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## FAMILY LIMITED PARTNERSHIPS PART I – ADVANTAGES

Other than life insurance, the annual exclusion, and the irrevocable trust, the family limited partnership (FLP) is arguably the best-known and most popular sophisticated wealth-transfer device. Although it is not appropriate in every situation, it is certainly a very important concept that must be considered in almost every large and rapidly growing estate.

In this two-part series, I will cover what FLPs are, who will find them useful, their advantages and downsides, and questions and answers based on the latest cases and rulings – including where life insurance fits in.

Let's start with some background and an overview of what you need to know and some of the many advantages of FLPs.

### TYPES OF PARTNERSHIPS

Federal income tax laws recognize the formation of a partnership when two or more parties act together for their common economic benefit, and at least one transfers title to property to the enterprise. A more formal definition provides that there must be "an association of two or more persons to carry on, as co-owners, a business for a profit."

In order for a partnership to be respected, it must be bona fide, have a substantial business purpose, and conform to applicable state law – both in form and substance. Although the arrangement should be reduced to writing in the form of a partnership agreement, an oral contract will suffice. The parties to the agreement typically contribute money or other assets, labor, or skills and in return receive the right to share in the profits of the enterprise.

Although both tax and non-tax laws recognize a partnership as an entity, a partnership generally incurs no entity-level tax; instead, its income, gain, loss, deductions and credits are “passed through” and reportable by (and taxable to) the partners. As a general rule, items are identified and their character is determined for tax purposes at the partnership level and each retains its character at the individual partner’s level.

Briefly, the most common partnership structures are described below:

**General Partnership:** The entity may take the form of a “general partnership” in which all partners have **unlimited** liability for partnership recourse debts and are legally entitled to participate in the management of the partnership. Each general partner is personally liable for the negligent or wrongful acts committed by other partners in the conduct of the partnership's business operations. Similarly, each can act on behalf of the partnership and thus bind the other partners. So, if a creditor (or someone else) sues the partnership and there are insufficient partnership assets to satisfy the claim, the individual partners’ personal assets can be jeopardized.

Although general partners are often allowed to transfer (or assign) all or a portion of their rights to partnership profits, most partnership agreements prohibit the transfer of the right to participate in management or the transfer of other major attributes of a general partner.

**Limited Partnership:** Alternatively, the entity may be structured as a “limited partnership.” A limited partnership has at least one general partner with unlimited liability and at least one limited partner with, as you would expect, limited liability. A limited partnership continues until all of the general partners have either died or withdrawn; the death of a limited partner will not terminate the partnership.

Only the general partner assumes full liability for the recourse debts of the firm. Correspondingly, only the general partner may manage the business and act on behalf of the partnership.

Limited partners are liable for debt assumed by the partnership – but essentially only up to the assets they have contributed. They are not allowed to act on behalf of the firm or participate in its management decisions or even work as partners in the day-to-day operations of the business.

In essence, limited partners are merely passive investors who receive a return on their investment from the partnership rather than directly from its underlying assets. Another way of looking at limited partners is as nonvoting minority owners who cannot exercise any control over the business.

As is the case with general partnerships, typically a limited partner can assign only his or her share of the partnership's profits to another party and may not assign other attributes such as the right to vote on investment or operations management issues. Likewise, a general partner cannot assign his interest to another person without the consent of all the general partners. Note that the same party can be both a general and a limited partner.

Partners may take income and assets out of the partnership in a number of ways. These include: (1) management fees paid to a general partner for services rendered, (2) distributions (to all partners including limited partners) in proportion to the value of their interests, (3) revocation (since the partnership is a contract between the parties, they can choose to revoke it at any time as long as all partners consent), and (4) loans (the partnership agreement can provide for bona fide fully secured interest-bearing loans to partners or third parties).

All property transferred to the partnership and all property purchased by the partnership is held in the partnership's name. Partners, in turn, own partnership assets as "tenants in partnership," i.e., each partner co-owns all partnership assets with all of the other partners. Likewise, each partner has an intangible interest in the firm's net profits.

