CHAPTER 43

FAMILY LIMITED PARTNERSHIPS

*Note:* A checklist of issues to consider when choosing an entity, such as a proprietorship, partnership, limited liability company (LLC), C corporation, or S corporation, appears at the end of Chapter 47 as Figure 47.4.

INTRODUCTION

A family partnership is a partnership that exists between members of a family (defined for income tax purposes as including only an individual’s spouse, ancestors, lineal descendants, and any trusts established primarily for the benefit of such persons).[[1]](#endnote-1) If a partnership among family members is a genuine partnership, it will be treated tax-wise the same as any other partnership and the same rules will apply.

The family partnership is a technique frequently used as a means of both shifting wealth and splitting income among a family unit. However, the benefit of shifting income to children under age 18 and in some cases under age 24, has been substantially eliminated. For children under age 18 and in some cases under age 24, unearned income in excess of $2,100 (as indexed for 2015) generally will be taxed at the parent’s top marginal rate under the “Kiddie Tax” rules.

Although some family partnerships have sometimes been attacked by the IRS as being mere tax avoidance schemes that should not be recognized for tax purposes, if the rules for establishing and operating such partnerships are carefully followed, the IRS currently recognizes the validity of this income shifting device.[[2]](#endnote-2) Although the IRS has asserted that a taxable gift can arise upon the contribution of capital to a family limited partnership, this argument was rejected where the partnership agreement allocated income and expenses on a pro rata basis based on the partners’ contributions to the partnership. The court stated there cannot be a gift on formation where each investor’s interest is proportional to the capital contributed.[[3]](#endnote-3)

Two major forms of family partnerships commonly used are the general partnership and the limited partnership.

The general partnership is an entity under which all partners have a voice in management (by percentage vote) but are personally liable for all of the debts and other liabilities of the general partnership. This very negative aspect often makes the general partnership entity unsuitable for family wealth preservation and has prompted the use of the limited partnership for the majority of family activities for which a partnership is appropriate.

One benefit of a general partnership is that, in some circumstances, the partners may share in the losses generated by the partnership for income tax purposes. This is much more difficult for limited partners due to the passage of various “anti-tax shelter” laws which restrict the sharing of losses among partners in limited partnerships.

A Family Limited Partnership (FLP) is a limited liability entity created under state law. Family limited partnerships are so named because ownership of partnership interests typically is limited to members of the same family unit. Since the limited partnership form is most frequently used for the majority of family activities, this chapter will deal mainly with that form of doing business or holding assets.

Ownership rights in the FLP are governed by state law as modified by the partners’ FLP agreement. Most states have adopted the Uniform Limited Partnership Act (ULPA) or some modified version thereof. Although there may be slight differences in the statutory partnership rules from one state to another, there generally is a high degree of uniformity among the states.

Upon formation, family members contribute property in return for an ownership interest in the capital and profits of the FLP. The partners designate a general partner (or general partners) who will be given management responsibility and who will assume personal liability for debts and other liabilities that are not satisfied from the assets of the FLP. Conversely, in return for giving up their rights of management and control over the assets of the FLP, the personal liability of the limited partners generally is limited to the amount of capital that they contribute.

Although an underlying purpose of most FLPs is to manage family assets and to plan for the transfer of such assets from parents to children, many parents are not willing to part with control over their assets when the FLP is created. In some cases, the parents simply desire to continue managing their property, and in other cases, the children lack the maturity or business skills required to manage the assets. In the latter case, an FLP usually provides the parents with the time and opportunity to educate their children about managing and investing their assets and involve them in the process and thus provide an important non-tax reason for their creation.

Although a thorough understanding of partnership law is essential to preparing an effective limited partnership agreement, the concepts underlying FLPs are not difficult to comprehend and an FLP can be easily integrated into an estate plan.

WHEN IS USE OF SUCH A DEVICE INDICATED?

Family limited partnerships are often used to fractionalize the ownership of business assets, investment assets such as marketable securities, or real estate to take advantage of gift and estate tax valuation discounts (see Chapters 57 and 59) which significantly reduce transfer taxes. In most cases, an FLP will be used to facilitate the making of gifts of limited partner interests from parents to children and other family members without divesting control from the parents. In other cases, an FLP will be used to ensure continuous ownership of assets within the family unit for several generations.

Until most recently, FLPs were used primarily as a means of (1) shifting the income tax burden from parents to children or other family members or (2) to “freeze” the value of assets by shifting future growth in various assets to other family members. Although these uses have been somewhat curtailed by the passage of the Kiddie Tax and the enactment of IRC Section 2701, the many other benefits provided by the FLP have made it a valuable tool in developing a comprehensive estate plan.

With greater frequency, many practitioners are coming to recognize the many tax and non-tax benefits that an FLP can provide. An FLP would be an appropriate device in the following circumstances:

1. To reduce the value of an estate for transfer tax (e.g., estate, gift, and generation-skipping) purposes.

Because control of the assets of an FLP is centralized in the general partner(s), a limited partner often experiences an immediate decrease in the value of his interest compared to the value of the property contributed to the FLP. This decrease in value results because of the lack of control and highly reduced marketability that accompany ownership of assets indirectly through a limited partnership interest, as well as the inherent inability of a limited partner to unilaterally or immediately access the capital or the profits of the FLP.

It is well accepted that value often appears and disappears in an FLP. Value can appear in the form of a control premium that attaches to the right to manage assets or to liquidate assets into cash. Value can disappear due to the giving up of management rights and exchange of assets in return for a virtually unmarketable ownership interest.

Past cases demonstrate that the value of FLP interests typically will be reduced by valuation discounts falling within the 30% to 35% range. Under these circumstances, it is possible that a married couple with a taxable estate (before discounts) of about $14,000,000 in 2015 could use an FLP to reduce the value of their estate to a point where little or no estate tax is owed.

2. When it is desired to shift the income tax burden from a parent who is in a high income tax bracket to a child or other relative who is in a lower income tax bracket, thus providing intra-family income splitting and tax saving.

Use of an FLP can facilitate parents’ shifting of income to their children, with the income taxed at the child’s lower income tax bracket. This will increase the family’s cash flow. Although the gradual narrowing of the federal income tax rate brackets for individuals (the maximum rate is 39.6%) and enactment of the Kiddie Tax have reduced the effects of income shifting, substantial income tax savings can still be achieved in the majority of cases. (Example 1 at the end of this chapter presents an illustration of the income shifting context in the case of a family business).

3. Where it is desirable to conduct a family business in a form other than a sole proprietorship or a corporation.

In selecting a choice of business entity, the use of a corporation may cause tax problems that would not exist if the business were instead operated as an FLP. For example, subchapter C corporations are subject to personal holding company rules, the accumulated earnings tax, and unreasonable compensation problems, while subchapter S corporations are restricted as to who and how many persons may be shareholders. Similarly, placing a sole proprietorship business into a trust may result in the trust taxed by the IRS as a corporation, which is usually a very bad result. FLPs generally offer flexibility in income taxation compared to these other forms of businesses. (A summary of some of the differences in these business entity forms is provided at the end of this chapter).

4. Where a parent desires to maintain control over assets that will be transferred to younger generations through gifts of limited partner interests.

One of the major benefits of an FLP is the ability to retain control over assets or business interests without having to own a majority of the interests of the FLP. This permits parents to transfer their assets to an FLP and then give or sell a majority interest (50% or more) to the children while retaining control over the assets. Such control can be achieved by retaining as little as a 1% general partner interest in the FLP. Although the children may hold a majority interest in the FLP, the effective control over the assets remains in the hands of the general partner.

Use of an FLP can also permit the parents to implement a succession plan for the ownership, management, and control of assets so that undesired beneficiaries do not gain access to the assets.

5. Where it is desirable to protect assets from creditors of the partners.

If a senior family member is in a high risk profession, such as a doctor, engineer, or builder who is vulnerable to lawsuits, an FLP may be effective to shield personal assets by placing them in the hands of other family members, away from the reach of the senior partner's future creditors. In most cases, a judgment creditor will be unable to attach partnership assets to satisfy a debt of an individual partner.

