schurig Beckett Tackett LLP
100 Congress Avenue, Suite 2200
Austin, Texas 78701
www.gsbtlaw.com

"The hottest idea in estate planning is using a family limited partnership to shift assets from senior family members to younger members. Advantages include lower estate taxes and clear control for the older generation. But overly aggressive moves could be scorched by the Internal Revenue Service." *New York Times*, April 3, 1994

I. INTRODUCTION.

A. General Structure. What is a family limited partnership and why is it so popular? The term "family limited partnership" has no technical reference or definition in the Internal Revenue Code because a family limited partnership is simply a limited partnership whose limited partners are family members. The family limited partnership's popularity stems from the donor's ability to transfer assets down to his descendants at a lower transfer tax cost (because of the minority interest discount available to transfers of entity interests) than would be incurred with a direct transfer of the assets to descendants. Coupled with the donor's ability to retain control of the assets by retaining control of the general partner, the limited partnership is a very attractive estate planning tool.

Parents own various assets. Although they can serve as general partners in their individual capacities, they establish and capitalize an entity to act as general partner of the family limited partnership for creditor protection purposes. This entity is usually an S Corporation or a limited liability company because these entities are taxed as passthrough entities for income tax purposes. The entity and the parents (and children too, if they desire) initially form the limited partnership with the general partner holding a 1% interest and the parents owning the remaining 99% interest in the partnership. In exchange for its interest in the partnership, the general partner contributes 1% of the capital and the parents contribute the remaining assets to the partnership. The parents would then assign their limited partnership interests to their children either immediately or over time, depending upon which would produce the lowest overall transfer tax cost. If any of the donees are either minors or need spendthrift protection from creditors, trusts may be utilized to hold their interests in the partnership. This structure allows the parents, as general partners, to transfer interests in the limited partnership to the children as well as control the management and investment decisions of the partnership.

- B. Term. The family limited partnership is typically structured as a fixed term partnership. A limited partner generally has a right to withdraw from the partnership, and to receive the fair value of the limited partner's interest by giving six months notice.¹ However, that provision does not apply if the agreement specifies "the time or the events upon the happening of which a limited partner may withdraw or a definite time for the dissolution and winding up of the limited partnership."² For example, the limited partnership might provide that it is to last for thirty years. In that case, under the appropriate state law principles, limited partners would not have the right to withdraw (and to receive the "fair value of his or her interest in the limited partnership") prior to the end of the thirty-year fixed term.
- C. Management. The general partners have all management rights with respect to the limited partnership. (If there are multiple general partners, it is possible to designate a "managing general partner".) Limited partners are excluded from the management of the partnership except with respect to certain limited matters designated in the Revised Uniform Limited Partnership Act.³ If a limited partner takes part in the control of the partnership, he or she may lose his or her limited liability status with respect to a person who transacts business with the partnership reasonably believing that the limited partner was a general partner.⁴
- D. Allocation of Income and Gain. Income and gain will generally be allocated among the various partners in accordance with their percentage interests in the partnership. The Internal Revenue Code contains very detailed rules that must be satisfied in order for allocations of income and gain to be respected. There are special rules under Section 704(e) of the Internal Revenue Code that apply to family partnerships (although it is typically easy to structure the partnership in order to satisfy the special family partnership requirements).⁵

II. PURPOSES/ADVANTAGES OF FAMILY LIMITED PARTNERSHIPS. Although estate planners focus on the discounted value of the partnership interests passing to the children as the advantage and purpose of the use of the family

¹ Rev. Unif. Limited Partnership Act § 603-604 (hereinafter "RULPA").

² Id.

³ RULPA § 302.

⁴ RULPA § 303.

⁵ Reference to "Sections" will be to sections of the Internal Revenue Code of 1986, unless indicated otherwise in the context of the discussion. The "Code" shall refer to the Internal Revenue Code of 1986, as amended.

limited partnership, the real benefit to many parents is the ability to give their assets away while retaining the ability to control them through control of the general partner.