As mentioned above, the same party may own general partnership interests and limited partnership interests (called "units"). Only partner(s) with general partnership interests (usually representing 1% to 25% of the value of the enterprise) will have voting rights and management control, but will participate equally with limited partners on a per unit basis in the profits and losses of the firm. Limited partnership interests, which carry with them the balance of the enterprise's value, will typically be given away or sold, either immediately in a single transaction or over time in installments or sporadically to children, grandchildren, and other donees (which can include charities).

**Family Limited Partnership (FLP):** This is a limited partnership in which the parties are so closely related that they are considered part of the same economic unit. In a typical FLP, parents or grandparents will transfer real estate, publicly traded securities, an interest in a closely-held business, or some combination of these, or other business/income-producing property, or appreciating assets into a partnership entity. The transferors will (initially at least) retain both general partnership and limited partnership interests. Other family members are given or sold (or both) limited partnership interests either all at once or over a period of time. Sales of partnership interests may take place in return for installment payments, self-canceling installment note payments, or even private annuities.

All parties are bound by an agreement which clearly defines the general and limited partners' responsibilities and interests as well as the ability to (or restrictions on) transfer of their respective interests. The agreement must conform to state law formalities.

## FLP CLIENT PROFILE

Typically, the person who sets up an FLP will be in his or her early to mid-50s or older, married, have several children and/or grandchildren. He or she has an estate in excess of \$3,000,000 (aside from his or her principal residence and life insurance) consisting of a business (or business interest), real estate holdings, and/or a large and diversified portfolio of securities that are appreciating in value. Wealthy ("investment" estates of \$2,000,000 or more) single individuals (divorced, widowed, never-married) who are concerned about transferring wealth to someone other than, or in addition, to a charity may find FLPs very appealing.

The client must be able to accept (and/or be prepared to live with) a significant change in the legal structure as well as control of his/her property transferred to an FLP. A general partner cannot unilaterally liquidate the FLP and recover assets, or continue to treat the partnership's assets as his or her own. Even the partnership agreement cannot be changed without the consent of all the partners.

The client must have sufficient tolerance for the aggravation, complexity, and risks involved in the planning, design, formation, and maintenance of the FLP. Also required is his/her willingness to bear the associated costs such as fees for competent legal/professional services and appraisals/valuation, and on-going accounting expenses.

The client should have already applied or considered all appropriate "basic" techniques such as: (1) classic will/marital/non-marital trust(s), (2) allocation of ownership of assets between spouses to assure full use of both spouses' unified credit equivalents, (3) irrevocable life insurance trusts, (4) annual exclusion gifts, (5) unified credit gifts – to the extent appropriate and his/her willingness to make lifetime gifts, (6) charitable remainder/charitable lead trusts, (7) grantor retained income/annuity trusts, and (8) revocable living trusts.

Example: Steve and his daughter Lara decide to enter into a business/investment venture together. They would like to operate informally and Steve would like to use the entity to shift both income and wealth to Lara. Steve transfers a building in his name worth \$1,000,000 with a basis of \$100,000 into a family limited partnership. Initially, he receives all the general and limited partnership interests. Then, he retains a 25-percent interest and gives Lara limited partnership "units" worth 75 percent. He has therefore made a gift to Lara of (for valuation purposes something less than) \$750,000 and has retained an interest worth (more than) \$250,000. Steve will be the general partner and Lara the limited partner. He may use his available lifetime gift tax exclusion amount to shelter all or part of the gift from current taxation.

## ADVANTAGES OF FLPs

**Wealth Shifting Tool:** Family partnerships have long been used by estate owners as tools to make inter vivos transfers to family members (usually members of younger generations) and shift future appreciation out of their estates for tax purposes. It is a useful and highly practical means of facilitating gifts to family members. Once the partnership is established, the estate owner can easily increase the relative interests of his or her donees by amending the partnership agreement. For instance, in the example above, Steve has made a gift to Lara of \$750,000, 75 percent of the \$1,000,000 value of the building. Steve retained a 25-percent interest and Lara has a 75 percent interest. (If they are general partners, both can bind the firm and both are equally entitled to make management and other decisions on behalf of the firm.)

