A Practitioners Guide to Establishing a Successful Family Limited Partnership

By Craig Stephanson, CPA, CVA

With a large number of "baby boomers" reaching retirement age, demographics across the country are such that the next decade will see a large shift in family wealth from one generation to the next. As a result, the family limited partnership ("FLP") is gaining wide spread popularity as the vehicle of choice for prudent estate and succession planning professionals. Opportunities exist for substantial gift and estate tax savings in intergenerational wealth transfer transactions if the FLP is properly utilized. Much has been written lately about FLPs. As business valuation experts, Valuation Services, Inc. has reviewed numerous FLP agreements and valued hundreds of fractional interests in FLPs. This article is a practical guide for gift and estate tax planning professionals and addresses some of the factors that gift and estate tax planning professionals should keep in mind in establishing, writing, and forming a FLP. Additionally, the valuation problems and pitfalls associated with the special valuation rules of Chapter 14 of the Internal Revenue Code and the current attack on FLPs by the Internal Revenue Service and the Courts is discussed.

Valuation Discounts

One of the main areas of opportunity lies in using valuation discounts for FLPs in situations where a senior family member contributes assets to a FLP and then subsequently gifts fractional limited partnership interests to younger generation family members. Various factors such as certain provisions in the partnership agreement, the nature of the partnership entity, and the indirect ownership of the partnership's underlying assets restrict the value of a limited partnership interest. These factors reduce the value of an interest below the interest holder's proportionate share of the underlying assets of the partnership. These reductions, or valuation discounts, from the proportionate share of the underlying partnership assets reduce the value of the gift for gift tax reporting purposes, resulting in significant gift tax savings. These transactions, if structured properly, also can remove value from the estate of the senior family member, thus potentially reducing the size of the taxable estate upon death. The FLP allows parents to transfer ownership interests to the children (or grandchildren) while still retaining operational control of the assets transferred to the FLP.

Although the Service has recently been scrutinizing the use of FLPs, the Service still recognizes and accepts valuation discounts for limited partnership interests. Probably the single most important document that will aid in determining the appropriate valuation discount is the FLP agreement. As such, the planning associated with the formation of the FLP and the terms and wording of the FLP agreement can have a significant impact on (i) the value of a fractional ownership interest, and ultimately (ii) the success in supporting valuation discounts before the Service.

Three of the most common areas which normally have the most impact on the value of a fractional FLP interest in a privately held limited partnership are (1) the control features of the interest, (2) the marketability and liquidity of the interest, and (3) restrictions on the transferability of the interest.

Control - A major factor affecting the value of a fractional limited partnership interest is the level or degree of control that the owner of the interest has over partnership decisions. In most limited partnerships, control over partnership decisions is vested entirely in the hands of the general partner, with the limited partners having very little say over partnership decisions. The Service and the Courts have long held, and logic dictates, that with all other factors being equal, a partial interest with absolutely no control is worth less than a controlling interest. In order to make it clear that the limited partnership interest being valued has no control rights, the partnership agreement should clearly state that the limited partners take no part in and have no control over the partnership's management and operations. The partnership agreement should sufficiently hinder the limited partner's control over day to day operations and management, partnership cash flow distributions, initiation of partnership expenditures, hiring personnel for the partnership, and initiation and control over the sale of any of the partnership assets.

Frequently limited partnerships provide that a limited partner, while not having control over the day to day operations and business of the partnership, may have a certain degree of control over major decisions, such as the sale of the partnership's underlying assets. For example, the partnership agreement may state that 51% of all the partners must consent to the sale of the partnership's assets. Accordingly, the desire to achieve the maximum valuation discounts must always be weighed against the desires and goals of the individual partners and prudent business judgment in situations where a fractional interest is large enough to influence a major partnership decision.

