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*Synopsis*

*In recent years, family limited partnerships have become a popular tool to transfer assets to younger-generation family members at reduced transfer tax costs. By contributing assets to a family limited partnership and gifting limited partnership interests instead of the underlying assets, the value of the assets transferred is reduced. At the same time, family limited partnerships enable senior family members to retain control over the underlying assets. Family limited partnerships also have advantages in minimizing operational costs, simplifying annual gifting, providing investment flexibility, and protecting assets from creditors.*

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**I. Overview of Family Limited Partnerships.**

**A. General Concepts.**

As indicated by its name, a family limited partnership ("FLP") is a limited partnership, the partners in which are members of the same family. Typically, the founders are senior-generation family members who transfer assets into the partnership and receive both general and limited partnership interests in return. They usually hold only a small interest (often as small as a 1% interest) as general partners—the remaining partnership interests are structured as limited partnership interests. Despite the small percentage represented by general partnership interests, these interests represent control of the FLP; the limited partnership interests, which are usually nonvoting, represent the bulk of the ultimate value of the partnership. The founders of the partnership usually retain their general partnership interests. They then often make gifts of some or all of their limited partnership interests to younger-generation family members. Sometimes, younger-generation family members contribute some of their own assets to the FLP in exchange for a limited partnership interest. The founders frequently own the general partnership interests in their own names, individually. In some circumstances, the general partnership interests are owned by a trust, a corporation, or a limited liability company controlled by the founders.

**B. Differences Between General and Limited Partnership Interests.**

Under Texas law, general partnership interests and limited partnership interests differ in several ways. The most significant differences between general partners and limited partners are as follows:

- **Limited Partners.** Limited partners are entitled to share in partnership profit distributions on a pro rata basis. In addition, if the partnership is liquidated, the limited partner receives his or her pro rata share of liquidation proceeds. For example, if partnership profits are distributed, a limited partner owning a 10% limited partnership interest would receive 10% of the distributed profits. If the partnership were liquidated, that partner would receive 10%

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\*Karen S. Gerstner, & Associates, P.C. has compiled the *Basics* series to provide plain-English, summary explanations of fundamental estate planning techniques and concepts. As a result, our discussions may gloss over some of the more complex topics. The Basics memoranda are *not* legal advice. Instead, they are generalized, educational tools designed to help our clients and potential clients develop an understanding of the estate planning process. Before engaging in any estate planning, you should consult a qualified estate planning attorney.

of the assets of the partnership. However, limited partners do not take part in partnership management (e.g., they cannot vote on whether to buy or sell a particular investment and cannot vote to liquidate the partnership). They are subject to the control of the general partner and have no assurance that distributions will be made to them. Limited partners are usually not required to make contributions to the partnership, and they are not responsible for partnership liabilities (i.e., they are not personally liable if the partnership is sued). State law restricts the rights of a person to whom a limited partnership interest is transferred. Unless the other partners agree to treat the transferee as a limited partner, the person will normally have only the rights of an "assignee" which are described below.

- **General Partners.** Like limited partners, general partners are entitled to share in partnership profits based on their percentage ownership in the partnership. However, the general partners have complete management authority and control over the partnership and partnership assets, including the power to decide if and when to distribute partnership profits. They typically receive reasonable compensation for performing their management duties. However, the price under Texas law for having management authority and control over the partnership and its assets is that general partners are personally liable for partnership liabilities that are not paid out of partnership interests. In other words, if a general partner makes a bad management decision and, as a result, the partnership is unable to pay its liabilities, the general partners may have to pay those liabilities out of their own pockets.

## II. Advantages of Family Limited Partnerships.

Family limited partnerships offer numerous tax and non-tax advantages to their founders and to members of the founders' families. To a certain extent, however, the benefits to be obtained depend in part on the motives of the founders in creating the FLP. In most cases, the founders of the partnership are seeking a variety of benefits from the FLP. It is frequently helpful in future dealings with third parties (such as potential creditors and the IRS) to spell out the objectives and business reasons for forming the FLP in the partnership agreement, while emphasizing the continuing "going concern" nature of the partnership. The following discussion highlights some of the effects of transferring assets to an FLP.

### A. Creditor Protection.

If a creditor wins a lawsuit against a debtor and obtains a judgment, the creditor may take possession of certain assets of the debtor. Family limited partnerships provide asset protection from potential creditors of a partner because a partner's creditor generally cannot seize the partnership interest and thereby become a partner. Instead, the remaining partners continue to control the partnership and the creditor typically receives only a "charging order" against the debtor-partner's interest. A charging order gives a creditor the rights of a mere "assignee" of the partnership interest to the extent of the debt. In this position, the creditor receives only the partner's share of income (as determined by the general partners) plus the right to inspect the books of the partnership. The creditor gets no voting rights, control, or any other power in the partnership. The creditor cannot sell partnership assets, liquidate the partnership to satisfy the debt, or force a distribution of profits. Although the creditor cannot require a *distribution* of profits, the creditor is required to pay income tax on its pro rata share of any income received by the partnership. This feature of partnership law makes an interest in an FLP an "ugly" asset to creditors. Consequently, most creditors would rather negotiate a settlement favorable to the debtor than become an assignee of the partnership interest.

The asset protection benefits of an FLP might induce a creditor to raise an allegation that the initial transfer by the partner to the partnership was made to "defraud" the creditor. Texas law provides certain protections to creditors from debtors who attempt to transfer property to defraud creditors. If the transfer is found to be "fraudulent," a creditor may persuade a court to undo the transfer to the extent needed to satisfy the claim. Generally, however, as long as transfers to the FLP are not made with an actual intent to hinder, delay, or defraud creditors, the transfer to the FLP should not be voidable. Therefore, persons forming an FLP should retain sufficient assets outside the FLP to enable them to satisfy any outstanding (and reasonably anticipated future) debts and claims.

