

I. An Introduction to Family Limited Partnerships

A. Overview of the Law Governing Partnerships

1. Limited Partnerships are formed by two or more persons, and have at least one general partner and one limited partner.

a. General Partner: A general partner in a limited partnership has all the same rights and responsibilities as a partner in a general partnership. He or she must be identified on the Certificate of partnership as well as in the partnership agreement. Compared to a limited partner, he or she has more rights and responsibilities, and thus greater liability; a general partner is fully liable for the acts of the partnership.

b. Limited Partner: It is the existence of a limited partner that makes a general partnership a limited partnership. Limited partners have certain rights and responsibilities under Pennsylvania law that are less expansive than the rights and responsibilities of general partners. However, these rights can be expanded upon in the partnership agreement. Limited partners can be named in the agreement only: they do NOT have to have their names on the partnership certificate. Liability for limited partners is less than the liability for general partners; a limited partner is liable only to the extent of his or her investment in the partnership, unless specified differently in the partnership agreement.

2. A limited partnership is formed by executing & filing a certificate of limited partnership with the Pennsylvania Department of State (see attachment)

a. The original general partners **MUST** be named on the certificate; limited partners do not have to be named.

3. Agreement to do business as a limited partnership may be oral or written, but certain provisions must be in writing to be binding

a. Such as:

i Rules governing the admission of additional general partners

ii Allocation of profits and losses among partners and classes of partners

iii. Distribution of cash or other assets among partners and classes of partners

iv. Rules governing the voluntary withdrawal of a limited partner

- v. Rules governing distribution in kind from partnership
4. Limited partnerships are dissolved:
 - a. As specified in the certificate of limited partnership
 - b. As specified in the written partnership agreement
 - c. Upon written consent of all partners
 - d. Upon order of judicial dissolution
 - e. When no general partners remain (unless all remaining partners agree in writing to continue business or agree to appoint one or more replacement general partners)
5. Dissolution of limited partnership will NOT effect the limited liability of a limited partner.
 - a. Limited partners will remain responsible for their portion of unpaid liabilities to the extent that they receive assets in connection with dissolution.

B. The Rights, Duties, and Responsibilities of Partners

- 1.** General partners have essentially the same rights/duties/responsibilities as partner in a general partnership.
 - a.** Manage / conduct business of partnership
 - b.** Inspect/copy partnership books
 - c.** Full liability for activities of partnership
- 2.** Limited partners have similar rights, only in a more limited sense
 - a.** Right to obtain upon reasonable demand full information regarding the state of the business and the financial condition of the partnership, including copies of all tax returns and all other just and reasonable information.
 - b.** Right to inspect and copy records the partnership is required to maintain at its registered office / place of business.
 - c.** These rights are subject to restrictions of partnership agreement and restrictions based upon the right of general partners to keep certain information confidential for a reasonable period of time. Typical restrictions include aspects such as transferability and participation in management of the partnership.

3. Certain rights are held by both general and limited partners
 - a. Right to share in profits and losses
 - i. As allocated in partnership agreement, or
 - ii. If no allocation exists, on the basis of the value of the contributions made by each as stated in the partnership agreement, or
 - iii. If these rights are not allocated in the partnership agreement and no value of contribution is stated in the partnership agreement, then on a per capita basis
 - b. Right of distributions
 - i. Each partner has right to receive distribution of partnership assets
 - 1) Upon withdrawing from the partnership
 - 2) Upon the dissolution of the partnership
 - 3) When otherwise specified in the partnership agreement
 - ii. Distributions are to be allocated in the same manner as profits and losses are to be allocated (see (a.) above)
 - iii. Exceptions
 - 1) Partners cannot demand distribution in a form other than cash, except as specified in the partnership agreement.
 - 2) While partners cannot demand distribution other in a form other than cash, they may receive distributions in a form other than cash. However, partners are not required to accept a distribution in kind more than their proportionate share of a particular asset, except as specified in the partnership agreement.
 - 3) A partner generally may not receive any distribution that would reduce the value of partnership assets below its total liabilities, except for liabilities to creditors who have recourse limited to specific assets of the partnership.

C. Discussion of General and Limited Partnership Interests

1. General and Limited partners have the same interests in the partnership

- a.** The interest is a share of the partnerships profits and losses
- b.** This interest is personal property
- c.** The interest of general and limited partners in a limited partnership is identical to the interest of partners in a general partnership.

2. Assignment of partnership interests

- a.** Partner's may assign their interest in whole or in part, except as otherwise provided in the partnership agreement.
- b.** Assignment of partnership interest does not terminate the partnership
- c.** Assignment entitles assignee to the same right to profits and disbursements of assignor, to the extent of the interest assigned.
- d.** If a partner assigns the entirety of his or her interest, he or she ceases to be a partner
 - i.** However, an assignee who receives all of a partner's interest does him/herself not become a partner automatically. He or she may become a limited partner:
 - 1)** if the assignor has that right through the partnership agreement
 - 2)** if all other partners consent or
 - 3)** through procedures outlined in the partnership agreement

D. Limited Liabilities for Partnership Activities

1. Liability for General Partners

- a.** General partners in a limited partnership are liable to the partnership and other partners to the same extent as partners in a general partnership.
- b.** Specifically all general partners are:
 - i.** Jointly and severally liable for everything chargeable to the partnership for the wrongful act of a partner and the breach of trust by a partner

ii. Jointly for all other debts and obligations for the partnership, but any partner may enter into a separate obligation to perform a partnership contract.

iii. These liabilities may be changed through the partnership agreement.

c. General partners in a limited partnership are similarly liable to third parties; however these liabilities CANNOT be modified by the partnership agreement.

2. Liability for Limited Partners

a. Limited partners are not liable, simply because they are limited partners, for a debt, obligation or liability of the limited partnership of any kind for the acts of any partner, agent or employee of the limited partnership. Limited partners are liable only to the extent of their investment.

b. If an investor, under mistaken belief he or she is a limited partner, later discovers that he or she is a general partner, the investor may limit his or her liability by executing a certificate of limited partnership or by withdrawing from future equity participation. During the intermediate time between the mistake and the correction, he or she is not liable as a general partner to third parties unless the third party in good faith thought that the investor was in fact a general partner and extended credit to the partnership due to reasonable reliance on the credit of the mistaken general partner.

c. If a limited partner acts like a general partner and a third party therefore believes the limited partner is a general partner, the limited partner may assume the liabilities of a general partner.

Take Away Points:

- Limited partnerships are just like regular partnerships, except they also have limited partners
- The specific relationship (i.e. responsibilities and duties) of limited partners MUST be enumerated in the limited partnership agreement
- Limited partners do not suffer from the same liability concerns as general partners; however the flip side of the same coin (or another benefit depending on how you look at it) is that limited partners generally do not have the same level of duties and responsibilities as general partners. The level of involvement is dictated by the partnership agreement.

II. The Use of Family Limited Partnerships in Estate Planning

A. Basic Estate Planning Principles

1. Key Sections of the Internal Revenue Code

a. § 2033 of the Internal Revenue Code embraces all property owned by the decedent. This includes items of speculative value, such as unresolved legal claims and contingent claims.

i. Valuation

1) Valuation is critical in the estate tax. Much of sophisticated estate planning involves the engineering of valuation reduction, for example, by interposing entities in a chain of ownership, such as placing property in a partnership or corporation. Valuation discounts are usually associated with interests in a limited partnership or minority interests in a closely held business. Discounts result from lack of marketability and lack of control.

Example: M (mother) has marketable securities, cash and real estate worth \$100. She transfers this property to a limited partnership in which C (child) is the general partner having a 1% interest in the capital and profits of the partnership. M is the sole limited partner with a 99% interest in the profits and capital of the partnership. M's interest in the partnership may be worth \$70 or less because of the difficulty she would have in selling partnership interests.

Example: F (father) is the sole owner of a small business. Over time he gives shares of stock to his adult children, until he eventually owns less than 50% of the business. Upon his death the value of the shares owned by his estate will be discounted because F lacked control over the business at the time of his death.

b. Chapter 14 and Other Tax Hurdles to Valuation Discounts

Chapter 14

i. Enactment of Chapter 14

1) In 1990, Congress dealt with perceived valuation abuses by the adoption of new Chapter 14, consisting of sections 2701, 2702, 2703, and 2704. The rules under Chapter 14 modified the valuation of specific retained rights in corporations and partnerships (section 2701), the

valuation of split temporal interests in property (section 2702), the effect of buy-sell agreements and options upon value (section 2703), the transfer tax consequences of lapsing rights (section 2704), and the gift tax statute of limitations (section 6501(c)(9)). In 1992, the Service issued final regulations under Chapter 14.