Take, for example, a situation where there are three limited partners in a partnership with ownership interests of 45%, 35%, and 19%. The general partner has a 1% interest. Assume further that the partnership agreement states that 51% of all partnership interests (general or limited) are required in order for the partnership to sell any of its assets. If the owner of the 45% limited partnership interest was to make a gift of a 2% limited partnership interest, the owner of the 2% interest would have absolutely no control over the partnership or the decision to sell any partnership assets. The owner of the 2% interest would have to combine his/her 2% voting right with that of at least two other partners in order to collectively have the requisite 51% majority in order to affect a sale of assets. Given the fact that the 2% limited partnership interest would have absolutely no control attributes, it is much easier to argue that the value of this 2% limited partnership interest should be accorded the highest possible discount related to lack of control. On the other hand, if the gift was a 16% limited partnership interest, the control features could be different. The owner of a 16% interest could combine with the 35% limited partner and together they would have the 51% voting power to force the sale of the partnership assets. Under this set of facts, the 16% limited partnership interest might possess a higher level of control. Singularly, the owner of a 16% limited partnership interest would have no more control than that of a 2% interest holder. Combined with other limited partnership interests, however, it does have slightly more influence over partnership decisions. Under this set of facts, the relative control that the owner of a 2% limited partnership interest has over the partnership business is less than that of the owner of a 16% limited partnership interest. Accordingly, the valuation discount for a 2% limited partnership interest should be higher. Accordingly, if there is a desire to have a specific partnership interest percentage comprise a majority for control purposes, it may be wise to start gifting smaller FLP interests which have no influence over FLP decisions.

It is usually helpful to give "exclusive and complete discretion" of business decisions to the general partner. However, placing absolute control in the hands of a general partner can lead to issues of continuity of the partnership if only one general partner exists. Should the sole general partner with absolute control become bankrupt or, if the general partner is an individual, pass away, the continued existence of the partnership could be jeopardized. For these reasons, it may be best from a business stand point to have a corporate general partner, or maybe two general partners. In the case of two general partners, control among the general partners then becomes important. If there is no mechanism for exercising control between general partners, then a stalemate or deadlock in the decision process can occur. A deadlock such as this can restrict the progress of the partnership and can serve to diminish the value of the equity ownership interests in the partnership, resulting in possibly a higher valuation discount. Once again, the practitioner responsible for creating the FLP must balance the desire for higher valuation discounts with good, sound business judgment.

The typical scenario in establishing an FLP involves senior family members contributing assets to the partnership in exchange for both general and limited partnership interests. The general partner interest allows the family member contributing the assets to the FLP to retain operational control of the assets through the exercise of general partner rights. As previously mentioned, it is usually the limited partnership interest that is gifted to other family members. Because of the nature of a general partner interest, there may be personal liability concerns. The general partner is personally liable for the debts, liabilities, and obligations of the partnership. While this article deals primarily with limited partnerships, it may be more advantageous or practical to establish a limited liability company instead of a limited partnership to avoid liability concerns. Many practitioners prefer to use a limited liability company which can be structured to closely resemble the functional characteristics of a FLP and achieve the same valuation discounts; yet still be able to shelter shareholders from personal liability. Since limited liability companies are a new form of entity relative to a limited partnership, it is always advisable to research the limited liability company statutes in the state where the company is to be established. The state statutes can have am impact on valuation discounts.

Marketability/Liquidity - Another major factor traditionally affecting the value of a limited partnership interest is the lack of marketability and liquidity associated with a limited partnership interest. This stems from the fact that there is no readily available source of financial information and no pool of investors willing to purchase such interests. Further, there is no organized exchange that prices or sells such interests. The marketability of an interest can be directly tied to the amount of cash distributions it receives. An interest with a smaller defined current cash flow, no cash flow, or a less certain stream of cash flow is much less marketable than an interest which receives a steady flow of cash distributions. The marketability of an interest is least affected by the wording and structure of the partnership agreement, and more by the nature of the partnership assets, debt at the partnership level, the cash flow distributions from the partnership, and the intent and desires of the partners in establishing a workable business arrangement. To attempt to increase valuation discounts at the risk of reduced marketability or liquidity, at first glance, appears to be somewhat foolish. However, there are several things that can be done to reduce marketability which may also help in meeting the overall family succession planning goals. Two items in a partnership agreement which can affect the marketability of an interest are (i) giving the general partner the sole and absolute control and discretion to determine the timing and amount of cash distributions, and (ii) providing the general partner with the right to receive compensation for services rendered.

