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USING FAMILY LIMITED PARTNERSHIPS FOR ESTATE PLANNING

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The Smith family owns a hardware store. The store has been in the family for three generations. The parents are in their fifties and are considering retiring in the next ten years and want to pass the business on to their children. They have two children: a son and a daughter. Both children are in their twenties. Neither child is currently prepared to step in and run the business. The parents want to begin training the children on how to manage and operate the business; however, the parents still want to retain control. Their daughter has shown an interest in the hardware business. Their son is currently a teacher-and has no desire to own or operate a business. The Smiths have come to seek counsel for their estate planning.

Several estate planning options are available for the Smiths. Some of them include creating a family limited partnership, a limited liability company or a corporation, all of which will allow the parents to retain control of the business while giving the children limited ownership. In a family limited partnership, the parents retain control by being the only general partners. In a limited liability company, the parents keep control by being the only managing members. Finally, in a corporation, the parents maintain control by being the only directors. This article will only discuss the family limited partnership, its purpose, the advantages and disadvantages of its use and how the law is developing in this area; however, some of the case law that is included about family limited partnerships can be found in limited liability companies, as well.

The family limited partnership is a tool used by estate planners for the purpose of asset protection. It can be used to lower or eliminate estate taxes, to reduce income taxes, and to

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provide a smooth succession of the business. A family limited partnership is not a legally recognized entity; rather, it is a type of limited partnership restricted to family members. A limited partnership is a legal entity recognized in one form or another in every state. The limited partnership consists of two classes of partners: the general partner and the limited partner. General partners have the same rights, duties and obligations as general partners in a general partnership. They manage and control the family limited partnership and make all the decisions for the partnership. Consequently, they are exposed to all of the operational risks of the business and are responsible for any liability created by the partnership.

The limited partners have no right to control or manage the business. They have no right to vote or a right to income; therefore, they are normally not responsible for any liability created by the business. Limited partners are investors who normally stand to lose only what they have invested in the business.

In our scenario, after talking to counsel and reviewing all of the options, the parents decide to create a family limited partnership to protect the assets of the hardware store and to allow the children to have an interest in the business. Both parents will be the general partners and each will have a two percent general partner interest in the business. They have also decided to be limited partners and to include their children as limited partners. Each limited partner will have a twenty-four percent interest in the business.

WHY USE A FAMILY LIMITED PARTNERSHIP?

CONTROL RETAINED BY THE GENERAL PARTNERS

One of the most common purposes of the family limited partnership is to allow older family members, the general partners, to retain control of the business and its assets while the younger family members, the limited partners, learn the business so that they can eventually run it themselves. Parents always have the option to give away their estate while they are still alive; however, by doing so, they lose control of the assts and managing the business and they will not be able to protect the business or assts from unintended beneficiaries. The family limited partnership, through the creation of an effective partnership agreement, can state how the business is to be distributed to partners for purposes of a smooth transition. For example, in our scenario, the partnership agreement can give both children a share of the business through their limited partnership interest, but the daughter can receive a salary for her work and assume the role of a general partner upon the death or retirement of one or both parent.

Additionally, the family limited partnership allows the family's assets to be consolidated and centralized. Any changes that are needed concerning family control can simply be done by changing the general partners.

ASSET PROTECTION

Another common purpose of the family limited partnership is to protect family assets. Assets owned by the limited partnership belong only to the limited partnership. Therefore, any personal liability created by individual decisions or actions of a partner will not affect the partnership's assets. The partnership agreement can provide additional protection by defining what partners can and cannot do. The law also provides some protection for the partnership that is not at fault and for the partners that have done nothing wrong. This asset protection stops creditors from seizing the partnership, interfering with management of the partnership, demanding a partnership distribution of income or assets, or terminating the partnership. However, any liability created by the partnership will expose the partnership's assets to creditors.