2) The specific application of Chapter 14 to partnerships, is as follows: (a) section 2701 values certain rights retained by the donor at zero; (b) section 2703 disregards certain value-fixing provisions in partnership, operating, and co- owner agreements; and (c) section 2704 treats the lapse of a voting, liquidation, or similar right as a deemed gift.

3) With most limited partnerships, the troublesome provision under Chapter 14 will be section 2704.

4) If the planner avoids creating two classes of partnership interests (other than a general partnership interest and a limited partnership interest with the only difference between the two interests being management rights and liability), section 2701 should not present a problem.

5) Because most of the restrictions on partnership interests that provide valuation discounts are similar to restrictions contained in partnership agreements among unrelated parties, section 2703 should not present a problem assuming the partnership is formed for valid business reasons.

6) On the other hand, section 2704 presents a mine field, particularly where the planner is trying to avoid a gift upon the formation of the entity. Although it is difficult, it is possible to avoid the pitfalls of section 2704 and also not have a gift upon the creation of the entity. This requires, however, careful planning and drafting.

ii. Section 2701 – Overview

1) Section 2701 provides special valuation rules to determine the amount of any gift when an individual transfers an interest in a partnership to a family member.

2) Before section 2701 applies, the following requirements must be met: (a) an individual must transfer an interest in a corporation or partnership to a member of

the transferor's family; and (b) the transferor or an applicable family member must hold an applicable retained interest (basically a controlling equity interest).

3) Section 2701(e)(1) defines a member of the transferor's family as a spouse, descendants, descendants of a spouse, and spouses of any such descendants.

4) Section 2701(e)(2) defines an applicable family member as a spouse, an ancestor, an ancestor of a spouse and spouses of ancestors. Section 2701(b)(1) defines an applicable retained interest as either a put, call, conversion, or liquidation right or, in a controlled entity, a distribution right other than a qualified payment right. Under section 2701(a)(3), an applicable retained interest is valued at zero.

5) If section 2701 is applicable to a transfer, the value of the transferred interest is determined under the subtraction method. Under this method, the amount of any gift is determined by starting with the aggregate value of the family-held interests in the entity and subtracting the equity interest retained by applicable family members based on the special valuation rules. The value of the transferred interest will be increased when the value of the applicable retained interest is reduced under the special valuation rules.

iii. Section 2701 - Interests of the Same Class

1) Section 2701 does not apply if the retained interest is of the same class of equity as the transferred interest.

2) Under Treasury Regulation ("Regulation") section 25.2701-1(c)(3), an equity interest is of the same class if the rights are identical to the rights of the transferred interest, except for "non-lapsing differences with respect to management and limitations on liability."

3) With most limited partnerships that are used as gift vehicles, the only differences between a general and a limited partnership interest are management and liability. Accordingly, section 2701 should not present a significant hurdle in most planning situations.

4) If a parent creates a family limited partnership, with the parent as the general partner, and the parent transfers a limited partnership interest to a child, the question is

whether the parent as a general partner has retained an applicable retained interest so that section 2701 will apply.

5) In Private Letter Ruling 9415007, the Service addressed this issue. The Service ruled that as a general partner the donor retained rights to distributions that were of the same class as the limited partnership interests that the donor transferred. Thus, the donor did not retain distribution rights, there were no applicable retained interests, and section 2701 did not apply to the transaction.

6) Accordingly, a transfer of a limited partnership interest by a general partner is not subject to the special valuation rules of section 2701 if the only differences between the interests transferred are management and liability.

7) The draftsman of the limited partnership agreement may avoid section 2701 by not creating two classes of equity. Failure to avoid section 2701 will result in the limited partnership interests being valued much higher than under traditional valuation methods.

iv. Section 2703 – Overview

1) Section 2703 provides, in part:

The value of any property shall be determined without regard to:

- a.** any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right), or
- b.** any restriction on the right to sell or use such property.

2) Regulation section 25.2703-1(a)(3) provides that a “right or restriction may be contained in a partnership agreement” and may be implicit in the capital structure of an entity.

3) The value of an interest in a limited partnership for estate, gift, and generation-skipping transfer tax purposes is determined without regard to any restriction relating to the property unless the restriction falls within one of the exceptions to section 2703.

4) Under Regulation section 25.2703-1(b)(1)(ii), the right or restriction must not be a device to transfer property to “the natural objects of the transferor’s bounty.” Similarly, Regulation section 25.2703-1(b)(3) defines members of the transferor’s family to include any “individual who is a natural object of the transferor’s bounty.”

v. Exceptions to Section 2703

1) Section 2703 does not apply to any option, agreement, right, or restriction:

- a.** That is a bona fide business arrangement;
- b.** That is not a device to transfer property to members of the decedent’s family for less than full and adequate consideration in money or money’s worth; and
- c.** The terms of which are comparable to similar arrangements entered into by persons in an arms’ length transaction.

2) According to Regulation section 25.2703-1(b)(2), each of these three requirements must be independently satisfied before a right or restriction will meet this exception.

3) If more than 50 percent in value of the property subject to the right or restriction is owned directly by individuals who are not members of the transferor’s family, a right or restriction is considered to have automatically met each of the three requirements. The property owned by the non-members of the transferor’s family must be subject to the same rights and restrictions to the same extent as the property owned by the transferor.

4) According to Regulation section 25.2703-1(b)(3), members of the transferor’s family include the persons described in section 25.2701- 2(b)(5) (controlled entity) and any individual who is a natural object of the transferor’s bounty.

5) The Regulations define a similar arrangement as one that could have been obtained at a fair bargain among unrelated parties in the same business dealing with each other at arms’ length. A right or restriction is considered a

fair bargain if it conforms with the general practice of unrelated parties under negotiated agreements in the same business. The problem is in determining what unrelated parties in the same business do in agreements.

vi. Impact of Section 2703 on Limited Partnership

1) It is the partnership entity that creates the significant discounts. Thus, before the Service can be successful in using section 2703 to limit discounts, the Service must apply section 2703 to the transfer of property to the partnership and not to the transfer of a partnership interest. Section 2703 applies to restrictions placed on the use of property. If the restrictions in a partnership agreement on the use of a partnership interest are disregarded, there should not be a significant reduction in the available discounts. On the other hand, there could be a significant reduction in the available discounts if the partnership entity were ignored.

2) If section 2703 is applicable to restrictions on liquidation, a strong argument can be made that most restrictions found in limited partnership and operating agreements used in estate planning come within the exception under section 2703(b). That argument should be successful for partnerships created for business purposes. Otherwise, the test under section 2703 of not being a device to transfer property to family members for less than full and adequate consideration may not be met.

3) Section 2703 applies to any right or restriction created or substantially modified after October 8, 1990. Until this area is clarified, the careful practitioner would avoid substantially modifying any grandfathered partnership or operating agreements.

vii. Section 2704(a) – Overview

1) Under section 2704(a), a lapse of a voting or liquidation right is treated as a transfer for gift or estate tax purposes if the individual holding the right and members of the individual's family control the entity both before and after the lapse. Section 2704(a) catches the individual who tries to get rid of a voting or liquidation right, while section 2704(b) catches the individual who restricts liquidation rights.

2) Two requirements must be met before section 2704(a) applies:

- a.** there is a lapse of any voting or liquidation right in a corporation or partnership, and
- b.** the individual holding such right immediately before the lapse and members of such individual's family must hold, both before and after the lapse, control of the entity.

3) The amount of the gift or increase in the gross estate is the excess, if any, of the value of all interests in the entity owned by the holder immediately before the lapse (determined immediately after the lapse as if the lapsed right were nonlapsing) over the value of such interests immediately after the lapse (determined as if all such interests were held by one individual).

4) Regulation section 25.2704-1(a)(2)(v) defines a liquidation right to be the ability to "compel the entity to acquire all or a portion of the holder's equity interest in the entity, including by reason of aggregate voting power, whether or not its exercise would result in the complete liquidation of the entity."

5) The Regulations make a distinction between voting rights and liquidation rights. Regulation section 25.2704-1(a)(2)(iv) provides: "the right of a general partner to participate in partnership management is a voting right. The right to compel the entity to acquire all or a portion of the holder's equity interest in the entity by reason of aggregate voting power is treated as a liquidation right and is not treated as a voting right."

viii. Section 2704(a) and Death of General Partner

1) Under Regulation section 25.2704-1(c), a lapse of a voting right or a liquidation right occurs at the time a presently exercisable voting or liquidation right is restricted or eliminated.

2) Example 5 under Regulation section 25.2704-1(f) illustrates a partnership that is caught by section 2704(a). In that example, Decedent and Decedent's two children, A and B, are partners, with each owning a 3 1/3 percent general partnership interest and a 30 percent limited partnership interest. The partnership agreement provides

that when a general partner withdraws or dies, the partnership must redeem the general partnership interest for its liquidation value. Under the partnership agreement, any general partner can liquidate the partnership. A limited partner cannot liquidate the partnership and a limited partner's capital interest will be returned only when the partnership is liquidated. A deceased limited partner's interest continues as a limited partnership interest.

