

DRAFTING TIPS TO OBTAIN MAXIMUM TAX SAVINGS FROM FLPs¹

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Introduction

The potential tax advantages of family limited partnerships have been documented in numerous publications. [See Willms, Family Limited Partnerships and Limited Liability Companies: New Estate Planning Tools for the 90s, Wisconsin Lawyer, March 1994, p. 17.] However, for a family limited partnership ("FLP") to produce the desired results, the drafting attorney must navigate dangerous waters. The purpose of this article is to expose some of the obstacles that lie just below the surface. Failure to circumvent these hidden dangers could doom the effectiveness of the family partnership, and perhaps the attorney who drafted the partnership agreement as well.

OVERVIEW

When an FLP is used in connection with estate planning, assets that are intended to be transferred from one generation to the next are contributed to a partnership by members of the senior generation, in exchange for partnership interests. Typically the partnership issues both general and limited partnership interests. The limited partnership interests can represent up to 99% of the equity in the partnership and the general partnership interests will represent the remaining equity.

If the senior generation makes gifts of limited partnership interests to members of the next generation, the FLP will be a very tax effective way to transfer assets from one generation to the next. To the extent these gifts are sheltered from tax by the unified credit or the annual exclusion, they are tax-free. [PLR 9415007; TAM 9131006.] Gifts of limited partnership interests can qualify for the annual exclusion from generation-skipping transfer taxes as well. [See I.R.S. §2642 (c).]

GIFTING OF FAMILY PARTNERSHIP INTERESTS

There are several unique advantages associated with gifts of FLP interests.

Maintaining Control

A limited partnership interest that has been gifted during life will generally not be included in a donor's estate for estate tax purposes, even if the donor is acting as general partner at the time of his or her death. [TAM 9131006; PLR 9415007; PLR 9332006; PLR 9310039.] Thus, an FLP allows a donor to maintain control of the assets that are to be gifted. It also

¹ This information is current as of 1996. Please contact Willms, S.C. for current information on this topic.

allows the donor to make a gift of undivided interests in partnership assets. This can be very useful when assets such as commercial property or farm land are to be gifted.

Discounted Value

As discussed below, if a family partnership agreement is drafted properly, the value assigned to gifts of limited partnership interests may be discounted to reflect (i) restrictions found in the partnership agreement on a limited partner's right to compel liquidation, and (ii) the lack of a ready market for the partnership interests. [Rev. Rul. 93-12, 1993 -1 C.B. 202.] These discounts often range from 20% to 50%. [See Covey, Family Limited Partnerships, Practical Drafting at 3761-94 (Oct. 1994).]

Shifting Income

If the donee of a limited partnership interest is taxed at a lower income tax bracket than the donor, an FLP could reduce total income taxes. That's because the limited partners will be taxed on a proportionate share of the partnership income, even if that income is accumulated. [I.R.C. §§701, 702.]

Creditor Protection

In those states that have adopted the Revised Uniform Limited Partnership Act, an FLP may provide protection for gifted property from the donee's creditors. Section 703 of the Revised Uniform Limited Partnership Act limits a creditor's remedy against a partnership interest to a charging order. Such an order entitles the creditor only to receive distributions that are actually made from the partnership to the limited partners. [Two decisions by the California Appellate Court have raised questions as to the reliability of the protection afforded by a family limited partnership. See *Centurion Corp. v. Crocker Nat'l Bank*, 255 CAL. RPTR. 794(CAL. APP. 1 Dist. 1989); *Woodward-Gizienski & Associates v. GeoTechnical Exp.*, 255 CAL. RPTR. 800 (CAL. APP. 4 Dist. 1989).] Moreover, for federal income tax purposes, the creditor will be taxed on a proportionate share of the partnership income, even if that income is not distributed.

Comparison to Irrevocable Trusts

An FLP also has advantages when compared to irrevocable trusts as a method of transferring assets from one generation to the next.

- Income that is accumulated by an irrevocable trust is subject to tax rates that are more accelerated than those that apply to individuals (and, therefore, to partners). [I.R.C. § 1(e).]
- Income of an irrevocable trust that is used to satisfy a support obligation of the Grantor is taxed to the Grantor. [I.R.C. §677(b).] The same is not true with regard to partnerships.