Even though a partnership may be generating cash flow, if there is no requirement to distribute cash and such distributions are subject to the sole discretion of the general partner, there is no real assurance that the limited partners will receive any projected cash flow distributions. In situations where the general partner is reserving excessive cash or withholding cash distributions from partners, it is not uncommon for limited partners to incur phantom income, taxable income with no associated cash distribution. This is the worst possible income tax situation for an owner of a limited partnership interest, and if not corrected could significantly affect the marketability/liquidity of a FLP interest. Further, some partnership agreements allow the general partner to be reasonably compensated for his/her services as general partner or (s)he is allowed to receive a management oversight fee. If the general partner does in fact elect to take such a fee from the partnership, cash flow distributions to the limited partners are accordingly reduced, thus potentially reducing the value of the interest. Where the general partner is the parent, this fee may also serve to provide a fixed stream of income.

As previously stated, the marketability and liquidity of a limited partnership interest is affected by the nature of the underlying assets owned by the partnership. Does this mean that a FLP funded with marketable securities should not receive a valuation discount for lack of marketability because the value of these assets is readily ascertainable and liquid? Many estate and succession planning professionals are currently establishing these types of FLP's. A valuation discount may very well still be warranted in such a situation. The facts and circumstances in each case must be thoroughly analyzed. Careful consideration, as explained later, should be given to the business purpose of such a FLP.

***Restrictions of Transferability* -** Typically, partnership agreements contain a right of first refusal wherein a partner receiving an outside, independent offer to purchase his/her interest must first offer the right to purchase the interest to the other partners. The marketability of a partial interest is reduced because of the discount a prospective purchaser would seek to be compensated for the risk associated with the other partners' purchasing the interest. Purchasers do not want to go through the costly and time consuming process of determining what to pay for a partnership interest only to have their offer matched by the other partners. Other times, the partnership agreement may require unanimous consent of all partners in order for any partner to sell, transfer, or assign his/her interest. Getting all the partners to unanimously agree in any partnership can be a difficult task.

Control, marketability/liquidity, and restrictions on the transferability of an interest are the three main areas where valuation discounts have generally been accepted by the Service. Other terms seen in FLP agreements include expulsion rights, onerous or drawn out payment terms in situations where a partner does exercise his right of first refusal to acquire another partner's interest and other more severe restrictions on the transferability of a limited partnership interest. Care must be taken, however, in including these types of clauses in a FLP agreement because as explained below, if they are not based on fair, arm's length terms, the IRS could ignore them for valuation purposes.

It is important to recognize that the specific wording of a partnership agreement can have an impact on the valuation discounts associated with FLPs. However, it will take more than just the right words to persuade the Service. Fancy words and special "bells and whistles" in the partnership agreement are no substitute for careful analysis and planning in the formation of a FLP.

Recent IRS Attacks on FLPs

For years the Service was concerned that wide spread abuse existed within the gift and estate tax system which manipulated the value of transferred property to artificially low levels. In reaction, Chapter 14 of the Internal Revenue Code was enacted in 1990 to curb some of the perceived abuses in intra-family transactions. Chapter 14 has been in existence for several years, however, only recently has the Service begun to launch an attack on FLPs. Any discussion on FLPs would not be complete without an analysis of the potential problems and pitfalls of Chapter 14 of the Internal Revenue Code, specifically IRC sections 2701, 2703, and 2704, and the current position of the Service on certain aspects of FLPs. In several recent Technical Advice Memorandums ("TAM") and court cases, the Service has expressed its hesitancy to accept the validity of valuation discounts related to FLPs. The Service has focused on the following areas of concern:

- the formation of the FLP and subsequent gift of a partnership interest and the treatment of such transactions as a single integrated "step transaction",
- the lack of legitimate business purpose for the FLP pursuant to IRC section 2703,
- the integrity and true nature and character of the FLP operations, and
- the applicable restrictions of IRC section 2704 and their impact on value.

