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FAMILY LIMITED PARTNERSHIPS PART II

In Part I, we covered the definition of an FLP, who should consider it, and discussed its major advantages as a wealth management/transfer tool. But since no planning tool or technique is without downsides and costs, it is equally important that we examine some of the disadvantages, as well as the potential pitfalls of FLPs that may attract IRS scrutiny and challenges. I will also go over some of the key tax implications of FLPs.

For Part III, I will review selected key issues from recent cases and rulings – and conclude with a checklist for a successful family limited partnership.

DOWNSIDES AND COSTS

Stringent Rules: Partnerships are neither simple nor unsophisticated in operation. There are some very strict rules which must be met for family partnerships to be respected and accomplish the desired income tax objectives.

In general, partners are taxable on their respective shares of partnership profits. For FLPs to receive the same tax treatment, it requires that the donee partners must (1) have a real ownership interest in the partnership and its underlying assets, and (2) own a capital interest in a partnership in which capital is a material income-producing factor.

If these rules are not met, income will be taxed to the party the IRS considers the "real" owner – namely, the general partner – the client. Furthermore, the IRS may disregard the FLP and assert that the client has retained ownership rights, so as to include partnership assets in his or her gross estate.

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Complex Taxation: Taxation of partnerships is conceptually relatively simple but in practice can be extremely complex. It has been said that: "The combination of flexibility, complexity, and multi-faceted change makes the partnership area one of great opportunity for the sophisticated practitioner and one of great risk for the novice."

Danger of Classification as "Investment Company": Planners should study the so-called "investment company" rules which may be triggered if the only assets transferred to the FLP are publicly-traded appreciated securities. Under those rules, gain on the appreciation may be triggered at the time transfers are made to the partnership unless certain exceptions are met.

Tax Return Costs and Aggravation: A partnership must file an information return (on Form 1065) showing its taxable ordinary income or loss and capital gain or loss. Also, each partner's share of partnership income, gain, loss, credits and deductions must be reported (on Schedule K-1) for their individual tax returns.

State and Local Tax Implications: Note that state law treatment may not mesh with, or be as favorable as, federal tax law. Some states (e.g., Pennsylvania) will not allow losses from one form of income-producing activity to offset income from other forms of activity.

State laws may impose taxes upon the transfer of title of real estate to a partnership even though it may be almost totally owned by the donor partner(s). For example, the transfer of real estate into a family limited partnership will trigger the Pennsylvania realty transfer tax.

Some states also impose personal property taxes on intangibles. If such a tax is imposed, it would be levied against the entity rather than the partners. Should an advisor fail to notify a client of the imposition of such a tax, embarrassment may be the least of the costs incurred.

No Step Up in Basis: If donees receive their partnership interests as gifts, there is no significant tax basis increase either at the time the FLP is formed, or subsequently when an interest is transferred to, or upon an increase in interest of, a donee-partner.

Loss of Control of Underlying Assets: The ability for a client to take advantage of valuation discounts when he or she transfers FLP interests to family members is not without its cost. The price is that the client must give up the unilateral ability to reach and liquidate the underlying holdings of the partnership.

Liability: Perhaps the single, major disadvantage of a partnership is the potential unlimited liability each general partner has for the debts and obligations of the partnership (as well as acts of any and

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all other general partners). Of course, this is generally not a problem with respect to limited partners of an FLP whose liability is limited to their investment; however, the general partner retains unlimited liability.

Fringe Benefits Restricted: Owners of a partnership are at a disadvantage (vis-a-vis owners of a corporation) with respect to the treatment of some otherwise nontaxable fringe benefits.

No Fiscal Year Planning: Partnerships are restricted to calendar year planning.

Greater Audit Potential: The IRS views partnerships suspiciously in light of all the tax shelters encapsulated in this entity form over the years. Consequently, the probability of audit is higher.

