

# **The Future of Family Limited Partnerships in Estate Planning**

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## I. Introduction

The limited partnership has become, for many, the entity of choice for small business owners and for people seeking to reduce exposure to estate taxes, make gifts, and develop a succession plan. Considering the heavy scrutiny being applied by the IRS to the discounts associated with limited partnership interests, many tax advisors have been nervous about recommending the use of the limited partnership as an estate planning tool. This outline will: 1) provide an overview of different forms of business entities; 2) discuss the benefits of the limited partnership to the small business owner; and 3) explain the use of the limited partnership as an estate planning tool with an analysis of IRS attacks on discounts associated with limited partnership interests.

II. Overview of Forms of Business Entities. 80 to 90 percent of businesses in the United States are small, family owned businesses. These small businesses account for 49 percent of the gross national product and employ 59 percent of the workforce in the United States.<sup>1</sup> When advising these small businesses regarding choice of entity, the professional advisor must consider and balance the following goals of the small business owner: 1) liability protection; 2) maintenance of control over the operation and assets of the business; 3) minimization of income and other related taxes; and 4) maximization of valuation discounts for transfer tax purposes.<sup>2</sup> Additionally, planning for the death or incapacity of the business owner is critical to the growth, value, and longevity of the business.

### A. Sole Proprietorship/General Partnership

1. Formation. The sole proprietorship or general partnership is formed when one or more individuals go into business. No other action is needed. If the business is conducted under an assumed name, then the business owner(s) must file an assumed name certificate and obtain an employer identification number from the IRS.

2. Liability Protection. Neither the sole proprietorship nor the general partnership offers liability protection to the business owners.

3. Formalities. The sole proprietorship and general partnership are alter egos of the business owners. Consequently, no observation of formalities is required.

4. Taxation. The taxation of sole proprietorships and general partnerships is very simple because sole proprietorships are disregarded entities and general partnerships offer flow through taxation of all profits and losses straight to the owners of the business. Additionally, neither the sole proprietorship nor the general partnership are subject to franchise tax in the State of Texas.

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<sup>1</sup>Justin B. Goldstein, *How to Succeed in Family Business: Human Issues Facing Succession of Family Owned Businesses*, 4 No. 6 LAWYERS J. 5, March 22, 2002.

<sup>2</sup>Charles M. Hornberger, *Choice of Entity for Small Businesses*, Presented at the Advanced Estate Planning and Probate Law Course, State Bar of Texas, Austin, Texas, June 3-5 (1998).

5. Common Uses. Businesses that typically benefit from being structured as a sole proprietorship or general partnership include very small businesses where the business owns assets of little value and where the business owners perform the activities of the business or the business owners hire independent contractors to perform the activities of the business. Once the business takes on employees or begins to accumulate assets, the business owner should consider doing business as a statutorily created business entity to limit his exposure to the liabilities of the business and/or to protect the assets of the business from his individual liabilities.

6. Limited Liability Partnership. A general partnership may elect to become a limited liability partnership by filing a statement providing the following information: 1) the name of the partnership; 2) the federal tax identification number of the partnership; 3) the street address of its principal office in Texas and outside the state, if applicable; 4) the number of partners at the date of application; and 5) a brief statement of the business in which the partnership engages. A partner's liability in a registered limited liability partnership differs from that in an ordinary partnership. In a registered limited liability partnership, a partner is not individually liable for debts and obligations of the partnership incurred while the partnership is a registered limited liability partnership, nor is the partner liable for tortious acts committed by other partners. However, each partner is exposed to unlimited liability for torts of the partnership. For example, if the partnership owns a building and fails to maintain it and, as a consequence, a person is injured and seeks a judgment against the partnership, each partner is exposed to individual liability.

## B. Corporation

1. Formation. A Texas corporation can only be created by filing articles of incorporation with the Texas Secretary of State. Texas corporations are governed by the Texas Business Corporation Act.<sup>3</sup>

2. Liability Protection. A corporation does provide limited liability for its shareholders such that shareholders' liability is limited to each shareholder's interest in the corporation.<sup>4</sup> Consequently, the recovery of a judgment creditor of a corporation is limited to the assets of the corporation. In other words, the corporation is responsible for its own debts and torts, not the shareholders.<sup>5</sup> The individual assets of the shareholders may not be used to satisfy the judgment creditor of a corporation, provided the corporate structure is respected by the shareholders and the courts. While the limited liability protection a corporation offers to its shareholders is a fundamental attribute of the corporate form, three important exceptions exist.

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<sup>3</sup>TEX. BUS. CORP. ACT ANN. art. 1.01 (Vernon Supp. 2002).

<sup>4</sup>See James Gerard Gaspard, II, *A Texas Guide to Piercing and Preserving the Corporate Veil*, 31-SEP BULL. BUS. L. SEC. ST. B. TEX. 24, 25 (September 1994)(explaining that "limited liability means that corporate shareholders are responsible for the corporation's liabilities only to the extent of their investment in the corporation).

<sup>5</sup>*Id.*

a. No Business Asset Protection. First, an often ignored drawback of the corporate form involves business asset protection. Business asset protection is the protection of business assets from the individual liabilities of the business owners. Liability protection does not extend to the assets of the corporation, as the shares owned by a shareholder may be attached by a judgment creditor of a shareholder. If a shareholder owned a controlling interest in the corporation and the judgment creditor of such shareholder satisfied the judgment with the controlling shares of the corporation, that judgment creditor could gain control of the business. The creditor could then ultimately run the corporation, sell off all the corporation's assets, and make a dividend distribution to itself to satisfy the judgment.

b. Piercing the Corporate Veil. Second, another exception to the doctrine that the corporate form will protect shareholders from the liabilities of the corporation involves piercing the corporate veil. "Piercing the corporate veil," or "disregarding the corporate entity," refers to the judicially imposed exception to the principle of limited liability by which courts disregard the separateness of the corporation and hold a shareholder responsible for the corporation's action as if it were the shareholder's own action."<sup>6</sup> Texas courts distinguish between claims arising from tortious actions and claims arising out of a contract. If the claim involves a tort, the plaintiff need not show that the corporation acted in a fraudulent manner. However, if the claim involves a contract dispute, the plaintiff's burden of proof is elevated because the plaintiff must show actual fraud.<sup>7</sup> The theory behind this distinction arises from the belief that in a tort case, the relationship with the corporation is involuntary; and in the case of a contract, the relationship with the corporation is voluntary.<sup>8</sup> The courts in Texas have disregarded the corporate form under the following theories: 1) the corporation form is used as a means to perpetrate fraud; 2) the corporation is organized and operated as a mere tool or business conduit of another corporation; 3) the corporate form is used to evade an existing legal obligation; 4) the corporate form is used to perpetrate monopoly; 5) the corporate form is used to circumvent statute; and 6) the corporate form is used to justify wrongdoing.<sup>9</sup>

3. Formalities. In order for the corporate structure to be respected by the courts and prevent the corporate veil from being pierced, the shareholders should observe corporate formalities. Specifically, the corporation should, *inter alia*: 1) keep the minute book up to date by including minutes of annual and special meetings; 2) maintain financial records separately from the individual shareholders; 3) issue stock certificates; 4) adhere to the bylaws; 5) maintain the stock ledger; 6) hold directors meetings to approve large expenditures, long-term leases, and compensation plans; 7) insure

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<sup>6</sup>*Id* at 25. See also Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036 (1991).

<sup>7</sup>TEX. BUS. CORP. ACT ANN. art. 2.21 (Vernon Supp. 2002).

<sup>8</sup>See Gaspard, *supra* note 4, at 28.

<sup>9</sup>See *Castleberry v. Branscum*, 721 S.W.2d 270, 271 (Tex. 1986).



that the corporation is adequately capitalized and insured; and 8) avoid transactions involving self-dealing.<sup>10</sup>

4. Taxation. All corporations are subject to franchise tax in Texas. A corporation must pay franchise taxes equal to the greater of .25% of the net capital of the corporation or 4.5% of the net taxable earned surplus. No franchise tax is due if the corporation: 1) had no gross receipts in the State of Texas; 2) had total gross receipts of less than \$150,000; or 3) had total taxable capital of less than \$40,000 and its earned surplus totaled less than \$2,222. Under federal law, a corporation may be taxed as a corporation under subchapter C of the Internal Revenue Code or as a pass through entity under subchapter S of the Internal Revenue Code.

a. C Corporation. Unless the corporation elects otherwise, it will be taxed under subchapter C of the Internal Revenue Code upon formation. Consequently, the net income of the corporation will be subject to income tax at the corporate level. If the net income is distributed to shareholders and not added to the retained earnings of the corporation, the shareholders must pay income tax on the dividend, resulting in what many practitioners refer to as “double taxation.” Some individuals get around this double taxation issue by taking the net income out of the corporate entity as wages. These wages are a deduction to the corporation and income to the shareholder employee.

b. S Corporation. If a corporation makes an election with the IRS on Form 2553 to be taxed as a subchapter S corporation, then the corporation will be taxed as a flow through entity. The Form 2553 must be filed: 1) at any time on or before the 15<sup>th</sup> day of the third month of the tax year; or 2) at any time during the preceding tax year.<sup>11</sup> Often times, practitioners interpret the 15<sup>th</sup> day of the third month to mean 75 days. However, if a corporation is formed, say on January 31, the Form 2553 is due by March 15<sup>th</sup>, which could give the tax professional as few as 42 days to file the election in a leap year. A corporation must have the following characteristics in order to qualify for subchapter S tax treatment: 1) it is a domestic corporation; 2) it has no more than 100 shareholders;<sup>12</sup> 3) the shareholders are individuals, estates, certain exempt organizations, or qualified subchapter S trusts; 4) no nonresident aliens are shareholders; 5) it has only one class of stock; and 6) it has a tax year ending December 31, unless electing otherwise.<sup>13</sup> The taxation regime outlined in subchapter S of the Internal Revenue Code allows flow through taxation so that the net profits of the corporation flow straight to the shareholders’ individual income tax return instead of being first taxed at the corporate level. Generally, the S corporation enables shareholders to receive a reasonable salary and then take the remaining profits as net income subject only to income tax, not

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<sup>10</sup>See Gaspard, *supra* note 4, at 53-54.