### **B. Valuation Discounts.**

Valuation of FLP interests is important: if assets are transferred to an FLP, estate and gift taxes are measured based upon the value of the partnership interests given during lifetime or retained at death. Because a founder exchanges contributed assets for FLP interests, the value of the contributed assets are not taxed in the founder's estate. Valuation of cash, stocks, bonds, and other readily tradeable assets is a relatively simple matter. When no public market exists for an asset, however, its valuation becomes somewhat subjective. Since there is no public market for interests in an FLP, the tools used to value unmarketable assets can contribute to a favorable valuation for estate and gift tax purposes.

The Internal Revenue Code provides that estate and gift taxes are measured by the "fair market value" of transferred assets. Fair market value is 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. The fair market value of a particular item of property . . . is not to be determined by a forced sale price. Nor is it determined by the sale price of an item in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item, wherever appropriate.

A "willing buyer" of a partnership interest does not become a partner under Texas law. Rather, like a creditor, the buyer is treated as an "assignee," unless the other partners agree to admit the buyer to the partnership as a partner. No buyer can be certain that he or she will be so admitted (in the context of a family partnership, the prospects for admission of a third party as a partner would appear especially remote). Therefore, the prospective buyer has no guarantee of any voice in partnership matters. This feature of the law regarding transferred partnership interests substantially diminishes the price that a willing buyer would pay for an interest in the partnership. Suppose for example that a partnership contained assets valued at \$1,000,000. The buyer of 10% of the *assets* generally would be willing to pay \$100,000. A buyer of a 10% interest in the *partnership* owning those assets, however, likely would pay much less, since the buyer, as an assignee, gets no voting rights, control, or any other power in the partnership, and cannot sell the partnership assets, require a liquidation of the partnership to receive the assets, or even require a distribution of his or her "share" of partnership profits. This price-depressing feature of limited partnerships substantially lowers the value of the property transferred by the founders of an FLP and, as a result, lowers overall gift and estate tax exposure.

Restrictions set out in the partnership agreement may also affect the valuation of a partnership interest because they prevent the partners from freely disposing of their interests. Historically, the ability of family members to include severe transfer restrictions in the partnership agreement provided an opportunity to obtain discounts on the value of partnership interests. Since 1986, however, Congress has provided that in a partnership controlled by family members, restrictions set forth in the partnership agreement are ignored for valuation purposes to the extent that they are more restrictive than state law.

Ironically, the limitations imposed upon partnership interests described above are imposed not by the partnership agreement but by state law. These restrictions have the most dramatic impact on the value of the partnership interests; they give partnership interests a value much lower than their value upon the liquidation of the partnership.

### C. Other Benefits.

Family limited partnerships provide a number of benefits beyond those associated with creditor protection and estate and gift tax minimization. For example, an FLP allows the founders to keep control of the assets as general partners. When property is gifted outright to a beneficiary, the donee gains control over the gifted property. In contrast, with an FLP, when the founder makes a gift of a limited partnership interest while retaining the general partnership interest(s), he or she retains control over all of the underlying partnership property. An FLP also allows a simplified mechanism to make gifts of assets that might otherwise be hard to divide.<sup>1</sup> Some donors view gifts made through the use of an FLP to be an excellent way to enable them to make gifts which are "fair" to everyone. A particular asset is not set aside for a particular person. Rather, everyone is treated equally, since everyone receives a pro rata portion of the same property. Family limited partnerships provide senior family members a convenient mechanism to take advantage of the \$12,000 annual gift tax exclusion.<sup>2</sup> At the same time, as limited partnership interests are gifted, the value of the underlying assets held by the partnership is effectively removed from the donor's estate, thereby decreasing the amount of federal estate taxes that otherwise would be payable at the donor's death. Once gifts of partnership interests are made, not only a percentage of the underlying property, but also a corresponding percentage of any appreciation in the property is effectively removed from the donor's estate.

Other FLP advantages are as follows:

- A person in a high income tax bracket holding income-producing assets can gift limited partnership interests to a person who is in a lower income tax bracket, which may permit income to be reallocated among family members and, thereby, decrease the overall income tax burden.<sup>3</sup>

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<sup>1</sup> Real estate is a good example of an asset for which gifting is simplified through the use of an FLP, especially if annual gifting is desired. Rather than having to prepare separate transfer deeds and pay filing fees to record the deeds of fractional interests each year, only one deed transferring the land to the FLP is required. Thereafter, the founders can execute a simple instrument assigning limited partnership interests to family members each year. The partnership assignments need not be recorded. At the same time, management of the real estate, instead of being fractionalized among co-owners, remains in the hands of the founders, who hold the general partnership interests.

<sup>2</sup> The Internal Revenue Code permits each person to give up to \$10,000 (adjusted for inflation after 1998) per donee per year without any gift tax implications. The exclusion is currently \$13,000 (2009). Parents utilizing this \$13,000 "annual exclusion" are each treated as donors, enabling married couples to make gifts of up to \$26,000 per donee (recipient) per year. Gifts of FLP interests enable founders to make these gifts without parting with cash, or with control of the FLP assets (as long as they retain the general partnership interests). In addition, because the valuation of the property is reduced by having been placed in a partnership entity, more value can be transferred than if the donor had instead gifted the partnership's assets outright. If the value of gifts to any person in any year exceeds the annual gift tax exclusion, gift tax returns are required. No gift tax is actually paid, however, until the total of all such excess gifts exceeds \$1,000,000. The \$1,000,000 lifetime gift tax exemption shelters property from gift tax until total taxable gifts made during life exceed this threshold.