- A. Parent Can Retain Control. The Internal Revenue Service has recognized that a parent may make gifts of interests in a limited partnership, and retain investment and distribution authority over partnership assets as the general partner without causing the partnership assets to be included in his or her estate as a transfer with the retained power to control “beneficial enjoyment.”⁶ On the other hand, if a parent makes a gift of assets either directly to children or into a trust for children, it is more difficult to give the parent retained controls, particularly over the power to decide when distributions will be made, without causing the parent to have to include the gifted assets in his or her estate for estate tax purposes under Sections 2036(a)(2) or 2038.
- B. Simplification of Annual Giving. The parent may have difficulty in making gifts of undivided interests in certain types of property, especially real estate. If assets are contributed to a family limited partnership, the parent can execute a very simple one page assignment each year to assign the limited partnership interests to children. However, if the family limited partnership assets are difficult to value, annual gifting may be even more difficult with the family limited partnership, because technically all of the partnership assets would have to be valued as the first step in determining the value of the limited partnership interests that are gifted. Gifts of limited partnership interests qualify as gifts of present interests for purposes of the annual gift tax exclusion (if the limited partnership interest is assigned directly to a donee or to a trust that qualifies for the annual exclusion).⁷ Therefore, complicated Crummey type trusts are not necessary.
- C. Valuation Discounts. Discounts below liquidation value may be available with respect to limited partnership interests that are gifted or transferred by parents to children for a variety of reasons.
- The limited partnership interest has no voice in management, and is therefore analogous to a minority interest in a corporation, for which discounts typically are permitted.
 - Limited partners have no rights to underlying partnership assets, but merely own their limited partnership interests.

⁶ Technical Advice Memorandum 9131006; Letter Ruling 9415007

⁷ Letter Rul. 9415007; Tech Adv. Memo. 9131006.

- A fixed term limited partnership would not permit any limited partner to withdraw from the partnership prior to its dissolution.
- The limited partner has no ability to control cash distributions from the partnership during the continued existence of the limited partnership.
- Restrictions on transfers prevent the limited partner from being able to assign his or her limited partnership interests to someone who is not already a partner until the transfer is approved by the other partners.

However, the Internal Revenue Service may try to attack the use of the discount in one of two ways.

1. Lack of Business Purpose. The IRS may argue that the entire family limited partnership is a sham, and that it is created merely for the purpose of generating valuation discounts.
 2. Section 2704. The IRS may attempt to argue that Section 2704 technically contains limitations that apply so that the discounting is not recognized.
- D. Income Shifting. Income of the partnership is shifted pro rata to the family members who own limited partnership interests. Special rules must be satisfied in order for allocations of income to donees to be respected. If special tests contained in Section 704(e) are not satisfied, a partner who acquires his partnership interest by gift, or in some circumstances by purchase, from a family member will not be recognized as a partner for purposes of allocation of income and loss—instead, the "donor partner" will be treated as owning the donee's share.
- E. Avoiding Probate. Assets owned by a family limited partnership are owned by the entity and not by the various partners. Only a decedent-partner's partnership interest is subject to probate. Therefore, if the client owns out-of-state real properties, it may be possible to avoid ancillary probates in states where those properties are located by transferring the properties into a partnership.
- F. Consolidation of Investments for Efficiency. Consolidation of family assets into a single family limited partnership may lead to significant efficiencies and minimization of investment expenses. Providing for a unified management of family assets may be desirable for centralized control as well as for minimizing accounting and management expenses.