<sup>11</sup>See instructions to I.R.S. Form 2553.

<sup>12</sup>A husband and wife, and their estates are treated as one shareholder for the purposes of qualifying the corporation for subchapter S tax treatment. The limitation number of shareholders increased from 75 to 100 for taxable years beginning after 2004. In 2004, congress amended § 1361(c)(1) to treat all members of a family as one shareholder.

<sup>13</sup>See IRC §§1361, 1362, 1378. See also Treas. Regs. 1.444-3T(b)(3).

social security and medicare taxes. However, the benefits associated with taking the profits out of the S corporation without those profits being subject to social security and medicare taxes must be balanced against the franchise tax. So, if a shareholder does not take the net income of a corporation in salary, which is deductible to a corporation, and pay the appropriate social security and medicare taxes (which social security wage base is \$94,200 in 2006<sup>14</sup> while the 2.9% medicare tax wage base is unlimited),<sup>15</sup> then such shareholder could pay 4.5% in franchise tax<sup>16</sup> on the net income earned in a corporation, as compared to only 2.9% in medicare tax on the wages paid out of a corporation.

5. Common Uses. The C corporation is frequently used by business owners seeking venture capital, planning to go public, anticipating much growth, seeking to increase the value of the business, and/or requiring the maintenance of a large capital base by the corporation (for research and development, as an example). Small businesses often operate as S corporations.

## 6. Other Types of Corporations

a. Professional Corporation. The professional corporation is formed by filing articles of incorporation with the Texas Secretary of State and setting out inside the articles that the corporation is a professional corporation. The professional corporation is governed by the Texas Professional Corporation Act.<sup>17</sup> The professional corporation may be taxed as either a C corporation or an S corporation. Business owners may form professional corporations if they are professional service providers such as attorneys, architects, CPAs, etc. The professional corporation does not offer limited liability protection for the professional malpractice of the shareholder. However, the business owner enjoys limited liability for claims accruing from sources other than the business owner's own activity. For example, if a client of the business owner suffers injury from a fall in the business owner's office, the business owner will be shielded from personal liability, so long as the fall did not result from the business owner's own negligence.

b. Professional Association. The professional association is formed by filing articles of association with the Texas Secretary of State and it is governed by the Texas Professional Association Act.<sup>18</sup> The professional association may be taxed as either a C corporation or an S corporation. The professional association *is not* subject to franchise tax in Texas. The types of individuals that can form a professional association are only those persons duly licensed to practice a profession, including: podiatry, dentistry, optometry or therapeutic optometry, or chiropractic medicine. Again, this type of entity does not offer limited liability protection for the professional

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<sup>14</sup>NOTICE 2005-85, and 2005-46 I.R.B. 961.

<sup>15</sup>IRC §§ 3101(b), 3111(b), and 3121(a)(1).

<sup>16</sup>TEX. TAX CODE ANN. §171.002 (Vernon 1992)

<sup>17</sup>TEX. REV. CIV. STAT. ANN. art. 1528e, §3(d) (Vernon 1997).

<sup>18</sup>TEX. REV. CIV. STAT. ANN. art. 1528f (Vernon 1997).

malpractice of the shareholder. However, like the professional corporation, the business owner enjoys limited liability for claims accruing from sources other than the business owner's own activity.

c. Nonprofit Corporation. The nonprofit corporation is formed by filing articles of incorporation for a Texas nonprofit corporation with the Texas Secretary of State. If the nonprofit seeks to be exempt from state and federal taxation, the corporation must file a Form 1023 Application for Recognition of Exemption with the IRS and pay a user fee amounting to \$150 if gross receipts will average less than \$10,000 per year for five years, or \$500 if gross receipts are expected to average more than \$10,000 per year. If the application is approved, then the nonprofit will receive a determination letter or advanced ruling from the IRS. If the nonprofit seeks tax exempt status with the State of Texas, the nonprofit must file a statement of activities with the Texas Comptroller of Public Accounts and enclose the determination letter or advanced ruling received by the IRS. Upon formation, all the officers and directors of a nonprofit enjoy limited liability so long as their actions do not constitute a breach of the fiduciary duty of loyalty to the nonprofit corporation. Generally, as long as the nonprofit corporation receives tax exempt status from the IRS, it is not subject to federal income tax and so long as the nonprofit corporation receives tax exempt status from the Texas Comptroller of Public Accounts it is not subject to sales or franchise tax. Three important exceptions exist to this rule. First, unrelated business income, which is income received that is not in furtherance of the nonprofit's tax exempt purpose, is subject to income tax. Second, the nonprofit must pay employment taxes. Third, the nonprofit must also pay property tax unless the real property is used in furtherance of its exempt purpose. Additionally, if a nonprofit's gross receipts total more than \$25,000 and it is not a church or other organization exempt from filing, then the nonprofit is required to file annual returns with the IRS. Such filings are done on Form 990.

### C. Limited Liability Company

1. Formation. The limited liability company is formed by filing articles of organization with the Texas Secretary of State and it is governed by the Texas Limited Liability Company Act.<sup>19</sup>

2. Liability Protection. Like the corporation, the limited liability company offers limited liability protection to its members, such that each member's liability is limited to each member's interest in the limited liability company. Consequently, if a liability accrues within the limited liability company, then the members' personal assets will be protected from a judgment creditor of the limited liability company, provided that the company form was respected by the members and the courts.

a. Business Asset Protection. Perhaps the most important difference between the corporation and the limited liability company relates to business asset protection. In the event a judgment creditor of a member of a limited liability company seeks to satisfy such judgment with such member's interest in a limited liability company, the creditor will obtain only the rights of an assignee. This assignee interest does not give a creditor voting rights nor does it give a creditor the power to

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<sup>19</sup>TEX. REV. CIV. STAT. ANN. art. 1528n (Vernon 1997).

force a distribution on such interest. As a result, the limited liability company and its assets are protected from the judgment creditors of its members.

b. Piercing the Company Veil. The same theories that apply to a corporation with regard to piercing the corporate veil likely apply to a limited liability company.<sup>20</sup>

3. Formalities. Like a corporation, in order for the company form to be respected by the courts, thereby shielding members from company liabilities, the members must adhere to the formalities of operating a limited liability company. The formalities associated with the limited liability company are similar to the formalities associated with a corporation, with one relatively important difference. If the limited liability company is taxed as a disregarded entity or partnership, minutes of annual and special meetings are unnecessary. However, most practitioners encourage business owners to conduct annual and special meetings even if they are not required.

4. Taxation. With a limited liability company, it is possible to have several different structures for taxation. A breakdown is as follows:

a. Sole Proprietorship. By default, if a single person or entity forms a limited liability company, then the taxation of such limited liability company will be deemed to be disregarded and the limited liability company will be taxed as a sole proprietorship if the member of the limited liability company is an individual, or it will be taxed as a branch or division of the entity owner. This type of taxation results in all of the limited liability company's income and expenses being reported on the individual or entity's income tax return.<sup>21</sup> While the limited liability company is a disregarded entity for tax purposes, it is not disregarded under state law, affording the members the benefits associated with limited liability.

b. Partnership. By default, if two or more single persons or entities form a limited liability company, then the taxation of such limited liability company will be deemed to be a partnership and the limited liability company will be required to file a Form 1065 tax return.

c. C Corporation. A limited liability company, after formation, may elect to be taxed as a corporation by filing Form 8832 Entity Classification Election and checking the box choosing to be taxed as an association taxable as a corporation. As a result, net income earned by the limited liability company will be taxed inside the limited liability company at the lower corporate

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<sup>20</sup>See David L. Cohen, *Theories of the Corporation and the Limited Liability Company: How Should Courts and Legislatures Articulate Rules for Piercing the Veil, Fiduciary Responsibility and Securities Regulation for the Limited Liability Company*, 51 OKLA. L. REV. 47, 429 (1998) (applying current law on veil piercing to the limited liability company). See also Eric Fox, *Piercing the Veil of Limited Liability Companies*, 62 GEO. WASH. L. REV. 1143, 1145 (1994)(arguing that many of the existing theories of veil piercing should be applied to the limited liability company).

<sup>21</sup>Treas. Regs. §301.7701-3(b)(1).

tax rate. Like a corporation, a limited liability company making this election is required to file income tax Form 1120.

d. S Corporation. If the limited liability company files Form 8832, electing to be taxed as an association taxable as a corporation, and Form 2553, electing to be taxed under subchapter S of the IRC, then the limited liability company will be taxed as a subchapter S corporation. Like a subchapter S corporation, the limited liability company making these elections is required to file income tax Form 1120S.

5. Common Uses. The Limited Liability Company is frequently used by business owners, small or large, who seek limited liability protection along with business asset protection, in a simple or complex type of entity.

6. Professional Limited Liability Company. The limited liability company will be deemed to be a professional limited liability company if the members file articles of organization which state that the company is a professional limited liability company formed for the purpose of rendering professional services by individuals licensed in any type of professional service which requires as a condition precedent to the rendering of such service the obtaining of a license, permit, or certificate. Examples of such professional service providers include: architects, attorneys, certified public accountants, dentists, public accountants, and veterinarians.

#### D. Limited Partnership

1. Formation. A limited partnership is created by filing a certificate of limited partnership with the Texas Secretary of State.