However, although the asset protection features of an FLP (discussed below) may discourage a creditor from aggressively seeking satisfaction of the debt from the partnership assets, the use of an FLP as an asset protection device may also prevent the assets from being reached by the partner since a judgment creditor has the right to attach the partner’s interest in the FLP or attach any assets that are distributed by the FLP to the partner. This characteristic may cause a stalemate between the partner and creditor, and encourage settlement of the debt at an amount that is favorable to both parties.

Protecting assets may also present a number of ethical issues for the practitioner since certain transfers can be attacked as fraudulent conveyances. For these reasons, extreme care and consideration should accompany the use of an FLP for any such purpose.

6. When retention of ownership of assets within the family unit is desired.

By including in the FLP agreement a right of first refusal for transfers of partnership interests, the partners can virtually guarantee that outside persons will not acquire ownership interests in the FLP. Also, by limiting the rights of a transferee partner to that of an “assignee” (who lacks voting rights) the ability of a partner to sell his interest is likely to be severely impaired, thereby achieving the intended goal of maintaining immediate family ownership.

7. Where a parent desires to protect assets, which are to be transferred to younger generations, from being dissipated through mismanagement or divorce.

A parent who makes gifts of property to his children runs the risk that the child will cause the gift to be unwisely managed or lost to a spouse or creditor. These pitfalls can be avoided by placing the assets into an FLP instead and transferring a limited partner interest to the child. In this case, the parent may retain control over the assets until the child is mature and has achieved sufficient financial acumen to manage the property.

Similarly, because a divorce action can result in the court awarding the spouse a share of the limited partner interest, it may be worthwhile for the parent to transfer the interest to the child in trust to be held for the child’s lifetime, thereby defeating the rights of the divorcing spouse.

8. Where flexibility in setting the rules for managing property is desired.

Unlike an irrevocable trust, an FLP can be amended by vote of a given percentage of partnership interests. This results in a parent being able to easily change the governing rules that apply to the partnership, if the parent maintains the necessary percentage ownership interest to amend the agreement.

9. To simplify ownership of assets.

Use of an FLP may allow for cost savings through consolidation of ownership into one entity. Such consolidation may result in diversification of money managers and reduced investment adviser fees. By pooling family assets, the FLP may obtain advantages in terms of diversification and size of investment that cannot be achieved individually by the partners.

Further, by giving the general partner discretion to reinvest partnership profits over the long-term, the FLP can carry out an investment strategy that focuses on long-term benefits to the partners. In situations where generation-skipping trusts are used to hold FLP interests during the lifetime of a beneficiary, the death of the beneficiary will not pose a threat to the continued operation of the FLP, since the FLP provides for continuity of ownership and estate tax will not be due on the FLP interest held in a generation-skipping trust (to the extent the assets and estate tax “skip” the child).

10. To ease the distribution of assets at death among family members without having to remove the assets from the partnership.

Upon the death of a parent, assets may remain in the partnership and only partnership interests are transferred to the heirs (to the extent permitted under the Limited Partnership Agreement), thereby enabling the partnership operations to remain intact.

11. To avoid out-of-state probate costs.

Since FLP interests are considered *personal* property, they should not be included for probate purposes in those states in which the property exists – even if it is real estate. Such interests are subject to probate only in the domiciliary state of the partner.

12. To discourage family members from fighting over FLP assets, and to provide a forum for the resolution of disputes among family members if and when such disputes arise.

Unlike trusts, an FLP agreement may require binding arbitration of disputes among the partners for all issues relating to partnership assets. Further, the FLP agreement may be drafted so that the losing partner must pay the court fees of the prevailing party, thereby reducing the likelihood and cost of litigation among the partners.

WHAT ARE THE REQUIREMENTS?

Because state law governs the formation of partnerships, it is necessary to refer to the applicable law of the state in which the partnership is formed to determine the various procedural aspects of forming a limited partnership. In general, the following requirements will need to be met in order to create a limited partnership that will be respected for state law purposes.

1. A written agreement setting forth the rights and duties of the partners. If no written agreement exists, the terms of the partnership may be difficult to prove if claimed to be different than under applicable state law.

2. Filing a certificate of limited partnership and obtaining all necessary business licenses and registrations.

3. Obtaining a separate tax identification number for the partnership.

4. Transferring title of all contributed assets into the name of the partnership and opening new accounts in the name of the partnership.

5. Amending contracts to show the partnership as the real party in interest (e.g., adding the partnership as an additional insured on liability insurance policies).

6. Avoiding commingling of partnership assets with those assets of the individual partners or using partnership assets for personal business of the partners.

7. Filing annual state and federal income tax returns and allocating partnership income to the partners.

8. Paying annual state franchise taxes, if applicable, and making any other filings required under state law.

PROVIDING MANAGEMENT AND CONTROL

Control over assets contributed to an FLP is achieved by retaining ownership of the general partner interest (or the managing partner interest in cases where the FLP has multiple general partners). In most instances, the most important decision to be made in creating an FLP is deciding whom to name as the general partners since they will exercise exclusive control over the partnership business operations and determine if, when, and how much of, the partnership income is to be distributed to the partners.

For estate planning purposes, it may be advisable for the partners to implement a succession plan for management. This may be achieved by designating a non-managing general partner who will succeed in the duties of management and control upon vacancy of the general partner’s interest.

For most FLPs, possible general partners include one or both parents, either individually or as trustee of a family living trust, an S corporation or limited liability company controlled by one or more persons, or mature and financially experienced and responsible children or grandchildren (individually or using trusts for their benefit). It is not recommended that children be given management powers over their parents’ assets unless the parents expressly desire to relinquish control and the child has sufficient experience and maturity in managing property.

Even though much of the value of the FLP may be given away by transferring limited partner interests to the children, the general partners maintain control of the management and investment of the assets in the FLP even though they retain only a small percentage ownership interest. For this reason, many practitioners recommend use of an FLP for parents who desire to maintain control of their assets while having transferred away most of the assets’ economic benefits.

The general partner should have the necessary willingness, knowledge, and experience to do the following:

1. Manage and invest partnership assets.

2. Make decisions as to distributions of partnership income and/or assets.

3. File income tax returns on behalf of the partnership and understand the income tax law.

4. Furnish annual partnership income tax information (Schedule K-1) to the partners.

5. Make necessary filings with the state’s Secretary of State.

6. Give or withhold consent to transfers of partnership interests and amendment of the FLP agreement.

ENSURING FAMILY OWNERSHIP

Continuous family ownership of the FLP is guaranteed by restricting each partner’s ability to sell or otherwise transfer his interest to non-family members. Because most FLPs are used by parents to transfer partnership interests to their children at reduced transfer tax values, the existence of rights of first refusal, buy-sell provisions, or other restrictions on transfer are of paramount concern and require considerable attention. However, much care must be exercised in drafting the partnership agreement in order to avoid the transfer tax pitfalls of Chapter 14 of the Internal Revenue Code (see Chapter 59).

In almost all instances, the FLP agreement should prohibit the partners from selling or transferring their interests in a manner that is disruptive to the continuation of the family asset arrangement plan or disruptive to family harmony. To achieve this result, the FLP agreement typically will provide the partners and/or the partnership a right of first refusal to deal with a circumstance where another partner wishes to sell, or otherwise transfer, his interest to a non-family member. In such cases, the non-selling partners will usually have the right to purchase the interest of the selling partner for cash or with an unsecured long-term promissory note which bears an interest rate favorable to the buyer (but note that the restriction should not constitute “financial detriment” to any donee partner and such restriction should also satisfy the requirements of IRC Sections 2703 and 2704). Only if the non-selling partners or the partnership itself fails to exercise purchase rights may the interest then be sold to the non-family member.

If the family members do not wish for the new partner to possess any voting rights, then the agreement should permit them to treat the new partner as a mere assignee, who is entitled to receive only income distributions and a proportionate share of partnership income, expenses, deductions and credits. This mechanism provides the family members with protection from the influence of undesired active partners, enhances continued family ownership, and does not disrupt good asset management.

