



Limited Partnerships

A properly structured limited partnership, formed and owned by family members to hold business and investment assets, can also be used to facilitate the transfer of ownership interests in such assets among family members. This structure accomplishes several significant family and estate planning goals and, at the same time, can provide the partners with substantial asset protection. This memorandum will discuss the general structure of a family limited partnership (“FLP”) and how it is used to accomplish these goals.

General Structure and Purposes of The Family Limited Partnership

A limited partnership is simply a partnership in which there is at least one general partner and one limited partner. The general partner manages and operates the partnership and is liable for any debts and obligations of the partnership that the partnership cannot satisfy. Typically, the general partner’s economic interest is very small (e.g., 1%) and, often, the general partner is a corporation or limited liability company (“LLC”) formed to limit the liability that must be assumed by the general partner. The limited partner(s) hold an investment position in the partnership and may not take part in its day-to-day management. A limited partner is not personally liable for the partnership’s debts or obligations and, therefore, the limited partner’s liability is “limited” to that partner’s interest in the partnership.

While FLPs are often touted for their transfer tax-saving potential, they are, in fact, excellent estate planning vehicles because of the numerous non-tax advantages that they offer. These include:

1. *Orderly Transfer of Wealth*

Estate planning necessarily involves the transfer of wealth from parents to children and grandchildren in ways that are favorable from a federal estate and gift tax perspective. An FLP facilitates this goal by allowing parents (or grandparents) to fund an FLP with valuable assets and then give limited partnership interests to their children or more remote descendants, either directly or in trust, at a discounted value based upon the significant restrictions on transferability and management placed on the limited partnership interests. These discounts are discussed in greater detail below.

2. *Flexibility*

The partnership is a flexible and useful vehicle for transferring interests in family assets and businesses. Because the limited partnership agreement is a contract, it can be amended from time to time by the consent of the partners. The income tax consequences of entry into, or withdrawal from, a partnership are normally fairly neutral.

3. *Transferability Restrictions*

The limited partnership agreement can be structured to include restrictions on transfers that will prevent the limited partners from readily disposing of their FLP interests. These restrictions can be advantageous because they apply to both voluntary and involuntary transfers. For example, the restrictions can apply in cases where a partner dies, becomes incapacitated, files for bankruptcy, or gets divorced.

4. *Creditor Protection*

The personal creditors of a limited partner generally cannot reach the partnership’s assets to satisfy their claims against the limited partner, unless the partner transferred assets to the partnership in fraud on his creditors. Instead, under the statutes of some states, a creditor may attach only a partner’s right to receive distributions from an FLP if and when they are made by the general partner. (This judicially granted creditor’s right to receive distributions from a partnership is known as a “charging order.”) The creditor obtaining a charging order does not become a partner, obtain management rights in the partnership, or obtain rights to the partnership’s assets. Consequently, a limited partnership interest is not a particularly valuable or attractive asset to a creditor seeking to enforce a judgment. States such as Alaska and Delaware have taken this protection a step further by explicitly providing in their statutes that a charging order is the “exclusive remedy”

against a limited partner's interest in a limited partnership, thus negating a creditor's ability to argue (as they could in some other states) that the charging order is not sufficient to satisfy his claim and that he should be allowed to foreclose upon the limited partnership interest.

In addition to the potential protection provided to the partnership from the limited partners' personal debts, an FLP can also prevent the partnership's creditors from reaching through the partnership and asserting claims against the partners individually. The only assets these creditors can reach are the partnership assets, except for a general partner, who is personally liable for claims against a limited partnership. Consequently, having a corporation or LLC serve as the general partner of a limited partnership usually provides a shield to the general partners for partnership liabilities.

5. *Retained Control*

The FLP's general partner controls the distribution of income from the partnership because the general partner can choose to either reinvest partnership earnings or distribute them. The general partner also controls the investment and management of partnership assets. Therefore, the FLP's creator, by serving as the general partner, or by using an entity that is controlled by the creator as the FLP's general partner, can time distributions of cash flow from the FLP to the owners of the limited partnership interests.

6. *Asset Consolidation*

Through the use of an FLP, family members—and trusts created for family members—can consolidate the various assets that they own to provide for easier management and to prevent the fragmentation of the management and ownership of these assets as they pass to future generations. Moreover, an FLP can survive the death of any family member and, thus, allows key family assets to be retained for the enjoyment and financial protection of future generations.