If at some later date, Steve wants to make additional gifts to his daughter, he merely amends the partnership agreement giving her a greater percentage interest and retaining a smaller one. Assume, for example, that while the building was still worth \$1,000,000, he gave Lara an additional 2 percent by amending the partnership agreement and, of course, retained only 23 percent. The 2 percent interest would be worth \$20,000. If Steve were to split the gift with his wife, Jo-Ann, and no other gifts were made to Lara, the value of the gift would be within their combined gift tax annual exclusion (currently at \$11,000 per donee), hence no gift tax would be due. By keeping the gift within his annual exclusion amount (or split the gift with Jo-Ann), Steve could continue to make gifts to Lara until the entire value of the property was shifted to her.

Of course, if the underlying property grew in value over time, Steve must also give away appreciation as well as the original principal. The faster the appreciation, the longer it would take (unless Steve “split” the gift with Jo-Ann, or if he was willing to exhaust his lifetime gift tax exclusion amount and/or pay some gift tax).

Assets which are difficult to divide – such as a farm, or ranch, or unincorporated business – can more easily be gifted if the client places the property into the partnership wrapper and then transfers partnership units to children and other donees. An interest in a partnership’s real estate holdings can be gifted to donees through simple transfers of partnership interests, rather than the cumbersome and time consuming filing and recording of separate deeds of specific properties (some of which might be located in different jurisdictions). Likewise, an individual can give his/her children interests in a diversified investment portfolio without the need to divide up, for example, blocks of stocks and bonds into many small lots.

**Funding Spouse's Estate Tax Exclusion Equivalent:** Instead of outright gift (or in an irrevocable trust for his/her benefit), a gift of a general or limited partnership interest to a less wealthy spouse can prevent or minimize waste of his or her applicable exclusion equivalent (currently at \$1,500,000). Use of an FLP rather than outright gift minimizes concerns that the asset will be lost in a divorce or other unforeseen situations. Similarly, an FLP provides more planning flexibility to meet changing needs and objectives than an irrevocable trust.

**Income Shifting:** Assuming the family partnership rules are met (see discussions under "Types of Partnership" and "Maintenance of Control"), an FLP can shift income from the parent (who may be in a 40% combined federal/state income tax bracket) to a child or children, or grandchild or grandchildren (who may be in a bracket as low as 15% or 28%). The savings potential is significant. [Note: Be aware, however, of the "kiddie tax."]

**Certainty:** Partnerships are among the oldest types of business enterprise; hence, there is a great deal of law concerning every phase of partnership operation. This results in guidance as to how the law will treat a given situation – unlike the case of an LLC. Furthermore, there is sufficient case history to provide planners, advisors and clients with practical guidelines with respect to what is or is not acceptable to the IRS and/or the courts.

**Simplicity:** Forming a partnership is relatively simple. Apart from the agreement of the parties involved and the property/asset, it requires only a "deed of gift" transferring the property/asset to the entity (and in the case of a limited family partnership there must be a certificate). This eliminates the need to record real estate deeds, for example. Only one transfer is required; once the property/asset is placed into the entity, a simple amendment to the written agreement shifts partnership interests (i.e., wealth and/or income) to meet changing needs or planning objectives.

Corporations, on the other hand, require a state issued corporate charter, a much more complex organizational structure, and may have to contend with issues as complex as a personal holding company tax, accumulated earnings tax, and collapsible corporation rules. Unlike corporations, partnerships may generally be terminated without adverse income tax consequences.

**Contractual Flexibility:** An FLP, because it is a creature of contract, is more easily changed than an irrevocable trust or a corporation. Although an irrevocable trust may be changed through court action or reformation, and can provide some flexibility through provisions such as powers of appointment, changes to trust operation and/or provisions are typically cumbersome, expensive, or practically impossible. Likewise, to alter or eliminate a corporate structure is often tantamount to triggering at least one and often two levels of income tax, one at the corporate level and a second at the shareholders' level.



Compare this with an FLP. Assuming state law permits, the partnership agreement of an FLP can be changed – at any time – merely through a positive vote of a simple majority of the firm's partners. And in most cases, it is possible to liquidate an FLP with minimal or, in some cases, no adverse tax implications.