REDUCING TRANSFER TAXES

For individuals having substantial wealth, another important benefit of implementing an FLP is the reduction of values for transfer tax purposes. As a general rule, the value of an FLP interest is worth less than direct ownership of the same percentage interest in the underlying assets of the FLP. Put another way, the sum of each of the FLP interests combined does not equal the sum of the assets themselves. This is because ownership of a limited partner interest in an FLP does not convey any rights of management or control over the underlying assets and the FLP agreement prohibits the partners from freely transferring their interests to non-family members. Accordingly, transfer tax values are reduced by the application of discounts (determined by appraisal) to reflect these restrictions.

Because FLPs may be used to transfer partnership interests to lower generation family members, reduced transfer tax values allow for (1) shifting a greater amount of partnership interests by percentage from parents to subsequent generations, and (2) lower overall estate tax liability on those interests retained by a deceased partner. For the majority of FLPs, combined discounts in the range of 25% to 35% are typically achieved – and in some cases valuation discounts are even higher. Lower discounts in the range of 5% to 10% should generally be expected when the underlying assets are themselves readily marketable. Even with a modest discount, the potential gift or estate tax savings can be considerable when compared to taking no action.

Recently in *Keller v. U.S*.[[4]](#endnote-4), the court dealt with the question of whether the securities were actually transferred upon the formation of the partnership even though the actual title was not transferred until after the death of the donor. On this basis, the Court upheld the valuation discount. The government had argued that decedent’s failure to complete the formalities of the transfer or fill out Schedule A prior to her death prohibited the bonds’ transfer. The prevailing argument in the case was that the transferor’s intent to transfer the assets was sufficient. This is an interesting case; but it is important to note that the holding was based upon Texas law and may not be generally applicable.

Despite the reduction in value of FLP interests, the real income production and growth potential of the FLP’s assets remain available to the partners since control remains within the family unit.

SECURING VALUATION DISCOUNTS

A *discount for lack of control* is routinely applied in establishing estate and gift tax values of minority limited partner interests (see Chapter 59 for a detailed discussion of discounts to FLP interests). This discount reflects the inability of a limited partner to control the operations of the FLP and to invest its assets in a manner that is of the greatest benefit to such limited partner.

Because management and investment decisions (including the decision as to when to distribute partnership income) are outside the control and influence of the limited partners, the value of a limited partner’s interest is reduced to reflect such lack of control. Typical discounts for lack of control (minority interest) generally range between 20% and 30%.

A *discount for lack of marketability* is also applied to the value of privately-held limited partnership interests that do not offer a readily available market for trading. Such a discount reflects the fact that a partner who contributes assets to an FLP in return for a limited partnership interest generally will have difficulty in finding a buyer (if one exists).

Because a central purpose of most family limited partnerships is to maintain ownership of assets for the benefit of members of one or more selected families, FLP documents generally contain specific provisions to assure that ownership interests will remain within the family group. Each of these provisions, by design, reduces the marketability and therefore the value of an interest to a hypothetical buyer.

Factors that typically influence the level of the discount for lack of marketability include the nature of the FLP’s asset mix (e.g., real property, securities, equipment, etc.), the availability and accuracy of information relating to the FLP and its owners, the existence of transfer restrictions against ownership interests, the willingness of the partners to accept new partners, whether income is currently distributed to the partners, and the expected date on which capital contributions will be returned to the partners.

The inclusion of rights of first refusal and other transfer restrictions in the FLP agreement reduce the marketability of an FLP interest for transfer tax valuation purposes (provided that the requirements of IRC Section 2703 are satisfied), further reducing values for estate tax and gift tax purposes. Based upon the number and severity of the transfer restrictions and the factors stated above, lack of marketability discounts may reach as high as 30% or more.

A discount for built-in capital gains tax may also apply to the value of privately-held limited partnership interests if the tax basis of the assets owned by the partnership is demonstrably lower than the current fair market value of such assets, thereby signifying future potential capital gains tax liability. To the extent that the net asset value of the partnership is subject to inherent gains tax liability, consideration should be allowed for valuation purposes.[[5]](#endnote-5)

Additionally, in determining the value of an interest in an FLP, consideration should always be given as to whether the interest can be liquidated through the enforcement of withdrawal rights. If the partnership agreement or state law does not confer upon the limited partner any right to withdraw capital, then the limited partner’s investment may remain in the partnership until expiration of the partnership term (often 35-50 years in length) or longer if the partners elect to amend the limited partnership agreement and continue the term of the partnership. In such case, the limited partner’s interest is said to be “locked-in” to maintaining his investment in the partnership and a *lock-in discount* is appropriate.

In determining whether a lock-in discount is applicable, IRC Section 2704(b) must be reviewed. This section is discussed in greater detail in Chapter 59.

PROTECTING ASSETS

Family limited partnerships provide a limited degree of asset protection to the partners since underlying assets of the FLP generally cannot be attached to satisfy personal debts of the limited partners. Under the Uniform Limited Partnership Act, the remedy of a personal creditor is to obtain a “charging order” from a court against the interest of the limited partner. The charging order entitles the creditor to receive the distributions that would normally be paid to the limited partner until the debt is fully paid.

A charging order does not give the creditor any voting rights in FLP matters and the creditor cannot be assured that the general partner will elect to pay out the FLP income to the partners. Furthermore, the IRS in Revenue Ruling 77-137 has indicated that even though the general partner does not pay out any income to the creditor and other partners, the responsibility for paying the income tax attributable to the attached limited partner’s interest will fall upon the creditor.[[6]](#endnote-6) This may, or may not, prove true in a given case. But the mere threat of tax liability without income to pay that liability is strong incentive for creditors to enter into more favorable settlement with debtor-partners.

Notwithstanding the negative aspects of a charging order, a debtor partner is not necessarily guaranteed access to FLP assets if the judgment creditor is insistent upon collecting its debt. The judgment creditor may quietly wait for the partnership to distribute assets to the debtor partner in hope of attaching the assets immediately after distribution. For this reason, the use of an FLP by itself as an asset protection device is not a guaranteed means of avoiding creditor liability. If creditor protection is a primary motivating force, tools and techniques other than FLPs should be considered.

Additionally, in view of the surge in popularity of the use of FLPs and the emphasis placed on their asset protection features, it is likely that future courts may be reluctant to continue such asset protection for partnerships in which substantially all of the interests are owned by one person or family, or the assets of the partnership are mainly liquid in nature (e.g., marketable securities, cash, etc.).

INCOME TAX ASPECTS

IRC Section 704(e) was enacted to prevent taxpayers from using family partnerships as a means of artificially splitting family income to circumvent the progressive tax rate structure of the federal income tax. In order for a donee-partner of an FLP to be recognized as a partner for income tax purposes (i.e., to shift the income tax burden to the lower bracket junior age partner), the following three factors must be satisfied:

(a) Capital must be a material income-producing factor. This means that the FLP’s business must require substantial inventories or substantial investment in plant, machinery, or other equipment, as contrasted with a personal service corporation.[[7]](#endnote-7)

(b) A donee or purchaser of a capital interest in a partnership is not recognized as a partner unless such interest is acquired in a bona fide transaction, not a mere sham for tax avoidance or evasion purposes. The donee or purchaser must be the “real owner” of such interest.[[8]](#endnote-8)

(c) The donee’s distributive share must be included in his gross income, except to the extent that such distributive share is determined without allowance of reasonable compensation to a donor partner for services rendered to the partnership and except to the extent that the portion of such distributive share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor’s capital.[[9]](#endnote-9)

The validity of an FLP for income tax purposes is dependent upon the donee partner’s “owning” a capital interest. The Code does not define exactly what constitutes “ownership” of a capital interest. However, the regulations state that a transferee of a partnership interest must be the “real owner” of the capital interest and have dominion and control over that interest.

As provided in the IRS regulations, there are four types of retained controls (i.e., powers retained by a donor of an FLP) that are of particular importance in showing that a donee lacks true ownership of his interest. If the donee is not the real owner of his capital interest, then the income attributable to the capital interest will be taxable to the donor.

These controls include:

(a) The donor’s retaining control of the distribution of income or restricting the amount of such distributions.

(b) The donor’s limiting the right of a donee partner to dispose of his interest without financial detriment.

(c) The donor’s retaining control of assets that are essential to the operation of the partnership's business.

