

# A DRAFTING GUIDE TO THE FAMILY LIMITED PARTNERSHIP

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## **A DRAFTING GUIDE TO THE FAMILY LIMITED PARTNERSHIP**

### **I. INTRODUCTION TO FAMILY LIMITED PARTNERSHIPS**

#### **A. Generally.**

The family limited partnership ("FLP") has become one of the most talked about estate-planning devices available to estate planners. There have been numerous articles discussing the FLP's benefits. The enactment of Internal Revenue Code ("Code") §2704 has provided guidance to practitioners. Still, there is much uncertainty and speculation on the effectiveness and advisability of using FLPs.

#### **B. Scope and Purpose.**

This article's scope and purpose is to provide a drafting guide for the FLP. Emphasis will be placed on drafting useful forms, avoiding pitfalls, and establishing practical procedures for the lawyer and the client to form and operate an FLP. Additional purposes of this presentation are to identify:

- the default provisions of your state limited partnership act ("Act") as applicable to FLPs;
- the provisions of Chapter 14 of the Code applicable to FLPs; and
- the FLP's advantages in estate planning.

To accomplish these goals, it will be necessary to address certain tax issues that are incumbent in organizing an FLP. A sample partnership agreement is attached to this article to assist in accomplishing these purposes.

### **II. PURPOSES**

#### **A. Introduction**

Every estate plan's foundation is a tax-planning will or revocable trust for a husband and wife that utilizes the unified credit and the unlimited marital deduction. Estate planners often add an irrevocable life insurance trust and begin an annual gifting program to round out a basic estate plan. When these techniques have been completed or put into motion, many estate planners feel their job is complete. There are other advanced estate-planning techniques now available. They often seem, however, disjunctive and incomprehensible to clients. The FLP can be the vehicle that ties together a family's overall estate plan. When used in conjunction with other advanced estate-planning techniques, it can actually maximize or leverage the benefits that can be obtained for the family. The FLP may be used to:

- obtain favorable income tax treatment;
- provide business flexibility;
- minimize franchise tax liability in states having a franchise tax;

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- provide numerous business objectives.

### **B. Client Motivations**

Clients are often in a quandary as to how to resolve conflicting desires. They don't want their assets subject to estate or gift taxes, yet they don't want to lose control over the assets or the income stream derived from those assets. They want to be able to transfer their assets to their children, but they don't necessarily want their children to enjoy the benefit of those assets now. They want to avoid the cost, inconvenience, and length of time it takes to probate their estates, but they don't want to think about death nor face the fact that there are hard decisions that need to be made concerning managing and distributing the assets of their estates. Clients are always looking for methods to protect their assets from creditors, yet they don't want to pay any additional income tax or have additional franchise-tax liability that often arises when limited liability entities are used to provide creditor protection. Clients want to achieve the maximum benefits, but they want to keep matters simple. In short, clients want to do something, but they are reluctant to do anything. The FLP responds to the inherent conflicts in the estate-planning process by allowing the clients the ability to achieve their estate-planning goals without giving up total control over their assets.

### **C. An FLP's Administrative Benefits**

Fragmented interests held by family members or their respective trusts may be consolidated into an FLP, which allows centralized control, enables investment at more optimum return rates, and reduces bookkeeping and operational costs. The assets placed in an FLP are owned by the partnership and not the individual partners. When an individual partner dies, it is the partnership interest in the FLP that is probated in the deceased partner's estate and not the partnership's individual assets. Thus, an FLP may be used to consolidate fragmented and far-flung family assets and place them in one basket for administration ease and minimizing probate costs. The FLP may be used in certain cases as an alternative to the revocable trust or in conjunction with a revocable trust to eliminate ancillary probate proceedings as well as estate administration costs.

### **D. The FLP's Estate and Gift Tax Benefits**

Using an FLP can depress the value of family assets for transfer tax and creditor protection purposes. This depressed value can be used to minimize estate and gift-tax liability, yet when the FLP terminates, the assets' liquidation value reappear.

Technical Advice Memorandum ("TAM") **9131006** (4/30/91) states that a general partner may retain investment and distribution authority over partnership assets without subjecting transferred limited partnership interests to estate-tax inclusion in the deceased partner's estate.

Gifts of limited partnership interests qualify as present-interest gifts for annual gift-tax exclusion purposes. Gifting interests in an FLP that holds family assets is often preferable to gifting splintered ownership interests in individual assets.

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An FLP may be used to acquire and own life insurance on a partner's life. **The proceeds of a life insurance policy owned by a partnership and payable directly to it on the insured's death will not be included in the insured's estate merely because of the insured's status as a partner, even when the insured is a controlling partner.** Only the value of the insured partner's ownership interest in the partnership is included in the partner's estate. Valuing this interest must take into account a corresponding percentage interest in the insurance proceeds payable to the partnership.

In certain cases income-tax benefits may be shifted among family members. Although an FLP is not usually considered as a vehicle to shift income, when partnership interests are gifted to various family members some income-tax savings can be achieved due to the different income-tax rates of the partners.

### **E. Family Relation Benefits**

An FLP may be used to accomplish a number of patriarchal goals for the family. Parents are always concerned about the effect divorce has on a child or grandchild. The FLP may be used to provide a measure of protection from the financial risk associated with a descendant's messy divorce. An FLP may be used as a vehicle to educate family members about family assets and how to manage and increase those assets. It may also provide for mediation and arbitration provisions to harmoniously resolve family disputes. One primary concern of a family's patriarch or matriarch is continued control over family assets and how and when to distribute the family wealth to family members. The FLP provides a mechanism by which the parents can accomplish these goals.

### **F. Using FLPs in Conjunction with Traditional Trust Planning**

Partnership interests in FLPs may be used to fund marital deduction trusts, credit shelter trusts, GST dynastic trusts, and Crummey educational trusts. In effect, using discounted partnership interests to fund these trusts can pack additional value into the trusts. If the trusts have already been funded, there are significant administrative benefits that may be derived when the trusts invests their assets into the FLP. Furthermore, having trusts as limited partners in the FLP may facilitate the discounts that may apply to other partnership interests owned by family members outright. An FLP may also integrate existing family trusts with one another. FLPs may be used to solve funding issues associated with life insurance trusts. FLPs may be used in conjunction with charitable remainder unitrusts, revocable living trusts, and Code §2503(C) trusts. Significant benefits to the family may also be obtained through using FLP interests to fund a grantor retained annuity trust ("GRAT"). Finally, the FLP may avoid conflicts among family members over what is fair for current trust beneficiaries versus remainder trust beneficiaries.

### **G. Creditor Protection**

An FLP may be used to limit the limited partners' liability from those risks arising from the FLP's activities. If a corporation or limited liability company ("LLC") is used as an FLP's general partner, then effectively all family members will have limited liability. Additional creditor protection is available to an FLP's partner from activities outside the FLP because the collection remedies available to the creditor may be limited.

### **F. Business Flexibility**

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An FLP is more flexible than a corporation. FLPs are not subject to a franchise tax. Unlike trusts, which are irrevocable and nonamendable, FLPs may be amended or revoked. Dissolving an FLP will not trigger adverse tax consequences that may occur with dissolving a corporation. An FLP can have more favorable income-tax treatment than either a corporation or a trust. An FLP provides more flexibility in making investments than a trust because the FLP is subject to the business-judgment rule whereas a trust is subject to the prudent-man rule. In addition, an FLP's manager can make investments in accordance with the modern portfolio theory while trustees of a trust are reluctant to do so.

### **III. CHAPTER 14 CONSIDERATIONS**

#### **A. Generally**

Chapter 14 of the Code ("Chapter 14") deals with valuation issues in relation to transferring ownership interests in certain types of business entities. The restrictions imposed by Chapter 14 must be considered in drafting an FLP. If properly drafted, significant valuation discounts are available to owners of interests in FLPs. There are several rules which if followed will avoid adverse transfer-tax consequences under Chapter 14.

#### **B. Code §2701**

Rule One: Draft an FLP with only **one class** of partnership interest. If an FLP has only one class of partnership interest, Code §2701 is not applicable.

In certain cases, an FLP may be designed with two classes of interest. In that event, care must be taken to comply with Code §2701. An example of this design is an FLP with two classes of equity interest. There is a junior equity class and a senior equity class where the rights of the senior equity class as to income and capital are superior to the rights of all other classes of equity interest. **Gifting the senior equity interest and retaining the junior equity interest is not a transaction that is subject to the valuation rules under Code §2701, because retaining ownership in the junior equity interest (analogous to common stock) generally does not give the transferor the right to manipulate the value of the transferred interest.** For a more detailed analysis of using two or more classes of equity interests in an FLP, see **"If Uncle Sam is Your Senior Partner, You Must Have a Lousy Partnership Agreement: Using Partnerships in a Lifetime Gifting Program"**, Fourth Annual Spring CLE and Committee Meeting, April, 1993, by S. Stacy Eastland.

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Using two or more classes of equity interest in an FLP may be very beneficial. Usually a public charity will serve as the nonfamily partner who is given the senior equity interest that pays a high-yield, preferred payment. Normally, the charity wants to continue the FLP because of the high yield on the preferred interest. **There are two reasons to have nonfamily members in an FLP.** First, **Code §2704(b) is not applicable when there are nonfamily members in the FLP and the family may not unilaterally remove an applicable restriction.** Second, it is comforting to rely on the favorable ruling in *United States vs. Marian A. Byrum, Executrix Under the Last Will and Testament of Milliken C. Byrum*, 408 U.S. 125, 92 S.Ct. 2382, ("Byrum") in regard to issues raised by Code §2036(a). These two benefits may also be achieved by an FLP that has only one class of equity interest where nonfamily members acquire an interest in the FLP. In this situation, the nonfamily members are usually trusted family retainers. A charity is not used because an FLP usually makes very few distributions, which is not appealing to a charity looking for income. A charity that is not receiving income will usually not be very cooperative and will vote to liquidate the FLP at the first opportunity.

The difference between general and limited partnership interests regarding participation in management and exposure to liability do not create two "classes" of partnership interest under Code §2701. Treasury Regulation ("Reg." or Regulations") §25.2701-1(c)(3) provides that nonlapsing differences with respect to management and limitations on liability do not create separate classes of interests. In addition, this regulation states that nonlapsing provisions required to comply with the relevant partnership tax allocation requirements [such as Code §704(c) allocations based on appreciated, contributed property and Code §704(b)] are also treated as nonlapsing differences. Thus, they do not create separate classes.

Private Letter Ruling ("PLR") 9415007 deals with an FLP where there is one class of partnership interest. It states that a distribution right does not include any right to receive distributions with respect to an interest that is in the same class as the transferred interest. It goes on to state that a retained interest is the same class as the transferred interest if the rights in the retained interest are identical to the rights of the transferred interest **except for, in the case of a partnership, nonlapsing differences with respect to management and limitations on liability.** It further states that for this purpose, nonlapsing provisions necessary to comply with the partnership allocation requirements of the Code are nonlapsing differences with respect to limitations on liability. In summation, PLR 9415007 states that the right to the distributions that the transferor/general partner proposes to retain are rights with respect to an interest that is of the same class as the interests that the transferor/general proposes to transfer. Consequently, the rights to be retained by the transferor will not constitute distribution rights. Thus, an applicable retained interest will not exist after the proposed transfers, and Code §2701 will not apply.

A payment right that qualifies as a guaranteed payment under Code §707(c) is an exception excluded from applying the provisions of Code §2701. To qualify as a Code 707(c) guaranteed payment, it must be fixed, specific as to amount, and definite as to the time of payment. A payment that is contingent as to time or amount is not a guaranteed payment of a fixed amount. Reg. §25.2701-2(b)(4)(iii).

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The reason an FLP is drafted to avoid the Code §2701 provisions is so the willing buyer and willing seller test will apply to the transfers of partnership interests rather than the unfavorable Code §2701 valuation rules. If there is a partnership interest where the payment to the partner is guaranteed, it will be an exception to Code §2701. The guaranteed payment must be paid to the partner whether there are profits or not. For partnership income-tax purposes, distributions to a guaranteed payment interest qualifying under Code §707(c) will be treated as salary for services rendered or interest on contributed capital. These guaranteed payments are a deduction against partnership profits and reported as income to the partner who receives the guaranteed payment. It is important to avoid a situation where there are more deductions than income. For this reason, if an FLP is drafted with two classes of ownership interest with one class qualifying as a guaranteed payment under Code §707(c), then the guaranteed payment is usually only a small interest to insure that there are always sufficient profits in the partnership to make the payments.

**If care is not taken, guaranteed payments may be characterized as debt.** If assets with modest basis that have experienced substantial increases in value are placed in a partnership in exchange for interest classified as debt, this transaction may be subject to capital gains treatment. The FLP must be designed so that the guaranteed interest will not be classified as debt, but rather classified as equity. This may be accomplished by making the remedy for a failure to make a guaranteed payment more like an equity remedy than a debt remedy. An equity remedy for an FLP that fails to make a guaranteed payment is to structure the FLP so that 80% of the holders of the guaranteed payment interest may replace the general partner who can then institute steps necessary to liquidate assets so that the guaranteed payments may be made. If substantial gifts of a guaranteed payment interest are made to nonfamily members such as a charity, it will be important to have the family retain enough of the guaranteed payment interest to block a nonfamily member from unilaterally replacing a general partner.

If it is desired to have a charity as an FLP's partner, design the FLP to have two classes of partnership interests with the senior class qualifying as a Code §707(c) guaranteed payment rather than a preferred interest that would be subject to Code §2701. All or a portion of the guaranteed payment interest is then gifted to the charity. Code §2701 provisions will not apply to this type transaction because the senior interest (the guaranteed payment) is excluded from the Code §2701 provisions, the gift of a senior interest and the retention of the junior interest by the transferor is not subject to Code §2701, and the gift to a nonfamily member is not subject to Code §2701. Thus, the benefits of having a nonfamily member as a partner in the FLP for Code §2704(b) purposes are achieved without applying the disfavorable Code §2701 valuation provisions.