In TAM 97-19006 and TAM 97-19009 (and other TAMs released in 1997) the Service has advanced several avenues of attack on FLPs. In these TAMs, the creation of FLPs and the subsequent assignment of limited partnership interests occurred in very close proximity to the taxpayers' death. In one case the death occurred 2 days after creation of the partnership and transfer of the partnership interest, and in another, only 54 days had lapsed. In challenging the formation of the FLP and the subsequent transfer of a partnership interest in the FLP, the Service concluded in both cases that the formation of the FLP, the transfer of assets to the FLP, and the subsequent transfer of partnership interests to the taxpayers' heirs should be viewed as part of a single testamentary transfer. In other words, the arrangement merely conveyed assets to family members who would have received the assets in any event under the testamentary instruments of the taxpayer. The Service asserted that nothing of substance was intended by the transactions and no discernible purpose was served by the partnership arrangements other than the intent to depress the value of the decedents estate and avoid estate taxes. Since the decedents' beneficiaries were left with the same basic property they otherwise would have received had they not formed the FLP, the Service concluded that (i) the FLP should be ignored, (ii) the assets transferred were the underlying assets themselves and not fractional partnership interests, and (iii) no valuation discounts were allowed.

In addition to asserting the "step transaction" theory, the Service claimed in both TAMs that the FLPs were essentially created at the date of death and that the bona fide business purpose for the FLP was not met. IRC section 2703, in Chapter 14 of the Internal Revenue Code, provides that the value of any property shall be determined without regard to any restriction on the right to sell or use such property. However, a restriction which meets each of the following requirements can be considered in determining the value of property transferred, provided:

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

Each of the above conditions must be met before a restriction can be used in determining the value of a FLP interest. The regulations under 2703 state that a right or restriction may be contained in a partnership agreement and may be implicit in the capital structure of an entity.

Based on the argument that the FLPs were essentially created at the date of death, the Service argued in the TAMs that the formation of the "partnership wrapper" created a restriction on the right to sell or use the underlying assets. The Service concluded that (1) there was no true business purpose for the FLP, (2) it was merely a means of transferring property for less than adequate consideration for the sole purpose of avoiding taxes, and (3) transactions between family members are subject to special scrutiny and *ipso facto* not presumed to be arm's length transactions. The Service asserted that the restriction of the partnership agreement did not meet the three pronged exception test and thus the partnership agreement and all of its related terms was to be ignored for valuation purposes. Since the limited partnership entity structure was no longer valid, no valuation discounts were allowed.

A recent court case which also provides some guidance to gift and estate tax planners when establishing a FLP is the *Estate of Dorothy Morganson Schauerhamer V. Commissioner* (TC Memo 1997-242, 73 TCM 2855). This case centered around a taxpayer who established three FLPs to hold interests in various business holdings. The taxpayer transferred these holdings to the FLPs and also made gifts of partnership interests to her children. Although each of the three FLPs established its own bank account, the taxpayer, who controlled the business holdings prior to the establishment of the FLPs, continued to deposit all partnership income into her personal bank account. No records were maintained to account separately for partnership and nonpartnership funds. She utilized the account as her personal checking account, and from this account she paid personal and partnership expenses.

The taxpayer died a year later. For estate tax reporting purposes, the estate attempted to exclude from the gross estate of the decedent the value of the assets transferred by the decedent to the three FLPs. The Court, however, ruled that the value of the assets transferred by the decedent to the three family partnerships should be included in the estate, because she retained the possession and enjoyment of the assets. IRC section 2036 (a)(1) provides that a decedents gross estate shall include the value of all property interests transferred by the decedent during his lifetime where he has retained for his life the possession or enjoyment of the property, or the right to the income from the property. In the Court's opinion, the term enjoyment refers to the economic benefits of the property. The fact that the partnership income was deposited into her personal account even after the transfer of the assets to the FLPs was evidence that she retained the "possession or enjoyment" of the property. As a result, by not respecting the integrity and nature of the operating entities, the FLPs in this case, the estate tax planning back fired on the taxpayer.

Another area of risk to taxpayers considering the use of FLPs for gift and estate tax planning purposes, relates to the nature of the assets transferred to the FLP. In TAM 97-36004, the taxpayer once again transferred assets to an entity and attempted to gift fractional interests to family members just two months before her death. Although the newly established family entity was a limited liability company and not a limited partnership, the TAM has important implications for valuation professionals and for estate attorneys and planners.