POTENTIAL PITFALLS AND IRS CHALLENGES

Valuation Issues: Gift tax valuation discounts are appealing. But the IRS may take issue with the value used at the time of the initial or any subsequent transfers by challenging the marketability or minority discounts. Attack is particularly likely if there is no "ongoing business" or if transfers to children or other family members occur shortly after the formation of the entity. As I have often emphasized in previous commentaries, a viable entity that has business and/or income-producing investment purpose and activity (as opposed to mere title-holding) is essential to the FLP's success.

If, for any reason, the IRS is successful in disregarding the partnership (see below) as a viable entity – perhaps because the only asset is life insurance and there is no enterprise or activity, or state law requirements are not met – a transfer of an FLP interest could be considered a direct transfer of (or an interest in) the underlying asset. As a result, the IRS will deny any valuation discount and tax the transfer based on the fair market value of the asset involved.

If the client had taken such a valuation discount, years later the IRS could impose interest and penalties on the underpayment of gift (or estate) tax. If the statute of limitations had not run (because the gift was deliberately cast in a form and amount to qualify for the annual exclusion, thereby obviating a gift tax return), or it had never run (because the transaction was never adequately reported on a gift tax return), the client could be hit with additional penalties and interest for failure to file gift tax returns. (A possible solution is to be sure to make an adequate and timely disclosure in a gift tax return or in a statement attached to the gift tax return in a manner sufficient to apprise the IRS of the nature of the transaction so that the value of the transfer cannot be redetermined at some later date by the IRS.)

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Sham Transaction: A family limited partnership will be disregarded for estate tax valuation purposes if the IRS determines that the creation of the partnership and the transfer of the partnership interests were merely and only a single testamentary act.

The IRS will often argue that, after the creation of the FLP and gifts of partnership interests to family members, the family unit still controls the assets after they were transferred to the partnership, and that the sole or primary impetus for the transfers was to reduce (or eliminate) federal transfer taxes. Therefore, it will view all of the transfers as a single testamentary transaction occurring at the client's death, and any discounts in valuing the FLP assets will be ignored.

Alternatively, the Service could argue that, in reality, the property passing from the client was not partnership interests, but rather the underlying assets placed into the partnership wrapper; and therefore the value of those assets should be determined without regard to the partnership or the partnership agreement and allow no valuation discounts.

Excessive Control: For FLPs to be recognized for tax purposes, donee-partners must have real ownership interest in, and control over, their partnership assets. If the client retains excessive control over interests transferred to donee-partners, he or she may be treated as "remaining the substantial owner of the interest." The IRS will focus on whether a donee's interest was acquired from a family member (by gift or by purchase), or from an unrelated party.

Likewise, if the client (as general partner) retains excessive control over assets essential to the business, the partnership may be disregarded. For instance, if the general partner leases essential assets to the partnership on a short-term lease, or licenses a patent and retains the right to withdraw that asset, the client may be considered to have retained the right to determine when the partnership will end.

Excessive Management Powers: The partnership may be disregarded if the donor-partner retains management powers inconsistent with normal relationships among partners. To be safe, the powers held by the general partner should not exceed those consistent with normal business practice. An example of an excessive management power would be the ability of the donor to prevent the donee from liquidating his or her interest "without financial detriment."

It is permissible to restrict a donee-partner's right to transfer or liquidate his/her/its interest – provided the restriction is reasonable. An example would be a buy-sell agreement which gives the partnership or the other partners a "right of first refusal" over the interest of a selling partner. But if the agreement gave the other partners or the partnership the right to purchase a donee partner's

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interest at a price less than that of a bona fide offer from a third party, such a restriction would be considered a "financial detriment" and, consequently, an excessive management power. The point is that, if the donee cannot realize the full value of his or her partnership interest, it may be an indication that the donee never had a "real ownership."

Control Held by Fiduciary: The IRS will not allow a donor to hold powers indirectly that he or she could not hold directly. The use of a fiduciary by the donor to obtain indirect control will be no more successful than the direct retention of that control. So a client cannot use a trust or custodial account to change the factors that are considered in determining who has "real ownership."