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Charities usually do not want 1% or 2% growth interest in an FLP, because this type interest does not distribute cash to the charity. A guaranteed payment will insure that the charity receives a steady cash flow. For example, a charity could receive a \$20,000 guaranteed payment interest paying 12%. This means the charity would receive \$2400 per year until the end of the partnership's term when the charity would receive \$20,000. This is a painless gift for the client. The client gets a deduction for \$20,000 without writing a check to anyone. In future years, the FLP paying the guaranteed payment to the charity does not count against the client's adjusted gross income limitation. In many cases the client is not out any money until the eighth or ninth year because of the income-tax savings. A charity being present in an FLP means there is one nonfamily partner, which can prevent the family from liquidating the FLP. Thus, even if the FLP had a restriction that may otherwise be classified as an applicable restriction, it will no longer be an applicable restriction.

### C. Code §2703

There are two more Chapter 14 rules under Code §2703 to remember in designing an FLP:

**Rule Two:** The fair market value of property will be determined without regard to any agreement to acquire or use the property or any restriction on the right to sell or use the property.

**Rule Three:** Rule Two will not apply to an agreement or restriction that (1) is a **bona fide business** arrangement, (2) **is not a device** to transfer property to the decedent's family for less than full and adequate consideration, and (3) has terms comparable to similar arrangements in arm's-length transactions. In other words, disregarding agreements or restrictions will not apply to business arrangements that are bona fide, typical, arm's length, and not a device to transfer property to family members at a discounted value.

Reg. §25.2703-1 states that for estate, gift, and generation-skipping tax purposes, the value of any property is determined **without regard to any right or restriction** related to the property. The right or restriction may be contained in an FLP agreement, articles of organization, corporate by-laws, shareholders agreement, lease, or any other agreement or may be implied in the entity's capital structure. This includes any agreement to use, acquire, or sell the property at a price less than the fair market value. Any restriction or agreement that complies with Rule Three will be honored for valuation purposes. The first two elements of Rule Three are recognized requirements that were applicable to rights and restrictions before Chapter 14 was adopted and have a prior history and meaning. The third element of Rule Three (the "comparability test"), however, is new and is, therefore, extremely difficult to apply in family-owned entities. A right or restriction is treated as comparable to similar transactions if the terms are arm's length and may have been obtained in a fair bargain between unrelated parties. A fair bargain is a bargain that may occur among unrelated parties in the same or similar business. General business practice can be shown from comparables from similar businesses. There are certain common restrictions in limited partnership agreements between unrelated parties that may satisfy the Code §2703 tests and have a significant valuation impact. The restrictions include:

- right-of-first-refusal provisions;

**Drafting Guide • Family Limited Partnership** restrictions on the ability to pledge the partnership interests; and

- provisions requiring the interest to be subject to a buyout agreement if there is an actual default under the partnership agreement.

Examples of defaults under the partnership agreement that justify buyout provisions are failing to make required capital contributions or attempting to transfer a partnership interest in violation of transfer restriction provisions. What is still unclear at this time, because the regulations do not contain any clarifying comments or good examples, is the **potential overlap between Code §2703 and Code §2704(b)** relative to restrictive FLP provisions. **Under Reg. §25.2704-2(b)**, an option, right to use property, or **an agreement that is subject to Code §2703 is not an applicable restriction** as defined below. **Therefore, certain restrictions that are subject to Code §2703 are not applicable restrictions triggering the analysis under Code §2704(b).**

**D. Code §2704**

1. CODE §2704(a) - TREATMENT OF LAPSED VOTING OR LIQUIDATION RIGHTS

**Rule Four:** Do not design an FLP with lapsing liquidation or voting rights. If there is a lapse of voting or liquidation rights in an entity that is controlled by a family before and after the lapse, the individual holding the right will be deemed to have transferred by gift or inclusion in that individual's gross estate the amount determined equal to the excess of the value of all interest in the entity held immediately before the lapse (determined as if the voting and liquidation rights were non-lapsing) over the value of the interest immediately after the lapse. If there is a lapse of voting or liquidation rights in an entity that is controlled by a family before and after the lapse, the lapse will be disregarded and the interest transferred will be treated as if there had been no lapse. Code §2704(a) may be avoided entirely by not having lapsing liquidation or voting rights in the FLP.

A voting right is a right to vote with respect to any matter of the entity. In the case of a partnership, a general partner's right to participate in management is a voting right. The right to compel the entity to acquire all or a portion of the holder's equity interest in the entity by reason of aggregate voting power is treated as a liquidation right and not as a voting right. A liquidation right is a right or ability to compel the entity to acquire all or a portion of the holder's equity interest in the entity. A voting right or a liquidation right may be conferred and may lapse by reason of a state law, the corporate charter or bylaws, an agreement, or other means. A lapse of a liquidation right or a voting right occurs at the time a presently exercisable right is restricted or eliminated. **A transfer of an interest that results in the lapse of a liquidation right is not subject to Code §2704(a) if the rights with respect to the transferred interest are not restricted or eliminated.** For example, if a holder owned 70% interest in an entity and the entity could be liquidated by a 66 2/3% vote of the ownership interest, and the holder gifts 10% ownership interest to the holder's children and, thus, could no longer cause the entity to liquidate because of the holder's aggregated voting power, then the loss of the holder's liquidation right is not subject to the Code §2704(a) valuation provisions. The rights associated with the 10% interest transferred to the children must not be otherwise restricted or eliminated.

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The FLP should not contain any lapsing voting rights or lapsing liquidation rights similar to those in Estate of Harrison vs. Commissioner, 52 T.C.M. 1306 (1987), ("Harrison") ("lapsing powers"). Lapsing powers exist when certain partners are given rights to liquidate the FLP upon certain events occurring or at will. Avoid these lapsing powers and rely on the default language of State law for all liquidation rights.

**There may be a technical problem with lapsing voting rights that may arise by operation of some state law or by contract.** This problem arises when a general partner attempts to withdraw from the FLP and has that general partner's general partnership interest, which has voting rights, converted to a limited partnership interest, which lacks those corresponding voting rights. The loss of those voting rights will be a lapse of voting rights, which will be caught by the Code §2704(a) valuation provisions. Thus, whenever possible the FLP should be designed in a manner to avoid or minimize the effect of any lapsing voting rights.

### **2. CODE §2704(b) - CERTAIN RESTRICTIONS ON LIQUIDATION DISREGARDED**

**Rule Five:** Do not design an FLP with applicable restrictions (any restriction that effectively limits the FLP's ability to liquidate, and after transferring an interest either lapses or can be removed by the family). If an interest in a family-controlled entity is transferred to a family member, any applicable restriction will be disregarded in determining the value of the transferred interest. An applicable restriction limits the entity's ability to liquidate and either lapses or may be removed by the family after the transfer. An applicable restriction excludes any commercially reasonable restriction imposed as part of a nonfamily financing arrangement or any restriction required by law. An applicable restriction does not include a commercially reasonable restriction on liquidation imposed by an unrelated person providing capital to the entity for its trade or business operations. The capital provided by the unrelated person may be in the form of debt or equity.

**Drafting Guide Family Limited Partnership** is a limitation on the ability to liquidate the entity, in whole or in part, that is more restrictive than the limitations that may apply under the State law generally applicable to the entity in the absence of the restriction. A restriction is an applicable restriction only to the extent that either the restriction will lapse by its terms or will lapse at anytime after the transfer or the transferor or the transferor's estate and any members of the transferor's family can remove the restriction immediately after the transfer. The ability to remove the transfer is determined by reference to the state law that may apply but for a more restrictive rule in the entity's governing instrument. A restriction that is required to be imposed by federal or state law is not an applicable restriction. Your state limited partnership act governs FLPs. The default provisions of your state limited partnership act impose on FLPs certain restrictions in the absence of contrary provisions in a partnership agreement. If the restrictions limiting an entity's ability to liquidate are as restrictive or less restrictive than the default provisions of state law limiting an entity's ability to liquidate, then those limitations are not applicable restrictions. These imposed provisions and restrictions are not applicable restrictions under Code §2704(b). If a restriction is an applicable restriction, it will be disregarded and the transferred interest is valued by reference to the default provisions of state law and as if the restriction does not exist. If an applicable restriction is disregarded and the remaining requirements for liquidation under the governing instruments are less restrictive than the state law that may apply in the absence of the governing instruments, then the ability to liquidate is determined by reference to the governing instruments.

When Code §2703 applies to an option, a right to use property, or an agreement, then they are not applicable restrictions. If the transferor and the transferor's family do not control the entity immediately before the transfer, Code §2704(b) will not be applicable to the FLP. In a partnership, "control" means 50% equity ownership, and in a limited partnership it means any ownership of a general partnership interest. [Code §2701(b)(2)]

If the transferor and transferor's family may not remove an applicable restriction after the transfer, Code §2704(b) does not apply. If the FLP provides that the partnership may not be liquidated without the unanimous consent of all partners and there is at least one nonfamily partner, the family cannot remove the restriction; thus, Code §2704(b) does not apply.

#### **IV. TEXAS REVISED LIMITED PARTNERSHIP ACT CONSIDERATIONS**

**A. Generally**

The Texas Revised Limited Partnership Act ("Act") is the state law governing FLPs. The Act makes certain requirements for organizing and operating the FLP. The Act provides a mechanism by which an FLP interest can be valued on a going-concern or a distributable-cash-flow basis rather than on the liquidation value of its underlying assets. This mechanism is a term-of-years partnership. A term-of-years partnership has a definite beginning and ending date. During its term, the limited partners may not withdraw from the FLP. The Act provides default provisions that will automatically be deemed to be part of the FLP unless the FLP specifically makes other requirements in writing. The ability to form an FLP that has all the estate and gift tax benefits desired depends entirely upon these default provisions. Code §2704(b) states that an applicable restriction is a limitation on an FLP's ability to liquidate and that this liquidation restriction will be disregarded unless it is imposed by federal or state law. Thus, the liquidation restrictions imposed by the Act in its default provisions are not applicable restrictions. The Act is one of the most favorable statutes for forming FLPs. Its default provisions will be contrasted with the Uniform Revised Limited Partnership Act ("URLPA").

**. Section 6.02(a) of the Act**

The default provisions of §6.02(a) of the Act are:

- in an FLP with a definite term, the withdrawal of a general partner breaches the partnership agreement;
- a general partner has the power to withdraw at any time by giving written notice to the other partners; and
- a general partner who breaches the agreement by withdrawing is subject to damages and those damages can be taken into consideration under §6.02(b) of the Act.

Under URLPA §602 a general partner may withdraw at any time by giving written notice to the other partners. But if the withdrawal violates the partnership agreement, the withdrawing general partner may be subject to damages to the limited partnership. The URLPA does not automatically provide that the withdrawal of a general partner from a term-of-years partnership breaches the partnership agreement. In an FLP organized under the URLPA, the agreement must specifically state that the withdrawal of a general partner violates the agreement. Also, the URLPA states the damages may be offset against the amount otherwise distributable to the withdrawing general partner. The URLPA does not appear to provide a default mechanism whereby a withdrawing general partner's general partnership interest can be converted into a limited partnership interest or purchased. The Act provides a default mechanism and even allows the damages caused by the withdrawal of the general partner to be taken into consideration in the conversion of a withdrawing general partner's general partnership interest to a limited partnership interest or its purchase.

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The default provisions of §6.02(b) of the Act provide that a general partner who ceases to be a general partner under §4.02(a) of the Act, subject to the damages provided in §6.02(a) of the Act, will, at the option of the remaining general partners or, if there are no remaining general partners, at the option of a majority-in-interest of the limited partners in a vote that excludes any limited partnership interest held by the withdrawing general partner:

- convert the interests in that general partner's capital account, profits, losses, and distributions to that of a limited partner; or
- pay to the withdrawing general partner in cash, or secure by bond approved by a court of competent jurisdiction, the value of that partner's partnership interest less the damages caused by the breach.

Under the URLPA there does not appear to be a corresponding provision to §6.02(b) of the Act. Thus, no default mechanism appears in the URLPA by which a general partner's general partnership interest may be converted to a limited partnership interest or purchased.

### **. Section 6.03 of the Act**

The default provisions of §6.03 of the Act are that a limited partner may withdraw at the time or on the occurrence of the event specified in a written partnership agreement and in accordance with that written partnership agreement. If the written partnership agreement does not specify a time or event, or a definite time for the FLP to dissolve and wind up, a limited partner may withdraw by giving six months notice. If the written partnership agreement provides for a definite time for the FLP to dissolve and wind up (a specific term or term-of-years partnership), then a limited partner may not withdraw. The default provisions of URLPA §603 are the same as the default provisions of §6.03 of the Act.

**. Section 6.04 of the Act**

The default provisions of §6.04 of the Act states that, except as provided in Article 6 of the Act, on withdrawal, any withdrawing limited partner may receive, within a reasonable time after withdrawal, the fair value of that limited partner's interest in the FLP as of the withdrawal date. The provisions of Article 6 provide that in a term-of-years partnership a limited partner may not withdraw before the end of the term. Under the URLPA default provisions, upon withdrawal, any partner (limited or general) may receive any distribution to which the withdrawing partner is entitled under the partnership agreement and, unless the partnership agreement otherwise provides, the withdrawing partner may receive, within a reasonable time after withdrawal, the fair value of the withdrawing partner's interest in the limited partnership as of the withdrawal date. This means that the general partner who withdraws from a partnership that states that such a withdrawal breaches the agreement may receive any outstanding distributions and fair value for the withdrawing partner's interest subject to any offset for damages, within a reasonable time after the withdrawing partner's withdrawal. Under URLPA §604, a limited partner's rights are the same as those under the Act. Under the Act a general partner who withdraws is subject to having that general partner's general partnership interest converted to a limited partnership interest or purchased. Whereas under the URLPA, a general partner who withdraws will receive any undistributed distributions and fair value for that general partner's interest.

**. Section 7.02(a) of the Act**

The default provisions of §7.02(a) of the Act are:

- the partnership interest is assignable in whole or in part;
- assigning a partnership interest does not dissolve an FLP or entitle the assignee to become, or to exercise the rights or powers of, a partner;
- an assignment entitles the assignee to be allocated income, gain, loss, deduction, credit, or similar items, and to receive distributions, to which the assignor was entitled, to the extent those items are assigned; and
- until the assignee becomes a partner, the assignor partner continues to be a partner and to have the power to exercise any rights or powers of a partner, except to the extent those rights or powers are assigned. On the assignment by a general partner of all of the general partner's rights as a general partner, however, the general partner's status as a general partner may be terminated by the affirmative vote of a majority-in-interest of the limited partners.