<sup>3</sup> To avoid perceived abuses in shifting income among family members, the Internal Revenue Code provides that the donee of a partnership interest will be taxed on partnership income computed *after* an allowance for reasonable compensation to be paid to the donor partner for any services provided by the donor to the partnership. In addition, net profits, in effect, must be allocated based on the percentages of partnership property that the partners would receive upon liquidation of the partnership.

- At death, fewer assets are subject to probate court jurisdiction. As a result, partnership real estate located in a state other than Texas avoids what might otherwise be an expensive "ancillary" probate proceeding.
- Because many different types of assets can be placed in one entity, accounting and management of family wealth can be consolidated.
- The partnership allows flexibility, since the terms of the partnership agreement can be modified as needed (subject to any restrictions on amendment that the family chooses to place in the partnership agreement).
- Some donors use the FLP entity to teach donees to work together while gaining business skills.
- Transfer restrictions can be placed on the limited partnership interests to prevent transfers to outsiders. These types of restrictions effect a type of "spendthrift" provision because they act as a restraint on a partner disposing of his or her interest.
- Unlike other entities, FLPs are not currently subject to Texas franchise taxes.
- The FLP form can help preserve the separate property character of a partner's interest in the underlying property.
- The senior generation may choose to focus control in one or more younger-generation family members, while providing equal value to all younger-generation family members. For example, a couple might transfer a 25% limited partnership interest to each of three children, giving the fourth child a 24% limited partnership interest and a 1% general partnership interest. While each child receives one-fourth of the value, control is effectively given to only one child.

### III. Some Disadvantages.

Like every estate planning tool, FLPs have both advantages and disadvantages that must be considered and compared before deciding whether an FLP is right for you.

FLP disadvantages include the following:

- FLPs can be costly. Creating an FLP generally involves attorneys, accountants, appraisers and other professionals, all of whom charge fees for their services. Additional ongoing professional fees are generally necessary to maintain the FLP (particularly accounting fees, and if frequent gifts are made, appraisal fees).
- FLP discounts are *real*. Creating an FLP will reduce your net worth. The reduction in net worth may make it more difficult to obtain credit and could violate the terms of existing loan agreements (which often require that a certain minimum net worth be maintained).
- FLPs can significantly alter the consequences of divorce. Although the divorce court can divide community property interests in an FLP between the spouses, a spouse who is not a general partner will typically never have a vote in partnership matters. Also, implementation

of an FLP can have the effect of altering the character of marital property (from community to separate, or from separate to community, depending upon the circumstances). Re-characterizing marital property can impact a divorce court's ability to make a meaningful division of property.

#### **IV. Planning Considerations.**

##### **A. The Partnership Agreement.**

The principal document needed to establish an FLP is the partnership agreement. In conjunction with Texas law and federal law, the partnership agreement governs the formation and management of the FLP. After the partnership agreement is properly executed, a one-page informational "Certificate of Limited Partnership" is placed on file with the Texas Secretary of State, and a one-time filing fee is paid (currently \$750). Thereafter, the founders transfer property to the partnership. These transfers are accomplished through deeds, assignments, opening of new bank or brokerage accounts, and other similar steps.

The partnership is established to continue for a specific term, typically 25 to 50 years. Limited partners cannot withdraw before the end of the partnership term unless the partners unanimously agree to liquidate the partnership. Limited partners are not entitled to mandatory distributions until the end of the partnership term.

##### **B. Management of the Partnership**

The partnership agreement can designate someone to serve as the "manager" of the partnership. The manager acts somewhat like the "president" of a corporation, taking charge of the day-to-day operations of the partnership to the extent required. Frequently, the manager is one of the founders of the partnership. The general partners of the partnership are typically given the power to remove and replace the manager by their unanimous vote. The manager is typically entitled to receive reasonable compensation for services rendered on the partnership's behalf.

##### **C. Using Trusts as Donees.**

Frequently, instead of transferring limited partnership interests to children or other family members directly, donors choose to establish trusts for the donees' benefit. They might select a trustee to assist younger family members. They frequently provide that, at some specifically-designated time in the future, each younger generation family member can become a co-trustee or the sole trustee of his or her trust. If a trust is utilized, the trustee owns the partnership interests that are intended to benefit the donor's family members. To the extent there is cash flow from the partnership, the trustees then use that cash flow to provide for the health, support, maintenance, and education of the donee family members and their descendants during their lifetimes. If the partnership is ultimately liquidated, the underlying partnership assets pass into these trusts, and the assets are again available through the trust to provide for the health, support, maintenance and education of the intended donees. The family members who are the beneficiaries of these trusts often are given the power in their respective Wills to designate who is to receive the property in the trust upon their deaths. The advantages of using lifetime trusts to hold the partnership interests include the following:

- An exemption of \$3,500,000 per "transferor" (thus, \$7,000,000 total for a married couple – 2009 amount) is available to minimize estate taxes when property passes from the donor's children to the donor's grandchildren.

- Even if the partnership is liquidated some day, the assets held in the trusts are not subject to claims of a donee's creditors; therefore, a large judgment will not cause the donee to lose the benefit of these assets.
- Holding assets in trust can preserve their exemption from creditors' claims and keep them beyond the reach of a divorce court's property settlement powers.
- Management assistance can be made available to donees through the use of trustees or co-trustees.

#### **D. Choice and number of general partners.**

The decisions of choosing general partners and the number of general partners go hand-in-hand. Under Texas law, a partnership dissolves upon the death or withdrawal of its sole general partner. A lapse in control of the FLP can cause adverse tax consequences at the time of the lapse of the partner's rights. Therefore, it is important to avoid a lapse in control of the FLP upon either a general partner's death or withdrawal from the partnership. Several options are available to avoid this occurrence, including having multiple general partners, successor general partners and/or having an entity such as a trust, corporation, or limited liability company serve as one of the general partners. Determining which approach is best in any given situation depends on numerous factors, including the number, age, and health of the founders; the nature of the activities to be undertaken by the partnership; and the overall estate planning objectives of the founders.