If the client names himself (or herself) as trustee or if the trustee is amenable to the client's wishes, the IRS and courts will examine the terms of the trust to see if the trustee is subject to the responsibilities of a fiduciary (under state law), as well as the terms of the partnership agreement and conduct of the parties (particularly if the trust is recognized as a partner in business dealings). If the trustee "actively represents and protects the interests of the beneficiaries in accordance with the obligations of a fiduciary and does not subordinate such interest to the interest of the grantor," the trust will be recognized as a partner.

The IRS will give particular attention to whether the trust's share of income not retained by the business is distributed to the trust annually and paid to beneficiaries or reinvested solely in the beneficiaries' interest. However, if the trustee or other fiduciary is independent of the donor and actively participates as a partner on behalf of the trust's beneficiaries, that fiduciary will be treated for tax purposes as the real owner.

Note that none of the above rules prevents a donor from retaining the right to withhold profits reasonable for the needs of the business.

Partnership Anti-Abuse Rule: The IRS is authorized to make a subjective examination of a taxpayer's motives and intent; the IRS is permitted to both disregard and recast a transaction or series of transactions, even if the transaction, partners, or partnership is otherwise in compliance with the literal language of the Code. Taken to its limit, the IRS can disregard the partnership entity for federal income tax purposes even if the arrangement otherwise qualifies as a partnership under applicable state law. It is the partnership's "purposes or intent" rather than its actions that may make it abusive.

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Implicit in the intent of the anti-abuse rules is that: (1) partnership activities inconsistent with the intent of partnership rules are abusive, (2) a partnership at a minimum must be bona fide and each transaction must be entered into for a substantial business or investment purpose, (3) the form of each partnership transaction must be respected under "substance-over-form" principles, and (4) the tax consequences of partnership operations and transactions between partners and their partnerships must accurately reflect the partners' economic agreement and each partner's income.

TAX IMPLICATIONS

Basis: As I have noted previously, the basis of a partner is generally the sum of the money plus the adjusted basis of property he or she has contributed. This initial basis is increased by the amount of any gain (if any) recognized on the formation of the partnership, and reduced by liability assumed in the transaction by the other partners (in which case, their basis are correspondingly increased).

From this point on, a partner's basis fluctuates. In general, it is increased to reflect: additional contributions, the partner's distributive share of taxable and tax-exempt income, any increases in his/her/its share of partnership liabilities, and the excess of the deductions for depletion over the basis of property subject to depletion.

Basis is decreased (but not below zero) by: current distributions to the partner, his/her/its distributive share of partnership losses, nondeductible partnership expenditures not chargeable to the capital account, any reductions in the partner's share of liabilities, and decreased (but not below zero) by the amount of his/her/its deduction for depletion with respect to oil and gas wells.

Note that all these events (recognition of income, losses, deductions, and credits and adjustments to basis) trigger accounting changes whether or not money is actually paid out to, or paid by, the partners. In other words, the books of the partnership are adjusted to reflect the changes in the partners' interests for both accounting and tax purposes.

An accurate account of a partner's basis (and changes in partnership interest) is important because it is used to determine tax, for instance, on cash distributions, gain or loss on sale of partnership interest, or the limits on loss deductions. For example, distributions are considered tax-free recovery of basis – therefore, a partner will only be taxable after his/her/its basis has been recovered, and any excess will then be treated as capital gain.

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In a family limited partnership, the donee-partner's basis is carried over from the donor with an adjustment for any gift taxes paid. This basis carry-over treatment applies regardless of whether the donee acquired the interest by gift or by purchase from another family member.

Income Allocation: As a general rule, where a partnership interest is created by gift, the share of income distributed to the donee under the partnership agreement will be includible in his or her gross income – except: (i) to the extent that share was determined without making an allowance for the payment of reasonable compensation for the donor's services (Reasonable Compensation Exception); or (ii) to the extent the portion of the share of income attributable to the donee's capital is "proportionately greater than the donor's share of income attributable to the donor's capital" (Proportionality Exception).