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In summary, assigning a partnership interest does not dissolve an FLP, and the assignee of a partnership interest does not become a partner. A general partner who assigns all that general partner's general partnership interest may have that general partnership interest terminated by the vote of a majority-in-interest of the limited partners. A general partner who assigns all that general partner's general partnership interest and whose status as a general partner has been terminated by vote of a majority-in-interest of the limited partners will cease to be a general partner under §4.02(a) of the Act. If a general partner ceases to be a general partner under §4.02(a) of the Act, then under §6.02(b) of the Act the remaining general partners, or if there are no remaining general partners, the majority-in-interest of limited partners may convert that general partnership interest to a limited partnership interest or purchase it. Under §7.03 of the Act, a judgement creditor who has a charge on a partnership interest has only an assignee's rights. Except for some subtle differences, the default provisions of URLPA §702 are virtually the same as the default provisions of §7.02(a) of the Act.

### **. Section 7.04(a) of the Act**

The default provision of §7.04(a) of the Act is that an assignee of a partnership interest, including an assignee of the partnership interest of a general partner, may become a limited partner if and to the extent that all partners consent. An assignee of a general partnership interest may only become a limited partner if all partners consent. The default provisions of URLPA §704(a) are virtually the same as the default provisions of §7.04(a) of the Act.

### **. Section 7.05 of the Act**

If an individual limited partner dies or is adjudicated incompetent, then that limited partner's executor, guardian, or other legal representative may administer the limited partnership interest and become a substitute limited partner in accordance with §7.04(a) of the Act. In summary, a holder of a deceased or incompetent individual's limited partnership interest holds a limited partnership interest as an assignee. A limited partner's death or incompetency does not dissolve a limited partnership or entitle the assignee to become, or to exercise rights or powers of, a partner. An assignee does not have a limited partner's right to withdraw from the limited partnership in accordance with §6.03 of the Act or to be paid for that assignee's limited partnership interest under §6.04 of the Act. This result is the same whether or not the FLP is a term-of-years limited partnership. An assignee of a deceased or incompetent limited partner in accordance with §7.04(a) of the Act may become a substitute limited partner if all partners consent or as otherwise provided in the partnership agreement. After an assignee of a deceased or incompetent limited partner has been admitted to the FLP as a substitute limited partner and the FLP is a term partnership, the substitute limited partner may not withdraw or receive fair value for the substitute limited partner's interest until the end of the term. If the FLP is not a term partnership, the substitute limited partner will be able to withdraw with six months notice and receive fair value for the substitute limited partner's interest. The URLPA applies to any partner (limited or general). If a partner is a corporation, trust, or other entity and is dissolved or terminated, that partner's powers may be exercised by its legal representative or successor.

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**. Section 3.01(b) of the Act**

The default provisions of §3.01(b) of the Act provide that after forming a limited partnership, a person may acquire a new limited partnership interest directly from the limited partnership on the written consent of all partners and in the case of an assignee of a limited partnership interest as provided by §7.04(a) of the Act. This means that, after an FLP is formed, unanimous written consent of all partners will be required before a person who has acquired a new limited partnership interest directly from the FLP or who is an assignee of a limited partner becomes a new or substitute limited partner. URLPA §301(b) is the same as §3.01(b) of the Act.

**. Section 4.01(a) of the Act**

The default provision of §4.01(a) of the Act is that after forming an FLP, additional general partners may be admitted with the written consent of all partners. URLPA §401 is the same as §4.01(a) of the Act.

**. Section 4.02(a) of the Act**

The default provisions of §4.02(a) of the Act are that a person ceases to be a general partner on the occurrence of any of the following withdrawal events:

- . as provided in §6.02 of the Act;
- . as provided in §7.02 of the Act;
- . as provided in the partnership agreement;
- . unless all partners agree to the contrary, the general partner does any of the acts provided in §4.02(a)(4)(A)-(F) of the Act;
- . unless all partners agree to the contrary, 120 days expire after the date of the commencement of a proceeding against the general partner seeking reorganization, arrangement, composition, readjustment, liquidation, dissolution, or similar relief under any law if the proceeding has not been previously dismissed, or 90 days expire after the appointment date, without the general partner's consent or acquiescence, of a trustee, receiver, or liquidator of the general partner of all or any substantial part of the general partner's properties if the appointment has not previously been vacated or stayed, or 90 days expire after the date of expiration of a stay, if the appointment has not previously been vacated;
- . in the case of a general partner who is a natural person, the general partner's death or adjudication as mentally incompetent;
- . unless all partners agree to the contrary, in the case of a general partner that is a trust, the commencement of winding up activities intended to conclude in the trust's termination, but not merely substituting a new trustee;

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- unless all partners agree to the contrary, in the case of a general partner that is a separate partnership, the dissolution and commencement of winding up of the separate partnership;
- unless all partners agree to the contrary, in the case of a general partner that is a corporation, the filing of a certificate of dissolution or its equivalent for the corporation or the revocation of its charter and the expiration of 90 days after the date of notice to the corporation of revocation without a reinstatement of its charter; or
- in the case of a general partner that is an estate, the distribution by the fiduciary of the estate's entire interest in the FLP.

URLPA §402 is virtually identical to §4.02(a) of the Act.

In summary, a general partner ceases to be a general partner if:

- the general partner voluntarily withdraws [§6.02(a) of the Act];
- the general partner assigns all that general partner's general partnership interest and a majority-in-interest of limited partners vote to terminate the general partner's status as a general partner;
- the partnership agreement provides an event or circumstance when the general partner ceases to be a general partner;
- the general partner does any items in §4.02(a)(4)(A)-(F) of the Act that deal with filing bankruptcy or reorganization (however, all partners may agree that these items will not cause the general partner to cease being a general partner);
- the events outlined in §4.02(a)(5) of the Act occur dealing with insolvency and appointing receivers, together with certain specified time periods (however, all partners may agree that these items will not cause the general partner to cease being a general partner);
- the general partner dies or becomes mentally incompetent;
- if a trust is serving as general partner and the trust affairs have begun to wind up (however, all partners may agree that it will not cease being a general partner);
- if a separate partnership is serving as general partner and the separate partnership dissolves and its affairs have begun to wind up (however, all partners may agree that it will not cease being a general partner);
- if a corporation is serving as a general partner and the corporation has its charter revoked without being timely reinstated or is dissolved (however, all partners may agree that it will not cease being a general partner); and
- if an estate is serving as a general partner and all the estate's assets have been distributed.

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**. Section 8.01 of the Act**

The default provisions of §8.01 of the Act provide that a limited partnership is dissolved on the first of the following to occur:

- on the occurrence of events specified in the partnership agreement to cause dissolution (the expiration of the term of a term-of-years partnership);
- written consent of all partners to dissolve;
- an event of withdrawal of a general partner [§4.02(a) of the Act]; or
- entry of a decree of judicial dissolution under §8.02 of the Act.

A term-of-years partnership (which provides for a specific time for the FLP to terminate and its affairs to be wound up either by stating that the FLP will not continue beyond a specified date or that the FLP terminates on a specified date) will dissolve on the specified date or by all partners agreeing or upon a general partner withdrawing. An FLP that is not a term-of-years partnership and does not otherwise specify dissolution events in the partnership agreement will dissolve by the agreement of all partners or the withdrawal of a general partner. The only differences between a term-of-years partnership and a non-term-of-years partnership are that in a term-of-years partnership, the partnership agreement states a date for the FLP to terminate. In a term-of-years partnership, a limited partner may not withdraw or receive fair value for the limited partner's interest before the FLP terminates, while a non-term-of-years partnership allows a limited partner to withdraw from the FLP at any time and to receive fair value for the limited partner's interest with six months notice. In either situation an assignee may not withdraw as a limited partner or receive fair value for the limited partnership interest. URLPA §801 is virtually identical to §8.01 and §8.03 of the Act with the exception that the URLPA additionally provides that the partnership will dissolve at the time specified in the certificate of limited partnership.

**. Section 8.03 of the Act**

The default provisions of §8.03 of the Act provide that upon the FLP dissolving as provided by §8.01(1) or §8.01(3) of the Act, the FLP may be reconstituted and continued if:

- **there remains at least one general partner and the partnership agreement allows the business to continue and the remaining general partners do so; or**
- if there are no remaining general partners, all remaining partners agree in writing to continue the FLP and appoint one or more general partners within 90 days.

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A term-of-years partnership has a specified termination date. It will dissolve on its termination date. [§8.01(1) of the Act] If there are multiple, single, or no general partners, then on the specified termination date all partners must consent in order to reconstitute and continue the FLP, and if there are no general partners, they will have to appoint new general partners. If the FLP dissolves before it terminates because a general partner withdraws [§4.02(a) of the Act], and there is at least one remaining general partner, and the partnership agreement permits the FLP to continue, the general partners may reconstitute and continue the FLP. The fact that the FLP has a specified termination date that is still in the future indicates that there is intent for the FLP to continue. The partnership agreement may also provide that the FLP is to continue if a general partner withdraws before the termination date. If the FLP dissolves before its termination date because a general partner withdraws [§4.02(a) of the Act] and there are no remaining general partners, the FLP may be reconstituted and continued if all partners agree and new general partners are appointed. Assignees do not get to vote.

**If a general partner withdraws [§4.02(a) of the Act] before the end of the FLP's term (a dissolution event under §8.01(3) of the Act) and there is at least one remaining general partner (§8.03 of the Act), the remaining general partners may convert a withdrawing general partner's partnership interest to that of a limited partner or purchase it [§6.02(b) of the Act] and reconstitute and continue the FLP until the end of its stated term.** If a general partner withdraws [§4.02(a) of the Act] before the end of the FLP's term [a dissolution event under §8.01(3) of the Act] and there are no remaining general partners, **a majority-in-interest of the limited partnership interest in a vote that excludes any limited partnership interest held by the withdrawing general partner** may convert a withdrawing general partner's partnership interest to a limited partnership interest or purchase it [§6.02(b) of the Act] and all partners must appoint a new general partner and consent to reconstitute and continue the FLP until the end of its stated term. [§8.03(2) of the Act]

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A non-term-of-years partnership does not have a specified termination date. Unless a partnership agreement specifies some other dissolution event, §8.01(1) of the Act will not cause a dissolution in a non-term-of-years partnership. If the FLP dissolves because a general partner withdraws [§4.02(a) of the Act] and there is at least one remaining general partner and the partnership agreement permits the FLP to continue, the general partners may reconstitute and continue the FLP. The partnership agreement may also provide that the FLP is to continue if a general partner withdraws. If the FLP dissolves because a general partner withdraws [§4.02(a) of the Act] and there are no remaining general partners, the FLP may be reconstituted and continued if all partners agree and new general partners are appointed. Assignees do not get to vote. If a general partner withdraws [§4.02(a) of the Act] (a dissolution event under §8.01(3) of the Act), if the partnership agreement permits the FLP's business to be carried on by the remaining General Partners (§8.03 of the Act), and if there is at least one remaining general partner (§8.03 of the Act), the remaining general partners may convert a withdrawing general partner's partnership interest to that of a limited partner or purchase it [§6.02(b) of the Act] and reconstitute and continue the FLP. (§8.03 of the Act) If a general partner withdraws [§4.02(a) of the Act] [a dissolution event under §8.01(3) of the Act], if the partnership agreement does not permit the FLP's business to be carried on by the remaining General Partners [§8.03 of the Act], and if there is at least one remaining general partner (§8.03 of the Act), the remaining general partners may convert a withdrawing general partner's partnership interest to that of a limited partner or purchase it [§6.02(b) of the Act] and all partners must consent to reconstitute and continue the FLP. (§8.03 of the Act). If a general partner withdraws [§4.02(a) of the Act] [a dissolution event under §8.01(3) of the Act] and if there are no remaining general partners (§8.03 of the Act), a majority-in-interest of the limited partnership interest in a vote that excludes any limited partnership interest held by the withdrawing general partner may convert a withdrawing general partner's partnership interest to a limited partnership interest or purchase it [§6.02(b) of the Act] and all partners must appoint new general partners and consent to reconstitute and continue the FLP. [§8.03(2) of the Act]

The key to §8.03 of the Act is to have a term-of-years FLP with a specified termination date or an FLP that is permitted to continue if a dissolution event occurs or both and to have multiple general partners. The added advantage of having a term-of-years FLP is that a limited partner will not be allowed to withdraw from the FLP before its stated term ends.

## **Drafting Guidelines for Limited Partners of the Act to Form an FLP**

An FLP should be formed as a term-of-years partnership under the Act. If an FLP is a term-of-years partnership, a limited partner may not withdraw before the term ends. A general partner of a term-of-years partnership may withdraw at any time before the term ends, but a general partner withdrawing will breach the partnership agreement. A general partner who breaches the partnership agreement is liable for damages, and the other partners may purchase the withdrawing general partner's general partnership interest or convert the withdrawing general partner's general partnership interest to that of a limited partner. A general partner commits an act of withdrawal when any event described in §4.02(a) of the Act occurs. The expiration of a specified term of a term-of-years partnership will be a dissolution event, and an event specified in §4.02(a) of the Act occurring will also be a dissolution event. Thus, a general partner who withdraws causes a dissolution event and breaches the partnership agreement. Even though a dissolution event has occurred, the general partner is not necessarily allowed to withdraw from the FLP, because the withdrawing general partner's general partnership interest may be converted to a limited partnership interest, and the general partner who is a converted limited partner may not withdraw from the FLP before its term ends unless the FLP is dissolving and winding up. The FLP may be reconstituted if there are remaining general partners and the partnership agreement provides that the FLP may continue and that the general partners do so. A term-of-years partnership specifically provides that the FLP is to continue to the end of its term. Thus, the remaining general partners may continue the FLP. If there are no remaining general partners, the FLP may be reconstituted and continued if all remaining partners agree in writing and they appoint new general partners. Thus, if there are multiple general partners and all partners agree, the FLP may be reconstituted and continued upon the dissolution event.

If an FLP is formed under the URLPA, all the foregoing would be correct except that if the general partner withdraws under URLPA §402, the general partner may receive any entitled distributions and fair value for the general partner's interest within a reasonable time. There does not appear to be any provision similar to §6.02(b) of the Act in the URLPA. Thus, the remaining general partners, and if there are no general partners, the majority-in-interest of the limited partners may not convert the withdrawing general partner's partnership interest to a limited partnership interest under the URLPA unless contractually provided in the written partnership agreement.

