Family Limited Partnerships (FLPs): Strategies and Planning Techniques

Reference Outline

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INTRODUCTION

For many years, the family limited partnership (the “FLP”) has been used as a vehicle to own and manage family property or family business enterprises in a custom designed entity to fulfill the family’s desires. Due to its use to transfer assets at discounted values, the FLP has come under intense scrutiny from the Internal Revenue Service (“IRS”) as they view the FLP as primarily a discount tool for the estate planning practitioner. Due to the focus by the IRS and practitioners on the discounts in FLPs, many practitioners have not considered the other uses for the FLP such as to minimize state and/or income taxes, to provide management control to the parent and succeeding generations, to provide creditor protection for the partners liabilities, to avoid fractionalization of key family assets, to provide limited liability for its partners, and even in some situations, marital property protections. For many practitioners, the FLP has been viewed as an alternative to a trust for holding and managing assets. As outlined below, there are multiple reasons for selecting the FLP as a planning tool, including ten which we believe are relevant in many family situations. All sections referenced in this outline refer to the I.R.C. unless otherwise indicated.

1.01 Preliminary Matters.

Abbreviations:

(a) FLP = Family Limited Partnership;

(b) I.R.C. = the Internal Revenue Code

(c) IRS = Internal Revenue Service; and

(d) TBOC = Texas Business Organizations Code.

ARTICLE 2
TOP TEN LIST

TOP TEN REASONS TO USE THE FLP

10. Limitation of Payroll Taxes

9. Accumulation of Wealth

8. Family Training in Management and Growth of Assets

7. State Taxes/Income Tax Flexibility

6. Valuation Discount
5. **Consolidation of Assets**

4. **Asset Protection-Inside & Outside of FLP**

3. **Separate Property Maintenance/Pre-Martial Planning**

2. **Continuity of Management**

1. **Control, Control, Control**

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**ARTICLE 3**

**VALUATION OF FAMILY LIMITED PARTNERSHIP INTERESTS**

3.01 **General.**

One of the more appealing aspects of the FLP is a client’s ability to make transfers of limited partnership interests (through gifts or sale) to his or her descendants (or trusts for descendants) on a leveraged basis due to valuation discounts which are customarily associated with transfers of limited partnership interests. Valuation discounts are attributable to a limited partnership interest in the FLP because the characteristics of a limited partnership interest generally cause the interest to be less valuable than the value of the underlying assets of the FLP. In many situations, the discounts are consistent with discounts attributable to a minority interest position in a closely held corporation.

The cornerstone test for determining the value of a limited partnership interest, and the percentage of valuation discount to be applied on a transfer of a limited partnership interest, is the amount a willing buyer would pay to a willing seller for the subject property (i.e., the limited partnership interest and not an interest in the underlying assets of the FLP), where neither the buyer nor the seller is under a compulsion to buy or to sell and both the buyer and the seller have reasonable knowledge of the relevant facts of such transfer. Treas. Reg. §20.2031-1(b).

3.02 **Valuation.**

(a) **Methods.**

In determining the fair-market value of a limited partnership interest, a professional appraiser must consider both the net asset value of the FLP and the net income/cash flow generated by the assets of the FLP. In both the net asset value approach and the income approach, the appraiser would need to take into account the distributions to the partners as allowed by the terms of the limited partnership agreement. The powers of the general partner regarding distributions to the partners of the FLP, as well as the history of the actual distributions made to the partners of the FLP, will be considered in valuing the limited partnership interest under either method.
The income approach to the valuation would take into account the current earnings and cash flow of the FLP as well as projected future earnings and cash flow of the FLP over a specified period of time. The income and cash flow approach to valuations is normally used where the FLP activity is an active, operating business as the value of the FLP’s business is based more on the income and cash flow generated from the assets of the FLP as opposed to the value of the assets held by the FLP. It is important to note that the amount of discount (as discussed below) that can be taken from the value of a limited partnership interest determined from the income approach may be limited where a partner’s return on his or her capital contribution to the FLP is significant.

The net asset value approach would involve the determination of the fair-market value of all of the assets owned by the FLP reduced by the aggregate value of all of the liabilities of the FLP. The net asset value approach is normally used where the FLP’s value is based on the value of its assets (normally passive type assets, i.e., real estate, publicly-traded securities, etc.) as opposed to the income generated from those assets owned by the FLP.

There are instances where an appraiser would choose to use both the income approach and the net asset value approach in determining the FLP’s value (i.e., an oil and gas FLP). In such instance, an appraiser would then attribute a reliability factor to the value of each approach (as each approach applies to the specific FLP) in order to arrive at the value of the applicable limited partnership interest.

(b) Discounts.

Once the FLP’s value is determined using one or both of the above two (2) methods, the appraiser could then apply two (2) discounts to the value of the subject limited partnership interest. These discounts are as follows: (i) a “lack of control” or “minority interest” discount, and (ii) a “lack of marketability” discount. Both of the above-referenced discounting principles have been recognized by the IRS. As mentioned above, substantial and/or frequent distributions to the partners of the FLP, as well as substantial income generated by the assets of the FLP, may restrict the amount of discount that can be taken from both the net asset value approach and the income approach in determining the value of the subject limited partnership interest.

The lack of control or minority interest discount is applicable to limited partnership interests due to a limited partner’s limited voting rights with respect to the FLP’s business and management. Typically, a limited partner would have very limited voting rights, and the voting rights the limited partner has are usually reserved to extraordinary items affecting the FLP’s business and operations such as (i) the merger or the dissolution of the FLP, (ii) the sale of all or substantially all of the FLP’s assets, (iii) the removal or admittance of a general partner, (iv) the admittance of an additional limited partner, and (v) the amending of the partnership agreement. A limited partner
would normally have (i) no voice in the management of the FLP’s day to day business, (ii) no rights or interests (to partition or otherwise) in the FLP’s underlying assets, (iii) no power (or a very limited power) to withdraw from the FLP, (iv) no power to compel distributions from the FLP, and (v) restrictions placed on the partner’s ability to transfer his or her limited partnership interest. These limited voting rights make the limited partnership interest substantially less attractive to a hypothetical willing buyer under the “willing buyer/willing seller” test. The amount of the minority interest discount is dependent upon the amount of distributions made from the FLP to its partners, the financial risk associated with the FLP’s assets, and the terms of the partnership agreement.

The lack of marketability discount may apply regardless of whether or not the limited partnership interest transferred actually represents a minority interest in the FLP. The premise for the lack of marketability discount is that the transfer restrictions attributable to the limited partnership interest (whether such restrictions are imposed by the terms of the partnership agreement or by state and/or federal law) will make the limited partnership interest a less attractive asset than comparative publicly-traded assets under the “willing buyer/willing seller” test. The amount of the lack of marketability discount is determined by comparable sales of restricted stock of publicly traded companies.

3.03 Role of the Appraiser.

Due to the recent scrutiny directed by the IRS on transfers of limited partnership interests, the role of the appraiser in identifying and evaluating the valuation discounts attributable to a limited partnership interest is crucial. It is extremely important that an appraiser be chosen who (i) is familiar with the nature and structure of the FLP as a family planning tool, (ii) routinely appraises FLPs, (iii) is familiar with Chapter 14 of the Internal Revenue Code (the “I.R.C.”) and state law related to limited partnerships, and (iv) has experience in defending his or her appraisals of the FLP in an IRS audit.

The need for an appraiser should be discussed with the client early on if the client wants to participate in a gifting program. Also, the appraiser’s assistance may be needed in establishing the appropriate values on the assets initially contributed to the FLP in order to substantiate the initial allocation of the limited partnership interest percentages among the initial limited partners. If the appraiser is not qualified or does not specialize in appraising the type of assets contributed to or owned by the FLP, a separate appraiser may be needed in order to ascertain the value of the underlying assets before the FLP appraisal is prepared.

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1 For example, if a limited partner were to receive an interest in the FLP based on an inflated value of his or her initial contribution, then upon the initial contributions to the FLP, the additional percentage attributed to the limited partner could be viewed by the IRS as a deemed gift to the limited partner by other partners of the FLP.
3.04 Timing.