(d) The donor’s retaining management powers which are inconsistent with normal partnership relations.[[10]](#endnote-10)

The cases that have discussed whether a donee is a real owner stress the importance of receiving current distributions of income.[[11]](#endnote-11)

Because partnership agreements frequently limit the ability of a partner to transfer or liquidate his interest, it is important that the partner be able to dispose of the interest “without financial detriment.” This test is aimed at determining whether the partner has control over the current benefits of the interest. The term “financial detriment” is interpreted as requiring that the partner be able to realize the fair market value of the interest. Thus, the regulations indicate that a partnership agreement that requires a partner to first offer his interest to the partnership (or partners) at the same price as that of any bona fide offer from an outside party will not be considered as imposing a financial detriment upon the interest of a donee partner.

The regulations under Section 704(e) allow a donor to retain management or voting control over a family partnership if the retention is of a manner that is common in ordinary business relationships.[[12]](#endnote-12) However, the donor’s retention of control is directly related to the donee’s ability to dispose of the interest without financial detriment. Generally, the donee will not be deemed to possess this right unless he is both independent of the donor and has sufficient maturity and understanding of his rights to exercise his right to withdraw his capital interest from the partnership. Thus, FLP interests that are transferred to minors should be held either by a guardian or in trust.

In addition to these direct controls, an examination of several indirect controls may determine if a donee partner is a real owner of his capital interest. As provided in the regulations, the following factors are to be examined:

(a) Whether the donee participates in the management of the business.

(b) Whether there have been income distributions to the donee partner.

(c) Whether the donee partner is held out to the public as a partner.

(d) Whether the partnership has complied with local laws regarding use of fictitious names and other business registration statutes.

(e) Control of business bank accounts.

(f) Whether the donee’s rights in distributions of partnership property and profits have been recognized.

(g) Whether the donee’s interest is recognized in insurance policies, leases, and other business contracts, and in litigation affecting business.

(h) The existence of written agreements, records, memoranda, which establish the partnership and partners’ rights.

(i) Whether the partnership has filed income tax returns.[[13]](#endnote-13)

Assuming that a FLP satisfies the requirements of Section 704(e), a number of valuable income tax benefits may be provided to the partners. Among these benefits are the following:

1. Pass through of items of income, expense, credit, and deduction to the partners.

2. Achieving a “step-up” in income tax basis in FLP assets for interests received from a deceased partner (or upon purchase by a new partner) if an election is made by the general partner under IRC Section 754.

3. Withdrawal of assets without recognition of taxable gain (unlike corporate ownership).

4. Income shifting to family members.

5. No income tax gain on contribution of assets to the FLP or upon dissolution of the FLP in most cases.

These income tax benefits make FLPs extremely attractive in planning for income tax responsibilities of the partners. If properly structured, the FLP will not increase income taxes and may even reduce income taxes in some cases.

Other tax implications exist in operating an FLP. In general, the following rules will apply:

1. A reasonable allocation of partnership income must be made to any donor partner (which includes a parent who has sold a partnership interest to a family member) to recognize the value of his services to the FLP in order for the family partnership rules of Section 704(e) to be satisfied.

Where interests of family members are acquired by gift and/or intra-family sale, a mandatory allocation of the FLP’s profits in proportion to capital contributed, after due allowance has been made for the donor’s services, must be made. For example, assume father and son are each 50% partners in an FLP that has a net income of $100,000. Father is paid $20,000 as reasonable compensation for his services. The remaining $80,000 would be taxed $40,000 each to father and son. This would be in addition to the father’s reporting $20,000 of income for his services to the FLP.

If a contributing partner acquires capital from an independent source and not by an intra-family gift or purchase, the mandatory allocations described above will not apply and profit and loss may be allocated in a different manner.

2. Unless an election is made by the FLP to be taxed as a corporation, the partnership itself does not pay federal income taxes since it is a passthrough entity.

However, a federal income tax return (Form 1065) must be filed showing each partner’s allocable share of income, expenses, deductions, and credits. Each partner must pay income taxes based upon his share of partnership income.

3. Generally, no gain or loss is realized when property is contributed to the FLP.

However, Code Section 721 should be examined in order to ensure that the FLP is not classified as an “investment company” which would cause income tax on gains to be owed due to the formation of the partnership if the formation causes diversification of concentrated positions. The Section is designed to prevent taxpayers from diversifying their investments without the recognition of gain. The rules for determining whether an FLP is an investment company are the same rules found under IRC Section 351. Under these rules, an investment company exists if 80% or more of the entity’s capital is comprised of marketable securities held for investment purposes and diversification of assets among the partners has occurred.[[14]](#endnote-14) In this instance, a limited partner will be forced to recognize built-in gain on property he contributes. In making contributions to an FLP, the basis of the FLP in the contributed assets is the same basis the property had in the hands of the contributing partners.

Recognition of gain can occur upon receipt of distributions to the extent that the money received exceeds the limited partner’s basis in his partnership interest. Marketable securities are deemed to be money unless they were contributed by the limited partner. Also excluded from being considered “money” are securities which were not a marketable security at the time they were acquired and distributions from an investment partnership (any partnership not engaged in a trade or business, 90% of whose assets consist of marketable securities).

There could also be income recognition in the event the property contributed is subject to debt, and the contribution relieves some of the debt of the contributor. Property with built-in gain can require recognition if: the partnership sells the property for a gain, then the gain is attributed to the contributing partner; the partnership distributes the property to a partner other than the contributing partner within 7 years of contribution (the gain is allocated to the contributing partner); or the property is distributed to the contributing partner within 7 years which will cause recognizable gain “to the lesser of the fair market value of the distributed property in excess of the contributing partner’s tax cost basis in his or her partnership interest or the pre-contribution gain.”[[15]](#endnote-15)

4. Gifts of FLP interests are subject to gift tax and will likely raise questions concerning the value of the transferred interest.

The regulations state that the same principles that apply in valuing stock in corporations apply to valuing interests in an FLP. The fair market value at the date of gift will be the value for gift tax purposes.[[16]](#endnote-16)

In valuing interests in a family limited partnership, regulations set forth requirements for providing “adequate disclosure” to the IRS, in order to commence running of the gift tax statute of limitations.[[17]](#endnote-17) The following is a synopsis of these requirements:

a. *Non-gift transactions*

* same information as required for adequate disclosure of a gift
* explanation describing why the transfer was not subject to the gift tax

b. *Gift transactions*

* description of the transferred property and any consideration received
* identity of and relationship between the transferor and transferee
* if property transferred in trust, the trust’s tax identification number and a brief description of the terms of the trust or a copy of the trust
* detailed description of the method used to determine the FMV of the property transferred
* any restrictions on the property or discounts taken

c. *Securities*

* recitation of exchange
* CUSIP number
* mean between the highest and lowest quoted selling price on the valuation date

d. *Transfer of an interest in an entity* (e.g., FLP or LLC)

* description of any discount claimed in valuing the interest or any assets of the entity
* if the value of the entity is determined based on the net value of the assets
* a statement regarding the FMV of 100% of the entity without regard to any discounts in valuing the entity or assets owned by the entity
* the pro rata portion of the entity subject to transfer
* a description of how the fair market value of the transferred interest is determined
* if 100% of the value of the entity is not disclosed, the taxpayer bears the burden of demonstrating that the FMV of the entity is properly determined by a method other than a method based on the net value of the assets held by the entity
* if the entity owns an interest in another non-actively traded entity, the same information must be provided for that entity if the information is relevant and material in determining the value of the interest

e. *Submission of appraisals*

* prepared by an appraiser who is an individual who holds himself out as an appraiser
* the appraiser must be qualified to make appraisals of the type of property being valued
* the appraiser must not be the donor, the donee, or a member of the family or any person employed by the donor, the donee, or a member of the family

f. *Appraisal contains*

* date of the transfer
* date on which property appraised
* purpose of appraisal
* description of the property
* description of appraisal process employed
* description of assumptions, hypothetical conditions, and any limiting conditions and restrictions
* information considered in determining the appraised value
* appraisal procedures followed and reasoning that supports analyses, opinions, and conclusions
* valuation method utilized
* specific basis for the valuation

5. Increased scrutiny for estate, gift, and generation-skipping transfer tax purposes of transaction involving FLP and valuation discounts.

