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Alan R. Eber

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A CPA's Guide to Today's Hottest Device in Estate Planning: The Family Limited Partnership



AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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FOREWORD

A popular estate planning tool, the family limited partnership, can protect a client's assets and reduce his or her estate tax burden. It lets clients achieve their estate and asset protection goals without surrendering control of their assets.

This material, written by a noted expert, offers all the how-to's and insights you need. You will learn specific money-saving steps and how an FLP should be integrated into your client's overall plan.

Linda Prentice Cohen

Publisher

Professional Publications & Technology Products

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OVERVIEW

The foundation of every estate plan is a will and living trust, and sometimes an irrevocable life insurance trust. When these techniques have been completed, many planners believe their job is complete. Until the advent of the family limited partnership, there was really little else readily available or practical for the mid-size estate. Asset protection for professional and business clients was thought to be impossible or impractical to accomplish.

FAMILY LIMITED PARTNERSHIP (FLP)

Then came two significant Tax Court decisions in 1985 and 1987.¹ With them came an awareness of the family limited partnership (FLP), a device that can reduce the estate tax burden for our clients by 35% or more and protect their assets from an often aggressive legal system.

Clients do not want their assets subject to estate or gift taxes, yet want to maintain control over their assets and the income stream derived from them. Clients are always looking for methods to protect their assets from creditors, yet they do not want to pay additional franchise tax liability which arises when limited liability entities are used to provide tax and creditor protection. Clients want to achieve the maximum benefits, but they want to keep matters simple. Clients want to do something, but they are reluctant to act. The FLP responds to the inherent conflicts in the estate planning and asset protection process by allowing clients the ability to achieve their estate and asset protection planning goals without giving up total control of their assets.

The FLP can tie together a family's overall estate plan and when integrated with other advanced estate planning techniques (discussed herein) it can actually maximize or leverage the benefits that can be obtained for the family.

TAX PROTECTION

The FLP is an entity formed as a statutory limited partnership usually under the state law in which the partners reside. Management and control are vested in senior family members as general partners and transfers of FLP interests are limited to members of the family. In a typical case, parents transfer assets to their FLP and receive in exchange partnership interests. They then gift or sell limited partnership interests to junior family members. The FLP interest, otherwise, is non-marketable and

¹ *Martha B. Watts Estate*, 51 T.C.M. 60 (1985); *Harrison Estate*, 52, T.C.M. 1306 (1987).

non-transferable. Non-family members cannot buy the interests without the consent of the family partner members. The FLP's assets cannot be taken from the partnership by the claims of a judgment creditor of a partner.

VALUATION

What is something worth if it cannot be sold? This is the key to understanding why non-controlling FLP interests can be substantially discounted for gift and estate tax valuation purposes. Assume I own 50% of my family's \$1 million limited partnership. If it dissolved today, I would receive \$500,000. However, if it will continue for 30 more years before it terminates, what would you pay me for my 50% interest if:

- You cannot sell the interests,
- You cannot replace my spouse as general partner,
- You cannot force the FLP to liquidate in order to get at your 50% of the assets,
- You cannot force my spouse, as general partner, to distribute to you your pro rata share of FLP earnings, and
- You cannot withdraw as a partner and receive your pro rata share of assets?

In decisions by the Tax Court in the mid 1980's, reductions in value of partnership interests ranged from over 35% to almost 90% based on (i) lack of marketability, and (ii) minority interest.²

The President's fiscal 1999 budget request contained proposals which would restrict or eliminate the use of several commonly used estate planning devices. The proposed change in the FLP area would eliminate any valuation discount for assets held through an entity, unless they were active business assets. To the extent that an entity held marketable assets such as cash, cash equivalents, foreign currency, publicly traded securities, real property, annuities, royalty-producing assets, art or collectibles, commodities, and options and swaps, an interest in the entity would be valued for transfer tax purposes as a proportional share of the entity's net asset value. For FLPs with active business interests, valuation discounts would still be available. This proposal would be effective for transfers made after the date of enactment.

² See below.

ASSET PROTECTION

The California Revised Limited Partnership Act [as does the Revised Uniform Limited Partnership Act (RULPA) in most states] contains two critical sections that protect the ownership interests in a limited partnership from the claims of judgment creditors. Sections 15672 and 15673 limit the rights of a judgment creditor of a limited partner to a charging order against the income interest of the charged partner in the partnership. The Hellman case in California expanded this to foreclosing on the interest.³ Either way, a judgment creditor may not “take,” “own,” or “vote” the partnership interest. The charging order is a dangerous remedy for a judgment creditor. If the FLP does not distribute its income, the judgment creditor must nonetheless pay income tax on his share of the partnership’s items of income and gain (“K-O by K-1”).⁴

From the parents’ perspective, asset protection offers several advantages. First, the parents may benefit from protection against their personal creditors. Second, when the parents retain only a limited partnership interest (for example, by using a 100% owned S corporation as the general partner), they are effectively shielded from creditors of the FLP as well. Finally, the FLP may succeed in protecting a spendthrift child’s share of FLP assets from that child’s personal creditors.

And, an FLP can minimize probate costs and disclosure since the only asset moved through probate is the FLP interest. Even though the FLP may own assets outside the state, ancillary probate proceedings may not be necessary.

³ 233 Cal.App.3d 840 (1991).

⁴ A charging order results in taxable income to the judgment creditor — even if income is retained by the partnership (Rev. Rul. 77-137, 1977-1 C.B. 178). Whoever is entitled to the income from a partnership is taxable on his or its share of the income whether or not the income is distributed.

CASE STUDY

Throughout this book we will discuss, expand upon, and embellish this case study:

- John and Mary Doe own a number of apartment buildings and commercial centers.
 - Their properties are valued at \$2,500,000 and generate \$200,000 in yearly income. The Does are considering an all-cash purchase of a \$500,000 home.
- Additionally, the Does have \$1,000,000 in stocks and bonds and \$500,000 in mutual funds which generate an additional \$150,000 of income, as well as \$50,000 in miscellaneous assets and home furnishings.
 - They are both 65 years old, have two children (Cain and Abel) and are in good health.
 - They would like to minimize their estate tax, but like many clients they would like to keep control over their assets and retain the cash flow.
- They do know that with over \$4 million in net worth, should they die tomorrow, over \$1 million of estate tax would be due, and many of their assets would have to be liquidated to raise the cash to pay the tax.
 - In liquidating assets, capital gains tax would be triggered. They realize that life insurance could be purchased to pay the tax, but at their age insurance is expensive and they would only like insurance considered as a last resort.
- How could a family limited partnership (FLP) work in conjunction with other planning tools in their situation?

CHAPTER 1

WHAT IS A FAMILY LIMITED PARTNERSHIP (FLP)?

DESCRIPTION OF AN FLP

An FLP is a partnership, a nontaxable entity created by state law. It is an association of two or more persons who carry on a business and divide its profits.¹ In the case of an FLP, the “two or more persons” are members of the same family.

GENERAL PARTNERSHIP

A general partnership is created under the Uniform Partnership Act (UPA), a uniform law adopted in most states. The partners’ duties and rights are governed by the partnership agreement, and in the absence of an agreement, by the UPA.

Each person admitted into the partnership owes a fiduciary duty to every other admitted partner. Each admitted partner must deal with other admitted partners in utmost good faith regarding the partnership’s affairs.

LIMITED PARTNERSHIP

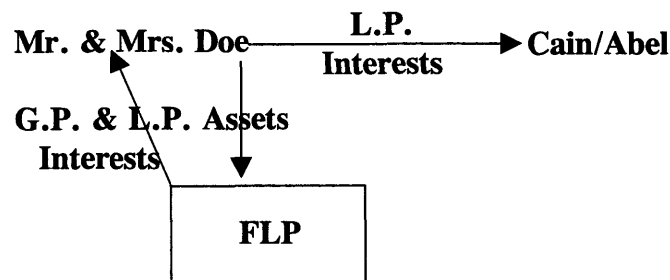
A limited partnership has one or more limited and one or more general partners. The limited partners have no voice in management and no control over the partnership. The admitted limited partners do have the right to inspect partnership records and obtain accounting information regarding its condition.² Most states have adopted the Uniform Limited Partnership Act (initially adopted by the National Conference on Uniform State Laws in 1916) and RULPA.³ To the extent that a situation is not covered by RULPA, the UPA will govern.⁴

¹ UPA §6(l), and Revised Uniform Limited Partnership Act (RULPA) §101(9).

² California Revised Limited Partnership Act (RLPA) §15634.

³ Revised Uniform Limited Partnership Act.

⁴ RULPA §1105 (1985).



Fiduciary Duty

There is a fiduciary duty between the general and admitted limited partners [a non-admitted person is one who has been assigned partnership interest but not substituted in (admitted) to the partnership]. A limited partner relies on the general partner to run the business enterprise for profit. The fiduciary relationship is that of an investor in a security offering – the fiduciary responsibility of the general to the limited partner is very high.

Choice of Law

A partnership may be formed under any state's law. However, the partnership will generally find that a contract or tort action is usually governed by the law of the place where the act took place. Many partnerships set up in Nevada (for example) will still find that if the partners reside in California the business is controlled out of California, and if the tort or contract action arose in California then California law will be applied.

In addition, although an FLP is formed in Nevada, if it is determined that it's "doing business" in California, the FLP must be registered to "do business" in California, and will be subjected to California franchise tax.

Formation

An FLP is formed when the Certificate of Limited Partnership is filed in the Office of the Secretary of State of the appropriate state.

Security

Since a limited partner is not active in the business and must rely on the efforts of others to succeed, a limited partnership interest is a security. The limited partnership interest is usually exempt under federal and state small offering exemptions (private placements), however, appropriate state exemption filings⁵ and Regulation D filings with the Security Exchange Commission should be considered.

A PERFECT WORLD?

The FLP allows senior family members [even if all they own is a one percent (1%) general partner interest] to:

- **Keep control** and management of their assets,
- **Protect** their assets from creditors and lawsuits,
- **Shift income** out of a high tax bracket family member into a lower tax bracket family member,
- **Remove** the assets from their estate for **estate tax** purposes – often at substantially discounted values for tax purposes,
- **Reduce the value** of their assets to creditors, and
- **Transfer** their interests easier than they could transfer undivided interests in the underlying assets.

All of the partners in an FLP share a close, usually blood, relationship (the partners are members of the same family).

NOTE: FLPs have recently come under strong IRS attack. However, if taxpayers avoid deathbed transactions and show a business purpose for FLP formation, FLPs should continue to be viable. [See chapter 6]

⁵ 25102(f) in California.

WHO IS THE GENERAL PARTNER — STEP-UP VS. CONTROL ISSUES

Usually, the senior family members are the general partners and the younger generation, the limited partners. The general partners have control and management of the FLP and are personally liable for FLP obligations.

Should assets in the FLP be considerably appreciated and the death step-up in basis be of overriding concern, this may be reversed. For instance, should the FLP contain a commercial property valued at \$1 million with a \$300,000 adjusted basis, if the senior family members maintain only 1% the property will only receive a 1% step-up in tax basis (less the valuation discount). On the other hand, if the children form the partnership and the parents contribute the appreciated assets in exchange for a 99% limited interest, the assets will receive a 99% step-up in tax basis (less the valuation discount). Before this method is used, the practitioner should discuss the effect this second method may have on the valuation discount with a partnership appraiser. In addition, consideration should be given to President Clinton's fiscal 1999 budget request, in particular his valuation proposals.

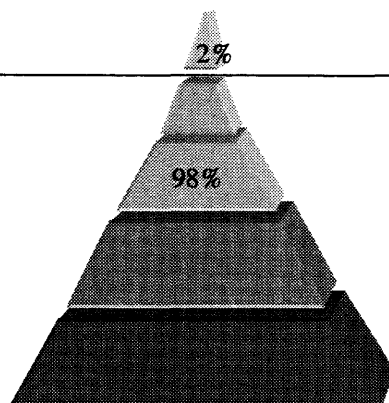
WHY USE AN FLP?

FAMILY LIMITED PARTNERSHIP (FLP)

- The client controls the FLP
- FLP has its own Taxpayer Identification Number
- The creditors cannot get at FLP assets
- K-O by K-1. A creditor who attaches a partnership interest pays tax without receiving income (a reverse tax shelter)

**GENERAL
PARTNER
UNITS**

**LIMITED
PARTNER
UNITS**



CONTROL PARTNERS

- Control Entire Partnership
- Make Investment Decisions
- Determine Cash Distributions
- Compensated for Services

PASSIVE PARTNERS

- Have No Control
- Make No Decisions
- Have No Responsibility
- Have No Liability

FLEXIBILITY

The FLP offers the older clients considerable flexibility in meeting their estate planning objectives. Serving as general partners allows them to determine the **amount and the timing of income distributions**. In addition, they can gift the limited partnership units over time and can downstream 99% of the FLP while still maintaining control.

CONTROL

The general partners serve as managers and fiduciaries of the FLP.

- As managers they earn a guaranteed payment for management services (this is subject to income and FICA/FUTA taxes).
- As a fiduciary they can either:
 - **Distribute** the remaining income to the partners pro rata in accordance with their percentage ownership of FLP interests (or special allocations can be drafted into the FLP), or
 - **Retain** income in the FLP for partnership investment or business purposes, or
 - Decide on a **combination of the above** (salary, partial distribution, partial retention).

CREDITOR PROTECTION

Assets **inside** the FLP are protected from creditors of both the General and the Limited Partners (Sections 15671-15673, Revised Limited Partnership Act). The FLP interests if held as sole and separate property may be protected in divorce proceedings.

The FLP offers protection against a partner's creditors, not against the creditors of the FLP itself. FLP creditors are entitled to all assets held by the FLP. For this reason, care must be taken to avoid placing "safe" assets (stocks, bonds, and cash) into partnerships which contain "dangerous" assets (apartment complexes, and businesses). One should very carefully consider how to fund the FLP.

In many instances, it is advisable to create more than one FLP to avoid the domino effect that a partnership-generated judgment could cause to all the assets held within that one entity.

Case Study Example 1-1: (Based on Case Study on p. 4)

- Mr. Doe is in a financially high-risk profession, Mrs. Doe is a teacher.
 - Mr. Doe has been advised to convert all of their community property into sole and separate property, place all of their business and investment assets into the FLP in exchange for general and limited interests, which are to be held by each of them as sole and separate property, and place much of their limited interests into a spendthrift and discretionary trust for their children.
- Several years after the plan was implemented, Mr. Doe was sued and suffered a \$10 million judgment.
 - As Mr. Doe's only major assets are his general and limited FLP interest, the creditor can obtain only a charging order and hope that Mrs. Doe will make distributions.
 - If Mrs. Doe makes no distributions, the creditor could foreclose on Mr. Doe's interest and, as before, wait for Mrs. Doe to make distributions.
 - At the same time, they will be taxed on their share of FLP income even though it is not distributed to them.

GIFT AND ESTATE TAX BENEFITS

Because FLP interests are easily divided, they are often the subjects of gifts within the annual exclusion (\$10,000 per donee each year indexed for inflation). And with respect to the unified estate and gift tax credit, a taxpayer may transfer tax-free up to \$650,000 in 1999 and \$675,000 in 2000 and 2001. This amount will increase to \$1 million in 2006 and beyond.

Even though the parents serve as the general partners and have control over income allocation and management of the partnership, only the value of partnership interests owned by them is included in their estate for estate tax purposes. Gifts of partnership interests, even to family members, are completed gifts and are not brought back into the parent's estate. However, be careful with gifts of FLP interests when the FLP is funded with closely held stock [TAM 9131006, PLR 9415007, *United States v. Byrum*, 408 US 125 (1972), §2036(b)].

One advantage of transfers of property to an FLP is that the donor, by designating himself as the general partner, may continue to control the property after the transfer. One may question whether retained control over FLP property could result in estate inclusion under either §2036 (right to vote property) or §2038. The IRS has ruled that no estate inclusion of the transferred limited partnership interests will result when the general partner's retained control must be exercised in a fiduciary

capacity [see TAM 9131006 and PLR 9415007]. While general partners owe a fiduciary duty to limited partners, general partners may not owe a fiduciary duty to assignees of limited partnership interests, and §§2036 and 2038 may create problems if children are given assignee interests.

INCOME ALLOCATION

The general partners control FLP income allocation. This allocation includes:

- Fees paid to them as managers of the FLP, and
- Allocation of income for interest on capital provided by all partners.

General partners can also control income by retaining it in the FLP for reinvestment. This power is valuable when creditors make claims against (attach or foreclose on) FLP interests.

INCOME ALLOCATIONS, INSURANCE AND *CRUMMEY* CONCERNS

The income allocation power is also valuable when cash flow for funding life insurance is required and the amount needed either exceeds the *Crummey* amount or the *Crummey* power may have been legislated out of existence.

The President's fiscal 1999 budget request, submitted to Congress on February 2, contains proposals to prohibit use of *Crummey* powers that take advantage of the gift tax annual exclusion for transfers in trust. This change would be effective for transfers made after December 31, 1998. In justifying this proposal, the Treasury Department described *Crummey* powers as a "legal fiction" that "undermines the statutory requirement of a present interest."

Income can be allocated to children as limited partners to pay for life insurance owned by the children. In addition, an irrevocable trust can be a limited partner and receive income allocation from the FLP. There are no gift tax implications for this transfer of income.

QUALIFIED FAMILY OWNED BUSINESS

Beginning in 1998, a portion of the value of a qualified family owned business may be excluded from a decedent's gross estate. New §2033A allows as much as \$1,300,000 of the value of such a business to be excluded from the gross estate, although the exclusion must be reduced by the allowed exemption equivalent of the unified credit. Therefore, the 1998 exclusion would be \$675,000 (\$1,300,000 minus \$625,000) if the decedent's unified credit was intact at his death. By 2006, the exclusion would be limited to \$300,000 (\$1,300,000 minus \$1,000,000).

Section 2033A eases the burden of the estate tax on a family that has participated in a family business for some time before the decedent's death and that intends to continue, through the decedent's heirs, to operate the family business. For this reason, the exclusion applies only to the estate tax. This is so because lifetime transfers would (presumably) be made for reasons other than the need to keep the business in the family. By contrast, a transfer is forced by a decedent-owner's death.

The exclusion suffers from two defects. First, the benefit is reduced by the exemption equivalent of the unified credit, so that it ranges from \$675,000 (1998) to \$300,000 (2006). Second, the provisions are quite complicated and bind the family to post-death participation with the potential for a recapture of the benefit.

To qualify for the exclusion, the value of the family business must exceed 50% of the decedent's adjusted gross estate. For this purpose, §2033A(b)(1)(C) includes certain lifetime gifts to family members in the value of the business interest held by the decedent at death (generally, if the donee family member still owns the stock at the decedent's death, the value of the transferred stock is included). Further, the family must meet one of three ownership tests:

1. The family must own at least 50% of the business, or
2. The family must own at least 30% of the business, and members of two families must own at least 70% of the business, or
3. The family must own at least 30% of the business, and members of three families must own at least 90% of the business.

The business need not be held in an entity, and an interest in a proprietorship will meet the ownership test. Also, the decedent's executor must elect the benefits of the exclusion and must file a consent to an addition to the estate tax if certain post-death requirements are not satisfied.

The family must have materially participated in the business for five of the eight years preceding the decedent's death, and must materially participate for five of eight years in the ten years following the decedent's death. Failure to continue to meet the material participation test after the decedent's death, or if the heir dispose of any portion of the business during those ten years, may cause tax savings attributable to the exclusion to be lost in whole or in part.

FORMING THE FLP

WHO CAN BE A PARTNER?⁶

Family Members

Two or more members of the same family can be partners in FLPs. For example, using the case study circumstances, Mr. and Mrs. Doe will usually want to serve as general partners, allowing them to manage the FLP's assets, collect management fees and allocate partnership income. They will have unlimited liability for FLP debts. Their sons, Cain and Abel will typically be given limited partnership interests.

Corporation or LLC

Because general partners have unlimited liability for FLP debts, many times a corporation or LLC will serve as the general partner of the FLP. The goal is to limit liability of the individual partners by making them limited partners, shareholders of a corporate general partner, or members of an LLC. If the corporate general partner is not well-capitalized, there is a possibility that no owner will have any real liability if the partnership fails. In effect, the FLP will have limited liability for its owners like a corporation, but with partnership income taxation. To combat this type of structure, the IRS had established various tests to determine whether an entity should be taxed as a partnership.