Income allocations under the terms of the partnership agreement which do not violate either the reasonable compensation exception or the proportionality exception should be allowed – but any special allocations under the partnership agreement must have "substantial economic effect."

For example, income (otherwise allocated to the donee partner) will be reallocated to the donor partner if the donor attempts to shift a disproportionate share of FLP income to the donees. The clearest evidence of such an attempt is where the donor partner performs services for the firm but is not adequately compensated either by the partnership agreement or in reality.

Income Tax (Basic Rules): A partnership is both a separate entity and, at the same time, has the characteristics of an aggregate of individual taxpayers.

As an entity, a partnership has its own taxable year, makes many tax elections, and deals with partners as though they were separate from the entity.

As a "flow through" entity, income of a partnership is generally not taxed at the entity level. Partnership income and gain are passed through and taxable to the partners; and its losses, deductions, and credits are passed through as well.

The character of each item remains the same in the partner's hands as it would have had the partnership report it. There is no partnership level AMT (but because of the pass-through, partners will have to report their share of AMT on their personal returns).

Each partner is taxed on his or her distributive share of partnership income – whether or not the managing partner decides to actually distribute it. Allocation of a partner's share of income, loss, deduction, and credit is determined by the partnership agreement. Or – if it is not specifically

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provided for (or if the allocation of these items has no substantial economic effect) – the allocation is determined by reference to each partner's relative interest in the partnership.

Losses may be available to offset personal income in the case of a general partnership. But losses from passive activities or activities in which the partner does not materially participate can be used only to offset passive income (which does not include portfolio income such as interest or dividends). In other words, inactive partners (even general partners) may not take current partnership loss deductions unless they materially participated in the activity that generated the loss. There is a slightly lower standard of "active participation" for real estate rental activity.

Limited partners, by definition, do not materially participate. So losses from limited partnerships (generally all passive) must be deferred until there is passive income against which those passive losses can be offset.

Since the contribution of cash or other property typically is not considered a "disposal," but can be viewed as putting cash or property into a partnership "wrapper," there is no gain or loss recognized upon the client's contribution of assets to the partnership. On the other hand, contribution of services in return for a partnership interest will trigger ordinary income measured by the value of the partnership interest received. (After recognizing the income, the partner is then treated as if he or she had contributed that amount of cash to the partnership for basis purposes.)

Removal of most assets from the partnership will not be considered a taxable event. But certain assets for instance, accounts receivable (which have not been taken into income) or highly appreciated inventory, can trigger recognition of income if withdrawn from the partnership under certain circumstances.

Income Tax (Family Partnership Rules): Specific rules for family partnerships must be met or the IRS may treat the donor-partner(s) as the owner(s) of all of the partnership income and capital – ignoring the other partners (donees). The IRS might disregard the partnership for income tax purposes based on the argument that: (1) income from personal services should be taxed to the party who earned it, or (2) income from property should be taxed to the owner of that property, or (3) the client retained excessive dominion and control over the property in question.

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Three major requirements must be met for a donee-partner (whose FLP interest has been acquired "by gift or by purchase" from another family member) to be recognized as an "owner" for income tax purposes:

First, the donee must own a capital interest in the FLP in which capital is a material income-producing factor.

Second, allocation between/among partners must allow for payment of reasonable salary to the donor (for services rendered to the FLP); and the donee's share of income must be proportionate to his or her capital interest.

Third, the gift/transfer must be complete, and the donee must, in fact, be the "real owner" of his or her capital interest. (Also see "Minor Children as Partners" below.)

If capital is not a material income-producing factor, such that partnership income consists principally or entirely of payments for personal services performed by partners or employees, the transfer of an interest to a family member may be disregarded as an ineffective assignment of income (rather than a transfer of property from which income is derived). Instead, the IRS will charge all of the partnership income to the donor.