**Structural Flexibility:** The respective rights and interests of partners in a family partnership can be structured in almost any imaginable way. For instance, it is possible to give away varying percentages of a partnership asset to a number of family members, or to a single member. In the Steve and Lara example above, we illustrated how Steve initially contributed a building to the FLP, he then gave a large partnership interest (75%) to Lara by amending the agreement. Later, he increased her interest by 2 percent (again, by amending the agreement), and retained a 23-percent interest.

If the total value of the partnership were to grow to \$1,400,000 (instead of remaining at \$1,000,000 as in the prior scenario), the gift value of the 2-percent partnership interest would be \$28,000. Even if Steve were to split the gift with his wife, it would still exceed the gift tax annual exclusion of \$22,000 (\$11,000 x 2). Therefore, he could give Lara 1.5 percent interest (worth \$21,000) to keep his gift within the annual exclusion limit of a split-gift. In fact, if he were to choose not to split the gift with his wife, he could give Lara a fraction of one percent interest (for example, 0.75% worth \$10,500) without paying gift tax – merely by amending the partnership agreement.

By definition, partners of a family limited partnership (or family partnership) are related (directly or indirectly, such as sons-in-law, nieces, etc.). Similarly, family corporations, trusts and estates of family members, other FLPs and LLCs with members who are related may be admitted as partners in an FLP.

Structural flexibility is an important aspect for an FLP to meet the varying (and changing) needs of different family members. For instance, by allocating different interests in the FLP (each with differing characteristics) a client can simultaneously (a) retain an adequate income for retirement, (b) retain control of the investment and operation of underlying assets and/or business, or shift responsibility for investing and operating to others, (c) ensure that members of younger generations share in profits, yet provide a higher level to those working in the partnership than to non-working family members, or to those more needy or deserving than to the financially secure or those who are wayward, and (d) maximize the shifting of wealth to, as well as the spitting of income with, the younger generation(s).

**Investment Flexibility:** To a great extent, state law governs the rules which regulate how business and investment decisions are judged. Typically, an estate owner who wants to control management and investment decisions will not want beneficiaries or donees second guessing him/her. Yet, bene-

ficiaries of trust can invoke the “prudent man” rule against a trustee, a rule which can provide a very rigid and strict standard. On the other hand, the general partner in a partnership is judged by the “business judgment” rule, a much more reasonable and flexible standard. So a family limited partnership gives some additional protection against the “20-20 hindsight” of family members to a managing partner/decision-maker than would be available to the same person as trustee.

There is another more sophisticated level to the investment flexibility issue. A trustee in a classic “income to my wife, remainder to my children” trust must constantly be concerned about the inevitable conflicting interests of the income beneficiary and the remainderman. The former, typically the grantor's spouse (or the current generation beneficiaries) would like the trustee to invest in such a manner as to maximize the current dividend, rental, and other interest income of the trust; whereas, the latter, typically the grantor's children or grandchildren, would much prefer that the trustee's investment decisions maximize the long-term growth of the trust corpus or principal. Professional investment managers often attempt to obtain the highest rate of overall return consistent with the risk tolerance of the investor (i.e., the client/grantor). Yet this might tend to favor one party over another in the typical trust situation.

Conversely, in a partnership, the general (or managing) partner can invest the firm's assets or steer the business' course in the direction that yields the highest return consistent with his or her risk tolerance. In some years this may result in income growth, and in others capital gain. But since the general (or managing) partner can distribute the percentage of assets deemed appropriate to current partners (taxable to them as income for accounting purposes), the diametric opposing interests typically found in trusts is avoided.

**Consolidate Asset Management:** A FLP can be used to simplify or consolidate the management of assets. Many clients have assets of various types, or those assets are located in different jurisdictions (or both). They may also have a number of beneficiaries with different needs or who would like to be treated differently.

Many investments can be placed into a single partnership, thereby investment planning can be more cohesive and asset management more streamlined. For instance, when multiple accounts are consolidated into one, it not only provides more opportunities for diversification, it would also reduce multiple management fees. Some clients think of this concept as a “family mutual fund.” Family wealth managed by one entity makes it possible to “concentrate” money and employ the “large capital theory,” i.e., bringing a large amount of capital to a single project can increase the overall return to the family investment/financial unit.



Yet another consolidation or unification advantage is that holding multiple assets by a single entity, the FLP, enables the family unit to realize economies of scale and reduce operating and management costs.