A corporate or LLC general partner has certain disadvantages:

- In most states there is a per year minimum annual franchise tax payment for either,
- In the case of a corporation, how do you protect the corporate shares from creditors? A creditor who attaches the shares controls the FLP. The corporation is an admitted partner.

Protect Stock of Corporate General Partner

Creditors of shareholders may be able to attach their stock, even though they cannot attach the assets of the corporation, **unless** they obtain enough stock to vote for liquidation of the corporation.

It is best to have the client own a minority interest in the corporation. The client's creditors will attach his or her stock, but that will not control enough stock to liquidate the corporation.

⁶ See the section on "Partnership Documents" in Chapter 3.

A client could give stock to a spouse, parents, or children. By doing so, ownership will be so diluted that no one person owns enough stock to cause liquidation.

Using Trusts

If the client is reluctant to part with control, stock that would have been given outright to a spouse, parents or children could be given to irrevocable protective trusts set up for family members. Indirect control of the stock is possible via a "close" trustee. For example, the client could keep 25% of the stock and give the rest to children in a series of protective trusts. Assuming the trustee of the trusts is friendly, the client will be able to indirectly control the corporation.

Using Family Limited Partnerships

A client keeps 25% of the stock and gives 75% to an FLP of which he owns a 2% interest and his spouse owns a 2% general partnership interest (both as sole and separate property). The rest is owned by his children's trust.

Revocable Trust

Mr. and Mrs. Doe may have their grantor revocable living trust serve as general partner. The trust allows for easy continuation of management should mom, dad or both become unable to manage partnership affairs due to death or mental/physical incapacitation. The living trust's contingent trustee, usually an adult child, could then assume the Doe's general partner responsibilities.⁷

"A person ceases to be a general partner of a limited partnership upon the happening of any of the following events...

(f) Unless otherwise provided in the partnership agreement, in the case of a general partner who is acting as a general partner by virtue of being a trustee of a trust, the termination of the trust (but not merely the substitution of a new trustee, in which case the net trustee automatically becomes the new general partner)."

What is in a living trust does not go into probate. Therefore, a living trust is an excellent partner. The prudent advisor may wish to have all but 2% of the limited partnership interests and all of the general partner interests held by a living trust. The remaining 2% will be held 1% by husband and 1% by wife outright. The reason that all of the interests are not held by the living trust is that a partnership requires two or more people/entities. The living trust may be counted as one only.

⁷ See §15642 and §15642(f) of the California Revised Limited Partnership Act.

Irrevocable Children's Trust

Mr. and Mrs. Doe can gift FLP interests to an irrevocable children's trust. The trustee should not be either Mr. or Mrs. Doe, a close relative, or anyone under the Doe's control.⁸ Valuation discounts will apply to the gift to the trust.

Foreign Trust

See discussion in Chapter 5.

Do Not Gift General Partner Interests

Be careful when gifting general partnership interests to your children. You may be creating a liability for the child. General partner interests have unlimited liabilities for the partnership problems. These liabilities are sometimes not easily identified. They could be financially devastating to the child. In addition, a transfer of general partner interests might invoke Chapter 14 anti-freeze rules.⁹ It is for this reason we suggested above in our discussion of stepping up basis, that the children initially be the general partner and the parents the limited. We do not want the parents to be both the general and limited and then "transfer" the general interests to the children.

Reasonable Fees

Parents may also enhance their personal cash flow by charging reasonable fees (§707 guaranteed payments) for fulfilling their general partnership duties.

TRUSTS AS PARTNERS

Liability of Trustee

Trustees hold property for the benefit of beneficiaries and not for their own benefit. They cannot use the trust corpus for their own benefit, and hence their creditors also cannot reach the trust corpus.¹⁰

⁸ Treas. Reg. §1.704-1(e)(2)(VII)(1988).

⁹ IRC §§2701-2704 and Treas. Reg. §25.2701-3(a)(2).

¹⁰ See "Creditors' Rights Against Trust Assets", 22 Real Prob. & Tr. J. 735 (1987).

As long as the trust is administered with due care and diligence, trustees are not liable for losses the trust may incur.

Liability of Settlor

The settlor has no liability unless he or she makes a fraudulent transfer. Take measures to avoid even the appearance of fraud.¹¹

Liability of Beneficiary

Without a protective provision, creditors of a beneficiary can reach the beneficiary's assets held in trust. All restrictions in a trust which are enforceable under applicable nonbankruptcy law are enforceable in bankruptcy. Therefore, protective clauses, such as spendthrift clauses, will be effective to protect non-self-settled trust beneficiaries. Neither the bankruptcy court nor creditors can attach any power of the beneficiary (such as a limited power of appointment) which is only exercisable on behalf of another person and not on behalf of the beneficiary.¹²

Grantor Trusts and Creditors

A settlor (or self-settled) trust is generally a trust created by the settlor for the benefit of the settlor. Most courts support the proposition that a trust established for the benefit of the settlor, by the settlor, can be reached by creditors, notwithstanding the fact that the trust is irrevocable, and irrespective of the fact that the trustee can decide in the trustee's sole discretion whether or not to invade the income or principal of the trust.¹³ Public policy will not permit a settlor to establish a spendthrift trust for himself or herself. However, in 1997 several states (most prominently Alaska and Delaware) amended their laws to specifically provide asset protection to self-settled trusts. Settlers of Alaskan irrevocable trusts are afforded greater creditor protection under the Alaska Trust Act (Chapter No. 6, SLA 1997, to be codified at AS Section 34.40.110), effective for trusts created after April 2, 1997, than settlors of trusts cited in other domestic jurisdictions.

¹¹ (i) Make sure the settlor is solvent when the transfer is made, (ii) consider and avoid as many Badges of Fraud as possible, (iii) make sure the settlor is not planning to start a new business venture. If he or she is, make sure he or she retains funds sufficient to adequately capitalize it, and (iv) if the settlor is planning to incur debts, make sure he or she can service the debt or retains capital sufficient to service the debt. See Chapter 4.

¹² 11 USC §541(b)(1).

¹³ See Cal. Prob. Code §15304(a) (West 1991).

Non-Grantor Trusts

Non-settlor trusts are trusts established for the debtor by a third party. The significance of planning for the transmission of assets to or for the benefit of the professional or business owner by others cannot be overemphasized. The protection which can be afforded to gifts or inheritances from any donor by recommending that the transfer be made in the form of a spendthrift or other protective trust is unparalleled by any action the donee can take once the transfer is made outright to him or her.

Case Study Example 1-2:

- Initially, Mr. and Mrs. Doe will serve as both general and limited partners and own all of the FLP interests. This is often a conservative “opening move.”

PARTNERSHIP CONTRIBUTIONS

Planning with an FLP is asset-specific. Not all assets are suitable for transfer to the limited partnership. For example:

- Your home generally should not be transferred to the FLP. If it is, it may be considered as held by the FLP as an investment asset, and as such if you continue to live in the home you should pay rent to the FLP. The rent would not be a tax deduction to you, however, it does create income to the FLP. This income will then be K-1'd to you causing tax to be due. In addition, you will lose the \$125,000 one-time capital gains forgiveness and your §1034 exchange will become a more complex §1031 exchange. However, some advisers take the position in the case of the home that the FLP is simply a nominee for title holding purposes and therefore the home may be held by the FLP without a need to consider it an investment.
- A qualified plan cannot be transferred into an FLP.
- An FLP cannot hold your professional practice, though it can hold certain assets of your professional practice.
- S corporation stock cannot be held by an FLP.

Real estate, cash, stocks, bonds, and equipment are all ideal investments for a limited partnership. Transfers of encumbered real estate **may require lender approval** if the real estate mortgage has a due-on-sale clause.

TWO WAYS TO FUND AN FLP WITH REAL ESTATE

Separate FLPs may be used to isolate the potential liability of high-risk real estate property from other assets. On the other hand, the creative use of trust deeds held by the FLP as security for notes which formed a partner's capital contribution to the FLP can eliminate the liability potential and the banker approval issue.¹⁴

Case Study Example 1-3:

- The Does will contribute their investment properties to the family partnership.
- The Does will additionally transfer their stocks and bonds to the FLP. The FLP will liquidate \$450,000 of the bonds.
 - The Does will purchase their home for \$50,000 cash down and a \$450,000 loan from the FLP secured by a first trust deed on their new home.

BASIS ADJUSTMENTS

The FLP's formation is not a taxable event to the partners. Partners generally do not recognize gain or loss when they contribute property to the FLP in return for their FLP interests. Similarly, the partners generally recognize no gain or loss on additional capital contributions to the FLP.

A partner acquires a basis by making an initial contribution of capital to the FLP in exchange for FLP interests. Further capital contributions by a partner result in an increase in the partner's basis in the already existing FLP interest. Typically, the adjusted basis of FLP property in the hands of the partner is the original cost to the partner less any depreciation deductions and other adjustments taken by the partner.

Case Study Example 1-4:

- Mr. and Mrs. Doe will have the same cost basis in the FLP they had in their real estate and stocks and bonds before the FLP's formation.

¹⁴ See "Structuring and Funding the FLP" in Chapter 2.

GENERAL PARTNERS — CONTROL

In the absence of specific partnership provisions related to the “managing general partner” or the requirement for majority vote of the general partners, general partners typically share equally in the management of the FLP. Each partner is a principal with full authority to act on behalf of the partnership and other partners. Each general partner is a fiduciary of the FLP and other partners. General partners have the duty of loyalty and must exercise good-faith judgment when representing the FLP in the scope of FLP activities. Each general partner is entitled to a share of partnership profits and remains ultimately liable for debts and obligations of the partnership.

- TAM 9131006 (4/30/92) confirmed that parent’s retention of the GP interest does *not* cause inclusion of the transferred LP units in the parent’s estate under §2036 or §2038.

The IRS cited the Washington Supreme Court as having held:

“GPs have a fiduciary duty to LPs and...LPs should be able to expect the highest standard of conduct from GPs...the duty of loyalty...is such that the severity of a partner’s breach will not be questioned. The only question is whether there has been any breach at all.

- The IRS said that the parent, as GP, “retained no power to alter the beneficial interests of the other partners” because the GP “occupied a fiduciary position with respect to the other partners and could not distribute or withhold distributions, or otherwise manage the partnership for purposes unrelated to the conduct of the partnership business.”

Two provisions that are being included in FLP agreements could result in a tax disaster and should not be used. The provisions are:

1. That partners cannot transfer their interests under any circumstances, and
2. The general partner has discretion to retain funds within the partnership for any reason.

If these provisions are included, the IRS may deny the annual \$10,000 gift tax exclusion for the gifts of partnership interests because that exclusion applies only to a gift of a “present interest.” IRC §2503. Under the regulations, the test is whether the gift was of “an unrestricted right to the immediate use, possession, or enjoyment of property or the income from property” [Reg. 25.2503(b) TAM 9751003]. In addition, the provisions may cause the entire value of the property in the partnership to be included in the client’s estate. It would be advisable to limit the general partner’s power to retain or distribute cash to a decision made in light of the provisions contained in Reg. Section 1.704-1(e)(2)(ii).

These provisions have been used because: (i) clients want the estate tax benefits but also want to keep as much control as possible, and (ii) the provisions increase the “discount” in the value of the gifts for tax purposes.

CHAPTER 2

STRUCTURING AND FUNDING THE FLP

INTRODUCTION

In structuring the FLP, the provisions of the state uniform partnership acts — RLPA, LPA and UPA — must be considered, and the practitioner should —

- Know the general partners' exposure for partnership liability.
- Analyze the effect of judgments against the limited and general partners on the partnership.
- Analyze the effect of a limited or general partners' bankruptcy or death on the partnership.

GENERAL STRUCTURE

Successor General Partner

The FLP should provide a successor general partner in case the general partner dies, becomes bankrupt or has his or her partnership interest charged or foreclosed upon by creditors. Another potential method to avoid this issue is to have a 1% or more general partner interest held by your living trust.

Lapsing Provisions

In consideration of Chapter 14 (§§2701-2704), note that if the FLP is more restrictive than state law, to the extent it is more restrictive, it will be ignored for valuation discount purposes.¹

Dissolution or Liquidation Provision/Withdrawal of Capital

To the strictest degree permitted by state law (without causing a “lapse” under Chapter 14), the partnership agreement should not permit a partner to dissolve or liquidate the FLP. The FLP agreement should specify the time when partnership capital may be withdrawn. Unless so specified,

¹ See “Valuation and Discounts” in Chapter 6.

under ULPA §16(2) (but see §15663 of the California RLPA), partners may withdraw their capital upon six months' notice to the other partners and dissolve the FLP. If partners can dissolve the partnership, it is possible that their creditors may be able to dissolve the partnership, or that the trustee in bankruptcy will be able to dissolve the partnership.² If a partner may receive the return of his assets within six months, a going-concern discount is severely limited.

Caveat: Liquidation restrictions which are more restrictive than state law are being ignored for valuation purposes under §2704. Many states provide that a limited partner may withdraw either under the terms of the FLP agreement or upon six months notice. The IRS has stated that any restrictions greater than six months were more restrictive than state law and will be disregarded. Note that California (Corporations Code 15663) and several other states provide that a limited partner may withdraw only as provided in the terms of the agreement. There are no provisions for a six month withdrawal. Accordingly, the IRS's analysis under §2704 should not apply to a limited partnership formed in California and other states with similar law.

Be warned that for tax purposes the FLP will be terminated if no part of any business, financial operation, or venture of the FLP continues to be carried on by any of its partners.³

No Substituted Partners

The FLP should be drafted so that an assignee cannot become a substituted partner without the unanimous consent of all of the partners (this prevents a creditor from becoming anything more than an assignee).⁴

Number of Partners

Several "innocent" partners (aside from the initial husband and wife) should be made limited partners of the FLP.⁵ This is a strategy to avoid what could be the next (post-Hellman) decision eroding the FLP. These "innocent" partners could be children or grandchildren.

² See Beverly-Killea Limited Liability Company Act (LLC Act) §17252(a)(1).

³ IRC §708(b)(1)(A).

⁴ RLPA §15674(a).

⁵ See Chapter 3, "How the FLP Protects Your Assets — Legal Effect of the Charging Order".

Maintain as a Separate Entity

As with a corporation which must be operated as an entity separate and apart from its owners to prevent a creditor from “piercing the corporate veil,” the FLP must be operated separate and apart from its partners to prevent a court or the IRS from ignoring it for creditor protection or estate tax savings purposes. A partner should use FLP assets only under a rental or lease arrangement. All filings and registrations should be undertaken, a written partnership agreement should be entered into, tax returns filed, and the assets of the FLP must not be commingled and treated as if they were assets of the general partner.

General Partner Liability

To prevent the court from holding general partners liable to limited partners for a financial return on their investment, the FLP agreement should clearly state that partners will only look to FLP assets for distributions of cash and repayment of contributions and loans, and no partner shall have the right to hold general partners liable upon dissolution of the FLP for these items.

Corporate General Partner

Corporate general partners will insulate individuals from liability provided the corporation is appropriately capitalized to avoid its veil from being pierced and to prevent the IRS from classifying the FLP as a corporation for tax purposes.⁶

Transferability

Limited partners may freely assign their interests.⁷ However, it should be stated that without unanimous consent of all other partners, the assignee is merely an assignee and not a substitute limited partner (RUPA §15674).⁸

⁶ Treas. Reg. §301.7701-2(d)(2)(1992).

⁷ RUPA §702 (1976), 6 ULA 388 (Supp. 1992).

⁸ RUPA §704 (1976), 6 ULA 392 (Supp. 1992).

STRUCTURING POINTS TO CONSIDER

- ***FLPs are business entities.*** They should be funded with business and investment, but not personal assets.
- ***Great caution must be exercised when using corporate general partners.*** As the corporation is an admitted partner, a creditor of a shareholder who possesses 33-1/3% or 51% of the corporate stock could, if he gained control of the stock, dissolve or control (respectively) the corporation, and through the corporation would control the FLP.
- ***Children's trusts should rarely be used as the general partner.***
 - The trust, and not mom and dad, would be entitled to a general partner fee,
 - The trust, and not mom and dad, could borrow from the FLP, and
 - The trustee would owe a fiduciary duty to the children, and not to mom and dad.
- ***At-risk general partner could receive an employment agreement to manage the FLP's assets.*** Therefore, even if she was removed as a general partner, she would maintain an income stream.
- ***Be careful when one of the spouse/general partners is high-risk.*** Make sure that their partnership interests are held as **sole and separate property** and not community property. If one must suffer bankruptcy, you do not want the other dragged in. You do not want to lose both general partners. Do not give the bankruptcy trustee the chance to try to force the dissolution of the FLP. See 11 USC §541(a)(1)(1988); UPA §§31(1), 31(2), 31(5), 38, 6 ULA 376, 456-457 (1914); RULPA §§402(4), 402(5), 602, 604, 801, 808 (1985) 6 ULA 359-360, 381-383, 395, 399 (1992); *In re Sunset Developers*, 69 BR 710 (Bankr. D. Idaho 1987).

BUSINESS FORM CLASSIFICATION

"CHECK-THE-BOX" REGULATIONS

Under the "check-the-box" rules, taxpayers may elect to treat domestic unincorporated and foreign business entities either as partnerships or as associations taxed as corporations. These taxpayer friendly regulations replaced a formal two-step approach in classifying business entities. The second step of the old rules, a four-factor analysis to determine whether a business most resembles a partnership or a corporation was abandoned. In its place, Reg. §301.7701-2(a) states that an entity that is not a trust is a "business entity" and is deemed either a partnership or an association taxed as a

corporation. A single-member entity is treated as a corporation or is disregarded, in which case the business is taxed as a sole proprietorship, branch, or division of the owner.

An entity that is not a *per se* corporation, as described in Reg. §301.7701-3(a), is an eligible entity that, at the taxpayer's election, may be taxed as a partnership or a corporation. Unless the taxpayer specifically elects corporate status, the entity will be classified as a partnership. Once an election is affirmatively made, rather than by default, the taxpayer cannot change its classification for 60 months. [Reg. §301.7701-3(2)].

MAKING THE ELECTION

The election on the form of business entity must be filed with the taxpayer's IRS service center on a Form 8832 (Entity Classification Election). Reg. §302-7701-3(c). Apart from the entity's name, address, and taxpayer ID number, the election must include the election chosen, whether the election is a change in classification for the entity, and whether the entity is domestic or foreign.

A copy of the election must be included with the entity's federal income tax return for the tax year of the election. If no return is due, the election must be filed with the return of a current owner.

FUNDING

FLPs can be funded in the following ways.

Gift FLP Interests. The senior generation makes gifts of FLP interests to the younger generation.

Gift Assets. The senior generation gifts assets directly to the younger generation, and then the younger generation contributes the assets for FLP interests. The problem with this approach is that unless undivided interests in property are transferred under conditions that would permit substantial valuation discounts, the valuation discounts created by transferring FLP interests will be lost.

Real Estate. Real property is usually transferred to an FLP by a general warranty deed (use of a quitclaim may make it more difficult for the FLP to transfer the property).

Personal Property. Tangible personal property should be documented by a bill of sale and the FLP should pay for insurance on these items.

In most cases, contributions to FLPs will be tax-free transactions under §721. But don't forget to consider the so-called *disguised sale rules* in Regs. §§1.707-3, -4, -5, -8, and -9. Under these rules, certain contribution transactions are turned into deemed taxable sales. However, the disguised sale rules are a problem only when a contribution of property is followed by an FLP distribution (other

than from cash flow) to the contributing partner (the parent) or when certain property burdened by debt is contributed.

BUSINESS INVESTMENT PURPOSE

Since the purpose of an FLP is business or investment, only business use or investment property ought to be placed into the FLP. If the contributor continues to use said property, she should lease or rent that property from the FLP at fair market rates.

Investment Company

Contribution of appreciated property to a partnership does not trigger recognition of capital gain unless the partnership is an "investment company." A partnership is an "investment company" if it directly or indirectly results in the diversification of the transferor's interest and the transferee is a corporation, more than 80% of the fair market value of whose assets, exclusive of cash and non-convertible debt is held for investment and is composed of publicly-traded securities.

Liabilities in Excess of Basis

If liabilities assumed by the partnership upon transfer exceed the basis of the property transferred, gain may be triggered.⁹

TWO METHODS OF FUNDING

Example: Commercial building FMV = \$800,000, 1st trust deed (TD) = \$200,000.

1. Deed

You could place the deed into the FLP. Before doing so you may want to make sure that: it does not trigger an acceleration on the 1st TD, and the FLP is the holder of the insurance on the property.