IMPLICATIONS AND ISSUES IN COMMUNITY PROPERTY STATES

In Arizona, California, Nevada, New Mexico, and Washington, the income from separate property of one spouse is separate property income. In Texas, Louisiana, Idaho, and Wisconsin, the income from the separate property of one spouse is community property income. It is in the former group of states where the FLP may require extra vigilance if it is owned prior to marriage, is given or inherited, or is separate property of a spouse for whatever reason. In these instances, it is necessary to make a distinction between the earnings of the manager (which is probably community property) and the income received from ownership of the partnership interest (which is separate property).

Using the separate property income from the FLP to purchase items that are taken in the names of both spouses creates a taxable gift (with the exception of real property taken as joint tenants). Thus, if the partner-spouse receives $80,000 in income from an FLP that was owned prior to marriage, over and above his wages from the FLP, and if he uses the $80,000 to buy stock in both his and his spouse’s names, he will have made a gift of $40,000 taxable to the spouse. This does not create a federal gift tax problem because of the unlimited marital deduction that applies to both separate property and community property (see Chapter 24). Depending upon state gift tax law, however, it may still create a gift tax problem.

The FLP should consider making an election under Section 754 to obtain a basis adjustment under Section 743 due to the death of either spouse. The election will adjust the income tax basis of the community property interest of both spouses in the FLP.

Another frequently encountered problem in an FLP in community property states is the failure to designate in the agreement whether the FLP interest is separate property or community property. This failure is a great source of comfort and fees to litigation attorneys in divorce proceedings. This is rather important in view of the high rate of divorce.

If an interest is held in a partnership, and income from the partnership is attributable to the efforts of either spouse, the partnership income is community property. If it is merely a passive investment in a separate property partnership, the partnership income will be characterized depending on the state involved. In some states, dividends, interest and rents from separate property are separate property. These states include Washington, Nevada, California, Arizona and New Mexico. Other states characterize interest, dividends and rents from separate property as community property. These states include Louisiana, Wisconsin and Texas.[[18]](#endnote-18)

DETRIMENTS

As exists with the formation of any entity (or for that matter the use of any tool or technique), the use of an FLP has some costs and downsides. For example, the following issues will generally be encountered:

1. The FLP will be required to pay applicable minimum franchise tax fees in most states in which it does business.

2. The FLP must file annual income tax returns and keep separate accounting records.

3. In states with restrictions on real property tax increases, great care should be taken in contributing real property to the FLP and in transferring partnership interests so that the property tax assessment on the property is not adversely changed.

4. There will be a cost incurred on the formation of the FLP and upon transferring title of assets into the FLP.

For the most part, the detriments that accompany the use of an FLP are heavily outweighed by its benefits and the decision to implement an FLP should not be materially affected by these issues.

COMPARING FLPs WITH OTHER BUSINESS ENTITIES

The differences between FLPs and other business entities can be significant in determining which entity would best suit a particular business need. Figure 43.1 provides a brief review of the differences between an FLP, C corporation, S corporation, and a limited liability company taxed as a partnership. More detailed explanations concerning these different types of business entities are discussed elsewhere in this book. (See Chapter 47 on Incorporation, Chapter 44 on Limited Liability Companies, and Chapter 46 on S Corporations.)

**Figure 43.1**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | **S Corp.** | **C Corp.** | **FLP** | **LLC** |
| Limited Liability | All Owners | All Owners | Limited Partners | All Owners |
| Income Tax Levels | Single | Double | Single | Single |
| Capital Ownership Restrictions | Yes | No | No | No |
| Limits on Classes  of Capital | Yes | No | No | No |
| Basis Adjustments | Outside Only | Outside Only | Outside and Inside | Outside and Inside |
| All Members Vote | Yes | Yes | No | Yes |
| Federal Tax  Election Required | Yes | No | No | No |
| Distributions on Liquidation Taxable | Yes | Yes | No | No |

HOW IT IS DONE – EXAMPLES

1. Mark Ciarelli, a successful businessman, is married and has two children, Irv and Eric. He presently is the sole owner of an unincorporated manufacturing business (Pierz Enterprises) in which both personal services and capital are material income producing factors. The net profits from the business for last year were approximately $200,000, before Mark’s salary. Mark files a joint return with his wife, Judy. His wife and children do not have an income of their own. Mark pays himself a salary of $1,000 per week. The net profit of the business after salary was actually $148,000. Because Mark is unincorporated, both the $52,000 salary and the $148,000 net profit are taxable to him.

Mark can minimize his income tax burden by “splitting” the income with his children through an FLP. He could transfer a 30% interest in the business assets directly to Irv and Eric, with each child receiving a 15% interest. If Irv and Eric were minors, these interests could be placed in trust for their benefit. A gift tax return would be filed and gift tax paid to the extent that Mark’s (and Judy’s) gift tax unified credit has been used up. An FLP agreement could be drafted and Irv and Eric could transfer their 15% interests to the FLP. Mark could continue to run the business and would have to pay himself a salary of $52,000 per year. However, the balance of the FLP income would be divided 70% to Mark, 15% to Irv, and 15% to Eric.

This planning would cause Mark to receive $103,600 in addition to his salary and Irv and Eric would each receive $22,200 of annual income. These amounts would be taxable to each partner. The net result is that Mark will have shifted $44,400 of income each year to his children. This income will be taxed at the children’s lower income tax brackets (if they are over the age of 17 or in some cases over 23), thus generating an immediate income tax saving. Further, if the business continues to grow, 30% of the future appreciation will accrue to Irv and Eric and not to Mark, thereby reducing Mark’s estate.

2. John and Robin Scott are each age 70. They have four children and six grandchildren and their estate consists of the following assets held in their family living trust:

|  |  |
| --- | --- |
| **Asset** | **Value** |
|  |  |
| Marketable Securities | $1,500,000 |
| Apartment Complex | $1,000,000 |
| Other Real Estate | $1,500,000 |
| Residence | $ 500,000 |
| Total | $4,500,000 |

During the year, John and Robin meet with their attorney and agree to implement an FLP to maintain ownership of their property in the family. The securities, apartment, and other real estate (but not the residence) are contributed to an FLP, constituting a total value of partnership assets of $4,000,000.

In return for their capital contributions, Mr. and Mrs. Scott each receive a 1% general partner interest and the Scott Family Trust receives a 98% limited partner interest. The FLP agreement gives the general partners the discretion to accumulate partnership income for future business needs and restricts the partners’ ability to transfer their interests to persons outside the Scott family.

At the end of the year, the Scotts implement a gift program in which they each transfer a 6.25% limited partner interest to each of their four children, thereby transferring away a total of 50% of the partnership and $2,000,000 of the underlying asset value. An appraiser is hired to determine the value of the gifts of limited partner interests and concludes that a combined 40% discount for lack of control, lack of marketability, and lock-in status is appropriate for the limited partner gifts.

After applying this discount to the proportionate value of FLP assets, Mr. and Mrs. Scott were found to have each given limited partner interests worth $150,000 to each child for a total gift by each of $600,000. Because the gift tax unified credit of each of them is fully intact, no cash payment of gift tax is required. At the end of the year, ownership of the Scott FLP is as follows:

|  |  |  |
| --- | --- | --- |
|  | **General Partner** | **Limited Partner** |
|  |  |  |
| John Scott | 1.00% | 0.00% |
| Robin Scott | 1.00% | 0.00% |
| Scott Family Trust | 0.00% | 48.00% |
| Child No. 1 | 0.00% | 12.50% |
| Child No. 2 | 0.00% | 12.50% |
| Child No. 3 | 0.00% | 12.50% |
| Child No. 4 | 0.00% | 12.50% |
| Totals | 2.00% | 98.00% |

In the next year and each year thereafter, the Scotts make annual gifts of limited partner interests worth $10,000 to each of the four children and six grandchildren. The same 40% discount to value is applied to the gifts. During the next ten years, the assets in Scott FLP grow at a 5% annual rate. During this period, Mr. and Mrs. Scott continue to make annual exclusion gifts to their children and grandchildren and significantly reduce their ownership interests in the FLP while remaining in control as the general partners.