There has always been debate among FLP practitioners and appraisers regarding whether time, and if so, how much, should be allowed to pass between the funding of the FLP and when gifts (other transfers, i.e., sale) of limited partnership interests are made. In certain cases, the IRS has been successful in arguing that a gift of a limited partnership interest made at or near the time of the formation of the partnership is an indirect gift of the partnership assets to the donee and not a gift of the partnership interest. If the IRS is successful in arguing that the gift was an indirect gift of the assets, no discounts for the partnership interest are allowed. There is no definitive time period, or safe harbor, on when a gift of a partnership interest can be made after the formation of the partnership to avoid an indirect gift. For planning purposes, it is best to make sure that the partnership has been completely signed and fully funded with the assets that are to be owned by the partnership. There are cases (when the partnership assets consist of publicly traded stock) where gifts within 6 days and 11 days of the funding of the partnership have been recognized as valid gifts of partnership interests due to the potential volatility of the publicly traded shares of stock. Some practitioners believe a minimum of 30 days should pass between the completion of the funding of the partnership and any gifts of partnership interests. It is normally best not to have documentation (letters or e-mails) of a plan to make gifts of partnership interests immediately after, or soon after, the formation of the partnership as this could cause the courts to extend the time period for analyzing the indirect gift argument proposed by the IRS. As in most situations, the longer the time period between the formation and funding of the partnership and the gift of limited partnership interests, the better the results.

3.05 McCord Case.

One of the biggest risks in transferring limited partnership interests utilizing discounts is the possibility that the IRS valuation of the transferred interest on audit will vary wildly from that determined by the taxpayer resulting in gift tax due. In a recent stream of cases a method for significantly limiting this risk has evolved, the defined value formula clause. Beginning in 2003, with the decision in the McCord case, the usefulness of the defined value transfer has become more apparent. See McCord v. Comm'r, 120 T.C. 358 (2003) and Succession of Charles T. McCord, Jr., et. al. v. Comm'r., 461 F.3d 614 (5th Cir. 2006). In contrast to earlier cases in this area that did not bode well for the taxpayer, the issue in McCord was merely the allocation of the gift between donees rather than the amount of the total gift. In other words, in McCord, no portion of the gifted amount was intended to revert back to the donor by way of a savings clause; instead the amount in excess of the defined dollar value (which primarily was payable to non-charitable beneficiaries) remained part of the gift and was payable to a charitable beneficiary.

In McCord, the donors made a single gift of interests that was allocated among charitable and non-charitable beneficiaries by way of a formula contained in the Assignment Agreement. The actual allocations were confirmed by the donees by way of a Confirmation Agreement executed at a later date. In the assignment document, the gift to non-charitable beneficiaries was capped at a defined dollar amount and the residual value of gifts in excess of $6,910,933 was to be gifted to two charitable organizations, the Communities Foundation of Texas, Inc. and the Shreveport Symphony, Inc., with the Symphony’s donation being capped at an additional defined
dollar amount of $134,000.00. Consequently, the Communities Foundation of Texas was to receive the gifted amount in excess of $7,044,933. Because the assignment agreement employed the language “fair market value” rather than “fair market value as finally determined for Federal gift tax purposes” the Tax Court declined to increase the amount of the charitable contribution deduction for the taxpayers even though the ultimate value placed on the gift by the Tax Court exceeded the amount the taxpayers had originally reported on their gift tax returns. Consequently, the Tax Court found that “while the fair market value of the property transferred to the Foundation was $435,019.00, taking into account annual exclusion, each petitioner [was] entitled to a charitable contribution deduction under §2522 of [only] $207,510.00,” which corresponded to the amount agreed to in the post transfer Confirmation Agreement between the donees. The Fifth Circuit reversed the Tax Court and declared that the focus should be on the Assignment Agreement itself as it was executed at the time of the gift rather than the Confirmation Agreement executed at a later date. Under the Fifth Circuit ruling, the entire portion of the gift passing to charitable beneficiaries qualified for a charitable deduction.

The Tax Court revisited and reaffirmed this approach to formula clauses in 2009. See Petter v. Comm’r, T.C. Memo 2009-280 (2009). The Petter case involved a lifetime defined value transfer of LLC units to non-charitable and charitable beneficiaries where the actual allocation of the transferred units was determined by a formula clause. The IRS had assessed a deficiency based on the valuation of the interests and the parties agreed on an alternative value that was larger than that originally reported by the taxpayer. Contrary to the IRS’s arguments, the Court determined that the increase in value resulted in a reallocation of the units between the charitable and non-charitable beneficiaries, but did not result in additional taxes due. Because the increase in value passed to the charitable beneficiary, the Court determined it qualified for a charitable deduction. In summing up its stance on the issue, the Tax Court noted “savings clauses are void, but formula clauses are fine.” Some practitioners using formula clauses have substituted grantor retained annuity trusts instead of charities. At this time, there is no case law validating this approach.

ARTICLE 4
GENERAL PLANNING/DRAFTING CONSIDERATIONS

4.01 Overall Considerations.

In drafting a partnership agreement for an FLP, the practitioner should carefully evaluate and address many of the same issues that are faced by the practitioner in the formation of any closely held entity. The major issues to be reviewed with a family are restrictions on transfer, withdrawal/distribution rights, and management powers. Decisions prior to formation need to be made regarding the ability of the owner to gift or transfer his interests to a third party, including family members, and other buy-sell rights typically contained in a buy-sell agreement for a closely held entity. Additionally, the ability of the owner to withdraw from the entity for full fair-market value or receive distributions from the entity are not particular to an FLP, but instead are issues to be addressed in any closely held entity. Finally, the management powers, and allocation of the power among the owners, are issues to be discussed with the family members prior to the formation of the FLP so that the partnership agreement reflects the purposes and
intent of the family members. It is important for the practitioner to discuss these issues with the family members and to tailor the partnership agreement to satisfy the business relationship of the family member partners. The fact that these partners are family members, and not third parties, does not change the importance of addressing these issues with the partners as they directly impact the relationship among the family members now and in the future. The family members should understand early on that the FLP is an operational entity structured to satisfy their business goals and purposes for the ownership, management, and operation of assets and not solely a tool for discounting asset values for gift and estate tax purposes. The following is a discussion of certain provisions of the partnership agreement which should receive careful attention by any practitioner in order to tailor the partnership agreement to the goals and needs of the family members.

4.02 Restrictions on Transfer (Overall).

A key planning issue is the restriction on the ability of a partner to transfer his or her interest outside the group of partners who formed the FLP. All transfer restrictions which impact the value of the partnership interest will be tested against the requirements of I.R.C. §2703. One of the general tests of §2703 is whether or not the restrictions are commercially reasonable. Therefore, any restrictions on the transfer of a limited partnership interest should be applied against this standard if the practitioner intends for the restriction to impact the limited partnership interest value. Any restriction that does not satisfy this §2703 standard will be ignored for purposes of valuing the limited partnership interest.

§153.251 of the TBOC provides that, unless otherwise provided by the partnership agreement, a partnership interest is assignable in whole or in part. Further, §153.252 of the TBOC provides that until the assignee becomes a partner, the assignor partner continues to be a partner in the FLP and to have the power to exercise any rights or powers of a partner except to the extent those rights or powers are assigned to the assignee. The assignment of a partnership interest under the TBOC does entitle the assignee to be allocated income, gain/loss, deductions, credit or similar items and to receive the distributions to which the assignor was entitled, to the extent those items were assigned. There are normally three general types of restrictions on assignment contained in a partnership agreement:

(a) an overall restriction on the right to assign the interest;

(b) a right of first refusal granted to the FLP and/or the other partners to purchase the interest being sold to a third party on the same price and terms of the third party offer; and

(c) specific buy-out rights granted to the FLP and/or the other partners upon a violation by a limited partner of the terms of the partnership agreement.

It is common for a partnership agreement to provide that a partner cannot transfer his interest in the FLP other than as provided in the partnership agreement. This is consistent with
the intent of partners in a closely held entity to control who they are partners with in a business relationship (i.e., the FLP).

Consistent with the partners’ desire to control with whom they are partners, it is normally very common to provide the FLP and/or the other partners a right of first refusal on any attempted sale or transfer of a partnership interest by a partner to a third party. A right of first refusal will normally give the FLP and/or the other partners a right to purchase any interest proposed to be sold by a partner to a third party on the same price and terms offered by the third party. A properly drafted partnership agreement will normally give the FLP and/or the other partners a right, exercised over a thirty or sixty day period, to step into the shoes of the third party purchaser and purchase the partnership interest being sold in order to maintain ownership of the partnership interests among the existing partners. If the FLP or the other partners do not exercise their option to purchase the partnership interest being sold, the selling partner would be entitled to sell his or her interest to the third party and the third party would become an assignee of the partnership interest. (See the discussion below in Paragraph 4.06 regarding the rights of an assignee.)