Decedent dies, leaving his limited partnership interest to his spouse. Because of a general partner's right to dissolve the partnership, a limited partnership interest has a greater fair market value when held in conjunction with a general partnership interest than when held alone. Section 2704(a) applies to the lapse of the Decedent's liquidation right because after the lapse, members of Decedent's family could liquidate Decedent's limited partnership interest. Accordingly, Decedent's gross estate includes an amount equal to the excess of the value of all Decedent's interests in the partnership immediately before Decedent's death (determined immediately after Decedent's death but as though the liquidation right had not lapsed and would not lapse) over the fair market value of all Decedent's interests in the partnership immediately after the Decedent's death.

3) Section 2704(a) applies to the lapse of a liquidation right. Under the laws of most states, a general partner has the ability to liquidate a partnership. Thus, if the planner wants to avoid section 2704(a), no individual partner should have the unilateral right to liquidate the partnership.

4) This can be accomplished by numerous ways. First, there can be more than one individual general partner and a majority of the general partners are required to liquidate the partnership (this type of provision could be an applicable restriction). Secondly, the general partner could be a corporation. Third, the partnership agreement could require that the partnership may not be terminated unless all partners' consent and there are nonfamily members as partners in the partnership. Fourth, the general partner is allowed to transfer the partner's general partnership interest to a permitted assignee.

5) In avoiding the lapse of a liquidation right under section 2704, the planner must be careful to avoid a gift upon the formation of the entity.

6) Section 2704(a) does not apply to a transfer of an interest that results in the lapse of a liquidation right if the rights with respect to the transferred interest are not restricted or eliminated. Thus, under section 2704(a) the transfer of a sufficient number of shares in a corporation to lose voting control is not a lapse. See Reg. § 25.2704-1(f), Example 4.

7) If a transfer results in the elimination of the transferor's ability to compel the entity to acquire an interest retained by the transferor that is subordinate to the transferred interest, the transfer is a lapse of a liquidation right with respect to the subordinate interest. See Reg. § 25.2704-1(c)(1).

8) If a limited partnership interest is treated as a subordinate interest within the meaning of section 2704(a), there may be a lapse within the meaning of section 2704(a) when the decedent gives up a general partnership interest.

ix. Section 2704(a) - Transfer of Partnership Interests

1) A general partner has the right to participate in management of the partnership, which a limited partner does not. If the general partner in a limited partnership transfers a portion of his or her partnership interest to a member of the family and under the partnership agreement the transferred partnership interest is converted to a limited partnership interest, section 2704(a) applies. The general partner would have made a gift under section 2704(a) equal to the value of the general partnership interest given away by the general partner.

2) A limited partner does not have the right to cause the liquidation of a limited partnership by the partner's withdrawal. Because a gift of a limited partnership interest should not involve a lapse of a voting or liquidation right, section 2704(a) should not apply and the value of the gift should be the value of the limited partnership interest.

3) As long as the limited partnership agreement permits the continuation of the limited partnership after the withdrawal of the general partner and there are two or more general partners, section 2704(a) should not apply. It is unclear whether this provision would be treated as an applicable restriction under section 2704(b).

x. Section 2704(a) - Default Rules and Term Partnerships

1) Section 2704(a) applies to the lapse of a right to liquidate. The determination of whether a family has the ability to liquidate an entity is determined by reference to the state law “generally applicable to the entity.” See Reg. § 25.2704-1(c)(2)(i)(B).

2) The laws of some states provide more restrictive rights on the power of a limited partner to withdraw than others.

xi. Section 2704(a) - Nonfamily Members as Partners

1) One method of avoiding section 2704(a) is to prevent the transferor’s family from having the ability to liquidate the partnership. Regulation section 25.2704-1(c)(2)(i)(A) provides that section 2704(a) does not apply to the lapse of the liquidation right to the extent that the transferor and members of the transferor’s family cannot immediately after the lapse liquidate an interest that the transferor held directly or indirectly and could have liquidated before the lapse.

2) Adding a nonfamily member (such as a charitable organization) as a limited partner or member may prevent the application of section 2704(a).

3) If the limited partnership agreement or operating agreement requires the unanimous consent of all partners or members before the withdrawing partner or member would be entitled to receive value for his or her interest, the family could not remove the restriction immediately after an interest in the entity had been transferred to another family member, the restriction would not be an applicable restriction, and section 2704(a) should not apply.

4) This restriction, however, may be subject to section 2703 if it is not a common business practice to have such a restriction. If section 2703 is applicable, the restriction will be disregarded for transfer tax purposes.

xii. Section 2704(b) - Overview

1) Under section 2704(b), certain restrictions on liquidation called “applicable restrictions” are disregarded when valuing an interest in a partnership for transfer tax purposes, thereby increasing the value of the transfer.

2) An applicable restriction is a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the state law generally applicable to the entity in the absence of the restriction.

3) A restriction is an applicable restriction only to the extent that either the restriction by its terms will lapse at any time after the transfer, or the transferor (or the transferor's estate) and any members of the transferor's family can remove the restriction immediately after the transfer. Section 2704(b) only applies if the transferor and members of the transferor's family control (as defined under section 2701) the entity immediately before the transfer.

4) The ability to remove the restriction is determined by reference to the state law that would apply but for a more restrictive rule in the governing instrument. The fact that a family-governing instrument could override the state's default rule restricting a limited partner's or member's withdrawal right should not be treated as an applicable restriction.

5) If an applicable restriction is disregarded under section 2704(b), the transferred interest is valued as if the restriction did not exist and as if the rights of the transferee are determined under the state law that would apply but for the restriction.

xiii. Section 2704(b) - Restrictions Subject to Section 2703

An option, the right to use property, or agreement that is subject to section 2703 is not an applicable restriction. Thus, it appears that a restriction that satisfies the exception under section 2703 that the restriction is based on common business practices should not be disregarded under both section 2703 or section 2704(b).

xiv. Section 2704(b) – Partnership Termination

1) Under Regulation section 25.2704-2(b), an applicable restriction is a limitation on the ability to liquidate the entity that is more restrictive than the limitations that would apply under the state law generally applicable to the entity in the absence of the restriction. Thus, selecting a state law that provides restrictions on

termination and the withdrawal of a limited partner will avoid section 2704(b).

xv. Section 704(b) - Nonfamily Member as a Partner

A method of avoiding section 2704(b) is to have a nonfamily member (such as a charity) as a partner and require under the partnership agreement that the consent of all partners is required to terminate the partnership. Assuming the nonfamily member is recognized as a partner, this should prevent the application of section 2704(b).

2. Other Tax Hurdles

a. Present Interest Requirement and Annual Exclusion

i. To obtain the annual exclusion of \$11,000/\$22,000 under section 2503(b), the donee must have a present interest in the property transferred by the donor.

ii. If a limited partner cannot require the partnership to purchase his or her interest, the donee must obtain a present interest in the property through another mechanism. If the limited partner has the unrestricted right to transfer his or her interest, the entity will have the corporate characteristic of free transferability of interest. This may cause the entity to be classified as a corporation for federal income tax purposes.

iii. The present interest requirement should be met if the donee as a limited partner has the right to assign his or her interest in the entity notwithstanding that the transferee would be a mere assignee and would not have the right to participate in the management of the partnership.

iv. In Technical Advice Memorandum 9131006 and Private Letter Ruling 9415007, the Service ruled that a donee of a limited partnership interest had a present interest because the donee could have assigned his or her partnership interest subject to the right of first refusal set forth in the partnership agreement. The fact that a limited partner could freely transfer his or her right to distributions should not cause a partnership to have the corporate characteristic of free transferability of interest.

b. Sections 2036(a)(2) and 2038(a)

i. If an individual transfers property and retains the right to control the possession or enjoyment of the property or the income from the property, the property is included in the gross estate of the

decedent under section 2036(a)(2). If a donor retains the right to alter, amend, revoke, or terminate the enjoyment of gift property, the property is included in the donor's gross estate under section 2038(a).

ii. Where the donor is the sole general partner and transfers a limited partnership interest by gift, the question arises whether that is a transfer with a retained life estate under section 2036(a)(2) or revocable under section 2038(a). Because a general partner has a fiduciary duty to the other partners, there should not be a retained interest within the meaning of either section 2036(a)(2) or 2038(a).

iii. The Service ruled in Private Letter Rulings 8611004, 9131006, 9310039, 9332006, and 9415007 that section 2036(a) did not apply where the decedent was the sole general partner and transferred limited partnership interests.

iv. If the partnership agreement negates the fiduciary duty of the general partner (for example, by containing an indemnity clause), the transfer may not be protected and may be included in the donor's estate under sections 2036(a)(2) or 2038(a).

v. If the limited partnership holds more than 20 percent of the stock of a closely held company, the general partners' right to vote the stock may cause the stock transferred by the general partner to a limited partnership to be included in the general partner's gross estate under section 2036(b).

vi. One way to minimize this risk is to use voting and non-voting common stock and transfer the non-voting stock into the entity. Another method is to allow the partners to vote all stock in proportion to each partner's interest in the partnership.