At the end of the tenth year, John is struck with a sudden illness and dies. At that time, the underlying value of the FLP assets is $6,205,313 and ownership is as follows:

|  |  |  |
| --- | --- | --- |
|  | **General Partner** | **Limited Partner** |
|  |  |  |
| John Scott | 1.00% | 0.00% |
| Robin Scott | 1.00% | 0.00% |
| Scott Family Trust | 0.00% | 18.40% |
| Child No. 1 | 0.00% | 15.46% |
| Child No. 2 | 0.00% | 15.46% |
| Child No. 3 | 0.00% | 15.46% |
| Child No. 4 | 0.00% | 15.46% |
| Grandchild No. 1 | 0.00% | 2.96% |
| Grandchild No. 2 | 0.00% | 2.96% |
| Grandchild No. 3 | 0.00% | 2.96% |
| Grandchild No. 4 | 0.00% | 2.96% |
| Grandchild No. 5 | 0.00% | 2.96% |
| Grandchild No. 6 | 0.00% | 2.96% |
| Totals | 2.00% | 98.00% |

In determining the value of the FLP interests includable in John’s estate, a 25% discount was applied to the general partner interest and a 40% discount was applied to the limited partner interest on the estate tax return. As shown on the return, the estate tax value of Mr. Scott’s interest in the FLP after adding back his $600,000 in gifts in prior years is as follows:

|  |  |
| --- | --- |
|  | **Value** |
|  |  |
| General Partner (1.00%) | $ 46,540 |
| Limited Partner (9.20%) | $342,533 |
| Total | $389,073 |
| Prior Taxable Gifts | $600,000 |
| Total Gifts and Interests | $989,073 |

Had the Scotts chosen not to form their FLP and if no discounts to value were applied on the estate tax return, the value of John’s one-half interest in the apartments, real estate, and marketable securities would have been $3,102,657 at his death. However, by implementing a gift program using an FLP, his taxable estate was reduced by $2,113,584 and, assuming a 35% tax rate, $739,754 in estate tax was saved.

FLP SUCCESS CHECKLIST

1. Were the papers necessary to set up an FLP under the appropriate state law filed in a timely manner?

2. Has the planning team carefully documented the significant non-tax benefits to the client to justify the creation and maintenance of an FLP? (i.e., Are there demonstrable bona fide business/investment purposes, beyond income or estate tax savings, in both the formation and operation, and is there real economic substance to the entity?)

3. Has the appraisal been obtained of a full time accredited, independent, and experienced (preferably court-tested) valuation professional who created a studiously crafted individual report (rather than a "fill in the blanks" quickie) based on this specific FLP's facts? (And were realistic and justifiable assumptions used in developing the valuation discounts, and did the expert document the reasons for the types and amounts of discounts?)

4. Has the client avoided co-mingling of funds? Has the client not treated the money and other assets in the FLP as his or her own money?

5. Has it been verified that there has in fact been a significant change in the administration and management of the transferred assets after the creation and funding of the FLP? Can it be proved that there was much more than merely a name change and a different wrapper around the assets?

6. Has the transfer of assets to the FLP account in a timely and business-like manner been supervised? Was the timing right? Has it been verified that the capital contribution was first credited to the senior member's (parent’s) capital account and then, a discrete time later, followed by a gift of the partnership interest to the children?

7. Did the client keep passive or personal assets that are not appropriate to a business or investment enterprise out of the FLP?

8. Was the FLP set up while the client was young/healthy/competent (or was the entity formed by a very old and very ill person, on or practically on his or her deathbed, or was the client incompetent at the time the FLP was set up?)

9. Did the client retain sufficient assets to maintain his or her standard of living without the need to rely on FLP assets (or did the client place all or essentially all of his or her assets into the FLP, leaving no visible and adequate means of support other than the FLP's assets and income)?

10. Were parties advised in writing that they could have no expectation or understanding that, directly or indirectly, status prior to creation of the FLP would remain (i.e., "It's still Pop's money" or "All of this will continue to be available to pay Mom's bills and meet her financial needs and expenses.") Did Dad always get what he asked for or what he wanted or needed from the FLP? Did Mom expect that her children would provide support for her through the FLP? Were Mom and Pop's taxes (income or estate) and related expenses (or funeral bills and death taxes) paid by the FLP?

11. Were only business or investment assets placed into the FLP and personal assets, such as the family home (particularly the client's personal residence), kept out of the FLP? Was the client made aware that the client had to either vacate a residence that he/she placed into FLP or actually pay the entity (not accrue) a fair and arm’s length rent? Has the client actually paid rent in a timely manner? Has documentation been retained?

12. Does this FLP really represent more than a mere change in title and more than a recycling of value? What has been done to prove it?

13. Did the FLP initially, and does it continue to, meet the appropriate state's definition of an FLP?

14. Are general partners really and actively involved in business?

15. Has investment strategy actually changed after securities were contributed?

16. Did the client give up the right to be, to replace, or to remove the general partner?

17. Did the client (and his or her spouse) give up the right (directly or indirectly) unilaterally to decide when distributions from the FLP would be made, how much would be distributed, and to whom distributions would go?

18. Does the FLP conduct formal meetings and observe business formalities?

19. Are there meaningful negotiations and bargaining between the general partners?

20. Do adult children actively represent their own interests, or did they do just what Mom and Pop tell them to do?

VALUATION QUALITY CONTROL CHECKLIST

1. Have an appropriately large number of guideline comparable companies been used in the comparison?

2. Are these comparable companies really comparable? Are they similar in fundamental ways? (Have core fundamentals been stated in the report?)

3. Have the companies used been sufficiently identified?

4. Has the valuation report justified and documented why they should be considered comparable?

5. Have cogent, realistic, defensible, and objective reasons been provided for the size of the discounts taken?

6. Has the valuation date been checked and rechecked?

7. Have full-time professional appraisers been used who have appropriate credentials, considerable experience with the type of property/entity being appraised, and court-experience?

8. Has it been verified that appraisers had full access to legal, financial, and tax documents and to information from the key people?

9. Has it been anticipated what the appraiser as a witness will have to testify to in court?

10. Has each and every assumption and position been backed up and proved or justified, in writing?

11. Has the appraiser shown, in writing, why numbers or assumptions or comparables are not arbitrary?

12. Have the arguments/assumptions/positions the other side should, and is likely to, make been examined?

FREQUENTLY ASKED QUESTIONS

**Question** – Can a minor hold a partnership interest directly?

*Answer* – Yes. A minor will be recognized as a bona fide partner if it is determined that he is competent to manage his own property and to participate in the FLP activities. This requires that the minor possess sufficient maturity and experience to assume dominion and control over the interest transferred to him. Ordinarily, however, a minor will not be deemed to possess the requisite maturity and experience. Therefore, as a practical matter, an FLP interest should not be transferred directly to a minor.

If a minor’s interest is transferred to a fiduciary, such as a court-appointed guardian whose conduct is subject to judicial supervision, the minor will be recognized as a partner. Similarly, if an FLP interest is transferred in trust for the benefit of a minor to an independent trustee, this will also permit the minor to own an interest in the FLP.

**Question** – Parent and children create an FLP to hold and operate a farm. The parent transfers interests in the farm partnership by gift to the children, who are limited partners. The parent is the sole general partner, lives in a farm house on the property, operates the farm, and takes most of the partnership profits as salary. Is this a valid FLP for estate tax purposes?

*Answer* – The IRS will likely assert that the parent has retained the enjoyment of the entire farm for his life and seek to include 100% of the value of the farm in the parent’s taxable estate under IRC Section 2036(a). The IRS reached this conclusion in Letter Ruling 7824005, where the parent lived on the property and received income in the form of salary although she did not manage the property. Compare Letter Ruling 9131006 where the FLP was recognized although the parent retained a great deal of control over it.

It is recommended that a person who uses assets of the FLP for non-business purposes should enter into an independently brokered arm’s length lease agreement and pay a reasonable market rent for the use of the property. The payment of rent is consistent with the FLP’s business purpose of owning assets for the purpose of making a profit. A failure to timely and consistently pay reasonable rental rates could be construed as a retention of the enjoyment of FLP assets and result in federal estate tax inclusion of the FLP interest.