Finally, most partnership agreements require the limited partner to satisfy certain obligations and responsibilities related to his ownership of a partnership interest and his duties to the FLP. These obligations and responsibilities could include a restriction not to pledge his partnership interest to a third party, a requirement that the partner make additional capital contributions to the FLP upon a call by the general partner or a restriction upon the limited partner’s ability to transfer or convey his interest other than as allowed in the partnership agreement. If a partner breaches the terms of the partnership agreement, the FLP, and/or the other partners, can be granted a right to purchase the breaching partner’s interest, normally at a reduced price and payable in installments over time. The reduced price could take into account the costs, expenses and damages suffered by the FLP due to the default of the partner and could also contain a limitation on the value paid by the FLP for the defaulting partner’s interest, i.e., a percentage of the fair-market value or a price that is based upon the partner’s unadjusted capital account. Such restrictions on value should be carefully evaluated by the practitioner to determine whether they are in compliance with the commercially reasonable requirements of §2703.

4.03 Restrictions on Transfers (Annual Exclusion Gifts).

One issue to keep in mind when drafting the FLP’s restrictions on transfers is the impact such restrictions may have on a partner’s ability to make gifts of partnership interests within the parameters of such restrictions and the applicable tax treatment of the same. For example, even when transfers to a subset of individuals, such as the lineal descendants of a partner, are allowed under the terms of the partnership agreement, if the other restrictions on transfer are too stringent, a partner still may not be able to make allowable gift transfers in a tax-neutral manner as with an annual exclusion gift.

The question of whether gifts of limited partnership interests qualify as gifts of present interests for annual exclusion purposes has become a big issue to the IRS. The IRS initial arguments against annual exclusion treatment were outlined in Technical Advice Memorandum 97-51-003, where the IRS concluded that gifts made by the donor in this situation were future
interest gifts and did not qualify for the gift tax annual exclusion based in part on the argument that the restrictions in the partnership agreement prohibited and restricted the limited partners (other than the donor) from transferring or assigning limited partnership interests. Accordingly, the IRS ruled that these restrictions were proof that the limited partners lacked the immediate and present benefit of the partnership interest, i.e., the transfers were not “present interest gifts” that qualified for the annual gift tax exclusion (currently $13,000 per year per donee). More definitively, in 2002, a full Tax Court opinion was rendered finding that LLC interests gifted were not present interest gifts due to the provisions of the LLC Agreement which vested too much control of the entity, including rights to transfer, in the LLC’s manager. See Hackl v. Commissioner, 118 T.C. 14 (2002), af’d, 335 F3d 664 (7th Cir. 2003). Though this case involved an LLC, the applicable provisions and restrictions of the entity’s agreement were closely analogous to those typically found in limited partnership agreements. The Court held that in order for a transfer to qualify for the gift tax exclusion, the transfer must give the donee “an unrestricted and noncontingent right to the immediate use, possession, or enjoyment (1) of property or (2) of income from property, both of which alternatives in turn demand that such immediate use, possession, or enjoyment be of a nature that substantial economic benefit is derived therefrom.” In Hackl, the Court decided that the LLC interests in question did not meet the first part of the requirement, largely because the members could only offer to sell their interest to the company, and the agreement did not allow for the sale of the LLC interests to third parties without the consent of the manager.

Since the Hackl case, the IRS has continued to argue against annual exclusion treatment for gifts of partnership interests subject to significant transfer restrictions. However, many practitioners feel that when the applicable partnership agreement contains a properly drafted right of first refusal (as discussed in Paragraph 4.02 above), the courts are more likely to allow annual exclusion treatment for such FLP interest gifts. The key to a favorable determination on this matter, in the opinion of many practitioners, revolves around the terms of the right of first refusal. In March 2010, the Fisher case affirmed this belief by finding no present interest gift even in the presence of a right of first refusal where the terms of such right of first refusal included payment by way of a fifteen (15) year, non-negotiable promissory note. See Fisher v. United States, 105 A.F.T.R.2d 2010-1347 (S.D. Ind)(Mar. 11, 2010). Finally, it should be noted that practitioners also believe that a gift of a partnership interest coupled with an immediate, but time-limited, withdrawal right, similar to a Crummey trust withdrawal right, can also serve to make a gift of FLP interests qualify as a present interest gift even in the absence of a right to require distributions or a proper right of first refusal.

4.04 Withdrawal Rights.

§153.110 of the TBOC provides that a limited partner may withdraw from a limited partnership at the time, or on the occurrence of an event, specified in the written partnership agreement and that such withdrawal must be made in accordance with that partnership agreement. Therefore, if the partnership agreement is silent as to the withdrawal right of a limited partner, the default provisions of Texas state law provide that a limited partner of the FLP does not have the right to withdraw from the FLP.
Restricting a limited partner’s right to withdraw from the FLP containing business or investment assets other than public securities or cash is a common occurrence in order to avoid having to liquidate real estate or other operational assets to purchase a limited partner’s interests. However, it is not unusual in investment FLPs (i.e., FLPs with publicly traded securities) to give limited partners limited rights of withdrawal upon the occurrence of certain events or on an annual basis. This limited right of withdrawal is normally provided to a limited partner in order to allow the limited partner the ability to recognize a return on his investment or opt out of the investment philosophy of the investment FLP. Therefore, in structuring an investment FLP, the practitioner should consider giving the limited partners a right of withdrawal in certain situations. There are numerous reasons for considering this type of provision. First, an investment FLP normally involves multiple family members contributing investment assets to the FLP in order to receive the benefit of diversification of assets, professional management of a larger portfolio, shared management costs and spread of the investment risk. If the limited partner cannot withdraw all or a portion of his interest and “cash it in,” it can disrupt family harmony if one or more of the family members do not approve of the investment strategy of the managers. Secondly, a limited right of withdrawal can increase the status of an investment FLP as a viable operating entity and not a tool solely used for discounting limited partnership interests for estate and gift tax purposes. This can be helpful in nullifying the IRS arguments regarding the application of §2703, as well as the overall business or investment purpose arguments advanced by the IRS, against the investment FLP. Any withdrawal rights should be weighed against the purposes and intent of the family members in setting up the investment FLP. In some cases, the partners want a commitment of an initial term of years, i.e., up to five years, whereby the partners will agree to let the managers manage the assets without any right to withdraw and cash in the limited partnership interest. Once an initial period has expired, the limited partners can have a right to withdraw a percentage of their partnership interests on an annual basis so that over a period of years a limited partner would be able to liquidate his entire interest. Of course, only a partner should be entitled to exercise this withdrawal right; an assignee of a partnership interest should not be entitled to exercise any withdrawal rights as to the limited partnership interests received by the assignee. The practitioner should carefully review and discuss these withdrawal rights with the family members to ensure that they are comfortable with the limited partner’s right to withdraw assets from the FLP in the selected circumstances and to ensure that it is consistent with their overall plan for the management and distribution of the investment assets in the FLP.

4.05 Distribution Powers.

In deciding on the type of distribution powers for a particular FLP, there are multiple issues a practitioner should consider. First, will the general partner be required to distribute part or all of the income of the FLP each year? In certain FLPs it is important to the partners that the general partner be required to make a mandatory distribution equal to the anticipated income taxes on the FLP flow-through taxable income (usually based on the highest individual income tax rate). In other FLPs, it is the partners’ desire that the income of the FLP be reinvested for growth purposes, i.e., an investment FLP. There is no right or wrong distribution plan for the FLP; the distribution plan should reflect the desires of the partners. Once the plan is determined, however, there are limits on how broad or strict the distribution powers should be structured.
The IRS has advanced arguments on both sides of this issue depending upon the particular case. They have argued that if the general partner has too much discretion in terms of withholding funds and not making distributions, that this could override the fiduciary duty of the general partner to the partners and restrict the ability of the gift of the limited partnership interest to qualify for the annual exclusion. On the other hand, where the partnership agreement provided for mandatory tax distributions, or distributions of cash-flow, the IRS has argued that the parent’s generation has retained the use and benefit of the assets transferred to the partnership in such a manner to cause inclusion of the assets of the FLP in the parent’s estate under I.R.C. §2036. The key is structuring the distribution powers in the partnership agreement to be consistent with the purposes of the partners in forming the FLP for short and long-range planning purposes.