### **. Default Provisions of the Act Not Applicable Restrictions**

The default provisions of the Act set out in Sections B through M above are not applicable restrictions for Code §2704(b) purposes. Nor is Code §2703 applicable to these default provisions. Thus, the FLP may be designed utilizing the default provisions of the Act or less restrictive provisions and achieve the valuation discounts for estate and gift-tax purposes. If an applicable restriction is more stringent than state law allows, it will be disregarded for valuation purposes. If a restriction is less stringent than state law allows, it will be honored for valuation purposes.

**V. VALUATION**

**A. Generally**

Valuing a client's assets has become a very hot topic. Estate planners are trying to learn about valuation issues and deal with appraisers more than ever before. Planners must understand the value of client's assets, the nature of their assets, why the assets are valuable, and how valuable those assets will be in the future.

Estate planners formulate ideas and put together entities or modify the client's existing entities in order to achieve estate-planning objectives and valuation discounts that are derived by the manner in which clients hold their assets. These new or modified entities allow us to make transfers of interest that are valued on a discounted cash flow basis, which is future cash flow to that interest brought back to present value, or allows one to analyze the entity interest as it compares to other similar interests in other entities that have value but do not produce cash flow to the interest.

The discounts trying to be achieved are minority-interest discounts, lack-of-marketability discounts, and where applicable, key-man discounts. Some appraisers include discounting concepts in the valuation methods they use. For example, in choosing the capitalization rate, the appraiser may utilize a higher capitalization rate because of a certain risk that is an integral part of the business, such as its reliance on a particular franchise right or contract right. These discounts are available to and among family members.

**B. Fair Market Value Defined**

Reg. §20.2031-1(b) defines "fair market value" as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.

**C. Ways in Which Property May Be Valued**

There are three ways in which property may be valued or appraised:

1. replacement-cost method, which is the cost to replace the asset in question;
2. capitalization method, which is the capitalization of net income or gross income less expenses times the capitalization rate; and
3. the comparable-sales approach where the sales price is compared to the sales prices of other similar types of properties.

**D. Factors to Consider in Valuing Property**

Revenue Ruling ("Rev. Rul.") 59-60 is the key ruling to determine how to value property. It gives eight factors to be considered:

1. background of the company;
2. economic outlook for that particular industry;
3. book value of the stock and the company's financial status;

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5. the business' dividend-paying capacity;
6. goodwill;
7. recent stock sales (minority interest discounts and marketability discounts); and
8. comparables in the industry (what is the stock of similar companies selling for).

**E. Establishing Fair Market Value**

There are two classic types of discounts - minority interest and marketability discounts. **Rev. Rul. 93-12 reversed the Internal Revenue Service ("IRS") position on minority discounts.** Revenue Ruling 93-12 involves a case where the father gave 20% of the company to each of five children. Each 20% block of stock that was given away was treated as a separate minority interest. Thus, the whole company is greater than the sum of its parts. A donor should be able to give away 10% of a company at less than 10% of the company's whole value. If the company is a million dollar company and 5 equal gifts of 20% each are given away, \$1 million dollars has not been given away. If there is a 40% discount then only \$600,000 has been given away. Each of the 5 children have been given a portion of the company worth \$120,000 each. If a donor can transfer a partnership interest (where the FLP owns the business and investment assets), the donor will be much better off than if the donor transfers particular property that can easily be comparable to other pieces of property. Often the only valid method for determining the fair market value of the partnership interest is the capitalization method. If the FLP may not be liquidated before its term, it must be valued as a going concern on a going-concern basis rather than on a liquidation basis.

**F. Using Distributable Cash Flow to Establish Value**

If a donor is willing to give up unilateral liquidation control of the donor's business and instead shares it with his family (the donor and the family members together share the liquidation control rights), **the business' liquidation value is almost irrelevant.** The relevant question becomes, what is the business' distributable cash flow? Congress, when it looked at the family-business issue, stated it would allow what is normal under state law. The default rules under state law for partnerships will govern. Since the passage of Code §2704 and the corresponding regulations, it has become clear that the Act provides **a default state law mechanism that allows an enterprise to be valued on the distributable-cash-flow method.** Once it has become apparent that the FLP's distributable cash flow will be a determining factor in establishing the valuation of a partnership interest, an appraiser will use the capitalization method for establishing fair market value. The value of the partnership interest will be valued in the donee's hands rather than in the donor's hands.

**G. Factors to Determine Minority-Interest and Lack-of-Marketability Discounts**

The value of a limited partnership interest will be the higher value determined by the capitalization method or the value determined after taking conscience percentage discounts. The minority-interest and lack-of-marketability discounts are based on various factors.

## **Notre Dame Tax & Estate Planning Institute, 9-96**

The economics of the interest relate to the present prospective cash flow that will be allocated to a particular partnership interest. To establish a value once the cash flow is known requires that a return rate be determined. A principal amount is determined as a result of taking a given cash flow capitalized at the given return rate. The net asset value (which is the FLP's assets less its liabilities) less the principal value determined by capitalizing the given return rate at the given capitalization rate is the discount. The lower the income factor or the absence of income causes a greater discount. This is really not a discount. It is the economic value based on its yield.

Conscience percentage discounts applicable to limited partnerships are legitimized by doing the following:

- by making the analogy of a minority interest in a corporation to that of an FLP;
- by verifying that the limited partners do not have a management role or control over the FLP's operations;
- by verifying that the partnership agreement has a provision that distances the limited partners from the underlying assets;
- by verifying that the partnership agreement provides that a limited partner is unable to withdraw from the FLP before it dissolves or liquidates and that there is a mechanism by which a general partner who withdraws before the partnership term ends will be converted to a limited partner;
- by verifying that there is an inability to dissolve the FLP and reach the value of the underlying assets;
- by verifying that there are restrictions on transfer, that there is a right-of-first refusal, and that an assignee is not admitted as a member until approved by the general partner or the other limited partners;
- by verifying the presence or absence of the right for a general partner to make a Code §754 election (In a family partnership, because it has few assets, usually with low basis in the assets, the general partner has a duty not to withhold the Code §754 election.);
- by verifying if the FLP requires additional capital contributions to meet operating expenses;
- by examining illiquidity factors; and
- by verifying that the partners cannot require a return of their capital contributions or require other distributions.

1. VALUING THE GIFT OF A LIMITED PARTNERSHIP INTEREST

In an FLP, there are general partners and limited partners. The general partner manages the partnership and has control over the partnership's investment and business decisions and determines when and in what amount any distributions will be made. A general partnership interest, because of its management and control of the partnership, will not receive a minority interest discount. A general partnership interest because it is not marketable will still have lack-of-marketability discount. In some cases a key-man discount may also apply to a general partnership interest.

A limited partnership interest does not have any rights to manage or control the partnership or compel distributions. Thus, because a limited partnership interest lacks management and control rights and is unmarketable, it will be subject to both minority-interest and lack-of-marketability discounts.

There has been some question as to whether or not a limited partnership interest that is owned by a partner who is both a limited partner and a general partner must have the partner's limited partnership interest valued higher than a limited partnership interest of a partner who is only a limited partner when a limited partnership interest is transferred. When an appraiser prepares a valuation report on the value of a limited partnership interest that is being transferred, the appraiser is not going to take into consideration whether or not that limited partnership interest is owned by a partner who is also a general partner. The value of the transferred limited partnership interest will be determined in the transferee's hands and not in the transferor's hands. It does not matter what the transferor may have done, but rather what the transferee may do. Thus, the value of a limited partnership interest that is transferred will be valued the same whether or not the transferor was both a general and limited partner or just a limited partner. The transferred interest will be subject to both a minority-interest and lack-of marketability-discount.

2. VALUING THE TRANSFER OF A LIMITED PARTNERSHIP INTEREST AT DEATH

One of the questions often asked is whether a limited partnership interest is aggregated with that of a general partnership interest held by that same person for valuation purposes at death. When you are dealing with gifts during lifetime, it is clear they are not aggregated. At death it becomes a more difficult question. The IRS has not given up attempting to aggregate interests for valuation purposes at death. **The default rule under the TRLPA is that a general partner who withdraws (including a withdrawal because of death) has that general partner's general partnership interest converted into a limited partnership interest.** The most the executor may transfer is a limited partnership interest. What the executor may transfer is the pre-existing limited partnership interest owned before death and the converted limited partnership interest that was formerly the general partnership interest.

**The question arises as to what the effect the lapse of a voting or liquidation right has under Code §2704(a) when the general partnership interest is converted to a limited partnership interest.** Under Code §2704(a) you value the interest before and after death. Before death all a holder may transfer is an **assignee's interest** in the holder's general and limited partnership interests. The value of the aggregated general and limited partnership interest will be equal to or less than the value of the holder's entire ownership interest in the partnership classified as a limited partnership interest. Actually, the aggregated interest will be valued as an assignee interest, which is worth less than that of a limited partnership interest. In fact, an argument may be made that the value of the aggregated interest goes up because after death the holder of that interest may at least become a limited partner, which is worth more than an assignee interest. The test is still what a willing buyer would pay for the interest both before and after death. If there is a general partnership interest for sale before death, a willing buyer will not pay any more than what that buyer thinks the value of the assignee's rights are worth. The buyer will doubt that the other partners will admit the buyer into the partnership as a general partner. The Harrison case still stands for the principal that in determining value you look forward in time. In *United States of America v. Charles M. Land, as Successor Executor of the Last Will and Testament of John Robert Land, Deceased*, 303 F.2d 170 ("Land case"), the court stated that in partnerships you do not base the value of the partnership interest on what happened in the past, but rather you value a partnership interest on what you expect to happen. If a general partnership interest is purchased before the general partner's death, the assumption is that the buyer will be acquiring an assignee's interest. After death, many state laws provides that that same interest is a limited partnership interest.

The only time there is a problem is when there is only one general partner and that general partner dies. Then the deceased general partner's estate is in a position to block appointing a new general partner. If a new general partner is not appointed, the FLP will be liquidated. Texas is the only state with this conversion provision in its limited partnership act.

If the general and limited partnership interests are aggregated, the value of the interest of the limited partnership interest will be increased because of the additional control the general partner has. But as long as the general partner lacks sufficient control to liquidate the FLP, the value of the aggregated interests is still significantly reduced. The FLP must be designed so that the general partner has enough control to control the income from the partnership's assets but is limited to distributing the income to the partners pro rata according to the general partner's fiduciary duty. In addition, the general partner must not have the ability to unilaterally liquidate the partnership.

**Drafting Guide Family Limited Partnership §2704(a) ON CONVERTING A GENERAL PARTNERSHIP INTEREST TO A LIMITED PARTNERSHIP INTEREST**

If a limited partner makes a gift, the fact that the limited partner making the gift is also a general partner will not be taken into consideration. In Texas and several other states, when a general partner dies or withdraws from the partnership, normally the withdrawing general partner's general partnership interest will be converted into a limited partnership interest. The general partner's general partnership interest has voting rights. When the general partner's general partnership interest is converted to that of a limited partnership interest, there will be a lapse of a voting right. This lapse of a voting right will be subject to Code §2704(a). This means that the general partner's interest in the partnership will have to be valued as if the general partner's interest in the partnership had not had a lapse of a voting right. The actual amount of valuation reduction that is lost because of this lapse is often very small or nothing.

An FLP may be drafted to avoid the lapse of a voting right under Code §2704(a). It is best to keep the general partner's general partnership interest very small. Multiple general partners may be established to manage the partnership with a voting scheme, so that the withdrawal of a general partner does not appreciably change the general partners' voting rights. Another alternative is to draft an FLP with an entity as the general partner. The ownership of the entity general partner is usually spread among several family members. These family members are usually from both the family's senior and junior generations. This type setup establishes a situation where there will not be a lapse of a voting right when a general partner withdraws. Multiple general partners may select from among themselves a managing general partner. **Clearly, if a general partner withdraws and the withdrawing general partner's general partnership interest is converted into a limited partnership interest, then Code §2704(a) will apply.**

Another drafting solution is rather than converting the general partnership interest to that of a limited partner, the general partner may will that general partnership interest to a permitted transferee. This means that a general partnership interest will remain a general partnership interest. The partnership agreement would provide that the beneficiary under the will or the estate during the estate administration may not be denied the right to become a general partner. This type arrangement is beneficial because there will be no lapse of a voting right and Code §2704(a) will not apply. The patriarch may change who will be the FLP's manager by changing his will, which gives great flexibility to the patriarch in deciding who is going to be his successor. A permitted transferee who is an assignee of a general partnership interest that is not converted to a limited partnership interest may not withdraw from the partnership. An assignee of a general partnership interest may not become a general partner nor may the assignee withdraw. If that interest is not converted into a limited partnership interest, then there is no lapse that can be subject to Code §2704(a).

**VI. GENERAL PARTNERS: A CRITICAL FACTOR**

**A. Generally**

An FLP's general partners are critical factors in designing an FLP. If a general partner's withdrawal can cause the FLP to dissolve and wind up before the FLP's stated term expires, the business and estate and gift tax valuation benefits may be lost. Therefore, providing in the partnership agreement that the FLP is either a term-of-years partnership or that the FLP's general partners are permitted to continue its business on the occurrence of a dissolution event is important. There must at all times be multiple general partners or successor general partners.

**B. Multiple General Partners**

Multiple general partners are a necessary design feature of the FLP. Using multiple general partners provides many advantages because when there is more than one general partner, there is a strong likelihood that there will always be at least one remaining general partner to elect to reconstitute and continue the FLP in accordance with §8.03 of the Act. Having at least one remaining general partner also gives additional flexibility under the default provisions of §6.02(b) of the Act, allowing the remaining general partner to elect to convert a withdrawing general partner's general partnership interest into a limited partnership interest.

An FLP may have several general partners who manage the FLP, or the general partners may appoint from among themselves one or more general partners to act as a manager for all the general partners. Having the benefits of multiple general partners may also be achieved by having one or more general partners and then naming successor general partners to serve automatically if a general partner withdraws. This type provision would be similar to a successor trustee provision in a trust agreement.

If individuals are serving as multiple general partners, it is prudent to name individuals from several different generations. This insures that if an older generation general partner dies or becomes incompetent, a younger generation general partner will be available to reconstitute and continue the FLP. As soon as one general partner withdraws as a general partner, the FLP may elect a new general partner outright as a designated successor general partner. This can be done in accordance with the default language of §4.01 of the Act, which requires the consent of all partners or as provided in the written partnership agreement. The partnership agreement may provide that only a majority-in-interest of the partners or some higher percentage of the partners may elect a new general partner. If there are no remaining general partners, §8.03 of the Act requires the consent of all partners to reconstitute and continue the FLP and elect a new general partner. If the remaining partners cannot agree, the FLP will be dissolved and its affairs wound up, which may be disastrous for the estate plan. It's best to use individuals as general partners when the patriarch wants to retain control of the family's financial affairs and when asset protection is not one of the prime objectives of the FLP.