### **V. Tax Considerations.**

#### **A. Income Tax Issues.**

Under the terms of the Internal Revenue Code, partnerships are not taxpayers. Rather, the partners themselves are taxed on the income recognized by the partnership, whether or not the income is actually distributed to the partners. As a result, the general partners or manager of an FLP must be aware of the income tax effects of the partnership's income upon the various partners. Frequently, the manager will distribute at least enough cash from the partnership each year to enable the various partners to pay any increase in their income tax bills caused by having to report their respective shares of partnership income.

Another income tax issue of which founders of an FLP must be mindful relates to the tax effect of contributing property to the partnership. Generally, no gain or loss is recognized on the transfer of property to a partnership. There are, however, some important exceptions to this rule. For example, if two or more persons transfer non-identical assets to a partnership, and more than 80% of the partnership's assets are readily marketable stocks or securities held for investment, the effect to the partners may be that their respective securities portfolios are thereby diversified. Under those circumstances, the so-called "investment company" rules of the Internal Revenue Code may cause the partners contributing appreciated securities to recognize gain at the time the securities are contributed to the partnership. For most Texas married couples forming an FLP, these rules should not apply, since contributions are typically from the couple's community property (in which the spouses hold identical interests). If more than 80% of the partnership's assets will be in the form of marketable securities, however, these rules should be carefully reviewed with your counsel. Certain other types of assets have income tax characteristics that are dependent upon their being owned by qualified individuals. These assets (notably, annuities and stock in closely held corporations that have elected to be treated as S corporations) generally are not suitable for contribution to an FLP.

**B. Estate Tax Inclusion Issues.**

One important consideration in the formation of an FLP is the treatment of the partnership assets and interests upon the general partner's death. One of the advantages of an FLP is the ease of gifting the partnership interests. Gifted partnership interests have the effect of removing the value of the partnership's underlying assets (and any post-gift appreciation) from the donor's estate. Accordingly, careful planning must be done to prevent the value represented by the assets contributed to the partnership from being inadvertently included in the general partner's taxable estate.

For example, special estate tax rules provide that—if a donor gives away an asset while retaining too much control of the possession or enjoyment of the asset (or the right to income from it)—it will be taxed in the donor's estate. In the partnership context, the founder's retention of control through the general partner interest is subject to an obligation to maintain a fiduciary relationship with the other partners and to act in the best interest of the partnership. This fiduciary duty generally has been held to prevent the gifted partnership interests from being included in the founder's taxable estate under those special estate tax rules. As discussed above, only the value of partnership interests still owned by a founder at death, subject to various discounts in value, will be included in the partner's gross estate.

One important exception to the rule discussed above applies to stock in a "controlled corporation." If a general partner owns an interest in a closely held corporation which he or she transfers to the FLP, while retaining the right to vote the corporation's stock, either directly or indirectly, the transferred interest in the corporation will be included in the general partner's gross estate. To avoid this result, we advise persons who hold, alone or with their family, 20% or more of the voting interest in a closely held corporation to recapitalize the corporation prior to transfer to the FLP, so that only nonvoting stock is transferred. If voting stock in a controlled corporation is transferred to the FLP, we advise the inclusion of language in the partnership agreement that prevents the contributing partner from voting the stock; rather, the other general partners (or if there are no other general partners, the limited partners) would then vote the stock.

**C. Income Tax Cost Basis Issues.**

Property which is inherited from a decedent generally receives a so-called "step-up" in basis in the hands of the estate's beneficiaries. This means that the cost basis of an asset in the hands of an estate's beneficiaries is equal to the asset's estate tax value (normally, the asset's fair market value at the decedent's date of death). The "step-up" is usually advantageous to the beneficiaries because, if the inherited asset is later sold, the beneficiaries will avoid all capital gain taxes attributable to any appreciation in the value of the property during the decedent's lifetime.<sup>4</sup>

By using an FLP, some portion of the partnership interests usually will have been transferred to a donee during the lifetime of the senior generation family members. Since neither the gifted partnership interests nor the partnership's underlying assets will have been transferred from a decedent at death, a step-up in basis is lost to the donee. In addition, since the partnership interests retained by the senior generation at death are subject to estate tax valuation discounts from the value of the partnership's underlying assets, the cost basis of those assets in the hands of the beneficiaries similarly will be discounted. In weighing these divergent tax effects, most people conclude that the current potential gift and estate tax savings obtained by using an FLP outweigh prospective future capital gains taxes in the hands of younger generation

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<sup>4</sup>Although commonly referred to as a "step-up" in basis, the asset's basis may actually "step-down" if the value of the property at the time of the decedent's death is less than the decedent's original cost basis. In general, the former cost basis of the asset in the hands of the decedent is simply ignored. The beneficiary's cost basis is the estate tax value of the asset, whether that value is more or less than the decedent's cost basis.



family members. This conclusion is bolstered by the fact that estate and gift tax rates (which effectively range from 41% to 50%) exceed long term capital gain tax rates (currently capped at 15% through 2010, unless Congress enacts further legislation, then 20% in 2011 and thereafter in most instances). When transferring appreciated assets to an FLP, however, the advantages of valuation discounts and annual gift tax exclusions should be balanced against potential capital gain taxes associated with the loss of basis step-up.