A partner's interest will be recognized as such even if the firm derives its income from both capital and personal services – but only if the primary source of that income is the capital rather than personal services, and only if the firm reasonably compensates the partners for any personal services they render. However, if the donor's services are extremely important and if the partnership does not adequately pay the donor for his or her services, the IRS will not recognize the donee's partnership interest.

Let us look at an example. Steve established an FLP and contributed an office building he owned to the partnership. He retained a 25-percent general partnership interest and gave a 75-percent limited partnership interest to his daughter, Lara. He manages the building, pays all the bills, negotiates the leases, and maintains the actual property. Steve receives no compensation for his services, and the FLP income is distributed to him and Lara according to their respective FLP interests (on a 25%/75% basis). The IRS could argue that since Steve does not receive a reasonable payment for his services, the gift of the FLP interest to Lara was merely an attempt to shift income that should have been taxed to him.

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Planners should therefore insert a provision in the partnership agreement that the donor partner will be paid a reasonable compensation for services rendered. Of course, that statement alone, without such reasonable payment, is worthless.

Lifetime Transactions: Generally, clients would not realize gain (or loss) when they contribute property (even appreciated property) to their partnership, either at its initial formation or at some subsequent time. The (adjusted) basis they had in the property contributed is carried over to their partnership interests.

Typically, most transactions between partners and their partnership will not trigger gain. This even extends to the contribution of property loaded with depreciation recapture potential or to the contribution of installment obligations.

But these general non-recognition rules do not apply in the following situations: Loans to the partnership, loans from the partnership, sales to the partnership, sales from the partnership, rendering of services to or for the partnership, assumption by the partnership of the partner's liabilities on contributed property in excess of basis, receipt of a partnership interest as compensation for services, and a contribution where the effect is a mere exchange of property among the partners.

Payments to Estates of Deceased Partners and Retiring Partners: When a partner dies or retires from a partnership in which capital is not a material income-producing factor, generally, the payments made are classified as either (a) payments made in exchange for a partner's interest in partnership property, or (b) "other payments."

Payments considered "made in exchange for the interest of a partner in partnership property" are taxed as a liquidating distribution from the partnership. The result is that there is no gain or loss at the partnership level. At the partner level, no gain is recognized by the distributee partner – except to the extent the cash (including reduction in liability) and marketable securities he/she/it receives is greater than the partner's basis. The result should be capital gains.

"Other payments" (those not in exchange for a partner's interest in the partnership property) are considered either as a "distributive share" or as a "guaranteed payment." The amount will be considered a distributive share of partnership income to the extent it is determined with regard to the partnership's income. If the payment is not determined with regard to the income of the partnership, other payments will be treated as "guaranteed payments." In either event, the recipient will pay tax at ordinary income rates but such payments will be excluded from the income of any remaining partners.

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Minor Children as Partners: In order for a minor to be recognized as a partner in a family partnership, a fiduciary should be appointed to act on his or her behalf. This implies the use of a custodian for partnership interests of relatively small value, and a trustee in the case of larger partnership interests. The custodian or trustee should aggressively take steps to represent and protect the interests of the beneficiary. Proper capital accounts must be maintained showing the children as partners and other formalities must be met.

Likewise, if there is a buy-sell agreement (which in most cases there should be), the restrictions on a minor donee's right to transfer an interest should be similar to that of other donee-partners. Otherwise, the IRS might claim that the donor client has kept essential rights over the partnership interest, and the donee does not have a "real ownership" interest. This could have adverse income as well as transfer tax implications.

Valuation Discounts and Transfers of FLP Interests: Under current law, it may be possible to obtain one or more significant gift tax valuation discounts when an interest in a partnership is transferred. The rationale is that, if a client does not have liquidation control of a family business, his or her interest in the enterprise may have a value which is lower than would be the case if the client does have liquidation control.

These valuation discounts reflect the difference between what a hypothetical buyer would pay for the interest in question based on the enterprise's "going concern" value and its "liquidation" value. In other words, to some extent (which varies from situation to situation) a number of factors may lower the gift (and subsequently, the estate) tax value of an FLP interest below the total value of the partnership's underlying assets.