Whichever distribution plan is selected, there should be limitations on the ability of the general partner to make distributions from the FLP in excess of the income or net cash flow of the FLP. The practitioner should be careful that he does not give the general partner such broad distribution powers that the general partner is able to effectively liquidate the FLP over a period of a few years. By granting the general partner such broad distribution powers the practitioner could markedly impact the discounting available for any limited partnership interest owned by the general partner.

### 4.06 Assignee Interests.

FLPs are closely held entities and, as such, restrictions should be placed on the ability of a partner to transfer his or her interest in the FLP. ([See Paragraph 4.02 and 4.03 above regarding restrictions on transfers.]) One mechanism to limit the ability of a partner to effectively transfer all of his partnership interest in the FLP to a third party is to provide that on any transfer of a partnership interest, the transferee is only an assignee. §153.251 of the TBOC provides that a partnership interest is assignable but that the assignment of a partnership interest does not entitle the assignee to become a partner or to exercise the rights or powers of a partner. Under §153.253 of the TBOC, an assignee of a partnership interest may only become a full limited partner to the extent that all of the partners consent or the partnership agreement provides that the assignee will become a full partner, i.e., substituted partner. Therefore, if a partnership agreement is silent as to the rights of an assignee, Texas law provides that the transferee of a partnership interest will be an assignee and not a substituted partner (i.e., a full limited partner), until all of the partners consent to the assignee becoming a limited partner.

The partnership agreement should either be silent as to the rights of a transferee of a partnership interest or provide a specific mechanism for a transferee to become a limited partner, and not an assignee. Generally speaking, the partnership agreement should not provide that a transferee will automatically become a substituted limited partner. Additionally, for valuation purposes, an assignee limited partnership interest is less valuable than a full partner limited partnership interest.
ARTICLE 5
PRACTICAL CONSIDERATIONS IN FORMING AND OPERATING A FAMILY LIMITED PARTNERSHIP

Due to the focus by the IRS and Courts on the discounts in FLPs, it has become increasingly important for practitioners and clients to properly maintain FLPs by observing the formalities of the partnership and truly treating it as a viable operating business entity.

As outlined below, there are several key aspects that should be observed and maintained to protect the viability of an operating FLP and to prevent its existence from being disregarded by the IRS and the Courts. These aspects also reflect the specific information and documentation often requested by the IRS in the course of an estate tax audit. (See Attachment #1.) It is clear from those requests that, in order to give your client the best chance of success, the formalities of the FLP need to be observed, multiple business or investment purposes for the formation/operation of the FLP should be established and the client should operate and manage the FLP in a professional manner as he or she would their other entities.

There has been a line of cases in which the IRS has been able to include the value of FLP assets in a decedent’s estate under §2036(a). Most of the cases in which the IRS has been successful in avoiding the recognition of the FLP are bad-fact cases, or as one speaker refers to them, “the wounded animal cases.” It is clear that just following the formalities of the FLP, by itself, will not protect the taxpayer/decedent’s estate from arguments of inclusion of FLP assets in the decedent’s estate under §2036(a). The IRS and the Courts are reviewing closely whether there is economic substance to the FLP formation and operation, i.e., are there business or investments purposes for the FLP. It is incumbent upon the planners to assist their clients in the formation and structuring of their FLPs to achieve the most advantageous business and tax advantages. In Article 6 and Article 7, we discuss key elements that the practitioner should be cognizant of in the formation and operation of the FLP.

ARTICLE 6
FORMATION ISSUES

6.01 Compliance with Filing Requirements.

(a) An FLP organized under Texas law should file a Certificate of Formation with the Texas Secretary of State’s office to form the entity prior to commencing business or funding the FLP. (See §§3.001 and 3.005 of the TBOC.) Additionally, if the FLP is engaged in business in another state, the FLP should register as a foreign limited partnership in the applicable state.

(b) A federal tax identification number for the FLP must be obtained upon formation by filing IRS Form SS-4 with the IRS.
6.02 **Partnership Agreement Among the Partners.**

The partners should enter into a written partnership agreement to govern the terms of their relationship. The partnership agreement should contain certain key provisions, including but not limited to, setting forth the partnership interests of the partners (general and limited), the required capital contributions of the partners, the term of the partnership, management and voting issues with respect to activities of the FLP, transfer and buy/sell restrictions regarding partnership interests and withdrawal rights of a partner. Each partner should sign the partnership agreement. Additionally, if buy/sell restrictions are to be applicable to a spouse’s community property interest, a spousal consent should be signed by the applicable spouse.

6.03 **Bank Accounts/Brokerage Accounts.**

The general partner should open an account in the name of the FLP with the cash contributed to the FLP at the time of its formation. Additionally, in the event the FLP will hold publicly traded securities, the applicable broker should open up a brokerage account, separate from the partners, for the FLP to hold the publicly traded securities.

6.04 **Following Formalities of the Partnership Agreement and State Law.**

(a) All of the partners should contribute their capital when, and in the amount, required under the partnership agreement. As a general rule, a partner’s contribution of capital should match up with how the partners are allocated profits and losses under the partnership agreement. Proper books and records should be set up for the FLP and the contribution of assets by the partners should be reflected in their capital accounts.

(b) If a partner is transferring real estate subject to a lease to the FLP, the lease must be amended or assigned so as to reflect the FLP as the landlord. Furthermore, an FLP that receives a contribution of real estate from its partner(s) should properly document such transfer by executing warranty deeds and filing the deeds in the deeds records of the applicable county clerk’s office.

(c) If real estate contributed to the FLP is agricultural use property and has previously received an agricultural use exemption, a new agricultural use exemption application needs to be filed by the FLP.

6.05 **Business/Investment Purpose.**

While the IRS has been unsuccessful in attacking FLPs solely on the issue of a lack of business purpose, they review the business purpose of the entity in analyzing whether or not the client has satisfied the bona fide sale for adequate and full consideration exception to §2036. In *Estate of Bongard v. Comm’r* (124 T.C. 8, 2005), the Court made the following statement when analyzing the application of the bona fide sale exception of I.R.C. §2036 to FLPs. “In the context of family limited partnerships, the bona fide sale for adequate and full consideration exception is met where the record establishes the existence of a legitimate and significant non-
tax reason for creating the family limited partnership... The objective evidence must indicate that the non-tax reason was a significant factor that motivated the partnership’s creation.” In more and more Tax Court cases, the Court is analyzing the stated reasons for the FLP’s formation and whether or not the reasons were valid and justifiable business or investment reasons. A statement that the FLP formation was for “creditor protection purposes” will lack economic substance in supporting the purpose of the FLP if the taxpayer had little or no creditors and was not involved in risk ventures. On the other hand, business purposes such as combining fractional interests of real estate, obtaining limited liability from real estate ownership, or combining investment assets of multiple parties to obtain better diversification and/or availability of professional investment managers are more credible if the FLP operations are consistent with the purposes stated. Another purpose could be the contribution of separate property by one or more family members to the FLP to avoid commingling of income from the property with a spouse and/or to maintain more clearly defined separate property characteristics of the property. Most of these items can be documented in correspondence between the legal counsel, accountant and their client, as well as meetings of the partners regarding the operations of the FLP. Annual FLP planning meetings can serve as a useful tool for the partners’ reviewing, documenting and implementing the business plan and purposes that were expressed prior to the formation of the FLP. After the formation of the FLP, it is important to operate the FLP in a manner consistent with the reasons for forming the FLP in the first place. Ongoing documentation of the implementation of the plan is always helpful.

6.06 Distribution Plan.

If it is anticipated that the FLP will be making distributions to its partners shortly after the formation of the FLP, the distribution plan should be discussed by all parties prior to the formation of the FLP and structured as one of the overall purposes of the FLP. Additionally, distributions during the operation of the FLP should be justifiable and not merely a means for meeting a partner’s (especially the contributing senior generation partner) personal expenses and gifting desires.