3. Death Taxes

a. Federal Estate Tax

- i.** A progressive tax imposed upon asset transfers at death. The estate tax can consume almost half of the estate for large estates. The maximum marginal estate tax rate is:

<u>Year</u>	<u>Maximum Marginal Tax Rate</u>
2004	48%
2005	47%
2006	46%
2007	45%
2008	45%
2009	45%
2010	estate tax repealed
2011	55%

b. Generation Skipping Transfer (“GST”) Tax

- i.** The GST tax imposes a separate, flat tax rate equal to the maximum marginal estate tax rate on property that is ultimately transferred down through multiple generations. Essentially, the GST tax is a substitute for the estate tax that would otherwise be imposed on such property if each generation acquired it and passed it on.
- ii.** Each taxpayer has a total GST exemption, which he or she may apply in whole or in part to any transfers during life or at death. Earnings and growth on any exempt property is similarly exempt.

4. Deductions

a. Marital Deduction

- i.** The marital deduction under Section 2056 is critical in many estates. Outright transfers of an unlimited value to a citizen spouse are deductible. Another popular form of interest that is deductible for federal estate tax purposes is the qualified terminal interest property ("QTIP") trust. A QTIP trust is one in which the surviving spouse receives all of the income for life and no one other than the surviving spouse may be entitled to principal during the surviving spouse's lifetime. The executor also must elect QTIP on the federal estate tax return for the estate. The advantage of the QTIP trust is that the decedent spouse's estate is not reduced by the estate tax, so that the entire estate remains intact for the surviving spouse, but at the same time the decedent spouse in his or her Will

controls the ultimate distribution of the QTIP trust at the surviving spouse's death.

Example: A owns valuable business interests. He is married to B, his second wife. A has children from his first marriage who are involved in the business and whom he would like to benefit in his will. A also wants to benefit B (his current wife) for her lifetime. By establishing a QTIP trust in his will, A may avoid any estate tax in his estate, yet make sure that A's children from his first marriage, and not B's children or others, ultimately take the business property. A also may name the children from his first marriage as trustees of the trust so that they control the voting of the stock or other interests in the business entity.

b. Charitable Deductions

i. Section 2055 permits deductions for property passing to charity. There is a prohibition against most split interest transfers, except for certain specific allowable split interest trusts, such as charitable remainder and charitable lead trusts as defined by statute and regulation. Hence, a testamentary charitable remainder trust or charitable lead trust may enjoy an estate tax deduction equal to the actuarial value of the charity's interest.

Example: A provides in his will that the trust will pay 10 percent of the estate tax value of certain property to charity every year for a period of 20 years. After the expiration of this 20-year term, any remaining trust principal passes to individuals named in A's will. Assume that the estate tax value of the property identified in A's Will is \$1 million. Charity therefore receives \$100,000 a year for 20 years. The value of \$100,000 a year for 20 years using an 8 percent discount rate is \$981,810. Hence, the taxable value of the trust property in A's estate out of the total \$1 million is \$18,190.

c. Debts, Claims and Expenses - Section 2053

i. Bona fide debts are deductible from the gross estate. Likewise, expenses of administration, which include executors' and attorneys' fees are deductible to the extent they are reasonable. Generally claims in the nature of will contests or breach of promise to make a will are not deductible. Deductible claims must be supported by fair and adequate consideration in money or money's worth.

5. Credits Against Tax

a. The Applicable Credit Amount

i. The applicable credit amount is a device by which most taxpayers are removed from the estate tax system. The applicable credit amount is currently \$1,000,000. The credit permits both lifetime and death transfers in the aggregate of \$1,000,000 to any person without any tax. Deductible transfers to spouse or charity are not counted. The result of the applicable credit amount is that people with estates of less than \$1,000,000 are not subject to the federal estate tax. Under recently passed tax legislation, the applicable credit amount is:

<u>Year</u>	<u>Lifetime Credit</u>	<u>Deathtime Credit</u>
2004	\$1 million	\$1.5 million
2005	\$1 million	\$1.5 million
2006	\$1 million	\$2 million
2007	\$1 million	\$2 million
2008	\$1 million	\$2 million
2009	\$1 million	\$3.5 million
2010	estate tax repealed	
2011	\$1 million	\$1 million

b. A major change from prior law is the fact that the lifetime and death time credits are no longer equal. With the possibility of permanent estate tax repeal, people are reluctant to give lifetime gifts greater than \$1 million.

c. The most basic technique in estate planning is to capture the applicable credit amounts of both spouses. Typically the applicable credit amount of the first spouse to die is transferred into a trust for the benefit of the surviving spouse, which would not be included in the estate of the surviving spouse, thus escaping estate tax upon the death of both spouses. Or the applicable credit amount could simply be given to someone other than a surviving spouse.

6. The Federal Gift Tax

a. Transfers Subject To Tax

i. Gifts

All transfers not in the ordinary course of business that are for less than adequate and full consideration, in which there is any interest, are at least potentially subject to tax.

ii. Indirect Transfers

The gift tax also applies to "indirect" transfers of wealth.

Example: M (mother) lends D (daughter) \$100. The transaction is evidenced by a valid promissory note from D to M and a mortgage on D's residence to secure payment of the loan. The loan, however, is non-interest bearing. M has made a gift to D of the foregone interest on the loan. If the loan is a demand loan, the gift is measured annually based on market rates of interest and the principal balance of the loan outstanding in each year. If the loan is a term loan, the value of the gift will be based on the fair market value, as computed under market rates of interest at the time of the transaction, of the payments to be made by D to M under the Note.

iii. Bargain sales

The tax includes bargain sales

Example: F (father) sells commercial real estate to S (son) for one-half of its fair market value. Despite casting the transaction as a sale, the gift tax is imposed on the difference between the fair market value of the real estate and the consideration received by the transferor, in this case 50%.

b. The Present Interest Exclusion

i. Under Section 2503(b), \$11,000 of transfers per year to an unlimited number of donees is excluded from the gift tax. Only present interests--not future interests--are eligible for the annual exclusion. This annual exclusion amount is indexed for inflation, in increments of \$1,000.

7. Transfer Tax Fundamentals

a. If a transfer has occurred, the fact that the transferor and transferee are related to each other is irrelevant to valuation.

Fair market value of property that has been transferred has long been defined as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. All relevant facts and elements of value as of the applicable valuation date shall be considered. Determining what a willing buyer would pay for the property is a question of fact, with the trier of fact having the duty to weigh all relevant evidence of value and to draw appropriate inferences.

For purposes of determining the fair market value of the gifts of partnership interest, the identity and intentions of the recipient of that interest are irrelevant. The standard is an objective test using hypothetical buyers and sellers in the marketplace, and is not a personalized one which envisions a particular buyer and seller. Thus, family relationships are ignored, and the ownership of a controlling interest among a family's members when each ownership interest is attributed to the others is also ignored.

For many years the Internal Revenue Service (the "Service") fought the non-attribution concept with regard to family-controlled businesses; however, the Service finally reversed its course due to the success of several taxpayers in court. In a 1993 Revenue Ruling, the Service considered a situation in which a father gave all of his stock in a closely held corporation in equal shares to his five children (20% each) and determined that each 20% interest transferred by the father was entitled to a minority interest discount for valuation purposes. This determination reversed the Service's prior approach, which required the aggregation of interests held by family members. In other words, the Service finally admitted that only 20% was transferred in each case.

b. If a transfer of a partnership interest has occurred, the identity of the remaining partners is a relevant fact in measuring the value of that transfer.

The Service has taken the position (with case law support) that the identity of the remaining partners at the time of the transfer is a relevant fact in determining what this "outsider," who is the hypothetical willing buyer, would pay for the transferred partnership interest. If upon a transfer of a partnership interest, only one remaining partner objects to the potential purchaser becoming a partner, that person will only be an assignee. That obviously may be a fact which convinces a hypothetical willing buyer that he or she will only become an assignee and will not be admitted as a partner. The Service has stated that if a willing buyer would acquire a "swing vote," the "minority" or "marketability" discount may not be appropriate. The theory of the "swing vote" is that, even though a single block of stock which is transferred by gift or bequest, by itself, does not represent majority ownership of a corporation, it should not be fully discounted as a minority interest for its lack of control if it is big enough that it could be pooled with the stock held by other large shareholders so that they can obtain control jointly.

c. Generally, unless federal law supersedes state law, the property rights inherent in a transferred partnership interest are determined under state law, and, under state law, a transferred partnership interest does not have any management rights or withdrawal rights and has only limited information rights.

