

# Limited Partnerships for the Family

Your client's attorney has read the latest articles in the estate planning field touting the use of family limited partnerships and has recommended that your client form one for the family business. The client is attracted to this business form because of any number of reasons, including management, gift/estate discounts for the limited partnerships interest, assets protection planning for the contributing partners, income tax shifting to younger (i.e. lower income bracket) family members, diversification, probate avoidance, and business succession planning. As CPA for the client, you are expected to provide advice about the tax aspects and the compliance requirements. This article will review some of the tax aspects unique to family limited partnerships. Topics to be covered include Valuation Discounts, Income Tax Recognition, Substantive Partners, Entity Taxation and Diversification.

## A Prototype Plan

The typical situation may involve a senior family member, your client, who owns a family business and wishes to set up a mechanism for passing ownership to the younger generation. Assume the business, a sole proprietorship, is worth \$3 million, the client is in the 46% estate tax and 45% combined federal and state income tax bracket, and the annual business income is \$300,000. If the client does nothing, the annual federal and state income taxes on the business income are about \$118,800 and \$25,500 respectively, and FICA tax is about \$8,000. Within nine months after the death of the client or the client's surviving spouse, an estate tax of \$1,380,000 is due (or a gift of approximately the same amount if the business is gifted outright). The client is advised to contribute the business to a limited partnership, and takes back all of the partnership interests.

Over time, the client gifts the limited partnership interests to family members and retains a 1% general partnership interest. Under partnership law, the general partner manages the partnership with little or not input from the limited partners. With the exception of payments for services to the client (e.g. management fees), the client is taxed on only 1% (\$3,000) of partnership income each year while the limited partners, who may be in a 10% or lower bracket, are taxed on the other \$297,000. Upon death, only the 1% partnership interest is included in the client's assets for probate and estate tax purposes.

## Valuation Discounts

Historically, an advantage is the discount available when valuing gifts of limited partnership interests. Because the rights of limited partners are minimal and their ability to sell their partnership interest is limited, the value of their limited partnership interest is typically worth much less to a potential buyer than suggested by the pro rata share of partnership assets attributed to the interest. Although the types of discounts to be used when valuing a limited partnership interest vary, the two most common discounts are for lack of marketability and for minority interest.

Although the IRS had previously suggested, in Rev. Rul. 81-253, that discounts were not appropriate if control existed in one family, it switched course in Rev. Rul. 93-12. The 1993

ruling revoked Rev. Rul. 81-253 and stated that minority interest discounts will be recognized without regard to family ownership. Perhaps in reaction to feeling that it had gone too far, the IRS in TAM 9436005 stated in a case involving gifts of 30% to each of three children that the interests should have a premium added for their “swing vote” potential, the theory being that any one of the owners could choose sides with one other 30% owner to gain majority control. Although the strength of the IRS reasoning in the 1994 TAM has been questioned by tax experts, the message is that discounts may be recognized but so will premiums in appropriate cases, which reduce the net amount of the discount.

Studies have shown discounts of as much as 48% to 76% for public trading of limited partnership interests (some of your clients who invested in limited partnerships in the 1980s may have faced this harsh reality when trying to unload their interests after the 1986 Tax Reform Act, which greatly curtailed the tax benefits), while discounts for closed end mutual funds, which more closely resemble a limited partnership invested in liquid securities, range from 4% to 26%. There are court cases supporting valuation discounts ranging from 10% to 50%, but you should retain the services of an experienced appraiser to make the determination through a formal appraisal.

In our example let’s assume that a number of restrictions were imposed on the limited partners’ ability to sell their interests and that they had no management or liquidation rights (these vary depending on the drafting of the partnership agreement). Your client obtained a professional appraisal which found that the value of each partnership interest should be discounted by 45% because the limited partners have no control over the management of the partnership assets and little chance of being able to freely transfer their interests. This means that the value of the limited partnership interests for gift/estate tax purposes would have been discounted to \$1,633,500.

1% General Partnership Interest	<u>\$ 30,000</u>
99% Limited Partnership Interests	\$2,970,000
minus 45% discount	<u>\$1,336,500</u>
Net value for gift tax	\$1,633,500

The gift/estate tax on the limited partnership gifts would be no more than \$751,410 (\$1,633,500 x 46%). The gift/estate tax savings is \$628,590. The gift/estate tax can be further reduced or eliminated by taking advantage of the \$12,000 per person per year gift tax exclusion and gifting the limited partnership interests over time rather than all in one year.

**Other Tax Issues**

As illustrated above, the financial and tax benefits from the family limited partnership can be enormous. In addition, this form can provide management succession and disability planning, creditor protection, and probate avoidance. Besides the special rules governing discounts, however, there are other special tax rules which the practitioner should consider when using a family limited partnership in order to make sure the tax savings are recognized by the IRS.

## **Income Tax Recognition**

If each partner contributes assets or services to the partnership, the partnership interests will generally be recognized. The same rule applies if a limited partnership interest is acquired by gift, and capital (as opposed to personal services) is a material income producing factor of the partnership. In this case, the gifted interests will be allocated a pro rata share of partnership income, but only after deducting a reasonable compensation allowance taxable to the donor/general partner (your client) for services provided to the partnership. If only personal services as opposed to capital are involved in producing partnership income, the partnership may be viewed as a mechanism to assign income of the active partner to the inactive, limited partners.

## **Substantive Partners**

This problem typically arises in families with minor children. The issue is usually whether the senior generation has retained so much control over minor's partnership interest that the minor does not actually have dominion and control over the interest. In addition to complying with partnership formalities, the minor must be the real, not just the formal, owner of the partnership interest. It is recommended that court-appointed guardians, custodians under the Uniform Transfer to Minors Act, or trustees, who are independent and unrelated to your client, be appointed to represent the child if possible.

## **Entity Taxation**

Because the IRS is not bound to follow the form, it is important to make sure the partnership does not resemble a corporation or trust. To avoid corporate taxation, the general partner should own at least 1% of the partnership (to avoid limited liability for all partners), partner consent should be required to continue the partnership upon removal of a general partner (to avoid continuity of life), and interests should not be freely transferable. Although there appear to be no cases reclassifying a partnership to a trust for income tax purposes, there should be "associates" and a "business purpose" to the entity to avoid trust classification. This may be difficult in a situation, for example, where one parent contributes assets and manages the partnership for the benefit of the other partners.

## **Diversification**

In most cases, transfers of property by a partner to a partnership are not a taxable event. If a significant portion of your client's contribution will consist of publicly-traded securities, however, you need to be careful that the contributions are not treated as sales to the partnership rather than non-taxable contributions.

## **Conclusion**

Family limited partnerships can provide a formidable collection of estate and tax planning benefits. As the practitioner with the responsibility for tax compliance, however, you need to be cognizant of the unique tax issues which can arise in the family context. In addition, the partnership papers should be backed up with competent appraisals by appraisers knowledgeable about the tax issues, annual gifts should be documented with reappraisals, and the unique income tax issues should be considered when completing the tax compliance work.