6.07 Contributions by Other Partners.

Contributions by other family members (or third parties) of more than nominal amounts add credibility to the structure of the FLP. Contributions by children, children’s trusts, or grandchildren’s trusts, to an investment FLP of the parents in order to take advantage of professional money managers makes good business and investment sense. The FLP is about multiple people coming together with a common purpose to pursue business or investment activities. Having multiple partners contribute to the FLP is consistent with that philosophy, provided that such contributions are of bona fide assets of real value.

6.08 Percentage of Assets Transferred to Partnership.

In certain cases (normally “bad facts” cases), substantially all of the assets of the decedent were transferred to the FLP and sometimes, the decedent has no control over the right to withdraw the assets. In the real world, how many 70, 80, or 95 year-old people would transfer
almost all of their assets to an entity that has a term 20 to 30 years past their life expectancy (or a perpetual term) and in which they did not control the right to withdraw the assets? Sufficient assets should be maintained outside the FLP in order to provide security and income to the client. Additionally, personal assets should not be transferred to the FLP. In these type of “bad facts” cases, the Court has commented on the fact that the vast majority of the decedent’s assets were transferred to the FLP. In these cases, this was one of the factors that influenced the Court of the decedent’s retention of control over the assets for §2036 purposes. Another factor to be considered when transferring the senior generation’s assets to the FLP, is not only are there sufficient assets for such senior generation to continue their current lifestyle, but also is there sufficient liquidity to pay the estate taxes on the death of the senior generation. If the only way for the decedent’s estate to pay estate taxes is to receive a distribution or loan from the FLP, then the IRS argues that there is implied agreement among the partners to make these funds available to the decedent so that the decedent did not give up the right to control the enjoyment of the property. This has been a factor mentioned by the courts when analyzing whether the decedent retained the possession or enjoyment of the right to the property under §2036(a)(1) (see Article 8 for discussion regarding §2036).

6.09 Investment Company Partnership.

One final issue worthy of consideration is the application of the investment company rules to FLPs, both on formation and on subsequent contributions to the FLP. As a general rule, under §721(a) no gain or loss will be recognized by a partner on a contribution of property to the FLP in exchange for a partnership interest. (See I.R.C. §721(a).) However, I.R.C. §721(b) provides that the non-recognition rules of §721(a) do not apply to gain realized upon a contribution of property to a partnership which would be treated as an “investment company” (within the meaning of I.R.C. §351) if the partnership was incorporated. (See Treas. Reg. §1.351-1(c)(1) for the definition of an “investment company.”) The FLP is deemed to be an investment company if, after the partners’ contribution, more than eighty percent (80%) of the value of the FLP assets (excluding cash and nonconvertible debt obligations) are held for investment and consist of readily marketable stock or securities or interests in Regulated Investment Companies (‘RIC”) or Real Estate Investment Trusts (“REIT”). Money, stock and other equity interests in a corporation (whether public or private), evidences of indebtedness, foreign currency, options, forward or future contracts, notional principal contracts and derivatives, metals (unless used in an active trade or business after the contribution), interests in a RIC or REIT, common trust funds or publicly traded partnerships, interests convertible into the above listed assets, interests in an entity substantially all of the assets of which are assets listed and interests in an entity to the extent of the value of the interest in such entity attributable to the assets listed, are all considered “stock or securities” for purposes of applying the eighty percent (80%) investment company test. The IRS has regulatory authority to add other assets to or under “appropriate circumstances” remove assets from the list. I.R.C. §351(e)(1)(B).

For §721(b) to apply, the contribution must result, “directly or indirectly, in the diversification of the transferor’s interest.” However, Treasury Regulation §1.351-1(c)(6) provides that a transfer of investment assets to a partnership will not be treated as resulting in diversification of a transferor’s interests if each transferor transfers a diversified portfolio of
assets within the meaning of I.R.C. §368(a)(2)(F)(ii). Pursuant to §368(a)(2)(F)(ii), a diversified portfolio of assets exists if not more than twenty-five percent (25%) of the value of the transferor’s total assets is invested in the stock and securities of any one issuer and not more than fifty percent (50%) of the value of the transferor’s total assets is invested in stock and securities of five or fewer issuers. Certain assets are disregarded in determining the transferor’s assets, in both the numerator and the denominator of the equation, when applying this test. (See I.R.C. §368(a)(2)(f) and Treas. Reg. §1.351-1(c)(6).) The issue of diversification must also be considered when contributing cash to an investment FLP as the IRS, in General Counsel Memorandum 39253, found that cash can be used to achieve diversification. Therefore, the contribution of cash along with a non-diversified portfolio would, most likely, be found to result in diversification unless the contribution of cash falls within the de-minimus exception to the diversification rule discussed below. In a series of letter rulings the IRS has found that the transfer of cash by one partner and the contribution of diversified portfolios by the other partners does not result in diversification. (See PLRs 200125053, 200118039, 200113010 and 200008025.) If certain of the assets transferred (i.e., non-diversified assets) are, when taken in the aggregate, an “insignificant portion” of the total value of the assets transferred to the partnership then a de-minimus exception to the diversification rule would apply. Treas. Reg. §1.351-1(c)(5). Unfortunately, there is no clear guidance as to what constitutes an “insignificant portion” and in Rev. Rul. 87-9 the IRS stated that the determination of what constitutes an “insignificant portion” of the total assets would have to be determined based on the facts of each case. In Rev. Rul. 87-9, a transfer of cash equal to eleven percent (11%) of the value of the total assets following contribution was not an “insignificant portion.” (In this Revenue Ruling, the other transferors transferred a non-diversified portfolio along with the cash. Based on the IRS rulings discussed above, the contribution of cash, whether insignificant or significant, and a diversified portfolio should not result in diversification.) In PLR 200006008 the IRS allowed transfers of non-identical assets to a limited liability company where the assets equaled less than five percent (5%) of the total assets of the company following the transfer. It is unclear if the de-minimus exception to the diversification rule discussed above applies on contributions to pre-existing investment FLPs as the language of the pertinent Treasury Regulation and the examples given therein specifically reference transfers to “newly organized corporations.” Treas. Reg. §§1.351-1(c)(5) and (7).

Care should be taken when making contributions to an FLP that is being formed to own, or already owns, investment assets. The discussion above is intended to be a general overview of the very complex rules regarding investment companies and does not discuss all of the issues which must be considered when applying these rules to a specific situation.
ARTICLE 7
OPERATION ISSUES

7.01 Partnership Formalities.

(a) General Operational Issues.

(i) The FLP bank account should be used in the FLP’s operations to deposit income earned by the FLP and to pay FLP expenses. FLP income should not be deposited in the individual partner accounts and personal expenses of a partner should not be paid by the FLP out of its funds.

(ii) The general partner should review and abide by the provisions of the partnership agreement concerning management responsibility.

(iii) Prior to taking substantial and unusual actions on behalf of the FLP, the partners should discuss the transaction at a meeting (including the limited partners), and such meeting should be evidenced by partnership meeting minutes. The transaction could involve the borrowing of a substantial amount of money or the selling of a valuable piece of real estate. Additionally, where a vote of the limited partners is necessary, the voting requirements of the partnership agreement should be complied with by the general partner.

(iv) An annual informational meeting of all of the partners of the FLP is recommended. If the FLP has a corporation or a limited liability company that is a general partner, such general partner should have meeting minutes pertaining to acts that it, as a general partner, will perform on behalf of the FLP.

(v) A Texas limited partnership must maintain certain records at its principal office in the United States or make such records available at such office within 5 days after request by a partner or assignee. (See TBOC §153.551.) Any partner or assignee of a partnership interest may, on written request stating a proper purpose, examine and copy the applicable records. (See TBOC §153.552.)

(vi) Documents should be executed on behalf of the FLP in the name of the FLP by the general partner. For example:

    FOUNDER FAMILY INVESTMENTS, L.P.

    By: Founder Management, LLC, its general partner

    By: _____________________________
    James Founder, President
(vii) The general partner should carefully follow the terms of the partnership agreement relating to distributions. As a general rule, distributions should be made pro-rata. If there are uneven distributions, the capital accounts of the FLP will not match the profit and loss allocations, and the IRS may attempt to recharacterize such transactions as a deemed gift of proceeds from one partner to another. If unequal distributions are made from the FLP, they should be reflected in the capital accounts of the partners, and the partnership interests should be adjusted. If it is anticipated that unequal distributions will be made from the FLP during its operations, then the partnership agreement should be structured to provide a mechanism for the adjustments of the capital accounts of the partners, on a quarterly or annual basis, to properly document the economic impact on the partners. If the unequal distributions are made to the senior generation and are utilized by the senior generation for lifestyle expenses, or gifts, then this would be viewed by the IRS as a retained right to enjoyment of the property which could cause inclusion of the assets in the decedent’s estate under §2036.