The rule would be to always provide for multiple or successor general partners and a method to easily add additional general partners before the last remaining general partner withdraws.

## Drafting Guide: Family Limited Partnership

### C. Revocable Trusts as General Partners

A revocable trust can be an excellent vehicle to serve as a general partner. It can provide management for the FLP through the trustee of the revocable trust, which is usually the patriarch or matriarch or their trusted friend, **without the risk of causing a dissolution event when the trustee of the revocable trust changes.** This technique is useful in death and disability planning for the older family members by providing a mechanism for the patriarch to continue to control the FLP's affairs until he is no longer able. The trust has an existence of its own and may continue for some period of time after the patriarch is deceased or incompetent. The revocable trust is a useful tool to avoid probate and guardianship costs and eliminate the need to have ancillary probate proceedings in foreign jurisdictions. Another advantage of using a revocable trust as an FLP's general partner is that the revocable trust does not provide any limited liability protection to the settlors of the revocable trust, who are usually the patriarch and matriarch. Since the patriarch and matriarch will continue to have personal liability in the trust and the fact that the trust is the FLP's general partner, the FLP will in all probability lack the corporate characteristic of limited liability. **This is advantageous when it is desirable for the FLP to lack the corporate characteristic of limited liability and yet there is a need to have an entity act as general partner so that the patriarch's and matriarch's death or incompetency will not be a withdrawal event under §4.02(a) of the Act.**

### D. A Corporation as General Partner

In many cases, a corporation may be used as a general partner for the FLP. The corporation could be a "C" or "S" corporation for income-tax purposes. **Using a corporation that is not adequately capitalized will probably cause the FLP to have the corporate characteristic of limited liability.** Using a corporation is beneficial when complete limited liability is desired for all family members. Usually the ownership is spread among several family members so that no one family member controls the corporation. "S" corporation status can be elected if the ownership of the corporation meets the necessary requirements. This means that the corporate general partner may not be owned by family trusts. A corporation that is unlikely to commit a withdrawal event under §4.02(a) of the Act is a good choice for general partner and helps insure that the estate and gift-tax valuation and business benefits of the FLP are achieved.

In certain situations Code §2036(b) may be a problem when a corporate general partner is used and the FLP's assets consist of closely-held stock.
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**E. An LLC as General Partner**

**1. USING AN LLC AS AN FLP'S GENERAL PARTNER**

In drafting an FLP, having an entity serve as the general partner is often useful. An LLC makes an excellent general partner because the LLC's ownership is not limited to certain types of shareholders as in an "S" corporation. The LLC may also assist in obtaining additional creditor protection and in pass-through federal income-tax treatment as a partnership. The creditor protection is obtained by the fact that a judgement creditor is limited to getting only a charging order on the judgement debtor's membership interest in the LLC without any rights to manage the LLC. Usually the LLC's ownership is spread among several family members or their trusts. An LLC owned and controlled by a GST Trust makes an excellent general partner. One disadvantage of using an LLC as the general partner is: If the LLC dissolves upon a member's death, bankruptcy, retirement, etc., the LLC will suffer a dissolution event. This dissolution event requires that all remaining members consent to continue the LLC. If the LLC dissolves because any member votes against continuing the LLC, the LLC's dissolution will be a dissolution event for the FLP, which we want to avoid. I normally draft an LLC acting as an FLP's general partner to lack:

- centralization of management by making it member-ruled;
- free transferability of interest by restricting the transfer of ownership interest in the LLC without the consent of all remaining members; and
- continuity of life by providing that the LLC will dissolve only upon any member's bankruptcy unless the holders of a majority-in-interest in the capital and profits of the remaining members elect to continue.

If only bankruptcy causes an LLC to lack continuity of life and if only holders of a majority-in-interest in the capital and profits of the remaining members may elect to continue, the likelihood that the LLC will dissolve is substantially lessened. Before Revenue Procedure ("Rev. Proc.") 95-10, I drafted the LLC as described above, except I provided that the LLC would not dissolve upon a member's death, bankruptcy, resignation, etc. This resulted in the LLC having the corporation characteristic of continuity of life. After Rev. Proc. 95-10, I can insure the LLC lacks continuity of life and accomplish almost the same benefit to the LLC as I formerly accomplished by making the LLC have the corporate characteristic of continuity of life.

**Drafting Guide Family Limited Partnership USING AN LLC AS A GENERAL PARTNER OF A SUBSIDIARY LIMITED PARTNERSHIP ("SUB- LP")**

In an estate plan that uses an FLP, to accomplish creditor protection and maximum income and franchise-tax benefits, forming a Sub-LP is often necessary. The Sub-LP will hold high-risk assets or operate an active business. To insure that the parent FLP is fully protected and has limited liability from the Sub-LP's assets or business operations, a limited liability entity needs to serve as the Sub-LP's general partner. The Sub-LP's general partner may be a "C" corporation or an LLC. An "S" corporation may not be used as the Sub-LP's general partner, because the parent FLP's ownership of the corporation's stock will prevent the corporation from electing status as an "S" corporation. If a corporation is used as the Sub-LP's general partner, there is no pass-through for federal income-tax treatment from the corporation to the parent FLP. If an LLC is used as the Sub-LP's general partner, the parent FLP may hold the membership interest in the LLC. The pass-through treatment for federal income-tax purposes will then be preserved.

In drafting an LLC as a Sub-LP's general partner, the LLC must be classified as a partnership for federal income-tax purposes. The LLC general partner of the Sub-LP will typically be owned 50% by the parent FLP's general partner and 50% by the parent FLP. I normally draft an LLC acting as a Sub-LP's general partner to lack the following corporate characteristics:

- centralization of management by making it member-ruled;
- free transferability of interest by preventing the transfer of ownership interest in the LLC and requiring that the LLC dissolve if the ownership interest is transferred as outlined in PLR 9510037 as summarized in this paper; and
- continuity of life by providing that the LLC will dissolve only upon the bankruptcy of any member unless the holders of a majority-in-interest in the capital and profits of the remaining members elect to continue.

**3. PRIVATE LETTER RULINGS LACKING FREE TRANSFERABILITY OF INTEREST OR CENTRAL IZATION OF MANAGEMENT WHEN AN LLC'S MEMBERS ARE CONTROLLED BY A COMMON SOURCE**

**a. PLR 9510037**

In PLR 9510037, a parent organization has two wholly owned subsidiaries. The two subsidiaries formed a Texas LLC. The LLC will dissolve upon any member's resignation, expulsion, bankruptcy, or dissolution or any other event that terminates a member's continued membership in the LLC. In addition, the LLC will dissolve upon the attempted transfer of a membership interest in contravention of the transfer restrictions in the regulations. The LLC's regulations provide that LLC membership is restricted to the initial members; that no membership interest, in whole or in part, may be assigned; and that no new members may be admitted. The initial members may transfer membership interest between themselves. The LLC lacked the corporate characteristics of continuity of life and free transferability of interest, even though both subsidiaries were controlled by the parent organization.

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### **. PLR 9507004**

In PLR 9507004, a parent organization owns a wholly-owned subsidiary. The parent organization and its wholly-owned subsidiary form an LLC. The LLC will dissolve upon any member's death, retirement, resignation, bankruptcy, or dissolution or any other event that terminates a member's continued membership in the LLC. The LLC's operating agreement provides that no member may sell, transfer, or assign its interest in the LLC. It further provides that if any member sells, transfers, or assigns its interest in the LLC, the LLC will dissolve. The LLC lacked the corporate characteristics of continuity of life and free transferability of interest, even though the parent organization controlled the subsidiary and the LLC.

### **. PLR 9320045**

In PLR 9320045, an individual formed a corporation. The individual contributed one percent ownership in oil and gas properties to the corporation. The individual owned all the stock and was the corporation's sole director. The individual and the corporation formed an LLC. The individual contributed 99% interest in the oil and gas properties to the LLC, and the corporation contributed its one percent ownership interest in the oil and gas properties to the LLC. The LLC was member-ruled, although the corporation managed the day-to-day affairs of the oil and gas properties through a management agreement. The LLC will dissolve upon any member's death, retirement, resignation, expulsion, bankruptcy, adjudication of insanity, incompetency or incapacity, or dissolution or any other event that terminates a member's continued membership in the LLC. The LLC lacked the corporate characteristics of continuity of life and centralization of management, even though the individual controlled the corporation and the LLC.

### **. A Limited Partnership as General Partner**

In certain circumstances, a limited partnership may be used as a general partner for the FLP. Usually the general partner of the limited partnership general partner is a corporation or an LLC. A limited partnership general partner has many of the advantages of an LLC general partner and the same disadvantages of the LLC.

### **. CAN AN LLC BE USED INSTEAD OF AN FLP?**

## Drafting Guide: Family Limited Partnership

Because of their applicable default provisions of state law, limited partnerships have been the entity of choice in estate plans to achieve valuation discounts applicable to ownership interests transferred among family members. Many commentators have debated whether LLCs may also be used to achieve similar discounts. For the reasons discussed below, limited partnerships are still the superior entity to achieve favorable valuation discounts. Two problems arise if an LLC is used instead of a limited partnership. First, under most state statutes, LLC members may withdraw from the LLC at will. After a member withdraws, the member may receive fair value for the member's interest in a reasonable period of time. Second, under most LLC acts, a member's withdrawal automatically causes the LLC to have a dissolution event. If a dissolution event occurs, the LLC will liquidate unless all remaining members consent to reconstitute and continue the LLC. In limited partnerships, however, limited partners may not withdraw at will in a term limited partnership. Even if the limited partners may withdraw at will, a limited partner's withdrawal does not cause a dissolution event. Only a general partner's withdrawal will be a dissolution event. If a general partner withdraws, all remaining general partners must consent to reconstitute and continue the limited partnership. The limited partners do not vote as to whether the limited partnership may continue after a general partner's withdrawal unless there are no remaining general partners. If all members must consent to continue an entity that has had a dissolution event, any one member may prevent the entity from continuing. Thus, an ownership interest in an entity requiring unanimous consent to continue the entity may be discounted less than that of an entity that does not require unanimous consent to continue. If many owners must vote to continue the entity, it is more likely that one will not vote to continue, which causes the entity to liquidate. If only a few owners must vote to continue the entity, it is more likely that those owners will vote to continue the entity.

Most LLC acts provide a put right for a member's membership interest when the member withdraws from the LLC. Four different methods have been adopted by LLC statutes. They are as follows:

- First, the traditional partnership approach, which has been adopted by the Uniform LLC Act, provides that a member of a term LLC does not have a put right. A member of a nonterm LLC, however, does have a put right.
- Second, the Arizona approach states that if an LLC is family-controlled within the meaning of Code §2704(b), a member may put the member's interest to the LLC. But the amount the member may receive is similar to what a member may receive under a discounted-cash-flow method of determining value. The assets are treated as if they are locked into the LLC for a 25-year period.
- Third, the Colorado approach, referred to as the "hotel Colorado approach", states that an LLC member may leave at any time and, thus, cut off that member's fiduciary duties. But that interest is converted into an assignee's interest, and an assignee of a converted membership interest may not withdraw from the LLC. The member may leave the LLC but not check out.

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- Fourth, the Texas approach is that a member may not terminate the member's membership interest in the absence of a contractual provision in the regulations. A member of a Texas LLC may not withdraw from the LLC unless the regulations specifically give the member that right. In effect, Texas has made each LLC's regulations the default provision of state law as to that LLC.

One real problem with utilizing an LLC instead of an FLP is that any member's death, retirement, bankruptcy, resignation, dissolution or expulsion ("Laundry List") will cause the LLC to dissolve under the state-law default rule. Unless the remaining members unanimously consent to reconstitute and continue the LLC, it will be forced to liquidate. Whether or not the LLC is member-ruled or manager-ruled does not change this result. In an FLP with multiple general partners, the Laundry List items cause the FLP to dissolve unless all remaining general partners consent to reconstitute and continue. The limited partners do not vote on whether the FLP may continue or liquidate. Upon a dissolution event, every LLC member may vote, and one negative vote may prevent the LLC from continuing. If a dissolution event occurs, an LLC is more likely to liquidate than an FLP.

### **. CLASSIFICATION CONSIDERATIONS**

#### **. Generally**

Just having an FLP doesn't mean it will be taxed as a partnership. If improperly crafted, it may be taxed as a corporation. An FLP will be taxed as a partnership if it lacks two of the four characteristics of a corporation. The four corporate characteristics are limited liability, continuity of life, free transferability of interest, and centralization of management.

#### **. Limited Liability**

Per the Regulations, an organization has limited liability if no members are personally liable for the organization's debts. One of the major benefits of an FLP is that the limited partners have no personal liability for the FLP's debts. An FLP's general partner will have personal liability. So long as an individual, corporation, or LLC that is well capitalized is serving as General Partner, the FLP will lack the corporate characteristic of limited liability. In situations where the individual, corporation, or LLC is under capitalized, the FLP will have the corporate characteristic of limited liability.

In the early 1980's, an organization with limited liability was classified as a corporation under the IRS regulations of that time. Those regulations were subsequently withdrawn. Revenue Ruling 88-76 stated that all four of the corporate characteristics were of equal weight, which meant that limited liability had no greater importance than any of the other three characteristics. Therefore, limited liability alone does not cause the FLP to be taxed as a corporation. If the FLP has limited liability, it is essential that the FLP lacks at least two of the remaining corporate characteristics.

The Treasury Regulations provide that a business organization will have centralization of management if management is reserved to less than all of the members. A limited partnership may lack the corporate characteristic of centralization of management in certain cases where management is reserved to less than all the partnership's members. An illustration would be a limited partnership where the general partner has a significant ownership interest in the limited partnership. In that case, the Treasury Regulations state that the limited partnership will not have the corporate characteristic of centralization of management because the general partner is managing for the general partner's own interest as well as in a representative capacity for the limited partners. One ruling has held that where the general partner owned 20% of the limited partnership, the limited partnership lacked centralization of management. In most FLPs the General Partner only owns a small percentage (usually 1 to 5 percent); thus, most FLPs will have the corporate characteristic of centralization of management.