2. Trust Deed

A second method would be to place a 2nd TD on the property in exchange for FLP interests.

⁹ IRC §752(b).

For instance: Instead of contributing real estate with \$800,000 of equity to the FLP in exchange for your FLP interests, you could contribute an \$800,000 promissory note secured by a 2nd TD on the property.

RESIDENTIAL PROPERTY AND THE FLP

Like a corporation, a partnership is a separate and distinct entity from an individual. Dealings with the partnership must be arm's-length or the partnership may be viewed as a sham and pierced by the creditor. Once a client places her residence into the FLP, the FLP owns it and holds it as investment property. If the client or anyone else wishes to live in it, it should be pursuant to a fair market lease.

Aside from the adverse consequences of making nondeductible lease payments to an FLP, and the FLP's having to treat depreciation of the asset, and deductions for interest and taxes subject to the passive loss rule, the more advantageous §1034 exchange becomes a §1031 exchange, and you lose the universal exemption and the ability to homestead the property. Perhaps a 2nd TD on the home would be appropriate.

Nevertheless, many practitioners have taken the position that the FLP can act as a nominee for the purpose of holding title. To the extent that a home exceeds in value, the amount of interest deductions you are entitled to (\$1,000,000 plus \$100,000 fix-up) via the use of a trust deed and note, what are your alternatives to protect this asset? If the answer is there are no others, you really have little to lose by allowing the FLP to own the asset.

UNFUNDING

A general partner can recover assets from the FLP by:

- Pro rata distributions of FLP interests in cash or in kind,
- Taking a general partner fee, or
- Taking a loan from the FLP.

GIFTING LIMITED PARTNERSHIP INTERESTS — VALUATION DISCOUNTS

VALUATION DISCOUNTS

The value of a gift made to a donee is the fair market value of the gift on the date the gift is made, not what the fair market value may be someday. It is commonly accepted among appraisers, estate

planners and the IRS (Rev. Rul. 93-12) that a minority interest in a limited partnership with restricted ownership rights for the limited partner qualifies for a discount from the fair market value of the underlying assets.

To be eligible for the full discount, the limited partner's interest should be:

- A minority interest;
- Not freely transferable; and
- Have limited marketability (lack of control and marketability).

In addition, restrictions under §§2701-2704 need to be reviewed. For instance, if a limited partner under state law has the right to withdraw from a partnership upon six-months' notice,¹⁰ but the partnership agreement locks partners in for thirty years, §§2701-2704 state that for valuation purposes the partnership restrictions are not to be considered and the interests are to be valued based on the six-month withdrawal period. The appraisal results could be the difference between a valuation based on a going-concern value (30% plus discount) and a valuation of the value of the underlying assets less a six-month future interest discount. (See also Chapter 6, "Valuation and Discounts.")

GIFTS OF FLP INTERESTS AND THE ANNUAL EXCLUSION

Is the gift of FLP interests a completed and present interest gift eligible for the \$10,000 per donee annual gift tax exclusion? Yes, §2036(b) only brings back gifts into the donor's taxable estate of corporate stock in a controlled corporation in which the donor retained the right to vote the stock. There is no corresponding Code section for partnership interests. The Byrum voting trust case *U.S. v. Byrum*, 408 US 125 (1972), is still good law for gifts of partnership interests in family limited partnerships (see also PLR 9332006 & PLR 9415007).

¹⁰ Contrast RLPAs §15681 for FLPs and LLC Act §17252(a)(1).

GIFTS OF FLP INTERESTS WHEN FLP HOLDS STOCK OF CONTROLLED CORPORATION [§2036(B)]

Case Study Example 2-1:

- Because of §2036(b), if Mr. and Mrs. Doe owned a corporation, placed the stock to that corporation into their FLP and gifted 99% of the limited partnership interests to Cain and Abel for estate tax purposes, since Cain and Abel cannot vote 99% of the stock, all of the stock will be valued in the Doe estate for estate tax purposes.

Discussion:

- To avoid this adverse result, the FLP must be amended to permit Cain and Abel to vote the controlled stock.
 - If properly drafted, this limited power should not cause adverse consequences to the FLP.
 - On the other hand, if neither Mr. nor Mrs. Doe can vote the stock, the §2036(b) issue will not arise.

GIFTS OF FLP INTERESTS AND THE UNIFIED CREDIT

Mr. and Mrs. Doe may wish to structure transfers of FLP interests to qualify for the unified credit exemption. These transfers do not need to qualify as present interest gifts even though estate exclusion at death is usually desired. Again, we rely on the Byrum case that even if the donor continues to serve as a general partner of the partnership and acts in a fiduciary capacity for all partners, gifted FLP interests will not be included in the deceased donor/general partner's estate.

In both cases, not only have Mr. and Mrs. Doe transferred the underlying value of a portion of the FLP at discounted gift tax values, they have also removed future appreciation of the gifted interests from their taxable estate.

Doe Family Example

| Initial Capital Structure of the Doe FLP | | |
|--|-----------------|---------------------|
| Partner | Interest | Capital |
| General Partner (Doe Family Revocable Trust) | 1.00% | \$ 40,000 |
| Mr. Doe (limited partner) (Doe Family Revocable Trust) | 49.50 | 1,980,000 |
| Mrs. Doe (limited partner) (Doe Family Revocable Trust) | <u>49.50</u> | <u>1,980,000</u> |
| Totals | 100% | \$ 4,000,000 |

Each parent gives \$600,000 worth of limited partnership interests to children.

| Capitalization of the Family Partnership After Parents Make Gifts to Children Valuation Without Rev. Rul. 93-12* (*See Valuation Discounts, above) | | |
|---|-----------------|---------------------|
| Partner | Interest | Capital |
| General Partner | 1.00% | \$ 40,000 |
| Mr. Doe (limited partner) | 34.50 | 1,380,000 |
| Mrs. Doe (limited partner) | 34.50 | 1,380,000 |
| Cain | 15.00 | 600,000 |
| <u>Abel</u> | <u>15.00</u> | <u>600,000</u> |
| Totals | 100% | \$ 4,000,000 |

**Capitalization of the Family Partnership
After Parents Make Gifts to Children
Valuation With Rev. Rul. 93-12
Using 35% Discount**

| Partner | Interest | Capital Account | Fair Market Value |
|-----------------|--------------|--------------------|----------------------|
| General Partner | 1.00% | \$ 40,000 | \$ 26,000 |
| Mr. Doe (L/P) | 24.50 | 980,000 | 637,000 |
| Mrs. Doe (L/P) | 24.50 | 980,000 | 637,000 |
| Cain | 25.00 | 1,000,000 | 650,000 |
| <u>Abel</u> | <u>25.00</u> | <u>1,000,000</u> | <u>650,000</u> |
| Totals | 100% | \$4,000,000 | \$2,600,000 |

Comments

- The 35% discount reflects discounts for minority interest, restrictions on transferability and marketability.
- Appraisal of real estate required.
- Children are minority owners of the FLP even though together they have a 50% interest.
- Mr. and Mrs. Doe, through their revocable trust, are managing general partners and have control.
- Children cannot transfer FLP interests without the permission of the general partners.
- Interests of children can be held by irrevocable trusts set up by the parents.

The IRS has taken the strong position that gifts of limited partnerships may not be gifts at all. In TAM 9751003, the IRS ruled that a gift was of a future interest, rather than a present interest, and, therefore, did not qualify for the Sec. 2503(b) \$10,000 annual exclusion.

OPERATING THE FLP

ROLE OF THE GENERAL PARTNER

In their capacity as general partners, Mr. and Mrs. Doe may receive a salary from the FLP for their management functions. In addition, they can determine whether the FLP will retain or distribute income to its partners or make a loan to a partner within the bounds of Reg. §1.704-1(e)(2)(ii). This means the parents can still get money out of the partnership to support their financial or retirement needs.

PARTNERSHIP INCOME

An FLP determines (but the partners pay) taxable income. Taxable income for the FLP is computed in basically the same manner as it is for individuals. However, deductions are not allowed for personal exemptions, foreign taxes, net operating loss carrybacks and carryovers, charitable contributions, itemized deductions, capital loss carryovers, or depletions.

ALLOCATION OF INCOME

The FLP does not pay income taxes. The partners are responsible for paying income taxes on FLP income.

Note: Tax liability accrues to the partners even if income is not actually distributed to them.

Generally, the FLP agreement controls the allocation of taxable income, loss, deductions or credits. When a partner is a member of the FLP for only a portion of the tax year, he or she is allocated only the portion of such items attributable to his or her tenure.

Case Study Example 2-2: Doe FLP Income Allocation

- The Doe FLP grossed \$350,000, of that, \$100,000 was paid to the general partner for property management compensation leaving \$250,000 for partner allocation.

**Cash Flow From
Annual Partnership Income**

| Partner | Gross Income Interest | Net Allocation |
|-----------------|--------------------------|-------------------|
| General Partner | 1.00% | \$ 2,500 |
| Mr. Doe (L/P) | 24.50 | 61,250 |
| Mrs. Doe (L/P) | 24.50 | 61,250 |
| Cain | 25.00 | 62,500 |
| <u>Abel</u> | <u>25.00</u> | <u>62,500</u> |
| Totals | 100% | \$250,000 |

Case Study Example 2-3:

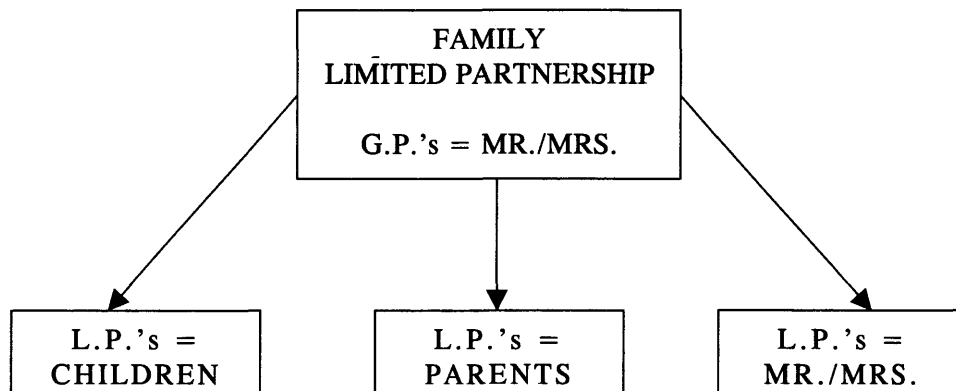
- Mr. and Mrs. Doe retained 64.3% of the property's income (\$225,000) through management compensation and partnership allocations.
- In future years, the general partners might receive higher or lower management compensation and might retain partnership income inside the partnership for reinvestment.

TAXATION OF INCOME

For income tax purposes, all items passed from the FLP to its partners retain the same character they had for the FLP. As an example, if the FLP receives tax-exempt income, the partner's share of that income is also tax-exempt.

The partner's distributive shares of such items as income, credits, deductions and nondeductible FLP expenses are identified on Schedule K-1 of Form 1065. The partners receive individual copies of Schedule K-1 to allow them to prepare their individual Form 1040 forms.

ROLE OF THE FLP AS AN INCOME-SHIFTING VEHICLE



Using a Family Limited Partnership has several advantages over using a trust, especially where income is to be shifted from a high-income wage earner to children, grandchildren, or other family members in a lower tax bracket.¹¹ Three reasons favor the FLP:

1. *FLPs Do Not Have to Pay Taxes*

FLPs are merely tax-reporting entities. They file Form 1065 which allocates profits and losses for the year to the partners in proportion to their respective partnership interests.

2. *Control Goes to the General Partner*

Unlike an irrevocable trust, the wage earner in the FLP is entitled to remain involved and be an active partner. The document which creates the partnership allocates the control, operation and management of partnership activities to the general partner.

3. *Income Can Go to the Partners Via Income-Shifting*

There is more flexibility and discretion in handling, terminating and distributing limited partnership income and assets than in the trust situation. As a result, the FLP is a more advantageous legal vehicle in most circumstances for handling family investments and providing income and estate tax planning.

In the event the limited partner children have not reached the age of legal majority, a custodian or guardian must be designated to sign FLP documents on their behalf and to represent their legal interest and rights in the partnership. A common procedure is to set up a trust for minor children to hold the FLP interests for their benefit.

¹¹ IRC §704(e).

The FLP can shift income from a high tax bracket parent to a lower or zero income tax bracket family member. There are numerous ways to accomplish this. For instance, the partnership may lease equipment or automobiles to businesses or professions owned or practiced by the parents; or other income-producing property or assets could be transferred from the parent to the FLP, thus shifting the income to the FLP and, in net effect, to the partners in a lower tax bracket.

Case Study Example 2-4:

- If Mr. and Mrs. Doe wish to use the FLP for income-splitting (income tax savings), the FLP interests could be distributed as follows:

\$250,000 Cash Flow From Annual Partnership Income

| Partner | Gross Income Interest | Net Allocation | Tax Bracket | Tax Due |
|---------------------------|--------------------------|-------------------|----------------|--------------|
| General Partner | 1.00 | \$ 2,500 | 40% | \$ 1,000 |
| Mr. Doe (L/P) | 31.50 | 78,750 | 40% | 31,500 |
| Mrs. Doe (L/P) | 31.50 | 78,750 | 40% | 31,500 |
| Mrs. Doe's elderly mother | 12.00 | 30,000 | *15% | 4,500 |
| Cain | 12.00 | 30,000 | 15% | 4,500 |
| <u>Abel</u> | <u>12.00</u> | <u>30,000</u> | 15% | <u>4,500</u> |
| Totals | 100% | \$250,000 | | \$77,500 |

* Approximate tax based on \$30,000 less standard deduction and personal exemption.

Discussion:

- Without the FLP, Mr. and Mrs. Doe would have paid 40% tax on \$250,000 or \$100,000. With the FLP, the Doe family saved \$22,500 in income tax.
- Put another way, if Abel needed approximately \$25,500 per year for college, Mr. and Mrs. Doe could either earn \$42,500, pay 40% tax on it and gift it to Abel, or they could allocate \$30,000 via the FLP to him.
- Would you rather earn \$30,000 to send your child to college or \$42,500? Put another way, if Abel needs over \$20,000 to go to college, the government can pay for it via tax savings.

CHAPTER 3

HOW THE FLP PROTECTS YOUR ASSETS — LEGAL EFFECT OF THE "CHARGING ORDER"

INTRODUCTION

A creditor of a partner has no right to execute or attach partnership assets or property. The creditor's sole remedy is to prosecute his or her claim to judgment against the debtor-partner, and then to obtain a charging order against the debtor-partner's interest in the partnership. The partnership is thereby impressed with a lien in favor of the creditor, who is entitled to all future distributions otherwise flowing to the debtor-partner until the judgment is satisfied. The debtor's partnership interest may also be sold under court order, in appropriate cases.¹

A partnership interest is personal property. This personal property right entitles the partner to a "pro rata" share of the partnership's gains and losses. However, this does not mean that the limited partner holds title to the assets of the partnership. Since a partner has only rights to the income generated by the asset and not the asset itself, a partner's creditor can only seek to satisfy a judgment with the income generated by the "partnership share" of the debtor-partner.

For income tax purposes, the holder of a charging order is treated as a substituted partner. The holder of a charging order is taxed on his pro rata share of FLP income irrespective of whether that income is distributed. That is to say, he is taxed on income he may never receive.²

LAW AND DECISIONS

RLPA §15673 states that the judgment creditor of a partner can only go against the limited partnership interest of the debtor by means of a charging order.

¹ UPA §28.

² See Rev. Rul. 77-137, 1977-1 CB 178, and *Evans v. Comm'r*, 447 F. 2d 547 (7th Cir. 1971).

A court may charge the partnership interest of the partner with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of the partnership interest.³

*Taylor v. S & M Lamp Co.*⁴

The court stated that prior to California's adoption of the Uniform Partnership Act a judgment creditor of a partner whose personal debt, as distinguished from partnership debt, gave rise to the judgment, could cause a sale at execution of partnership assets, including specific items of partnership property, to satisfy his judgment.⁵ A judgment creditor no longer enjoys such right.

Evans v. Galardi

In this case, the Supreme Court of California stated that the charging order had replaced levies of execution as the sole remedy to reach a partner's interest in the partnership. The Court stated:

Where, as in the instant case, the partnership is a viable business organization and plaintiff does not show that he will be unable to secure satisfaction of his judgment by use of a charging order or by levy of execution against the debtors' other personally owned property, there is no reason to permit deviation from the prescribed statutory process.

In *Evans*, a case where the partnership was entirely owned by judgment debtors, only a charging order was allowed.⁶

UPA §15025

Subdivision (2)(c), provides that "a partner's right in specific partnership property is not subject to attachment or execution, except on a claim against the partnership...."

UPA §15028

This provides that "(1)...the court...may charge the interest of the debtor partner with payment of the unsatisfied amount of...judgment debt with interest thereon."

³ ULPA §703.

⁴ 190 C.A. 700; 12 Cal Rptr. 323 (1961).

⁵ California Corp. Code (UPA), §15001 et. seq.

⁶ 16 Cal. 3d 300, 310-311, 128 Cal. Rptr. 25.

Section 15028, corresponds to §28 of the Uniform Partnership Act which was taken from the English Partnership Act of 1890. Lord Justice Lindley gave the following reason for the English rule forbidding execution sale of a partner’s interest in the partnership to satisfy non-partnership debt:

When a creditor obtained a judgment against one partner...the sheriff went down to the partnership place of business, seized everything, stopped the business, drove the solvent partners wild...A more clumsy method of proceeding could hardly have grown up.

It was to prevent such “hold up” of the partnership business and the consequent injustice done the other partners resulting from execution against partnership property that the quoted code sections and their counterparts in the Uniform Partnership Act and the English Partnership Act of 1890 were adopted.

Crocker Nat. Bank v. Perroton

In this case (1989), the California Court of Appeals held that a debtor-partner’s interest could be sold pursuant to the UPA which was held applicable to limited partnerships:

The court could authorize a sale of the debtor partner’s interest since three conditions were met: the creditor had previously obtained a charging order; the judgment remained unsatisfied; and all partners other than the debtor had consented to the sale of the interest.⁷

It also held that “the sale of the debtor’s interest in the...partnership was not an order for the sale of any property owned by the partnership, but was a sale of whatever interest the debtor held by virtue of his being a limited partner.”

A limited partner has no interest in the partnership property by virtue of his or her status as a limited partner; therefore, such assets are not available to satisfy a judgment against a limited partner in his or her individual capacity.

Hellman v. Anderson

This case (1991) held a judgment debtor’s interest in a partnership may be foreclosed upon and sold, even though other partners do not consent to the sale, provided the foreclosure does not unduly interfere with the partnership business.⁸

⁷ 208 Cal. App. 3d 1, 225 Cal. Rptr. 794 (1989).

⁸ 233 Cal. App. 3d 840.

A partner's right in *specific partnership property* is not subject to enforcement of a money judgment, except on a claim against the partnership....⁹

A partner's right in specific partnership property is different from his interest in the partnership. "The property rights of a partner are (1) his rights in specific partnership property, (2) his interest in the partnership, and (3) his right to participate in the management."¹⁰ "A partner's interest in the partnership is his share of the profits and surplus, and the same as personal property."¹¹

"If a money judgment is rendered against a partner but not against the partnership, the judgment debtor's interest in the partnership may be applied toward the satisfaction of the judgment by an order charging the judgment debtor's interest pursuant to Section 15028 [general partnership] or 15673 [limited partnership] of the Corporations Code."¹²

Hellman concluded that:

A partner's "interest in the partnership" is a personal property right separate and distinct from the partner's (1) rights in specific partnership property and (2) right to participate in management..."interest in the partnership" means only the partner's share of profits and surplus.¹³ Foreclosure entails no execution upon partnership assets, and the interest acquired by foreclosure does not include the right to participate in management.

In some cases, foreclosure might cause a partner with essential managerial skills to abandon the partnership. In other cases, foreclosure would appear to have no appreciable effect on the conduct of partnership business. Thus, the effect of foreclosure on the partnership should be evaluated on a case-by-case basis by the trial court in connection with its equitable power to order a foreclosure. The *Hellman* court disagreed with *Crocker's* inflexible requirement of partners' consent in order for the court to authorize a sale of a charged partnership interest.

⁹ Cal. UPA §15025, subd. 2(c).

¹⁰ Cal. Corporations Code (UPA) §15024.

¹¹ Cal. Corporations Code (UPA) §15026.

¹² California Code of Civil Procedure §708.310.