Co-tenants of real estate who are given undivided interests each have a “right of partition.” This could result in the co-tenants’ inability to manage the property effectively. An FLP can be used as a wrapper to provide centralized management – while the partners are “tenants in partnership” of the real estate. This unification, as opposed to potential fractionalization, is an important advantage both from the psychological aspect as well as the legal.

**Maintenance of Control:** As the general partner of an FLP (or the managing partner of a family partnership) the client may control the firm and through it – to a great extent – the underlying assets. A client can maintain a significant degree of control over the gifted assets – both currently and in the future – even while shifting income and wealth to member(s) of the family. It is possible for the client to keep significant managerial control over property until and unless he/she chooses to shift it – all at once or over time – to the other partners.

Stated in another way, the FLP allows clients to address equity and management succession issues without giving assets outright to their family members. This control is particularly important where the clients are concerned about the investment/business capabilities of the younger generation(s) and have one or more assets they consider essential to their (the senior generation’s) financial security. It is also very much appreciated when members of the senior generation are worried that those in succeeding generations may be divorced, sued, or spend money frivolously.

Within reasonable limits, a client can control if and when cash will be paid out to limited partners of the FLP. So, by choosing to reinvest all, or a great portion, of the entity’s earnings back into the business, the client can engineer lower or higher payments to his or her donee children. By reinvesting FLP assets in long-term appreciating investments, the client can lower distributable income; or conversely, invest in assets that produce a relatively high rate of current return. (Compare this with a similar power held by the client as trustee. A grantor’s power to determine the amount of distributable income the trust will pay to its beneficiaries would probably cause the assets in the trust to be includible in his gross estate.)

Control can go beyond mere cash flow or managerial decisions. Assets can be kept in the client’s family by placing them into the partnership wrapper, and then binding that wrapper with a buy-sell agreement that requires any limited or general partner who is divorced, becomes bankrupt, or tries to sell or give away his or her interest (to a party other than the partnership or other partners) to

first offer or sell it to the partnership and/or its current partners at fair market value. (Remember that fair market value of a partnership interest is almost always less than the underlying value of the assets in the partnership.)

A provision can (and should) be placed in the buy-sell agreement specifying that an involuntary transfer to a creditor, former spouse, or any non-family member, is not a permissible transfer, nor can a partnership interest be pledged as security for a debt. Family members or the partnership can be given a right to purchase an FLP interest at a stated or formula price before it can be transferred to any other party.

Yet another level of control lies in the nature of a partnership entity. It is a creature of contract and, as such, can be amended or terminated without the need for court approval and often without adverse tax implications. Compare this with an irrevocable trust which, by definition, cannot easily be amended or terminated and either amendment or termination for any reason will typically trigger severe tax consequences.

Trustees have been removed because of legal actions against them brought by trust beneficiaries. But it is difficult, if not impossible, for disgruntled limited partners to remove and replace a general partner. This is because the partnership agreement is a contract which cannot easily be rewritten to remove or exclude a party. This provides yet another layer of protection and control for the client.

The ability to control both cash distributions and management of the underlying assets can provide the client a tremendous psychological comfort, as a result, the client is not threatened with the cessation of importance, a loss in some cases more devastating than giving away mere wealth.

FLP interests can be owned by custodians under UTMA/UGMA for the benefit of minors. The formation of a FLP using UTMA/UGMA assets may be a way to satisfy the desire of the custodian to postpone possession by the minor of the UTMA/UGMA assets beyond age 18 or 21. But has a custodian breached his/her fiduciary duty (the diminution in value, real or perceived) – by contributing assets to a FLP in exchange for a limited partnership interest? The solution is to be sure that the fair market value of the custodial account transferred to the FLP is replaced by an interest which, after proper discounting, is worth at least equal to the cash, securities, or other assets given up.

**Bifurcation of Interests:** Bifurcation of control and equity value of a family business is possible through an FLP, while simultaneously centralizing control in the hands of one generation. This may be particularly appealing in a farm or ranch situation where, for example, one member of a generation often stays on the farm, while other members leave the area and work in other

business/industry. The older generation wants to assure the child (or children) who has (or have) remained would end up with control of the farm, while the others receive an equitable share of their wealth (even though all or the bulk of the parents' wealth is tied up in the farm). The general partnership interest can be given or left to the farming child (or children) and limited partnership interests can go to the other children.

