FAMILY LIMITED PARTNERSHIPS

The family partnership is a structure for the holding of assets which enables a person to transfer property to younger family members at a significantly reduced transfer tax cost while retaining the right to management and control of the asset and obtaining a measure of creditor protection.

A. Typical Transaction

The Grantors establish a family limited partnership under which the Grantors are the general partners and owners of all or substantially all of the limited partnership units. The Grantors then give limited partnership units to family member beneficiaries at a significantly discounted value. As general partner, the Grantors retain management and control of the partnership assets.

B. Purposes of Family Limited Partnerships

1. Transfer of wealth without losing management or control over investment assets.

    a. Allows some control over cash flow.

    b. Allows consolidation of investments to reduce management cost for a portfolio of assets that might otherwise be held in multiple accounts for multiple family members and not meet minimum account balance requirements.

    c. Buy-Sell provisions can help retain assets in family.

    d. Convenient method of segregating assets to protect against failed marriages.

    e. Convenient method for resolving family disputes as agreement can require settlement of disputes by arbitration.

    f. Flexibility in amending and/or terminating partnership.

2. Substantial reduction to transfer tax cost when making gifts of limited partnership units.

    a. Value of limited partnership interest gifted are discounted due to lack of marketability.

    b. Value of limited partnership interest gifted are also discounted due to lack of control.

3. Protecting assets from future creditors.

    a. No creditor protection for existing or foreseeable creditors.

b. Future judgment creditors may not execute against the debtor's interest in the underlying partnership property as the creditor's remedy is limited to an order which makes the creditor an assignee of the debtor's interest, not a substitute partner.

c. A creditor who becomes an assignee of a limited partner runs the risk of receiving "phantom income" from the partnership.

d. Some uncertainty under California law.

C. Rights of General and Limited Partners

1. Rights of General Partner

a. Has sole authority to manage and invest partnership assets.

b. Has sole power to authorize distributions be made to partners.

c. Right to receive pro rata share of partnership distributions.

2. Rights of Limited Partners

a. Right to receive pro rata share of partnership distributions.

b. Right to inspect partnership books and records.

c. Limited partners do not have the right to:

Manage assets.
Remove general partner.
Recover his or her shares of the underlying assets until the partnership ends.
Transfer his or her partnership interest to anyone except family members.
Pledge his or her partnership interests.

D. Income Tax Consequences

1. Generally, no income tax consequences of contributing property to partnership. Possible increase tax liability if family members contribute marketable securities.

2. Partnership does not pay income tax on income earned by the partnership.

3. Each partner (both general and limited) reports his or her proportionate share of partnership income on his or her individual income tax return whether or not partnership income is actually distributed to the partners.

4. Generally, distributions from the partnership to partners are not subject to tax.

5. Generally, there is gain recognized on the dissolution of a partnership.

E. Gift Tax Consequences

1. The value of gifts of limited partnership interests are discounted due to lack of marketability and control. The donee has no right to become a substituted limited partner; i.e. the donee only receives an assignee interest.

2. Gifts of limited partnership interest qualify for annual gift tax exclusion.

3. Generally, no gift tax will be payable on gifts in excess of the annual gift tax exclusion, although a portion of the donor's unified estate and gift tax credit will be used.

F. Estate Tax Consequences

1. All limited partnership interests gifted (including the appreciation on such interests) will be excluded from the donor's estate.

2. All income attributed to limited partner interests gifted will be excluded from the donor's estate.

3. Partnership interests retained by donor may be valued at a discount for estate tax purposes.

G. Limited Liability Companies (LLCs)

Due to changes made under California law in recent years regarding limited liability companies, gifts of limited liability company interests now receive valuation discounts similar to those attributable to gifts of limited partnership interests. Limited liability companies are now a viable alternative to family limited partnerships, especially where real estate is involved.

H. Gifting Limited Partnership Interest to Grantor Retained Annuity Trust

1. Allows greater discounting leverage to be achieved.

2. Allows Grantor to retain an income interest in the limited partnership interest gifted for a term of years.

I. IRS Challenges

The Internal Revenue Service has aggressively challenged the utilization of family limited partnerships for wealth transfer purposes. Although most commentators have criticized the IRS position except in the most egregious situations, the risk of audit must be considered. Fortunately, taxpayers have received a number of favorable decisions in recent tax court cases where the IRS attempted to challenge the use of family limited partnerships. These decisions uniformly rejected the technical legal arguments which the IRS raised to attack family limited partnerships. It now appears that family limited partnerships will be respected for tax purposes if proper state law form is followed unless the IRS can show that the taxpayer disregarded the partnership after formation.