¹³ Cal. Corporations Code (UPA) §15026.

REPURCHASE OF CHARGED OR FORECLOSED INTEREST

Because purchase or partnership redemption of a charged or foreclosed interest for less than fair market value could be viewed as a fraudulent transfer, it is best to wait for a public auction to buy the charged or foreclosed partnership interest at a considerable discount.

UNIFORM PARTNERSHIP ACT REMEDIES

The UPA applies to general partnerships and to limited partnerships to the extent that it is consistent with RULPA. Under UPA §28(1), there are four different remedies a court can grant:

1. A charging order,
2. Appointment of a receiver for the debtor’s share of distributions,
3. Sale of the debtor’s interest in the partnership, and
4. Under UPA §28, possible dissolution of the partnership.

RULPA §703 deals with charging orders only but does not include any of the other remedies enumerated above.

Important: An assignee is merely entitled to receive the profits and capital to which the assigning partner would have been entitled. The assignee does not become a partner; and he is not entitled to interfere with management of the partnership or to exercise any rights with respect to its affairs. The reason for this is that a partnership is an association voluntarily entered into. Innocent partners should not have an unwanted person forced upon them. They need not accept a new partner, unless they voluntarily substitute him in. The inability of an assignee to become a partner prevents that assignee from attempting to cause a liquidation of the partnership. Only a partner can seek judicial dissolution when “it is not reasonably practical to carry on the business in conformity with the partnership agreement.”¹⁴

¹⁴ RULPA §802.

CHARGING ORDER

The general partner does not owe a duty to the holder of a charging order because there exists no fiduciary relationship between them.

- The holder of the order is a mere assignee and has not been substituted into the partnership.¹⁵

The charging order is a lien against the interest in the partnership of the charged partner. The lien or charge thereby establishes priority as against security interests which later attach. This lien only has priority as to the partner's interest in the partnership, it does not take priority over partnership liens or liens against the debtor's other assets.

- After the charging order is issued, the debtor-partner remains a partner but is not entitled to distributions or liquidating proceeds until the order is satisfied.

Apparently the order does not stop the partner from receiving other payments which may be made to a partner in a capacity other than a partner, such as a guaranteed payment, wages, or legal, accounting, or consulting fees.

CHARGING ORDERS MAKE IT DIFFICULT FOR CREDITORS TO COLLECT

To collect on a claim, a creditor must:

- First, litigate and obtain a judgment against the debtor partner,
- Then, obtain a charging order from the court,
- Then, have a receiver appointed to receive distributions from the FLP,
- Finally, if no distributions are forthcoming, apply to the court to foreclose on the debtor partner's limited or general partnership interest.

When the process is completed, the creditor still has no ability to attach partnership assets and still may find that he is being taxed on income that may never be received.

¹⁵ *Kellis v. Ring*, 92 Cal. App. 3d 854, 859-860, 155 Cal. Rptr. 297 (1979) (assignee cannot bring an action for breach of fiduciary duty), see RULPA §704.

K-O BY K-1

SUGGESTION

To enhance the limited partnership as a tool of asset protection, the language used in the agreement should provide that “the earnings of the partnership shall be distributed at least annually, **except** if those funds which, at the sole discretion of the general partners, are reasonably reserved for the conduct of the partnership business.”

Given that “at the sole discretion of the general partners” income may be held in the partnership, the creditor would find that even though he has not received any income distributions, he will receive a K-1 (a 1065 partnership tax return) form indicating that he must pay income taxes on the undistributed profits and income of the partnership in proportion to his interest as determined by the “charging order.”

However, note the discussion above regarding the general partner having the discretion to retain funds within the partnership for any reason. It would be advisable to limit the general partner’s power to retain cash to a decision made in light of the provisions contained in Reg. Section 1.704-1(e)(2)(ii).

REVENUE RULING 77-137

This Ruling dealt another blow to the creditor by making him a “substituted limited partner” for tax purposes. The ruling states:

A, a limited partner...assigned [his]...interest to B. The agreement of the partnership provides, in part, that assignees or limited partners may not become substituted limited partners in the partnership without the written consent of the general partners. However, it also provides that a limited partner may, without the consent of the general partners, assign irrevocable to another the right to share in the profits and losses of the partnership and to receive all distributions, to which the limited partner would have been entitled had the assignment not been made.

Result

Even though the general partners did not give their consent to the assignment, since B, “... the assignee, acquired substantially all of the dominion and control over the limited partnership interest, for federal income tax purposes. B is treated as a substituted limited partner for tax purposes. Therefore, B must report the distributive share of partnerships items of income, gain, loss, deduction and credit attributable to the assigned interest on B’s federal income tax return in the same manner and in the same amounts that would be required if B was a substituted limited partner.”

STRATEGY

By using this strategy, the debtor has created a great negotiating tool. Who would want to pay income taxes year after year after year on income that may never be distributed?

Care must be exercised not to be in a situation where clients cannot pay taxes either, since no distributions could be made to any limited partner. To lessen this situation, the partnership agreement may provide for a "guaranteed salary" to the less vulnerable general partner who may in fact be "the managing general partner" and by approval of the majority of the partners, this "guaranteed salary" may be increased or decreased.

Provision may also be made in the partnership agreement to permit loans to partners.

ATTACHMENT OF INTERESTS

Case Study Example 3-1:

- Let us look again at the Annual Cash Flow of the Doe FLP discussed above. The Doe FLP grossed \$350,000, of that, \$100,000 was paid to the general partner for property management compensation leaving \$250,000 for partner allocation.
- Previously, the Does received the FLP's remaining cash according to their FLP partnership percentage as follows:

**Cash Flow From
Annual Partnership Income**

| Partner | Gross Income Interest | Net Allocation |
|-----------------|----------------------------------|---------------------------|
| General Partner | 1.00% | \$ 2,500 |
| Mr. Doe (L/P) | 24.50 | 61,250 |
| Mrs. Doe (L/P) | 24.50 | 61,250 |
| Cain | 25.00 | 62,500 |
| <u>Abel</u> | <u>25.00</u> | <u>62,500</u> |
| Totals | 100% | \$250,000 |

(continued)

Case Study Example 3-1 (Continued):

- Let us see what would happen if Mr. Doe’s interests were attached. The creditor would attach his ½ % general partnership interest and his 24.5% limited partnership interest.
- Since Mrs. Doe has decided not to substitute the creditor into the FLP, the creditor has no right to vote or manage, and the general partners owe the creditor no fiduciary duty.
- For managing the FLP, Mrs. Doe would take the same \$100,000 fee as before, however, she would reinvest the remaining \$250,000 of profit.

**Cash Flow and Taxable Income (K-1)
From Annual Partnership Income**

| Partner | Gross Income Interest | Cash Distributions | K-1 Taxable Income |
|-------------------------|--------------------------|-----------------------|-----------------------|
| Gen. Partner (Mrs.) | 0.50% | 0.00 | \$ 1,250 |
| Gen. Partner (Creditor) | 0.50% | 0.00 | \$ 1,250 |
| Creditor (L/P) | 24.50 | 0.00 | \$ 61,250 |
| Mrs. Doe (L/P) | 24.50 | 0.00 | \$ 61,250 |
| Cain | 25.00 | 0.00 | \$ 62,500 |
| <u>Abel</u> | <u>25.00</u> | <u>0.00</u> | <u>\$ 62,500</u> |
| Totals | 100% | 0.00 | \$250,000 |

- The Doe Family as a group has received \$100,000 cash for managing the FLP and \$287,500 (\$100,000 from management plus \$1,250, \$61,250, \$62,500, and \$62,500) taxable income.
- In total they received \$287,500 in taxable income and \$100,000 in cash. If they are in the combined 35% tax bracket, they have received just enough cash to pay their tax obligation.
- The creditor has received a K-1 showing taxable income of \$62,500 (\$1,250 + \$61,250). If he is in the 35% tax bracket he owes almost \$22,000 in tax. He has received no cash. How will he pay the IRS?

PARTNERSHIP DOCUMENTS

Creditors of a partner (but not of the partnership) succeed to the right of the partner when the partner's interest is attached. Therefore care in review is important to ensure that creditors of a partner cannot attach a partner's interest and then force liquidation of the partnership. Do not give partners the right to partition, liquidate or dissolve the partnership or demand distribution.

Planning

Consider the following:¹⁶

■ *Transfer Valuable Assets Into a Limited Partnership*

Donor is both a general partner and a limited partner. Gift limited partner interest to donor's children. Assuming no fraudulent transfer arguments (see Ch. 4), the interests in the partnership, which are given to the donor's family, would be excluded from the donor's estate and not subject to attachment by the donor's future creditors.

- The partners of a partnership may be, inter alia, individuals, corporations, LLCs, custodianships for children, trusts, grantor retained annuity trusts (GRATs), and other partnerships.

- **Donor as General Partner**

If a general partner's interest is attached, this interest might be so structured so that it ceases to carry general partner status.¹⁷ In addition, the creditor would only hold partnership interests as an assignee, not as a partner. The disadvantage of directly holding a general partnership interest is that a noninsured risk becomes the financial responsibility of the holder of the interest.

- **Corporation or LLC as the General Partner**

An individual general partner is personally responsible for partnership liabilities. If the assets of the FLP were comprised of "dangerous" assets, such as apartment complexes, and if a major mishap occurred with one of the buildings, the general partner could be financially destroyed. In this situation, an adequately funded corporation or LLC could serve as the general partner and insulate all of the members of the family. The corporation or LLC must be adequately funded to prevent the FLP being taxed as an association taxable

¹⁶ See "Who Can Be a Partner" in Ch. 1.

¹⁷ See RLPA §15662(b)(1).

as a corporation. An S corporation or an LLC should be considered if double taxation is a concern, or when family members in lower tax brackets than the donor/parents will own the stock.

- **Use of Trust**

A debtor could give limited partnership interest to an irrevocable spendthrifted protective trust established for the benefit of family members. Since the interests given away are limited, the donor maintains control. The donor might still be able to exercise some control over the interest given away by appointing a friendly trustee.

- **Minor’s Interest**

If held directly, either a guardian may be required¹⁸ or a trust¹⁹ should be used.

¹⁸ See your state’s Uniform Gifts to Minors Act and Uniform Transfers to Minors Act.

¹⁹ IRC §§2503(b), 2503(c), or irrevocable.

CHAPTER 4

FRAUDULENT TRANSFERS AND PROFESSIONAL LIABILITY

INTRODUCTION

Before assets are transferred into an FLP, we must be sure that we are not “hindering, delaying or defrauding” a creditor of the transferor.

In order to navigate this minefield, it is necessary to rely on accounting input and, often, accounting opinions. Accounting determinations of “solvency,” “unreasonably small capital,” “debts beyond the debtor’s ability to repay,” and an appraiser’s determination of “inadequate consideration” will, in most cases, determine whether a client can appropriately use an FLP for asset protection.

Professionals involved in transferring assets into FLPs must know the law of fraudulent conveyances and screen clients carefully because there is potential criminal, civil and ethical exposure for violations in these areas that can be brought against both the client *and the client’s professional advisors*.¹ A debtor who engages in a fraudulent transfer can find the transfer nullified and be denied a discharge in bankruptcy, and the attorney and accountant may be subject to professional discipline as well as potential civil and criminal penalties.

FRAUDULENT CONVEYANCE LAWS INVOLVED

The laws we are concerned with chronologically are:

- **Uniform Fraudulent Conveyance Act (UFCA)**

Enacted in 1918.

¹ See Jack F. Williams, “Revisiting the Proper Limits of Fraudulent Transfer Law”, 8 Bankr. Dev. J. 55 (1991).

■ **Bankruptcy Code (Code)**

Enacted in 1978 and amended by the Bankruptcy Reform Act of 1994.² Transfers which are made with *intent* to “hinder, delay, or defraud” creditors (“HDD”) as well as those which are constructively fraudulent can be avoided. The federal statute of limitations is one year or, under the long-arm provisions of the Code, any applicable state law if longer. The Code is more debtor-oriented than the UFCA.

■ **Uniform Fraudulent Transfers Act (UFTA)**

Enacted in 1984. It is more debtor-oriented than the UFCA.³

TWO TYPES OF FRAUD

Actual Fraud

Actual fraud by itself is difficult to prove. It is usually proved by showing the circumstances surrounding the transfer. These circumstances are called “badges of fraud” and are sufficient, standing alone, to establish actual fraud. Inadequacy of consideration for the transfer and insolvency are major badges of fraud.

Constructive

For constructive fraud, the transaction must lack adequate consideration, **plus** one of the following must be present. The debtor:

- Is or will be rendered insolvent, or
- Is engaging in or is about to engage in a transaction with unreasonably small capital, or
- Is about to incur debts beyond the debtor's ability to pay.

² 11 USC §548, and 11 USC §544(b) West (1995).

³ California has adopted the UFTA.

TYPES OF FRAUDULENT TRANSFERS

■ Actual Fraud

- Actual intent — Hard to prove
- Badges of Fraud — Establish intent
- Insolvency/Inadequate Consideration are Major Badges

■ Constructive Fraud

Lack of adequate consideration and transfer made when debtor:

- Is or will be rendered insolvent, or
- Engages or is about to engage in transaction with unreasonably small capital, or
- Is about to incur debts beyond ability to pay

■ Types of Creditors

- Existing
- Future Foreseeable
- Future

SOLVENCY AND INTENTIONS

Insolvency is the most important factor in determining whether a transaction is voidable as an actual fraud or a constructive fraud.⁴

Before transferring assets, we must determine if the client is solvent and what the client's intentions are (enter business, incur debts, etc.). In order to determine solvency, the CPA must put together a balance sheet.

Note:

- Assets such as pension plans and other exempt assets are not counted.
- Only assets subject to the creditors' attachment should be set forth.

⁴ UFTA §§4(a)(2) and 4(b)(9), 5, 7A ULA 639, 653, 657 (1984).

INTENTIONAL FRAUDULENT CONVEYANCES

ACTUAL INTENT

A transfer is fraudulent if made “with actual intent to hinder, delay, or defraud any creditor of the debtor.”⁵ The statute states the intent can be one of three kinds:

- Intent to hinder,
- Intent to delay, and
- Intent to defraud.

Either one will trigger the statute equally.

The transfer is fraudulent as to a creditor whether the creditor's claim arose *before* (“Present Creditor”) or *after* (“Future Creditor”) the transfer, *if intent to defraud was present at the time of the transfer* [emphasis added].⁶ For this purpose, future creditor really refers to future foreseeable creditors because the statute refers to a creditor who presently has a contingent, unliquidated or unmatured claim.⁷ If the client has no creditors, it is very difficult to prove that he or she had an actual intent to defraud. On the other hand, if the transferor has a present creditor, and fraudulent intent can be shown as to that creditor, then the transaction is also fraudulent as to a future creditor since the intent established applies to both.⁸

Unlike constructive intent, discussed below, if actual intent can be shown, irrespective of the fact that the transferee paid adequate consideration and irrespective of the transferor being solvent, the transaction is still fraudulent.⁹

⁵ Cal. Civil Code §3439.04(a).

⁶ UFTA §4(a)(1), 7A U.L.A. §665 (1984).

⁷ UFTA §1(3).

⁸ UFTA §4.

⁹ See *Heffernan v. Bennett & Armour*, 239 P. 2d 129, 140-141 (Cal. Ct. App. 1952).

BADGES OF FRAUD

The courts have developed badges of fraud as *circumstantial evidence of “actual intent to hinder, delay or defraud.”* “Clear and convincing evidence” is required. Some of these badges of fraud are *also elements of constructive fraud.* Like constructive fraud, insolvency and lack of adequate consideration are key badges. The UFTA lists these badges.¹⁰

CONSTRUCTIVE FRAUDULENT TRANSFERS¹¹

BANKRUPTCY FRAUD

■ ***Constructive Fraud*** — Bankruptcy Code §548(a)(2)

Received less than a reasonably equivalent value *and* transfer made when debtor:

- Is or will be rendered insolvent because of such conveyance, or
- Engages or is about to engage in a transaction for which any property remaining with the debtor after the transfer represented unreasonably small capital, or
- Is about to incur debts beyond ability of the debtor to repay.

Since most asset protection plans involve gratuitous transfers, the “reasonable equivalent value” test will not be satisfied. Therefore, great care must be taken that none of the other three elements are present.

If intent cannot be found, the transfer is still fraudulent *if* the transferee did not pay reasonably equivalent value¹² *and* one of the three above considerations was present (the three conditions are each really a type of insolvency). In addition, there must be a causal connection between the transfer and the failure to pay the creditor’s claim. The longer the timespan between the transfer and the claim, the weaker the causal connection.

¹⁰ UFTA §4(B).

¹¹ UFTA §4(A)(2), 7A U.L.A. 639, 653 (1984); 11 USC §548(a)(2).

¹² Under Bankruptcy Code §548(a)(2) or UFTA §§4(a)(2), 5, 7A U.L.A. §§653-657 (1984).

FAIR OR ADEQUATE CONSIDERATION

The determination of whether the consideration is fair depends on whether it is of value to the creditor, not the debtor.¹³ Under the Bankruptcy Code, the issue is whether the value transferred is disproportionately small compared to the value received by the debtor. In the Ninth Circuit, the conclusive presumption arises that the price obtained at a regularly conducted foreclosure sale is reasonably equivalent value.¹⁴

INSOLVENCY

If the transfer is made when the transferor is insolvent or will be rendered insolvent (shortly thereafter), the transfer is constructively fraudulent.¹⁵ Under the UFTA, the transfer is fraudulent only to pre-transfer creditors.¹⁶ Under the Code, this rule applies to creditors existing both at the time of transfer as well as at post-transfer, provided the transfer occurs within one year of the filing of bankruptcy.¹⁷ The Code uses a balance sheet test and the debtor is considered insolvent when the sum of the debtor's debts exceed the fair market value of the debtor's property.¹⁸ All fraudulently transferred and all exempt property is excluded from the calculation. The UFTA states that the debtor is insolvent if all the debtor's debts exceed all of the debtor's assets at a fair valuation.¹⁹ However, if the debtor is not paying debts as they become due, the debtor is presumed insolvent.²⁰

Under the UFTA, unlike engaging in business with a small capital or incurring debts (in both cases the person to be potentially hurt is foreseeable), in insolvency the potential plaintiff is not a "future foreseeable person," therefore, creditors of the debtor who become such after the fraudulent transfer do not have standing to complain.

¹³ *Patterson v. Missler*, 238 Cal. App. 2d 759, 766, 48 Cal. Rptr. 215 (1965).

¹⁴ See *In re Madrid*, 725 F. 2d 1197 (9th Cir. 1984), cert. denied, 469 US 833 (1984).

¹⁵ UFTA §5 ULA 639, 657 (1984).

¹⁶ UFTA §4, 7A ULA §639, 657 (1984).

¹⁷ 11 USC §548(a)(2)(B)(i).

¹⁸ 11 USC §101(32) (Supp. II 1991).

¹⁹ UFTA §42(a) 7A ULA §648 (1984).

²⁰ UFTA §42(b) 7A ULA §648 (1984).

ENGAGES OR IS ABOUT TO ENGAGE IN BUSINESS WITH UNREASONABLY SMALL CAPITAL

A schedule of reasonable capital existing after the transaction should be prepared. The level of assets needed to conduct a business varies with the nature of the business. It is a question of fact.²¹ Capital includes reasonably foreseeable cash flow determined at the time of the transfer.

This applies to present and future creditors because the future creditors are really future foreseeable creditors. You can foresee who will be injured by your lack of adequate capital.

TRANSFERS BY PERSONS ABOUT TO INCUR DEBTS

The debtor must be left with enough assets to repay his or her debts. Since this is constructive, neither lack of intent to hinder, delay, or defraud, nor solvency at the time the transfer is made will be a defense if fair or adequate consideration was not received, and the debtor cannot repay the debt.

This applies to present and future creditors because the future creditors are really future foreseeable creditors.²² You can foresee who will be injured by the debt.

PROPER REASONS TO TRANSFER ASSETS

If the motives are proper, the transfers have a greater chance of surviving an attack based on intent. If the principal intent is, for example, income tax planning (example: income tax savings may be achieved if you shift income to the children via a family limited partnership), then it should not be a problem that a side benefit of the income tax plan is asset protection.

An FLP is a powerful and sophisticated tool designed to give your family the benefit of two significant valuation discounts:

1. Lack of marketability,
2. Minority interest.

²¹ See *Credit Managers Ass'n of S. Cal. v. Federal Co.*, 629 F. Supp. 175, 182-183 (CD Cal. 1985).