2. Liability Protection. A limited partnership does provide limited liability to its limited partners, such that each limited partner's liability is limited to such partner's interest in the limited partnership. However, the general partner of a limited partnership is personally liable for the liabilities of the limited partnership. Consequently, if the limited partnership will own assets giving rise to liability exposure, the well advised business owner will not serve as the general partner of the partnership, individually. Rather, such business owner will form another business entity such as a limited liability company or a corporation to serve as the general partner of the limited partnership, shielding the business owner from personal liability. When selecting a business entity to be used as the general partner of a limited partnership, most practitioners favor the use of the limited liability company over the corporation because the limited liability company provides business asset protection, which protects the assets of the limited liability company's from the individual liabilities of its stakeholders. In this scenario that would probably mean one percent (1%) interest in the partnership in which the limited liability company serves as General Partner and maybe even control of the limited partnership itself.

a. Business Asset Protection. Like the limited liability company, the assets of the limited partnership are protected from the judgment creditors of the limited partners. If a judgment creditor of a limited partner seeks to satisfy such judgment with the limited partner's

interest in the limited partnership, the judgment creditor is treated as having the same rights as an assignee.

b. Piercing the Partnership Veil. Little authority exists on the issue of whether the partnership veil may be pierced so that limited partners are exposed to personal liability for the wrongdoings of the limited partnership. However, practitioners suggest that piercing the partnership veil is likely not a remedy available to the judgment creditors of a limited partnership.<sup>22</sup>

3. Formalities. As with any other type of entity, the structure of the limited partnership must be respected by its partners. If it is respected, then the limited partners' personal assets will be protected from a lawsuit. To insure the protection afforded to limited partners, the partners must adhere to the formal requirements of the limited partnership. This involves keeping all limited partnership income and expenses separate from the partners' personal income and expenses.

4. Taxation. Currently, limited partnerships do not pay Texas franchise tax. Federal partnership taxation is governed by subchapter K of the Internal Revenue Code. The partnership is required to file Form 1065 and issue a K-1 to each partner, setting out each partner's share of partnership net income or loss. The taxation of a limited partnership is often referred to as "flow through" or "conduit" taxation because net income and losses are not taxed at the partnership level, rather, net income and losses flow through to the partners and are reported by the partners on their individual income tax returns. While subchapter S corporations and partnerships both offer flow through taxation, key differences make taxation under subchapter K preferable in many cases. Partnership taxation offers unique flexibility with regard to the distribution of income and losses to the partners.<sup>23</sup> Most of this flexibility springs from Section 704 of the Internal Revenue Code, which allows a partner's distributive share of each income or loss to be determined by the partnership agreement.<sup>24</sup> Therefore a partner's distributive share need not be the same for each item. For example, an item producing income can be allocated to a partner with losses from outside the venture, and any item producing losses can be allocated to a partner with income from external sources.<sup>25</sup> However, such allocation will be re-allocated in proportion to the partner's interest in the partnership if the allocation does not have "substantial economic effect."<sup>26</sup> Subchapter S does not provide this type of flexibility in the allocation of income and loss. Another key advantage of taxation under

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<sup>22</sup>See Wayne M. Gazur & Neil M. Goff, *Assessing the Limited Liability Company*, 41 CASE W. RES. L. REV. 387, 461 (1977)(explaining that "piercing a thinly capitalized limited partnership has apparently not been a creditor remedy if the limited partner does not participate in the control of the partnership business").

<sup>23</sup>See Lee A. Sheppard, *Partnerships, Consolidated Returns, and Cognitive Dissonance*, 63 TAX NOTES 936 (1994).

<sup>24</sup>I.R.C. §704(a).

<sup>25</sup>Rands, *supra* note ?, at 18-19.

<sup>26</sup>I.R.C. §704(b).

subchapter K involves the addition of partnership liabilities to the basis of the limited partners. Under subchapter K, as the partnership takes on debt, each partner's basis will be increased by such partner's proportionate share of the debt.<sup>27</sup> Again, subchapter S does not allow the shareholders of an S corporation to increase their basis in the corporate stock when the corporation takes on liabilities. As a result, highly leveraged businesses prefer the use of the limited partnership over the S corporation.

5. Common Uses. Families often use limited partnerships for estate planning and asset protection purposes. This topic will be addressed at length later in the outline. Additionally, businesses seeking to avoid franchise tax and businesses that are highly leveraged use the limited partnership. Finally, the limited partnership is attractive to profitable businesses that plan to distribute most of the profits to investors.<sup>28</sup>

### III. Limited Partnerships and the Small Business Owner

A. Asset Protection Needs of the Small Business Owner. Asset protection is a growing concern for the small business owner, especially where the legal climate seems to charge the deeper pocket, not the most culpable.<sup>29</sup> In the past, business owners increased insurance coverage in an attempt to hedge liability exposure. With the advent of outrageous jury verdicts and the resulting increase in the price of insurance coverage, business owners are looking for other methods to protect assets.<sup>30</sup> Three themes dominate asset protection planning: 1) invest in assets that are exempt from creditors; 2) isolate assets to insulate them from the liability exposure of other assets; and 3) structure business entities to make them unattractive to creditors.

1. Investing in Exempt Assets. The small business owner's first line of defense against potential liability exposure involves his investment decisions. Specifically, the small business owner wishing to protect himself and his family from liability exposure should maximize his investment in exempt assets. In Texas, exempt assets include, *inter alia*, the homestead,<sup>31</sup> qualified retirement plans,<sup>32</sup> cash surrender values of life insurance policies,<sup>33</sup> and annuities.<sup>34</sup> In urban areas,

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<sup>27</sup>I.R.C. §§772, 752(a).

<sup>28</sup>*See Rands, supra note ?, at 17.*

<sup>29</sup>*See Gerald A. Marks, An Overview of Asset Protection, Business Succession and Estate Planning Considerations for Franchisees, 201-FEB N.J. LAW. 23 (2000).*

<sup>30</sup>*Id at 23.*

<sup>31</sup>TEX. PROP. CODE ANN. §41.001 (Vernon 2000).

<sup>32</sup>TEX. PROP. CODE ANN. §42.021 (Vernon 2000).

<sup>33</sup>TEXAS INS. CODE ANN. art. 21.22, §3 (Vernon 2002)(*providing* in relevant part that policy proceeds and cash values to be paid or rendered to the insured or any beneficiary under any

the homestead of a family or single adult may not exceed one acre. In rural areas, the homestead of a single adult may not exceed 100 acres, but the homestead of a family may include up to 200 acres.<sup>35</sup> In addition to the homestead, an individual's rights under any stock bonus, pension, profit sharing, or similar plan, including retirement plans for the self employed, any annuity purchased using proceeds from a plan described above, and any retirement or annuity account described under IRC §403(b) is exempt from attachment, execution, and seizure for the satisfaction of debts.<sup>36</sup> Finally, Article 21.22 of the Texas Insurance code provides that benefits from insurance policies, such as policy proceeds and cash values payable to an insured or beneficiary, and benefits under an annuity contract shall be fully exempt from execution, attachment, garnishment, or other process, including any bankruptcy proceeding of the insured or beneficiary.<sup>37</sup> The protections afforded to exempt assets will be frustrated, however, if a person uses non-exempt property to obtain an interest in, make improvements to, or pay an indebtedness on exempt property with the intent to defraud, delay, or hinder the acquisition of such non-exempt asset by an interested person entitled to such non-exempt property.<sup>38</sup>

2. Isolate Assets to Insulate Them from the Liability Exposure of Other Assets. In addition to boosting investments in exempt assets, the business owner must isolate, to the extent economically efficient, the activities and/or assets of the business. For example, a construction company would probably create at least three different business entities. The land on which the business operates would be owned one business entity, the construction services would be managed under another business entity, and the equipment would be owned by yet another separate business entity. The business entity providing the construction services might then lease the building and equipment from the respective business entities owning such building or equipment.<sup>39</sup>

3. Structuring Business Entities to Make Them less Attractive to Judgment Creditors. Limited partnerships and limited liability companies offer an added layer of asset protection not

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annuity contract issued by a life, health, or accident insurance company is fully exempt from execution, attachment, garnishment, or other process, and further, is fully exempt from being seized, taken, appropriated, or applied by any legal or equitable process or operation of law to pay any debt or liability of the insured or of any beneficiary, either before or after said money or benefits is or are paid or rendered).

<sup>34</sup>*Id.*

<sup>35</sup>TEX. PROP. CODE ANN. §41.002(a) (Vernon 2000) .

<sup>36</sup>TEX. PROP. CODE ANN. §42.0021 (Vernon 2000).

<sup>37</sup>TEX. INS. CODE ANN. §21.22 (Vernon 2002).

<sup>38</sup>TEX. PROP. CODE ANN. §42.004(a) (Vernon 2002).