7. *Potential Disadvantages*

Difficulties can arise in the creation and operation of an FLP. The primary disadvantage of the partnership structure is that, after the death of the creator of the FLP, the beneficiaries of the lifetime transfers will become or remain partners with each other for the remainder of the partnership term, unless, by unanimous agreement, they agree with all of the partners to terminate the partnership sooner. This feature might be perceived as a disadvantage if family members do not share common investment goals with respect to partnership assets, and it highlights the need for careful planning for the succession of the partnership.

In addition, it is important that distributions from the partnership generally be made on a pro-rata basis to all partners. If outright distributions to certain family members would not be desirable, trusts can be created to hold the partnership interests of these family members. Under this structure, a trust rather than the individual would be the partner and any partnership distributions would be payable to the trustee. The trustee would then determine whether to accumulate or further distribute the partnership distributions to those family members. The importance of pro-rata distributions also highlights the need to carefully select the assets that will be conveyed to the FLP, so that distributions from the FLP will be adequate for the senior generation's needs, when combined with assets held by them outside the FLP.

As described below, the principal rationale for claiming valuation discounts for gifts of limited partnership interests is that those interests are subject to substantial restrictions under the partnership agreement that limit the holder's rights to get to the value of the underlying partnership assets. These restrictions are not solely for tax purposes. They are real and material to the holder of the limited partnership interests. The general partner totally controls the management of the partnership, the decisions to buy and sell partnership assets, and the decision to make distributions of partnership income to the partners. The limited partner's lack of control over the partnership's affairs severely restricts the limited partner from using partnership interests to satisfy his or her debt obligations.

Transfer Tax Issues

A significant estate planning use of an FLP is to transfer to children and grandchildren, in a tax favorable manner, the potential appreciation inherent in family assets. This objective is accomplished by transferring to the partnership property that the donor anticipates will appreciate in the future and by applying court-recognized discounts to the value of gifts of partnership interests. For example, if a donor gave \$20,000 in cash to the donor's child, the obvious value of the gift is \$20,000. But if the donor instead gave the child an interest in an FLP, the transfer restrictions on the

child's FLP interest might warrant a 30%-40% discount on the value of the underlying FLP assets for gift tax purposes; and a transfer to the child of an FLP interest with a current value of only \$20,000 might represent partnership assets with an actual current liquidation value of \$28,571-\$33,333. As a consequence, assets transferred in this manner will incur less gift tax liability, allowing the assets to be transferred at a faster pace.

The argument that an FLP interest is worth less than the liquidation value of the underlying FLP assets is primarily based on the application of two types of court-recognized discounts. The first of these is known as a "minority interest" discount. The basic rationale behind the application of a minority interest discount to a limited partnership interest is that an otherwise willing buyer would be cautious about buying (and, therefore, be unlikely to pay as much for) an interest in a business entity if he knew he would have no voice in how the business is run. Since a limited partner in an FLP has few voting rights in determining the operation of the FLP, the minority interest discount is generally considered applicable in determining the fair market value of a limited partnership interest for transfer tax purposes.

The second court-recognized discount that might be applied in connection with valuing a limited partnership interest is the "lack of marketability" discount. The theory behind the application of a lack of marketability discount is that an otherwise willing buyer would be cautious about buying (and, therefore, be unlikely to pay as much for) an interest in a business entity if he knew he would not be able to freely sell the interest to another investor at a later time. Since the partnership agreement of an FLP generally includes many significant restrictions on the transferability of interests, a lack of marketability discount is generally considered applicable in determining the fair market value of a limited partnership interest for transfer tax purposes.

These two discounts can reduce the value of a lifetime gift significantly, depending upon the nature of the underlying assets in the partnership and how the partnership agreement is written. While we cannot advise a donor on the amount of discount appropriate for each gift, we can discuss discounts allowed in similar cases and recommend a valuation expert who can render an opinion on value that can be used if any issue regarding the discount's propriety is raised by the IRS.

Furthermore, these discounts will generally apply for estate tax purposes as well, meaning that the size of a decedent's gross estate can also be significantly reduced to the extent that he or she owns only limited partnership interests.

It should be noted, however, that the IRS closely scrutinizes gifts of FLP interests and estates containing FLP interests should not represent that we have knowledge of relative audit risks.

Income Tax Issues

Like a general partnership, a limited partnership is a "flow through" entity for income tax purposes. This means that each partner is allocated a proportionate share of each item of income, deduction, and credit. To that extent, it is possible that the partners will be taxed on income never distributed. While this is yet another aspect making limited partnership interests undesirable to creditors, it may require that the general partner make distributions to help the partners cover the taxes due on the allocated income.