**Question** – Do gifts of interests in an FLP qualify for the gift tax annual exclusion?

*Answer* – The IRS has ruled that such gifts do qualify where there is no substantial restriction under the FLP agreement on the rights of the donee partners to dispose of their interests in the FLP. However, if the partnership agreement attempts to prohibit assignment, the IRS will probably disallow the exclusion[[19]](#endnote-19) In addition, advisors and practitioners should be aware that the IRS has recently taken the position that gifts of membership interests in a family LLC were not gifts of present interests and therefore did not qualify for the gift tax annual exclusion. This position was upheld by the Tax Court and the Seventh Circuit in *Hackl v. Comm*.[[20]](#endnote-20) It is very important that advisors and practitioner be familiar with *Hackl*, and that gifts of FLP interests be carefully structured to qualify as present interests that qualify for the gift tax annual exclusion.

**Question** – When a partner dies, is there any change in the income tax basis of partnership assets?

*Answer* – Generally, under IRC Section 1014, the income tax basis of a decedent’s assets is adjusted to the value of such assets for federal estate tax purposes, typically their fair market value as of the date of death. Where the estate owns an FLP interest, this basis adjustment will apply to the basis of the FLP interest. Also, if the general partner makes a timely election under IRC Section 754, the basis of the assets owned by the FLP will be adjusted to reflect the date of death values according to IRC Section 743(b). If assets have appreciated in value, this adjustment will be advantageous only to the interest of the deceased partner who will receive a date of death basis in the FLP assets.

**Question** – What are some helpful hints for operating an FLP?

*Answer* – Helpful hints (see the checklists above as well) include:

1. There should be a written FLP agreement setting forth the rights of the partners.

2. Accurate business records should be kept.

3. The donor (general partner) should receive reasonable compensation for his services.

4. Distributions to the donee partners should not be used to discharge parental support obligations.

5. If minors are partners and their interests are held in trust, the trustee should be an independent trustee and not subject to the direct or indirect control of the donor.

6. Assets should be transferred into the name of the partnership.

**Question** – Can a family partnership be funded solely by contributing marketable securities?

*Answer* – To date, family partnerships holding such assets have not yet been successfully attacked by the IRS. IRC Section 7701(a)(2) defines a partnership as including a “syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation.” Those practitioners who advocate the creation of family partnerships solely to hold marketable securities often point to this statute as partial authority for their position. However, the attempt of the IRS in promulgating Treas. Reg. §1.704-2 and retraction of Examples (5) and (6) (the latter of which was to be used to attack certain “paper shuffling” partnerships) suggests that the IRS may attack such entities in the future. Where the transferred assets include large amounts of publicly traded securities, the investment company rules, discussed above, which could result in gain or loss on the transfer, must be met. Obviously, gift and estate tax valuation discounts based on an FLP holding mostly or totally marketable securities will be lower than an FLP holding business interests or real estate. In fact, the Tax Court has upheld the use of a FLP as a vehicle for owning primarily marketable securities. In a couple of cases, the IRS attacked the use of a FLP as a vehicle for applying valuation discounts to the interests of the decedent, but still allowed discounts.[[21]](#endnote-21)

**Question** – How does the IRS determine whether an entity should be taxed as a partnership?

*Answer* – Effective January 1, 1997, business entities other than corporations or trusts can elect their tax classification (under the so-called “Check-the-Box” regulations). If the entity has at least two members, it can be classified either as a partnership or an association taxable as a corporation. An election will be effective on the date specified by the entity on the IRS Form 8832 or the date filed if no date is specified on the IRS Form 8832 (the effective date specified on IRS Form 8832 cannot be more that 75 days prior to the date on which the election is filed and cannot be more than 12 months after the date on which the election is filed). After that period, the election is effective on the date the election is made. A copy of the election must be included with the entity’s first tax return. If the entity with two or more members fails to file an election, the default classification would be a partnership.[[22]](#endnote-22)

**Question** – How does a state determine whether an entity should be taxed as a partnership for state tax purposes?

*Answer* – Prior to enactment of the Check-the-Box regulations noted in the preceding answer, the IRS and states determined the tax classification of an entity based upon the number of corporate characteristics it possessed. Since enactment of the federal Check-the-Box regulations, many states have conformed their state law to the new federal classification regulations. California elected to follow federal entity classification for state income tax purposes, beginning January 1, 1998.[[23]](#endnote-23)

If a state does not follow the federal Check-the-Box regulations, then the state may treat a family partnership as an association taxable as a corporation for state tax purposes if three or more of the following characteristics are determined to exist in the partnership.

1. Centralized management;

2. Free transferability of interests;

3. Continuity of life; and

4. Limited liability.

The drafter of the partnership agreement in such a state should be careful in assuring that the partnership lacks at least two of the above corporate characteristics. For FLPs, the agreement is usually drafted so that free transferability of interests and continuity of life are lacking.

**Question** – What are guaranteed payments and are they significant in the family limited partnership?

*Answer* – Guaranteed payments are payments for services or the use of capital, often made to senior partners, under IRC Section 707(c). If these are determined without regard to partnership income, they will be treated as payments to unrelated persons, which will generally be taxable income to the recipient and deductible by the partnership if they are reasonable, ordinary, and necessary. They provide a method of making cash flow available to senior family members on a tax deductible basis. Note, however, they may be subject to the self-employment tax.

**Question** – What action should be taken in structuring a family limited partnership to avoid the special valuation rules of IRC Section 2701?

*Answer* – Gifts of interests in a family limited partnership may be required to be valued under the artificial valuation rules of Section 2701, which are discussed in Chapter 60. Section 2701 will apply if the senior family members retain interests that are defined as “applicable retained interests.” These partnership interests resemble preferred stock in that they confer preferential distribution rights, or have a fixed liquidation value.

A so-called “vertical slice” in the entity is not covered by this section. For example, if the transferor, each family member, and each applicable family member hold substantially the same interest before and after the transfer, Section 2701 does not apply. Similarly, it does not apply if the interests transferred are of the same class proportionately as the interests retained. Differences only in voting rights, or in the case of partnerships, differences in management and liability, are generally considered proportionate.

The key to avoiding Section 2701 is to structure the partnership so that each partner will share proportionately in capital, income, losses, and distributions. For examples, see Letter Rulings 9427023 and 9451050.

**Question** – Are there any problems in transferring stock in a closely held corporation to a family limited partnership?

*Answer* – If voting stock in a controlled corporation as defined in IRC Section 2036(b) is transferred to a family partnership and the transferor votes the stock as a general partner, this would appear to be an indirect retained voting power over the stock, resulting in its inclusion in the transferor’s taxable estate. It would be better to limit transfers of stock to nonvoting shares. Note that control under this statute is broadly defined, and includes any corporation in which the transferor and family members own a 20% interest. If the stock is S corporation stock, the S election will generally be deemed revoked.

**Question** – Can life insurance be transferred to a family limited partnership?

*Answer* – The family partnership may be an excellent vehicle for holding life insurance, functioning in a manner similar to an irrevocable insurance trust as discussed in Chapter 31. However, if the *only* function of the partnership is to hold life insurance policies, there are serious questions. Under both general legal principles and tax law, a valid partnership is supposed to engage in some business or financial activity. Although one private letter ruling implies that ownership of life insurance with investment characteristics is sufficient,[[24]](#endnote-24) caution indicates (and the authors strongly suggest) the partnership should be engaged in some other business or investment activity in addition to merely holding life insurance.[[25]](#endnote-25)

As the table below indicates, life insurance inside an FLP is advantageous because of the increased flexibility and control the FLP affords the reduction in estate tax exposure to the policy proceeds, and the reduction in paperwork and aggravation.

|  |  |
| --- | --- |
| **Irrevocable Trust** | **FLP** |
| Irrevocable | Can be changed |
| Entire amount includable if client is trustee | Only portion includable |
| Crummey notice required | No crummey notice needed – no "5 or 5" limits |

**Question** – What are the potential IRS attacks against FLPs?

*Answer* – The IRS has been aggressive in attacking FLPs. However, many of the theories underlying these IRS attacks have been rejected by the courts. In creating and administering a FLP, it is very important to be familiar with and understand the arguments the IRS has made, and is continuing to make, against FLPs and the manner in which the courts have dealt with such arguments. Below is a list of several arguments the IRS has made against particular FLPs, with citations to some of the cases in which the arguments have been litigated. It is not an exhaustive list of IRS arguments against FLPs or cases dealing with FLPs, and should not serve as a substitute for reading the cases cited. The "FLP Success Checklist" above should eliminate or minimize most of these IRS attacks.