<sup>39</sup>Marks, Gerald A., *An Overview of Asset Protection, Business Succession, and Estate Planning Considerations for Franchisees*, NEW JERSEY LAWYER, February 2000, at 23.



available to the shareholders of a corporation. A properly run corporation will protect the shareholders from being exposed to personal liability by the judgment creditors of a corporation. However, the stock of the corporation is not protected from the individual liabilities of its shareholders. The creditors of a shareholder may attach the corporate stock of the shareholder; and if the shareholder has a controlling interest in the corporation, the creditor may gain control of the corporation. Even if a creditor is unable to gain control of the corporation, the acquisition of corporate stock by a judgment creditor of a shareholder could pose a meaningful threat to other shareholders in the corporation, especially in the context of a small business. For example, an S corporation could lose its S corporation tax status if a creditor, who was not a permitted shareholder of an S corporation, were to attach the stock of the S corporation. The added measure of protection afforded to limited partners of a partnership and members of a limited liability company stem from statutory and non-statutory sources.

a. **Statutory Protections Afforded to Limited Partners of Partnership.** While the judgment creditors of a shareholder may attach, via judgment, the corporate stock of such shareholder, the partners of a limited partnership and the members of a limited liability company are protected from such attachment, as the only remedy under statute that a judgment creditor may receive against the interest of a partner in a limited partnership or a member of a limited liability company is a charging order against such interest.<sup>40</sup> Rooted in English law, the charging order developed as a way to prevent the creditor of one partner from holding up the business of the entire partnership and causing injustice to the other partners. To prevent the “clumsy method of proceeding,” the English rule forbidding execution sale of a partner’s interest in the partnership to

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<sup>40</sup>*See* TEX. REV. CIV. STAT. ANN. art. 6132b, §7.03 (Vernon 1997) (“TEXAS REVISED LIMITED PARTNERSHIP ACT”):

On application to a court of competent jurisdiction by a judgment creditor of a partner or of any other owner of a partnership interest, the court may charge the partnership interest of the partner or other owner with payment of the unsatisfied amount of the judgment, with interest, may then or later appoint a receiver of the debtor partner's share of the partnership's profits and of any other money payable or that becomes payable to the debtor partner with respect to the partnership, and may make all other orders, directions, and inquiries that the circumstances of the case require. To the extent that the partnership interest is charged in this manner, the judgment creditor has only the rights of an assignee of the partnership interest.

*See also* TEX. REV. CIV. STAT. ANN. art. 1528n §4.06 (Vernon 1997) (“TEXAS LIMITED LIABILITY COMPANY ACT”):

On application to a court of competent jurisdiction by a judgment creditor of a member or any other owner of a membership interest, the court may charge the membership interest of the member or other owner with payment of the unsatisfied amount of the judgment. Except as otherwise provided in the regulations to the extent that the membership interest is charged in this manner, the judgment creditor has only the rights of an assignee of the interest. This Section does not deprive any member of the benefit of any exemption laws applicable to that member's membership interest.

satisfy a non-partnership debt was codified in the Uniform Partnership Act and English Partnership Act of 1890. Under the revised English rule, the creditor's remedy against a partner was limited to receiving the partner's share of the partnership's profits and surplus.<sup>41</sup> When a creditor of a limited partner receives a charging order against such limited partner's partnership interest, the creditor's interest in the partner's share of the partnership is limited to that of an assignee.<sup>42</sup> While the creditor may enjoy the partnership distributions that would have been distributed to the debtor partner in the absence of such creditor, the creditor does not receive the rights of such partner.

As an assignee of a partnership interest, the creditor may not become a limited partner unless all other partners consent, something unlikely to occur. The creditor cannot vote on partnership matters, inspect or copy partnership records, or even obtain from the general partner business and tax information regarding the affairs of the limited partnership that are usually available to limited partners as a matter of law. Moreover, in a family limited partnership, the general partner will likely be a family member sympathetic to the plight of the partner who has been subject to the creditor's charging order. Thus, it is unlikely that the general partner would elect to make a cash distribution to partners which would entitle the creditor/assignee to a distribution.<sup>43</sup>

Even though the judgment creditor of a limited partner has no rights with regard to the partnership, other than receiving an income distribution, the IRS has long taken the position that an assignee acquiring substantially all of the dominion and control over the interest of a limited partner is treated as a substituted limited partner for federal income tax purposes.<sup>44</sup> Since the income of a partnership flows through to the partners, the partners are taxed on the income whether or not they actually received it. Further, only the general partner of the partnership may make distributions to the limited partners. As a consequence, well advised creditors of limited partners will not seek satisfaction of judgments through charging a limited partnership interest for fear that they will be required to pay income taxes on partnership income not distributed to them. The limited liability company offers its members the same level of protection from creditors as the limited partnership, perhaps even more protection because the Texas Limited Liability Company Act fails to list the remedies available to a

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<sup>41</sup>See *Taylor v. S & M Lamp Co.*, 190 Cal. App. 2d 700 (1953).

<sup>42</sup>VERNON'S ANN. TEXAS CIV. ST. art. 6132b, §§ 25(2)(c), 28 (Vernon 1997).

<sup>43</sup>Mata, Mario A., *Asset Protection Strategies for Business Owners*, presented at the Corporate, Partnership, and Business Law course, offered by the University of Houston Law Foundation (July 2001).

<sup>44</sup>Rev. Rul. 77-137 1977-1 C.B. 178 (*explaining that even though the general partners did not give their consent to an assignment, since the assignee acquired substantially all of the dominion and control over the limited partnership interest, for federal income tax purposes, the assignee is treated as a substituted limited partner and the assignee must report the distributive share of partnership income attributable to such interest on the assignees federal income tax return*).

creditor who obtains a charging order. Conspicuously, the Texas Revised Limited Partnership Act provides the remedy of foreclosure<sup>45</sup> while the Texas Limited Liability Company Act fails to list foreclosure as a remedy to a creditor holding a charging order.<sup>46</sup> Practitioners have been reluctant to replace the limited partnership with the limited liability company as the centerpiece of an estate plan, perhaps because the limited liability company is relatively new in the United States and, as a consequence, does not have a depth of case law supporting its use as an asset protection tool. Also, the fact that the limited liability company is subject to franchise tax in Texas may stymie the growth of its popularity. The limited liability company has replaced the corporation as the entity of choice for serving as a general partner of a limited partnership. In the past, corporations typically served as the general partner of limited partnerships, as the shareholders of a corporation were protected from the liabilities of the corporation. However, this arrangement failed to protect the limited partners from the creditors of the shareholders of the corporate general partner because the creditors could attach the stock of the corporation and potentially gain control of the partnership. The limited liability company offers the benefit of protecting the members from the liabilities of the company. Moreover, the limited liability company is protected from the judgment creditors of its members in much the same way as a limited partnership. Consequently, because control of the limited liability company cannot be transferred to the judgment creditors of a member, the limited liability company is preferred over the corporation as the entity of choice to serve as general partner of a limited partnership.

b. Non-statutory Protections Afforded to Limited Partners. In light of the limited and disagreeable options available to a creditor seeking to satisfy a judgment by charging a limited partner's interest in a limited partnership, a creditor will likely be more amenable to settlement. Moreover, the partnership should anticipate the possibility of partnership interests being charged by the judgment creditor of a limited partner and draft the partnership agreement to protect the limited partners. Mario A. Mata, an attorney in Austin, Texas, suggests that a well drafted partnership will have protective language granting to the limited partners, who are not affected by the creditor, the option to purchase the creditor's interest in the partnership.<sup>47</sup> In addition, the partnership agreement should "provide for a quick, simplified, and favorable method of valuing the interest of the charged partner."<sup>48</sup>

## B. When is Converting a Client's Business Form Appropriate?

1. What are the Benefits Associated with Conversion? For many businesses exploring the possibility of converting a business entity from a C or an S corporation to a limited partnership, the following benefits are sought: 1) exemption from franchise tax; 2) business asset protection; and 3) compression in value of business for transfer tax purposes. Under the Texas Business Corporation

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<sup>45</sup>See TEXAS REVISED LIMITED PARTNERSHIP ACT §7.03.

<sup>46</sup>See TEX. LIMITED LIABILITY COMPANY ACT §4.06.

<sup>47</sup>See Mata, *supra* note 43.

<sup>48</sup>*Id.*

Act, a corporation may convert to a limited partnership.<sup>49</sup> Immediately after the conversion, the limited partnership may elect under the check-the-box regulations<sup>50</sup> to be treated as a corporation by filing Form 8832. If the limited partnership (converted entity) elects to be taxed as a corporation, the conversion of the corporation to a limited partnership should be deemed a tax-free F reorganization, which is a mere change in identity, form, or place of organization of a corporation. The converted entity will inherit the federal tax attributes of the former corporation including: taxable year, employer identification number, and other tax elections.

a. Franchise Taxes. When a closely held corporation or limited liability company is paying high franchise taxes, such business might consider converting to a limited partnership to avoid the franchise tax. For years, Texas legislators have introduced amendments to Section 171.001 of the Texas Tax Code to subject limited partnerships to taxation. If this ever comes to pass, the number of conversions of corporations to limited partnerships motivated by the avoidance of the Texas franchise tax will taper off. However, such conversions will still take place due to the business asset protection features a limited partnership and limited liability company offer compared to a corporation.

b. Asset Protection. When the shareholders of a closely held corporation seek business asset protection, then such shareholders might consider converting to a limited liability company or limited partnership under Texas state law. As previously discussed, such entities offer superior asset protection capabilities compared to a corporation because the assets of the limited partnership and the limited liability company are protected from attachment by the judgment creditor of a limited partner or member. The superior asset protection attributes offered by the limited liability company and the limited partnership will be discussed at length later in this outline.

c. Compression in Value of Business Interests. It is possible to obtain a greater compression in value of the assets inside a corporation if such corporation is converted to a limited partnership. This compression in value is due to the discounts a limited partnership interest receives as compared to a corporation. For example, a corporation might receive a discount for a block of shares owned by a shareholder if those shares represent a minority interest in the corporation. With a limited partnership, a limited partner can own a majority of the interests in such entity and still receive valuation discounts for lack of marketability, lack of control and lack of liquidity. These discounts ultimately give the interests owned by the limited partner a higher discount in value for transfer tax purposes in relation to the discounts achieved with the corporation's minority shareholder's block of stock.

## 2. Steps to Performing a Conversion in Texas:

a. Determine What Type of Entity You Are Converting and How it Is Taxed.

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<sup>49</sup>TEX. BUS. CORP. ACT ANN. art. 5.17, (Vernon 1997).