In determining the value for gift and estate tax purposes of any asset that is transferred, the legal rights and interests inherent in that property must first be determined under state law (unless federal law supersedes state law). After that determination is made, the federal tax law then takes over to determine how such rights and interests will be taxed.

Under Pennsylvania's law, a limited partner may withdraw if allowed by the partnership agreement or if the agreement is silent, a limited partner may withdraw upon six months' notice and be paid as provided in the agreement or, if the agreement is silent as to such payments, be paid the "fair value" of his interest in the partnership as of the date of withdrawal based on the partner's right to share in distributions. On the other hand, some states, including Delaware, provide that a limited partner may not withdraw except as provided in the partnership agreement.

d. In measuring what a hypothetical willing buyer would pay a hypothetical willing seller of a family limited partnership interest, valuation experts generally conclude that significant discounts are appropriate because the transferred assignee interest lacks management control and is not readily marketable.

e. Types of Discounts

i. Fractional Interest Discounts

A fractional interest discount is the discount applied to the ownership of an undivided interest in an asset. A fractional interest discount is similar to a minority interest discount. Because of the lack of immediate control and the problems associated with dealing with co-owners, the hypothetical willing buyer would discount the fractional interest being acquired. Each co-owner of property has the right to possess and use the point property so long as the rights of the other co-owners are not adversely affected. If there is a dispute among the co-owners, the laws of most states grant a co-owner the right to file suit to partition the joint property. A fractional interest discount is usually based in part on an assessment of the costs, uncertainty, and delay that would be involved in a partition suit.

ii. Minority Interest Discounts

A discount for a minority interest reflects the owner's lack of control with no ability to direct distributions, compel liquidation, elect officers or directors, set salaries, and set policy in general. An important element of a minority interest discount is the inability of the owner to compel liquidation and thereby realize a pro rata share of the net asset value of the entity.

iii. Lack of Marketability Discounts

A lack of marketability discount reflects the lack of a ready market for the interest being valued. Discounts for minority interest and lack of marketability are frequently claimed together and often overlap. Specifically, in a family owned entity, a fractional interest may be entitled to both a lack of marketability discount and a minority interest discount.

8. Application of Tax Fundamentals to Family Limited Partnerships

a. Transferor and transferee may be family members

For estate and gift tax valuation purposes, the Service will not aggregate all voting power held by family members for purposes of determining whether the transferred interests should be valued as a part of a controlling interest. Consequently, a minority interest discount would not be disallowed solely because a transferred interest, when aggregated with interest held by family members, would be part of a controlling interest. This would be the case whether the donor held 100% or some lesser percentage of the interests immediately before the gift.

b. Identity of other partners is relevant.

The identity of other owners of a business, exclusive of the transferor and transferee, and their expected actions, can have a negative impact on the valuation of a transferred ownership interest just as well as it can have a positive impact. For example, adding a nonfamily member (such as a charitable organization) as a limited partner may lend credence to restrictions set forth in the partnership agreement upon the withdrawal of a limited partner or upon liquidation (unanimous consent), since the family members, either alone, or collectively, would not have the right to such actions.

c. State law is important in determining property rights inherent in a transferred partnership interest.

Under a typical partnership agreement, usually drafted under Delaware law, which states that the terms of the agreement govern, limited partnership interests may be transferred only after certain approvals by other partners. To acquire all of the rights of a transferring limited partner, the transferee must be admitted by all the other partners and must agree in writing to be bound by all provisions of the FLP agreement. Further, *no* limited partner has a unilateral right to withdraw from the FLP and thereby "cash in" his or her interest. Thus, a limited partner could only "cash in" with the consent of all the other partners.

Therefore, a very relevant fact for consideration by a hypothetical willing buyer of a limited partnership interest is that hypothetical willing buyer's assessment of whether the other partners would admit the buyer into the partnership as a partner or an assignee. It is clearly more relevant to consider the "assignee" rules under the applicable state's partnership law because only very rarely would a hypothetical willing buyer consider it likely that all of the other partners would admit the buyer into the partnership as a partner. Other relevant considerations in connection with determining the gift or estate tax value of a transferred partnership interest are the liquidation restrictions and voting restrictions which are inherent under the default state law rules.

d. Application of Discounts

Most ownership interests in family limited partnerships are worth less than liquidation value when valued by the income approach or net asset value approach.

The primary reasons for a discount for a minority interest are that most of the cash flow generated within a limited partnership is reinvested instead of being distributed to the partners and that a buyer generally does not obtain management control, much less liquidation control. A buyer who obtains liquidation control would pay a higher price for access to the retained cash than a buyer who does not acquire liquidation control would pay for the low distributable yield.

An investor in other types of investments usually has an expectation for current income of cash distributions. Even in the case of privately held businesses, income derived from the operating surplus or gains from the sale of assets are sources of cash that provide an owner with an economic benefit which the secondary market can use as a basis for pricing the security. In contrast, an investor in a FLP is aware that current income, if any, could well be (and typically is) only enough to cover his or her portion of the tax liability allocable from the partnership's taxable income. The general partner of the FLP in all likelihood has little motivation or requirement to sell assets and generate a return of capital to an investor.

A discount for lack of marketability results from the lack of any organized secondary market for FLP interests. Removing the most obvious vehicle for liquidity from a security with relatively undesirable investment attributes is virtually unforgivable from the perspective of a third party.

The magnitude of the minority interest discount depends on, among other things, the level of distributions from the partnership to the partners, the financial risk associated with the partnership's assets, and the terms of the partnership agreement. Because control premiums have been studied in the corporate takeover context, the inverse relationship of a minority

interest discount to a control premium gives experts an accurate base from which to determine a minority interest discount. A minority interest discount for an assignee's rights attributable to a partnership interest often is in the range of 20% to 40%.

The magnitude of the marketability discount often is determined by reference to sales of restricted stock of publicly traded companies. Because of several independent studies, experts confirm a range of restricted stock discounts from 30% to 45%. Another source of reference for experts is the comparison of the sale of a minority block of stock in a closely held corporation to the value of the same block of stock after the corporation "goes public." Such studies have revealed discounts ranging from 42% to 74%.

Substantial discounts are appropriate even if the only assets of the entity are passive investments such as undeveloped real estate, stocks, bonds, and cash. As to such assets, in general, valuation experts and courts allow for a minority interest discount in the range of 10% to 20% (similar to closed-end investment funds) while still allowing for the normal range of marketability discounts.

B. Non-Tax Advantages Associated with Creating and Transferring Partnership Interests

1. Simplification of Annual Giving

Many assets are difficult to value and not easily gifted as undivided fractional assets. Rural land and closely held unincorporated business are good examples. Contributing those assets to a family limited partnership, however, allows a donor to assign partnership interests to a descendant with the use of a simple form. A fractional interest is given away by gifting an interest in the partnership; yet there is no immediate risk of partition of the asset, and management of the asset remains consolidated. If a client wishes to transfer part of his limited partnership to his issue, it generally will qualify for the annual exclusion.

2. The pooling of partnership assets will lower operating costs and increase diversity.

Families often have many members, and often several trusts have been created over time in conjunction with prior gifts. Keeping up with investments for multiple parties can be frustrating and expensive. By consolidating assets into one partnership, however, these problems over the long term are solved. It is easier and cheaper for a partnership to diversify investments because the size of the portfolio is larger. Likewise, it is easier and cheaper to diversify across several money managers because larger accounts generally are less expensive on a percentage basis and because minimum size requirements are more easily met. Thus, over time, the pooling of assets will lead to greater value and wealth for all

of the partners. For investors who are not concerned with short-term lack of control and marketability, and who wish to realize long-term growth of their assets for themselves and their family, the family partnership is an excellent institutional tool.

3. Keep assets in the family

Family partnership agreements often are drafted with certain buy-sell provisions to ensure that the partnership's assets will stay in the family. Under such provisions, if any partner attempts to assign his or her interest in the partnership to a person outside of the family, the other partners or the partnership itself may acquire that interest on the same terms, or, in the case of a gratuitous transfer, at its fair market value. Secondly, even without buy-sell provisions, no outsider can have any rights as a partner unless all of the partners admit that outsider as a partner (and can only be an assignee with limited distribution rights).

4. The ability to transfer capital without losing control of the capital and without killing the transferee's productivity and initiative.

