

Family Limited Partnerships

The formation of a family limited partnership has become a popular method to reduce transfer tax liability. The goal of such an arrangement is to cause investment assets and other property contributed to a partnership by a senior family member to be valued at a discount for gift and estate tax purposes by virtue of the existence of the partnership structure. This memorandum briefly explains the steps necessary to form a family limited partnership, the effect of the partnership structure on the valuation of property contributed to the partnership, and certain drawbacks accompanying the use of a family limited partnership. An example of the potential estate tax benefits resulting from the use of a family limited partnership is also presented.

Creating the Family Partnership

Family members establish a family limited partnership by entering into a written partnership agreement and by contributing assets (securities, real estate, cash, etc.) to the partnership in exchange for an interest in the partnership. The partnership agreement sets forth the relationship among the partners, including the management of the partnership, the share of profits each partner is entitled to receive, the right of a partner to transfer his or her partnership interest, and the term of the partnership. The partnership also must file a certificate of limited partnership with the state.

The partnership does not pay tax on its income but "passes through" any profits or losses to its partners. Partners must include their share of items of partnership income or loss on their individual income tax returns. In most cases, a partner's share of income or loss is determined by the partnership agreement. For a family limited partnership, items of income and loss usually are shared on a pro rata basis. Although the partnership is not a taxable entity, it must file an informational return each year with the Internal Revenue Service (the "Service"). The partnership also must prepare a separate schedule for each partner (a "K-1") which shows the amount of income or loss the partner must report on his/her individual tax return.

In order to gain the benefits of a valuation discount, the family member who desires the discount (usually a parent) receives in exchange for the assets contributed a small percentage, perhaps five percent (5%), as a general partnership interest (i.e., the interest which controls the operations of the partnership), and a large percentage, perhaps ninety percent (90%) or greater, as a limited partnership interest.¹ The parent subsequently gives or sells separate portions of his or her general partnership interest to the children, with the gift or purchase price being relatively low due to the small percentage represented by the general partnership interest so transferred. After all contributions and transfers are completed, the parent ends up owning a significant limited partnership interest, while the children hold all of the general partnership interests. From a management perspective, the parent, by owning only a limited partnership interest, has transferred control over the operation of the partnership and the management of its assets to the younger generation. It is the limited partnership entity and the lack of control on the part of the parent that form the basis for the valuation discount.

Valuation Discounts

The primary benefit of a family limited partnership results from the valuation of the deceased parent's limited partnership interest when the parent dies. Because the deceased parent has retained ownership of the limited partnership interest, this interest is included in the parent's taxable estate when he/she dies. However, in valuing the parent's limited partnership interest for estate tax purposes, a substantial discount should be applicable. Although the basic rationale for a discount is the lack of control over the operation of the partnership, case law has developed two separate but related discounts -- a lack of marketability discount and a minority interest discount. The Service acknowledges discounts for lack of marketability in the context of closely-held business interests based upon the concept that, to the extent a prospective purchaser will have difficulty reselling an ownership interest, the value of such ownership

¹Generally, management control over the operations of a limited partnership is vested exclusively with the general partners.

interest will be reduced. The minority interest discount is based on the premise that a potential purchaser of a business interest will pay less for a non-controlling interest.

Both the lack of marketability and minority interest discounts frequently are applied in valuing stock in a closely-held corporation. In many cases, the combined discounts amount to 20% to 30%. Although the authority for applying the same discounts in the context of a limited partnership is not as well-defined, a recent case allowed the deceased limited partner's estate to claim a combined discount of 35% in valuing the decedent's limited partnership interest. We also are aware of a recent appraisal by a recognized appraiser using a discount of 57% in valuing the deceased limited partner's interest. Although it is unclear whether the Service would accept such a steep discount without argument, even a lower discount in the range of 20% to 30% encourages the formation of a family limited partnership in many cases.

The senior family member can achieve even greater estate tax savings by gifting a portion of his/her limited partnership interests to his/her children over a period of time. The value of the transferred limited partnership interests for gift tax purposes also is subject to a valuation discount. By transferring the limited partnership interest during life, the parent removes the interest from his/her gross estate completely. The transfer also directs any income and appreciation attributable to the limited partnership interest away from the parent and to the child.

Drawbacks

The possibility of a substantial discount makes this form of asset transfer quite attractive, but there can be significant drawbacks to the family limited partnership transaction. Because the minority interest valuation discount is based upon the owner's inability to control the contributed assets, the senior family member who desires the minority interest or lack of control discount must give up sole managerial control of the investment assets to his/her children or the other general partners, although he/she probably could remain as a general partner and participate in management with the other general partners.

Although moderate discounts are routinely allowed, the Service seeks to eliminate the use of discounts that it views as unjustified. A statutory penalty may be imposed by the Service for an underpayment of gift or estate taxes attributable to a valuation understatement. The penalty, ranging from 20% to 40% of the tax deficiency depending upon the extent of the understatement, should be carefully considered before a discount that significantly exceeds the 30% range is claimed. The statutory penalty reinforces the importance of obtaining a competent appraiser to value the transferred partnership interests. The appraiser can determine a discount that should be reasonably allowable, thereby maximizing the discount and reducing the risk that a penalty will be imposed.

Example of Potential Tax Savings

Assume Father's estate presently is valued at \$3.0 million. Father has three adult children. His estate consists of a residence valued at \$500,000, cash and other liquid assets valued at \$1.0 million, and investments valued at \$1.5 million. Without the use of a family limited partnership, the estate taxes payable by Father's estate at his death are \$1,071,500. After subtracting estate administration expenses and estate tax liability, Father's children receive a net amount of \$1,878,500, as shown below:

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	<u>Estimate of Estate Tax</u>
Gross Estate	\$ 3,000,000
Administrative Expenses	<u>(50,000)</u>
Taxable Estate	\$ 2,950,000
Tentative Tax	\$1,264,300
Unified Credit ²	(192,800)
Net Tax	<u>1,071,500</u>

Assume now that Father and the three children form a family limited partnership. Father contributes his cash, liquid assets, and other investment assets to the partnership. Father receives in exchange for the \$2.5 contribution a 3.4% general partnership interest and a 95.1% limited partnership interest. The three children each contribute \$12,500 to the partnership for a .5% general partnership interest. The children then separately purchase one-third of Father's general partnership interest for the underlying asset value (i.e., book capital value) totaling \$87,000.

After the above transfers are completed, Father's gross estate consists of the \$500,000 residence, \$87,000 in cash received from the sale of his general partnership interest to his children, and his 95.1% limited partnership interest with a discounted value of \$1,690,000 (total value of partnership (\$2,537,500) multiplied by Father's interest in the partnership (95.1%) reduced by a 30% discount). By creating the family limited partnership and then selling off or giving away his general partnership interests, the value of Father's gross estate is reduced to \$2,277,000, resulting in an estate tax savings of over \$370,000, as shown below.

	<u>Alternative Estimate of Estate Tax</u>
Gross Estate	\$ 2,277,000
Administrative Expenses	<u>(50,000)</u>
Taxable Estate	\$ 2,227,000
Tentative Tax	\$892,030
Unified Credit ³	(192,800)
Net Tax	<u>699,230</u>

² For Estate Tax Purposes in years 2006, 2007 and 2008 the Unified Credit has been raised to \$780,800.

³ See footnote 2 above.