**. Free Transferability of Interest**

Under the Treasury Regulations, an organization will have free transferability of interest if any member or any members as a group owning substantially all the interest may, without the consent of the other members, substitute another person for themselves in the business organization. Free transferability of interest does not exist when a member merely assigns the member's economic interest without substituting the assignee as a member with full voting rights, accounting rights, and management rights. Therefore, it is easy to provide in the partnership agreement that the FLP will not have free transferability of interest. The partnership agreement simply provides that a member may assign the member's economic rights in the FLP, but a partner may not substitute the assignee as a replacement partner without the remaining partners' consent. This can also be accomplished by relying on the Act's default provisions. The Act itself requires unanimous consent of the remaining partners to admit a substitute partner unless the partnership agreement provides otherwise.

In the limited partnership context, the IRS has indicated that unanimous consent of the remaining partners will not be required to admit a substitute limited partner in order for the partnership to lack the corporate characteristic of free transferability of interest.

**. Continuity of Life**

Under the Treasury Regulations, a business organization will lack the corporate characteristic of continuity of life if death, bankruptcy, or withdrawal of the member will cause the organization to dissolve.

Limited partnership agreements are often drafted so a limited partner's death, bankruptcy, or withdrawal does not trigger the limited partnership's dissolution, but rather only one of those events as it applies to a general partner will trigger the limited partnership's dissolution. The IRS has ruled that a limited partnership organized and formed under the Act will automatically lack the corporate characteristic of continuity of life.

**. Simplification of Entity-Classification Rules (IRS Notice 95-14, 1994-1 (C.B. 7))**

On March 29, 1995, the IRS issued Notice 95-14 announcing a proposed simplification of entity-classification rules. The IRS and the Treasury Department are considering simplifying the classification regulations to allow taxpayers on an elective basis to treat domestic, unincorporated business organizations as partnerships or as associations. The notice recognizes the narrowing in the past several years of the differences under local law between corporations and partnerships. The consequence of this is that taxpayers are able to achieve partnership tax treatment for entities that are almost indistinguishable from corporations. The Notice acknowledges the considerable resources that are expended to determine the proper classification for "domestic, unincorporated business organizations".

If the classification regulations are simplified, taxpayers may elect to treat domestic, unincorporated business organizations as either partnerships or associations for federal income-tax purposes. Unless classification is determined by another Code provision, it is anticipated that any unincorporated organization with two or more associates and an objective to carry on business and divide the profits will be eligible to make the election. An example of another Code section governing classification is Code §7704, which classifies publicly traded partnerships as corporations. All affirmative elections will be prospective from the date the election is filed or a later date designated in the election. Retroactive elections will not be allowed. All members will be required to execute the elections. After the election is made, it will be binding on all members until superseded by a subsequent election.

The Notice proposes that an entity that elects to change classification will be subject to the same federal tax consequences that exist under current law. If an organization that is classified as an association and taxable as a corporation elects to be classified as a partnership, the election will be treated as a complete liquidation of the corporation and a formation of a new partnership. This will require a final return for the corporation and a first-year return for the partnership. The new partnership will also have to ensure that its allocations comply with Code §704(b) and its accompanying regulations.

It is proposed that a new unincorporated business organization that does not make an affirmative election will automatically be treated as a partnership for federal income-tax purposes. Unless an affirmative election is made, existing entities will retain their current classification status.

Some state LLC statutes have taken a conservative approach concerning classification issues. These "bulletproof" state statutes that do not allow divergence from a strict structure that guarantees compliance with the classification rules will be at a disadvantage if the proposal announced in Notice 95-14 becomes reality.

**. ANTICIPATED IRS ATTACKS**

## Drafting ~~General~~ Family Limited Partnership

Because of the pressure on the IRS to collect revenue and because using FLPs in an advanced estate plan can produce significant valuation discounts of family assets and thus reduce the amount of revenue that can be collected by the IRS, the IRS will scrutinize an estate plan utilizing FLPs. Thus, it is incumbent on the estate planner to understand the likely attacks the IRS may raise to negate the benefits that may be derived from using FLPs. The IRS has had a difficult time disputing the valuation discounts achieved by using FLPs that are supported by legitimate appraisals. Even its own valuation training guide for appellate officers states that the IRS has been soundly thrashed by the courts in the area of lack-of-marketability and minority-interest discounts. It goes on to say that because of this thrashing, the IRS modified its position in this area in Rev. Rul. 93-12. The manual also states that routine lack-of-marketability discounts may be as much as 30% and that minority-interest discounts of 30%-35% are common. Thus, because the valuation training manual for appellate officers of the IRS and IRS' own appraisers recognize or utilize similar valuation discount percentages to those of taxpayers, the IRS is left only with attacks that allege fraud or sham in using FLPs or which will invoke the provisions of Code §2704(a) or Code §2704(b), which disregards the lapses of certain rights and restrictions on an entity's ability to liquidate in the valuation process.

### **. Attack that FLPs are not Formed for Legitimate Nontax Business Purposes**

The first attack the IRS will raise is that the FLP is a sham and a fraud. The IRS will argue that the sole purpose for organizing the FLP and its utilization in an estate plan is to artificially depress the value of family assets to unfairly take advantage of the estate and gift tax scheme. Thus, the valuation discounts achieved by using an FLP should be totally disregarded. It is incumbent upon the estate planner and the taxpayer to organize the FLP for legitimate nontax business purposes.

In the Harrison case, the IRS argued that the Court should ignore the effect the partnership agreement had upon the decedent's limited partnership interest because the partnership agreement was an attempt to artificially depress the value of the decedent's property for estate-tax purposes. The Court held that the agreement will be ignored only if there is no business purpose for creating the partnership or the agreement is merely a substitute for testamentary disposition. The taxpayer produced convincing proof that the partnership's business purpose was created as a means to provide necessary and proper management of decedent's properties and that the partnership was advantageous to and in the decedent's best interest. This was in spite of the fact that the partnership was established while decedent was incapacitated and he died four months after its creation. The Court disregarded the IRS' argument that the FLP was merely a substitute for testamentary disposition. The taxpayer proved:

- the agreement applied to all partners and no partner's assignee or estate could liquidate the partnership without the remaining partners' consent;
- the decedent received adequate consideration for the decedent's transfer of assets (partnership interest) to the partnership; and

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- although creating the partnership eventually resulted in a substantial decrease in estate taxes, there was no proof that the partnership was created other than for business purposes.

It is important for the estate planner to educate the client on the nontax business purposes for organizing an FLP. The worse thing to happen to an advanced estate plan utilizing an FLP is for the IRS to ask the taxpayer why did the taxpayer set up an FLP and the taxpayer respond that my lawyer told me that I could avoid paying significant estate and gift taxes if I form an FLP. The FLP must be formed for legitimate nontax business purposes. Thus, an estate planner needs to have the FLP agreement clearly reflect the nontax business purposes. The taxpayer needs to be educated on these nontax business purposes. The estate planner's file needs to reflect the nontax business purposes for forming the FLP and the FLP's business operation needs to demonstrate the FLP's nontax business purposes.

### **. Attack of Family Attribution**

For a number of years the IRS has argued that family attribution is applicable in determining the value of ownership interest of family entities. This theory has not only been applied to FLPs, but to all other types of family-owned entities. The IRS' training manual on valuation issues for appellate officers states the definition of fair market value requires a hypothetical willing buyer-willing seller. No assumptions should be made about who will buy the stock to be valued. The Regulations, Rev. Rul. 59-60, and case law uniformly require a truly hypothetical willing seller and willing buyer. For years the IRS' position was that a minority discount is not allowable for an individual's ownership interest when the entity is controlled by members of the individual's family. The manual goes on to say that the Courts have uniformly rejected this position. The leading cases in this area are *Estate of Andrews v. Commissioner*, 79 T.C. 938 (1979); *Estate of Bright v. United States*, 81-2 U.S.T.C. 13,436, (5th Cir. 1981); and *Propstra*, 689 F.2d 1248, 82-2 U.S.T.C. 13,475. Further, in *Minahan*, 88 T.C. 492 (1988), the taxpayer was awarded attorneys fees in a case where the Government "persists in the face of the *Estate of Andrews* and its progenitors [to espouse a family attribution approach]." As a result of this sound thrashing of the IRS by the Courts, Rev. Rul. 93-12, which modifies the IRS' position in this area, was issued.

After reading the cases and the IRS' own training manual, it appears that the IRS has abandoned family attribution in regard to valuation issues. Local district offices, however, have been very creative in devising new theories of "unity of interest" and a "limited member control group", which are nothing more than a means of disguised family attribution.

The IRS under its "linked member control group" theory argues that the minority interest owners in a corporation acting collectively would be hypothetical willing buyers who would desire to purchase control of the corporation from other minority interest owners, the hypothetical willing sellers who would know that the hypothetical willing buyers wanted to purchase their interests. The minority interest owners who are the hypothetical willing buyers would want to acquire the other minority interests in order that they might control the corporation. The other minority interest owners who are the hypothetical willing sellers would know this and, therefore, would not sell their stock at a discount. This means under this theory there would almost never be a minority interest discount allowed by the IRS in any type of entity owned by a family. There does not appear to be any reputable basis for this type theory.

The IRS has argued the unity-of-interest theory as an alternative to family attribution. The IRS argued this theory in *Samuel J. Lefrak and Ethel Lefrak v. Commissioner of Internal Revenue*, T.C. Memo 1993-526 ("Lefrak"). In *Lefrak* the parents gave undivided interests in a number of commercial real estate properties to their children and were allowed combined minority-interest and lack-of-marketability discounts of 30% by the Court. The IRS argued that because the donor and donee were all members of the same family, a unity of interest in the control of the buildings existed, which obviated any basis for discounting the value of the gifts. The IRS noted the close and harmonious relationship between members of the *Lefrak* family, concluding that no discount was appropriate because there was no indication that some action detrimental to any of the property owners would be taken. The Court stated that it rejected the IRS position that allowing a minority discount is inappropriate in valuing gifts between family members. The Court went on to state that it found no basis to depart from a well-settled principle. Further, "the mere fact that all persons with ownership interests in the buildings are family members should not preclude allowance of a minority discount because the possibility of internecine bickering and dissention can never be excluded, and so it cannot be assumed that a family will always act as a unit in matters regarding the property."

Minority-interest and lack-of-marketability discounts are available to and among family members who own minority interests in family-owned entities. The cases and Rev. Rul. 93-12 clarified this point. The IRS still refuses to give in to this issue even though they have been soundly defeated in every court case that has raised this issue. If the IRS raises a new or novel family-attribution theory, it should be vigorously opposed. Several practitioners have indicated that when these types of theories have been argued by the IRS at the agent level, then they have been abandoned when the issue reached the appellate level or tax court.

#### **. Attack that a Term-of-Years Partnership Itself is an Applicable Restriction**

It has been argued that the IRS may take the position that creating a term-of-years partnership is in itself creating an applicable restriction. This argument is contrary to the plain language of the Act. Forming a term-of-years partnership is not a restriction against liquidation because the FLP will dissolve, in accordance with §8.01(3) of the Act, at any time whether or not it is a term-of-years partnership. Only a term-of-years partnership will dissolve under §8.01(1) of the Act, which may or may not be a prior dissolution event to that of §8.01(3) of the Act.

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Under the Act there are two types of partnerships that may be organized. There is the term-of-years partnership, which has a definite beginning date and a definite ending date. The other alternative is a non-term-of-years partnership, which has a definite beginning date, but has no definite ending date. A non-term-of-years partnership is a perpetual partnership or a partnership at will. The best way to determine if a term-of-years partnership is an applicable restriction is to compare the two types of limited partnerships.

If the general partner withdraws, regardless of whether the FLP is a term-of-years partnership or non-term-of-years partnership, the general partner will cease to be a general partner, which will be a withdrawal event under §4.02(a) of the Act. In either case, under §6.02(b) of the Act, the remaining general partners, and if there are no remaining general partners then a majority-in-interest of the limited partners, may convert that withdrawing general partner's general partnership interest to a limited partnership interest or purchase it. Under §8.01 of the Act, the fact that a general partner withdraws is a dissolution event. In either case, under §8.01(2) of the Act, if the partners want to voluntarily terminate and liquidate the partnership, it requires unanimous consent of all the partners.

The only difference between a term-of-years partnership and a non-term-of-years partnership is that a term-of-years partnership must liquidate at a specified time at the end of the term, while a non-term-of-years partnership does not have to liquidate at anytime in the future. Whether or not the partnership is a term-of-years partnership or non-term-of-years partnership, under §8.03 of the Act the results are the same. In either case, the remaining general partners may elect to reconstitute and continue the partnership when a dissolution event occurs if the partnership agreement allows the partnership to continue and the general partners do so. If there are no remaining general partners, then all partners must agree to reconstitute and continue the partnership and elect new general partners within 90 days.

The reason it is argued that the IRS may claim a term-of-years partnership is an applicable restriction is that in a term-of-years partnership the limited partners are not allowed to withdraw from the partnership until the end of the term. In a non-term-of-years partnership, a limited partner may withdraw with six months notice and receive fair value for the withdrawing partner's interest. If a limited partner may withdraw with six months notice, the valuation discounts will not be as great.

The only advantage a term-of-years partnership provides is that a limited partner may not withdraw from the FLP before it terminates and the indication it gives that the FLP is to be continued if a dissolution event occurs under §8.01(3) of the Act. This indication of an intent to continue is necessary if the FLP is to be easily reconstituted and continued under §8.03 of the Act. This same benefit will arise by including a statement in the partnership agreement that the FLP is permitted to continue. In either situation, whether there is a term-of-years partnership or a non-term-years-partnership, and where both have multiple general partners and both permit the FLP to continue, the general partner may reconstitute and continue the FLP. Effectively, there is very little difference from a liquidation viewpoint.

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In a term-of-years partnership, §1.01(1) of the Act provides that the FLP will be required to liquidate at the end of its term. This provision does not prohibit the partnership from liquidating, but rather it requires that the partnership must liquidate. A term-of-years partnership is not an applicable restriction because it does not limit the partnership's ability to liquidate in a manner more restrictive than the default provisions of state law. Actually, it is a restriction that requires liquidation, or rather it is a restriction against continuing. If the IRS takes the position that a non-term-of-years partnership is the type of default partnership created under the Act, a strong argument may be made that the term-of-years partnership is less restrictive than the default provisions of state law. Therefore, the default terms of a term-of-years partnership must be given effect.