A family limited partnership allows fractional interests held by individuals or entities to be controlled by the general partner(s). Further, many successful clients fear that substantial gifts to descendants may hinder their productivity and initiative. In particular, clients with a substantial portfolio of stocks and bonds believe that giving a child or grandchild a readily marketable asset would not be doing that child any developmental favors. Most clients believe that no one understands their children better than they do. By creating a family limited partnership and transferring only a limited partnership interest to a descendant, a donor controls the marketability of the wealth transferred because the interest effectively cannot be sold and because the donor can reinvest the partnership's cash flow rather than making distributions to the partners. This retained, indirect power to affect the marketability of the transferred partnership interests does not subject the transferred interest to estate taxes on the donor's death. By contrast, a retained power as trustee to determine the amount of distributions to trust beneficiaries may subject the trust assets to estate tax on the donor's death.

5. Provide some protection against future unforeseeable creditors.

A family partnership can be a flexible vehicle to provide some protection of an individual's assets from future creditors. The principal remedy of a partner's creditors is to receive a "charging order" against the partner's interest in the partnership. Under many states' limited partnership laws, unless a partner has made a fraudulent conveyance to the partnership or a conveyance deemed to be fraudulent, his or her creditors cannot reach the partnership's assets. Instead, a creditor may obtain a charging order against the partner's interest in the partnership, which does not give the creditor any management rights but entitles the creditor only to the partner's share of partnership distributions (i.e., an assignee's interest). In addition, the partnership agreement can be drafted so that

an involuntary transfer of a partnership interest to a creditor or any other third party triggers buy-sell provisions which allow the other partners or the partnership itself to purchase that interest at its fair market value. Since the fair market value of a limited partnership interest is usually much less than the underlying asset value, the creditor effectively is paid with less money, and the family assets are more likely to survive the creditor's claims. Furthermore, partnership agreements can be drafted to prohibit the pledging of partnership interests for the debts of a partner.

6. Protect assets against failed marriages

The risk of a gift to a descendant being awarded to his or her spouse upon divorce can affect an estate plan, and prenuptial or postnuptial agreements may be distasteful or impractical in many situations. In particular, stocks and bonds are very prone to being commingled with assets of the marriage and in community property states effectively might become community property. Limited partnership agreements, however, can be drafted so that gifts of limited partnership interests are protected from the risk of divorce. Many jurisdictions will not award separate property to a divorced spouse or will limit that award. A partnership provides a convenient means of segregating a descendant's separate property so that commingling is avoided. In addition, a partnership agreement can provide that an involuntary transfer of a partnership interest required by a divorce court will trigger buy-sell provisions under which the other partners or the divorced partner can buy that interest at its fair market value.

7. Partnership agreements are flexible.

In comparison to an irrevocable, unamendable trust, a limited partnership is a very flexible arrangement. If all of the partners agree, the partnership agreement may be amended or the partnership may be terminated, and usually all of the partners are family members. By contrast, an irrevocable trust generally may not be amended or terminated without court participation and participation by a guardian or an attorney ad litem for certain beneficiaries. As compared to corporations, a partnership requires fewer formalities and may be terminated without the potential adverse tax consequences associated with the termination of a corporation.

8. Business judgment rule offers flexibility in management.

The "prudent man" rule applicable to trustees is a stricter standard than the business judgment rule applicable to the managing partners of a partnership. Many financial investments, such as options and commodities, and many business decisions, such as wildcat oil drilling, may be reasonable in terms of normal business judgment but could be considered imprudent under trust law. Most families want to protect the family member who is charged with the responsibility of making investment decisions. In particular, families often want that family member to be protected from the "20/20 hindsight" of a court or jury.

9. Arbitrate family disputes rather than litigate

Recent history is replete with examples of highly publicized intrafamily litigation involving the management of family assets. It is extremely difficult to replace a trust beneficiary's right to sue his trustee with a commitment to binding arbitration: the state law right of a beneficiary to sue his or her trustee in many jurisdictions may not be removed by a trust agreement. Because a partnership agreement is a mere contract, however, it can be written so that all of the partners agree to settle disputes by arbitration. When compared to a jury trial, arbitration is usually preferable, especially in the family context. The publicity associated with family disputes can provide an unfair advantage to the person bringing a lawsuit against the family's decision maker. With a well-drafted partnership agreement, such publicity can be avoided through the arbitration process and enforced by a confidentiality provision. In addition, an experienced businessperson or financial advisor may serve as arbitrator and fact finder. Thus, where the client determines there is an advantage to arbitration, the partnership vehicle is clearly superior to the use of a trust in many jurisdictions.

10. Institutionalize communication on financial matters.

One of the more enjoyable aspects of a family limited partnership is that it can serve to institutionalize the education of younger family members on the family's wealth management philosophies. Many people see nothing wrong with wealth per se, but fear that it can be abused and therefore want to oversee the financial experiences of younger family members. In addition, prudent investment can generate employment and serve other altruistic purposes. The collectivism provided by a partnership agreement institutionalizes this education process.

C. The Valuation of Family Limited Partnership Interests and The Availability of Minority Interest Discounts

1. Valuation of Interests

A limited partnership interest is not as liquid or negotiable as the underlying partnership assets. To preserve ownership in an appropriate manner, certain restrictions on transfer of limited partnership interests must be included in the Partnership agreement. If the Partnership is structured so that an individual or estate would not retain control over its assets, the Partnership may produce discounts for interests that remain owned by the individual or estate for estate tax purposes. Such a structure also may result in valuation discounts for gift tax purposes if an individual transfers limited partnership interests during his or her lifetime to or in trust for his or her descendants.

For gift and estate tax purposes, discounts from the value of the underlying assets on transfers of limited partnership interests may be most likely if a partnership contains actively managed, income-producing business property or real estate. To date certain limited partnership interests in investment partnerships that hold real

estate or marketable securities have nonetheless been receiving valuation discounts. While the IRS is litigating cases where gift and estate tax valuation discounts have been claimed on limited partnership interests, there currently exists precedent that such discounts should apply in appropriate circumstances. Such discounts (which may, for example, approximate 20-30% of underlying asset value) would be attributable to the non-marketability of a limited partnership interest (compared to underlying assets in the Partnership) and the inability of a limited partner, as such, to participate in Partnership investment and distribution decisions. Although the IRS has challenged family limited partnerships (and specifically, the discounts associated with the transfer of limited partner interests) in the Tax Court on a number of legal grounds, and the IRS continues actively to do so at both the trial court and appellate court levels, the results of the court decisions to date generally have been pro-taxpayer (see the *Kimbell* case discussed below) when the taxpayers followed entity formalities and did not engage in deathbed transactions. The IRS, however, has yet to concede any of its arguments.

2. The Minority Interest Discount

As previously stated, a discount for a minority interest reflects the owner's lack of control with no ability to direct distributions, compel liquidation, elect officers or directors, set salaries, and set policy in general. An illustration of this minority interest discount is shown in the following example.

D. Gifting of Family Partnership Interests

1. Limitations on Amount

a. Gifting of family partnership interests are limited by the donor's annual exclusion limit.

i. In calculating the impact of a gift towards the donor's annual exclusion limit, the discounted value is used, NOT the fair market value of the gift.

Example: John gifts an interest to his daughter with a market value of \$20,000. If the gift is subject to a 25% discount, this gift will only count \$15,000 towards his annual exclusion limit.

2. Limitations on Timing

a. As the Internal Revenue Service subjects family limited partnerships to a level of scrutiny, it is important that some period of time lapse between the formation of the partnership and any gifting of interests.

To receive the proper discounts, the family limited partnership must have a legitimate purpose; if it is viewed simply as a vehicle for estate tax evasion it will not pass IRS muster.

Thus, any gifting of interests must occur after, and independent of, the partnership creation and its initial funding. A good rule of thumb is that the founding documents of the partnership be “old and cold” before any gifting of interests occurs.

E. Funding and Gifting A Family Limited Partnership: An Example

1. Background:

John Doe has recently passed, leaving significant assets behind to his wife, Jane Doe, and his only child, John Doe, Jr. John Doe, Jr., as executor of his father’s estate, seeks to maximize his benefits by creating a family limited partnership for his mother and himself. The Doe family assets include a rural farm as well as a marital trust. To properly manage the assets in a productive manner, two limited partnerships would be created: one to manage the farm, and one to manage the remaining family assets.

2. Key Partnership Terms and Issues

The Partnership agreements would include the following terms:

a. A corporation created for this purpose would serve as the General Partner and it would have authority to manage the Partnership assets on a day-to-day basis. The General Partner would only own a 1% partnership interest of each Partnership. The stock of this corporate General Partner would initially be owned by Jane, but Jane would be free to later give stock to her son John Jr.

b. The corporation would decide whether and when to distribute Partnership income, if any, and it would do so on a pro-rata capital interest basis. The corporation, however, would have a fiduciary duty to all of the partners to distribute Partnership income to the extent it is not needed by the Partnership.

c. Partners may transfer their limited partnership interests outside the family only if approved by other partners or if subject to a right of first refusal. All the partners must approve substitution of a transferee as a limited partner.

d. No limited partner would have the unilateral right to withdraw from the Partnership and thereby “cash in” his, her or its interest. Thus, a limited partner could only “cash in” with the consent of all the other partners.

