

# **THE FAMILY LIMITED PARTNERSHIP**

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# THE FAMILY LIMITED PARTNERSHIP

- A LIMITED PARTNERSHIP IN WHICH FAMILY MEMBERS ARE THE PARTNERS.
- REDUCES OR ELIMINATES ESTATE TAXES.
- ENSURES CONTINUOUS FAMILY OWNERSHIP FROM ONE GENERATION TO ANOTHER.
- SHELTERS FAMILY ASSETS FROM LAWSUITS, TRANSFER TAXATION AND CREDITORS.
- THE CHARGING ORDER: A creditor of a partner (not of the partnership) cannot usually reach partnership assets. In Texas, outside of bankruptcy, and assuming there has not been a fraudulent transfer, creditors of a partner (whether a general partner or a limited partner) have a limited remedy, which is a "charging order".
- CHARGING ORDER limits the judgement creditor to the right to the income portion of the partner's interest in the partnership and a right to inspect the records of the partnership. It does not give the creditor the right to force a liquidation of the assets of the partnership.
- THE GENERAL PARTNER DOES NOT HAVE TO MAKE ANY DISTRIBUTIONS TO THE LIMITED PARTNERS INCLUDING THE JUDGEMENT CREDITOR.
- THE INCOME TAX OF THE LIMITED PARTNERSHIP INTEREST WITH THE CHARGING ORDER MUST BE PAID BY THE JUDGEMENT CREDITOR!
- THE GENERAL PARTNER IS STILL ENTITLED TO A SALARY FROM THE PARTNERSHIP WHILE THE CREDITOR IS PAYING THE INCOME TAXES.
- FRAUDULENT TRANSFER STATUTES MUST BE CONSIDERED.
- ASSETS ARE ENTITLED TO DISCOUNTS FOR PURPOSES OF ESTATE TAX VALUATIONS SUCH AS:
- MINORITY INTEREST DISCOUNTS because limited partners can not control the partnership.
- MARKETABILITY INTEREST DISCOUNTS
- CANNOT TRANSFER ALL ASSETS TO A FAMILY LIMITED PARTNERSHIP.

# THE FAMILY LIMITED PARTNERSHIP

## A. BACKGROUND.

The Family Limited Partnership is a limited partnership in which family members are the partners. It ensures continuous family ownership from one generation to another and shelters family assets from waste, transfer taxation and creditors.

The transfer tax benefits can be staggering.

Usually the parents are the creators of the family limited partnership because they have the most wealth and that wealth needs to be protected.

The family limited partnership involves the preparation of a carefully and specially designed limited partnership agreement and related documents to form the limited partnership, which is filed with the secretary of state. It also involves the appraisal of assets and limited partnership interests.

a) CLIENT FEARS: One commentator has noted that our clients primary motivation for Estate Planning is their fear, which may be categorized as follows:

1. The fear of substantial transfer taxes;
2. The fear of loss of control;
3. The fear of probate costs;
4. The fear of exposure to creditors;
5. The fear of "too much - too soon" for their children.

The family limited partnership is an outstanding estate planning tool because it reduces or eliminates all of these fears.

## B. SOME ADVANTAGES OF THE FAMILY LIMITED PARTNERSHIP:

1. Estate and Gift tax benefits. Gifts of limited partnership interests qualify for the annual gift tax exclusion. The general partner can retain investment and distribution

authority over assets without including the assets which he has transferred in his estate (the limited partnership interest which he now owns will instead be included).

2. The fair market value of assets can be reduced for purposes of dealing with the IRS and third parties. The family can artificially depress values for transfer tax purposes and for creditor protection. The underlying asset value may still be there for the family.

3. Life Insurance estate tax inclusion may be reduced while the control of the policy and use of the policy may be retained. Proceeds of a life insurance policy which is owned by the limited partnership will not be included in the estate of the insured. Only the value of the insured partner's limited partnership interest will be included in the partner's estate.

4. Income tax shifting may be available to shift income taxes to other family members.

5. Assets that are contributed to a partnership are owned by the partnership, which will minimize probate costs. The partnership interest is probated, not the assets.

6. Family investments can be protected from transfers to outsider third parties.

7. The partners retain the ability to amend and revoke without the courts being involved and without adverse tax consequences. In comparison, an irrevocable trust can not be amended without court approval.