## **VI. Operational Issues.**

An FLP is more than just a set of words on paper. Regardless of one's motives for forming an FLP, it will accomplish its objectives only if its form is respected. If the goal is consolidation of investments, the investment assets must actually be conveyed into the partnership. If one hopes to facilitate gifting, then partnership interests have to be given to family members. Using an FLP to teach investment policies and values to the younger generation works only if the partners actually meet and discuss investment philosophies, strategies and goals. If the idea is ensure that the FLP is respected not only by the family, but also by third parties, then undertaking these steps is not enough. It is equally important to establish and maintain adequate records, which show that partnership formalities have been observed. The founders of an FLP should hardly be surprised that the IRS or a creditor may ask a court to ignore the existence of an FLP if the family has done so. The courts cannot be expected to give more credence to the existence of the entity than do those who have formed it and are expected to benefit from it. To paraphrase an old saw, if you walk like a duck, quack like a duck, fly like a duck, and are constantly seen in the company of other ducks, then it is reasonable to suppose that you are a duck. By the same token, if you expect others to treat the entity that has been so laboriously formed as a true partnership, then it should "walk, talk and act" like a partnership.

### **A. Formalities Upon Formation.**

FLPs are formalized by the execution of an agreement which sets forth the rights and duties of the various partners, and specifies the relationship between the general and limited partners. In addition, the partnership must formally register as a limited partnership with the office of the Secretary of State of Texas, and the partners must actually convey assets into the FLP.

#### **1. The FLP Agreement.**

The partnership agreement designates the original partners, describes their initial contributions, sets forth whether and how additional contributions will be made, and describes how profits are to be allocated among partners. It also frequently sets forth limitations on transferability of partnership interests, and sets out such technical information as the formal address of the partnership and its "registered agent," who acts to receive official notices on behalf of the partnership. The agreement may describe in detail how books and records are to be maintained, what partnership matters may require a vote, whether more than a simple majority vote is required for any matter, how and when partnership meetings are to be held—in short, any information relevant to the conduct of partnership business. Most clients view these matters as mere "boilerplate," which requires little attention on their part either during the formation of the partnership or during its later operation. On the contrary, however, an FLP is a business, and should be operated in a businesslike fashion. The provisions of the agreement outline exactly how those business operations are to be undertaken, and should be adhered to in the operation of the partnership.

#### **2. Certificate of Limited Partnership.**

In Texas, no partnership may qualify as a limited partnership unless and until it has filed a certificate of limited partnership with the Secretary of State of Texas. This instrument sets forth the name of the partnership, the name and address of its registered agent and registered office, and the name and address

of each general partner. The certificate must be signed by each general partner and filed, together with the payment of the appropriate filing fee (currently \$750.00). Until the certificate is filed, third parties without knowledge of the limited nature of the partnership, may treat all partners as general partners. As noted above, it is the unique features of limited partnerships under Texas law that provide many of the benefits of FLPs. As a result, it is imperative that the certificate be filed as soon as the partnership is formed.

### **3. Conveyance of Assets.**

Until assets are transferred to an FLP, the partnership exists in name only. It is the actual transfer of assets from the partners to the partnership that breathes life into the entity. As a result, it is critically important that steps be taken to document the transfer of assets to the partnership. Conveyance documentation may take the form of deeds; mineral deeds or division orders; stock powers (or endorsement of stock certificates); opening of partnership bank or brokerage accounts into which checks or brokerage assets of the partners are conveyed; assignments; etc.

#### **a. Deeds**

A deed from a partner to the FLP ensures that the partnership is properly identified as the owner of any real estate in the official real property records. Recording this deed thus adds an important link in the chain of title. It serves to establish ownership, and fixes liability for future property taxes. Occasionally, partners execute only special warranty deeds (or even deeds without warranty). However, some title companies reportedly argue that execution of a special warranty deed does not transfer insurance protections in the partner's policy of title insurance, since it warrants only actions by the partner, and not others in the chain of title.

#### **b. Oil and Gas Interests**

Oil and gas interests constitute interests in real property. When a partner wishes to convey minerals, those minerals are generally transferred by mineral deed. Where a retained royalty is at issue, the royalty is typically transferred by execution of new division orders (or issuance of letters in lieu of division orders) provided to the payor of the royalty.

#### **c. Mortgages, Notes and Cash**

Transfers of cash are generally undertaken by issuing checks from the partners, which are then deposited into a bank account established for the FLP. As to mortgages and notes payable to a partner, the original instruments representing those notes should be transferred. Promissory notes are typically assigned by endorsement. If the note is secured by real estate, then in addition to the endorsement of the note, an assignment of the lien should be recorded in the deed records where the real property is located. In any event, the contributing partner should notify the maker of the note to ensure that future payments are made directly to the FLP.

#### **d. Stocks and Bonds**

Partners frequently transfer stocks and bonds held by them in a brokerage account held in "street name." Subsequent transfers of stocks and bonds registered in the street name are substantially simpler than the process required if original stock certificates are owned by the partner, and then reissued to the partnership. Typically, the manager of the FLP creates an account in the name of the partnership with the same brokerage firm or financial institution that holds the founding partners' stock, so that a simple journal entry can be utilized to transfer securities. If the stock issued is not publicly traded, the partners must determine

what steps are necessary to transfer the shares. In the case of a closely held business in which the partner is a shareholder, the partner (or perhaps his or her counsel or accountant) likely has possession of the corporate minute book and stock transfer ledger. Old stock certificates in the partner's name should be canceled, and new stock certificates should be issued in the name of the FLP. The stock transfer ledger contained within the corporation's minute book should be appropriately updated.