**Pass Through in General:** Items of income, deduction, gain, and loss at the partnership level pass through with the same character it had and is reported by the partner as if it was directly earned or received by him or her. This avoids the all too well-known “double taxation” associated with corporations, where income is taxed first to the entity and a second time as a nondeductible dividend when paid to the shareholder. In partnerships there is only one level of income tax (at the partners' level).

**Net Operating Loss Pass Through:** In the early years of most business enterprises up-front expenses typically cause a net operating loss. This loss may not be taken against the owners' income if the business operates as a C (regular) corporation, but it can be deducted personally if the business is a partnership.

**Special Allocations Possible:** Within limits, it is often possible to allocate income and even income-tax deductions and credits among the partners in ways that optimize their personal income tax planning.

**Avoidance of Ancillary Administration and Costs:** A partnership interest, whether general or limited, is personal property – even if the partnership holds only real estate. As such, a client can “convert” real property to personal property, or “wrap” out-of-state real property into the partnership. Thus the costs (potentially in different jurisdictions), delays, and inconveniences of probate can be avoided. There could be potential tax savings, if the FLP is domiciled in a jurisdiction that has no inheritance taxes.

**Avoidance of Publicity:** As a contract, the FLP agreement can provide a great measure of confidentiality. It can even contain penalty clauses for the exposure of terms or provisions of the contract to public scrutiny.

Should there be intra-family litigation with respect to a trust, the odds are that it will be both bitter and, in the case of a celebrity or well-known parties, public knowledge. There is rarely a way to bind the parties to silence or to arbitration. There is a possible solution: A partnership agreement can be drafted so that the parties are bound, in the event of a dispute, to submit the disagreement to binding and confidential arbitration. Since the finder of fact in an arbitration is typically an

experienced business person – rather than a jury (or judge) that is either unsophisticated or unfamiliar with the client's business or investments – arbitration is generally preferred by the managing partner/decision-maker client.

Furthermore, trial publicity usually works against the wealthier client, and for the litigant children. A confidentiality provision in the partnership agreement can help avoid publicity as well as reduce the ferocity and fallout of a disagreement. The partnership agreement could also provide that the loser of arbitration must pay all costs. This would discourage trivial or frivolous actions or those brought merely to harass another partner. These terms and provisions would be difficult to replicate in a trust agreement.

**Creditor Protection:** To some extent, a partnership wrapper provides a shield against creditors of both the client and the limited partner donees. Assume, for example, the client sets up a partnership and places assets and/or business interests into it. At some later date, the client is sued and his insurance coverage is not sufficient to cover the entire amount of his liability. As a partner, he has no interest in specific partnership assets; therefore, a creditor has no right to the debtor-partner's share of the firm's assets.

Stated another way, once a client contributes assets to a partnership in exchange for interests in that partnership, the transferor-client receives an asset that is nowhere near as attractive to others as the sum of the individual assets contributed – especially when you consider that ownership and control have been separated – and control typically remains in the hands of the client, even if the creditor can obtain some measure of ownership.

The creditor's main remedy against the partnership is to obtain what is called a “charging order.” This is a court order against the partnership interest the client owns entitling the creditor to any distributions made by the partnership to the partner. Essentially, it puts the creditor in the debtor-partner's place – but only to a very limited extent. At best, the creditor receives what the debtor-partner would have received if there is in fact a distribution from the partnership. If there is no cash distributed, neither the debtor-partner nor his or her creditor can obtain cash flow.

The creditor with a charging order is an assignee and, as such, cannot: (1) reach partnership assets, (2) manage the partnership or vote, (3) control the cash flows (cannot force distributions of either income or principal to partners), or (4) cause the liquidation of the entity. A creditor with a charging order cannot exercise any rights the debtor-partner may have had, and can only receive those distributions which other similar partners receive and only then if the general partner chooses to make those distributions.

