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Dysfunctional Family Limited Partnerships

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DYSFUNCTIONAL FAMILY LIMITED PARTNERSHIPS[1]

I. SUMMARY OF PURPOSES FOR ESTABLISHING FLP.

Legitimate business purposes or significant non-tax reason must be identified for the creation of a family limited partnership (or "FLP") if it is to withstand scrutiny from the IRS. As stated in *Kimbell v. United States*, 371 F.2d 257, 263 (5th Cir. 2004), if the transaction is motivated solely by potential tax advantage and without a business purpose, the transaction is ignored for tax purposes. Partnership. Accordingly, at the beginning of each engagement, the prudent advisor will discuss most or all of the benefits described below to the client and identify specific ones which will support a business purpose for the creation of the client's FLP.

A. Non-Tax Benefits to the Creation of an FLP.

1. **Probate Avoidance.** An FLP can serve as a superior "probate avoidance" planning vehicle. Similar to the revocable living trust, the process of creating an FLP entails the retitling of assets into the name of the FLP. Keeping in perspective that the principal purpose of estate probate administration is to retitle assets held in the decedent's name at his or her date of death into the name of the intended beneficiaries, to the extent that legal title is not registered in the name of the decedent, then formal estate probate administration with regard to such assets is avoided. Instead, the partnership interests received by a decedent for his contribution of assets to an FLP represent probate assets. However, the retitling procedure for a partnership interest usually involves a simple assignment and possible amendment to the partnership agreement in order to retitle the partnership interests into the name of the beneficiaries.

2. **Consolidated Asset Administration.** Transferring property to an FLP creates an investment entity which is capable of integrating the investment strategies of the family members on a consolidated basis. For example, if gifts of assets were previously being made directly to children or grandchildren or into trusts for their benefits, these assets were separately invested by the child or trustee. With an FLP, the assets already gifted may be contributed to the partnership to be invested by the general partners.

3. **Asset Protection.** The FLP helps to insulate the assets of the FLP from future judgment creditors of the partners (e.g. negligence suits or judgment creditors). Generally, a judgment creditor of an individual partner will not be able to seize the assets held by the partnership. The TBOC provides that a creditor of a partner in a limited partnership is relegated to a charging order, which generally provides only limited rights to partnership distribution, if, as and when made by the general partners.

4. **Facilitation of Gifting Program.** Many people, even after being fully informed of the advantages as to an annual gifting program, are reluctant to implement a gifting program because of the complexities involved with the transfer of property, loss of

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[1] The authors desire to thank Matthew S. Beard for his assistance in compiling this outline.

control, uncertainty as to the business acumen of the donee, etc. Once an FLP has been implemented for a family, the process of implementing an annual gifting program becomes much more palatable.

a. Retention of Control. The donor of the limited partner interests generally retains control over the investment decisions of the partnership pursuant to his position as a general partner.

b. Gifting Process Simplified. The gift of limited partner interest is made pursuant to a simple assignment of limited partner interest to the donee. This assignment often takes the place of a more difficult gifting process, especially if the assets consist of real property.

c. Business Acumen of Donee. There is little or no risk regarding the competency or business judgment of the donee because there are no investment decisions to be made regarding the receipt of a limited partner interest. Including the children in an FLP has the additional benefit of increasing communication between parents and children, and provides a mechanism whereby parents can educate children regarding investments and business matters.

d. Retention of Interests in Family Members. The gift of a limited partner interest to a child will remain that child's separate property. There is little chance of the limited partner interest becoming co-mingled with the community or separate property of the spouse of a child. Therefore a gifted limited partner interest should not be subject to division upon divorce. An example of discord or dysfunction actually providing a family benefit can be found in the case of *Keller v. United States*, 104 AFTR 2d 2009-6015 (S.D. Tex. 2009), aff'd, 697 F.3d 238 (5th Cir. 2012). In *Keller*, the District Court found that the primary purpose underlying the Partnership's formation was to protect family assets from depletion by ex-spouses through divorce proceedings. This was accomplished by creating an entity that, by altering the legal relationship between [the decedent] and her heirs, could facilitate the administration of significant family assets. In other words, the creation and funding of the Partnership was undertaken for a legitimate business purpose and not the mere "recycling" of wealth.

B. Tax Benefits to the Creation of an FLP.

1. Shifting of Income Among Family Members. Although usually not a primary purpose of an FLP, to some extent following gifts of limited partner interests to children, a portion of the income which would be taxable to the parent is shifted to the child at presumably a lower tax rate. There are, of course, detailed rules regarding the income tax consequences of an FLP. See Section 704 of the Internal Revenue Code.

2. Federal Gift Tax Benefits. The gift of a limited partner interest in a FLP is subject to valuation discounts for federal gift tax purposes. If drafted correctly, both a lack of marketability and minority interest discount is available upon gifts of limited partner interests. Accordingly, if a parent were making annual gift tax exclusion gifts to

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