#### **4. Respecting the Conveyances.**

A common mistake made by persons who form FLPs is to forget that they no longer own the assets they have transferred to the FLP. For example, they do such careless things as paying personal expenses directly from partnership accounts. They prepare financial statements for lenders which list the partnership assets as their own, instead of listing only the partnership interests that they themselves retain. These types of actions give rise to claims by third parties, such as creditors or the IRS, that the FLP exists only in form and not in substance, and as a result, should be disregarded.

#### **B. Operating Formalities.**

Formalities of formation and conveyance are usually overseen by the attorney that assists with establishing the FLP. Once the partnership has been set up, it is not unusual for the attorney to take a much less active roll. This reduced involvement helps keep legal fees low. It is important to remember, however, that the formalities of *operating* the partnership are just as important as the formalities involved in the formation process. Most clients prefer not to incur the costs associated with keeping their counsel on retainer to ensure that operating formalities are followed. They feel that they are able to take whatever steps are required to document the fact that the partnership is being operated in a businesslike fashion. When the partnership regularly employs an accountant to undertake the keeping of partnership books and the preparation of partnership tax returns, those steps help document the partnership's status as a separate entity. But preparing financial statements and tax returns are only part of the formalities that should be maintained. And even in the case of partnership financial information, many clients prefer to adopt a "do it yourself" approach so that the professional oversight that an independent accountant might bring is foregone.

#### **1. Books and Records**

The partnership should keep a regular record of its assets and its receipts and disbursements. Contributions, distributions to partners, sales of partnership assets, purchases of new assets, partnership income and expenditures, all should be documented. Frequently, the partnership maintains a relatively few number of bank and brokerage accounts whose monthly statements can form the basis of these accounts. A formal set of "double entry" journals is not required. Many partnerships utilize simplified accounting software such as Quicken or Microsoft Money. In any event, the partners in charge of the partnership should keep adequate records to report to the partners on the status of the partnership and the results of its operations. The manager or general partner should give regular reports of partnership financial information to the partners. These same records are critical in enabling the FLP to prepare its tax returns, which are discussed below.

#### **2. Partner Meetings.**

Regular meetings of the partners are usually required by the partnership agreement. Even if the agreement doesn't specify that the partners must meet, good business practices suggest that they do so, at least annually. Partners' meetings are a good opportunity for the family to gather together to discuss the operations of the FLP. Although such meetings tend to be less formal than the meetings of corporate boards of directors, they nonetheless should be carried out with a similar sense of importance. Partnership books and records should be reviewed at the meeting. Important actions undertaken by the FLP since its last

meeting, such as acquiring or disposing of partnership assets, should be reviewed. The partnership's goals and objectives, both in the short run and for the long term, should be discussed. As important as holding regular meetings is documenting each meeting, and recording the important points discussed. Minutes like those maintained for corporate shareholders' or directors' meetings should form a model for the record of partner meetings.

### **3. Votes on Partnership Matters.**

The managing partner or general partners attend to the day-to-day business affairs of the FLP, and most matters requiring a vote of the partners are undertaken by the agreement of the general partners. If the general partners are unable to agree, the partnership agreement frequently sets forth the manner in which partnership interests are to be voted to resolve the dispute. The partnership agreement may provide that some matters require the approval of the limited partners, or a vote of all of the partners. It is important that the managers of the partnership review the agreement to ensure that they understand what sort of vote is required for each matter that must be submitted to a vote of the partners. Equally important, the managers must hold and record votes of partners as required by the agreement to ensure that partnership matters are being tended to in a businesslike way.

### **4. Other Operating Formalities.**

The FLP can observe a number of other formalities to show that the partners respect the nature of the entity. For example, some FLPs maintain their own separate business offices from which their affairs are operated. Frequently, the FLP establishes a separate mailing address or post office box to receive mail for the partnership. The FLP might have its own stationery printed (or might use current computer technology to design and print correspondence on its own "letterhead").

### **C. Formalities of Transfer.**

Most FLP agreements limit the transfer of partnership interests, so that interests are not transferred to non-family members. In addition, under Texas law, the transferee of a partnership interest does not become a partner unless admitted as a partner under the terms of the partnership agreement and the Texas Revised Limited Partnership Act. Therefore, partners in an FLP must be mindful of the limitations on transfer, and the formalities to be observed, to document a valid gift or other transfer of a partnership interest. Most corporations issue certificates representing stock in the company. This stock is often freely transferable by endorsing the stock certificate. In contrast, most FLPs do not issue certificates representing partnership interests. Instead, partnership interests are transferred by written "assignments" whereby the assignor agrees to transfer a specifically described interest in the partnership, and the assignee agrees to accept the assignment, subject to the terms of the partnership agreement. Unless the partnership agreement otherwise so provides, the assignee is not automatically admitted to the partnership as a partner until the requisite vote of partners approve the transfer and agree to admit the transferee as a substitute partner. Thus, a valid transfer of a partnership interest and the admission of the transferee as a substitute partner requires at least two pieces of formal documentation, one reflecting the assignment and another reflecting the vote to admit the assignee as a partner. Some partnership agreements permit the partnership to demand further documentation, such as an opinion of counsel that the transfer will not violate federal or state securities laws or result in adverse income tax consequences to the remaining partners. All required documentation should be prepared and signed prior to treating any transferee as a new partner in the FLP. The documentation should be maintained as part of the permanent books and records of the FLP.

#### **D. Tax Formalities.**

As indicated above, under current tax laws, partnerships are not treated as taxpayers. Instead, the partners are taxed on the income recognized by the partnership. Likewise, partnership credits, deductions, and expenses are reported directly by the partners.