In addition to transferring certain business related assets to a limited liability company, the taxpayer in this TAM also transferred personal property, including her automobile. The Service attacked the transaction stating that under IRC section 2703, the transaction lacked a bone fide business purpose. The TAM went on to state that *"the transfer of personal property indicates that the purpose of the transaction was an attempt to depress the value of the assets for estate tax purposes. There would seem to be no business purpose for the transfer of these personal assets to the Company. We believe that the primary purpose for creating the limited liability company was to artificially depress the value of the decedent's assets. Consequently, the limited liability company was not a bona fide business arrangement but, a device intended to artificially depress the value of the decedent's assets to avoid estate tax".*

Another weapon in the Service's arsenal used in its recent assaults on FLPs relates to IRC section 2704. This argument was advanced by the Service in several recent TAMs including 97-30004, 97-23009, 97-25002, and 97-36004. Generally, section 2704 (b) provides that if there is a transfer of an interest in a corporation or partnership to a member of the transferor's family, and the transferor and members of the transferor's family hold control of the entity immediately before the transfer, then any applicable restriction shall be disregarded in determining the value of a transferred interest. An applicable restriction for theses purposes means any restriction which effectively limits the ability of the corporation or partnership to liquidate or the shareholder or partner to withdraw and liquidate his/her ownership interest. Treasury Regulations 25.2704-2 further adds that an applicable restriction is a limitation, in the governing instruments of the entity, on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under state law generally applicable to the entity in the absence of the restriction.

The facts in these specific TAMs revealed that under the FLP agreements, the decedents could not withdraw from the FLP and liquidate their ownership interests. Under applicable state law, however, absent the terms in the FLPs, the decedents could withdraw and receive fair value for their liquidated interests by giving the partnership six months advance written notice. As a result, the Service concluded that the withdraw restrictions in the FLPs were more restrictive than state law, and thus constituted applicable restrictions under IRC section 2704. As an applicable restriction, the withdraw restriction must be ignored for valuation purposes and thus does not artificially depress the value of the gifted limited partnership interest. The implications of these interpretations on the valuation of a fractional limited partnership interest are significant. If a limited partner can liquidate his/her interest under state law statute, then the argument supporting a marketability/liquidity valuation discount is weakened. More importantly, the liquidation value of a FLP interest must now be considered over the normally smaller value determined under a discounted cash flow or going concern scenario.

The above described risk related to the denial of contractual liquidation rights which are more restrictive than state law might be avoided through the use of an assignees interest. The owner of an assignees interest, as opposed to a substituted limited partner interest, can be structured within the partnership agreement such that it will not be entitled to any rights granted to a limited partner other than the right to receive all or part of the share of distributable net cash to which the assignor would otherwise be entitled. Accordingly, the owner of an assignees interest, even under state law, would not have the right to withdraw from the partnership and liquidate his/her interest. As a result, many practitioners have begun to structure FLP transactions wherein senior family members designate the donee of an interest as an assignee, not a substituted limited partner.

An added benefit to the use of an assignees interest is its relative unattractiveness to a potential purchaser. If the FLP interest being valued for gift tax reporting purposes is that of an assignee, it might be more difficult to sell and liquidate the interest if the willing buyer is concerned about becoming something "less than" a full limited partner. It could be argued that an additional valuation discount is warranted due to the unique nature of an assignees interest.

The final pitfall buried in Chapter 14 which may need to be addressed by estate planners in the context of establishing FLPs, relates to the provisions in IRC section 2701. Senior family members sometimes want to receive special guaranteed payments or special allocations in newly established FLPs. Section 2701 provides a specific methodology for valuing partnership equity interests and the resulting gift amounts for gift tax reporting purposes. Section 2701 provides special valuation rules for valuing junior equity interests in partnerships where (i) older generation family members transfer an equity interest in the partnership to members of the transferor's family, and (ii) immediately thereafter, the transferor holds an "applicable retained interest" in the partnership. An applicable retained interest is defined under Section 2701 as an interest that has preferential distribution rights or extraordinary payment rights.