²² 11 USC §548(a)(2)(B)(iii)(1988); UFTA §4(a)(2)(ii), 7A ULA §653 (1984).

A side benefit is that to the extent clients own a limited partnership interest rather than the underlying asset, their creditors will have a more difficult time satisfying a judgment.

CLASSIFICATION OF CREDITORS

PLANNING IN ADVANCE OF LAWSUIT IS CRITICAL

Fraudulent transfer laws protect both present and future foreseeable creditors, however, rarely do they afford protection to future creditors.

Present Creditors

Generally those creditors who have matured claims against the transferor, such as judgment creditors who have prevailed in litigation against the transferor or mortgage lenders who have foreclosed against real estate collateral and have established a deficiency under applicable state law.

Future Foreseeable Creditors

Presently identifiable parties with foreseeable claims who could get enforceable rights against the transferor's property.

Future Creditors

Those currently unidentifiable claimants who haunt the dreams of professionals, directors of public companies and business people who suffer free-floating anxiety about the possibility of becoming targets of predatory litigation in the future.

STATUTES OF LIMITATION

The statutes of limitation in most states range from four to seven years for creditors in fraudulent transfer cases.²³

²³ California Civil Code §3439.09.

Actual Intent

An action based on a transfer made with actual intent to hinder, delay or defraud creditors must normally be brought within four years after the transfer was made or, if later, within one year after the transfer was or reasonably could have been discovered by the creditor, but in no case can the time period exceed seven years after the transfer was made.

Others

All other types of fraudulent transfer cases must normally be brought within four years after the transfers were made.

Because of the statute of limitations, and the fact that creditors are becoming increasingly sophisticated in attacking potentially fraudulent transfers, it is critical that clients be informed that the earlier they implement their estate planning the more secure that planning will be if a problem arises in the future. Four years is generally a safe-harbor time limit.

PROFESSIONAL RESPONSIBILITY

Checklist to Prevent Fraudulent Transfer Claims

■ Financials

Obtain from the client:

- Affidavit regarding financial condition,
- Personal financial statements and audited business financial statements prepared by competent accountants, and
- Certificates for all liability insurance carried.

These documents should establish that the client is solvent and can pay his or her debts as they become due.

■ Letter

Provide client with letter of anticipated results and the negatives, such as loss of ownership, control, consequences of divorce, loss of full step-up in basis, etc. Include a statement that the client is responsible for providing financial information.

(continued)

Checklist to Prevent Fraudulent Transfer Claims (Continued):

- **Volume of Transfers**
Limit the amount of the transfers to a predetermined amount to preserve solvency and working capital.
- **Implement**
Record and file documents required to implement the plan.

LIABILITIES

The liability of a CPA, or an attorney or other professional advisors arises in the context of:

- Counseling fraudulent transfers, and
- Failing to transfer assets and record documentation in a timely fashion.

SCOPE OF ENGAGEMENT

Of increasing concern as more and more is being written on this area is whether an attorney or accountant is liable for *failure to inform* a high-risk client that asset protection techniques are available. The answer is probably yes if the accountant or attorney practices in an area where reasonably prudent accountants and attorneys would have so informed the client. Even if the accountant or attorney is not specialized in the area, he or she has a responsibility to refer clients to others who have specialized knowledge and he or she can be held liable for negligent referral if due care is not used in selecting the referred CPA or attorney.

COUNSELING FRAUDULENT TRANSFERS

If the CPA, attorney or other professional counsels fraudulent actions, he or she may be a co-conspirator and if there are damages may be liable.²⁴ Damages are the lesser of the property fraudulently transferred or the debt owed. If there is fraud, however, the CPA and attorney may also be liable for punitive damages. Malpractice coverage does not cover damages arising out of fraud or punitive damages.

²⁴ *McElhannon v. Hing*, 151 Ariz. 386 (1985), aff'd in part and vacated in part on other grounds, 151 Ariz. 403, cert. denied, 481 US 1030 (1987) (drafting the instruments pursuant to which the fraudulent conveyance was made with knowledge of the fraudulent use to which they were to be put).

If the accountant, attorney or other advisors engage in conduct that violates the Uniform Fraudulent Transfer or Conveyance Acts, or violates the fraudulent transfer laws under the Bankruptcy Code, they may be subject to disciplinary actions pursuant to the codes of ethics of their professional societies even if they believe their action is legally justified, and they may be subject to civil and criminal law sanctions. In addition, their clients are also exposed to most of the same penalties.²⁵

It should be clearly noted that an attorney may discuss fraudulent transfers with the client, as long as the discussions are not in furtherance of a plan to actually engage in the proscribed conduct. There is no attorney-client privilege that protects an attorney assisting a client to perpetrate a fraud.²⁶

HOW MARRIED COUPLES SHOULD HOLD THEIR FLP INTERESTS

The system of property ownership determines the rights of each spouse's creditors to reach the other spouse's assets. If your property is community, when an adverse judgment is rendered against you, the judgment holder will foreclose on every asset that you own (community or separate). However, your creditors cannot foreclose on your spouse's separate property.

Asset protection strategies involve titling of assets between spouses. When clients convey property that they own as community property into a tenancy in common with each spouse owning 50% as sole and separate property, they gain considerable asset protection benefit. Whereas prior to the transfer their creditor would have been able to attach the entire property, now they can only attach a fractionalized portion of it — which has a greatly diminished appeal and value.

Remember that with community property, upon the demise of the first spouse, a full step-up basis is received on the property, which can minimize the estate tax consequences upon the second-to-die. With separate property, there is only a one-half step-up.

Community property is deemed to be owned fifty percent by each spouse, but it is *subject to the debts of either spouse*.²⁷ That is why your spouse gets named in your lawsuit even though he or she may not have had anything to do with the case. The plaintiff's attorney is after the community property.

²⁵ See *Coppock v. State Bar of California*, 44 Cal. 3d 665, 679 (1988).

²⁶ American Bar Association Model Rules.

²⁷ Cal. Civ. Code §5120.110 (West Supp. 1993), Cal. Family Code §§910, 911, effective Jan. 1, 1994.

The community and sole and separate assets of the debtor are attachable by a creditor. The sole and separate property of the debtor's spouse is not attachable by the debtor's creditors.²⁸

PROTECT ASSETS FROM FAILED MARRIAGES

The normal way to protect an heir's assets from consequences of an heir's always-possible divorce is a premarital agreement. Many find these agreements offensive and, therefore, fail to use them. The partnership agreement can require a buyout at a low value. If the "inheritance" is in the form of FLP units, the heir's nonmarital property is easily tracked. In the unlikely event a court awards your heir's FLP units to your heir's ex-spouse, the partnership agreement can require a buyout at a low value.

POSTNUPTIAL (TRANSMUTATION AGREEMENTS)²⁹

Transmutation Agreements protect half of a family's assets.

Spouses may deviate from the statutory scheme of community property through an agreement between themselves.

SEPARATE OWNERSHIP

Spouses could divide property between themselves so that they each own separate property. This would ensure that creditors of one spouse cannot attach the assets of the other spouse (unless they were jointly and severally liable).

Like a third-party creditor, an ex-spouse will generally not place a high value on ownership of a limited partnership interest in an FLP. Also, FLPs can contain provisions requiring mediation and arbitration to handle family disputes out of court.

²⁸ §5122 of Cal. Civ. Code.

²⁹ For an in-depth view of separating assets, please see Kasner, "Community Property Law," The Southern California Tax & Estate Planning Forum, March 1992.

CHAPTER 5

HOW AN FLP CAN FUND A LIFE INSURANCE POLICY

INTRODUCTION

You can keep insurance proceeds outside your estate by having your children become the owners of the policy.

Reasons not to have your children own the policy include:

- Children may not use the money that is gifted to them to pay the premiums,
- Your children's creditors can attach the insurance proceeds to satisfy their debts or taxes, and
- Your children, not you, will have access to the policy's cash value.

IRREVOCABLE LIFE INSURANCE TRUST

An irrevocable life insurance trust (ILIT) can eliminate the estate tax on life insurance by keeping the insurance proceeds outside of your and your spouse's estate. In addition, the ILIT can protect the cash value and the proceeds from your and your spouse's creditors.

The trust becomes the owner of the policy. Since you no longer have control or ownership, the proceeds are out of your and your spouse's estate. More importantly, if the trust constitutes a spendthrift or other type of protective trust, you prevent the insurance proceeds from falling into the hands of your creditors, your spouse's creditors, and your children's creditors and other adversaries.

Assuming that the trust is set up sufficiently in advance to avoid any fraudulent conveyance argument and assuming that the insured has no ownership rights over the policy ("incidents of ownership") and no control, direct or indirect, over the trust, the cash values and the proceeds of the life insurance policies should not be attachable by the insured's creditors. When the insured dies, the insurance policy proceeds will go into the trust. If the trust is set up to qualify as a spendthrift or other type of protective trust for state law purposes, creditors of the beneficiary should not be able to attach the assets of the trust.

INCIDENTS OF OWNERSHIP

An insured's gross estate includes the amount of insurance proceeds from policies on his or her life, regardless of to whom they are paid, *if* the insured person on the date of death possessed *one or more "incidents of ownership"* on the policy.¹ This is the most common cause for life insurance proceeds to be included in your estate and therefore both subject to estate tax as well as your creditor claims.

Life insurance planning revolves around avoiding "incidents of ownership." Incidents include the power to:

- Change the beneficiary,
- Surrender or cancel the policy,
- Assign the policy or to revoke an assignment,
- Pledge the policy for a loan,
- Borrow against the cash surrender value.

It is the mere possession of an incident, not its exercise, that causes life insurance in the estate to be taxed.

INCIDENTS POSSESSED AS COMMUNITY PROPERTY

Special rules apply to insurance that is purchased, in whole or in part, with community funds. A life policy owned as community property gives each spouse incidents of ownership over half the proceeds.² The surviving spouse, who is usually the beneficiary, will be deemed to have created his one-half interest in each premium dollar paid and, therefore, half of the proceeds will be in his estate.

¹ IRC §2042.

² Reg. §20.2042-1(c)(5).

GIFT TAX MINIMIZATION — *CRUMMEY* POWER

The annual gift exclusion is achieved by using the *Crummey* withdrawal powers. If the beneficiaries of the trust have *Crummey* withdrawal rights, then all or a portion of the gift to the trust will qualify for the \$10,000 annual gift tax exclusion. The *Crummey* technique converts the beneficiary's future interest in the gifts to the trust to a present interest which then qualifies for the \$10,000 annual exclusion.

BENEFITS OF A PROPERLY DRAFTED ILIT

- Can double the insurance coverage.
- Keeps insurance proceeds outside of the estate.
- Protects cash value from your, your spouse's, and your children's creditors.
- Protects cash proceeds from your, your spouse's, and your children's creditors.
- Protection of corpus from beneficiary's creditors.
- Centralized control of assets for several generations.

DISADVANTAGES OF AN ILIT

- ILIT's are irrevocable.
- Beneficiary cannot be changed.
- The insured cannot be the trustee.
- Premiums paid to the ILIT are future interests and must rely on possibly uncertain *Crummey* powers to utilize the annual \$10,000 gift tax exclusion.

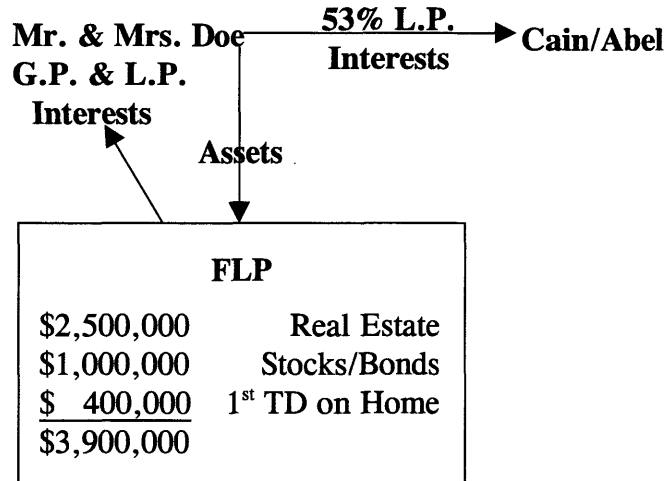
FLP AND INSURANCE

Rev. Rul. 83-147 had been cited by commentators to explain the estate taxation of life insurance owned by a partnership on one of its partners. The result, as described by the revenue ruling, should be the same as corporate-owned life insurance. If the FLP is the beneficiary of the life insurance, then

the insurance death benefit will only be included in the partner's estate indirectly by the change in value of the deceased partner's FLP interest.³

Case Study Example 5-1:

Doe Family Life Insurance Purchase



After the formation of the FLP and the gifts of 47% of the partnership interest by both John and Mary Doe (valued at \$1,191,450 utilizing a 35% discount), the couple's taxable estate is comprised of the following assets:

| | |
|----------------------|------------|
| Miscellaneous Assets | \$ 50,000 |
| Equity in Home | \$ 100,000 |
| FLP Interests (53%) | 1,343,550 |

Discussion:

- The Does and their professional advisors have indicated the need for a million dollar survivor life policy to cover estate taxes, final expenses, and to leave a bit over for the widow.
- A million dollar survivor life policy with an increasing death benefit would require an annual premium of \$42,000 for ten years.

³ See also *Estate of Frank H. Knipp, Deceased* 25 T.C. (1955), acq. in result, 1959-1 C.B. 4.

The use of the FLP to purchase insurance offers certain advantages not available with the more common Irrevocable Life Insurance Trust (ILIT). The income and estate tax results of using an FLP or an ILIT are virtually identical.

DISADVANTAGES OF AN FLP

- Creature of state statute.
- Minimum franchise tax in some states.

ADVANTAGES OF AN FLP

- Flexibility — Owners, managers and distributions can be changed.
- Centralized control of assets for several generations.
- Need not rely on *Crummey* provisions to fund the insurance premiums.
- Protection of corpus and potential income from beneficiary's creditors.

INCREASED FLEXIBILITY

- The FLP is revocable.

The partners (family members) can decide to liquidate it. The insurance policy could be distributed as an asset in kind to one of the partners and cash to the others.

- Since the FLP is contractual in nature, its terms can be changed.
- A parent who is a 1% general partner and whose life the insurance is on can maintain all of the powers of a general partner and still have only 1% of the policy proceeds in his or her estate.

This is not the case with an ILIT.

- The parent as general partner could be distributed the insurance out of the FLP as a distribution in kind should conditions so warrant, or, the policy could be assigned to a particular partner subject to the fiduciary responsibility of receiving full and adequate consideration.
- Additional partners can be added and partnership percentages changed.

CONTROL

The grantor of an ILIT generally cannot serve as trustee or exercise any powers over the trustee of an ILIT without causing total inclusion of the life insurance in the grantor-insured's estate.⁴

By contrast, the insured can be the managing general partner of an FLP that owns insurance on the grantor's life without causing the insurance to be included in his or her estate.

INCOME TAX

The proceeds of a policy of insurance on the life of the general partner, which insurance is owned by the FLP, is received by the FLP income tax free. Gross income does not include insurance proceeds paid because of death.⁵ Hence the FLP does not recognize income on receipt of those proceeds. This receipt results in a proportionate increase in each partner's basis in his or her interests and hence an income tax free distribution to the partners.⁶

ESTATE TAX

The proceeds are includable in the insured-partner's estate in proportion to his or her interest in the partnership. However, the full amount of the insurance owned and paid for by the FLP should not be includable in said insured-partner's estate because:⁷

- The proceeds are not received by the partner's estate,⁸ and

⁴ See Rev. Rul. 76-261, 1976-2 CB 276. The IRS had maintained for years the decedent's ability to control the enjoyment of the insurance proceeds constituted an incident of ownership. In certain restricted situations, the IRS had modified this position, see Rev. Rul. 84-179, 1984-2 CB 195.

⁵ IRC §101(a).

⁶ IRC §705(a). IRC §705(a)(1)(B) increases a partner's basis by his or her distributive share of tax-exempt income.

⁷ IRC §2042 or IRC §2033. IRC §2033 states that the value of a decedent's estate shall include the value of a decedent's interest in property possessed at death. Treas. Reg. 20.2031-3 defines fair market value.

⁸ IRC §2042(1) does not apply to cause inclusion of the life insurance in the decedent's estate provided the FLP is the recipient of the proceeds, the FLP is not subject to pay taxes or debts enforceable against the decedent's estate, and the FLP does not permit the insured to use the proceeds of the policy as collateral for a loan to him or her.

- The partner possesses no incidences of ownership.

An insured-partner should not be deemed to have incidents of ownership in the policy under IRC §2042(2) even if the insured partner has the controlling interest in the partnership.⁹ Care must be taken that the estate freeze rules are not violated under Chapter 14.¹⁰

CRUMMEY POWER

The concern has been voiced that the *Crummey* withdrawal rights, discussed earlier in this chapter, will be legislatively eliminated.¹¹ This makes reliance on the *Crummey* power to fund insurance premiums less than conservative planning.

In the FLP area, by contrast, the IRS's position is that gifts of FLP interests qualify as gifts of present interest for purposes of the annual gift exclusion.¹² Therefore parents, without needing to rely on *Crummey* powers, could contribute cash to the partnership, thereby increasing their percentage of FLP interests and then gift those added interest to their children directly (not in trust). Or they could gift cash directly to the children (without benefit of FLP discounts), and the children could contribute the cash to the FLP. In either case, the contributed cash could be used to make the premium payments.

Of course, in proper circumstances, FLP interests could be placed within an ILIT in a percentage large enough to permit the partnership distributions to those interests to fully pay the premium.

⁹ See Reg. §20.2042-1(c)(6) for the results reached in the corporate context. Control of a corporation will not cause the insurance proceeds from a policy owned by the corporation on the life of the controlling shareholder to be included in the shareholder's estate to the extent the insurance is paid to the corporation. The same position (though FLPs are not addressed in the Treasury Regulations) should apply to insurance owned by an FLP on the life of the controlling general partner, provided the insurance is paid to the FLP. See *Estate of Knipp v. Comm'r*, 25 TC 153 (1955), acq. in result, 1959-1 CB 4. In *Knipp*, the decedent held a 50% interest in a partnership that held policies on his life. The partnership paid the premiums, and the proceeds were payable to the partnership. The Tax Court explored the issue of whether at the time of death the decedent possessed incidents of ownership over the insurance exercisable alone or with another party, and found none. The Court found the policies were assets of the partnership and the partnership had control over them and held the incidents of ownership. Using a rationale similar to that which does not allow a partner's creditors from attaching partnership property, the Court held that decedent as an individual had not power to exercise rights over assets of the partnership. The IRS in Rev. Rul. 83-147, 1983-2 CB 185, agreed with the result in *Knipp*, provided that the policy proceeds were paid to or for the benefit of the partnership. See also *Watson v. Commr.*, 36 TCM 1084, T.C. Memo. 1977-268.

¹⁰ See IRC §§2701-2704.

¹¹ *Crummey v. Comm'r*, 397 F.2d 82 (9th Cir. 1968).

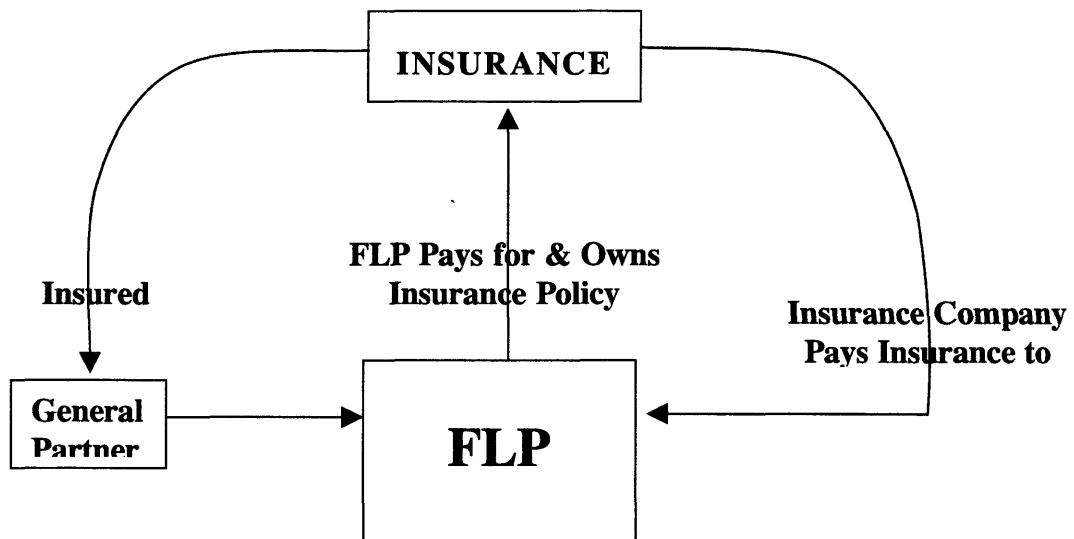
¹² PLR 9131006.