- G. Keeping Assets in the Family. Transfer restrictions in the partnership agreement may limit the ability of any partner to transfer his or her partnership interest to any outsider, unless the consent of all partners can be obtained. If the consent is not obtained, any transferee of a limited partnership interest would merely become an "assignee" with very limited rights until formally admitted as a substitute partner.⁸
- H. Additional Hurdle to Creditors. If a partner is unable to satisfy his or her creditors, and if the creditor seizes assets of the partner, all the creditor could acquire would be the partner's partnership interest and not any interest in specific partnership assets. A creditor would typically become simply an "assignee" whose only right is to receive the income attributable to the debtor's interest in the partnership, and with no ability to force the partnership to distribute assets to the creditor.⁹ However, some recent cases have tended to limit this protection against creditors. At the minimum, having assets in a partnership can be a substantial additional hurdle for a creditor as opposed to the creditor having the ability to seize assets individually owned by a debtor which are not in a partnership.
- I. Protection Against Failed Marriages. Some jurisdictions will not award one spouse's separate property to the other spouse in a divorce action. The partnership can assist in preserving the separate property character of a spouse's assets that are placed in the partnership. The partnership interest itself typically would be characterized as a spouse's separate property. Furthermore, most partnership agreements provide in the transfer restrictions that any transfer of a partnership interest by divorce or otherwise to any other individual must be approved by all existing partners before the transferee will become a substitute partner with full rights of a partner. Furthermore, a limited partnership interest that is subject to the management control of family members may not be an attractive asset to the ex-spouse. Some planners have even suggested using limited partnerships rather than pre-marital agreements in order to provide protection against a possible failed marriage.
- J. Retained Ability to Amend or Revoke. If a gift is made by an irrevocable trust, making any changes to the trust is extremely cumbersome (if possible at all) and involves the necessity of judicial proceedings. On the other hand, transfers to a family partnership allow much more flexibility, because the partners may agree to revise the partnership agreement at any time without court involvement.

⁸ RULPA §§ 702, 704.

⁹ RULPA § 702.

- K. Institutionalizing Communication on Family Business and Financial Matters. Having the partnership may institutionalize family communication on business and financial matters. For example, the general partner may choose to have an annual meeting with all of the family member-partners to discuss family investment goals and results, and to involve all family members in the investment process.

Mrs. Sam Walton has emphasized the importance of this factor in their family's partnership, which held their Wal-Mart stock:

It was great moneywise, but there was another aspect to it: the relationship was established among the children and with the family. It developed their sense of responsibility toward one another. You just can't beat that.¹⁰

- L. Example of Non-Tax Advantages—Sam Walton Family. Family partnerships are not new, and some families have had a long history of the very substantial non-tax advantages of family partnerships. Sam Walton discussed the importance of his family's partnership in maintaining a sense of balance and control for all family members:

Helen's [i.e., Mrs. Sam Walton's] father organized his ranch and family businesses as a partnership, and Helen and her brothers were all partners. They all took turns doing the ranch books and things like that. Helen has a B.S. degree in finance, which back then was really unusual for a woman. Anyway, Mr. Robson advised us to do the same thing with our family, and we did, way back in 1953. What little we had at the time, we put into a partnership with our kids, which was later incorporated into Walton Enterprises.

Over the years, our Wal-Mart stock has gone into that partnership. Then the board of Walton Enterprises, which is us, the family, makes decisions on a consensus basis. Sometimes we argue, and sometimes we don't. But we control the amount we pay out to each of us, and everybody gets the same. The kids got as much over the years as Helen and I did, except I got a salary, which my son, Jim, now draws as head of Walton Enterprises. That way, we accumulated funds in Enterprises rather than throwing it all over the place to

¹⁰ Walton, Sam. Sam Walton: Made in America. 1992, 7.

live high. And we certainly drew all we needed, probably more, in my opinion.

The partnership works in a number of different ways. First, it enables us to control Wal-Mart through the family and keep it together, rather than having it sold off in pieces haphazardly. We still own 38 percent of the company's stock today, which is an unusually large stake for anyone to hold in an outfit the size of Wal-Mart, and that's the best protection there is against the take-over raiders. It's something that any family who has faith in its strength as a unit and in the growth potential of its business can do. The transfer of ownership was made so long ago that we didn't have to pay substantial gift or inheritance taxes on it. The principle behind this is simple: the best way to reduce paying estate taxes is to give your assets away before they appreciate.