(viii) If the real estate or other assets of the FLP are used by a partner or other family member, such use should be documented by a lease or other occupancy arrangement. The lease should be at fair-market value and the rent and other terms of the lease should be complied with like any other third party.

(b) Tax and Bookkeeping Compliance.

(i) Annually, the FLP must provide to each partner, information necessary to complete such partner’s federal income tax return, i.e., the FLP must provide an IRS Form K-1 to each partner.

(ii) Annually, the FLP must complete and file a partnership federal income tax return (IRS Form 1065) on or before the 15th day of the 4th month following the date its tax year ends (i.e., April 15 for calendar-year partnerships).

(iii) As a general rule, in the FLP, the income should be allocated in accordance with partnership capital. In the event there is a special allocation in the partnership agreement, the allocation should be reviewed carefully by the accountant and/or tax practitioner for the FLP. I.R.C. §704(e)(2) applies to FLPs where a gift of limited partnership interests has taken place and provides that the amount of the individual’s distributive share of the partnership income is subject to two restrictions: (1) the donee’s share must be determined by the allowance of reasonable compensation for the donor’s services rendered to the partnership; and (2) the share of the income allocated to the donee must not be proportionately greater than the share of the donor attributable to the donor’s capital. The effect of this rule is to limit income allocated to the donee to that earned by his share of the capital. Thus, the FLP’s total income should first be reduced by reasonable compensation for the donor partner, if applicable, and then the remaining income can be allocated among the partners in proportion to their capital accounts.
(iv) Accounting records must be kept on behalf of the FLP. Depending on the size of the FLP, financial statements should be prepared at least annually and in many situations, quarterly. Additionally, the FLP’s accountant should keep track of each partner’s capital accounts, distributions of capital and allocation of profits.

(v) As a general rule, a Texas limited partnership is classified as a taxable entity subject to the Texas margin tax. By contrast, passive entities are excluded from the definition of taxable entities and are not subject to the Texas margin tax. To qualify as a passive entity, an entity must meet the following requirements for the entire accounting period upon which the margin tax is based: (1) be either a general, limited, or limited liability partnership and (2) generate at least ninety percent (90%) of its federal gross income from passive sources. Generally, the types of income that are considered passive income for Texas margin tax purposes are dividends, interest, distributive shares of partnership income, net capital gains from the sale of real property, and royalties from mineral properties. One important exclusion from the definition of passive sources of income is rental income. A Texas limited liability company taxed as a partnership for federal tax purposes will not be considered a passive entity for Texas margin tax purposes. Additionally, an entity which is classified as a taxable entity for Texas margin tax purposes cannot convert into a Texas limited partnership to take advantage of the passive entity classification for that conversion year since the entity must be considered passive for the entire accounting period upon which the margin tax is based. The converted entity would be eligible to be a passive entity in subsequent accounting periods provided that the entity meets the two-prong test set forth above to be considered a passive entity for such subsequent accounting period.

(c) Miscellaneous Formalities.

(i) The partners should avoid co-mingling personal assets with FLP assets.

(ii) The partners should not borrow money from the FLP or loan money to the FLP without signing a promissory note and complying with the terms of the partnership agreement and the applicable state law.

(iii) The FLP should not guarantee or pledge business assets of the FLP for personal obligations of the partners. However, if a guarantee or pledging of FLP assets on behalf of a partner is undertaken, all of the partners should consent to such action taken by the FLP. Furthermore, the FLP should receive a fee, i.e., a guarantee fee, from the applicable partner for such FLP undertaking.
(iv) In the event the FLP is operating under an assumed name, the FLP should file an assumed name certificate with the Secretary of State’s office and with the county clerk of the county in which the FLP’s principal office is located.

(v) FLP letterhead (reflecting the FLP’s legal name) should be prepared and used in the business operations of the FLP.

(vi) In the event the FLP has multiple limited partners, consider quarterly or semi-annual reports to the limited partners to update them on actions taken, business plan revisions and ongoing FLP philosophy.

7.02 Gifts of Partnership Interest/Proper Documentation.

If senior members of a family desire to transfer a limited partnership interest to their descendants or trusts for descendants, such gift should be properly documented as to the amount of the gift and the date of the gift.

The documents that should be prepared to reflect the gifts of limited partnership interest by the limited partners are as follows:

(a) An assignment document to reflect the amount of limited partnership interest being assigned by the donor to the applicable family members. Such assignment document should be dated and signed by the applicable donor.

(b) An acknowledgment signed by the donee accepting the limited partnership interest and agreeing to accept and abide by the terms of the partnership agreement.

(c) In the event the partnership interest being transferred is an assignee interest and the applicable partners of the FLP agree to admit the assignee as a substituted limited partner, the applicable consenting partners should sign an acknowledgment to that effect.

(d) The partnership agreement should be amended to reflect the new limited partners and the partnership interest adjustments resulting from the gift of a limited partnership interest. One method to simplify amending an agreement when partnership interests change by reason of gifts, etc., is to provide in the partnership agreement that an Exhibit will be prepared and signed by all of the partners if the partnership interests change.

7.03 IRS Questions on Audit.

A number of practitioners who have represented clients in estate tax audits have received a series of IRS questions requesting specific information and documentation related to the FLP. (See Attachment #1.) It is clear from these questions that the formalities of the FLP need to be observed, that multiple purposes for the formation/operation of the FLP should be established
and followed and that the client should operate and manage the FLP in a professional manner as he or she would their other entities.

ARTICLE 8
OTHER CONCERNS

8.01 I.R.C. §2036(a).

While the IRS has espoused multiple theories to contest FLPs, few have been adopted by the Courts. However, the IRS has been successful in persuading the Courts to apply I.R.C. §2036 to the properties contributed by the founders of the FLP (usually one or both parents). In the cases where the argument has been successful, the Courts included the value of the properties transferred to the FLPs in the decedents’ estates because of the application of §2036. It is difficult to determine how broadly §2036 will be applied by the Courts as it historically has only been effective in bad fact cases. (The cases normally involve very poor facts including: (i) elderly or sick taxpayers; (ii) co-mingling of funds and not following partnership formalities; (iii) transferring almost all of the taxpayers’ assets to the FLP; (iv) no business purpose for the FLP; and (v) implied agreements that the decedents would retain the economic benefits of the property contributed to the FLP. While all five factors may not be present in a case, most of the factors were present in every case where the IRS has been successful. In planning the FLP for your clients, specific attention should be given to these factors.)

§2036(a) provides that the value of the decedent’s gross estate includes the value of all property the decedent has transferred (by trust or otherwise) and then has retained for life, for any period not ascertainable without reference to the decedent’s death, or for any period which does not in fact end before the decedent’s death either: (1) the possession or enjoyment of, or the right to income from, the property, or (2) the right to designate the persons who shall enjoy the property or the income therefrom. I.R.C. §2036(a). A key component of §2036(a) is that it does not apply if there was a bona-fide sale for adequate and full consideration in money or money’s worth. Normally, upon the formation of the FLP, a partner transfers assets into the FLP in return for a partnership interest equal to the proportionate share of the assets transferred to the FLP. One of the first arguments advanced by the taxpayer in any case involving a §2036 argument by the IRS, is that they transferred assets of a certain value and received partnership interests based on the proportionate share of the value of those assets contributed to the FLP. However, when the formalities of the FLP are not followed, and there appears to be an implied agreement among the partners that all the funds of the FLP will be available for the benefit of the decedent, the IRS has been successful in arguing that the re is not a bona-fide sale for full and adequate consideration (i.e., the contribution of assets for a partnership interest) because there was an “implied agreement” among the partners that the FLP assets will be for the benefit of the decedent.

Due to the vast use of the FLP as a discount tool in the estate planning process, the courts have used §2036(a) as a tool to cause the inclusion of the FLP assets in the decedent’s estate in bad-fact cases. The courts want the taxpayers to prove that there was significant and legitimate non-tax reasons for forming the FLP other than discounts related to the estate planning process.
It is critical to the successful implementation of an FLP to follow the formation and operational matters related to the FLP outlined earlier in this outline to avoid being the “wounded animal” case.