The mere complexity of many FLP arrangements tends to discourage creditors and may increase the bargaining position of the debtor. The aggravation and cost of the potential litigation required are daunting to most attorneys who will probably advise a settlement rather than a long drawn-out court battle. It is advisable to draft the FLP agreement to block any partner from pledging a partnership interest as collateral for a personal debt. This provides additional “spendthrift” protection for the family unit.

Planners and advisors should note that recent trends are beginning to erode the protection against creditors and what protection there is comes at a cost: the use of the property. The client must be prepared to “do without” the partnership interest for an indefinite period of time. Creditors may now have weapons against debtors other than charging orders. Foreclosure and sale of a limited interest is just one such possibility. And as long as innocent non-debtor partners and their business are not hurt (which they typically would not be in a FLP), courts seem to be more willing to support the charging order. If the FLP is used as a vehicle for avoiding judgment creditors, it is likely the trend of less protection of debtors and more support of creditors will increase.

A limited partner (or member of an LLC) is, of course, personally liable for his/her own negligence as well as for debts of the partnership he/she guarantees. Federal environmental law may also make a limited partner liable as an “owner” or “operator.”

**Spousal Protection:** Protection of family assets from failed marriages has become as important as – if not more than – normal creditor protection in the minds of senior family members who are concerned that their offspring may not have made the best possible choices in relationships. Keeping a family business or key investments within the family unit is a strong motivation in the creation of FLPs. As opposed to a pre- or post-nuptial agreement, the FLP is less emotionally charged and perhaps, in some ways, more practical.

As noted above, the FLP buy-sell agreement can provide that involuntary transfers trigger a first-offer option for the other partners or the partnership at fair market value – which may be less than the underlying asset value of the partnership’s assets. The most that the divorcing spouse of a partner will receive is cash rather than a family business interest.

**Planning for Unmarried Couples:** Unmarried couples have no opportunities to use marital deductions or other useful tax-saving devices, such as gift-splitting. Yet the use of “family” partnerships provides them an advantage not available to those defined as “family members” under Code Sections 2701 to 2704; that is, they are not subject to the onerous restrictions of those code sections. This makes it possible for unmarried couples to safely transfer “growth” interests in a partnership while retaining “preferred” interests. In other words, a wealthy domestic partner can transfer her or his assets to a partnership, keep the right to a preferred return, and give the less wealthy partner all the rights to future appreciation.

Little, if any, gift tax cost will be incurred on the establishment of the growth interest and the non-contributing partner will grow wealthy – at minimal or no cost to the wealthier partner. Note that value-reducing legal restrictions – that would be ignored for gift tax valuation purposes if the parties were married – are respected if the same individuals are unmarried. This may lead to a less costly intra-(unmarried) couple gift and a lower estate tax value for the wealthier partner.

**Potential for Gift, Estate, GST Tax Discount:** Through an FLP, it may be possible to transfer huge amounts of wealth from one generation to another – yet minimize or even eliminate the transfer tax costs. By “unbundling” the various inherent property rights, an estate owner can give the property away (all at once or in increments over a period of time) at a discount and still keep considerable control.

Why a valuation discount? Wrapping assets into an FLP adds complexity, reduces marketability, and diminishes the control of the owner over the property. A limited partner in particular has little say with respect to how partnership assets are managed, how much return will be realized on the underlying assets, or when (if any) distributions will be made.

Those factors would lead a willing buyer to pay less than liquidation value for an interest in a family limited partnership, and that can translate into significant transfer tax savings. My opinion is that combined discounts aggregating 20 to 30 percent are relatively safe and in many cases significantly higher discounts can be substantiated.

**But all discounts must be justified by “facts and circumstances” and discounts well in excess of these amounts will almost surely attract stringent IRS scrutiny, and be vigorously challenged. It is most important that independent and court qualified appraisers prepare (as close as possible to the date of the gift or sale) thorough valuation reports listing the factors used to justify the discount(s) taken.**

**Avoidance of Dividend Treatment:** It is difficult in many family-owned business situations to avoid characterization of a stock redemption as a dividend because of the so called “attribution” (“constructive ownership”) rules. Yet a partnership comprised of the same individuals who own the shares of a corporation can purchase the stock of a deceased shareholder who is also a partner without fear of dividend treatment.