The general rule of Section 2701 states that classes of equity interests that are entitled to preferred distribution rights held by senior family members are accorded a zero value. If this general rule were to apply to a transfer, then by application of the special valuation rules of IRC section 2701, the senior equity interest (the applicable retained interest) would be valued at $0 and the entire aggregate value of all family equity interests would be allocated to the transferred or junior equity interest. This would result in a higher gift amount. The exception to this rule is that distribution rights considered "qualified payments" are not valued at zero. Qualified payments are cumulative distributions payable periodically, at least annually, with respect to an equity interest, which are determined at a minimum fixed rate or as a fixed amount. Accordingly, if the senior generation family member wants to receive a preferred distribution, strict adherence to the requirements of IRC 2701 and the regulations thereunder is necessary in order to avoid potentially disastrous gift tax results.

The Need for Careful Advanced Planning

So after all is said and done, has the Service closed down the window of opportunity on FLPs? No! The fact patterns in most of the TAMs discussed above are bad. With bad facts come bad results. The key is to start the planning early. These "death bed" transfers will receive very close scrutiny. If planning begins early, and distance can be put between the formation of the FLP and the subsequent transfer of limited partnership interests, the likelihood of Service attack similar to these TAMs is less likely. Once the FLP has been established, wait several months or more, if possible, before gifting fractional FLP interests. If possible, the estate and succession planning professionals should encourage clients to begin the planning process as wealth begins to grow, not after it has already accumulated. Creating a history of operations for the FLP prior to the first gift also lends credible business purpose to the transaction and the Service is not likely to, or will be precluded from, advancing the "step transaction" theory.

Additionally, careful consideration should be given to the business purpose of the FLP in the partnership agreement. Once again, words alone will not keep the Service away, but make sure all the "T's" are crossed. The transaction should have a real business purpose and as such should look, feel and smell like an arm's length relationship. Do not give family members special treatment which do not reflect third party, arm's length terms. If possible, have the children contribute capital to the FLP. A contribution by the children gives the formation of the FLP a real business purpose which appears to be part of an arm's length transaction as opposed to a gift. Fund the FLP properly and adequately and maintain the integrity of the partnership entity. If the FLP is to be funded with real property, it may also be helpful to contribute marketable and non-marketable securities and other assets to the FLP. This can support the intention to consolidate family assets and diversify risk, both valid business reasons for establishing the FLP. Set up separate bank accounts and be sure not to commingle FLP funds with other family cash or assets. The estate planning professionals should stay involved even after the formation of the FLP and transfer of partnership interests. In this way, they may help the taxpayer/client in following through on maintaining the integrity of the FLP entity structure.

Finally, in establishing the FLP, research the applicable state law in the jurisdiction where the FLP is to be created. If the state law proves to be a hindrance as it relates to I.R.C. 2704, consider using an assignees interest or consider establishing the FLP in another state. Valuing a FLP interest based on the liquidation value, however, is not always detrimental. Situations do exist where the current liquidation value may be less than the going concern value. The facts of each specific case need to be fully explored before running and hiding from the potential pitfalls of Chapter 14. For example, special distribution preferences can be established in FLPs without the harmful impact of the special valuation rules under I.R.C. 2701 if careful planning and thorough analysis is utilized in setting up the FLP and structuring partnership allocations.

If used properly, the FLP is a powerful tool in gift and estate tax planning. Valuation discounts can save significant tax dollars. The partnership agreement can have all of the appropriate bells and whistles to maximize valuation discounts. However, it is likely that the substance of the FLP will be reviewed by the IRS. There should be a balance between minimizing the value of the gift or estate, and the economic reasoning in the formation of the FLP and the actions of the partners. The key to success in any succession or gifting plan is careful analysis of the facts and advanced planning.

Craig Stephanson, CPA, CVA
Valuation Services, Inc.
Suite 20
1750 Rockville, Maryland 20852
(301) 770-2077
Fax (301) 770-5526
E-mail: craig @ TZG.com

Craig Stephanson, CPA, CVA is President for Valuation Services, Inc., a Washington, D.C. based firm which exclusively values closely held businesses and fractional interests in closely held businesses. He is a leading expert on the formation and valuation of family limited partnerships and specializes in the valuation of real estate partnerships for estate planning and administration, succession planning, divorce proceedings, partner disputes, and litigation support. He is also is a member of the Institute of Business Appraisers.