8. Because the general partner retains control over the assets, the problem of "too much - too soon" is solved.

9. Family members are educated about wealth matters.

10. Family members position is improved in a divorce proceeding. The separate property character of the gifted partnership interests to family members is easily retained.

#### **C. LIABILITY TO PARTNERSHIP CREDITORS.**

a) LIMITED PARTNERS: The most the limited partner is at risk in losing to partnership creditors is their investment in the partnership, including amounts agreed to be invested in the future. This is similar to the liability shield of a corporation.

b) GENERAL PARTNERS: General partners have joint and several liability for all liabilities of the partnership. Liability exposure of the general partner is the trade off for maintaining control. The general partner's exposure may be reduced by having the general partner be a corporation or a limited liability company.

#### **D. LIABILITY TO CREDITORS OF A PARTNER.**

a) THE CHARGING ORDER: A creditor of a partner (not of the partnership) cannot usually reach partnership assets. In Texas, outside of bankruptcy, and assuming there has not been a fraudulent transfer, creditors of a partner (whether a general partner or a limited partner) have only one remedy, which is a "charging order".

The charging order may be foreclosed on by the judgement creditor, which means that the judgement creditor will, after foreclosure, permanently own the right to distributions from the partnership and not just the right to an amount that will satisfy their judgement.

A "charging order" limits the judgement creditor to the right to the income portion of the partner's interest in the partnership and a right to inspect the records of the partnership. It does not give the creditor the right to force a liquidation of the assets of the partnership.

The judgement creditor obtains the charging order by applying to a court. A reasonable salary can be paid to a general partner even when his interest is subject to a charging order. The creditor does not become a partner but instead has a right to the income of the partnership.

b) INCOME TAX TO THE JUDGEMENT CREDITOR: There are income tax deterrents to a judgement creditor obtaining a charging order. Revenue ruling 77-137 requires that the creditor who has a charging order must pay income tax on the income of the partnership in proportion to the interest represented by the partnership even if no income is distributed. Thus, it is possible that the general partner could withhold income and the judgement creditor, after the long and arduous road to obtain the judgement, may receive nothing but a tax bill for their efforts.

## **E. BANKRUPTCY OF A PARTNER.**

a) BANKRUPTCY OF A GENERAL PARTNER: In bankruptcy, the bankruptcy trustee's options are decidedly greater than a judgement creditor's options. The bankruptcy of a general partner does not have entirely predictable results.

Usually the partnership agreement provides that a general partner ceases to be a general partner upon the filing of a bankruptcy petition and gives the remaining partners the option to pay cash for the bankrupt general partner's interest. However, the bankruptcy trustee can preempt state law and the partnership agreement when necessary to preserve the value of the bankrupt estate's asset. Thus it is possible that the bankruptcy trustee can take control of the limited partnership and actually manage the partnership.

As a practical matter, the bankruptcy trustee wants to convert the bankrupt general partner's interest into cash as soon as possible. These matters are most likely to be settled by the trustee rather than run the expense of litigation. The most prudent method for reducing

bankruptcy problems involving the general partner is to keep the percentage interest of the general partner as low as possible i.e. one percent or thereabouts.

b) BANKRUPTCY OF A LIMITED PARTNER: In a properly drafted limited partnership, the bankruptcy of a limited partner should not cause any serious problems. The bankruptcy trustee may be in no better position than the judgement creditor.

All of the creditor protection discussed above is subject to the fraudulent transfer statutes. No transfer can be made with the intention of avoiding claims of or defrauding existing creditors.

## **F. DISCOUNTING FOR ESTATE TAXES.**

a) BACKGROUND: Because of minority interest discounts and marketability discounts and the utilization of discounted cash flow methods in valuing the partnership, there may be substantial estate tax discounts as a result of placing assets in a family limited partnership, as much as 25% to 50% or greater. The use of appraisers to appraise the assets is usually also required.

The transfer of assets to the family limited partnership will greatly reduce their value. For example, take a family having cash and marketable securities worth one million dollars which are owned directly by the matriarch and the patriarch. If those assets are transferred to a family limited partnership, the same assets will be valued, for estate tax purposes, at some dollar amount like \$650,000. Additionally, if the matriarch and the patriarch serve as the general partners, they will be able to retain control of the asset.

