

# Family Limited Partnerships

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## **Abstract:**

A family limited partnership is a very attractive estate-planning tool because it permits a parent to significantly discount the value of gifts to children. This material discusses the advantages and disadvantages of forming a family limited partnership.

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## **ISSUE 5: FAMILY LIMITED PARTNERSHIPS**

A family limited partnership is a very attractive estate-planning tool because it permits a parent to significantly **discount** the value of gifts to children that might not be discountable if made outright. A family partnership enables a donor to divide a large asset or pool of assets to make several smaller gifts, in much the same way that a family corporation enables a donor to make multiple gifts of shares of stock. Like an S corporation, a family partnership preserves the character of items of income, deduction, gain, and loss recognized at the partnership level and taxed directly to the partners.

A family partnership, however, can be more flexible than a corporation (even an S corporation) in that

- The partners can, in their agreement, detail their respective rights and interests with far greater precision.
- The tax problems attendant on withdrawal of contributed property from a partnership are far fewer than those attendant on withdrawal of contributed property from a corporation.
- The limitations on the number and type of stockholders imposed on an S corporation do not apply to a family partnership.

**Discounts.** Two discounts generally are available: a lack of marketability discount and a minority discount.

**1. A lack of marketability discount** reflects the fact that the partnership agreement will restrict the sale or transfer of the partnership interests so that there is no ready market for those interests.

**2. A minority discount** reflects the inability of the limited partner to compel partnership distributions or to compel liquidation to obtain the limited partner's share of the partnership assets. It also reflects the inability of the limited partner to control partnership investments. Reversing its long-standing position, in Rev. Rul. 93-12, the IRS held that a minority discount is available with respect to transfers between family members despite the fact that, after the transfer, control exists as a family unit.

**Economic Effect.** The combined discounts for lack of marketability and minority can be quite substantial and might range from 30% to 60%, depending upon the facts and circumstances.

**Advantages.** Family partnerships offer a number of advantages as a means of transferring family wealth.

- The creation of a family partnership is relatively simple, requiring a partnership agreement, a deed of gift, and (in the case of limited partnerships) formation as a separate legal entity under State law to receive a partnership certificate.
- Using a family partnership to make gifts of real estate located in a state in which the donor does not reside can eliminate ancillary probates. Real estate owned by the decedent directly is subject to probate in the state where it is located—regardless of the state of residence of the deceased owner. A partnership interest is treated as personal property and is subject to probate only in the state of the decedent’s domicile, even if the partnership owns real estate.
- A family partnership enables a donor to retain control over the property being given away. The donor can be designated the managing partner (of a family general partnership) or the general partner (of a family limited partnership). In either case, the donor could retain most or all of the managerial controls over the property, until all of it has been transferred to the donee-partners, without jeopardizing the estate tax advantages of the partnership. The IRS has ruled privately on a number of occasions that the retention of control over the partnership activities by a donor who serves as a general partner is not a retained right to control the beneficial enjoyment of the transferred partnership interests. See Ltr. Rul. 9415007, 9310039, and 9310006.
- Unlike a corporation, a partnership is not a taxable entity for income tax purposes, so the donor’s interest in the family partnership’s net income escapes taxation at the partnership level.
- Multi-class partnership interests can be used to freeze the value of the interests of a deceased partner for gift and estate tax purposes under the special valuation rules of Chapter 14 of the Internal Revenue Code.
- A partnership interest is relatively secure against the claims of the partner’s creditors. A creditor of a partner may force the partner to transfer his or her partnership interest to the creditor, but the transferee becomes an “assignee,” rather than a new partner, and is not eligible to participate in partnership activities and management. The assignee may obtain only a

“charging order,” entitling the assignee to the assignor-partner’s share of any partnership distributions that are actually made. Status as an assignee with a charging order is generally very undesirable, because the assignee is treated as a partner for federal income tax purposes and is taxed on a share of partnership income, even if the partnership does not make any distributions. (Rev. Rul. 77-137, 1977-1 C.B. 178).

- An outright gift of a partnership interest in a family partnership (or a gift in a trust that otherwise qualifies for the gift tax annual exclusion) is generally eligible for the gift tax annual exclusion.

**Disadvantages.** Family partnerships used as a means to transfer family wealth have relatively few disadvantages, but any one could be significant for a particular situation.

- Legal fees for setting up a family limited partnership could be substantial. When appraisal fees are taken into account, this amount could be even higher.
- Loss of stepped-up basis. Any lifetime transfer of assets results in a tax trade-off. Although transfer taxes may be greatly reduced, the donee may take a much lower basis in the transferred assets by taking the assets with a carryover basis rather than a stepped-up basis. The transfer tax (estate and gift) advantages must be weighed against the possible income tax (capital gains) disadvantages.
- The donor’s annual gifts of a partnership interest are valued on the date of each individual gift. Thus, a donor who retains a significant partnership interest in a family partnership in which the underlying asset continues to appreciate in value is credited with a portion of the appreciation in the value of the retained interest, making it necessary to make even more gifts to give away the donor’s entire asset.
- Family partnerships are subject to the family partnership rules under I.R.C. §704(e) in order for a donee-partner to be recognized as a partner for income tax purposes. Specifically, capital must be a material income-producing factor for the partnership, and the donee-partner must be the real owner of an interest in that capital. If these tests are not met, partnership income will be taxed solely to the donor and others who invested their own capital or services, depriving the donor of the income-shifting advantages otherwise available through the family partnership.