- If the Grantor of an irrevocable trust acts as trustee and, as such, has the discretion to use trust assets to satisfy a support obligation, this discretion may be deemed to be a general power of appointment. [Treas. Reg. §20.2041-1(c)(1).] In this event, the trust assets would be taxable in the Grantor's estate for federal estate tax purposes. These rules do not apply to partnerships.
- A partnership agreement can be amended or revoked upon the agreement of all of the partners. [Revised Uniform Limited Partnership Act §§202, 801, 6 U.L.A. 479, 569 (Supp 1995).]
- While the trust beneficiaries are free to sue the trustee at any time, a partnership agreement can require that all disputes are to be resolved by arbitration and require the unsuccessful partner to pay all arbitration costs.

COMPARISON TO LIMITED LIABILITY CORPORATIONS

A limited liability corporation ("LLC") can offer many of the same planning advantages as an FLP. In simplest terms, an LLC is an "unincorporated business entity" that, when properly structured, is taxed in the same manner as a partnership. Ownership of the LLC is represented by "membership units". Like a partnership, a combination of both voting and non-voting membership units may be used. These membership units may then be used to make gifts to family members of the next generation.

The primary advantage of an LLC as compared to an FLP is that there is no requirement that a member of the LLC be personally liable for the debts of the LLC. As a result, an LLC may be preferable to an FLP if the assets to be transferred is an interest in an active trade or business, or an asset which could be the basis for litigation (such as environmental hazards, personal injury claims and the like) [An FLP with a corporate general partner may offer significant creditor protection.] However, because members of an LLC may have greater rights than limited partners under applicable state law, there may be valuation issues present with an LLC that are not present with an FLP. As a result, an FLP may be preferable to an LLC where personal liability is of little concern.

AVOIDING IRS CHALLENGES

The IRS has two principal arguments that can torpedo FLPs. First, the IRS can assert that the arrangement does not qualify as a partnership for federal income tax purposes [Failure to qualify as a partnership for income taxes may not destroy the estate tax advantages of a family limited partnership.] Second, the IRS might look to Chapter 14 of the Internal Revenue Code as a way to defeat the family's intentions. Careful drafting can go a long way towards fending off attacks on either of these grounds.

QUALIFYING AS A PARTNERSHIP

A partnership will be found to exist for tax purposes if an unincorporated organization carries on any business or financial operation or venture in a form other than a corporation or association, a trust or an estate. [Treas. Reg. §301.7701-3(a).] Factors which indicate the existence of an association or corporation, rather than a partnership, are:

1. centralization of management;
2. continuity of life;
3. free transferability of interests; and
4. no personal liability for debts and obligations.

To qualify as a partnership, two of the above four factors must not be present. In determining, if the factors are not present the planner or taxpayer should consider the following:

- Centralized management will not exist in the case of a general partnership because of the agency relationship that exists among its members. However, a limited partnership will have centralized management if substantially all of the equity interests are owned by limited partners. [Treas. Reg. §307.7701-2(c)(4).] Therefore, this factor will normally be present in connection with an FLP.
- Continuity of life is present under the Regulations unless the death, insanity, bankruptcy, retirement, resignation or expulsion of a partner would cause the dissolution of the partnership. [Treas. Reg. §301.7701-2(b)(1).] Note that under the Regulations an organization does not lack the corporate characteristic of continuity of life merely because it exists for a stated term. Therefore, it is important that the partnership agreement provide for the partnership's termination upon the occurrence of at least one of the events described in the Regulations. [Continuity of life will not exist if any of the above events causes the dissolution of the partnership unless the remaining partners agree to continue the partnership.]
- Transferability of limited partnership interests can be limited by the partnership agreement [Revised Uniform Limited Partnership Act § 702, 6 U.L.A. 563 (Supp 1995).] For example, the partnership agreement can prohibit the transfer of partnership units to non-family members or create a right of first refusal on behalf of the partners. However, when imposing such restrictions, consideration should be given to Treasury Regulation §1.704-1(e)(2)(ix), which provides that the donee of a limited partnership interest will not be recognized as a partner for federal income tax purposes if the limited partner's right to transfer or liquidate his interest is subject to substantial restrictions. Giving the other partners a right of first refusal should not, however, violate this regulation.

- Personal liability for the debts of the partnership falls only on the general partners. If a corporate general partner has no substantial assets, then the corporate characteristic of limited liability may be found to exist. [Treas. Reg. §301.7701-2(d)(2).] Accordingly, careful consideration must be given when selecting a general partner.

The need to avoid at least two of the above four factors can be an important consideration when selecting between an FLP and an LLC. [For a thorough discussion concerning the ability of a limited liability company to qualified as a limited liability company see, Styron, W. Joey, Securing Partnership Tax Status for Limited Liability Companies , Journal of Taxation of Investments (Summer 1995).] Revenue Procedure 95-10 sets forth the requirements that an LLC must satisfy for the IRS to rule that the LLC qualifies as a partnership for income tax purposes. [1995-3 I.R.B. 20 (1995).]