TRANSFER FOR VALUE

Life insurance proceeds are not taxable income to the beneficiaries.¹³ If the insurance policy is transferred or assigned for valuable consideration, the insurance less the valuable consideration and premiums paid is included in income.¹⁴ There are exceptions to this “transfer for value” rule. Proceeds are excluded from income if the ultimate transferee of the policy is:

- The insured,
- Partner of the insured,
- Partnership in which the insured is a partner, or
- Corporation in which the insured is a shareholder or an officer.

The transfer-for-value rule is not applicable in an arrangement in which a policy on the life of a shareholder-partner was transferred to an existing partnership.¹⁵



¹³ IRC §101(a)(1).

¹⁴ IRC §101(a)(2).

¹⁵ PLR 9012063 (December 28, 1989) and PLR 9042023 (July 19, 1990).

INSURANCE AS SOLE FLP ASSET

The Uniform Partnership Act defines a partnership as an association to carry on a business. A partnership is an organization “through or by means of which any business, financial operation or venture is carried on....”¹⁶ Is insurance a sufficient investment to qualify the partnership as a business? Owning a life insurance policy should constitute a business for state law purposes, because owning insurance is an investment. Managing a life insurance policy should be sufficient business activity to avoid termination of the partnership for income tax purposes. However, it is advisable to ascertain whether local state law allows investment in a life insurance policy as a valid business purpose for the partnership, and it is probably prudent to add other assets into the partnership solution.

FLP AND GRANTOR RETAINED ANNUITY TRUSTS (GRATs)

GRAT

Case Study Example 5-2:

- Should the Does not wish to utilize life insurance, their estate tax could be further reduced by utilizing a GRAT funded with FLP interest.
- Using this technique, we can:
 - Permit the Does to maintain control over their estate,
 - Reduce the value of the estate because of valuation discount (see above).
 - Reduce the value of the FLP interests further by using a GRAT.

(continued)

¹⁶ IRC §7701(a)(2).

Case Study Example 5-2 (Continued):

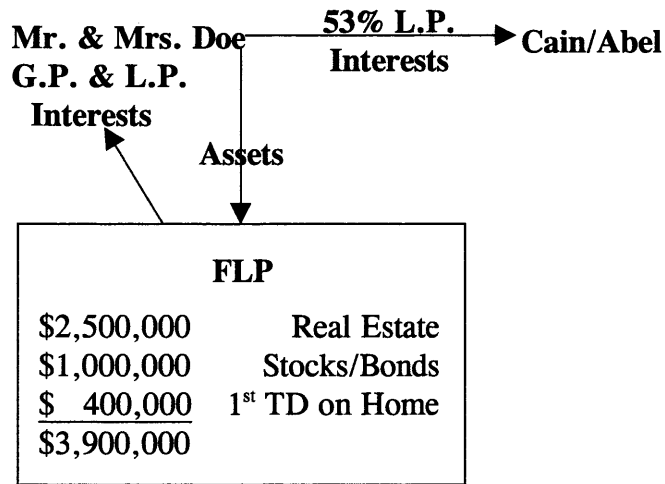
Discussion:

- The amount of the gift (provided Mr. or Mrs. Doe survives the period of the GRAT) is the value of the remainder interest on the day the gift is made.
 - This is calculated actuarially by reference to tables and interest rates published by the IRS monthly.¹⁷
 - All of the appreciation on the property transferred, plus the cash flow not distributed to the GRAT, provided Mr. or Mrs. Doe survives the term of the GRAT, would be in the FLP (i.e., it would be in the estate of Cain and Abel and not Mr. or Mrs. Doe).
 - Upon termination of the GRAT in accordance with its predesigned number of years, the FLP interests would be transferred to the designated remainderman (either Cain and Abel or a trust set up for them, most likely without any transfer tax being imposed).
- Should Mr. and Mrs. Doe die during the term of the GRAT, the value of the property transferred plus its appreciation is drawn back into his or her estate, however, any gift tax paid on the creation of the GRAT will be restored.
 - Because of this restoration, there really is no penalty to the Does' if this technique is used (other than the costs incurred in structuring the transaction).
- One strategy might be to create several GRAT's with several different periods.
 - In this fashion, a premature death would not adversely affect the entire plan.

USE OF GRAT

The success of the GRAT is in large part dependent on whether the return on the trust assets outperforms the IRS §7520 rate published monthly by the IRS. However, remember that if the asset's return is 10%, and the FLP interests were discounted by 35%, a client would need to give 6.50%. The discount of 35% almost guarantees a client can outperform the 7520 rate.

¹⁷ See IRC §7520.



Case Study Example 5-3:

- As discussed above, after the formation of the FLP and the gifts of 47% of the partnership interest by both John and Mary Doe (valued at \$1,191,450 utilizing a 35% discount), the couple's taxable estate is comprised of the following assets:

| | |
|----------------------|------------|
| Miscellaneous Assets | \$ 50,000 |
| Equity in Home | \$ 100,000 |
| FLP Interests (53%) | 1,343,550 |

Restructured Using FLP and GRAT:

- The Doe FLP contains \$3.9 million in assets.
 - These assets produce \$340,000 of income (\$200,000 from the real estate, \$100,000 from the stocks and bonds, and \$40,000 from the TD).
- This \$340,000 flows to the GRAT.
- Fund a GRAT with 99% of the FLP interests discounted by 35%, i.e., valued at \$2,535,000.
 - The \$340,000 produces a 13.4% yield on the GRAT assets.

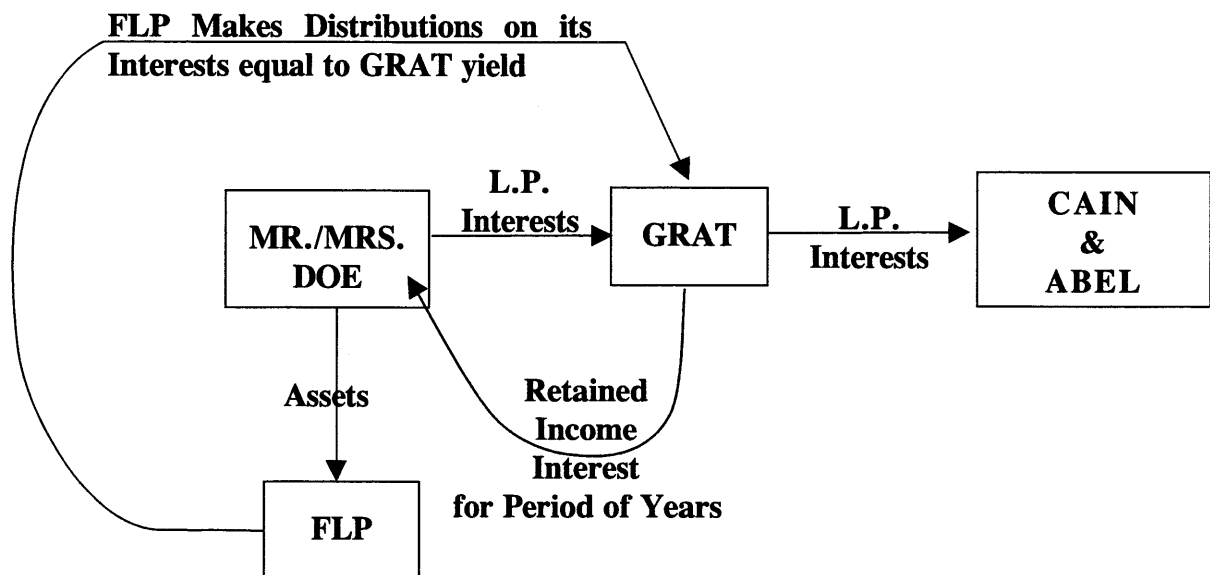
GRAT FUNDING

For asset protection purposes, the GRAT creates fractionalized interests, the remainder interest no longer is subject to the donor's predators (in the technique outlined above we are doubly protected because the property itself is FLP interests), and the income is protected the same as it would be in an annuity.

The GRAT is exempted from the estate freeze rules of Chapter 14 (§§2701-2704). The payout is calculated as a fixed sum based on the initial contribution and no further contributions may be made. In the GRAT, commutation (the right to distribute to the donor as a lump-sum his interest free of the trust) must be prohibited, and no payments may be made to others.¹⁸

To the extent the trusts are grantor trusts, they may be funded with S corporation stock.¹⁹

The \$1 million generation-skipping tax exclusion is not available in a GRAT situation, consequently the remainder interest should not be given to a grandchild.²⁰



¹⁸ Treas. Reg. §25.2702-3(d)(1992).

¹⁹ IRC 1361(c)(2)(A)(i).

²⁰ IRC §2642(f)(3).

Case Study Example 5-4:

- Assume 99% of the Does' FLP was placed into a GRAT on March 1, 1996 (\$7520 rate was 6.6%). The Does are 65.
- If we assume that \$304,200 of the \$340,000 annual income is distributed to limited partners (12.0%) and the trust is for seven years, the amount of the gift is approximately \$995,000.
- Since the remainder of the Doe estate is \$150,000, all estate tax has been eliminated.
 - The \$3.9 million in the FLP is protected, the \$100,000 equity in the home is protected by homestead, and the remaining \$50,000 of miscellaneous assets (the normal nonsalable used clothes, furniture, etc.), for all practical purposes, is of little use to creditors.

**Mr. and Mrs. Doe's Estate After They Make Gifts
of FLP Interests to Seven-Year GRAT
Using 35% Discount**

| Partner | Interest | Value of Doe Estate |
|-----------------|-----------------|--------------------------------|
| General Partner | 1.00% | \$ 26,000 |
| GRAT | 99.00 | 995,000 |
| Home Equity | | 100,000 |
| Miscellaneous | | \$ <u>50,000</u> |
| Totals | 100% | \$1,171,000 |

Comments

- The 35% discount reflects discounts for minority interest, restrictions on transferability and marketability.
- No gift tax will be due because of the unified credits.

- Appraisal of real estate required.
- Mr. and Mrs. Doe, through their revocable trust, are managing general partners and have complete control.
- Children cannot transfer FLP interests without the permission of the general partners.
- Interests of children can be held by irrevocable trusts set up by the parents.

Case Study Example 5-5:

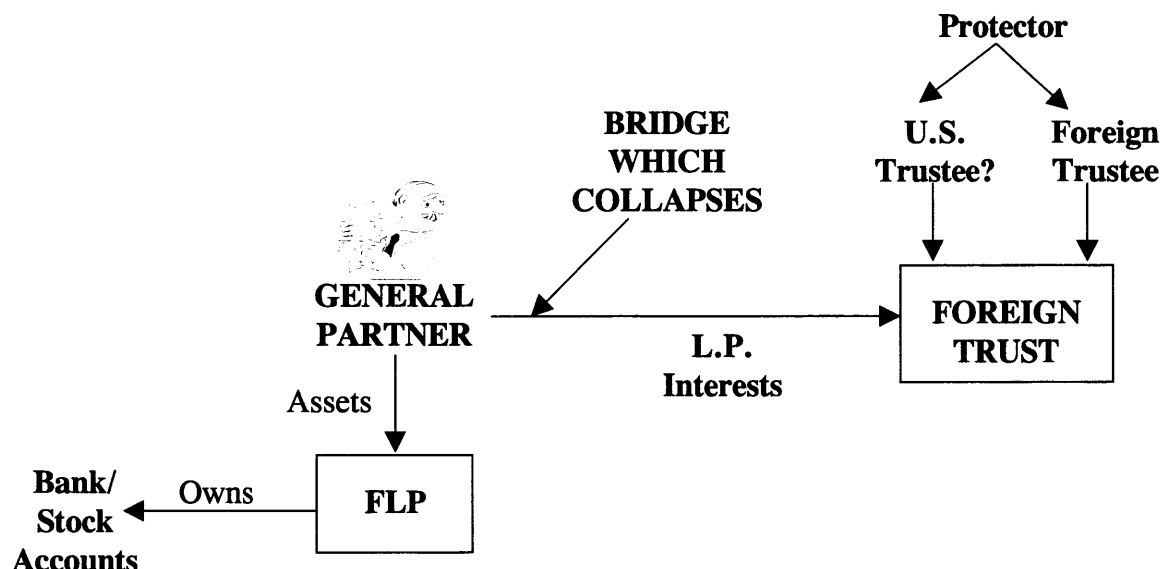
- Mr. and Mrs. Doe gave their children virtually their entire estate. They paid no estate or gift tax. They retained virtually 100% of the income.
- They gave their children an over \$4 million estate.
 - They paid no gift tax.
 - They will pay no estate tax.
 - They kept all of the cash flow.

TAXATION OF INCOME

For income tax purposes, all items passed from the FLP to its partners retain the same character they had for the FLP. As an example, if the FLP receives tax-exempt income, the partner's share of that income is also tax-exempt.

The partner's distributive shares of such items as income, credits, deductions and non-deductible FLP expenses are identified on Schedule K-1 of Form 1065. The partners receive individual copies of Schedule K-1 to allow them to prepare their individual Form 1040 forms.

FOREIGN TRUSTS AND FLP: COLLAPSING BRIDGE TECHNIQUE



In the case of the FLP-asset protection trust (APT) “collapsing bridge technique,” most of the client’s assets are placed into one or more U.S. FLPs in which the APT owns a controlling interest, or has at the least the power to wind up the FLP at any time. The grant of the power must be balanced against the loss of marketability/minority discounts. This technique is very powerful asset protection; however, it does not normally provide estate planning discounts.

If you do not want your assets to leave the U.S. until the last possible moment (perhaps because you are not comfortable with offshore trustees or banks), you can continue to have your assets in your U.S. FLP, and thereby, as the general partner, invest and reinvest the same personally, until litigation occurs.

If litigation occurs, the FLP is wound up by the APT and the assets of the FLP are distributed tax free to the APT. This does not change the tax reporting and payment position of the Settlor of the APT or of the General Partner or the FLP (who are usually one and the same person), but the assets are now transferred outside the jurisdiction of the U.S. courts so forcing the creditor concerned to take action in the foreign jurisdiction of the APT to recover those assets. In other words, the bridge between the U.S. and the foreign country of the APT has collapsed, leaving the creditor with the task of trying to seize any assets of the alleged errant debtor all over again and at great expense.

The client in the meantime has no assets in the U.S. (except such as enable him or her to earn a living and continue to pay leaving expenses and taxes to the IRS), and is unable to force the APT to return the assets to the jurisdiction of the U.S. courts (the anti-duress clause of the APT may come into play).

This technique is likely to be met by an angry creditor claiming every act of fraudulent transfer that his or her lawyer can identify, and therefore we advise that whilst this collapsing bridge technique is one way of defeating a creditor's unjustified claims or unrealistic judgments, it is always best to have moved assets offshore into the APT (either by direct personal transfer or from the FLP) long before any litigation arises.

There is nothing better than to have already placed assets into the APT long before litigation arises, and to be used to the activities of the APT and how it operates before litigation arises, rather than to learn in a very short time what happens if things go wrong in the U.S. As usual, forward planning is most important and a long history of offshore activities can only serve to support your defense that no fraudulent transfer is or was involved using the APT or in transferring assets to the same. In this sense it is best to have the FLP make regular cash or similar distributions to the APT before any litigation occurs.

Some of the reasons for an APT are:

1. More favorable laws than U.S.
 - a. Fraudulent conveyances
 - b. Retained control and benefit
 - c. Flexibility and options
2. Psychological barriers to lawsuit
3. Costs of pursuing litigation overseas
4. Predator's uncertainty of prevailing
5. Increased time factor

When this technique is utilized the FLP agreement must be changed from its standard drafting as follows. Normally you would make FLP termination as difficult as your state statute permits. For instance in California we would say:

The Partnership may be terminated and dissolved at any time in accordance with Act §15681(b) by written consent of ALL GENERAL PARTNERS AND A MAJORITY IN INTEREST OF THE LIMITED PARTNERS.

For collapsing bridge purposes, since the APT owns (usually) 95% or more of the limited partnership interest, this clause should read:

The Partnership may be terminated and dissolved at any time by written consent of A MAJORITY IN INTEREST OF THE LIMITED PARTNERS.

In late 1997, Form 3520 was completely revised (and significantly expanded) and Form 3520-A was retired. Form 3520 must be filed every year that an APT exists. If you wish a copy of this form and its instructions you may call my Fax On Demand system at (818) 784-4329, and request document 2900. If you wish the instructions for the form, request document 2901.

Caution: Foreign trusts were affected by 1996 legislation, including such provisions as: any U.S. person (other than specified tax-exempt organizations) that receives purported gifts or bequests from foreign sources totaling more than \$10,000 during the year is required to report the gift to the Treasury Department. Monetary penalties and other sanctions apply to a failure to comply with the reporting requirement. Under prior law, there was no requirement to report gifts or bequests from foreign sources.

CHAPTER 6

VALUATION ISSUES

Aside from the tax issues explored below, transfer of real property to an FLP could cause the triggering of a due-on-sale provision and incur transfer tax.¹ Transfer of personal property could trigger sales tax.

VALUATION AND DISCOUNTS

DISCOUNTS

By using an FLP, you are able to transfer in excess of your lifetime exemption and you are able to make individual gifts in excess of \$10,000 yearly without gift taxation. You are also able to minimize the value of your estate on death. This is a major benefit of operating in the FLP format – the value of the FLP's assets are reduced both for gift and estate tax purposes and for creditor attachment (and negotiating the release of the creditor's attachment) purposes.

VALUING A PARTNERSHIP

In valuing a partnership interest, you first obtain an appraisal of the underlying asset and then for the entire FLP. Then you obtain an appraisal for the individual FLP interests discounted for lack of marketability, minority status, potential that the purchaser will not be substituted into the FLP, and other restrictions imposed on the interests by the FLP agreement.

Liquidated or Going-Concern Value

It is important to note that if the interests being appraised have the power to liquidate the FLP (then subject to any fiduciary duty the holder may have to other partners not to liquidate the FLP – which may be quite significant), the FLP will be appraised at a liquidated value (the value of its assets) rather than a going-concern value subject to the restrictions previously discussed.

¹ In California, Proposition 13 could be triggered.

Attribution

It should be noted that there are no “attribution of ownership” rules that would attribute to Partner #1 the interests held by other family members (Partner #2) for purpose of valuing the interests of Partner #1, as if Partner #1 was entitled to exercise the privileges of Partner #1 and #2 combined. This is true even if husband and wife own interests as community property – if husband owns 50% and wife owns 50%, neither owns a sufficient percentage to have control.² However, other rules of law may cause unintended attribution.

For instance, property transferred from a living trust, if not first transferred back into the grantor's name, can be drawn back into the grantor's estate if the grantor dies within three years of making the gift.³

This could have disastrous consequences on the manner in which the discount is calculated. The subject of transfers of interests and powers in trusts should be well understood and researched before advising any transfers.

Attorney-Client Privilege

In regard to the appraisal, note that the work-product of the appraiser if the appraiser is retained by an attorney (and not by the client) may fall within the attorney-client privilege and therefore not be obtainable by the IRS.

Fraudulent Conveyances

Appraisals also support “reasonable equivalent value” for purposes of avoiding fraudulent conveyances to family members who purchase the interest at a significantly discounted value to avoid its falling into creditor's hands. It should be noted that because the sale is to insiders, irrespective of the appraisal, it will be suspect. The insiders may want to bid for the interests from a public auction or bankruptcy sale where the price will most likely be lower still, and the nature of the sale will cause the price to be less suspect.

² See Rev. Rul. 93-12.

³ PLR 8609005.

CONTROL PREMIUMS

Interests that possess voting control may be valued at a premium. The premium is not present in a debtor-creditor situation because the debtor as an assignee does not benefit by obtaining the right to vote. The premium is present for estate and gift purposes, though it may be offset by the fiduciary duty the majority owe to the minority holders.

CASE LAW AND DISCOUNT FACTORS

Watts

In *Estate of Watts*⁴ the Tax Court allowed a discount for the value of an interest in a family partnership for lack of marketability, minority interest and restrictions in the partnership agreement. The decedent in *Watts* had owned a 15% interest.