Why is there such a reduction in value for estate tax purposes? Partly because the terms of the limited partnership agreement restrict the ability of partners to sell a limited partnership interest to outsiders, to force a liquidation of the partnership assets, and the distribution of cash is controlled by the general partner. In other words, the assets are not as desirable to third parties as they were when they were outside the partnership. The limited partnership has depressed the value of the underlying asset. Additionally, when appraisers value the limited partnership interest, they will do so using the distributable cash flow method rather than the liquidation value of the partnership.

b) DISTRIBUTABLE CASH FLOW METHOD: The distributable cash flow valuation method (also known as the discounted cash flow method) is based upon the expected return to a hypothetical buyer based upon the cash flow to be received from the family limited partnership interest. This usually will be a lower value because it is likely that a substantial portion of the cash flow will be reinvested and not distributed, usually there are no assurances regarding minimum distributions to a partner and the present value of the liquidating distributions at the end of the partnership is small.

c) OTHER DISCOUNTS: In addition to obtaining a favorable valuation method, other discounts will lower the value of family limited partnership interests.

d) MINORITY DISCOUNT: Holders of minority interests in a family limited partnership cannot force distributions or liquidation. They have a lack of control over management and voting. In revenue ruling 93-12, the Internal Revenue Service approved minority discounts for family owned entities, unless chapter 14 applies.

e) MARKETABILITY DISCOUNT: This discount exists because few buyers are willing to pay full value for a non controlling interest in a business with restrictions and limitations. This discount reflects the lack of a readily available market as compared to a publicly traded entity and also the lack of transferability. This discount, unlike the minority discount, applies regardless of the size of the interest.

#### **G. DISADVANTAGES OF A FAMILY LIMITED PARTNERSHIP.**

The most significant disadvantages for the family in forming a family limited partnership include:

a) The cost, which would include the legal fees, accounting fees, and appraisal fees if there are transfers of partnership interests.

b) If distributions are made from the partnership, they must be made to all partners pro rata.

c) The discounts are real so if a partner wanted to sell their partnership interest before the partnership dissolves or liquidates, the discounts would apply to the sale. However, the partnership agreement is usually going to restrict the sale of a partnership interest anyway.

#### **H. INAPPROPRIATE ASSETS FOR CONTRIBUTION TO A FAMILY LIMITED PARTNERSHIP.**

a) Homestead - The homestead exemption would be lost.

b) Qualified Retirement Benefits, IRA's - Such transfers would be prohibited transactions under ERISA. They also already appear to be protected assets under Texas law.

c) S corporation stock - The partnership is not a qualified shareholder.

d) Tangible personal property not held for investment

e) Heavily encumbered assets

f) Operating companies - There is too much exposure to liabilities. Other entities, such as corporations or limited liability companies are better choices.

**I. ASSETS WHICH SHOULD BE CONSIDERED FOR A FAMILY LIMITED PARTNERSHIP.**

a) Non-homestead real estate

b) Oil and Gas Properties

c) Closely Held Stock (if a C Corporation)

d) Marketable Securities

e) Cash and Cash Equivalents

f) Life Insurance Policies

g) Plant and Equipment leased to an operating entity - This gives added protection from creditors of the operating entity and the franchise tax base of the operating entity is reduced.

When assets are transferred to a family limited partnership they have reversed the tale of the ugly duckling. They have turned beautiful assets into ugly assets that creditors and potential third parties no longer desire. However, these assets are still beautiful and now more valuable to family members.

Sources: A Family Limited Partnership as the Centerpiece of an Estate Plan, by Larry W. Gibbs, Trusts and Estates (September and October 1992); Practical Considerations in Family Limited Partnerships, by James M. Mincey, Jr. and Michael D. Allen, 17th Annual Advanced Estate Planning and Probate Course (June 1993); Family Limited Partnerships, by Richard L. Chaney and Linda S. Fogarty (1993); The Transfer Tax Reasons Why Many Families are Creating Family Limited Partnerships, by S. Stacy Eastland (1993); The Non-Transfer Tax Reasons Why Many Families are Creating Family Limited Partnerships, by S. Stacy Eastland (1993).