In truth, few limited partners, if any, could compel a liquidation of the entity and/or receive the fair market value of the underlying assets (held as a partnership interest). Even in the case of marketable securities, limited partners have little (if any) control over investment decisions, mix, or control of distributions – especially if an independent investment manager oversees the FLP's portfolio.

So the value of an FLP interest can be discounted - reasonably. (It is not true that the further we "push the envelope, the further it will expand to accommodate us." Unjustified discounts may be cutting edge planning – but the cut may be the client's – and advisor's – throat, indeed the unkindest cut of all.)

The extent of a reasonable discount should be based on a number of factors, such as: (1) how little control the interest represents (i.e., how large the "lack of control" or "minority interest" discount

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should be), (2) how "thin" the market is for the interest (i.e., how large the "lack of marketability" discount should be), (3) how realistic are the restrictions placed on the partners' ability to withdraw, sell, or assign the interest (either required by state law or by the partnership agreement). Also, the length (or remainder) of the FLP term (during which assets are "tied up") can be a factor when considered in conjunction with the intent of the general partners to retain the assets, and expected time to liquidation.

The Tax Court has approved valuation discounts ranging from 20 percent to 50 percent and even higher in some cases. To strengthen the case for a discount, the services of an independent, qualified, full-time professional appraiser are essential to prepare a thorough valuation report that can be substantiated and withstand scrutiny. While significant and meaningful restrictions should be placed on a partner's transfer/liquidation right, they should not be more stringent than those allowed under state law or that serve no valid business purpose – since in either case, the restrictions would be disregarded.

It is arguable that if a client transfers an interest in one closely-held entity into the FLP and then transfers the limited partnership interest, one discount could apply to the value of the initial entity and a second discount when measuring the value of the FLP interest. (Be aware that a transfer of S stock to a FLP would trigger a loss of S status.)

Shifting control to any one individual in a single year could inadvertently result in a "reverse discount;" that is, instead of a discount a valuation premium may be imposed. The solution is to transfer control, if that is the client's desire, over a period of years or divest the client of control by shifting it to a number of individuals and, thereby, conquering by dividing.

Gift Tax: If a client contributes money or other assets to an FLP and does not reflect the contribution in the form of an increase in his or her ownership interest, the client has made an indirect but taxable gift to the other partners. This can occur where the FLP is formed with non-pro rata general and limited partner interests.

On the other hand, if a client gives an interest to a family member at the inception of the firm or at a later time by amending the partnership agreement and enlarging the interest of the donee partner (and reducing his/her interest), both transfers should be considered as present interest gifts. If the transfer is properly and timely documented, and the gift is outright and complete, there should be no question as to its qualification for the annual exclusion (currently $11,000 or $22,000 for a split-gift, indexed for inflation).

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Planners should be sure that all of the applicable state law requirements for family partnership have been met, and it is recognized for federal income tax purposes. Failure to meet them could cause the entity to be disregarded and would trigger further adverse estate tax implications. Note, however, that the mere fact that a client is a managing partner (or the sole general partner), should not, per se, cause a gift to be considered a transfer with retained interest, or an incomplete gift (and negate the existence of the entity, in whole or in part), since state law and general fiduciary rules restrict powers of a general partner over limited partners.

Estate Taxes: Retention of routine and normal managerial controls by the client should not automatically trigger inclusion of the FLP in his or her gross estate. Accurate records should be kept to show that the FLP is in compliance with applicable state statute. Also, documents such as FLP agreement, buy-sell agreement, separate accounts/financial records for the partnership and its partners, etc., should establish the entity as one that meets the procedural rules for federal income tax purposes.

In other words, rules and procedures should be carefully followed, and meticulous records should be kept to substantiate – in form and operation – that the donor-partner has parted with sufficient dominion and control as to remove the underlying assets and partnership "wrapper" from his or her estate. Only his or her partnership interest held at death should be includible.

But there are powers which, if retained without restriction by the donor, may cause estate tax inclusion – even if the donor's control does not violate the income tax principles of "real ownership."