<sup>50</sup>Treas. Reg. §301.7701-3(a).

b. Determine Your Goal in Converting. Is the main goal to reduce franchise taxes, obtain better asset protection, or receive a compression in value?

c. Structure Requirements for Different Entities:

i. Conversion of S Corporation into Limited Partnership. If an S corporation seeks to maintain its subchapter S status at the federal level while converting to a limited partnership with a limited liability company as a general partner at the state level, the limited liability company must be a single member limited liability company and, as a consequence, a disregarded entity at the federal level. If the limited liability company has more than one member, it will not be a disregarded entity for federal tax purposes. Rather, the multiple member limited liability company must be treated as either a corporation, S corporation, or partnership for federal tax purposes, and none of those entities are permitted shareholders of a subchapter S corporation. After creation, the limited partnership must file Form 8832, electing to be taxed as an association taxable as a corporation, and Form 2553, electing to be taxed as a subchapter S corporation. This election will continue the prior taxation of the converted entity. While the IRS has previously sanctioned the conversion of an S corporation into a limited partnership with a limited liability company as the general partner in a private letter ruling,<sup>51</sup> it is currently unclear whether the IRS will determine that a business converting from an S corporation into limited partnership with a limited liability company as general partner for state tax purposes may maintain its subchapter S status for federal tax purposes. In a recent publication of revenue procedure, the IRS hinted that a limited partnership with a limited liability company as general partner might be deemed to have two classes of stock and fail to qualify for subchapter S tax treatment.<sup>52</sup> In light of the uncertainty the IRS has raised by their “no rule” policy on the issue of whether a limited partnership has two classes of stock, a more cautious, yet less direct approach might be to convert the S corporation to a Texas general partnership which elects to be taxed as an association taxable as a subchapter S corporation. Before such a conversion takes place, however, the S corporation should contribute all of its assets to a Texas limited partnership in which a limited liability company is the general partner. In exchange, the S corporation would receive a 99% limited partnership interest in the new limited partnership. After transferring the assets and receiving the limited partnership interests, the S corporation, whose primary asset is a 99% interest in the Texas limited partnership, should convert to a Texas general partnership. The resulting conversion should: 1) qualify as a tax-free F reorganization; 2) avoid the second class of stock issue

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<sup>51</sup>See P.L.R 199942009 (*providing* that a converted entity structured as an LP with an LLC general partner will not constitute more than one class of stock for purposes of §1361(b)(1)(D) as long as all partners have identical rights to partnership distributions and liquidation proceeds under the partnership agreement).

<sup>52</sup>See Rev. Proc. 99-51, 1999-52 IRB 760. *See also* §5.05 of Rev. Proc. 2001-3, 2001-1 I.R.B. 111 “[On] whether a state law limited partnership electing under § 301.7701-3 to be classified as an association taxable as a corporation has more than one class of stock for purposes of § 1361(b)(1)(D), the service will treat any request for a ruling on whether a state law limited partnership is eligible to elect S corporation status as a request for a ruling on whether the partnership complies with §1361(b)(1)(D).”

raised by Rev. Proc. 99-51, 1999-52 IRB 760; and 3) provide the general partners of the converted entity (who are the former shareholders of the S corporation) with the limited liability of a limited partnership. The only problem with this type of conversion is that the distribution of the assets to the limited partnership by the S corporation could be a deemed distribution to the shareholders and a recontribution to a limited partnership which is a taxable event.

ii. Conversion of C Corporation into Limited Partnership. The conversion of a C corporation is similar to the conversion of an S corporation except that Form 2553 need not be filed. Additionally, the second class of stock issue is irrelevant. It is important that the limited partnership (converted entity) maintain the same tax attributes as the C corporation (converting entity) by filing Form 8832 to avoid a liquidation event.

C. Planning for the Death of a Business Owner with a Focus on the Family Business. Planning for the death or incapacity of a business owner is often overlooked, despite its importance to the continued success of the business. According to Bill Van Pelt, senior vice president of The Mid-Continent Companies, Ltd., Houston, Texas, “[t]he greatest threats to the continuing family ownership of privately held companies are usually bad family dynamics and taxes.”<sup>53</sup> The statistics show that these threats stymie the success and continuity of most family businesses, as 30 percent of family businesses are continued by the second generation and only 12 percent survive until the third generation.<sup>54</sup> Well advised business owners diminish the potency of these threats by: 1) recognizing the difference between equity interests and controlling interests; 2) understanding that the goals of future equity interest holders may be incongruent with the goals of the business; and 3) structuring gifts or bequests of such interests to minimize estate, gift, and income taxes.

1. Issues Involved in the Death of a Business Owner. Most business owners must balance two often competing goals: 1) survival of the small business; and 2) equality in the treatment of family members. The competition between these goals is intensified if estate tax is anticipated to be an issue and if the small business represents a large portion of the business owner’s estate. Given the fact that family members will have differing levels of personal interest in the family business, the business owner should understand that equality among family members does not necessarily mean equality of control and equality of equity. Rather, it is often necessary to separate equity from control in a family business in order to harmonize the goals of maintaining a successful business and maximizing equality among family members.

a. Succession of Ownership and Control. A succession strategy which focuses too heavily on equality among family members will often fail to survive for future generations because the ownership and control of the family business will become too diffuse to compete in a nimble

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<sup>53</sup>Bill Van Pelt, IV, *Saving a Family Business for Future Generations*, TRUST & ESTATES, December 2002, at 41.

<sup>54</sup>See Goldstein, *supra* note 1.

marketplace.<sup>55</sup> A successful succession plan for the business owner will: 1) provide for centralized control by family members active in the family business; 2) grant to other, non-participatory members of the family an equity interest in the business; 3) provide for the valuation of a family member's business interest in the event the family member seeks to liquidate his or her interest; and 4) minimize income and transfer taxes.

b. Valuation of Business Interests and Deductions Available to Estates of Business Owners. Naturally, the interests of a family member, or any investor for that matter, seeking to divest himself from the business will conflict with the goals of the business. To reduce this conflict, a mechanism for calculating the divesting stakeholder's interest must be developed by the business owner and set out in the governing instruments of the business.

i. Appraisal Methods. Accepted methodologies for the determination of value of business interests include: 1) pre-determined price; 2) book value; 3) liquidation value; and 4) market value.<sup>56</sup> Most investors prefer using market value of a business interest as the value for which a transfer may take place, as it most accurately reflects the value of the business interest.<sup>57</sup> In Revenue Ruling 59-60, the IRS sets the groundwork for the valuation of small business interests. While the language of this ruling applies only to valuations of closely held corporations for tax purposes, the analysis used by the IRS may be applied to other small business interests and is useful as a framework to value business interests for purposes other than tax matters. Specifically, the factors the IRS considers include: 1) the nature of the business and history of the enterprise; 2) economic outlook in general and the condition and outlook of the specific industry in which the business is engaged; 3) book value of stock and financial condition of the business; 4) earning capacity of business; 5) dividend paying capacity of business; 6) whether or not the business has goodwill or other intangible value; 7) past sales of stock and the size of the block subject to valuation; and 8) the market prices of stock of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market.<sup>58</sup> The considerations outlined by Revenue Ruling 59-60 may create a framework for the valuation of a business interest, but the methodology used by the Revenue Ruling was not designed to define the range of possible outcomes nor did it contemplate lack of marketability discounts, lack of control discounts, or premiums for control. Consequently, when designing a framework for valuation of business interests upon transfer, the well advised business owner should define what factors will be considered in an appraisal of business interests.

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<sup>55</sup>See Van Pelt, *supra* note 53. "Succession strategies, usually seeking to reduce estate taxes, tend to be strongly influenced by a strong desire to treat all children and grandchildren similarly. One result is that equity ownership of the family business often gets diffused."

<sup>56</sup>T. Deon Warner, *Shareholder Agreements* (July 2001)(unpublished manuscript, on file with the University of Houston Law Foundation).

<sup>57</sup>*Id* at 15.

<sup>58</sup>Rev. Rul 59-60, 1959-1 C.B. 41.

ii. Special Use Valuation. The executor of a business owner's estate may elect under Section 2032A of the Code to value qualified farm or other real property owned by a closely held business based on the *actual use* of the property instead of based on its fair market value, which considers its *best and highest use*. In order for an estate to qualify to elect special use valuation, two tests must be satisfied. First, at least 25 percent of the adjusted gross estate must contain U.S. real property which: 1) passed from a U.S. resident or citizen decedent to a qualified heir; 2) was used by the decedent or the decedent's family as a farm or business for at least five years during the eight years preceding the decedent's death; and 3) the decedent or the decedent's family materially participated in the operation of the farm or business for at least five years during the eight years preceding the decedent's death.<sup>59</sup> Second, at least fifty percent of the adjusted gross estate must consist of real and/or personal property of the decedent being used by the decedent or his family as a farm or in a closely held business and such property must have passed to a qualified heir.<sup>60</sup> While the IRS factors the value of the personal property into the second test, no special use valuation is available to the personal property.

iii. Alternate Valuation. Section 2032 of the Code enables the executor of an estate to value the assets remaining in the estate of the decedent as of six months after the date of the decedent's death, as opposed to the date of the decedent's death. If an alternate valuation date is used, assets which were disposed of or distributed during the six month period after the decedent's death will be valued as of the date such assets were disposed of or distributed. Electing an alternate valuation may allow an estate to pay less estate tax if the assets in the estate declined in value after the decedent's death. The alternate valuation may only be used if it decreases the value of the gross estate and if it results in less estate or generation skipping transfer tax being due.<sup>61</sup> Consequently, it may not be used to increase the value of a non-taxable estate in an effort to increase basis. Further, the alternate valuation may not be used to decrease the value of assets where the decline in an asset's value is due to the mere passage of time.<sup>62</sup>

iv. Payment of Estate Tax in Installments. If a closely held business interest constitutes at least 35% of the value of a decedent's adjusted gross estate, the executor of the decedent's estate may elect to pay estate tax in installments over an extended period of time.<sup>63</sup> The portion of estate tax that may be paid in installments over an extended period of time is equal to the proportion in which the value of the closely held business interest bears to the value of the adjusted gross estate.<sup>64</sup> Additionally, if an estate qualifies under the rules set out in Section 6166, it may pay

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<sup>59</sup>I.R.C. § 2032A(b)(1).