- The partnership agreement provided that partnership interests could not be transferred without the consent of all the partners and also that the partnership would not terminate upon the death of a partner.

Harwood

The Court noted that in *Harwood* it had allowed discounts to reflect the fact that an interest was:

- Minority interest,
 - Not publicly traded, and
 - Subject to restrictions on transferability⁵
- Finding that all three of these factors existed, the court applied a 35% discount.

Loss of Control

When assets are placed in an FLP by persons who become limited partners, they lose control over the asset. Absence of control results in a valuation discount, as do the following:

⁴ TCM 1985-595.

⁵ 82 TC 239 (1984).

- **Distributions**

Because the general partners control distributions, limited partners could be placed in the position of receiving taxable income without the cash to pay the tax.

- **Minority Discounts**

A minority owner cannot control management, cause the FLP to make cash distributions, or determine compensation levels for FLP employees.⁶

- **Transfer, Assignability, and Marketability Discounts**

There may be significant transfer and assignability discounts. Marketability discounts may apply even where there are no restrictions in the partnership agreement.

- A person selling an FLP interest will have a harder time doing so than he or she would be selling stock on an exchange. A binding buy-sell agreement could negate this.

- **IRC §754 Discount**

Because of the difference to a partner between inside and outside basis, a partnership which restricts an IRC §754 election may create a further discount for a partner who would benefit by such an election.

- **Liquidation**

The inability to liquidate the partnership could cause a discount.

- **General Partner Discount**

A general partner, because he or she is liable for partnership debts and liabilities, could get a discount.

- **Undivided Interest Discount**

A transfer of an undivided fractional interest in property may be entitled to a discount.⁷

⁶ IRC §2704 creates a control premium upon the death of a general partner.

⁷ See *Propstra v. United States*, 680 F. 2d 1248, 1251-53 (9th Cir. 1982).

UNITY OF INTEREST

For a number of years, the IRS argued no discounts for minority interest should apply where family members own all of the interests. This theory has been rejected in numerous cases: *Estate of Andrews v. Commissioner*, 79 T.C. 938 (1979); *Estate of Bright v. U.S.*, 81-2 U.S.T.C. (CCH) 13436 (5th Cir. 1981); *Minahan*, 88 T.C. 492 (1988) (taxpayer awarded attorney's fees because the IRS persisted in the face of the *Estate of Andrews*). The IRS ultimately backed off this theory in Rev. Rul. 93-12, 1993-1 C.B. 202. The IRS has not given up entirely. The IRS has argued a unity-of-interest theory as an alternative to family attribution. This theory has been rejected in a 1993 Tax Court Memorandum Decision, *Lefrak v. Lefrak*, T.C.M. 1993-526. If a revenue agent raises a family attribution or unity-of-interests theory, the position should be vigorously opposed. Several practitioners have indicated that the IRS will abandon these theories at the appellate or tax court level.

ONE CLASS OF INTERESTS

An FLP should generally be structured with one class of partnership interests. Such a structure will avoid the restrictive valuation rules of §2701 (Private Letter Ruling 9415007). Reg. §25.2701-1(c)(3) provides that non-lapsing differences in management and liability (such as general partner/limited partner distinctions) are not considered multiple classes of interests for purposes of §2701. The Regulations also permit compliance with the allocation rules under §704. Certain properly structured guaranteed payments will also not be classified as a second class of interests [Reg. §25.2701-2(b)(4)(iii)].

CHAPTER 14⁸

An estate freeze is a method in which future appreciation in the value of an asset is limited or "frozen," reducing future transfer taxes. Chapter 14 of the IRC was enacted to control this practice thus increasing the amount of the gift tax.

The anti-lapse rules apply to determine whether a gift has been made and the value of the gift when family members control⁹ the entity both before and after the lapse.¹⁰ Contractual restrictions rules do not apply unless the control exists before the transfer.¹¹

⁸ IRC §§2701-2704.

⁹ Control means a general partnership interest in an FLP account.

¹⁰ IRC §§2704(a)(1) and (b)(1).

¹¹ IRC §2704(b)(1)(B).

Anti-Freeze Rules

There are three anti-freeze rules:

1. Powers that lapse and contractual restrictions on the power to liquidate, both of which reduce the value of an interest, are disregarded in arriving at value,
2. Buy-sell and other arrangements pursuant to which property may be purchased for less than fair market value are ignored in arriving at value, and
3. Traditional freezes wherein parents receive interests that do not participate in future appreciation are ignored for valuation purposes.

These rules were a response to cases wherein contractual restrictions against liquidation were placed on the holder of an interest that were more severe than state law. These restrictions would lapse upon death. This resulted in the entity valuation being based upon the considerably lower "going-concern" value (rather than the higher "liquidated" value).¹²

Lapsing Rights

Powers that lapse are rights that are terminated upon the occurrence of a particular event. For instance, pursuant to state law a partner's voting rights cease when that partner's interests are charged or foreclosed on by a creditor. This is beneficial from an asset protection point of view. State law makes an FLP interest worth less to a creditor than to the debtor-partner. However, under certain other circumstances, the lapse of voting power could trigger a taxable gift.

In order to avoid triggering these rules, neither the general nor the limited partners alone should be given the power to cause partnership liquidation and the partnership should restrict liquidation to the fullest extent permitted by local law. If the general partner alone has the power to liquidate, then that power will be taken into consideration at death and the entity valued at its liquidated value rather than its usually more advantageous going-concern value.

It is critical to recognize that the transfer of an interest which possesses voting rights which remain in existence is *not* the lapse of voting or liquidation rights with respect to those interests or interests senior to those interests.¹³ A transfer of limited partnership interests that eliminates the transferor partner's right to liquidate the partnership is not subject to these rules.

¹² See, for example, *Estate of Harrison v. Comm'r*, TC Memo. 1987-88.

¹³ Treas. Reg. §25.2704-1(c)(1).

A lapse does not occur with respect to the retained limited interests because the voting rights of the transferred interests do not lapse, and a lapse does not occur for the retained general interests because they are senior (or in any event not junior) to the transferred interests.

The question that is not answered by the Code or Regulations in any satisfactory fashion is what occurs if all of a transferor's general partner interests are transferred but his or her limited interests are maintained. The regulations under §2701 are unclear whether in a partnership context a general partner interest is a senior security vis-a-vis a limited partner interest.¹⁴

Contractual Restrictions

For example, under §15681(b) RLPA, an FLP can only be liquidated if all the general partners and 50% of the outstanding limited partners agree. Thus, a person other than the transferor or the decedent would have to either own over 50% of the limited, or a general, partner interest for the FLP to be valued at a going-concern value. Attribution does not affect family members. Therefore, if two members of the family own general partner interests, the partnership will be valued on a going-concern basis.¹⁵ However, if husband and wife own the general partner interests, and upon death of the first spouse, the surviving spouse receives all of the first spouse's general interests, upon the death of the second spouse the partnership may well be valued on a liquidated basis. Therefore, the deceased spouse's interest should be downstreamed to a child, or a third general partner should have been admitted, or the children should own over 50% of the limited interests. (Watch out if over 50% is transferred in one year.)

In addition, even if this is not the case, the state law restriction concerning the fiduciary duty a majority owner owes a minority owner may still be a state law restriction which would prevent the evaluation being done on a liquidated value basis.

Section 2701

Section 2701 does not apply to an FLP because of its exception for the transfer of interests that are proportionately the same without regard to "nonlapsing difference with respect to management and limitations on liability."¹⁶

Although many FLP's contain provisions that cause a general partner interest to convert to a limited interest upon events such as transfer, bankruptcy, and death, and even though these cause rights to lapse, §2701(a)(2) provides that any differences in management rights or limited liability that "lapses

¹⁴ Treas. Reg. §25.2701-3(a)(2).

¹⁵ Cal. Corp. Code §15681(b)(West 1991).

¹⁶ IRC §2701(a)(2).

by reason of any Federal or State law shall be treated as a nonlapsing difference for purposes of subparagraph (C).”

So long as the partnership agreement is no broader than applicable local law (e.g., broader would be lapses if the general divorced), §2701 will not apply.

Section 2703 — Buy-Sell Agreements

Buy-sell agreements are used to regulate the transfer of ownership in a family business and to provide a market for family members' business interests. Although the buy-sell agreement may be effective for debtor-creditor purposes, §2703 may disregard certain buy-sell valuation discounts if certain rules are not followed. Section 2703 does not apply to a buy-sell if the following three requirements are met:

- The right or restriction is a bona fide business arrangement,
- It is not a device to transfer property within the family for less than full and adequate consideration, and
- The terms and conditions are those found in arm's-length arrangements.

All conditions are deemed met if more than 50% of the property to be transferred is held by transferors who are not members of the transferee's family.

The rules apply to a partnership agreement, articles of incorporation, corporate bylaws, shareholder's agreement or any other agreement.¹⁷ The rules also apply to a favorable lease which would be disregarded in valuing property for transfer tax purposes.¹⁸

If the restrictions are disregarded for valuation purposes, the interest transferred is more valuable than planned for. These rules can cause a large gift tax to be due presently and must be reviewed carefully when drafting family buy-sell arrangements.

Section 2704

This section treats the lapse of a voting or liquidation right as a gift. The value of the gift is the value of all interests held by the individual before the lapse less the value of all the interests held by the individual after the lapse.

¹⁷ See Treas. Reg. §25.2703-1(a)(3) (1992).

¹⁸ IRC §2703(a).

Regulations under §2704 provide that a general partner's rights to participate in partnership management constitutes a voting right for purposes of §2704.¹⁹ Thus, a conversion at any time (including death) of a general to a limited interest will trigger a gift. When lapses are caused by controlling state law, §2704 does not come into play.

Traditional Freezes

In a traditional freeze, the older generation keeps a security structured to produce cash flow but no appreciation. The younger generation is given interests that capture all future appreciation. This kind of configuration can still be undertaken provided the senior interests retain the rights to distributions called "qualified payments." Failure to properly structure the senior interests will result in an immediate gift tax being due.

Problems associated with traditional freezes can be avoided if the entity issues only one class of interests or two where the only distinction is in voting rights, provided the voting rights don't lapse. Therefore, an FLP is generally exempt from these rules.²⁰ A partner can transfer limited interests and retain general interests unless the transferor has the power to alter the liability of the transferee of the transferred property.²¹

Extreme care must be used before an FLP is structured with two classes of interests.

ESTATE TAXES

Gifts by a general partner of FLP interests, while retaining voting control of the FLP, should not constitute a retained power under §2036(b) that would trigger inclusion of the interest transferred in the transferor's estate under §2036 or §2038 because a general partner's control over the partnership and partnership distributions is subject to the general partner's *fiduciary* obligation to the limited partners.²²

A general partner is not required to include in his or her estate the fair market value of those assets held by limited partners in a partnership controlled by the general partner. As a result, the assets of the partnership will be excluded from the parent's or general partner's estate for estate tax purposes, except that percentage of the partnership assets owned by the general partner. This is because the

¹⁹ Treas. Reg. §25.2704-2(iv) (1992).

²⁰ IRC §§2701(a)(2)(B) and (a)(2)(C).

²¹ IRC §2701(a)(2).

²² See also *Harrison v. Comm'r*, 52 T.C.M. 1306, 1309 (1987).

holder of voting control is subject to a fiduciary duty to the noncontrolling partners or minority shareholders.²³

The rule is different, however, for controlled corporations. By statute, retention of voting power by the decedent, either directly or indirectly, will cause the interest to be included in his or her estate.²⁴ The reference in §2036(b) to indirect voting power requires a special provision in a partnership agreement for controlled stock. One solution is to have a clause in the partnership agreement for the controlled stock. The clause would provide that voting power will be exercised by the partners in accordance with their proportionate ownership of the partnership, rather than solely by the general partner.

Under §754, assets of the FLP will receive a step-up in basis at the death of a partner in the same ratio that the deceased partner held limited and general partnership interests as a percentage of all interests. The step-up will be reduced by the discount applied to the partnership interest.

GIFT TAX

Gifts of general and limited partnership interests should constitute “present interests” and thereby qualify for the gift tax annual exclusion.²⁵ It should be noted that if parents put additional property into an FLP, they must on a proportionate basis receive more FLP interests and then make gifts of those interests in order to take advantage of the present interest gift exception (be sure they receive an appropriate amount of interests considering the fact that the interests are subject to “discounts”).

Or, they could make gifts of the property directly (thereby potentially losing the valuation discount) to their children and then all parties could contribute the property to the FLP (don't forget the step-transaction argument). Should the parents allow all partners to benefit by the additional contribution, they will be making a future interest gift, and will not be able to use the present interests \$10,000 exclusion.²⁶ If the contribution is made for a non-gift “business purpose,” these rules do not apply. A transfer pursuant to an asset protection plan or to consolidate assets for ease of management or ease of refinancing may all be considered business reasons.

²³ See *Skone v. Quanco Farms*, 261 Cal. App. 2d 237, 241 (1968).

²⁴ See IRC §2036(b) (a controlled corporation is one in which the decedent possessed 20 percent or more of the voting power of all the outstanding stock).

²⁵ Treas. Reg. §25.2503-3(b).

²⁶ Treas. Reg. §25.2511-1(h)(1).

Retention of Powers

Retention of certain powers over transferred interests (e.g., the property is subject to the deemed ownership rules because the decedent retained effective ownership or beneficial use or the power to effect enjoyment of the property) will render the gift incomplete, and the gift will then be included in the donor's estate for estate tax purposes.²⁷ It is crucial that leases of property from the FLP be at a fair market rental and be properly documented. Failure to do so will render the gifts in the FLP ineffective for estate tax purposes.²⁸

Retention of Income

A general partner who gifts limited interests yet retains the income from the gifted interests will find that the interests are still in his or her estate. When interests are transferred, and the general partner takes a large management fee from the partnership, the general partner may find himself or herself in that same position; the IRS will consider the fee to be a disguised payment of income from the transferred interests. Be sure that management fees as well as retention of partnership profits in the partnership (i.e., distributions are not made to partners) are documented to prevent §2036(a)(1) problems.

RECENT DEVELOPMENTS

CHECK-THE-BOX

One constraint in using an FLP to obtain valuation discounts was the need to have the entity classified as a partnership for tax purposes. Thus, transferability restrictions, which would help justify a discount, may have to be limited to avoid the corporate characteristic of free transferability of interests. The final check-the-box regulations remove any risk that such an entity might be an association. (See Chapter 2 for a discussion of these rules.)

Family limited liability companies (FLLCs) may be very popular under the final check-the-box regulations. The FLLC can be used to create valuation discounts while allowing members, and not just the limited partners, to enjoy a liability shield. Further, unlike limited partners, members of an FLLC may participate in management of the entity. The ability to participate in management may be important as children mature and a parent wants to increase the child's involvement in the business.

²⁷ IRC §§2036 to 2038.

²⁸ See IRC §2036(b) (a controlled corporation is one in which the decedent possessed 20% or more of the voting power of all the outstanding stock).

The final classification regulations may lead to changes in state LLC statutes that further enhance the value of the FLLC for estate planning purposes. Elimination of state law dissolution provisions that were designed to avoid the corporate characteristic of continuity of life may help to avoid certain aspects of the "chapter 14" valuation rules applicable to transfer tax valuations.

Partnership status of a family entity will allow for a Sec. 754 basis adjustment following the death of a family member and will avoid the IRS "swing vote" valuation argument made in TAM 9436005. Similar to a limited partnership interest, a junior family member in an FLLP may, by agreement, have very limited rights to participate in control of the entity, thereby avoiding a swing vote argument.

RECENT RULINGS

Family limited partnerships were first used mainly as asset-protection devices. Over the years, they have become more prevalent in estate planning to transfer assets at a discounted value.

In several technical advice memoranda (TAMs), the IRS has come down hard on the use of family limited partnerships as a device for saving transfer taxes. Although TAMs lack the force of law and cannot be cited as precedent, they're very clear guidelines of IRS thinking. More importantly, by highlighting specific circumstances where the taxpayer is most vulnerable, they are helpful in determining where a taxpayer may be safer.

Review of TAMs

Common Facts. All the rulings arose out of estate tax valuations. None of these addressed gifts of minority limited partnership interests during the donor's lifetime, rather they addressed interests left in the donor's estate.

Second, in all cases, the FLPs had been set up within two months of the donor's death. None of the partnerships had any meaningful business activity between their formation and the donor's death.

Third, all of the donors had been dying, either because of diagnosed illnesses, extreme old age, or both. None of the rulings addressed the situation where a healthy married couple in their 50's set up an FLP with their children with the clear expectation of operating it as a business for many years.

TAM Details

TAM 9719006

This TAM involved two trusts. One was a marital trust and the other was a revocable “living” trust that the decedent had set up during her lifetime, both of which would be fully includable in her estate. Both were funded with marketable securities and real estate.

Two days before her death, after having been removed from life support, the family limited partnership was formed. It was set up by the trustee of the trusts, her son, with the beneficiaries of the trusts, her son and daughter. Nothing in the ruling indicates that the mother was even aware of the transactions.

Since the partnership was formed mostly with assets of the trusts, the trusts initially owned 98 percent of the partnership. Immediately after the formation of the partnership, the son and the daughter each bought 30-percent interests from the marital trust, primarily with 30-year notes, thereby leaving the estate with a minority interest in the partnership. The result was a claimed discount of 48 percent (in this case over \$1 million) created over a two-day period.

The ruling stated that the discount should be disregarded for two reasons:

- First, since the partnership transactions benefited the remainder beneficiaries of the trusts, the partnership transfers should be regarded as a single transaction with the death transfers.
- Second, there is the issue of §2703(a)(2). This section states that the value of any property shall be determined without regard to “to any restriction on the right to sell or use such property.” The TAM uses this to cut to the heart of the valuation discount. After all, if a partner had an unrestricted right to sell his or her partnership interest, then two rationales for minority discount (lack of control, lack of marketability) wouldn’t apply. The valuation result is the same where there is a sale or use restriction imposed by the partnership agreement or inherent in the partnership structure, since §2703(a)(2) mandates ignoring those restrictions. TAM 9719006 continues:

Section 2703(b) provides that §2703(a) shall not apply to any option, agreement, right, or restriction which meets each of the following requirements:

- (1) It is a bona fide business arrangement;
- (2) It is not a device to transfer such property to members of the decedent’s family for less than full and adequate consideration in money or money’s worth;
- (3) Its terms are comparable to similar arrangements entered into by persons in an arm’s length transaction.

Section 25.2703-1(a)(1) provides, in part, that the value of any property is determined without regard to any right or restriction relating to the property. Section 25.2703-1(a)(2) provides that the terms right or restriction include "any" restriction on the right to sell or use the property. Section 25.2703-1(a)(3) provides that a right or restriction may be contained in a partnership agreement. A right or restriction may be implicit in the capital structure of an entity.

Regarding the exceptions to the application of sec. 2703(a) contained in sec. 2703(b), sec. 25.2703-1(b)(2) provides that each of the three requirements must be independently satisfied for a right or restriction to meet the exception. Thus, for example, the mere showing that a right or restriction is a bona fide business arrangement is not sufficient to establish that the right or restriction is not a device to transfer property for less than full and adequate consideration.

Thus, §2703(a)(2) applies, and the exception contained in §2703(b) does not. Read literally, this could spell the end of all family partnerships unless the partnership agreement meets the three-part test of §2703(b).

TAM 9723009

This TAM was similar to TAM 9719006 in that the FLP was formed by the decedent's son, under a durable power of attorney, and there was similarly no indication that the decedent was even aware of the arrangement.

In this ruling, the family did not attempt to reduce the decedent's share to a minority interest. Instead, there was a partnership agreement with restrictions on, among other things, the decedent's ability to liquidate her interest. On this basis, the estate sought a 46-percent discount of the value of her interest in the partnership.

In disallowing the discount, the IRS cited the same two theories as those in TAM 9719006, and added a third, that IRC §2704 applied to the transaction. The ruling stated:

Section 2704(b)(1) provides, in part, that in the case of a transfer of an interest in a partnership to a member of the transferor's family, if the transferor and members of the transferor's family hold, immediately before the transfer, control of the entity, then any "applicable restriction" shall be disregarded in determining the value of the transferred interest.

Section 2704(b)(2) provides in part that the term "applicable restriction" means any restriction:

(A) which effectively limits the ability of the partnership to liquidate, and

(B) with respect to which the transferor or any member of the transferor's family, either alone or collectively, has the right after such transfer to remove, in whole or in part, the restriction.