It turned out to be a great philosophy and a great strategy, and I certainly wouldn't have figured it out way back then without the advice of Helen's father. It wasn't lavish or exorbitant, and that was part of the plan—to keep the family together as well as maintain a sense of balance in our standards.¹¹

III. ADDITIONAL TAX CONSIDERATIONS. There are so many tax considerations inherent in the use of family limited partnerships that it is not possible to fully address them all in this article. However, a few of these additional considerations are briefly addressed below.

A. Brief Overview of Basic Taxation of Partnerships.

1. No Double Tax. The partnership itself is not subject to tax—each partner reports his or her allocable share of partnership income or loss on Schedule K of his or her personal income tax return(s).
2. No Gain Recognition on Distribution of Appreciated Property. If a corporation distributes any appreciated property, the corporation will recognize a gain as if it had sold the property. There is no gain recognition by a partnership when it distributes appreciated property.

¹¹ Walton, Sam. Sam Walton: Made in America. 1992, 6-7.

3. Cash Distributions Not Generally Subject to Income Tax. A cash distribution to a partner will not create taxable income (because the partner is taxed directly in each year on partnership profits). However, cash distributions in excess of the partner's basis in the partnership will result in recognition of gain to the extent of the excess.
4. Step-Up of "Inside Basis" upon Transfer of a Partnership Interest. If a person purchases a partnership interest at a cost greater than the transferor's share of the partnership's basis in its assets, the partnership's basis in the assets for purposes of determining future gains or cost or recovery deductions attributable to that partner can be increased (if an appropriate election under Section 754 is made).
5. Basis of Partnership Assets for Deceased Partner's Interest. An election may be made under Section 754 that will permit a deceased partner's interest in partnership assets to receive a step up in basis.
6. Flexibility in "Bailing Out" Assets From the Partnership and Flexibility of Planning Liquidation of Retiring or Deceased Partner's Interest. Distributions from the partnership to a partner generally will result in taxable gain to the partner only if money distributed exceeds the adjusted basis of the partner's interest.¹² (Distribution of property other than money generally does not result in taxable gain or loss, and the partner has a carryover basis in the asset—based on the partnership's basis in the asset in the case of a non-liquidating distribution, and based on the partner's basis in his partnership interest in the case of a liquidating distribution.)¹³ An exception exists for non pro rata distributions from a partnership that has unrealized receivables or substantially appreciated inventory, in which case the recipient partner or partnership can recognize a gain.¹⁴ Special rules apply to payments from the partnership to a retiring or deceased partner. Even in that case, however, distributions of assets other than money generally are treated the same as under the general distribution rules described above.¹⁵

¹² I.R.C. § 731(a)(1).

¹³ I.R.C. § 732.

¹⁴ I.R.C. § 751.

¹⁵ I.R.C. § 736.

7. Partnership Return Required. Although a partnership uses a flow-through treatment for tax purposes, a partnership income tax return is required (which can be rather complicated).

B. Classification As Partnership Rather Than Association.

1. Significance. Consideration must be given to whether the partnership could be treated as an "association taxable as a corporation" under Section 7701. If an organization thought to be a partnership by the participants were reclassified as an association taxable as a corporation, the classic "double tax" applicable to corporations would be imposed on the partnership.
2. Overview of Corporate Characteristics. The regulations provide that there are six corporate characteristics that must be considered in determining whether an entity will be classified as an association taxable as a corporation. Two of the characteristics (associates and objectives to carry on business and to divide the gain therefrom), are common to both corporations and partnerships, and thus are not taken into account. Accordingly, the remaining four characteristics, continuity of life, centralization of management, limited liability, and free transferability of interests, are the determinative factors.¹⁶ The regulations state that only in a situation in which a majority of the corporate characteristics are present will the entity be deemed an association taxable as a corporation. Therefore, if an unincorporated organization lacks any two (or more) of these characteristics, it will not be classified as an association.

- C. Anti-Abuse Regulation. Proposed Regulation § 1.701-2 was a very broad anti-tax abuse regulation. Although it was part of the income tax regulations, the preamble to the regulation states that it is intended to apply "for all purposes of the Code (e.g., income, estate, gift, generation-skipping, and excise tax)." The operative portion of the regulation provides as follows:

". . . if a partnership is formed or availed of . . . with a principal purpose of substantially reducing the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of Subchapter K, the Commissioner can disregard the form of the transaction. In

¹⁶ Treas. Reg. § 301.7701-2.

such case, . . . the Commissioner can recast the transaction for federal tax purposes as appropriate."