Some of the factors that the IRS will look at in an FLP for purposes of determining whether there are bad facts related to the formation and operation of the FLP are as follows: (i) personal assets contributed to the FLP; (ii) contribution of substantially all of the decedent’s assets to the FLP; (iii) creation of the FLP utilizing a power-of-attorney of decedent or just prior to the date of death of the decedent; (iv) minimal contributions by other partners; (v) commingling of the personal assets of the decedent with FLP assets; (vi) the decedent paying personal expenses or making gifts out of the FLP’s bank accounts; (vii) limited documentation regarding the investment or business purpose of the FLP, or in the alternative, good documentation regarding the only reason for the FLP being created was the utilization of discounts; (viii) the decedent’s estate receiving a distribution from the FLP or borrowing from the FLP to pay estate taxes; and (ix) outlining extensive investment reasons or business reasons for the formation of the FLP and then the FLP not following any of those purposes (i.e., if you say you are forming the FLP to diversify assets or obtaining outside third-party managers but continue the same investment structure and management that was there prior to formation of the FLP).

By avoiding the bad-case facts, following the formalities in the formation and operation of the FLP and utilizing the FLP as a legitimate investment or business vehicle for the family, you should be able to avoid the application of §2036(a) to your FLP’s operations and gifting program.

Another issue under §2036 that arises when the FLP holds closely held corporation stock of a business is whether the retention of voting control by the general partner, who is the senior member of the family, causes inclusion in his estate of the value of one hundred percent (100%) of the stock for purposes of §2036(b). (In Tech. Adv. Mem. 99-38-005, the IRS ruled that closely-held stock was includible in an individual’s estate where he transferred the closely-held stock to an FLP, retained the right to vote the stock as a general partner and later transferred limited partnership units to his children. While there are facts in this TAM that could be distinguishable from the normal partnership holding closely-held stock, it is clear from the ruling that the IRS intends to take the position that the retention of voting control by a general partner who also transfers limited partnership interest to his children will cause inclusion of the closely-held stock in the estate of the general partner due to the retention of the right to vote the closely held stock under §2036(b).) One might consider giving the voting rights of the stock to the limited partners or only contributing non-voting stock of closely held corporations.

8.02 Marketable Securities Distribution.

I.R.C. §731 of the Code provides that certain distributions of marketable securities are treated as cash distributions. For purposes of determining the amount of gain that a partner recognizes upon a distribution of marketable securities by an FLP, the fair-market value of securities is treated as money. Thus, under §731 and subject to satisfying one of the exceptions
below, a partner will recognize gain to the extent that the sum of the fair-market value of marketable securities and money received by him exceeds his basis in his partnership interest. The value of marketable securities is its fair-market value on the date of distribution.

Exceptions:

1. FLPs formed for the purposes of holding marketable securities for investment or for sale to customers is not subject to the above marketable securities distribution rule. An investment partnership is a partnership that (i) has never been engaged in a trade or business and (ii) substantially all of its assets consist of specified investment type assets. Please note, however, if the investment partnership owns a partnership interest in a lower tier partnership and such interest is equal to or greater than twenty percent (20%) (capital and profits interest) or such investment partnership participates in the management of the lower tier partnership in which it owns an interest, such lower tier partnership’s business operations will be treated as the operations of the upper tier investment partnership. Thus, the upper tier partnership may not meet the investment partnership exception because it would be deemed to be engaged in a trade or business. Treas. Reg. §1.731-2(e)(4).

2. The marketable security distribution rule generally does not apply to the distribution of a marketable security to a partner if the security was contributed to the FLP by the partner.

3. The marketable securities distribution rule permits a partner to receive a distribution of marketable securities without recognizing the gain that is attributable to his share of the FLP’s net appreciation with respect to securities of the type distributed.

4. The securities in such FLP were not originally actively traded.

8.03 Dispositions of Interests in Partnership Holding Installment Obligations.

In Rev. Rul. 60-352, 1960-2 CB 208, the IRS has taken the position that a charitable contribution of a partnership interest where the partnership held installment obligations constituted a “disposition” of the installment obligations held by the partnership. The logic of the ruling of the IRS in not recognizing the partnership as a separate entity for installment obligations is open to debate. However, if the IRS ruling is correct, any charitable contribution, gifts, and other transfers of partnership interest would trigger a disposition as to all of the installment obligations held by the partnership at the time of the applicable transfer, and therefore, gain would be recognized by its applicable partners.

8.04 Income Tax Basis Step Up or Step Down.

If a partnership files a §754 election, the basis of partnership property will be adjusted (“stepped up” or “stepped down”) as to the applicable partner’s share of the partnership assets in the following cases:
1. Sale or exchange of partnership interest or on the death of a partner. Such adjustments are made in the manner provided in §743 and its Regulations. Note, §754 adjustments do not apply to income in respect of decedent items; and

2. Distribution of property in the manner provided in §734.

In the case of a transfer of an interest in a partnership, either by sale or exchange or as a result of the death of a partner, a partnership which has a §754 election in effect shall:

1. Increase the adjusted basis of partnership property by the excess of the transferee’s basis for his partnership interest over his share of the adjusted basis of the partnership property; or

2. Decrease the adjusted basis of his share of the partnership property by the excess of the transferee partner’s share of the adjusted basis of all partnership property over his basis for his partnership interest.

For purposes of depreciation, depletion, gain or loss, and distribution, the transferee partner will have an adjusted basis in the underlying assets of the partnership equal to his outside basis.

In the case of a distribution under §734, if a §754 election is in effect, the basis of the partnership’s remaining assets after a distribution must be decreased or increased depending on the effect of the distribution to the liquidating partner.

It should be noted that where a partner has a community property interest in a limited partnership, not only is all of his estate’s interest in the inside assets of the partnership adjusted if there is a §754 election in place, but the deceased partner’s spouse’s interest in such assets is adjusted also.

Prior to 2004, if the partnership did not have a §754 election in place, a partner could avoid a step-down in basis of the FLP assets under §743 if there was not a §754 election in place. However, in 2004, §743(b) of the I.R.C. was amended to provide that if the partnership had built-in losses over $250,000, then upon the death of a partner or a transfer of an interest in the partnership, there will be a forced reduction in the partnership’s inside basis attributable to those assets. If the partnership interests of the decedent are valued at a discount (or there is a taxable sale of the partnership interest utilizing the discount) and such partnership interests are valued at more than $250,000 less than the partner’s pro-rated share of the partnership’s assets, there is a forced reduction in the basis of the assets inside the partnership attributable to that interest under §743(b). This can be problematic in an investment partnership where the fair-market value of the assets and the tax basis of the assets are similar and where there is a substantial discount taken on the partnership interest in the decedent’s estate.
§752 and the Regulations thereunder, as set forth above, outline the sharing of liabilities among partners in a partnership. Additionally, §752 sets forth when a partner may have an increase or decrease in his share of partnership liabilities. If a partner shares in the liability of a partnership, it will be treated as a contribution to capital and will have the effect of increasing his basis in his partnership interest. I.R.C. §752(a). The partner’s increase in a partner’s basis is important for two reasons: (1) a partner may receive nontaxable distributions of money from a partnership only to the extent that the distribution does not exceed the adjusted basis in his partnership interest (§731(a)(1)); and (2) a partner’s distributive share of partnership losses is deductible only to the extent of the partner’s adjusted basis for his partnership interest at the end of the tax year (§704(d)).

A decrease in a partner’s share of liabilities is treated as a deemed distribution of money by the partnership and decreases the distributee’s basis (but not below zero). However, to the extent the deemed distribution of money exceeds the partner’s basis in his partnership interest, gain recognition will result. I.R.C. §§731(a)(1) and 752(b).

The Regulations under §752 provide for different sharing rules with respect to recourse and nonrecourse liabilities of a partnership depending on whether the partnership is a general partnership or limited partnership.