For example, in our scenario, the daughter is involved in an accident in one of the partnership's vehicles. The person she hits sues her and obtains a judgment against her that is beyond the auto insurance coverage limits. The creditor tries to satisfy the judgment by seizing the property, but finds that it is owned by the family limited partnership and is protected. Generally, most states will not allow partnership assets to be taken into judgment if a partner, rather than a partnership, is liable for a debt. Instead, the creditor can ask the court to issue a charging order. Section 28 of the Uniform Partnership Act defines a charging order as a device by which an individual creditor of a partner levies upon the partner's interest in the partnership. Since the daughter has a twenty-four percent interest in the partnership, the creditor would receive twenty-four percent of the earned partnership returns. The charging order requires the partnership to distribute money to the judgment creditor that the partner would have received. This order does not give the creditor the right to become a partner or interfere with the management or control of the partnership.[1]

However, this charging order is ineffective if the partner never receives a distribution. In most partnership agreements, the general partners have complete control over distributing income to partners. So, if the general partners decide to withhold payments of distributive shares, the creditor may never receive payment from partnership funds. Proceeds may continue to be made through the payment of salaries. Additionally, a partner who has a charging order against their distributive shares remains a partner in the partnership and can continue with their assigned duties, even though someone else is receiving the distribution.[2] Admittedly, if the general partners decide to withhold payments, then no partner may receive a distribution.

There is at least one danger in using a charging order. The order gives the creditor a right to any proceeds from the partnership until the creditor has been paid in full or until the time limit for collecting the judgment has expired (usually twenty years). Thus, the debt is forgiven after the twenty year period.

Some states have provided new powers to reach assets by allowing a creditor to foreclose on a debtor's partnership interest. A foreclosure takes place when the court allows a seizure and sale of the debtor's management interest.[3] The creditors then can receive the debtor's share of distribution without regard to the amount of the judgment. This issue was upheld in *Hellman v. Anderson*.[4] The court held that a judgment debtor's interest in a partnership may be foreclosed upon and sold, even though other partners do not consent to the sale, provided the foreclosure does not unduly interfere with the

1. The Law Offices of Richard Kroll, *The Power of Family Limited Partnerships, at* http://articles.corporate.findlaw.com/articles/file/00458/005543/title/Subject/topic/Business/Small%20Business%20Law_Debtor/Creditor/filename/businesssmallbusinesslaw_1_376 (last visited April 6, 2004).

2. ROBERT W. HAMILTON, BUSINESS ORGANIZATIONS: ESSENTIAL TERMS AND CONCEPTS 79 (Aspen Law & Business 1996).

3. The Law Offices of Richard Kroll, *supra*, note 1.

4. 233 Cal. App. 3d 840, 842 (Cal. App. 3d Dist. 1991).

partnership business. In *Crocker Nat'l. Bank v. Perroton,*[5] the court upheld an order for sale of a judgment debtor's partnership interest where the creditor showed that it was unable to obtain satisfaction of the debt and the remaining partner consented to the sale.

This threat of foreclosure is frequently used by well-informed plaintiffs when spouses are the general partners and they also have all or most of the limited partnership interests. It is advisable, therefore, that the limited partnership interest be given to the children or transferred to a trust.

In another case where the U.S. Bankruptcy Court held that a creditor of a single member LLC has rights beyond the charging order remedy. In *Ashley Albright,*[6] the court held that since there were no other members to protect, there was no reason to limit the ability of a creditor to reach the assets of the LLC. Therefore, based on these three holdings, we must be careful in advising individuals who are the sole general partner and limited partner.

In either case, the use of a charging order or a foreclosure may cause a creditor to be leveraged to accept a settlement that is advantageous to the debtor.

REDUCING INCOME TAXES

Unlike a corporation, a partnership is not a tax-paying entity. The method of taxation that applies to a partnership is usually referred to as pass through taxation. The partnership must file an annual information tax return which states its income and expenses, but it does not have to pay tax on its income. The income or loss of the partnership is allocated to the partners per the partnership agreement. Each partner is required to include in their personal income tax return the amount of each allocated item. The partnership sends each partner a statement as to the amount of income, deduction or loss allocated to him or her for the year.

The family limited partnership can provide tax savings to the partners by spreading income from the parents, who are probably in a higher income tax bracket, to the children, who are probably in a lower income tax bracket. Additionally, the partnership agreement can be written to state that all proceeds

5. 208 Cal. App. 3d 1, 2 (Cal. App. 1st Dist. 1989).
6. 291 B.R. 538, 540 (Bankr. D. Colo. Apr. 04, 2003)

to the children will not be actually distributed; portions may be used to pay their income tax and some or all of the rest may be put aside for savings. Using our scenario, if the hardware store is making money, the parents do not have to pay taxes on all the income. They can pay out income to their children through their distributive shares and the children will pay their taxes, which should be at a lower tax rate than their parents.