- Centralized management is not present if the LLC is managed by its members.
- Continuity of life can be avoided if the LLC provides for its termination upon the death, bankruptcy, retirement, resignation or expulsion of one of its members.
- Free transferability may be easier to avoid with an LLC than an FLP because Treasury Regulation §1.704-1(e)(2)(ix) does not apply where all persons holding an interest in the enterprise are entitled to participate in management. Thus, greater restrictions on transferability may be possible with an LLC than an FLP so long as all of the members of the LLC have a say in management.
- Personal liability is lacking unless one member of the LLC assumes personal liability for the debts of the LLC, and that the assuming member's net worth is at least ten percent of all contributions to the LLC. [Id.]

Treasury Regulation Section 1.701-2.

On December 29, 1994, the IRS issued new Treasury Regulation §1.701-2. In essence, this Regulation allows the IRS to disregard a purported partnership for tax purposes if the partnership is:

"Formed or availed of in connection with a transaction or series of related transactions ... with a principal purpose of substantially reducing the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K ... In such a case, even if the partnership and partners comply with the literal language of one or more provisions of the Code or Regulations they are under, the Commissioner can recast the transaction for federal tax purposes, as appropriate." [Treas. Regs. § 1.701.2(b)(1994).]

Several weeks later, the IRS issued Announcement 95-8 [Announcement 95-8, 1995-7 I.R.B. 56.] In this Announcement, the IRS declared that the new anti-abuse rule is to apply for income tax purposes only, and not for purposes of the estate, gift, or generation-skipping tax. However, the IRS also stated that no inference is to be drawn from this change of position with regard to the transfer tax treatment of FLPs under current law.

Nonetheless, the IRS' attempt to apply this regulation for transfer tax purposes emphasizes the importance of making sure that a valid business purpose for the FLP can be demonstrated. [For a discussion of the importance of establishing a valid business purpose for a partnership see Halperin, Dr. Jekyll And Mr. Hyde: The IRS States That Final Anti-Abuse Regulation Does Not Apply To Family Limited Partnerships, But What Is Next? Vol. 36 No. 8 Tax Management Memorandum 115 (4/17/95); Sheppard, Can The IRS Challenge Family Limited Partnerships? 63 Tax Notes 1388, 1390 (6/13/94).] For this reason, the business purpose for the FLP should be well documented.

CHAPTER 14 CONSIDERATIONS

I.R.C. §2704(a) – Inadvertent Taxable Transfers

Under I.R.C. §2704(a), the gift of a partnership interest can result in an inadvertent taxable transfer. This Code section applies if there is a gift or bequest of stock or of a partnership interest that is followed by a lapse of a voting right or liquidation right held by the donor after the transfer. In that event, the lapse will be treated as an additional taxable transfer by the donor to the donee.

I.R.C. §2704(a) will apply only if both of the following conditions are met: (i) there is a lapse and (ii) the donor's family controls the entity. A partnership is family controlled so long as either the donor or his family own at least 50% of the capital or profit interests in the partnership, or hold an equity interest as general partner. [Treas. Reg. 25.2701-2(b)(5).] Since this is typically the case where an FLP is used as an estate planning tool, the question becomes whether a lapse of a voting right or liquidation right occurs.

Lapse of a Power to Withdraw- A partner who withdraws from a partnership is entitled to receive the fair market value of his or her partnership interest. [Revised Uniform Limited Partnership Act §604, 6 U.L.A. 556 (Supp 1995)] Therefore, the right to withdraw is, in essence, a liquidation right. Upon a partner's death, he can no longer withdraw from the partnership (i.e. the right lapses). Accordingly, if a partner has the right to withdraw during life, the death of that partner could result in an additional transfer under §2704(a).

Section 603 of the Revised Uniform Limited Partnership Act provides that limited partners may withdraw on six months' notice to the partnership unless the partnership agreement specifies that the partner may withdraw only at a future time or upon the termination of the partnership. To avoid a lapse, the partnership agreement should therefore provide that the partnership is to continue for a set term. In addition, a limited partner's right to withdraw should be restricted prior to the expiration of that term.