<sup>60</sup>*Id.*

<sup>61</sup>I.R.C. § 2032(c).

<sup>62</sup>I.R.C. § 2032(a)(3).

<sup>63</sup>I.R.C. § 6166(a)(1).

<sup>64</sup>I.R.C. § 6166(a)(2).



interest only for the first four years after the date the tax is due and begin making installment payments of principal and interest after that for up to ten years.

## 2. The Limited Partnership as a Tool to Aid Business Owners in Succession Planning.

The widespread use of limited partnerships in succession planning can be attributed to the following estate planning benefits with which the limited partnership has been associated: 1) valuation discounts for estate and gift tax purposes; 2) gifting of equity interests without transferring control; 3) protection from creditors; 4) flexible distribution of income and allocation of losses; and 5) ease of maintaining property as separate property. Further, with the advent of the check the box regulations<sup>65</sup> and the amendments to the Texas Business Corporation Act, which provide for the conversion of a Texas corporation into another entity without a merger or transfer of assets,<sup>66</sup> many small Texas business corporations have converted into limited partnerships to avoid the Texas franchise tax.

a. Valuation Discounts for Estate and Gift Tax Purposes. Generally, the valuation discounts for estate and gift tax purposes available to limited partners of a limited partnership are deeper than the valuation discounts associated with closely held stock, or membership interests in a limited liability company. Tax courts have recognized the discounts associated with limited partnership interests in numerous cases.<sup>67</sup> Limited partnership interests are discounted based on their lack of marketability, lack of control, and illiquidity.<sup>68</sup> While the tax courts have generally upheld the valuation discounts on limited partnership interests, these discounts may be frustrated if, *inter alia*, a limited partner has the power to dissolve the partnership or if gifts of limited partnership interests are made before the limited partnership is funded. The availability of deeper discounts in value on limited partnership interests exists because the rights of limited partners are similar to the rights of an assignee under the Texas Revised Limited Partnership Act (TRLPA).<sup>69</sup> However, if a limited partner is also a general partner, such discounts may be limited. This follows because Section 6.02 of the TRLPA provides that a general partner may withdraw at any time and such withdrawal will result in dissolution of the partnership unless another general partner remains and the partnership agreement allows the partnership to continue, or within 90 days of the withdrawal, the remaining partners appoint a successor general partner.<sup>70</sup> The general partner's right to withdraw may frustrate

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<sup>65</sup>Treas. Reg. §301.7701-03.

<sup>66</sup>See TEX. BUS. CORP. ACT ANN. arts. 5.17-5.20.

<sup>67</sup>See *Estate of Dailey*, T.C. Memo. 2001-263 (allowing a 40% discount); *Estate of Stevens*, T.C. Memo. 2000-53 (supporting a 25% discount); *Estate of Jones*, 116 T.C. 121 (2001)(upholding a 48% discount).

<sup>68</sup>See *id.*

<sup>69</sup>See TEXAS REVISED LIMITED PARTNERSHIP ACT §7.03.

<sup>70</sup>See TEXAS REVISED LIMITED PARTNERSHIP ACT §8.01.

claims of discounts on the limited partnership interests held by the general partner.<sup>71</sup> Consequently, if a business owner's goal is to compress the value of the business for estate and gift tax purposes, some practitioners believe it is critical that such owner is not a sole general partner of the partnership, nor a controlling member or shareholder of an LLC or corporation that serves as the general partner of the partnership, lest the value of such partner's limited partnership interest fail to receive a significant discount.<sup>72</sup> Other practitioners assert that, if the partnership agreement provides that a general partner's interest converts to a limited partnership interest upon the death of such general partner and such converted interest is deemed an assignee interest, the valuation of such general partner's assignee interest will not receive as deep a discount as the valuation of such partner's limited partnership interest, but such general partnership interest will not greatly limit the valuation discount of such general partner's limited partnership interest.

Another important pitfall for the unwary involves the timing of transfers to the partnership and gifts of units of limited partnership interests. The Tax Court in *Shepherd v. Commissioner* accepted the IRS' position that if a taxpayer contributed property to a family limited partnership in which interests in the limited partnership were already gifted before contributions of assets were made to such partnership, that the taxpayer should be deemed to have made a gift of the difference between what the taxpayer contributed to the limited partnership and what the taxpayer received back from the limited partnership in the form of limited or general partnership interests.<sup>73</sup> In the instant case, the Tax Court focused on what the taxpayer gave, and not what the beneficiary received, signaling a move toward the rule applied in England where gifts are valued to the extent they reduce the net worth of the grantor.<sup>74</sup> In the 1990's, the estate and gift tax regime posed a grave threat to the family business, as the maximum estate tax rate was 55% (60% for estate valued at more than \$10,000,000). The planned increase in the unified credit will make discounts less attractive to small businesses, especially if the value of a business makes estate tax planning irrelevant. If planning for estate tax is unnecessary, receiving a discount on a decedent's interest in a family business might actually cause more tax to be due in the long run because the decedent's family might have been better off claiming a higher value and, as a consequence, receiving a higher step up in basis.

b. Gifting Equity Interests Without Sacrificing Control. Another important advantage of the limited partnership for estate planning purposes involves the ability of a business owner to transfer equity interests in the business without transferring control. Limited partnerships provide a mechanism for separating equity interests from control interests. The separation of equity interests and control interests is especially important in two situations. First, when a business owner seeks to transfer wealth down to children or grandchildren but does not want those individuals

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<sup>71</sup>See Thomas W. Houghton, *Family Limited Partnerships: Uses, Limits, and Ethical Considerations* (July 2001)(unpublished manuscript, on file with the University of Houston Law Foundation)

<sup>72</sup>*Id.*

<sup>73</sup>See *Shepherd v. Commissioner*, 115 T.C. 30 (2000).

<sup>74</sup>See James L. Dam, *U.S. Tax Court Restricts Family Limited Partnership Discounts*, LAW. WKLY., November 27, 2000.

involved in making business decisions, he can make gifts of limited partnership interests to them, transferring value but not control. Second, when a business owner desires to transfer equal amounts of equity to children or grandchildren but also wants control of the business to remain centralized in family members who are active participants in the business, the business owner may transfer interests in the entity acting as general partner to the actively participating family members while transferring limited partnership interests to other family members.

c. Protection from Creditors. See discussion in Sections II.A.3.a and II.A.3.b of this outline.

d. Flexible Distribution of Income and Allocation of Losses. A partnership easily allows for the shifting of income between different taxpayers by means of gifts of limited partnership units. Each partner is liable for tax on his or her distributive share of partnership income, whether or not that income is distributed. Ultimately the allocation of taxable income to family members in lower tax brackets can substantially reduce overall family income taxes.

e. Ease in Maintaining Separate Property. When a person receives property via a gift or bequest, it is that person's separate property. However, it may easily become co-mingled with community assets and cause the entire gift or bequest to be deemed community property. Texas has a complex marital property regime. Rooted in Spanish law, the laws of Texas view marriage as a contract between spouses; and when the marriage is entered into, a new legal entity is created.<sup>75</sup> In Texas, a married couple's assets may be characterized as separate property or as community property. Other states that use the community property system include: Washington, California, Nevada, Arizona, New Mexico, Louisiana, Idaho, and Wisconsin.

i. Separate Property. Assets brought into a marriage are generally the separate property of the spouse bringing such assets into the marriage.<sup>76</sup> In addition, property received by a spouse as a gift or inheritance during the marriage is separate property. Finally, proceeds resulting from a claim for personal injury are characterized as the injured spouse's separate property. The growth in value from separate property remains separate property, but income from separate property is generally community property.<sup>77</sup> For example, the growth of a spouse's separate property corporate stock, generally remains separate property. However, dividends paid on such corporate stock are characterized as community. If a spouse owns mutual funds as his separate property and reinvests the income from the mutual funds, he is co-mingling separate property with community property. The presumption of Texas courts is that co-mingled property is community property. This presumption may be overcome only by clear and convincing evidence to the contrary.

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<sup>75</sup>See William Orr Huie, *The Community Property Law of Texas* (Kansas City, Missouri: Vernon Law Book Company, 1960).

<sup>76</sup>Tex. Fam. Code §3.001(3).

<sup>77</sup>In the following community property states, income from separate property is not community property: Arizona, California, Nevada, New Mexico, and Washington.

Some exceptions exist to the general rule that income from separate property is community property. For example, even though royalties are predominately characterized as income for income tax purposes, royalties from separately held oil and gas leases are separate property. Also, if a spouse devotes an inordinate amount of time enhancing the value of his or her separate property and such spouse does not receive income adequate to compensate him or her for such time, then the Texas courts may find that the other spouse has a right to reimbursement.<sup>78</sup> Making gifts or bequests of limited partnership interests, as opposed to outright distribution of assets, limits the exposure of the bequest or gift to co-mingling with the community property of the transferee.

ii. Community Property. In Texas all property acquired during a marriage, save gifts, inheritances, recoveries for personal injuries, growth of separate property, and royalties of separate property, is community property.<sup>79</sup> Community property typically includes earned income, income from separate and/or community property, dividends, royalties purchased during the marriage with community property funds, and bonuses. Texas courts presume that all property of the marriage is community property unless it is shown by clear and convincing evidence to be separate property.<sup>80</sup> Income from limited partnership interests would be, without agreement to the contrary, deemed the community property of the limited partner. Consequently, it is a good idea to distribute income proportionately each year to the limited partners, unless a separate property agreement or prenuptial agreement is in place which keeps this income characterization as separate property.