##### **1. Partnership Income Tax Returns.**

Despite the fact that an FLP does not pay taxes, it must nevertheless file an income tax return (Form 1065) which reports to the IRS: (i) each item of income, expense, deduction, and credit incurred by the partnership during the year; and (ii) the identity of the various partners, and how each item of income, expense, deduction, and credit is allocated among the partners. The FLP must also deliver to the partners the information necessary to enable them to report their respective shares of partnership income, etc. This reporting is undertaken through a form K-1, delivered to each partner, which sets forth that partner's share of partnership tax attributes. The Form K-1 also tracks partnership contributions, distributions, and capital accounts.

##### **2. Taxation vs. Distribution.**

As noted earlier, each partner must pay tax on his or her share of partnership income, whether or not the income is actually distributed. Actual distributions from the partnership have no tax impact on the partners (unless distributions exceed a partner's total contributions plus profits). As a result, the general partners or manager of an FLP must be aware of the income tax effects that the partnership's income will have upon the various partners. Frequently, the manager will distribute at least enough cash from the partnership each year to enable the various partners to pay any increase in their income tax bills caused by having to report their respective shares of partnership income. If no distributions are made, the partners may have to use other outside sources of cash to pay the income taxes associated with their share of partnership income. In most cases, the partnership agreement permits, but does not require, the distribution of enough partnership cash to pay resulting tax liabilities. Potential buyers of partnership interests would likely pay less for a partnership interest if the agreement does not require distributions, since they could not ensure that they would be able to compel distributions in amounts sufficient to pay taxes arising from their ownership of the acquired interest.

#### **VII. Valuation of the Family Limited Partnership.**

Valuation of FLP interests is a vital part of the process in creating an FLP. As noted above, valuation begins with determining the price that a willing buyer would pay to a willing seller for the partnership interest. For estate tax purposes, value is determined at the date of death. For gift tax purposes, value is measured by the value of the property passing from the donor on the date of the gift. Although the Internal Revenue Code has endeavored to provide guidance for determining value, different methods of valuation have developed based on that guidance. Consequently, discrepancies may exist as to the value of an asset depending on who is seeking and who is making the valuation. In addition, several methods may exist for valuing the same property. And the method used may vary, depending on the specific type of property involved.

##### **A. Obtaining Independent Appraisals.**

Due to the complexities involved in valuing FLP interests and applying appropriate discounts, the choice of an appraiser is very important. With top estate and gift tax rates currently at 45%, the stakes can be high. The importance of obtaining a thorough appraisal is illustrated by several court cases involving disputes between taxpayers and the IRS regarding the value to place on partnership interests. The courts often look to the reports of the valuation experts of the parties. They focus in detail upon the qualifications of each expert, including general experience, background, and experience in the particular industry at issue.

In addition, courts frequently note the various factors and approaches used by each expert in reaching an opinion on valuation, including the extent of investigation of the company and comparable companies, assumptions made by the expert, and valuation of the underlying assets.

Because an appraisal is the evidence supporting the valuation and corresponding discounts for the FLP, it is important to consider several factors when hiring an appraiser. These factors include: (1) qualifications of the appraiser, (2) prior experience of the appraiser with similar assets or industries, (3) prior experience with similar appraisals, (4) potential conflicts of interest, (5) the appraiser as a credible witness, (6) successes and failures of the appraiser in prior valuation work, and (7) the general valuation approach of the appraiser. Courts are not bound to choose one expert's valuation. In fact, a court may adopt only part of a valuation as determined by an expert, or a court may find that none of the experts came to the correct conclusion and adopt its own valuation. However, it is apparent from a review of the cases that courts frequently will adopt a valuation made by an appraiser when the appraisal is well researched and supported by relevant facts.

### **B. Valuation Discounts.**

Valuation of FLP interests is really a two-step process. Most appraisers start the FLP valuation by valuing the assets owned by the FLP. Once a value is placed on the assets contributed to an FLP, appraisers may apply various discounts in valuing the partnership interests themselves. Valuation discounts vary depending on factors such as the intent of the partners to continue the business, the type of assets contributed to the partnership, and restrictions placed on the partners under state law (such as lack of management control over the partnership, lack of unlimited access by the partners to the assets of the partnership, and inability of the partners to freely withdraw from the partnership or transfer their partnership interests). Appraisers frequently focus their analysis on two prominent factors in fixing the discounts available for an interest in an FLP—the lack-of-control discount and the lack-of-marketability discount.

*A lack-of-control discount* is based on the concept that the holder of a minority or nonvoting interest lacks control over the management and operations of the entity. The holder of such an interest cannot compel distributions from, or a liquidation of, the entity. In the context of an FLP, a hypothetical buyer of a partnership interest becomes a mere "assignee." Assignees of partnership interests generally have no voting rights whatsoever, unless admitted as substitute partners. Since no buyer can ensure that he or she would be so admitted, a buyer would not be willing to pay an amount equal to the liquidation value of the partnership interest. Instead, the buyer would pay only the value of an assignee's interest, discounted to reflect its lack of control.

*A lack-of-marketability discount* applies when there is no current market for the interest being sold, making it difficult for a hypothetical buyer to convert the purchased interest into cash. In other words, the value of the assets is discounted because it would be difficult to find a hypothetical buyer to purchase the interest in light of the restrictions placed on ownership of the interest. Although there is a market for certain publicly traded limited partnerships, FLP interests are not registered to trade on public securities markets. As a result, they have no ready market. Even if an exception from federal and state securities laws is identified, sales of privately held limited partnership interests are rare. A hypothetical buyer of a limited partnership interest would naturally take this lack of liquidity into account in placing a price on the purchase of an interest in an FLP.

## VIII. Frequently Asked Questions.

- **How does an FLP reduce gift and estate taxes?**

An FLP simply makes assets less attractive to potential third party purchasers. The buyer of a partnership interest (as opposed to a buyer of the partnership's assets) forfeits a substantial degree of control and marketability. Because estate and gift taxes are based on the "fair market value" that a hypothetical third party buyer would be willing to pay for assets, placing them in an FLP decreases the value of the assets for gift and estate tax purposes.