Furthermore, since the partnership is a flow-through entity, its partners become owners of the stock the partnership purchases from a deceased shareholder in proportion to their respective partnership interests. They take that indirect ownership of the stock with a step-up in basis; that is, since the partnership purchasing the stock receives a basis equal to the price it pays at a shareholder's death, that basis flows through to the individual partners.



**Avoidance of AMT:** Generally, 75% of the proceeds payable to a C corporation may be subject to a potential alternative minimum tax (AMT) – unless it is a “small corporation” (defined as one with a 3-year average gross receipt not exceeding 7.5 million). Corporate-owned life insurance, per se, does not subject the corporation to the AMT; rather, it is only one of many items used to determine if a C corporation pays either the regular tax or the AMT (if higher). The AMT is 20%.

In business succession planning, life insurance held by a partnership on the life or lives of its partners will have no impact whatsoever on the AMT issue. There is no entity level AMT imposed on partnerships. This can significantly enhance the use of life insurance in a key person or buy-sell situation if the entity is structured as a partnership.

**Qualification for Section 6166 Installment Payments of Estate Tax:** A client, who could not otherwise meet the rigid percentage (e.g., more than 35 percent of adjusted gross estate) tests of Section 6166, may be able to qualify if he or she contributes a farm, business, investment real estate, and/or other property to boost the percentage of the business relative to the value of the adjusted gross estate. This technique is not, of course, a viable death-bed technique; but as part of a long-range planning effort, it should work.

**Avoidance of Transfer for Value Rules:** A stock redemption agreement may be converted to a cross purchase buy-sell or even to either a partnership entity purchase agreement or a cross-purchase for partners without fear of violating the transfer for value rule. A valid partnership and its partners, and their respective relationships to the insured are the essential elements to the transaction – because they are the exempt parties under the safe harbor exception to the transfer for value rule. That is, when life insurance is transferred to a partnership in which the insured is a partner, or to a partner of the insured – even if it is for a valuable consideration – the death proceeds will retain their income-tax-free status.

So, if a corporate-owned life insurance policy is sold, or otherwise exchanged for fair market value to a co-shareholder – who is also a partner of the insured in a valid partnership (but not necessarily a related entity to the corporation) – to fund a cross-purchase buy-sell, the transfer will not trigger the transfer for value tax trap. Likewise, if the transfer of life insurance is to a legitimate partnership (i.e., one recognized under both federal and applicable state laws), or to a partner of the insured, the transaction will fall within a safe harbor and the proceeds will be income-tax free. Similarly, the safe harbor applies to transfers of life insurance for non-business needs as well. For example, a sale of policy owned by the insured's former co-shareholder to the insured's irrevocable trust that is a partner of the insured's FLP is an exception to the rule. Remember, it is the transferee that determines if a safe harbor applies; the identity of the transferor is irrelevant.

**Caution:** It is my strong opinion that a partnership which holds no assets other than life insurance will not be respected by the IRS or the courts – in spite of PLR 9309021 which has been read, analyzed, and interpreted by many as a sanction for a life insurance partnership with no additional valid business activities or investment assets.

Also, note that when substantially all of an unincorporated organization's assets consist – or will consist – of life insurance on the life or lives of its members, the IRS has refused (and probably will continue to take that position) to issue a ruling on whether, in connection with the transfer of a life insurance policy to an unincorporated organization, (a) the organization will be treated as a partnership, or (b) whether the transfer of life insurance to the organization will fall within a safe harbor to the transfer for value rule. This reinforces the importance of the “enterprise” (with business or investment activities for economic purposes), and is a warning that applicable state law requirements of a valid partnership must be continually met.

## SUMMARY

Many clients often want to bring family members into a business, and simultaneously improve intra-family communication and reduce friction, at times unavoidable, among family members because of their diverging needs, interests, abilities, and opportunities. The multi-faceted partnership entities and their inherent flexibility in terms of design, structure and operation can serve a client well in achieving his or her family wealth management/transfer planning objectives – while, at the same time, can more easily satisfy other family members their respective needs. Additionally, family limited partnerships can be used as a vehicle to help educate the junior family members about their seniors' investment philosophy and strategies. In fact, clients often express the thought that inter-generational involvement is one of the greatest of all the advantages of family limited partnerships.

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