None of the examples cited in the proposed regulation addressed the application of the regulation in the estate and gift tax area. Final regulations were issued December 30, 1994, and the final regulations surprisingly included two examples dealing with the estate tax effects of family partnerships. Example 5, illustrated permissible tax treatment of a family partnership valuation, and Example 6 illustrated a transaction which impermissibly valued a family partnership (which contained only a vacation home). Announcement 95-8, I.R.B. 1995-7 deleted Examples 5 and 6 from the final regulations. Announcement 95-8 announced that the regulation will be amended as of its effective dates to provide that it applies solely with respect to taxes under subtitle A (income taxes), and not through transfer taxes. Announcement 95-8 specifically stated that no inference is intended as to the treatment under current law of transactions not covered by the regulation.

IV. CREDITOR ISSUES. Limited partnerships also provide some protection from creditors.

- A. General Remedy—Limited to Charging Order. Because partners do not have interests in specific partnership assets, creditors of partners similarly have substantially less rights than they would have against assets directly owned by a debtor not inside a partnership. The creditor's remedy is generally limited to obtaining a "charging order" against the debtor's partnership interest. Absent any fraudulent conveyance to the partnership, a creditor generally may not reach specific partnership assets.¹⁷ The creditor's "charged" interest includes only the rights of an assignee of the partnership interest.¹⁸
- B. Limits of Rights as Assignee. Because the "charging order" gives a judgment creditor only the rights of an assignee, it is important to understand that an assignee has the right only to the income portion of the partner's interest when, and to the extent, declared by the general partner.¹⁹ The partnership laws of some states also give an assignee the right to inspect partnership records.²⁰

¹⁷ RULPA § 703.

¹⁸ Id.

¹⁹ RULPA § 702 (right to receive only distributions to which the assignor would be entitled).

²⁰ E.g., Tex. Limited Partnership Act § 1.07(d).

- C. Income Tax Effect of Creditor's Charging Order and Foreclosure. Revenue Ruling 77-137 provides that if a limited partner irrevocably assigns his or her interest in profits and losses of the partnership to an assignee who is not recognized as a substitute limited partner by the remaining partners, the assignee must report the distributive share of partnership items of income, gain, loss, deduction, and credit attributable to the assigned interest where the assignee acquired substantially all of the dominion and control over the assigned limited partnership interest.²¹ Under this ruling, income of the partnership will be taxed to the assignee even if no income is distributed by the partnership. However, it is unclear to what extent Revenue Ruling 77-137 will apply to a charging order. Revenue Ruling 77-137 applied to a situation in which a limited partner had irrevocably assigned its interest to an assignee. In the situation of a charging order, the creditor owns the interest only until the debt is paid, and the assignment is not irrevocable (unless the creditor actually forecloses on the partnership interest). Accordingly, it is unclear whether the debtor-limited partner or whether the creditor will be taxed on the partnership's distributive share of income during the period of time that the creditor merely holds a charging order.
- D. Creditor's Rights in Bankruptcy. Upon the bankruptcy of a general partner, the Bankruptcy Code can preempt state law limited partnership provisions and provisions of a partnership agreement if they are economically detrimental to the bankrupt estate.²² The effect of the bankruptcy of a limited partner is more restricted because the bankruptcy of a limited partner generally will not cause the dissolution of the partnership.
- E. Summary. Fraudulent conveyance principles are applicable to family limited partnerships. Therefore, family partnerships should not be planned with the intent of hindering or delaying creditors. At best, clients should look upon the family limited partnership as a possible hurdle to a creditor rather than as an absolute protection device.

²¹ Rev. Rul. 77-137, 1977-1 C.B. 178.

²² See Collier Real Estate Transactions and the Bankruptcy Code § 4.07[1] (King ed. 1991).