- **Are these valuation discounts "real"?**

Yes. If an FLP works to decrease your net worth for gift and estate tax purposes, it also decreases it for other purposes as well. For example, if you must maintain a certain net worth for commercial borrowing purposes, or for purposes of guaranteeing the debt of your closely held business, you should discuss the impact that valuation discounts may have on your net worth in dealing with your lender and other third parties.

- **What assets can I transfer to an FLP?**

Most people transfer income-producing assets to the FLP. These include real estate, securities, investments, business interests, and the like. Special precautions need to be taken if a closely held corporation is transferred to an FLP. If the corporation has elected to be taxed as an S corporation, transferring it to an FLP will terminate its S corp. status because a partnership is not a permitted S corp. shareholder. In addition, special precautions need to be taken before transferring stock in a corporation in which you and your family own 20% or more of the voting control. The IRS may try to tax the value of contributed stock in your estate unless you part with voting control. The safer course is to recapitalize the company with a nominal amount of voting stock (retained by you), transferring only nonvoting stock to the FLP. Other assets that warrant special scrutiny include annuities and property with debt in excess of the contributor's cost basis.

- **Can the partnership own life insurance?**

An FLP may be used to shift life insurance out of the insured's taxable estate. Unlike corporate-owned life insurance, which is 100% includable in the estate of the insured if he or she owns more than 50% of the stock, partnership-owned life insurance is included only to the extent of the insured's percentage ownership of the partnership. For example, if the insured has given away 95% of the limited partnership interests while retaining control by keeping a 5% general partnership interest, only 5% of the insurance proceeds should be included in the insured's estate. While a life insurance trust can act to remove all insurance from an insured's taxable estate, it has the disadvantage of being irrevocable. Some FLP owners are willing to risk estate tax inclusion of a portion of the life insurance proceeds to maintain the flexibility and control that an FLP offers.

- **Do I really need to get an appraisal?**

If you plan to make gifts of FLP interests, you need an appraisal. Often, depending on the nature of the property contributed, you may need *two* appraisals—one for the value of the contributed property and another for the value of the resulting partnership interests. Investment in a quality

appraisal is money well-spent. Most fights with the IRS regarding FLPs boil down to a question of value. Your appraiser must provide convincing testimony that his or her valuation is well reasoned and supportable.

- **May I use an FLP to protect assets from creditors after creditor problems arise?**

Because Texas courts protect creditors with a concept known as the "fraudulent conveyance" statute, the creation of an FLP will be of little or no use with respect to existing and reasonably anticipated claims against a debtor. If a transfer is found to be "fraudulent," a creditor may persuade a court to undo the transfer to the extent needed to satisfy the claim. Therefore, persons forming an FLP will have to retain sufficient assets outside the FLP to enable them to satisfy any outstanding (and reasonably anticipated future) debts and claims.

- **Will the IRS challenge the FLP?**

As you might guess, the value-depressing features of the FLP have been the cause of considerable frustration to the IRS. They originally tried to argue that family members can be expected to act together, and therefore, the IRS should be entitled to assume away some of the discounts that appraisers apply to FLPs. The courts, however, have been unsympathetic to the IRS on this issue, and it recently abandoned its "family attribution" theory. Having lost that battle, the IRS recently has tried to apply a new argument to FLP valuations, saying that FLP agreements are really only elaborate "buy-sell" agreements among family members. A special statute restricts the use of buy-sell agreements among family members for estate and gift tax valuation purposes. Although their argument seems strained, this effort shows the frustration of the IRS with the success of FLP discounts and indicates their resolve to continue to challenge the technique. More recent cases involving FLPs indicate a new theory of attack by the IRS: namely, that the creator of the FLP retained too much control over or too great an interest in the FLP, so that the full value of the assets is taxed in his or her estate upon death, without a discount. In most of the cases where the IRS has been successful, the creators of the FLPs made many mistakes, such as (i) placing nearly all of their assets in the FLP, so that they had insufficient assets outside the FLP for their maintenance and support; (ii) using the FLP as if it were a personal checking account; (iii) not following any of the rules and procedures in the FLP document; and (iv) paying their personal expenses directly from the FLP.

- **Why doesn't everyone use an FLP to hold assets?**

FLPs are just one tool in the estate planning tool box. Despite claims to the contrary by some FLP proponents, they are not the only solution for every estate planning situation. They are very effective in a variety of contexts, however, and seem to work especially well when: (1) the senior generation has diverse investment assets; (2) the senior generation wants to retain control of gifted assets, or the seniors want control consolidated in one or more of the younger generation family members; (3) the founders have assets that are difficult to divide (such as real estate), or assets difficult to part with in the form of annual gifts; (4) younger generation family members have assets of their own (perhaps acquired by inheritance or earlier gifts from the senior generation) which they want to consolidate; (5) the senior generation has a general concern about potential future creditors who might seek to attach the assets of the founders or the children or other family members of the founders; and (6) the founders have a certain tolerance for the complexity associated with the formation and subsequent management of the FLP.



**IX. Summary.**

The family limited partnership is an increasingly popular estate planning and gifting tool. By contributing assets to a family limited partnership and gifting limited partnership interests instead of the underlying assets, the value of the assets transferred (and related gift tax cost) is reduced. At the same time, the family limited partnership enables senior family members to retain control over the underlying assets through retention of general partnership interests. The family limited partnership also has advantages in minimizing operational costs, simplifying annual gifting, providing investment flexibility, and protecting assets from creditors. Through proper and careful planning, the family limited partnership can be an ideal asset transfer tool.