1. The FLP should be disregarded because it lacks a valid business purpose and/or economic substance.[[26]](#endnote-26)

1. On formation of the FLP, the founding partners made a gift to the other partners of the difference between the fair market value of the assets transferred to the partnership and the discounted value of the partnership interests.[[27]](#endnote-27)
2. All of the assets of the FLP should be included in the estate of a decedent under Section 2036(a)(1), because the decedent retained the possession or enjoyment of, or the right to withdraw income from, such assets.[[28]](#endnote-28)

4. All of the assets of the FLP should be included in the estate of the decedent under Section 2036(a)(2), because the decedent retained the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or its income (e.g., the ability, either alone or in conjunction with the other partners, to dissolve the partnership).[[29]](#endnote-29)

A discussion of strategies for minimizing the potential for a successful IRS attack is beyond the scope of this chapter.[[30]](#endnote-30) It should be noted, with regard to family limited partnerships that most cases which resulted in a government loss relied on the parenthetical in IRC 2036(a), i.e. “The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money’s worth)”.

However, the case of *Estate of Kelly*,[[31]](#endnote-31) was noteworthy in that it held that Section 2036 does not apply to assets held in a family limited partnership without relying entirely on the bona fide sale exception. While the Court held that the bona fide sale exception did apply, the gifts of the partnership interest were not included in decedent’s estate because the court concluded that there was no implied agreement of retained enjoyment under Sec. 2036(a)(1). The government, as it has in the past, also contended that the management fee paid to the decedent was a retention of income such that the interests are includable under Sec. 2036. The court held that the value of the transferred partnership interests should not be includable in the estate. The decedent’s primary motive was to ensure effective property management and equal distributions among the children – not reduction in tax.[[32]](#endnote-32)

Likewise in *Stone v. Commissioner,[[33]](#endnote-33)* the Court held that the value of woodland parcels transferred during decedent’s lifetime to a FLP are excludable from her gross estate under the bona fide sale for adequate consideration exception; that the transaction was motivated by the family’s interest in managing the property and that decedent received partnership interests proportional to what she transferred.

CHAPTER ENDNOTES

1. . IRC Sec. 704(e)(3). [↑](#endnote-ref-1)
2. . Treas. Reg. §1.704-1(e) sets forth additional requirements in order for a family partnership to be acknowledged for income tax purposes. Although the IRS’s attempt at applying the scope of these regulations to estate, gift, and generation-skipping taxes has generally failed, it is likely that the IRS will continue to look for ways to challenge family partnerships that substantially reduce transfer taxes. [↑](#endnote-ref-2)
3. . *Church v. U.S*., 2000-1 USTC ¶60,369 (W.D. Tex. 2000). [↑](#endnote-ref-3)
4. *. Keller v. U.S*., 110 AFTR 2d 2012-6061 (9/25/2012). [↑](#endnote-ref-4)
5. . *Est. of Davis v. Comm*., 110 TC 530 (1998). [↑](#endnote-ref-5)
6. . Rev. Rul. 77-137, 1977-1 CB 178. [↑](#endnote-ref-6)
7. . IRC Sec. 704(e)(1). [↑](#endnote-ref-7)
8. . Treas. Reg. §1.704-1(e)(1)(iii). [↑](#endnote-ref-8)
9. . IRC Sec. 704(e)(2); Treas. Reg. §1.704-1(e)(1)(ii). [↑](#endnote-ref-9)
10. . Treas. Regs. §§1.704-1(e)(2)(ii)(a), 1.704-1(e)(2)(ii)(d). [↑](#endnote-ref-10)
11. . See, e.g. *Payton v. U.S.*, 425 F.2d 1324 (5th Cir. 1970) cert denied 400 U.S. 957 (1970); *Kuney v. U.S.*, 524 F.2d 795 (1975). [↑](#endnote-ref-11)
12. . See Treas. Reg. §1.704-1(e)(2)(ii)(d). [↑](#endnote-ref-12)
13. . See Treas. Reg. §1.704-1(e)(2)(vi). [↑](#endnote-ref-13)
14. . See Treas. Reg. §1.351-1(c) for rules pertaining to what constitutes diversification of investment securities. [↑](#endnote-ref-14)
15. . See LISI Income Tax Planning Newsletter #21 (January 12, 2012), at http://www.LeimbergServices.com which provides an in depth analysis. [↑](#endnote-ref-15)
16. . See Treas. Regs. §§25.2512-2, 25.2512-3. See also Rev. Rul. 59-60, 1959-1 CB 237. [↑](#endnote-ref-16)
17. . Treas. Reg. §301.6501(c)-1(f). [↑](#endnote-ref-17)
18. . IR Manual § 25.18.2.1 (03-04-2011), Community Property: Income Reporting Considerations of Community Property. [↑](#endnote-ref-18)
19. . See TAMs 199944003 (present interests) and 9751003 (future interests). [↑](#endnote-ref-19)
20. *. Hackl v. Comm.*, 118 TC 279 (2002), aff’d 335 F.3d 664 (7th Cir. 2003). [↑](#endnote-ref-20)
21. . See, e.g. *Knight v. Comm*., 115 TC 506 (2000). [↑](#endnote-ref-21)
22. . Treas. Reg. §301.7701-3. [↑](#endnote-ref-22)
23. . Cal. Rev. & Tax. Code §23038(b)(2). [↑](#endnote-ref-23)
24. . Rev. Rul. 9309021. [↑](#endnote-ref-24)
25. . See Let. Rul. 200017051. [↑](#endnote-ref-25)
26. . See, e.g., Est. of *Strangi v. Comm*., 96 AFTR 2d 2005-5230 (417 F.3rd 468) (5th Cir. 2005) ; *Knight v. Comm*., 115 TC 506 (2000); *Church v. United States*, 2000-1 USTC ¶60,369 (W.D. Tex. 2000), aff’d without published opinion 268 F.3d 1063 (5th Cir. 2001); 1. [↑](#endnote-ref-26)
27. . See, e.g., *Est. of Strangi v. Comm*., 96 AFTR 2d 2005-5230 (417 F.3rd 468) (5th Cir. 2005) *Knight v. Comm*., 115 TC 506 (2000). Estate of Kelly, supra. [↑](#endnote-ref-27)
28. . See, e.g., Estate of Bigelow, 503 F.3d 955 (2007); *Est. of Schauerhammer v. Comm*., TC Memo 1997-242; *Est. of Reichardt v. Comm*., 114 TC 144 (2000); *Est. of Harper v.* *Comm*., TC Memo 2002-121; *Est. of Thompson v. Comm*., TC Memo 2002-246, aff’d 94 AFTR2d 2004-5764 ; ; Strangi, supra. [↑](#endnote-ref-28)
29. . See, e.g., *Est. of Strangi, supra.*  (5th Cir. 2005). [↑](#endnote-ref-29)
30. . For a discussion of such strategies, see Blattmahr and Gans, “Avoiding the *Strangi II* Legacy for Old and New Partnership,” Tax Notes, September 1, 2003 and Qualifying New FLPS for the Bona fide Sale Exception: Managing Thompson, Kimbell, Harper and Stone, Journal of Taxation, Feb. 2005, J. Joseph Korpics. [↑](#endnote-ref-30)
31. *. Estate of Kelly*, T.C. Memo 2012-73. [↑](#endnote-ref-31)
32. . See LISI Estate Planning Newsletter No. 1956 (April 30, 2012). [↑](#endnote-ref-32)
33. *. Stone v. Commissioner*, TC Memo 2012-48. [↑](#endnote-ref-33)