#### IV. Family Limited Partnerships as Estate Planning Tool.

A. Characteristics of Limited Partnerships that Make them Attractive Estate Planning Tools. Since the 1990's the family limited partnership has developed into a widely used estate planning tool for wealthy and moderately wealthy families. The family limited partnership represents the centerpiece of many estate plans because of the tax and non-tax advantages of the limited partnership.

1. Limited Partnerships Enable Consolidation of Management and Separation of Equity from Control. Even if a moderately wealthy person does not own a small business, he should still think like a business owner. In other words, he should be thinking about maximizing the use of his resources. Most families want to maintain equal distributions to children but they are hesitant about dividing control equally. Dividing control may pose the following challenges: 1) slow or impede response to investment opportunities; 2) make it difficult or impossible to sell assets (especially in the case of real property); and 3) place control in the hands of misguided or unintended beneficiaries. The limited partnership offers a way to consolidate assets and control while making distributions of equity interests. The general partner of a limited partnership is the only person or entity who controls the limited partnership. The general partner alone makes decisions regarding the

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<sup>78</sup>*See Vallone v. Vallone*, 644 S.W.2d 455 (Tex. 1982).

<sup>79</sup>Tex. Fam. Code §3.002.

<sup>80</sup>Texas Fam. Code §3.003.

management and distribution of partnership assets and income. For more discussion on the topic, see Section II.C.2.b. of this outline.

2. Limited Partnerships are Effective in Asset Protection Planning. See discussion in Sections II.A.3.a and II.A.3.b of this outline.

3. Discounts Associated with Limited Partnership Interests. While the discounts associated with limited partnerships engaged in an active trade or business may enjoy a deeper discount for estate and gift tax purposes, limited partnerships owning passive assets like stocks, bonds, and undeveloped real property enjoy discounts, albeit more modest. All things being equal, the more the assets of the limited partnership require active management, the deeper the discount the limited partnership interests will enjoy. In addition, and as will be discussed later in this outline, the business purpose of the limited partnership will be easier to defend in an IRS attack if the assets of the limited partnership require active management.

4. Limited Partnerships Offer Efficient Tools for Making Gifts. Limited Partnerships enable a client to make gifts of limited partnership interests yet maintain control of the assets inside the limited partnership. In addition, because of the discounts associated with the limited partnership units, more value may be transferred to a donee. For a broader discussion of this topic, see Sections II.A.3.a and II.A.3.b of this outline.

## B. Discussion of IRS Attacks on the Family Limited Partnership

### 1. History of IRS Attacks.

a. Attempts to Disregard Partnership under Sections 2703 and 2704. The hostility of the IRS toward the use of limited partnerships in estate planning became pronounced with the issuance of a series of technical advice memoranda (“TAM”) in 1997 and 1998.<sup>81</sup> The TAM were aimed at disregarding the limited partnership for transfer tax purposes. These TAM sought to apply Sections 2703 to limited partnership interests, which in part provide that, for transfer tax purposes, the value of an asset is to be determined without regard to any restrictions on the right to sell or use the property. In addition, the TAM used Section 2704(b) to argue that any provisions relating to the liquidation of the partnership in the limited partnership agreement which were more restrictive than state law, would be disregarded.

i. Unsuccessful Attempts to Disregard Partnership Pursuant to Section 2704 for Valuation Purposes. Under Section 2704, if the limited partnership agreement sets out greater restrictions on liquidation of the partnership than those restrictions set out by state law, the more restrictive provisions of the partnership agreement will be disregarded. The IRS attempted to disregard restrictions set out in two Texas limited partnership agreements in *Jones v. Commissioner*, 116 T.C. 121 (2001) and *Kerr v. Commissioner*, 113 T.C. 449 (1999), aff’d, 89 AFTR 2d 2002-2838 (5<sup>th</sup> Cir. 2002). In both cases, the tax court concluded that the restrictions of the partnership

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<sup>81</sup>See TAM 9842003, TAM 9730004, and TAM 9719006

agreement relating to dissolution of the partnership were no more restrictive than Section 8.01 of the Texas Revised Limited Partnership act which provides that:

Sec. 8.01. A limited partnership is dissolved and its affairs shall be wound up only on the first of the following to occur:

- (1) the occurrence of events specified in the partnership agreement to cause dissolution unless within 90 days after the event causing the dissolution, all remaining partners (or another group or percentage of partners as specified by the partnership agreement) agree in writing to continue the business of the limited partnership;
- (2) written consent of all partners to dissolution;
- (3) an event of withdrawal of a general partner, unless:
  - (A) there remains at least one general partner and the partnership agreement permits the business of the limited partnership to be carried on by the remaining general partner or general partners, and that general partner or those general partners do so; or
  - (B) within 90 days after the event of withdrawal, all remaining partners (or another group or percentage of partners as specified by the partnership agreement) agree in writing to continue the business of the limited partnership and, to the extent that they desire or if there are no remaining general partners, agree to the appointment, effective as of the date of withdrawal, of one or more new general partners; or
- (4) entry of a decree of judicial dissolution under Section 8.02 of this Act.

So, it appears that the IRS can no longer attack the valuation of Texas limited partnership interests based on Section 2704(b).

ii. Unsuccessful Attempts to Disregard Partnership Pursuant to Section 2703. Section 2703 of the Code provides that:

For purposes of this subtitle, the value of any property shall be determined without regard to—

- (1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of such property (without regard to such option, agreement, or right), or
- (2) any restriction on the right to sell or use such property.

(A) In *Church v. U.S.*, 85 AFTR 2d 2000-804 (2000), the Fifth Circuit refused to apply Section 2703 and held that Section 2703 did not operate to disregard the partnership for valuation purposes. For a broader discussion of this case, see Section IV.B.1.b.ii.(A) of this outline.

(B) In the *Estate of Dailey v. Commissioner*, T.C. Memo 2001-263, October 3, 2001, the Tax Court allowed a 40% discount on the decedent's limited partnership interests for gift and estate tax purposes. The facts of the case are set out below:

On October 20, 1992, Mrs. Dailey executed a limited partnership agreement along with her other estate planning documents. When the document was executed, Mrs. Dailey retained a 1% general partnership interest and a 98% limited partnership interest. She gave her son a 1% limited partnership interest. On November 13, 1992, Mrs. Dailey contributed the following assets to the limited partnership:

| <b>Stock</b> | <b>Value</b>   |
|--------------|----------------|
| Exxon        | \$1,203,750.00 |
| ATT          | \$19,175.00    |
| Bell South   | \$44,694.00    |
| Total Value  | \$1,222,925.00 |

On December 8, 1992, Mrs. Dailey signed gift letters transferring 45%, 15%, and 38% of her limited partnership interests to her son, his wife, and her revocable trust, respectively. On March 16, 1995, Mrs. Dailey resigned as the general partner of the partnership, allowing her son to serve as general partner. On January 10, 1997, Mrs. Dailey died. Mrs. Dailey's son, as the executor of her estate filed an estate tax return and a gift tax return and claimed a 40% discount for the limited partnership interests.

At trial, the taxpayer's valuation expert compared the limited partnership interests to closed end mutual funds, and citing published data, opined that the aggregate discount is 40 percent for lack of marketability, control, and liquidity and testified that he considered the significant amount of unrealized capital gains relating to the Exxon stock. The expert called by the IRS, on the other hand, relied on an unpublished study that he co-authored, and opined that the aggregate discount should be in the range of 14%. When asked by the taxpayer's attorney if the expert had reviewed the partnership agreement, the expert testified that he could not recall reviewing the Agreement and, although he believed that unrealized capital gains, are "an important source of discounts," he did not review the documents to determine if the limited partnership had such gains. The Tax Court issued an opinion supporting the taxpayer's claim of a 40% discount.

b. IRS Attempts to Disregard Limited Partnership based on Sections 2036 and 2038. Section 2036 of the IRC provides in relevant part that:

The value of the gross estate shall include the value of all property to the extent of any interest therein 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, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact

end before his death-- (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

The IRS has been successful at arguing that the assets of a limited partnership should be included in the taxable estate of the Testator or Donor in cases where it can be shown that the Decedent and the family had an understanding that the assets of the partnership could be used or were in fact used for the personal expenses of the Decedent or the expenses of the Decedent's estate. Section 2038 of the IRC provides that the value of a Decedent's gross estate includes property that:

To the extent of any interest therein 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 his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3 year period ending on the date of the decedent's death.

In a number of cases, the IRS has sought to include in the gross estate of a decedent the value of the assets which were transferred to a limited partnership, rather than the discounted value of the Decedent's limited partnership interests. Most taxpayers defend against Section 2038 attacks by arguing that the transfer was a bona fide sale for full and adequate consideration because there was a substantial business or other non-tax purpose tied to the transfer.

i. Successful Attempts to Bring Partnership Assets Back into Estate Pursuant to Sections 2036 and 2038. The IRS was successful in some attempts at bringing the assets of the partnership back into the taxable estate of the decedent pursuant to Section 2036. In three notable cases, the IRS successfully argued that, based on the activities of the partnership, the limited partners had an understanding with the Decedent that the Decedent would have access to the limited partnership assets if needed. In each of these three cases the Decedent died shortly after the partnership was created.<sup>82</sup>

(A) *Strangi v. Commissioner*. An important Texas case, *Strangi v. Commissioner*,<sup>83</sup> brought new strength to the IRS' argument that the limited partnership should be disregarded for valuation purposes if the donor/testator retained the beneficial enjoyment

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<sup>82</sup>See *Thompson v. Commissioner*, T.C. Memo 2002-246; *Estate of Harper v. Commissioner*, T.C. Memo 2002-121; and *Estate of Reichardt v. Commissioner*, 114 T.C. 144 (2000).