REDUCTION/ELIMINATION OF ESTATE TAXES

The federal estate tax can be reduced through various estate planning methods. The family limited partnership can drastically reduce or even eliminate estate taxes, especially for businesses where the estate assets are investment real estate used for family business purposes. Under a family limited partnership, the general partners can make a gift of the limited partnership interest to their children. This would allow parents to shift their assets out of their estate, but yet still have control.

The IRS has provided an additional advantage for using a family limited partnership. The law allows transferred interests in limited partnerships to be discounted to reflect their true value in the market. These discounts can range from twenty percent to fifty percent. Why can limited partnerships be discounted? There are several reasons. First, even though limited partnerships are similar to stock in a corporation, they are not as valuable as stock because they are not traded and do not have any immediate value. They also cannot be easily sold. Second, the limited partner has no right to participate in management and therefore cannot control decisions that affect business income and profitability.

Therefore, the value of the limited partnership interest transferred is lower, the size of the parent's estates and the amount of estate tax liability is reduced. For example, if the Smiths own a 50% limited partnership interest in a limited partnership worth $1 million, then at a 20% discount, it would actually be worth $400,000 instead $500,000. If their tax bracket is 55%, then their tax payout would be $220,000. The Smiths' tax savings would be $55,000. This is using a conservative discount. Imagine the savings that they would have if they used a 30 or 40% discount. However, using higher, more aggressive discounts may draw IRS attention and challenge.

Lastly, whenever a family limited partnership for estate tax savings is used, make sure that a credible appraisal is obtained to support the amount of the discount, that documents are properly drafted and that there is a sound purpose for the plan other than to avoid paying taxes.[7] In *Strangi v. C.I.R.*,[8] the court upheld the tax court's decision that disallowed the claimed discount on the grounds that the founder retained too many powers over supposedly gifted partnership assets. The family limited partnership made disproportionately large distributions to the founder and ultimately paid his estate taxes and other expenses, ignoring the legal interests of the limited partners. The founder continued to treat all the assets as his own and to maintain control and enjoyment over the gifted assets. The limited partners did not enjoy any benefits or protection of their rights under the plan.

SAFE AND DANGEROUS ASSETS

In forming family limited partnerships, the partners must understand the difference between safe assets and dangerous assets. Safe assets are those assets that are not likely to incur a legal liability for which you can be sued. Some examples of safe assets are stocks, bonds, mutual funds, cash accounts, collectibles – such as art, antiques and coin collections, and real estate investments for which there is substantial liability insurance.[9]

Dangerous assets are assets that, by their nature, create a substantial risk of liability. These include rental real estate and commercial real estate – such as office buildings, hotels, restaurants, nightclubs or other buildings where large groups of people assemble and where there is a great potential for some type of disaster. A family limited partnership can still be used to protect these dangerous assets, but it should be held in its own family limited partnerships separate from the safe assets.

Lastly, there are some assets that should not be assigned to a family limited partnership due to their complexity of the tax and administrative implications. They include retirement plans,

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7. The Law Offices of Richard Kroll, *supra*, note 1.

8. 293 F.3d 279 (5th Cir. 2002).

9. Peter J. Parhiala Law Firm, *The Family Limited Partnership*, *at* http://library.lp.findlaw.com/articles/file/00456/000982/title/Subject/topic/Business/Small%20Business%20Law_Debtor/Creditor/filename/businesssmallbusinesslaw_1_376 (last visited April 6, 2004).

S corporation stock and stock of profession corporations.[10]

CONCLUSION

What is the best tool to use for estate planning? A good advisor will review all of the factors that affect his or her client and choose the entity that is the best fit for the client's state of affairs. Using a family limited partnership can be very powerful in protecting family assets. In general, many of the laws and court decisions offer favorable protection for the family limited partnership plan as long as the planning is not intended to defraud creditors or violate existing fraudulent transfer laws.

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10. *Id.*