ARTICLE 9
ETHICAL/LEGAL MALPRACTICE CONSIDERATIONS:
REPRESENTATION IN THE CONTEXT OF A FAMILY LIMITED PARTNERSHIP

In the context of the FLP, oftentimes, each of the family members (i.e., mother, father, daughter, son, etc.) regards the lawyer as his or her personal attorney, i.e., looking out for his or her own best interests. In other words, the family views the lawyer, not only as the attorney for the FLP (i.e., the entity), but as their individual attorney as well. This situation can put the lawyer “between a rock and a hard place.” On the one hand, it may be very difficult for the lawyer to selectively represent only the FLP or the FLP and certain family members to the exclusion of everyone else. On the other hand, representation of each of the family members, along with the FLP itself, may give rise to conflicts of interest that impede the lawyer’s ability to effectively represent and advise each family member and the FLP. So, what is the lawyer to do? Should the lawyer take the position that the lawyer is solely representing the FLP itself, and not any of the family members, and therefore, require each family member to hire his or her own legal counsel in connection with the FLP transaction? Although a lawyer may be able to take this position in selected transactions, practically, the lawyer would run into resistance from family members in most situations. Therefore, should the lawyer blindly proceed with representing all of the family members and the FLP and hope that he has been lucky enough to be hired by the Brady Bunch?

The following are three (3) fundamental steps that a lawyer should take in any FLP representation matter in order to help protect the family members, as well as the lawyer:
9.01 Perform a Conflicts Analysis.

The first thing the lawyer should do is perform a conflicts of interest analysis to determine whether the lawyer’s joint representation of family members and the FLP is appropriate in the first place. Such a conflicts analysis requires the lawyer to have a solid understanding of the “conflict of interest” rules of the Texas Disciplinary Rules of Professional Conduct (the “TDRPC”) as well as a solid understanding of the facts and family situation underlying the FLP matter. The TDRPC can be found at Title 2, Subtitle G, Appendix A, Article X, Section 9 of the Government Code. The TDRPC conflict of interest rules that will likely be most relevant to the family limited partnership practitioner include Rule 1.06 (Conflict of Interest: General Rule), Rule 1.07 (Conflict of Interest: Intermediary) and Rule 1.12 (Organization as a Client).

This conflicts analysis may lead the lawyer to conclude any one of the following: (i) there is no conflict at all; (ii) there is a conflict, but the conflict is a type that can be “cured” by disclosure to, and consent of, all of the family members; or (iii) there is a conflict, and the conflict is a type that cannot be “cured” (even with disclosure to, and the consent of, all of the family members); therefore, the joint representation of the family members and the FLP is inappropriate. Comment: If the lawyer determines that the joint representation is not appropriate under the TDRPC, the lawyer must notify the family members of the conflict and that the lawyer will not be representing all of the family members and the FLP. In such case, one or more of the family members and the FLP will need to obtain separate legal counsel. We recommend that the lawyer obtain a written acknowledgement from each of the family members confirming their understanding that the lawyer is not representing him/her in the FLP matter.

The very nature of the FLP, having two distinct classes of partners, general and limited partners, can lead a lawyer to conclude that the joint representation of all partners involves a conflict—though a type of conflict that can be cured by disclosure and consent. In particular, the fact that limited partners do not have any real control over the management and operations of the FLP, including distribution decisions, may be a ripe area of conflict where, for example, the FLP will have the parents as general partners and the children as limited partners. This should be discussed with all of the family members and an appropriate engagement, conflict, and consent letter should be prepared.

9.02 Prepare Engagement/Conflict/Consent Letter.

Assuming the lawyer, after performing the conflicts analysis, determines that the joint representation of the family members and the FLP does not present a conflict, or presents a conflict that can be “cured” (i.e., waived) by disclosure and consent. At that point, the lawyer should send to each of the family members a written letter that sets forth: (i) the persons and entities who the lawyer will be representing, (ii) the nature and scope of the legal services to be performed, (iii) the manner of calculating the lawyer’s legal fee, (iv) the conflict disclosure matters required by the TDRPC, including a description of the conflicts perceived by the lawyer (See Rules 1.06 and 1.07 for a detailed description of the disclosures required to be made), and (v) a request for each person’s consent to the representation. In addition, the practitioner should
inform all of the family members that the joint representation will be conducted as an “open-relationship” among all of the family members. In other words, any communications from a family member to the lawyer regarding the FLP matter will not be confidential, but shall be disclosed by the lawyer to all of the other family members if relevant to their decision making. The lawyer should be sure to have each family member and the general partner of the FLP return to the lawyer an executed original of the letter evidencing their consent to the joint representation.

9.03 **Remain Alert for New or Escalating Conflicts.**

Even if the lawyer obtains the consent to the joint representation as outlined above, the lawyer cannot assume that joint representation will be appropriate forever. Rather, the lawyer must remain on the look-out for new conflicts arising in the future or the escalation of existing conflicts that might cause the ongoing joint representation to be inappropriate or require additional disclosures and consents from the family members. Furthermore, in the event a dispute among two or more of the family members (or a family member and the FLP) arises in connection with the FLP matter, absent the consent of the family members (which is unlikely), the lawyer cannot take sides in the matter and represent one family member against the other. Each would need to retain different legal counsel.
SAMPLE IRS QUESTIONS

1. All documents relating to the creation of the partnership (including bills) from any attorney, accountant or firm involved in recommending the creation of the partnership agreement. If a claim is made that any of these documents are [sic] privileged, identify each privileged document by date, source, audience and reason for the privilege.

2. Original partnership agreement and all amendments thereto.

3. Articles of incorporation of the general partner if the general partner is a corporation.

4. All documents that were prepared to meet state law requirements on the formation and operation of the partnership (i.e., Certificate of Limited Partnership which has the filing date stamp on it and all amendments thereto; stamped copies of annual reports; supplemental affidavits on capital contributions, etc.).

5. All partnership financial statements and tax returns prepared and/or filed since inception.

6. All of the partnership’s bank and other records (i.e., general ledger, cash receipts and disbursements journals, check registers, etc.) which reflect the amount and nature of all deposits and distributions, including distributions to partners, for the period since the partnership was formed to the date of death/current date.

7. Minutes of all partnership meetings; if none, indicate the dates of all the meetings and the business discussed.

8. Evidence showing how the value of each partnership asset was arrived at as of the date:

   (a) it was contributed to the partnership;

   (b) of each gift of a partnership interest; and

   (c) of the death of the donor; provide all appraisals and supporting work papers obtained of the partnership’s assets, including partnership interests and any discounts.

9. Evidence to substitute all initial and subsequent capital contributions and the source of all contributions by partners other than the donor/decedent.

10. For each partnership asset, explain/provide:

    (a) evidence that the partnership owns the asset (i.e., deeds, bill of sale, other title changes, and account statements);

    (b) when the donor/decedent acquired the asset;
(c) how the asset was used by the donor/decedent since its acquisition and how the partnership has used the asset since (i.e., held for rent, personal residence, investment, etc.); and

(d) who managed the asset prior to and after its contribution; explain in detail what the management consisted of and how it changed after the partnership was formed.

11. For each gift or transfer of a partnership interest, provide:

(a) evidence that the partnership interest was legally transferred under state law and under the partnership agreement;

(b) any assignment of partnership interest prepared;

(c) the terms of the assignment, if not indicated in a written assignment;

(d) the amount and source of any consideration paid;

(e) an explanation of how the amount of the consideration was arrived at.

12. Indicate whether the partnership is currently in existence, and, if so, provide the current ownership interests.

13. A statement describing the donor’s/decedent’s state of health at the time of the formation of the partnership and for the six-month period prior thereto, including a description of any serious illnesses. Please also provide the names, addresses and telephone numbers of all doctors who would have knowledge of the donor’s/decedent’s state of health during this period to the present and provide these doctors with authorization to respond to the Service’s future requests for information, including a copy of the medical records, if necessary.

14. A statement indicating the identity of the parties recommending the use of the partnership, when the recommendations were made, and the reasons set forth in support of the partnership.

15. A “family tree” for the decedent going “up” from the decedent one generation and “down” from the decedent two generations.

16. An explanation of how the partnership assets were managed before and after the contribution to the FLP.

17. A statement as to who manages the FLP assets, their duties, and the approximate time devoted to the management activities. Also, include a description of the qualifications
and expertise of the general partners of the FLP and an explanation of the specific duties performed in connection with managing assets both before and after they were contributed to the FLP.

18. A statement as to the purpose for establishing the FLP. Include a description of the specific economic and other goals to be achieved through its creation and how the partnership was expected to meet those goals.

19. A statement as to how the goals and purposes described above could not be achieved equally as well through the medium of a trust or through outright gifts of the underlying property.

20. Where were the fees charged to create the entity deducted?