**Example 5.** John and Mary, each age 55, jointly own and operate J & M Land & Cattle Company. Their two sons Jim, age 27, and Joe, age 24, are each paid a salary and are gradually taking additional management responsibilities. John and Mary would like to keep control of the assets rather than give too much too soon to their sons, who, they feel, may not be ready for the responsibility. But they

want to transfer the assets during their lifetime to protect them from future creditors and reduce their taxable estate.

John and Mary have the following assets and liabilities:

<u>Asset</u>	<u>Fair Market Value</u>	<u>Debt</u>	<u>Tax Basis</u>	<u>Potential Gain/Loss</u>
Land & Improvements	\$1,000,000	\$250,000	\$500,000	\$500,000
Raised Livestock & Grain	200,000	100,000	-0-	200,000
Machinery & Equipment	300,000	150,000	85,000	215,000
Total	\$1,500,000	\$500,000	\$585,000	\$915,000

Assume that John and Mary contribute their assets to a family limited partnership in exchange for general partnership interests and limited partnership interests. There is no gain or loss on the transfer.

If John and Mary each retain a 30% general partnership interest and gift a 20% limited partner interest to each of their sons, the gift **may qualify for discounts for lack of marketability and a minority ownership discount**. Assuming a combined discount of 40%, John and Mary can each use their annual gift exclusion to transfer free of gift tax \$16,666 FMV of assets to each of their sons. The portion of the gift over and above his or her annual gift exclusion will use up a portion of each parent's unified credit. John and Mary would be able to give a larger share of their estate by limiting the general partner interests to 10% and increasing the limited partner interests to 90%.

**Question 5A.** What is the value of the gift to each son, and how much of the parents' applicable exclusion amount is used?

**Answer 5A.**

Net value of company	\$1,000,000	(\$1,500,000 FMV – \$500,000 debt)
20% given to each son	200,000	
Less 40% discount	-80,000	
Less split gift annual exclusion	-20,000	
Taxable gift	100,000	
Applicable exclusive amount used	<u>100,000</u>	
Gift subject to tax	-0-	

**Question 5B.** How much applicable exclusion amount would be used if discounts were not used?

**Answer 5B.**

20% given to each son	\$200,000
Less split gift annual exclusion	<u>\$ 20,000</u>
Taxable gift	\$180,000
Applicable exclusion amount used	\$180,000

**Question 5C.** Would future annual gifts of partnership interests be allowed the same discounts?

**Answer 5C.** Yes. Assuming the same combined discount of 40% (see Answer 5.1), John and Mary could use their joint gift splitting to give \$20,000 of discounted partnership interest to each of their sons each year. The fair market value (FMV) of the underlying partnership assets would be \$33,333.

FMV of partnership assets	\$33,333
Less 40% discount (\$33,333 $\times$ 40%)	<u>13,333</u>
Discounted partnership interest	\$20,000

**Practitioner Note.** The \$10,000 annual gift tax exclusion is indexed for inflation and therefore may increase for future years.

**Question 5D.** Would John and Mary's individual remaining general partner interest in the family limited partnership be eligible for the same discounts when valued in their respective estates?

**Answer 5D.** Yes.

**Planning Pointer.** Reduction in estate taxes and meeting the parents' control objectives must be weighed against a loss of potential step-up in basis and cost associated with formation and operation of the family limited partnership.

**Recommendation.** To protect a gift of a limited partnership interest from a possible valuation contest, make a formula gift of the interest. For example, a married couple's annual exclusion gift to a child might be described as "that number of limited partnership units (including a fraction thereof) equal in value to \$20,000." If the IRS successfully challenges the valuation discount, the formula simply absorbs the extra value allocated to the transferred interest. Thus, the transfer remains fully protected by the annual exclusion.

**Warning.** These are complex rules. Advice from specialists is strongly recommended to achieve the desired tax benefits.

**Caution.** Planners should be aware of the provisions of the White House proposed 2000 fiscal year (Y2K) budget, described in the Treasury Department's "General Explanations of the Administration's Revenue Proposals" (known as the "Green Book"). Among other provisions, these budget proposals would **eliminate the use of valuation discount planning in most estates** by precluding

discounts for lack of marketability and lack of control with respect to family corporations, partnerships, and limited liability companies, **except to the extent that they represent an operating business.** No discounts would be allowed for stock, partnership interests, or LLC interests, to the extent that the entity's assets consisted of cash, cash equivalents, foreign currency, publicly traded securities, real estate, annuities, royalty-producing assets, non-income-producing property such as art or collectibles, commodities, options, and swaps. Interests in investment holding companies would be valued at their net liquidation values. This proposal would be effective for transfers made after the date of enactment. Congress flatly rejected this proposal, also introduced as part of the fiscal year 1999 budget proposals, in 1998, and again in 1999, and it seems no more likely to be successful in 2000, an election year.