If the IRS disregards the argument that a term-of-years partnership is less restrictive than a non-term-of-years partnership, then a provision can be drafted in the partnership agreement that states that no limited partner may withdraw from the partnership before the end of the term. This type of provision is subject to Code §2703. The Regulations state that if there is an option, a right to use property, or agreement that is subject to Code §2703, then it is not an applicable restriction. This type provision would meet the requirements of Rule Three above. Almost every limited partnership agreement drafted has a provision that prohibits the limited partners from withdrawing before the end of a stated term. In this situation, Rule Three of Code §2703 should trump Rule Two, because it should meet all three elements of Rule Three.

If all the previous arguments fail, it can be argued that if a transferee is only an assignee, it is clear that an assignee may not withdraw from a partnership. After Rev. Rul. 93-12, one no longer looks to the transferor's rights, but rather the transferee's rights. If the transferee is only an assignee, clearly the assignee may not withdraw and the transferee's interest in the partnership must be valued accordingly.

Even if a limited partner may withdraw from the partnership, the limited partner may only receive the fair value of the limited partner's interest within six months. It does not say liquidation value, but rather fair value. After looking at all the cases and looking to corporations for an analogy, it appears that fair value is similar to what would exist under a willing seller/willing buyer test. At worst, if a limited partner is allowed to withdraw after six months notice, the withdrawing limited partnership interest would significantly reduce the lack of marketability discount, but it would still be entitled to a minority interest discount. The FLP itself would provide a buyer for the withdrawing limited partner's limited partnership interest at the end of six months. This would mean that there would be a market for the limited partnership interest, and the lack of marketability discount would be limited to an adjusted value based upon this six month delay. The limited partnership interest would continue to lack management rights, and, thus, a minority interest discount would remain intact.

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If all the previous arguments are disregarded, an entity with a term will have an applicable restriction. This would mean that Congress intended that only small interests in corporations would be entitled to receive minority-interest and lack-of-marketability discounts. There is no evidence of this type of intent in the legislative history. There is a sentence in the preamble to the legislative history that states that "these rules" (talking about Code §2704) "do not effect minority-discounts or other discounts available under present law." There were numerous cases establishing that discounts were available to limited partnerships at the time Chapter 14 was enacted. Thus, it appears that Congress intended that minority-interest and lack-of-marketability discounts were not to be disregarded when Chapter 14 was enacted.

### **. Attack that Remaining General Partners May Continue the Partnership is an Applicable Restriction**

It has been argued that the IRS may claim there is an applicable restriction if a partnership is organized with multiple general partners and the partnership agreement provides that the partnership may be reconstituted and continued upon a dissolution event.

Section 8.03 of the Act states that if there has been a dissolution event, there are remaining general partners, the partnership agreement provides that the partnership may continue, and the general partners in fact continue the partnership, then the partnership will be reconstituted and continued. If there are no remaining general partners, the partnership may be reconstituted and continued if all partners consent and appoint successor general partners within 90 days. The fact that there is a term-of-years partnership is evidence that the partnership is to continue to the end of the term even if there is a premature dissolution event. If all the business purposes and business activities indicate and support the fact that the partnership is to continue, it will be difficult to argue that a provision that the partnership may continue after a dissolution event is an applicable restriction. It is dangerous, for Code §2704(b) purposes, for a partnership agreement to provide that upon a dissolution event that the partnership will automatically be reconstituted and continued. This goes one step too far. To counteract this problem when drafting an FLP, it is important to track the Act as closely as possible and provide that the partnership be permitted to continue but not required to continue upon a dissolution event. Many of the same arguments that support the position that a term-of-years partnership is not an applicable restriction will also apply to this potential attack. If the IRS is successful in claiming that this type of provision is an applicable restriction, the requirement that all partners consent to continue the partnership will apply. This could be detrimental because any family member would then be able to block the partnership's reconstitution and continuation upon a dissolution event of the FLP. An appraiser could still determine that there is an expectancy that the partnership would be reconstituted and continued and that all partners would consent to the action. This would mean the discount amount could be reduced but would not wipe out the discount all together. In the Land case, it is stated that when valuing an entity, one must look forward in time to determine the expectancies. The expectancy is that the other partners will want to continue the partnership. The Tax Court in the Harrison case upheld this position. If a general partner's death does not cause a dissolution event because there is an entity serving as general partner, then this issue never arises.

**Drafting Guide: Family Limited Partnerships May Not Be formed Solely for the Purpose of Being an Investment Partnership.** Among practitioners there has been concern that the IRS will contest the validity of a partnership formed solely for investment purposes. After careful examination, this concern evaporates. The Code provides the following:

- § 7701: The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation.
- § 761: The term "partnership" is defined identically as in § 7701 and it provides that an unincorporated organization with a business or financial purpose will be a partnership unless it is formed solely for investment purposes and all the members elect out of partnership status. This means that an investment unincorporated organization where the members have not elected out of partnership status will automatically be a partnership.
- § 721: This section clearly contemplates that marketable securities may be contributed to a partnership and that that partnership may be an investment partnership.

There are numerous other provisions in subchapter K of the Code that make reference to the investment nature of partnerships or its financial operations, which clearly contemplate that a partnership may be formed to hold primarily passive type investments such as marketable securities.

Rev. Rul. 75-523 recognized that an "investment club" formed by a group of individuals solely for investing in securities was a partnership for Federal income-tax purposes. The income from the partnership was derived solely from taxable dividends, interest, and gains from selling securities. Code § 7701 and Code § 761 define the term "partnership" as including syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation. Under § 761, a partnership may be availed of for investment purposes only, and need not actively engaged in the active business conduct.

Based upon the Code and Revenue Rulings, it is clear that an FLP may be formed as a partnership to hold marketable securities. An investment club is often formed to allow its members to learn how to invest, handle money, and make a profit. Many of my clients have indicated that one of the features that they like about an FLP is that it allows them a mechanism to make gifts to family members or have family members make contributions to the FLP and those family members learn about investing. It is important to them that their family learn about wealth and the responsibilities that come with wealth and to do so in a structured format, which the FLP provides. Virtually all the valid business purposes discussed earlier in this paper are available to investment FLPs. Experience, conversations with other practitioners, and conversations with appraisers have indicated that minority-interest and lack-of-marketability discounts of 25-35% are common when limited partnership interests are transferred in an investment FLP.

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### **. Attack that FLPs Formed to Hold Passive Investments Violate §701 Anti-Abuse Rules**

The final regulation for the Code §701 anti-abuse rule was issued on December 29, 1994. The rule authorizes the Commission of Internal Revenue ("Commission"), in certain circumstances, to recast a transaction involving using a partnership. The final regulation affects partnerships and the partners of those partnerships. It was issued because the IRS believed that guidance was needed to insure compliance with the applicable tax law. The regulation was issued because the IRS believed that Subchapter K was used for tax-avoidance purposes. When the proposed regulation was issued in May, 1994, numerous spokespersons for the IRS, when questioned about applying the anti-abuse rule to FLPs, stated that the anti-abuse rule was not aimed at FLPs and under normal circumstances would not be used in connection with FLPs. As the summer of 1994 progressed, the IRS began to change its comments, and more and more concern was expressed by practitioners that the IRS was going to attempt to apply the anti-abuse rule to FLPs.

The final regulation stated that:

- it applies to operating and interpreting any Code provision and the regulations under the Code that may be relevant to a particular partnership transaction (including income, estate, gift, generation-skipping, and excise tax);
- Subchapter K is intended to permit taxpayers to conduct joint business (including investment) activities through a flexible, economic arrangement without incurring an entity-level tax;
- the partnership must be bona fide and each partnership transaction or series of related transactions (individually or collectively, the "transaction") must be entered into for a substantial business purpose;
- the form of each partnership transaction must be respected under substance over form principles;
- the tax consequences under Subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must, subject to certain exceptions, accurately reflect the partners' economic agreement and clearly reflect the partner's income (proper reflection of income); and
- the regulation applies only if both (1) the taxpayer has a principal purpose to achieve substantial federal tax reduction, and (2) that tax reduction is inconsistent with the intent of Subchapter K.

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In the final Reg. 1.701-2(b) issued in December, 1994, Example 6, it appeared that the IRS tried to apply the anti-abuse rule to FLPs. In Example 6, a husband and wife form a partnership, contributing their interests in their vacation home. Wife subsequently transfers limited partnership interests in the partnership to their children, and discounts are applied in determining the value of the transfers. The example stated that in this case, the partnership was formed with a principal purpose to reduce husband's and wife's aggregate federal tax liability in a manner that was inconsistent with Subchapter K, and the Commissioner could invoke Reg. 1.701-2(b) to recast the transaction as appropriate to achieve tax results that are consistent with the intent of Subchapter K. The inconsistency with the intent of Subchapter K was based on the conclusion that the partnership was not bona fide and there was no substantial business (or investment) purpose for its activities. Because these are fact questions, this conclusion was wrong, even under the logic of the

Regulations. The anti-abuse rule, and in particular Example 6, released a firestorm of criticism concerning its application to FLPs and over emphasized the fact that the asset placed in the FLP was not going to be actively managed. Some commentators were concerned that the FLP's assets would have to be actively managed to have a valid FLP, which means that FLPs formed to hold primarily passive investments, such as cash, bonds, and marketable securities, would be recast by the Commissioner with the partnership entity being disregarded. Please note that Example 6 did not talk about cash, bonds, and marketable securities but only about an FLP that was formed to hold only a vacation home.

The anti-abuse rule did provide some significant good news as reflected in Reg. 1.701-2(d), Example 5. In Example 5, a husband and wife formed a partnership, contributing their interests in actively managed, income-producing real property that the partnership will own and operate. Wife subsequently transfers limited partnership interests in the partnership to their children, and discounts were applied in determining the value of the transfers. Example 5 stated that the decision to organize and conduct the business through a partnership was consistent with the intent of Subchapter K as stated in Reg. 1.701-2(a)(1),(2), and (3), and the Commissioner could invoke Reg. 1.701-2(b) to recast the transaction. Most FLPs are formed by the contribution of a mixture of cash, securities, rental real estate, and active businesses, which require a significant amount of active management. Even in situations when an FLP is formed to hold cash and marketable securities, significant nontax business purposes do exist to justify forming an FLP.

The IRS will have some difficulty applying the anti-abuse rules to FLPs that are formed for legitimate nontax business purposes, especially if the assets contributed to the FLP require active management and supervision. In addition, there was some question as to whether or not the IRS has the authority to regulate estate and gift tax issues by issuing regulation for an income-tax provision of the Code that deals with valuation discounts, which have been specifically addressed by Congress in Chapter 14. The IRS realized this when it issued Announcement 95-8, which stated that the anti-abuse rules apply solely to income taxes and not to transfer taxes. In accordance to the IRS' new position, Examples 5 and 6 were retracted and deleted.

**. How to Defend Against IRS' §2703 Attack on FLPs**

The IRS takes the position that the taxpayer should not invest in FLPs, but should invest in mutual funds. Also under Code §2703, the IRS states that they can ignore the partnership and look directly to the underlying value of the assets. In addition, the safe harbor under Code §2703(b) is not available to the taxpayer for the creation of the partnership. The services takes the position that the creation of the partnership is nothing more than a device to transfer the assets contributed to the FLP for less than full and adequate consideration in money or money's worth to the other members of the family.

The first response that can be made is that after taking into consideration Code §7701(a)(2), you cannot use Code §2703 to ignore the partnership's creation. Under Code §7701(a)(2), an entity will be a partnership if it meets certain tests or requirements. The Code, not state law, establishes the tests or standards for determining an organization's classification. For estate-tax purposes, state law does govern in determining whether the legal relationships that have been established in the formation of an organization are such that the standards are met. Code §7701(a)(2) states that if you are a group, pool, syndicate, joint venture; engaged in a trade or business or financial operation; and the organization is not a trust, estate, or corporation, then the organization is a partnership. A family is a group engaged in financial operations or a trade or business, and the family is not a trust, estate, or corporation; thus, it must be a partnership for all Code sections.

A key principal of partnership law is that the partners get to choose who their partners are. You may wish to be partners with a particular person and no one else. If your partner transfers part of his partnership interest to another person, you do not have to share management rights with that other person. The assignee of the transferred partnership interest does not have any withdrawal rights, management rights, voting rights, information rights, liquidation rights, or distribution rights. The only right the assignee has is to receive distributions if, as, and when those distributions are made. The only duty the other partners have to the assignee of the transferred partnership interest is to pay the assignee his pro rata share of any distributions.

A hypothetical willing buyer that is well-informed knows that when he buys a partnership interest, he will only be an assignee. As an assignee, he will not be able to control, manage, direct, or compel the partnership or its partners to do anything. The only thing he will have a right to receive will be a pro rata proportion of any distributions if any are made. The only way the assignee can be admitted to the partnership as a full partner is by the unanimous consent of the partners. The assignee may have to pay the other partners for the privilege of being admitted to the partnership. The assignee does not pay the seller, because the seller has no power or authority to make the assignee his successor partner in the partnership. Thus, the buyer will pay the seller only for the naked right to receive distributions from the partnership.

The regulations under Code §7701(a)(2) state that a key element in distinguishing partnerships from corporations is that partnerships lack free transferability of interest. Being a partnership and lacking free transferability of interest is the foundation upon which valuation discounts are based in determining the fair market value of property under a transfer tax system.

If the partnership meets all the requirements of a partnership, then it is a partnership.

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Code §2703(a) states that the value of any property will be determined without regard to any restriction depressing the value of the property. What property is being valued? Clearly, it is the partnership interest that is being transferred and not the underlying assets of the partnership.

The second response to the IRS' attack is that the IRS' position ignores legislative intent. The legislative history makes it clear that Code §2703 is meant to apply to agreements and not to the creation of entities. Congress, in the legislative history of Chapter 14 (which includes Code §2703), stated that the bill enacting Chapter 14 does not affect minority discounts or other discounts available under present law. Congress was making it clear that you may enter into partnerships and corporations and that the willing buyer and the willing seller test was retained, but that certain factors are no longer deemed relevant.