Clearly, the FLP interests that have been given away should be excluded from the donor client's gross estate. It is, therefore, logical to conclude that if a client gives FLP interests to family members, the fact that he or she has retained certain fiduciary powers as a general partner should not cause inclusion of the limited partnership interests for estate tax purposes.

However, abuse or breach of fiduciary powers, duties and responsibilities will be treated accordingly. For instance, if a client sets up a family limited partnership, names himself as general partner, takes a hefty salary for managing the enterprise, but does not do any work in return for the salary, the IRS is likely to argue that no real ownership interest was ever given away and the entire partnership should be included in his gross estate.

Planners must also consider that the partnership interest held by the donee-partner at death is includible in the donee partner's estate. This requires liquidity planning for the donee-partner's estate. Without a doubt, it suggests the need for a fully funded buy-sell agreement (if it is not

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already in place). An added value of the buy-sell is to demonstrate that the donee-partners are the "real owners" of their respective partnership interests – which may be used to parry an IRS assertion that the donor, and not the donee, is the owner of the FLP.

Planners should remember that an intra-family buy-sell arrangement will not be persuasive on the IRS or courts for estate tax valuation purposes – unless certain requirements are met. In addition to other tests applicable to all taxpayers, intra-family buy-sell arrangements must meet all the requirements of a three-prong test stipulated by Code Section 2703. This code section deals with below-market buy-sell agreements and options that artificially depress the fair market value of property subject to gift and estate taxes. For family-owned businesses, valuation discounts are disregarded, unless the buy-sell agreement (1) is a bona fide arm's-length business arrangement, and (2) does not serve as a device to transfer property to a family member for less than adequate and full consideration, and (3) is comparable to similar agreements made in arm's-length transactions.

Other Chapter 14 Rules: Attorneys, advisors and planners involved with clients in creating and implementing family limited partnerships must be acutely aware of the tax traps in Code Sections 2701, 2703, and 2704. (These sections of the Code were designed to prevent an "estate freeze," whereby the client would transfer growth interests but retained frozen interests with or without certain "bells and whistles" that would depress the value of the transferred asset(s). Typically, an "estate freeze" resulted in shifting a client's wealth on a gift-tax-free basis, and lowering the value of his or her estate for federal estate tax purposes.)

Fortunately, the typical limited partnership interests that are given away should not be subject to sections 2701 and 2704 which have draconian gift and estate tax consequences. This is because general partners and limited partners typically have the same interests in profits and losses based on each partner's proportionate interest in the partnership.

Where the client retains a general partnership interest with no preferences and fully participates in the growth of the firm's assets upon liquidation – and transfers limited partnership interests with preferential "senior" rights upon liquidation, Section 2701 should not apply.

If the partnership agreement provides for allocations and distributions among partners in a manner other than pro rata, extreme caution must be exercised. If the partnership avoids Section 2704, then gift tax valuation discounts for lack of marketability and lack of control may be allowed.

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Generation-Skipping Transfer Tax (GSTT): If a client gives (either during lifetime or at death) an interest in an FLP to a grandchild (or someone in that or a lower generation), the GSTT rules may apply. Tax on a direct transfer of an FLP interest to a “skip” person such as a grandchild can be offset by allocating a part, or all, of a client's GST exemption ($1,500,000 for 2004 and 2005). So, a grandparent could allocate his or her GST exemption to a trust into which he or she has placed an appreciating FLP interest with a discounted value of $1,500,000 or less and entirely avoid the GSTT.

Furthermore, to the extent the direct skip gift was not in excess of $11,000, it would be excludable under a “quasi-annual exclusion” type rule. In fact, even if the gift was made to a trust for the grandchild's benefit, it could qualify as a direct skip and be eligible for the $11,000 annual exclusion from the GSTT if it met certain requirements.

PART III TO FOLLOW

In Part III we will address some of the frequently-asked questions about FLPs and examine a number of the key issues and rulings from important recent cases.

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