<sup>83</sup>*Strangi v. Comm'r*, 115 T.C. 478 (2000), aff'd in part, rev'd in part sub nom.



of partnership assets. In *Strangi*, the decedent's son-in-law, who served as the Decedent's attorney and attorney-in-fact, created a limited partnership and transferred most of the Decedent's assets into the limited partnership. The Decedent received a 99% limited partnership interest and a minority interest in the corporation which served as the general partner. While the Tax Court held that the partnership agreement did not amount to restrictions pursuant to Section 2703, the Tax Court ultimately, on remand from the Fifth Circuit Court of Appeals, found that the Decedent retained beneficial enjoyment over partnership assets, and as a consequence, the partnership assets should have been included in the Decedent's taxable estate. The Tax Court based its conclusion that the assets of the partnership should be included in the Decedent's taxable estate pursuant to Section 2036 on the fact that: 1) the Decedent was in poor health when the partnership was created; 2) many of the Decedent's personal expenses and some of the estate's expenses were paid out of the partnership; 3) the Decedent continued to live in his residence after it was transferred to the partnership without paying rent; and 4) the other family members did not participate in the preparation of the limited partnership documents.

(B) *Estate of Ida Abraham v. Commissioner*<sup>84</sup>. A case out of the 1<sup>st</sup> Circuit Court of Appeals bolstered the success of the IRS' 2036 arguments as a way to disregard limited partnerships. The IRS successfully argued that the Decedent retained the lifetime income and beneficial enjoyment of partnership assets. Ironically, it was the testimony from one of the Decedent's daughters that bolstered the IRS' claim that the limited partners and the Decedent had an understanding that the Decedent would have the use and enjoyment of the property for the rest of her life. The daughter testified that "if there wasn't money in her ("the decedent's") partnership fund, it had to come out of my partnership shares or my brother's, but the protection was there for her ("the decedent) as a guaranty that she ("the decedent") would live status quo." The Tax Court and First Circuit both concluded that assets of the partnership should be included in the taxable estate of the Decedent.

ii. Unsuccessful Attempts to Bring Partnership Assets Back into Estate Pursuant to Sections 2036 and 2038.

(A) *Church v. U.S.*, 85 AFTR 2d 2000-804 (2000). Notably, the IRS was unsuccessful at bringing the assets of a limited partnership back into the estate of the Decedent in *Church*. The U.S. District Court did not apply 2036 even though the Decedent died two days after the limited partnership agreement was formed and before the certificate of limited partnership had been filed with the Texas Secretary of State. Importantly, the facts indicated that the partnership was created for a genuine business purpose and, as a consequence, the transfer was deemed bona fide and for full and adequate consideration.

(B) *Kimbell v. U.S.*, 371 F.3rd 257 (5<sup>th</sup> Cir. 2004), vacd & rem'd, 244 F.Supp. 700 (N.D. Tex. 2003). In *Kimbell*, the Decedent formed a limited partnership and retained a 99% limited partnership interest. An LLC served as the general. The decedent held

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<sup>84</sup>*Estate of Ida Abraham v. Commissioner*, 95 AFTR 2d 2005-2591 (1st Cir. May 25, 2005), *aff'd* T.C. Memo 2004-39 (February 18, 2004)

a 50% interest in the LLC general partner and her son and daughter in law each owned a 25% interest in the LLC general partner. The assets transferred to the limited partnership included oil and gas interest which required active management. The circuit court reversed the district court's findings that: 1) family members cannot enter into bona fide transactions; and 2) a transfer of assets in return for a pro rata partnership interest is not a transfer for full and adequate consideration. In support of its findings, the circuit court looked to the facts surrounding the purpose of the partnership. The facts indicated that the partnership was formed for the following purposes of the limited partnership: 1) protect assets from creditors; 2) continue oil and gas operations beyond the decedent's lifetime; 3) reduce administrative costs by consolidating accounting functions; 4) avoid costs associated with transferring oil and gas properties from generation to generation; 5) preserve property as separate property for her descendants; 6) provide succession of management; and 7) create a mechanism for the resolution of disputes.

C. 10 Commandments When Planning using Family Limited Partnerships. Considering the potency and success of the IRS arguments relating to Section 2036 planning professionals should take particular care to avoid the common pitfalls associated with limited partnerships.

1. Never Mix Personal Business with Limited Partnership Business. If the client fails to respect the limited partnership formalities, the IRS and courts are almost certain to disregard the partnership pursuant to Section 2036 and 2038. In order to demonstrate a respect for the partnership formalities, the client should:

- a. never commingle personal assets with limited partnership assets;
- b. open and operate a separate bank account for the limited partnership;
- c. keep detailed records of limited partnership activities;
- d. not transfer personal use assets to the limited partnership; and
- e. not transfer too much wealth into the limited partnership, as the client should retain enough assets to insure that the client can be maintained using assets outside the limited partnership.

2. When Possible, Fund the Limited Partnership with Assets Which Require Active Management. One of the reasons why the court in *Kimbell* was persuaded that the transfer to the limited partnership was a bona fide sale and for full and adequate consideration was due to the fact the assets transferred to the limited partnership requested active management.

3. Require Limited Partners to Contribute to the Limited Partnership. Have the limited partners purchase their limited partnership units or the client may make a gift to the limited partners and have the limited partnership contribute such gifted assets to the partnership or use the gift to purchase units of limited partnership.

4. Allow Family Members to Participate in the Estate Plan. For example, consider allowing family members to:

a. serve as general partner or control the entity which serves as the general partner of the limited partnership;

b. allow limited partners to participate in the preparation of the limited partnership agreement;

c. create and fund the limited partnership, to the extent possible, long before the death of the client; and

d. transfers via sale or gift a significant amount of the limited partnership interests to the other limited partners.

5. Do Not Give the General Partner the Power to Make Discretionary Distributions. Giving the general partner the power to make discretionary distributions will increase the likelihood the IRS will find that the donor has retained power to use and enjoy the limited partnership interests the donor transferred.

6. Carefully Consider the Choice of General Partner. Consider forming an LLC in which the members are persons other than the client and the client is hired as the manager of the LLC.

7. Make Sure Gifts Qualify for Annual Exclusion. Planning with limited partnerships often involves making annual exclusion gifts of limited partnership interests. In order to qualify for the annual exclusion, the donee must have “an unrestricted and noncontingent right to the immediate use, possession, or enjoyment of the property or of income from property both of which alternatives in turn demand that such immediate use, possession, or enjoyment be of a nature that substantial economic benefit is derived therefrom. *Hackl v. Commissioner*, 118 T.C. 279 (2002). Most estate planning attorneys draft the partnership agreement with an eye toward maximizing discounts of limited partnership interests. Maximizing discounts involves placing restrictions on the use of limited partnership interests. When drafting restrictions, care must be taken to insure that the donor may make annual exclusion gifts of limited partnership interests. To address this difficulty, some attorneys include Crummy type powers in their limited partnership agreements to enable donees to withdraw from the FLP an amount of cash equal to the value of the limited partnership interest that was gifted to them.<sup>85</sup>

8. Have Successorship Provisions Built into the Limited Partnership Agreement. Under the Texas Revised Limited Partnership Act, limited partnerships dissolve on death or

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<sup>85</sup>See Nakos, Alex E., “Care and Feeding of the Family Limited Partnership,” Presented to the Advanced Drafting: Estate Planning and Probate 2002, State Bar of Texas, October 31, 2002, Austin, Texas.

withdrawal of a sole general partner.<sup>86</sup> Consequently, when drafting a limited partnership agreement, it is important to clearly state who will serve as successor general partner in the event a general partner dies or withdraws.

9. Employ an Appraiser Experienced at Evaluating Limited Partnership Interests. A good appraiser is worth his weight in gold, as was illustrated in the *Dailey* case. Never file a gift or estate tax return claiming discounts associated with limited partnership interests unless the return is accompanied by a comprehensive appraisal.

10. File Gift Tax Returns Timely for the Limited Partnership Units Gifted. Often times, it can be difficult to calculate or determine the timing and value of limited partnership interests. For example, in the *Dailey* case, Mrs. Dailey gifted a 1% interest in the limited partnership to her son when the partnership was formed. This is a common practice for unmarried persons creating a limited partnership because it takes two to form a partnership. At the time Mrs. Dailey's son received the 1% interest in the limited partnership, the partnership was not funded. The gifts occurred when assets were transferred to the limited partnership. It can be tedious to determine the timing and value of gifts when the partnership is funded over time with a variety of assets because each transfer represents a gift to the non-contributing limited partners. Filing gift tax returns timely will start the statute of limitations running and will bolster the argument that gifts of limited partnership units were completed gifts.

## V. Future of Family Limited Partnerships as an Estate Planning Tool

The future of limited partnerships as business planning and estate planning tools is particularly bright in Texas because of the fact that Texas is located within the jurisdiction of the Fifth Circuit Court of Appeal's jurisdiction and because of the provisions of the Texas Revised Limited Partnership Act. The only cases in which the IRS has been able to successfully attack the limited partnership are, in the words of Stanley M. Johanson, "wounded animals." Wounded animals are cases in which the taxpayer's facts are so weak that the blood thirsty IRS can't help but pounce and rip the case to shreds. As long as the taxpayer is careful to abide by the 10 Commandments, as outlined in Section IV.C of this outline, the limited partnership will remain an effective estate planning tool.

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<sup>86</sup>Texas Revised Limited Partnership Act, Section 2.3.