Under §602 of the Revised Uniform Limited Partnership Act, a general partner is given the right to withdraw at any time regardless of provisions in the partnership agreement to the contrary. However, the partnership agreement can limit what the general partner is entitled to receive upon withdrawal. Accordingly, the partnership agreement should provide that the general partner only receives the rights of an assignee of a partnership interest if he or she withdraws from the partnership. This limitation should prevent general partners from being able to liquidate their general partnership interest by withdrawing and, therefore, should prevent a lapse of a withdrawal right from occurring when a general partner dies.

Dissolution- Another potential problem associated with general partnership interests concerns the partnership's potential dissolution. The death of a general partner causes the partnership to be dissolved unless there is at least one other general partner and the written provisions of the partnership agreement permit the partnership to continue. If the partnership terminated at the general partner's death, the general partner would (in essence) have a liquidation right. However, this problem can be avoided if either (i) the partnership names a corporation as general partner or (ii) the partnership agreement provides that there must always be two general partners.

I.R.C. §2704(b) – Disallowance of Valuation Discounts

As mentioned above, an FLP agreement normally restricts a partner's ability to withdraw from a partnership, prevents the termination of the partnership before the expiration of a set term, limits limited partners' ability to participate in management, and restricts the transferability of partnership interests. These restrictions can significantly reduce the value of limited partnership interests for transfer tax purposes. [The discounts which apply when gifts of limited partnership interests are made may be offset in part when the general partnership interests are transferred because a control premium may apply at that time. See PLR 9436005; Estate of Winkler v. Commissioner, 58 T.C.M. (PH) 231 (1989).]

I.R.C. §2704(b) provides that if there is a transfer of a partnership interest and the partnership is controlled by the donor's family, then restrictions imposed by the partnership agreement are to be disregarded when valuing the partnership interest for transfer tax purposes. If I.R.C. §2704(b) applies, partnership interests will have to be valued for transfer tax purposes as if the donee of the partnership interests could withdraw from the partnership at any time and receive fair market value for his or her partnership interests.

As mentioned previously, most family limited partnerships are family controlled. Nonetheless, a restriction will be disregarded under §2704(b) only if it constitutes an "applicable restriction." An applicable restriction is one that is more restrictive than the limitations that would otherwise apply under applicable state law and that can be removed by the transferor or any member of his or her family.

State Law Exception- Treas. Reg. §25.2704-2(b) states that a restriction that is less restrictive than those that would apply under state law will not be an applicable restriction

under §2704(b). However, the Code itself says that the restriction must be "imposed" under state law in order to avoid application of §2704(b).

Under the Revised Uniform Limited Partnership Act, a limited partner does not have a right to withdraw if the Agreement is for a stated term. Accordingly, while most states allow a partnership to restrict a limited partner's right to withdraw when a partnership is for a specified term, state law does not actually impose this restriction. Likewise, as previously mentioned, the Revised Uniform Limited Partnership Act gives a general partner the right to withdraw even if the partnership agreement provides otherwise. Therefore, when valuing the partnership interests, it may be ill-advised to rely on state law to avoid a restriction on the right to withdraw from being disregarded. [Some state laws do impose a limitation on a limited partner's right to withdraw. See Ga. Code Ann. § 14-9-603 (1995). Therefore, selecting the appropriate state as the place for creation of the partnership could overcome this obstacle, at least in part.]

Similarly, if a partner has the right to demand the partnership be terminated, he or she would be able to liquidate his or her partnership interest at any time, and his or her interest would not be illiquid. The partnership agreement should therefore restrict a partner's right to terminate a partnership. However, state law does not restrict the partners' collective right to terminate a partnership by unanimous agreement and hence liquidate their interests. Accordingly, state law cannot be relied on to prevent the application of I.R.C. §2704(b) in this regard.

Family Control Exception- A safer way to avoid application of I.R.C. §2704(b) is to provide that restrictions found in the partnership agreement can only be removed with the consent of all persons holding an interest in the FLP and further to arrange for a non-family member to hold an interest in the FLP. In this event, the restriction could not be removed solely by members of the family, and, accordingly, the restriction would not constitute an "applicable restriction." [I.R.C. §2704(b)(2)(B)(ii).]

The term "member of the family" is defined by §2704(c)(2). Basically it means a spouse, lineal descendent, sibling or spouse of a lineal descendent or sibling. In this regard, it is important to note I.R.C. §2704(c)(3) applies "family attribution rules" to the application of certain aspects of I.R.C. §2704. However, it seems clear that those attribution rules apply solely for the purpose of determining who holds an interest in the partnership, and not when determining who "members of the family" actually are.