3. State of Creation

While a family limited partnership can be formed under the laws of any state, Delaware has laws advantageous to discount valuation. Delaware limited

partnership law has a "default" provision that precludes a limited partner from unilaterally withdrawing from the partnership prior to the end of the partnership term, and this may support discount valuation.

4. Doe Family Farm, L.P.

The Farm real estate owned by John Jr. and Jane would be transferred to a new real estate partnership, Doe Family Farm, L.P. Under John Sr.'s trust, Farm property passed to the Marital Trust created for Jane. John Jr. owned adjoining land. John Jr. and Jane would create Doe Family Farm, L.P. and Jane would create a corporation to act as its sole general partner. The Partnership would be funded with transfers from John Jr. and Jane, namely the title to the Farm property and \$1.5 million cash to cover anticipated carrying expenses. Jane could use her own funds and/or funds distributed to her from her Marital Trust. Initially, John, Jr. and Jane would be the owners of Doe Family Farm, L.P. interests, and Jane would be the sole shareholder of the corporation. However, Jane may subsequently decide to give John, Jr. all of the stock in the corporation and give a portion of her limited partnership interests in the Doe Family Farm, L.P. to, or in trust for, John, Jr. and/or John, Jr.'s children.

a Purposes of Doe Family Farm, L.P.

The business purposes for Doe Family Farm, L.P. would be the:

- i.** creation of multiple interests in a total property which may be transferred easily to family members;
- ii.** ability to transfer undivided interests in the real estate via limited partnership interests while maintaining collective asset management in a desired manner;
- iii.** limited personal liability for the property owners from accidents associated with the property; and
- iv.** applicability of business judgment rules (rather than fiduciary rules faced by trustees) to investment management and flexibility of Doe Family Farm, L.P. provisions to address contingencies, e.g., arbitration and right-of-first-refusal provisions in future years when many descendants may share ownership.

b. Ownership Structure

A new corporation would be created to own a 1% interest in Doe Family Farm, L.P. as its general partner. Jane would contribute cash to the corporation, and the corporation would contribute cash to Doe Family Farm, L.P. in exchange for the 1% general partner interest in Doe Family Farm, L.P. Jane initially would own the stock of this corporation, although she may subsequently decide to give it to John Jr. A corporate

general partner would provide continuity of management of Doe Family Farm, L.P.

In exchange for limited partnership interests in Doe Family Farm, L.P., John Jr. and Jane would contribute their respective interests in the Farm real estate, and Jane would contribute additional cash.

c. Real Estate Transfer Tax.

Real estate transfer tax would be payable on the Doe Farm real estate when it is transferred to the Doe Family Farm, L.P. Such tax, determined by state law, would be payable by the transferors at the time of the transfers.

d. Partnership Startup

The initial capitalization of the Real Estate Partnership would be:

<u>General Partner</u>	Contributed <u>Property</u>
New Corporation	Cash
<u>Limited Partners</u>	
Jane Doe	Doe Farm property and Cash
John Doe, Jr.	Doe Farm property

F. Protection of Partnership Interests from Claims of Creditors

1. The Inherent Liabilities of a Family Limited Partnership

a. Under the statutes governing Family Limited Partnerships, liability for limited partners to outside creditors for actions of the partnership exists only to the extent provided by the partnership agreement. Thus a properly drafted limited partnership agreement will protect limited partners.

b. General partners, however, have greater liability. In order to protect the assets of the general partner, a corporate general partner could be used. An individual would be the sole shareholder of this company; as shareholders are not liable for the actions of the corporation, this adds an extra layer of protection.

2. Protection of Assets from Non-Family Members

a. One of the purposes of creating a family limited partnership is to keep assets within the family. To further this end, the partnership agreement can contain limitations on the transferability of partnership interests. Specifically, transfer of family interest to an outsider can be made contingent upon agreement of all other partners. Without this consent, any attempted transfer to a non-family member would result in the non-family member becoming merely an assignee instead of a partner.

3. Protection of Assets During Divorce Proceedings

a. Outside of a pre-nuptial or post-marriage agreement stating otherwise, a partner's ex-spouse has the ability to claim all or part of a partnership interest as marital property. To prevent the ex-spouse from obtaining full partnership rights, the partnership agreement should be crafted so it treats divorce proceedings as an involuntary transfer of interest. This could trigger provisions that restricted the ex-spouse to receiving the fair market value of the partner's interest.

4. Protection from Judgment Creditors

a. While the partnership itself has protection, individual partners might have judgment creditors seeking to execute a judgment against that partner's interest in the partnership. The statutes that regulate family limited partnerships would prevent the creditor from seeking rights to the extent that the creditor could force liquidation or distribution of partnership assets. Instead, the creditor simply becomes an assignee of the debtor partner; they have no power within the partnership.

G. A Comparison of Family Limited Partnerships to Trusts and LLC's – Choice of Entities and When to Use Which.

1. Trusts

a. Revocable Lifetime Trusts

A revocable lifetime trust is a trust in which the grantor retains some method of control, be it direct or indirect, over the property.

i. Advantages

1) The grantor can retain direct or indirect control of the trust while he or she is still alive / capable of exercising control.

ii. Disadvantages

- 1)** The retained interest in a revocable lifetime trust is subject to full estate tax inclusion at death value.
- 2)** Revocable lifetime trusts offer the grantor no protection from creditors during life and little protection at death. A person cannot establish a trust for his or her own benefit and remove assets from the reach of creditors.

b. Irrevocable Trusts

The grantor in an irrevocable trust may retain a lifetime, limited, or no interest. However, an irrevocable trust is inflexible; once established the terms cannot be modified.

i. Advantages

- 1)** Total discretionary trusts (trustee determines beneficiary's right to income or principal) offer protection to beneficiary's interest from outside creditors

ii. Disadvantages

- 1)** Gifts to an irrevocable trust in which the grantor has not retained a beneficial interest typically will not qualify for the annual exclusion unless beneficiaries are given a right to withdraw. Giving beneficiaries a right to withdraw, however, means the grantor must surrender control of those assets.
- 2)** If the grantor retains a beneficial interest in the property granted to the trust, all trust property will be included in the gross estate of the grantor.
- 3)** In a spendthrift trust (a trust that prohibits the assignment of a beneficiary's interest), claims for spousal or child support, claims based on providing necessary goods or services, or claims necessary for the preservation of the beneficiary's interest (i.e. claims made for maintenance actions necessary to retain the value of the interest) may reach back to the beneficiary's interest.

c. When a Trust Might Be Useful

- i.** A trust might be useful depending upon the nature of the assets to be placed into the trust. Passive interests might be best utilized as a trust, as such assets might not receive discounts in

valuation if contributed to a family limited partnership (see *Strangi* case discussed below).

ii. Typically, transfers of real estate to a trust are not subject to eral estate transfer tax, but transfers to a partnership are subject to this tax. A comparison of real estate tax saved by utilizing a trust must be compared to the savings impact of the valuation discount for assets placed into the partnership.

2. Limited Liability Companies

a. General Similarities

Limited liability companies are very similar to family limited partnerships. Both may take advantage of valuation discounts for assets within control of the entity. The general structure of a limited liability company is very similar to a general partnership.

i. Much of the structure of the limited liability company is defined in its agreement.

ii. The interests and responsibilities of the members of the company are defined in the agreement.

b. The Crucial Difference: Liability

i. While a family limited partnership has a general partner who is personally liable, a limited liability company does not have an individual who takes this responsibility.

ii. Instead, no members of the company have any personal liability

1) Members will not suffer liability for their participation in the company management.

2) Members only become liable for business debts if they have guaranteed the debt or was personally responble for the act or omission that caused the debt.

c. Another Difference: Management

i. While members of the company do not suffer from the same liability as general partners in a family limited partnership, this advantage over a general partner is offset by the lack of control that may be exercised by the company.

1) Unlike a family limited partnership, with power centralized to some extent around the general partner, a limited liability company does not have the same inherent stratification between its members.

2) Without this stratification, it becomes difficult to have the same sort of hierarchical management found in a family limited partnership. Thus, while in a family limited partnership the general partner “head” might be a corporation whose sole shareholder is the eldest child, a company does not offer the same sort of inherent structure; any such division of rights and duties must be made in the company agreement.