If the IRS' position is correct and Code §2703 can be used to ignore the creation of the partnership, there is no reason to have a Code §2704(b). This is because of how the Regulations are written under Code §2704(b) where anything that is covered by Code §2703 is not covered by Code §2704(b). An option, right to use property, or agreement subject to the provisions of Code §2703 is not an applicable restriction under Code §2704(b). Thus, Code §2703 trumps Code §2704(b) if there is a conflict in the application of these two provisions. An applicable restriction is a limitation that restricts the ability of an entity to liquidate that is more restrictive than the default provisions of state law. The more restrictive limitation must be included in the governing instrument organizing the entity. If Code §2703 can be used to ignore the creation of the entity, then a restriction included in the governing instrument does not matter because you never look to the governing instrument. If Code §2703 cannot be used to ignore the formation and creation of the entity, then having Code §2704(b) makes sense and does have a purpose.

A third response is, that in two different places of the Regulations under Code §2703, the Regulations do not assume that Code §2703 applies to the creation of an entity. Regulation 25.2703-1(a)(3) states that a right or restriction may be in a partnership agreement, articles of incorporation, corporate by-laws, shareholders agreement, or any other agreement or may be implied from an entity's capital structure. These rights or restrictions will be ignored in determining the fair market value of an ownership interest in an entity. It is the right or restriction found in an agreement or implied in the entity's structure that is ignored and not the entity itself. It does not say that the IRS can ignore the entity's creation, but only restrictions or agreements included in the documents creating or regulating the entity or the entity's structure. If the entity itself can be ignored, then why would the regulation provide that you ignore restrictions included in an agreement affecting an entity? This Regulation also does not address restrictions imposed by state law and required under Code §7701(a)(2) that are required to qualify the entity as a partnership.

Under Regulation 25.2703-1(b)(5), which deals with multiple rights and restrictions, an agreement with both objectionable provisions and nonobjectionable provisions is upheld except for the objectionable provisions. The nonobjectionable provisions are retained and given effect.

The fourth response is that the IRS position ignores estate law property rights. Estate and gift taxation almost always follow state law property rights. Under state law, a partner has no interest in any of the underlying assets of the partnership.

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A fifth response is that there is a safe harbor under Code §2703(b). Even if any of the provisions that the IRS has a problem with are ignored, the substantial discounts desired by taxpayers are retained. The provisions in an FLP that might be ignored are:

- The restriction that a limited partner may not withdraw until the end of the partnership's term.
- The provision that requires the partnership to continue until the set term has expired.
- The provision that prohibits a limited partner from withdrawing.

Under the 2703 Regulations, after all the objectionable provisions are ignored, then the other provisions of the partnership can be retained. There must be some form of partnership that is acceptable to hold stocks and bonds since most investments clubs are partnerships.

To meet the Code §2703(b) safe-harbor test, the partnership must meet all three requirements of the test.

- First, the arrangement must be a bonafide business arrangement. There are a lot of nontax reasons to form a partnership to hold stocks and bonds. For instance, it can save fees, provide access to professional money managers, provide for asset diversification, provide creditor protection, provide for centralized control, provide protection for marital property rights; and provide for investing according to the modern portfolio theory. Revenue Rulings 75-523 and 75-525 state that investment partnerships that invest only in stocks and bonds are valid partnerships. See response to IRS attack on investment partnerships discussed above.
- Second, the partnership must not be a device to transfer property for less than full and adequate consideration. The IRS has misread the elements of the device test. There must first be a device and second there must be a transfer of property for less than full and adequate consideration. What is transferred to the members of the family are interests in the partnership itself. The partnership cannot be a device to transfer the partnership's assets when the partners making the transfer of a partnership interest do not have an interest in the partnership's underlying assets. The recipients of a partnership interest do not have any rights in the partnership's assets. The partners do not have right to use the property, and they do not have the right to possess the partnership property. In addition, the partnership is not a device unlike in *St. Louis County Bank, Executor of the Estate of Lee J. Sloan, Deceased, Appellee v. U.S.* 674 F.2d 1207, which reasoning was adopted by the Senate Finance Committee. The court found in this case that the taxpayers never followed the buy-sell agreement. Thus, it is important to follow the partnership agreement and act like partners. The court also found that it was not appropriate to use the buy-sell formula since it had become outdated and had no applicability to the corporation's current business. In the FLP situation, it is important to make sure that you have a valid business purpose and that all buy-sell provisions determining the price of a partnership interest require that the interest will be transferred at its full fair market value.

Third, the terms in a partnership agreement must be comparable to those found in third-party arrangements, as more fully discussed above.

**. Attack that the Creation of an FLP and the Contribution of Property to the FLP is a Gift**

There are at least three different regulations that indicate that if you contribute property to a partnership or corporation and you receive in return a pro rata partnership interest or pro rata corporate interest, there is no gift made. The partnership or corporation should have only one class of ownership interest except possibly for differences in voting rights or management rights.

Regulation 25.2511-2 states that the gift tax is an excise tax on the value of property transferred. The gift tax is not a tax on the subject of the gift. In other words, just because a person's net worth may go down because the value of a partnership interest that is received in return for a contribution of assets to the partnership is worth less to a willing buyer than the assets themselves, that is not a gift. The gift tax is not a tax on the decrease in net worth. The gift tax is a tax on the value of what is transferred from one person to another without adequate consideration in money or money's worth.

Regulation 25.2511-1(h)(1) states that there is not a gift to the other partners, even if the partnership interest received in return for assets contributed to the partnership is less valuable than the assets themselves. If a person makes a transfer that is classified as a gift to a partnership or corporation, it is not a gift to the partnership or corporation. It is a gift to the partners or shareholders of the corporation. But a transfer (that is classified as a gift) of property to a corporation or partnership will only be classified as a gift to the extent that some owners receive more value for what they contributed to the entity proportionately as compared to what the other owners contributed proportionately.

In a family context, if mom and dad receive less value for what they contribute to the partnership than their children receive for their contribution to the partnership, then the parents have made a gift. But if everyone contributing property to the partnership gets back pro rata the same type of interest in the partnership, then there has been no gift. If mom and dad contribute \$1 million in cash or property (fair market value) and receive \$1 million partnership units and each of two children contribute \$10,000 in cash or value of property to the partnership and receive in return 10,000 units of partnership interest, then everyone has been treated the same. They have gotten the same type and quality of partnership interest in a quantity pro rata to the value of property contributed to the partnership.

Regulation 25.2512-8 states that a contribution to a partnership or corporation will not be considered a gift if the contribution is a transaction that is bonafide, arms length, and free from donative intent. If these factors exist, the ownership interest in the entity that is received in return for the contribution will be deemed to be full and adequate consideration in money or money's worth.

**. CODE SECTIONS 2036, 2038, and 2503 CONCERNS**

**. Generally**

Some estate planners have indicated concern over applying Code sections 2036, 2038, and 2503 to FLPs. There is concern that retaining management powers and the discretion to make distributions to the partnership's partners will cause a portion, if not all, the FLP's assets that were contributed by general partners and other family members to be includable in a deceased general partner's gross estate for federal estate-tax purposes or that retention of those powers by a transferor/general partner will cause the transfer of the transferor's limited partnership interest to fail to qualify as a present-interest gift. Practitioners also have concerns about applying Code §2036(b) to FLPs when control stock of the family-owned corporation is contributed to the FLP. Several private letter rulings and TAM 9131006 have been promulgated by the IRS, which give significant guidance to estate planners in handling and resolving these concerns.

## Drafting Guide 2036(a) and 2038 of the Code

Code §2036(a) provides that the decedent's gross estate includes the value of all property to the extent of any interest in the property of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or moneys worth), by trust or otherwise, under which the decedent has retained for the decedent's life or for any period not ascertainable without reference to the decedent's death or for any period that does not in fact end before the decedent's death (1) the possession or enjoyment of, or the right to income from the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who will possess or enjoy the property or the income from the property. Code §2038 states that the value of the gross estate will include the value of all property to the extent of any interest in the property of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of the decedent's death to any change through exercising a power by the decedent acting alone or with others for a three-year period ending with the decedent's date of death. TAM 9131006 deals with creating an FLP where the overall management authority was invested in the general partners. The amount and timing of all distributions was reserved to the general partner's discretion. The limited partners were prohibited from taking any part in or from interfering in the partnership's management. The limited partners, however, had the right to sell their units to third parties subject to a right-of-first refusal in the other partners. The taxpayer retained partnership interests (both general and limited), which enabled the taxpayer to control the partnership's management, including control over any distributions to be made from the partnership. After the transfers made by the taxpayer just before the taxpayer's death, the taxpayer no longer possessed voting control of the partnership. Thus, the taxpayer could be removed as a general partner by a vote of a majority of the partners. At the time of the transfers no gift exceeded \$10,000. In this TAM the IRS looked to the Byrum case which states that stock in a corporation transferred by the decedent to an irrevocable trust was not included in the decedent's gross estate under Code §2036, although the decedent expressly retained the right to vote the transferred stock and to veto the sale or disposition of the stock by the trustee. The Byrum court held that the decedent, as a controlling shareholder and a member of the board of directors, had a fiduciary duty to promote the corporation's interests and not to exercise the decedent's power to promote the decedent's personal interests at the minority shareholders' expense. The decedent's retained power to vote the stock did not constitute the retained "enjoyment" of the transferred stock, or the right to designate the income from the transferred stock, for purposes of Code §2036. This TAM stated, as was the case in Byrum, the value of the transferred partnership interests is not includable in the decedent's gross estate under Code §2036. The value of the transferred partnership interests is also not includable in the decedent's gross estate under Code §2038 because under that section the taxpayer retained no power to alter the other partners' beneficial interests. Similar results were reached in PLR 9415007.

**. Code §2036(b)**

Code §2036(b)(1) provides that for purposes of Code §2036(a)(1), directly or indirectly retaining voting rights in transferred stock of a controlled corporation will be considered retaining the enjoyment of transferred property. The Senate Finance Committee Report relating to Code §2036(b)(1) provides that the rule would not apply to transferring stock in a controlled corporation where the decedent could not vote the transferred stock. For example, where a decedent transfers stock in a controlled corporation to the decedent's son and does not have the power to vote the stock any time during the three-year period before the decedent's death, the rule does not apply even where the decedent owned, or could vote, a majority of the stock. Similarly, where the decedent owned both voting and nonvoting stock and transferred the nonvoting stock to another person, the sale does not apply to the nonvoting stock simply because the decedent owns the voting stock. The legislative history of Code §2036(b) demonstrates that the rule of that section will not apply to transferring stock in a controlled corporation where the decedent could not vote the transferred stock.

Code §2036(b)(1) can be a problem if the FLP holds primarily closely-held corporate stock. One way to avoid Code §2036(b)(1) is to make the partnership's general partner an entity with the ownership spread among several family members so that the patriarch or the matriarch do not control the entity. Another alternative is to provide in the partnership agreement that all the partners will vote the corporate stock in proportion to their partnership interest at the time that they contributed the stock to the partnership. To the extent there are future gifts of partnership interests, there should not be a problem. In a corporate context it is permissible to create voting and nonvoting stock and then give away the nonvoting stock. This is analogous to the matriarch and patriarch contributing corporate stock in return for 99% partnership interest in a limited partnership and at a later date they give away limited partnership interests to their children. Gifting the limited partnership interests to the children is similar to gifting nonvoting stock. If the corporate scenario is permissible, then so should the partnership scenario. This is a tricky area, thus Code §2036(b)(1) must be considered when closely-held stock is contributed to the FLP.

## Drafting Guide ~~§2503~~ Family Limited Partnership

Some practitioners have raised the concern that transferring a limited partnership interest from a transferor to a transferee as a gift may not qualify for the annual gift-tax exclusion. Both TAM 9131006 and PLR 9415007 discuss this question. In both, the IRS concludes that gifting a limited partnership interest will qualify for the annual gift-tax exclusion under Code §2503(b). It was held that the management powers possessed by the transferor/general partner under the partnership agreement, including control over partnership distributions, are similar to the powers possessed by general partners in most limited partnerships. It was acknowledged that a general partner must exercise those powers in a fiduciary capacity and is held to a high standard of conduct toward the limited partners. Thus, the IRS stated that the general partner's powers are not the equivalent of a trustee's discretionary authority to distribute or withhold trust income or property (i.e., a power that generally results in characterizing a gift to that type trust as a future-interest gift). The IRS concluded that the proposed gifts of limited partnership interests by the transferor will constitute present-interest gifts that will qualify for the annual exclusion under Code §2503(b), because the proposed gifts of limited partnership interests will constitute outright gifts of ownership interests in a business entity, and each donee will receive the immediate use, possession, and enjoyment of the subject matter of the proposed gifts, including the right to sell or assign the interest even though those interests were subject to the right-of-first refusal.

### . FORMS AND DISCLAIMERS

#### . Drafting Approach

The attached drafting guide will go through a paragraph-by-paragraph analysis of the FLP and will discuss income tax, estate and gift tax, business, and other practical considerations necessary to design an FLP.

#### . Caveat

**WARNING!** Blindly using the attached forms may be dangerous to your legal health.

Before drafting these forms for the client, careful attention must be given to the FLP being created as it affects the participants' desires and needs. Detailed information concerning the parties involved and the FLP's business purposes are to be obtained, analyzed, and discussed with the proposed FLP's representatives before forming an FLP. In a perfect world, an attorney would obtain a disclaimer stating all the "opt-in" features and default rules contained in the Act and affirming that the forms prepared by the attorney contain those and only those features desired. The forms used amount to a contract of parties whose interests, in certain details, may well differ. In addition, there are certain tax questions that must be addressed, which can have varying affects upon an FLP's partners. Great care is to be exercised in drafting an FLP in regard to its tax status.

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- \_ Texas Revised Limited Partnership Act
- \_ HB 273, Texas Revised Partnership Act
- \_ Uniform Revised Limited Partnership Act
- \_ Internal Revenue Code: §704, §707, §754, §2032, §2036, §2038, §2701, §2703, and §2704

**Drafting Guide - Family Limited Partnership** (C.B. 7)

- \_ IRS Announcement 95-8
- \_ Private Letter Rulings: 9132042, 9133015, 9210019, 9253013, 9220045, 9415007, 9507004, and 9510037
- \_ Revenue Procedure 95-10
- \_ Revenue Rulings: 59-60, 75-523, 88-76, and 93-12
- \_ Tech. Advice Memo. 9131006
- \_ Treasury Regulations: 20.2031, 25.2701, 25.2703, and 25.2704