Frozen Family Partnerships

With a typical partnership, if the general partner elects to distribute partnership income, then all of the partners have an equal right to receive a share of the partnership income in proportion to the number of partnership units they hold. Partners also share proportionally in the appreciation in the value of the partnership's assets. An alternative to the typical arrangement is the "frozen" FLP.

With a frozen partnership, the partnership agreement provides that the general partners are entitled to a specified periodic payment each year. The limited partners are only entitled to share in partnership income over and above this amount (if any). When a general partner dies, the amount included in his or her estate for estate tax purposes is equal to that amount of assets which would be needed to generate (at then-current interest rates) an income stream equal to the guaranteed partnership payment. [Treas. Reg. §25.2701-2.] Thus, if the value of the assets transferred to the partnership appreciates more quickly than current interest rates, the transfer tax savings attributable to the partnership will be increased. [For a discussion of potential tax advantages offered by a frozen FLP, see H. Zaritsky and R. Aucutt, Structuring Estate Freezes Under Chapter 14 (1993 & Supp. 1995).]

The value assigned to a frozen partnership interest for transfer tax purposes is determined under Chapter 14 of the Internal Revenue Code. [I.R.C. §§ 2701 - 2704.] Under I.R.C. §2701, the general partner's payment right will be valued at zero unless it constitutes either a "guaranteed payment right" as defined by I.R.C. §707(c) or a "qualified payment right" as defined by I.R.C. §2701(b)(3). [See Treas. Reg. §25.2701-2(b)(4).]

A guaranteed payment right entitles the partner to receive a payment which is fixed both as to time and amount. [I.R.C. §707(c) Reg. §25.2701-2(b)(4)(iii).] The recipient of a guaranteed payment must include the entire payment and income even if the partnership's total income is less than the amount of the guaranteed payment. Thus, such a payment right can result in greater income taxes if the partnership income in any given year is less than the guaranteed payment amount.

A qualified payment right entitles the holder to a specified payment, provided the partnership has sufficient income to make the payment. Such a payment right must satisfy all of the requirements of Chapter 14. Most importantly:

- A. Any unpaid amounts must accumulate.
- B. If a qualified payment isn't paid within 4 years of when it was due, additional gift or estate taxes will be imposed when the attained interest is transferred.

It is also important that the person holding the frozen partnership interest be deemed to be a partner, rather than a creditor for tax purposes. [Rev. Rul. 75-31, 1975-1 C.B. 10.] This can be avoided by providing that the frozen partner hold at least one percent of the non-frozen partnership interests. [Rev. Proc. 89-12; 1989-1 C.B. 798.]

There are at least 4 potential advantages of a frozen FLP.

1. The donor's can receive an ongoing payment from the partnership, which may encourage gifts that would otherwise not be made.
2. Because of the reduced income rights, the values of the limited partnership interests are worth less at the time of the gift.

3. There is an opportunity for additional tax savings if partnership assets appreciate at a rate that is greater than that assumed by the IRS.

4. At death, the frozen income producing partnership units could be given to children and the unfrozen, appreciating units to grandchildren. That way the subsequent appreciation would escape taxation at two generational levels.

A frozen FLP is not appropriate in all cases, however, because:

- There may be less income shifting because the general partners will be receiving an annual payment.
- A larger amount may be includable in the grantor's estate for federal estate tax purposes.
- It may be advisable to tie the general partners' capital accounts to the value assigned to their general partnership interests under Chapter 14. Failure to do so could increase the size of the general partners' taxable estate if interest rates were to drop after the partnership was created (i.e. the capital account balance could exceed the present value of the payment right).

CONCLUSION

With the foregoing in mind, the following 10 tips should be taken when drafting an FLP.

1. A valid business purpose for the partnership should be clearly documented.
2. The partnership agreement should restrict the transferability of partnership interests.
3. The agreement should provide that the partnership terminates upon the incompetency or bankruptcy, but not death, of a partner.
4. The general partner should have significant assets.
5. The partnership agreement should provide for a set term and should restrict the partners' right to liquidate their interests prior to the expiration of the term.
6. The partnership should restrict all partners' rights to withdraw from the partnership and to transfer their partnership interests.
7. The partnership agreement should provide that if a general partner withdraws from the partnership, the former general partner's rights will be limited to that of an assignee of a partnership interest.

8. The partnership agreement should name a corporation as general partner, or require more than one general partner at all times.

9. A non-family member should be a limited partner.

10. Avoid combining assets with high liability risk with low risk assets in a single FLP.

If the above safeguards are followed, an FLP can be a very effective way to implement gifts to children and grandchildren while retaining control over and perhaps an income stream from the gifted property.