Section 25.2704-2(b) provides, in part, that 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 state law generally applicable to the entity in the absence of the restriction. A restriction is an applicable restriction only to the extent that the transferor (or the transferor's estate) and any members of the transferor's family can revoke the restriction immediately after the transfer. An option, right to use property, or agreement that is subject to sec. 2703 is not an applicable restriction.

Section 25.2704-2(c) provides, in part, that if an applicable restriction is disregarded, the transferred interest is valued as if the restriction does not exist and as if the rights of the transferor are determined under state law that would apply but for the restrictions.

Under applicable state law, N.Y. Partnership Law, sec. 121-603 (*Mckinneys* supp. 1997), if a partnership agreement does not specify the time or events upon the happening of which a limited partner may withdraw, then the limited partner may, unless prohibited by the partnership agreement, withdraw upon not less than six months notice to the partnership. As noted above, under Article 1.6 of the partnership agreement, the Partnership is to terminate on December 31, 2029, and under Article 2.12, a limited partner is prohibited from withdrawing from the partnership prior to dissolution or termination. Under Article 9.1(a), dissolution prior to the termination date requires the vote of 65% of the limited partners and the unanimous consent of the general partner. Article 11.11 provides that the agreement may be amended only by the unanimous approval of all the partners.

In the instant case, under the terms of the partnership agreement, the Decedent could not withdraw from the partnership and liquidate her interest. However, under applicable state law, in the absence of the prohibition in the partnership agreement, the decedent could have withdrawn and liquidated on six months notice. The prohibition on Decedent's right to liquidate her interest contained in the partnership agreement is more restrictive than state law, and thus, is an applicable restriction under sec. 2704(b)(2)(A). See, sec. 25.2704-2(d), Example 5, illustrating that a restriction on a right to put preferred stock to the corporation is a limitation on the ability to liquidate the entity (in whole or in part) and is disregarded in valuing the preferred stock for transfer tax purposes.

Further, we believe the requirements of sec. 2704(b)(2)(B) are satisfied. That is, the restriction could be removed by a unanimous vote of all the partners (Decedent, Son and Corporation)....

Accordingly, the provisions of the partnership agreement prohibiting the Decedent from liquidating her interest constituted an applicable restriction under sec. 2704(b) and should be disregarded in valuing the Decedent's partnership interest.

In this case, there was an unidentified minority owner who was not a member of the decedent's family. But this person was clearly inserted to create the appearance of a business arrangement, and, for the reasons given, was ignored in the tax analysis.

TAM 9730004

In this memorandum, the facts and conclusions were similar to those in TAM 9723009. In that ruling the documentation contained additional restrictions and recitations of business purpose, all of which were ignored under the general principles stated. There, the terminally ill decedent funded a FLP with a farm and left a written explanation of the nontax reasons for creating the entity. A corporation was also formed with the decedent retaining 99% of its stock, which was left to a nonfamily member. The corporation was the sole general partner of the FLP, with the decedent as the sole general partner. Soon after, the decedent, who died 54 days after forming the FLP, gave 1 percent limited partnership interests both to his son and his daughter-in-law, as well as a 3% limited partnership interest to a trust for the benefit of a granddaughter and a grandson. A 40% discount was disallowed. The timing of the formation of the FLP and the decedent's death was evidence that the primary reason for the FLP was to lower the transfer tax liability.

TAM 9735003

This memorandum restates some of the principles in the other rulings, and adds that a check written to make a contribution to a family limited partnership that has not cleared at the time of the decedent's death will be included in the estate as cash on hand.

In other rulings involving "deathbed" FLPs, including TAM 9723009, the IRS objected that the recipients of the decedent's property, his children, were also active in forming the FLP, either under a power of attorney or as trustee of the revocable trusts set up for the parent. The IRS viewed this activity as a disguised testamentary transfer and that the FLP should be disregarded for tax purposes.

CONCLUSION

Family limited partnerships are certainly not dead. However, the rulings do demonstrate that there are circumstances that are more likely to favor the successful use of the family limited partnership than others.

CHAPTER 7

TAX OVERVIEW AND STRATEGIES

INTRODUCTION

Consider the following tax points prior to forming an FLP:

- The manner in which FLP income and distributions are taxed.
- How FLP losses are taxed.
- Tax ramifications upon FLP formation.
- Tax treatment of FLP interests.
- How transfers of FLP interests by partners are taxed.
- Taxation of FLP liquidations.
- Consequences of death or retirement of general and limited partners.

This section is intended to be an overview only. It is intended to highlight some of the more common tax holdings and problems.

In brief, an FLP is taxed as a tax conduit and files only an information return that reports the items of partnership income and loss and apportions each item between its partners. Each partner receives a partnership K-1.¹ The IRS then taxes each of the partners on their share of gain or loss without regard to whether the FLP has actually distributed cash or property to the partners.²

¹ IRC §6031.

² IRC §702(a).

TAX OVERVIEW

CONTRIBUTIONS

Property

Generally, a contribution of money to a partnership in return for an interest does not cause a recognition of gain or loss for the contributing partner or the other partners or the partnership.

Services

The receipt of a partnership interest for services constitutes taxable income to the service partner and a deduction to the partnership. The receipt of a profits (not a capital) interest, to the extent it can be valued, is taxable, to the extent it cannot be valued, it probably is not taxed.³

PARTNER'S BASIS

Encumbered Property and Unrealized Receivables (Accounts Receivables and Depreciation Recapture Items)

The contributing partner is treated as reducing his or her share of the encumbrance from 100% to his or her share of the partnership liability. This reduction is treated the same as a cash distribution and, if it exceeds the outside basis of the contributing partner, gain will be recognized. That is to say, if the property contributed to a partnership is subject to an encumbrance that is greater than the adjusted basis of the property to the contributing partner, it is possible that the contributing partner could recognize a taxable gain. The taxable event can be avoided if the transferor remains liable for the encumbrance.

Example of §752

- Assume A, B and C each contribute \$100,000 to the ABC Partnership.
- A contributes real property with an FMV of \$250,000 subject to a mortgage of \$150,000 (net value = \$100,000) and it has an adjusted basis of \$75,000.
- Assume B and C each contributes \$100,000 cash.

³ See *Diamond* 56 T.C. 530, 544-546 (1971) and its progeny.

- Pursuant to §752, the beginning basis for A's partnership interest is \$75,000, §752 increases his outside basis by his share of the assumed mortgage by \$50,000.

Result:

- He thus has a total basis of \$125,000. His basis is also reduced by the amount of the mortgage he is relieved — \$150,000.
- Thus he is taxable on \$25,000.

Recourse/Nonrecourse

Whether the debt is recourse or nonrecourse is important. Nonrecourse liabilities are allocated to all partners, recourse liabilities are allocated only to the partner(s) responsible for the debt.

Property Partially in an FLP

If a party transfers 90% of a property into an FLP and maintains a 10% personal interest, he or she can deduct 100% of all interest and taxes attributable to the property.⁴ If this technique is used, the parties should elect out of partnership tax treatment.⁵

Transfer of FLP Interest to a GRAT

A deemed cash distribution under §752(b) does not occur if there is no decrease in the partner's share of partnership liabilities. The transfer of FLP interests to a GRAT does not result in the grantor being relieved of partnership liabilities for purposes of §752(b) because the grantor of the GRAT will be considered the owner of the FLP interest and, therefore, will not be relieved of liabilities upon the gratuitous transfer.⁶

⁴ Rev. Rul. 71-268, 1971-CB 58, and see Rev. Rul. 75-374, 1975-2 CB 261, for the concern that this may simply be a way around the rules concerning special allocations.

⁵ See Treas. Reg. §1.761-2.

⁶ See Treas. Reg. §1.1001-2(c) (1992) (Example 5).

EFFECT ON PARTNER OF PASS-THROUGH OF INCOME AND LOSS

Basis Limitation

A partner's distributive share of loss can be deducted by the partner only up to the amount of that partner's outside basis at the end of the year in which the loss occurred.

"At-Risk" Rules

Even if allowable because there is sufficient basis, the loss incurred in an activity may only be deducted by the partner to the extent that partner is "at risk" in that activity.

Passive Loss Rules

Section 469 applies additional restrictions on the deductions of passive losses. These are losses derived from passive activities, i.e., a trade or business in which the taxpayer does not materially participate, as well as any rental activity. As to rental activities, there is a \$25,000 exemption. To qualify for the exemption, the taxpayer must materially participate in the partnership, this usually means 500 hours per year, or 100 hours per year and no other partner participated more. The exemption is phased out between \$100,000 and \$150,000 of adjusted gross income.

Losses from an FLP are passive to a limited partner,⁷ and active to a general or a person holding both limited and general interests. Therefore, persons who are solely limited partners may not be able to deduct their passive losses.

Self-Employment Tax

Self-employment tax is applicable to a general partner distribution if the FLP is engaged in a trade or business.⁸ The tax is not imposed on a partner if the partnership is not engaged in a trade or business.⁹ The distributive share of a limited partner is not subject to self-employment tax.¹⁰

⁷ IRC §469(h)(2).

⁸ IRC §1402(a).

⁹ IRC §162.

¹⁰ IRC §1402(a)(13).

PARTNERSHIP-PARTNER TRANSACTIONS

Guaranteed Payments

If payments to a partner are determined without reference to partnership income, the payments will be considered as made to one who is not a partner, and subject to §162, deductible to the partnership and taxable to the recipient, even if the amount paid is more than the FLP's income.¹¹ Since the payment is not an "applicable retained interest," it will not trigger the valuation rules of Chapter 14.

Section 704(e) Considerations

Section 704(e) specifically applies to FLPs and sets forth criteria to prevent income shifting among family members.

Who Is a Partner?

To be considered a partner for income tax purposes, a person must have a capital interest and not merely a profits interest. The capital interest can be obtained via purchase or gift.¹²

What Produces the Income?

If personal services constitute the material income-producing factor of the FLP, or if the donor partner is not adequately compensated for services rendered, the transfer of the FLP interest will be deemed to be an attempt to shift income and either the partnership or the donee will not be recognized.

In determining how much a general partner should properly be paid, an arm's-length amount plus an amount for the risk a general partner takes is appropriate.¹³ If capital is a material income-producing factor, the partner is recognized for income tax purposes irrespective if the interest was obtained by gift or purchase, and the assignment of income is allowed. The §704 rules constitute a safe harbor for assigning income.

¹¹ IRC §707(c).

¹² Treas. Reg. §1.704-1(e)(1)(ii).

¹³ Treas. Reg. §1.704-1(e)(3)(ii)(c).

Transfer Must Occur

The transfer under §704(e) must not be a sham. The transfer of the interest must be complete. The transferee must exercise dominion and control over the interest transferred.¹⁴

If the donor retains too much control, the allocation of income will not be recognized; for instance, retaining income in the partnership beyond the reasonable needs of the business (owners of interests should under “normal” situations be entitled to the income attributable to their interest).¹⁵

Interests in Trust

If the donor retains too much control by acting as a trustee, or having someone under the donor's control act as trustee of a trust holding FLP interests for the donor's children, especially if the trustee does not have the right to liquidate the FLP interest, or where the donor must consent to the transfer of the interest, the allocation of income will not be recognized.

The trustee should be independent of the donor. If the trustee is not independent, then the trustee should have fiduciary responsibilities placed on him or her on behalf of the donor; the trustee should always act primarily on behalf of the trust beneficiary and not the donor, and the trust should be treated by the FLP as a partner, not a controlled entity.

The grantor must also avoid the grantor trust rules, i.e., the grantor must not retain control over the trust. Cases have recognized that if the grantor trust rules are satisfied, even if the grantor is both the trustee of the trust and the general partner of the FLP, the trust may be recognized as a partner in the FLP.¹⁶

It should be noted that the use of FLP income for the child's support will be considered used for the parent's benefit.¹⁷

¹⁴ Treas. Reg. §1.704-1(e)(1)(ii) (1992).

¹⁵ Treas. Reg. §1.704-1(e)(2)(v).

¹⁶ Such as *Bateman v. United States*, 490 F. 2d 549, 553 (9th Cir. 1973).

¹⁷ Treas. Reg. 1.704-1(e)(2)(vii)(1992).

Summary of Factors

In *Kuney v. Frank*¹⁸ the court relied on three factors to show whether the interest was transferred:

- Whether rent was paid for the use of the FLP's property,
- Whether FLP income was retained or paid out, and
- Whether FLP assets were used by the donor to obtain credit.

However, since a general partner in an FLP generally has control over distributions, and since many FLP's are set up to retain income and grow family assets, in an FLP context, retention of income is not considered a serious element of not transferring of an interest.

In *Joseph A. Garcia v. Comm'r*, the court approved an FLP agreement wherein the partners could not demand or receive money from the FLP prior to its termination because the court believed this to be consistent with the goals of a small family business having adequate working capital.¹⁹ However, it should be noted that in the FLP context it is necessary to treat the FLP separate and distinct from the family members — i.e., separate phone, address, and letterhead are important.

GIFTS — INCOME TAX CONSEQUENCES

A reduction in the partner's liabilities associated with the gift will be treated as a cash distribution to the donor-partner, and if the amount of the donor-partner's share of liability reduction exceeded the outside basis of his or her interest, taxable gain would result.²⁰ It should be noted that the use of a GRAT (a donor trust) will avoid this constructive distribution rule.

TRANSFER OF PARTNERSHIP INTERESTS

An FLP terminates for tax purposes if there is a sale or exchange of 50% or more of its total interests.²¹ Gifts, bequests and inheritances and contributions in exchange for partnership interests are not sales or exchanges under these rules.

¹⁸ 308 F. 2d 719 (9th Cir. 1962).

¹⁹ TC Memo. 1984-340 (1984).

²⁰ IRC §731(a)(1).

²¹ IRC §708(b)(1)(B).

A tax planning opportunity arises when a partner dies and the decedent's partnership interest passes to a family member. The issue is whether to make a Sec. 754 election after a surviving spouse inherits the decedent spouse's partnership interest. Subchapter K provides a tax advantage when a successor to the decedent's partnership interest receives a basis step-up to fair market value under Sec. 1014(a). Under the Sec. 754 election, the successor partner can raise his or her share of the basis of partnership assets (so-called "inside basis") by the difference between the stepped up basis of his or her partnership interest ("outside basis") and the partnership's lesser basis in its individual assets. Note, however, because of 1997 tax law changes to the basis allocation rules on liquidation of a partnership interest may make liquidations a more preferable course of action.

PROPERTY TAX ISSUES

The transfer of real property raises the issues of triggering "due on sale" mortgage clauses, transfer taxes and property insurance issues.²²

STRATEGIES

BASIC PERSONAL PROTECTION

Facts

The Brown estate is worth \$1,600,000 (not considering their home valued at \$400,000 with a \$200,000 mortgage — \$200,000 equity) and the Browns would like to:

- Protect all of their assets,
- Lower their estate taxes, and
- Make sure that even if the IRS lowers the estate exemption to \$200,000, they are not adversely affected.

²² In California, Prop. 13 issues must be carefully researched.

Strategy

In addition to the above “Basic Personal Protection,” the Browns will place all of their assets (other than their home) into the FLP. They will then increase the mortgage on their home and place the withdrawn equity into the FLP. In addition, they will gift \$1,200,000 worth of limited partnership interests to their children.

Outcomes

FLP

The FLP protects all the assets placed into it. The FLP will use the exemption since they will give it to their children today and file a gift tax return today and utilize \$1.2 million of the exemption today. If the law changes five years from now, they should be grandfathered. In addition, to the extent that the FLP assets appreciate, the appreciation will take place outside of the Browns’ estate.

Even though they will have given 95% of the limited partnership interests to their children, as the general partners, they will maintain complete control of the partnership.

They have the option of either taking some of the FLP earnings for themselves as general partner fees, or allowing them to go 95% to the children as partnership pro rata distributions. To the extent that the children are in a lower or no tax bracket, the Brown family could save considerable current income taxes.

The \$1.8 million in assets placed into their FLP will receive significant valuation discounts. The Browns may be able to give their children the 95% FLP interest at a valuation of only \$1.2 million (and therefore gift tax free).

Children’s Trust

The parents via the trust can effect the timing of the cash that their children receive; they can also control the purposes the cash is put to and the amount of the cash each of their children eventually get.

BASIC BUSINESS PROTECTION

Form an FLP that contracts with your professional or business corporation to manage its daily business, collect its receivables, and lease equipment.

This technique will:

- Shift income to the children.
- Isolate the equipment from judgment creditors.
- Protect some portion of accounts receivable.

APPENDIX

LIMITED PARTNERSHIP CLAUSES

1. **Purpose.** Create an entity which will facilitate: (i) consolidation, (ii) preservation, (iii) enhancement of the property transferred to or owned by the Partnership.
2. **Section 704(c).** Capital will be a material income-producing factor.
3. **Successor General Partner.** If the Limited Partners have not by UNANIMOUS vote elected a new General Partner within 90 days from the withdrawal of a General Partner, the following person will serve as "Successor General Partner."
4. **Participation by Limited Partners.** Power to vote stock of a "controlled corporation."
5. **Return of Capital.** Waiver of rights to withdraw or demand the return of capital contribution except upon dissolution of the Partnership.
6. **General Partner Service Income.** All service income allocated to the General Partner whose service generates the service income. Compliance with §707(c), §707(e) and Reg. §1.707-1(c) is required.

Section 704(e)(2) limits distributions of income to a family member who acquires his or her interest by gift or purchase from another family member except and to the extent the income is derived from capital and not from personal services rendered by the family member who makes the gift or sale.
7. **Loan to Partner.** The General Partner is specifically granted the authority to loan Partnership funds to any of the Partners.
8. **Cash From Operations.** All distributions of cash available for distribution from operations shall be made when deemed appropriate by the General Partner in the General Partner's sole discretion.
9. **Cash From Sales or Refinancing.** All distributions of cash from sales or refinancing (other than in connection with the liquidation and dissolution of the Partnership) shall be made when deemed appropriate by the General Partner in the General Partner's sole discretion.
10. **Partition.** Each Partner waives the right to compel a dissolution of the Partnership or to compel a partition of the property of the Partnership.

11. **Ownership of Partnership Assets.** No Partner will have any direct ownership interest in the property of the Partnership.
12. **Restrictions on Transfer.** Neither title nor beneficial ownership of a Limited Partnership interest may be transferred or encumbered without the UNANIMOUS consent of the General Partners and consent of at least a MAJORITY in interest of the Limited Partners.
13. **Existing Relationship.** This Partnership is formed by a closely held group who know and trust one another, and who will have surrendered management rights (in exchange for limited liability in the case of a Limited Partner) or assumed management responsibility and risk (in the case of a General Partner) based upon their relationship and trust. The restrictions upon ownership and transfer are not intended as a penalty, but as a method to protect and preserve existing relationships based upon trust.
14. **Unauthorized Transfer.** The Partnership will not be required to recognize the interest of any transferee who has obtained a purported interest as the result of a transfer of ownership that is not an authorized transfer. If the ownership of a Partnership interest is in doubt, or if there is reasonable doubt about who is entitled to a distribution of the income realized from a Partnership interest, the Partnership may accumulate the income until the issue is finally determined and resolved.
15. **Tax Reporting.** Assignees shall receive Forms K-1 and report all income/loss on the income tax returns each year per Rev. Rul. 77-137, 1977-1 C.B. 178.
16. **Right to Purchase From Unauthorized Transferee.** The interest of the transferee may then be acquired by the Partnership upon the following terms and conditions:
 - a. **Appraisal.** Unless agreed otherwise, the fair market value of a Partner's interest is to be determined by written appraisal.
 - b. **Installment Payments.** The Partnership will have the option to pay its purchase money obligation in Twelve (12) equal annual installments.
17. **Right of First Refusal.** This applies if a Partner receives an offer from a non-Partner to buy all or any portion of his, her or its interest.
18. **Assignment.** Except as herein provided, a Partner shall not assign his or her Partnership interest. However, a Partner may assign his or her Partnership interest to other Partners without the consent of any other Partner.
19. **Substituted Limited Partner.** A new Limited Partner may only be admitted with the UNANIMOUS consent of the General Partners.

20. **Conditional Acceptance by Substitute General Partner.** Subject to the occurrence of an event that will invoke my service, and subject to the terms, conditions, and limitations of liability expressly provided in the Articles of Limited Partnership, I acknowledge my appointment as successor General Partner and my willingness to serve.

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