H. Current Status of Family Limited Partnerships in Estate Planning

1. Attacks by the Service

a. Position of Service

i. The use of family limited partnerships to obtain discounts for estate and gift tax purposes is an area in which the Internal Revenue Service has taken a keen interest.

ii. The following situations appear to give rise to greater scrutiny by the Service:

1) Limited partnerships formed shortly before death;

2) Limited partnerships formed where the significant partner or member is incompetent and a power of attorney is used to form the entity; and

3) Limited partnerships where the substantial assets are cash and marketable securities.

4) Limited partnerships where corporate formalities are not recognized and partners use partnership assets as personal assets.

5) Limited Partnerships where a partner has contributed all of his or her assets to the partnership. A partner must hold enough assets outside of the partnership to maintain his or her living expenses.

2. Recent Decision #1: *Strangi v. Commissioner of Internal Revenue*
(May 20, 2003)

a. Background

Decedent's son-in-law, an attorney ("Mr. Gulig"), took over decedent's affairs in 1993 pursuant to a 1988 power of attorney. In 1994, Mr. Gulig set up a family limited partnership, the Strangi Family Limited Partnership ("SFLP") after attending a financial planning seminar. Acting under power of attorney, Mr. Gulig assigned 98% of decedent's wealth, including his house, to SFLP in exchange for a 99% limited partnership interest. Mr. Gulig also established Stranco as a corporation to act as general partner; decedent acquired a 47% interest in Stranco and decedent's children acquired a 53% interest.

The SFLP agreement held that the distributions of assets and proceeds would be made in the sole discretion of the managing partner. The sole managing partner was Stranco. Stranco's by laws, in turn, established Mr. Gulig as the manager of its day-to-day business. Thus Mr. Gulig, who was responsible for the day-to-day execution of decedent's interests, was also responsible for the operations of the SFLP partnership.

The family limited partnership was established in early August, 1994; the decedent passed away on October 14th. SFLP had been paying for his maintenance.

Following a tax filing in 1996, the IRS filed a notice of tax deficiency of \$2.5 million in estate taxes and \$1.6 million in gift taxes, resulting from the government's conclusion that decedent's interest in SFLP and Stranco should have been increased in value; the decedent's estate claimed an interest of \$6,560,730 in SFLP; the government claimed \$10,947,343; the total value of property held by SFLP at time of decedent's death was \$11,100,922.

On remand from the Fifth Circuit, the Tax Court held found for the government that the property value should be included to the extent declared by the government in their notice based on the following analysis.

b. Analysis of 2036

The government claimed that the value of the property contributed to SFLP and Stranco was includible in the decedent's gross estate under either 2036(a)(1) or 2036(a)(2) without discount.

i. Section 2036(a)(1)

Section 2036(a)(1) provides for the valuation of property contributed to a partnership based on the extent to which the decedent retained, by express or implied agreement, possession, enjoyment or the right to income.

In this instance, the court noted that the decedent had only \$761 in liquid assets available in his checking account. Thus it appeared that everyone expected that SFLP and Stranco would be the primary source of decedent's liquidity.

In addition, SFLP funds were used to provide extensive medical care, funerary expenses, and tax costs for the decedent's estate.

In light of these facts, the court stated that the SFLP/Stranco arrangement bore greater resemblance to one man's estate plan than to any sort of arm length joint enterprise. In fact, virtually nothing beyond formal title changed in decedent's relationship to his assets. Thus, the court found that decedent retained full possession of, enjoyment of, and the right to income from his contributed property within the meaning of 2036(a)(1); the valuation towards the estate was the full value of the contributed property.

ii. Section 2036(a)(2)

Section 2036(a)(2) mandates the inclusion in the decedent's gross estate the value of contributed property based on the extent to which the decedent retained the right to designate the persons who shall possess or enjoy the property or its income.

While other cases involving mere control or influence of the actions of a partnership were deemed worthy of a valuation discount, the court in *Strangi* found that the SFLP/Stranco agreement granted the decedent full power of designation over the property, and again no valuation discount was appropriate.

Specifically, the provisions of the governing documents of SFLP/Stranco provided ascertainable and legally enforceable rights to designate persons who shall enjoy the transferred property and its income.

The SFLP agreement named Stranco managing general partner and gave Stranco sole discretion to determine distributions. The Stranco shareholders, including the decedent through Mr. Gulig, then gave Mr. Gulig the power to delegate the

authority through the Stranco management agreement. The end result was that decedent's attorney in fact had the power to make the distribution decisions of the partnership that had been almost completely funded by the decedent's assets.

Cases cited the other way in favor of the discount usually involved additional layers of separation between the decedent and the recipient of the property that were lacking in SFLP. One example involved a trust where an individual who retained a controlling interest in the management of the trust received a valuation discount because an independent trustee had also been appointed with authority to pay or withhold income. Also the funds transferred in the other cases were subject to economic and business realities, as the assets were working interests as opposed to mere monetary or investment assets.

c. Take Away Points

i. It is vitally important not to intermingle personal assets and partnership assets; partnership assets should not be utilized to provide for the private expenses of partners.

ii. There must be separation between the management of the partnership and those granting assets to the partnership. There must be a legitimate change in control of the assets, not merely a change in title.

iii. It is beneficial to have assets requiring active management in the partnership. Functional businesses are subjected to various business world stresses that monetary or investment assets are not subjected to. These stresses make the transfer of assets appear less like a mere tax evasion scheme and thus those assets are more likely to receive a valuation discount.

3. Recent Example #2: *Kimbell v. United States* (Decided 5/20/2004)

a. Background

Ruth Kimbell died on March 25, 1998, leaving her son David as executor of her estate. Just prior to Ruth's death, David, his wife, and Ruth's revocable living trust ("The Trust") joined to form a limited liability company. The Trust owned a 50% interest in the LLC.

The Trust and the LLC later formed a family limited partnership ("The Partnership"). The Trust contributed \$2.5 Million in cash for a 99% pro rata limited partner interest. The LLC contributed \$25,000 for a 1% general partner interest. The end result was that Ruth, through the Trust and the LLC, owned 99.5% of the company. As Ruth controlled the Trust,

transfers made to the partnership by the trust were seen as transfers made by Ruth.

b. The IRS Audit

The IRS determined that the value of the assets transferred to the Partnership and the LLC, rather than the Ruth's interest in those entities, was includible in the gross estate under § 2036(a) of the Revenue Code. The estate paid the tax and filed for a refund; the refund was denied, and a lower court found for the IRS on grounds that Ruth's transfers to the Partnership and the LLC were subject to Revenue Code Section 2036(a). Specifically since family members were on each side of the transaction, the transfer was not a bona fide sale.

c. The Lower Court Decision for the IRS

The Kimbell family appealed on grounds that the transfer qualified for an exemption to § 2036(a) as it was a bona fide sale for an adequate and full consideration in money or money's worth.

The Government claimed, and the lower court agreed, that the sale was not bona fide; it was not conducted at arms length as family members were on both sides of the transaction. In addition, the Government claimed and the lower court agreed that the transaction was not for an adequate and full consideration: the pro rata interest in the partnership was not adequate consideration for the assets she transferred to the partnership.

d. The Decision on Appeal: Pro-Family Limited Partnership

The Fifth Circuit Court of Appeals reversed the lower court decision.

First, the court found that the transaction was in fact for adequate and full consideration. They found a three-part test to reach this determination.

i. Whether the interests credited to each partner was proportionate to the fair market value of the assets each partner contributed to the partnership

ii. Whether the assets contributed by each partner to the partnership were properly credited to the respective capital accounts of the partners

iii. Whether on termination or dissolution of the partnership the partners were entitled to distributions from the partnership in amounts equal to their respective capital accounts.

The court found that the Kimbell transaction met all of these requirements.

More important was the question of whether or not the transaction was bona fide. The fact that tax planning motives were involved was not the determinative factor; the question instead was whether the sale was a bona fide sale or was instead a disguised gift or sham transaction.

In showing that the transaction was bona fide, the Kimbell family established three crucial facts. First, Ruth had sufficient assets outside of the partnership for personal use; she retained \$475,000, more than enough to support her at the age of 96. The assets transferred to the Partnership, specifically oil and gas operations, were actually transferred to the Partnership. These assets required active management. Therefore the transaction had all the elements of a bona fide sale.

e. Take Away points from *Kimbell*

- i.** Partnership interests received by an individual in exchange for assets contributed to a family limited partnership constitute full and adequate consideration.
- ii.** When contributing assets to a family limited partnership, it is vital to maintain enough assets outside the partnership for self-support.
- iii.** The bona fide transaction can still occur despite the fact that family members are on each side of the table.
- iv.** To prevent a determination that a transaction is merely a 'change in form' or 'recycling of value', it is helpful to transfer assets to the partnership that require active management.